Guidelines on the implementation of the revised large exposures regime

11 December 2009
Executive summary

1. A revised large exposures regime has been included in the amended Capital Requirements Directive. The amendments will have to be transposed into Member States’ national law by 31 October 2010 and will be applied from 31 December 2010.

2. To ensure harmonised implementation of the revised large exposures regime across the Member States, CEBS developed the present guidelines, which cover two specific aspects, where CEBS sees a need for further guidance. The focus of the first part of the guidelines is the definition of ‘connected clients’, in particular, ‘control’ and ‘economic interconnections’; the second part deals with the treatment of schemes with exposures to underlying assets for large exposure purposes. CEBS has also developed guidance on the reporting requirements for large exposures, which is published in a separate document as it would be included in the COREP framework as to ensure a unified European reporting system.

3. For the large exposures regime to act effectively both as a backstop regime and to mitigate the impact on an institution of the failure of a counterparty, large exposures need to be clearly identified by institutions. This includes the identification of connections between clients. Consequently, the guidelines seek to provide clarity on the concept of interconnection, in particular when control issues or economic dependence should lead to the grouping of clients.

4. CEBS provides a non-exhaustive list of indicators of control that will guide institutions in the identification of control relationships. Even if the issue of control of one client over another does not apply, an institution is obliged to determine whether there exists a relationship of economic dependence between clients. If it is likely that the financial problems of one client would cause 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 a non-exhaustive list of examples that illustrate possible dependencies between clients which should cause institutions to carry out further investigations regarding the need to group the clients.

5. CEBS also gives consideration to the possible connection of clients through a common main source of funding and provides guidance on cases where the clients should (or should not) be considered as connected because of funding relationships.

6. The identification of connected clients should be an integral part of an institution’s credit granting and surveillance process and every institution should have in place a robust process to conduct this identification. While institutions should strive to apply this process to all of their exposures, CEBS recognizes that this can be difficult in practice and proposes a proportionate approach: as a minimum, an intensive process should be applied to all exposures that exceed 2% of an institution’s own funds at a solo or consolidated level.
7. Exposures can arise not only through direct investments by institutions, but also through investments in schemes\(^1\) which themselves invest in underlying assets. Ideally – and in addition to the scheme - the underlying assets of a scheme should be taken into account when calculating exposures for large exposures’ purposes.

8. Therefore, CEBS considers that the look-through approach is the most risk sensitive approach from a large exposures’ perspective. However, CEBS recognises that it is not always possible or feasible to look-through and proposes as alternatives more conservative approaches to deal with such cases. CEBS believes that these approaches provide, on the one hand, the right incentive to use the look-through approach, but, on the other hand, provide sufficient flexibility for institutions. Consequently, the decision as to the most appropriate approach for a specific scheme is left to the institution.

9. The alternative approaches provide flexibility by taking into account either fractional knowledge about the scheme or its underlying assets (partial-look-through, structure-based approach) or the granularity. However, the greater uncertainty inherent in unknown underlying exposures (or entire schemes) must also be reflected. Therefore, it is required to consider all unknown underlying exposures of a scheme and entire unknown schemes as belonging to one separate group of connected clients.

10. CEBS has also considered the application of the proposed approaches to tranched products and has developed a number of examples, which are set out in Part 2, Section C of this paper, to illustrate how the different approaches would work.

\(^1\) Such as collective investment undertakings (CIUs) and structured finance/structured finance vehicles (e.g. securitisations)
# Table of contents

**Executive summary**.....................................................................................................................2

**Introduction** ....................................................................................................................................5

**Part I. Connected clients**...............................................................................................................8

A. **Definition of a group of connected clients in Article 4(45) of Directive 2006/48/EC**.................................................................8

B. **Interpretation of control**.........................................................................................................9

C. **Exemption from the requirement to group clients in relation to “control”**. 11

D. **Interpretation of economic interconnection (single risk)**.........................................................12

E. **Relation between interconnections through control and interconnections through economic interconnection**.................................................................16

F. **Control and management procedures in order to identify connected clients** 17

**Part II. Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC**.........................................................19

A. **Principles underlying the draft guidelines**..................................................................................20

B. **Treatment of schemes with underlying assets**.........................................................................20

C. **Treatment of tranched products**.............................................................................................24
Introduction

11. A revised large exposures regime is included in the amended Capital
Requirements Directive\(^2\) (referred to hereafter as the ‘CRD’). The
amendments will have to be transposed into Member States’ national law by
31 October 2010 and will be applied from 31 December 2010.

12. The revised provisions on large exposures build on CEBS’s advice to the
European Commission\(^3\). To ensure harmonised implementation of the
revised large exposures regime across the Member States, CEBS developed
the present guidelines, which focus on two aspects where CEBS sees a need
for further guidance:

i) the definition of ‘connected clients’, in particular ‘control’ and
‘economic interconnection’, and

ii) the treatment of schemes with exposures to underlying assets for
large exposure purposes.

CEBS also developed guidance on the reporting requirements for large
exposures, which is published in a separate document as it will be included
in the COREP framework to ensure a unified European reporting system.

Impact assessment

13. The guidelines set out in this paper build on CEBS’s work on large exposures
and CEBS’s advice to the European Commission. Nevertheless, CEBS has
conducted a high-level Impact Assessment (IA) on connected clients and
treatment of schemes with underlying assets\(^4\). CEBS sought advice from an

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\(^2\) Capital Requirements Directive (CRD) is a technical expression which comprises Directive
2006/48/EC” and “Directive 2006/49/EC” or “CRD” refer to the amended versions of the
Council of 16 September 2009 is published under: http://eur-

\(^3\) CEBS has issued two technical advices on large exposures. The first advice, delivered during the
course of 2006, included a stock-take of current supervisory practices and a report on current
industry practices. CEBS’s second advice focused on substantive aspects of the large exposures
framework and was called for in two parts. Part 1 of the advice was delivered in November and
dealt with the objectives of a large exposures regime - the purpose, the need for and appropriate
levels of large exposures limits; whether the large exposures regime can be considered to be
achieving its objectives; examination of the ‘metrics’ for the calculation of exposure values; and
consideration of the extent to which the credit quality of a counterparty can or should be
recognised. Part 2 of the advice was delivered in April 2008 and addressed the questions of credit
risk mitigation and indirect exposures; treatment of inter-bank exposures; treatment of intra-
group exposures and other group-related issues; trading book aspects; scope of application of the
regime including the question whether a ‘one size fits all’ approach is desirable or not; consistency
of definitions, in particular the definition of connected clients; treatment of breaches of limits; and
reporting requirements.

\(^4\) An IA was not conducted for the guidelines on reporting requirements since the proposed
reporting template and guidance will be included in the COREP framework for which an overall IA
will be conducted.
IA adviser and followed, as far as time constraints allowed, the output methodology set in the 3L3 IA guidelines.\(^5\)

14. On connected clients, CEBS assessed the cost and benefits of issuing detailed guidelines in respect of the current situation. CEBS has concluded that there is a clear cost/benefit analysis case for choosing to issue detailed guidelines, as set out in this paper. While it is likely that there will be some additional costs for institutions as a consequence of the requirement to meet the guidelines, the benefits appear to outweigh the costs. Clear rules for the identification of connected clients (cluster risk) will improve risk management of these risks, foster a level playing-field and provide a positive contribution to financial stability.

15. On the treatment of schemes with underlying assets, CEBS has considered the costs and benefits of a requirement to apply the ‘full look-through’ approach or a combination of approaches compared with the current situation. To require the application of the ‘full look-through’ approach would address market failures, but appears to impose large costs on institutions and would not fully consider the benefits of granularity or tranched exposures. Therefore, CEBS has concluded that a combination of approaches appears to address major failures in this area while keeping costs to a minimum.

**Consultation with market participants**

16. Members and Observers from the Consultative Panel were invited to nominate industry experts to provide technical input to CEBS’s work\(^6\). These industry experts were invited to comment on previous drafts of the guidelines and have provided CEBS with their technical input on a number of important aspects.

17. On 12 June 2009, CEBS published a consultation paper (CP26)\(^7\) on its preliminary proposals. The consultation closed on 11 September 2009 and seventeen responses were received.\(^8\) In addition, CEBS organised a public hearing on 7 September 2009.\(^9\) CEBS has considered the feedback received and has reviewed the proposals put forward for consultation in order to address the main issues raised by market participants.\(^10\) The guidelines set out in this paper are the result of that review.

\(^5\) The impact assessment guidelines were published on 30 April 2008: [http://www.c-ebs.org/getdoc/9681fba5-2521-4b10-8e80-ac98f9a4e26c/3L3-Committees-reinforce-their-commitment-to-the-p.aspx](http://www.c-ebs.org/getdoc/9681fba5-2521-4b10-8e80-ac98f9a4e26c/3L3-Committees-reinforce-their-commitment-to-the-p.aspx)

\(^6\) The list of industry experts is published on CEBS’s website: [http://www.c-ebs.org/getdoc/b4e8fb8b-6b94-47cd-a311-8006be40c753/Large-Exposures.aspx](http://www.c-ebs.org/getdoc/b4e8fb8b-6b94-47cd-a311-8006be40c753/Large-Exposures.aspx)

\(^7\) The CP26 is published under: [http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP21-CP30/CP26.aspx](http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP21-CP30/CP26.aspx)

\(^8\) Sixteen responses are public and are published on the CEBS website under: [http://www.c-ebs.org/getdoc/9f78301c-2da1-4c62-b7d1-f17174a1ae0c/Responses-to-CP26.aspx](http://www.c-ebs.org/getdoc/9f78301c-2da1-4c62-b7d1-f17174a1ae0c/Responses-to-CP26.aspx)

\(^9\) The summary of the public hearing is published under: [http://www.c-ebs.org/getdoc/19377c30-c90d-4189-8e7a-2f538499ca76/CEBS-organises-a-public-hearing-on-its-draft-guideline.aspx](http://www.c-ebs.org/getdoc/19377c30-c90d-4189-8e7a-2f538499ca76/CEBS-organises-a-public-hearing-on-its-draft-guideline.aspx)

Implementation of the guidelines

18. CEBS expects its members to apply the present guidelines by 31 December 2010, at the same time as the revised large exposures regime will come into force. In respect to the treatment of schemes with underlying assets set out in Part II of these guidelines, CEBS proposes that until 31 December 2015, institutions may treat schemes acquired before the 31 January 2010 according to the treatment of schemes that was required prior to the implementation of the guidelines. CEBS acknowledges that the implementation of some specific aspects of the guidelines will have costs for the supervised institutions as they will give rise to changes in the current procedures. Therefore, CEBS recommends that - whenever necessary - national supervisors provide the supervised institutions with sufficient flexibility regarding the implementation of specific aspects of the guidelines.

19. To ensure the harmonisation of practices across Member States, CEBS is considering conducting an implementation study one year after the recommended implementation date.
Part I. Connected clients

20. The large exposures regime is a backstop regime designed to limit the impact on an institution of a counterparty failing. Idiosyncratic risk represents the effects of risks that are particular to individual borrowers. The objective of the definition on connected clients in the CRD is to identify clients so closely linked by idiosyncratic risk factors that it is prudent to treat them as a single risk. Consequently, there is a need for regulators to be clear on the concept of interconnection, in particular when control issues or economic dependence should lead to the grouping of clients.

A. Definition of a group of connected clients in Article 4(45) of Directive 2006/48/EC

21. “Group of connected clients” means:
   
   (a) two or more natural or legal 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 natural or legal persons between whom there is no relationship of control as set out in point (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”

22. The concept of connected clients is applied in two different contexts in Directive 2006/48/EC. Apart from large exposures, it is also applied when categorizing clients in the retail market portfolio (see Article 79 of Directive 2006/48/EC). However, in these guidelines CEBS is focusing on the application of Article 4(45) in relation to the large exposures regulation only.

23. The definition of connected clients as per Article 4(45) of Directive 2006/48/EC refers to interconnections arising from one of the following:

   - one client has control over the other;
   - the clients are interconnected by some form of material economic dependency, as for instance:
     - direct economic dependencies such as supply chain links or dependence on large customers, or
     - the clients have a main common source of funding in the form of credit support, potential funding or direct, indirect or reciprocal financial assistance.

24. In cases of divergence between the opinion of the institution and that of the competent authority, it is the competent authority which decides whether a client must be regarded as part of a group of connected clients.

25. The definition of control in Article 4(9) of Directive 2006/48/EC is specifically aimed at describing the conditions for requiring a consolidated annual
report. While the concept of connected clients within the large exposures regime includes control, as defined in Article 4(9), it also covers interconnections arising through other means such as economic dependence. These draft guidelines seek to provide clarity on interconnection, however it arises.

B. Interpretation of control

26. The institution must first rely on the CRD definition of control (Article 4(9) of Directive 2006/48/EC), which is taken from the accounting definition (Article 1 of Directive 83/349/EEC on consolidated accounts). Control means the relationship between a parent undertaking and a subsidiary or a similar relationship between any natural/legal person and an undertaking.

27. This means that control is presumed to exist when the client owns directly, or indirectly through subsidiaries, more than half of the capital or voting power of an entity, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

28. A client owning 50% of the shares/voting power of another client may be able to exercise one or more of the powers mentioned below. This is even the case when there are two equal partners/owners who share the power and govern the entity jointly (see example in paragraph 32).

29. However, control may also exist when the client owns less than half of the voting power of an entity or does not hold any participating interest in the entity at all.

30. In those cases, the institution should refer to indicators of control that are seen in cases where the client is able to exercise one or more of these powers:

- power to direct the activities of the other entity so as to obtain benefits from its activities;
- power to decide on crucial transactions such as the transfer of profit or loss;
- power to appoint or remove the majority of directors, the supervisory board, the members of the board of directors or equivalent governing body where control of the entity is exercised by that board or body;
- power to cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body where control of the entity is exercised by that board or body; and/or
- power to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, for instance, in the case where the same natural persons are involved in the management or board of two or more undertakings.

31. In cases where the institution needs to make a discretionary judgement, these indicators, along with other relevant indicators used for accounting purposes, could be used in order to identify a control relationship.

11 In this context, a client which is a natural or legal person (undertaking).
32. There will be some situations where there could be a requirement to include an entity in more than one group of connected clients, for example, in the case of an entity in which two persons/companies hold 50:50 participations if they exercise equal control on the entity, but are not otherwise interconnected in the sense of Article 4(45) of Directive 2006/48/EC (see Figure below). The same applies to a case where a client has entered into a "shareholders’ agreement" with other shareholders so as to obtain the majority of the voting power of an entity and this implies that all of the shareholders involved have control over the entity. A natural or legal person that is a partner in one or more (limited) partnerships also exercises control over these (limited) partnerships and (limited) partnerships are, therefore, to be included in the group of connected clients of every one of their partners.

33. The entire exposure to a connected client must be included in the calculation of the exposure to a group of connected clients; it is not limited to, nor proportional to, the formal percentage of ownership.

34. It follows from the definition of connected clients that horizontal groups according to Article 12 of the Directive 83/349/EEC on consolidated accounts, which draw up consolidated accounts and a consolidated annual report, are to be grouped as connected clients. This is the case if an undertaking is related to one or more other undertakings because they all have the same parent or are managed on a unified basis. This management may be pursuant to a contract concluded between the undertakings, or provisions in the Memoranda or Articles of Association of those undertakings, or if the administrative management or supervisory bodies of the undertaking and of one or more other undertakings consist for the major part of the same persons.

35. It follows from the control criterion that exposures to entities within the same group as the reporting institution are to be regarded as a single risk. All entities within the same group are connected clients, although exposures to some or all of them may be exempted from the large exposures regime depending on how the Member State has implemented Article 113(4) (c).

36. It should be understood that the control situation is not just for a transitional period but that it should be a reasonably stable state. In Article 4(45) of Directive 2006/48/EC the wording "unless it is shown otherwise" is used. It should be interpreted in the sense that if the institution is able to demonstrate that what seems to be a control relationship truly is not, then, there is no requirement to group the clients. Most notably, this would be the
case for owners of shares without voting rights. However, in cases where control exists, it is not relevant that the client, for the time being, does not actually exercise its potential control. Accordingly, voluntarily self-imposed limitations on the exercise of control such as legal ring-fencing or statements of a similar nature issued by the client do not obviate the need to consider such clients as connected.

C. Exemption from the requirement to group clients in relation to “control”

37. For entities where the majority of the shares are directly owned by the central government (in the example below entities A and D), and where exposures to the central government\(^\text{12}\) receive a 0% risk weight under Directive 2006/48/EC, there is no requirement to group these entities as a group of connected clients. This also applies to entities controlled by regional or local authorities treated as a central government which receives a 0% risk weight under Directive 2006/48/EC. In such cases, even though the owner has control over each entity, the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities. In addition, the failure of one entity, which is a separate legal person, does not necessarily impose a duty on the owner to invest more capital. If the owner still decides to do so, it is assumed that this ultimately could be financed by raising revenues. This exemption, however, does not apply to further sub-structures of these entities (in the example below entities B, C, E and F). In such cases, these entities and their subsidiaries are to be included in a group of connected clients. This also applies to other cases of interconnections.

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\(^{12}\) It was implicitly understood in the original advice from CEBS of April 2008 that this exemption is limited to those governments whose exposures receive 0% risk weight (and their regional and local authorities) under the Standardised Approach to credit risk, as such default is outside the scope of the risks that the large exposures regime is designed to address.
D. Interpretation of economic interconnection (single risk)

Scope of large exposures regime in relation to concentration risk

38. Geographic and sectoral concentration risks fall outside the scope of the large exposures regime and are addressed by other means such as concentration risk under Pillar 2 of the CRD. Institutions that operate in a well defined geographic area only, or in an area dominated by one specific industry (sector), are not more affected in their conduct of business by the connected clients’ rule than other institutions. Sectoral concentration is a common risk affecting all entities in the same industry; geographic risk is a risk affecting all entities in the same region, whereas economic interconnection is an idiosyncratic risk that arises in addition to sectoral and geographic risk.

39. Sectoral and geographical risks can be described as a dependency linked to an external factor (such as, for example, a certain product market or a specific region) which affects all entities active in the sector or region in the same manner. Idiosyncratic risk is where, in a bilateral interrelationship, financial problems of one entity are transferred via this interrelationship to another entity which otherwise would not be concerned.

Interpretation of economic interconnection

40. Even if the issue of control of one client over another does not apply, an institution is obliged to determine whether there exists a relationship of economic dependence between clients. If it is likely that the financial problems of one client would cause difficulties for the other(s) in terms of full and timely repayment of liabilities, there exists a single risk that needs to be addressed. An economic dependence between clients may be mutual or only one way.

41. Dependence might arise in the context of business interconnections (such as supply chain links, dependence on large customers or counterparty exposures, financial dependency) which are not linked to respective sectoral or geographic risks, and suggests that the clients involved are exposed to the same idiosyncratic risk factor. If this idiosyncratic risk materializes, the solvency of one or both obligors can be threatened. Consequently, interdependencies between enterprises (or persons) due to bilateral business relationships may lead to default contagion which is independent from sectoral or geographic risk. The fact that the existence of common idiosyncratic risk factors may lead to default contagion for otherwise independent clients, is the core of the concept of economic interconnection.\(^\text{13}\)

42. The rationale for the definition of economic interconnection in Article 4(45) (b) is to identify economic dependencies that a client cannot overcome without experiencing repayment difficulties. However, even if a client is depending on another client through, for instance, a business relationship, it could still be possible for the client to find a replacement for this business partner (in case of his default), or to compensate for such a loss by other means, for example, through reduction of costs, concentration on other sectors etc. This may cause practical problems, such as lower margins or

\(^{13}\) This definition of a common idiosyncratic risk factor was developed for the purpose of analyzing aspects of the IRB model, but it is applicable also for large exposures purposes.
other inconveniences, but as long as the institution comes to the conclusion that the client will be able to experience such a situation without facing substantial, existence-threatening repayment difficulties, there is no requirement to consider such clients to be interconnected. On the other hand, if it is likely that a client would not be able, for example, to experience the loss of an important customer, i.e. the institution comes to the conclusion that the failure of such a customer would lead to substantial, existence-threatening repayment difficulties for the client, then these clients shall be considered to be interconnected.

43. The following examples are illustrative of possible economic dependence between clients, where institutions should carry out further investigations regarding the need to group these clients:

- when one counterparty has guaranteed fully or partly the exposure of the other counterparty, or is liable by other means and the exposure is so significant for the issuer that the issuer is likely to default if a claim occurs. If the exposure is not significant, meaning that the potential liability, if it materializes, would not threaten the issuer’s solvency, then such relationships are covered through the Credit Risk Mitigation rules or counterparty substitution;
- the owner of a residential/commercial property and the tenant who pays the majority of the rent;
- significant part of production/output is for one single customer;
- significant part of receivables or liabilities of the client is to one counterparty;
- a producer and vendor that this producer is depending on and which it would take time to replace;
- undertakings that have an identical customer base, consisting of a very small number of customers and where the potential for finding new customers is limited;
- if the institution becomes aware that clients have been considered as interconnected by another institution; and
- for the retail market:
  - the debtor and his/her co-borrower;
  - the debtor and his/her spouse/partner if by contractual arrangements or marriage laws both are liable and the loan is significant for both; or
  - the debtor and a collateral provider or guarantor, provided that the collateral or guarantee is so substantial for the issuer to the extent that his/her/its ability to service the liabilities will be affected if the guarantee or collateral is claimed by the institution.

44. It is not possible to give a comprehensive list of possible cases of economic interconnection. Each case will have its own characteristics, and the identification of interconnected clients requires thorough knowledge of the customer/client and not least a consciousness of connected risks among the institution’s staff.
Interpretation of economic interconnection through a main source of funding

45. In relation to interconnection and funding in general, it is evident that Article 4(45) of Directive 2006/48/EC requires institutions to identify clients that are connected because of funding relationships. This means that funding problems of one entity are likely to spread to another due to dependence on the same funding source. “Dependency” in this context means that the source of funding is not easily replaceable and that the clients in this case are not able to overcome their funding dependence on this entity even by taking on practical inconvenience or higher costs. The intention is not to include cases where the respective counterparties draw on the same market (e.g. the market for commercial paper), but when the funding of the clients is based on the same source. Furthermore, it should be noted, that it is a basic principle of the large exposures regime, that in the determination of interconnections, the quality of management or the credit quality of the entities concerned is not taken into account.

46. In the example below, the ability of CL1 to CL5 to refinance their business depends on the solvency/reputation of the initiating and guaranteeing institution A and on the quality of the underlying assets of each individual entity (CL1 to CL5). As institution A is directly/indirectly responsible for the whole structure (green colour) and also the lender of last resort, A shall consider CL1 to CL5 as one connected client.

47. From the perspective of the investing institution B, in general, the same shall apply. However, if institution B is able to demonstrate that CL1 to CL5 do not represent a single risk, institution B may treat them as separate counterparties. A single risk shall be assumed if there is risk of contagion or synchronic risk between the respective entities CL1 to CL5. Synchronic risk can emerge from, for example:

i) use of one funding entity;
ii) same investment advisor (e.g. investment committee);
iii) similar structures;
iv) reliance on commitments from one source (such as guarantees, credit support in structured transactions or non-committed liquidity facilities) and its solvency, and;
v) similar underlying assets.

48. In the example below CL1, CL2 and CL3 on the one hand and CL4 and CL5 on the other hand have similar risks, i.e. there is either a risk of contagion or synchronic risk. The general assumption in this example is that all five are interconnected because they depend on institution A and have a common source of funding. However, if institution B which invests in conduits CL3 to CL5 can demonstrate that the risk of contagion/synchronic risk is limited to conduits CL4 and CL5, i.e. CL3 and CL4 and CL5 do not constitute a single risk and that the common source of funding for all the conduits can be easily replaced, it may only consider CL4 and CL5 as interconnected and treat CL3 as another single client.
49. An illustrative case in relation to connected clients due to a common source of funding is the following: where a bank has committed itself to be the existing or potential funder or provider of credit support to more than one conduit or SPV under similar conditions and where it is possible that all of these commitments may materialize into exposures at the same time because they are dependant on the same funding entity. As an example, an entity provided liquidity for a number of different conduits, and relied on issuing commercial paper (CP) in order to finance the conduits. The conduits had no other source of funding and invested in long-term assets. As the asset quality of the conduits came into question, the loss of trust in the market was immediate and significant, and the funding entity was unable to issue new commercial paper. Consequently, it could not provide the necessary funds to refinance all the conduits. Therefore, the bank, as the main guarantor for the conduits, had to fund the whole structure. Although the different conduits were not invested in the same assets and were legally independent as they were owned by separate trusts, it is obvious that the different conduits constituted a group of connected clients as they formed a single risk. This risk was not a sectoral risk, as it was the specialization in product and niche in the money market or, more specifically, the market for commercial paper, which caused the dependence. The moment there was no market for new commercial paper of the funding entity, the limited scope, competence and solidity of these SPVs became evident.

50. While the above example refers specifically to conduits and the problems experienced in the commercial paper market, it should be noted that the requirement to connect clients due to a common source of funding is not dependent on either the type of entity being funded nor the form of funding used, but rather it is dependent on entities receiving all or the majority of their funding from a common source which cannot easily be replaced. As in general, for the concept of interconnection, it requires a case by case assessment.
51. However, it should be noted that a common source of funding due solely to geographic location does not, in itself, lead to a requirement to connect clients. Small and medium sized entities will, in many cases, not have the capacity or commercial incentive to use other than their local bank, and in addition, for most of them the personal relationship with their banker is the key to better financial services. This fact does not in itself justify these clients be regarded as interconnected, even though they have a common source of funding. Such a situation differs from funding dependencies described in this chapter because the motivation for sharing a common source of funding is the geographic location and because such a common source of funding can normally be replaced.

52. Clients that are depending on their existing source of funding simply because they are not creditworthy do not belong in this category. In the same way, being clients of the same institution does not in itself create a requirement to group the clients. It is not required that an institution should collect information about whether it's clients share an external common source of funding, however, institutions shall take into account accessible information in this regard.

E. Relation between interconnections through control and interconnections through economic interconnection

53. Interconnections arising through control and interconnections arising through economic interconnection are two different concepts and a mandatory requirement to interlink them could lead to far reaching grouping requirements. Therefore, CEBS abstains from a general requirement to link these two concepts together which the following example (see Figure below) shall illustrate: The reporting institution has identified two groups of connected clients (GCC) based on the control criterion. In addition, there is evidence that clients D and F are economically interdependent as set out in Section D (e.g. 1-way dependency of F towards D). If the financial problems of client F are not likely to result in difficulties in terms of full and timely repayment of liabilities for other members of the group of connected clients in GCC.1, there is no need to include client F in GCC.1 – D and F are to be included in a third GCC. Only in the case when financial problems spread from one GCC into the other GCC (risk of contagion of the whole group) because of the economic dependency between two of their members, is there a need to treat the two groups as one single GCC.
F. Control and management procedures in order to identify connected clients

54. Identification of possible connections between clients should be an integral part of an institution’s credit granting and surveillance process. It is in the interests of the institution to identify all possible connections in order that it has a clear understanding of its cluster risk. Institutions shall increase their efforts to identify connections as exposures grow or reach a certain threshold. While an institution should in general examine interconnections for all exposures, CEBS expects that institutions intensively investigate possible economic connections with appropriate documentation for all exposures that exceed 2% of own funds at a solo or consolidated level.

55. Having information about connected clients is essential in limiting the impact of unforeseen events. In this regard, institutions shall use all available information to identify connections; this includes publicly available information. The data that needs to be collected may go beyond the institution’s client and include legal or natural persons connected to the client. Information about business links or economic dependencies is not usually captured by the existing information systems of banks. The necessary inputs require utilising “soft information” that typically exists at the level of individual loan officers and relationship managers. Institutions shall take reasonable steps to acquire this information.

56. In relation to the identification of interconnected clients, every institution should have in place a robust process for determining connected clients. CEBS does recognize the possibility of practical difficulties in determining interconnections for all the exposures of an institution. Notwithstanding this, the institution must be in a position to demonstrate to its competent authority that its process is commensurate to its business. In addition, the process should be subject to on-going review by the institution to ensure its appropriateness. It will rarely be possible to implement automated procedures for identifying economic interconnections; therefore, case by case analysis and judgement will be required. Consequently, for the identification of economic interconnections, institutions need to rely primarily on the expertise of their loan officers and risk managers. Therefore, an institution’s board of directors and senior management must ensure that adequate processes for the identification of economic interconnections are in place and risk managers and loan officers are sufficiently trained in this regard. Furthermore, institutions should also monitor for changes to interconnections, at least in the context of their normal periodic loan reviews and when substantial expansions of the loan are planned.

57. A crucial point in the process is the first time an exposure is granted to the client, or the first time an exposure reaches a level that requires individual handling from the institution. At this point, there is normally a loan officer involved and personal contact between the loan officer and the client. This opportunity to collect information relevant to disclosure of connected clients should be utilised.

58. Normally, the institution’s largest exposures will be allocated to loan officers dedicated to following the client on a regular basis. This includes personal contact as well as scrutinizing accounts and reports. The occasions to
develop a deeper understanding of the client’s business and possible dependencies are there and the collection of such information is a normal part of conducting prudent banking.

59. The institution has to assess for example the diversity of the client’s customer base, or of the tenants. In cases where the institution has identified interconnection, it has to acquire information on the other entity(ies) in the group of connected clients if this is necessary to form a view on the creditworthiness of its customer. The institution, however, is not obliged to investigate, whether the other entity, to which its client is interconnected, itself is part of other groups of connected clients, as long as the other entity is not a client of the institution.

60. Notwithstanding the above, all interconnections to the knowledge of an institution shall be recognised, independently of the size of the exposure. As the determination of interconnection is dependent on the one hand on economic judgement, and on the other hand on the information available to, or gathered on a best effort basis by the reporting institution, it is possible that different institutions will arrive at different results when analysing the same entities. Supervisors should be aware of this issue and subject to the specific case may except or challenge such differences.
Part II. Treatment of exposures to schemes with underlying assets according to Article 106(3) of Directive 2006/48/EC

61. Exposures can arise not only through direct investments of institutions but also through investments in schemes\textsuperscript{14} which themselves invest in underlying assets. Consequently, when an institution invests in a scheme it is exposed on the one hand to the risk associated with the scheme manager/depositor and on the other hand to the credit and market risk linked to the underlying assets of the scheme. Therefore, ideally, the underlying assets of a scheme should always be taken into account when calculating exposures for large exposure purposes.

62. The revised large exposure rules include the treatment of exposures to underlying assets. The new Article 106(3) has been included in the amended CRD: "In order to determine the existence of a group of connected clients, in respect of exposures referred to in points (m), (o) and (p) of Article 79(1), where there is an exposure to underlying assets, a credit institution shall assess the scheme or its underlying exposures, or both. For that purpose, a credit institution shall evaluate the economic substance and the risks inherent in the structure of the transaction."

63. Article 106(3) makes clear that institutions have to separately assess for large exposure purposes, schemes with underlying assets in order to determine the existence of groups of connected clients. Institutions are required to assess whether the scheme itself, its underlying assets or both are interconnected with the institution’s clients (including other schemes) and, therefore, should be grouped together with such connected clients for the purpose of the large exposure requirements. Article 106(3) does not, however, specify under what circumstances the scheme or the underlying exposures or both have to be assessed. Article 106(3) also does not provide an option for institutions to choose between these three approaches, but requires institutions to decide on the basis of “the economic substance and the risks inherent in the structures” which approach is the most suitable for a scheme. Furthermore, Article 106(3) does not explain what an institution should do if a look-through is not possible or too burdensome.

64. In addition, there is evidence to suggest that institutions’ exposures to schemes with underlying assets are not being consistently (or prudently) treated for the purposes of determining the existence of a group of connected clients with regard to the large exposure requirements. This leads to the increased risk of the large exposure limits being breached and consequential risks of firm failure, which can result in negative externalities. Therefore, CEBS has developed the draft guidelines set out below on the appropriate treatment of various structured finance/structured finance vehicles.

\textsuperscript{14} Such as collective investment undertakings (CIUs) and structured finance/structured finance vehicles (e.g. securitisations)
A. Principles underlying the draft guidelines

65. CEBS developed the draft guidelines on the basis of the following principles:

- the guidelines should provide comprehensive prudential guidance for different kinds of schemes with underlying assets;
- the look-through approach is considered to be the most risk-sensitive approach for determining interconnections of the underlying assets with the institution’s clients, as it provides the most prudent treatment from a large exposures’ perspective;
- because it is not always possible or feasible to look-through, the guidelines should provide prudent alternative approaches that adequately deal with such cases. In these approaches, greater uncertainty should be reflected in a more conservative treatment;
- the guidelines should appropriately take into account the granularity of schemes, significance of exposures and situations where institutions can positively assess whether unknown clients are different and not connected with other clients in an institution’s portfolio;
- regardless of the question of interconnections of the underlying assets to other schemes or direct exposures to clients, risk arising from schemes themselves should be recognised.

B. Treatment of schemes with underlying assets

66. Potential losses stemming from schemes with underlying assets can arise from two sources: the risk associated with the scheme itself and the risk associated with the underlying assets of the scheme. Article 106(3) makes clear that these two sources of risk need to be taken into account in the determination of the existence of a group of connected clients. The different nature of the two sources implies that different factors should be taken into account when assessing the materiality of the risks stemming from each source, and therefore the need to apply look-through to cope with the risk stemming from the underlying assets or to limit the investment in a specific scheme to cope with the risk stemming from the scheme itself. In the case of the risk stemming from the underlying assets one important factor would be the degree of diversification in the scheme. While in the case of the risk stemming from the scheme itself the legal framework applicable to the fund managers would be an important factor to take into account.

67. Regarding the risk of the underlying assets, taking into account the burden that a compulsory full look-through approach could impose in some cases, CEBS’s approach provides incentives to look-through instead of applying a more conservative treatment. Thus, the decision on the most appropriate approach for a specific scheme is left to the institution.

68. However, institutions should, whenever feasible, use the more risk sensitive approaches and should be able to demonstrate to the competent authorities that regulatory arbitrage considerations have not influenced their choice. Competent authorities would expect that the institution’s decision is justified in terms of the relative risk that the scheme could pose in terms of breaching the large exposure limits and the cost to mitigate that risk by the look-through. For example, if an institution makes an investment, that
represents 5% in terms of its own funds, in a fund with a very granular and
dynamic portfolio, the marginal contribution of this scheme to the
"unexpected idiosyncratic credit risk" of the institution may be low, while the
cost of a full look-through of this portfolio may be high. Conversely, if the
institution invests in a non-granular and static portfolio, the contribution of
this scheme to the "unexpected idiosyncratic credit risk" of the institution
could be material, while the cost of a full look-through is not likely to be
very high. Therefore, competent authorities would expect that in the latter
case institutions aim to look-through to the scheme and to fully justify their
decision when it is not the case.

69. Where an institution cannot ensure that there are no interconnections
between the institution’s clients and the underlying assets of a scheme,
prudential treatment cannot allow for such exposures and schemes to be
considered as independent counterparts. Such an approach would open the
doors to regulatory arbitrage because the number of schemes in an
institution’s portfolio is not limited and they can be reproduced at will. Thus
an institution would always be able to avoid breaches of its large exposure
limits by suitably small investments in a large number of schemes.
Therefore, all unknown exposures from schemes should be considered as
belonging to one single group of connected clients. CEBS is aware that this
solution would disregard the possibility of interconnection between the
unknown exposures and the portfolio of the institution. However, CEBS
believes that limiting the investment in schemes where a look-through
approach is not possible or feasible is sufficiently restrictive and mitigates
the possible idiosyncratic risk of a client or a group of connected clients.

70. The fall back solutions set out below reflect the greater uncertainty inherent
in unknown underlying exposures (or entire schemes) by offering a
conservative treatment that considers all unknown underlying exposures
and schemes to belong to one separate group of connected clients, although
the degree of conservatism would vary a lot case by case. For an institution
that mainly invests in granular and dynamic investment funds (which,
nevertheless, would not fall under the 5% threshold as set out in paragraph
74) this approach would be conservative, while for an institution that
normally does not invest in schemes, but decides to use a scheme to
circumvent the large exposure rules by investing in a scheme with only one
or a few assets in which the institution has already directly invested close to
25% of its own funds, this approach would be not conservative at all.
Therefore, as pointed out above, it is important that institutions should be
able to demonstrate to the competent authorities that regulatory arbitrage
considerations have not influenced their choice of whether to look-through
or not.

71. However, the fall-back solutions do allow firms to treat all the underlying
exposures of a scheme that can be identified in accordance with the normal
rules.

72. An important issue in the context of look-through is the question of changes
in the underlying assets of a scheme. For static portfolios where the
underlying assets do not change over time, an assessment can be made
once and does not need to be monitored in the future. For dynamic
portfolios the treatment is more complicated as the relative portions of
underlying assets as well as the composition of the scheme itself can
change. In these cases a look-through or partial look-through approach must always be accompanied by on-going monitoring of the composition of the scheme. On-going in this context means that the monitoring frequency must be appropriate to the frequency and materiality of the changes in the underlying assets of the scheme.

73. Moreover, a prudential treatment needs to take into account that interconnections between the underlying assets of different schemes or schemes themselves are possible.\(^{15}\)

74. As a result of these considerations, CEBS proposes that institutions apply the following approach or combination of approaches for the treatment of exposures to schemes with underlying assets according to Article 106(3) for the purpose of determining the interconnections of the underlying assets in the scheme with other clients:

   a) **Full look-through**: The institution may identify and monitor over time all exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients.

   b) **Partial look-through approach**: The institution may look-through to the known exposures in a scheme and assign them to the corresponding client(s) or group(s) of connected clients. The remaining exposures shall be treated as unknown exposures in accordance with (c) below.

   c) **Unknown exposures**: All unknown exposures (including schemes where the institution does not look-through by any of the methods described above and which are not sufficiently granular) are to be regarded as a single risk and shall, therefore, be considered as one unknown client. A scheme may be considered as sufficiently granular if its largest exposure is smaller than 5% of the total scheme.

   d) **Structure-based approach**: If an institution can ensure (e.g. by means of a CIU’s mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution’s portfolio (including other schemes) that is higher than 2% of the institutions own funds, it may treat these schemes as separate unconnected clients.

Institutions shall consider the risk arising from the scheme itself separately\(^{16}\), in addition to the risk stemming from the underlying assets. Therefore, investments in single schemes (including the group of unknown exposures referred to in c)) shall be limited to 25% of own funds according to Article 111(1) of Directive 2006/48/EC.

75. Institutions should adhere to the following principles when applying the approaches above:

   - For funds of funds, the granularity criterion may be applied on the level of the underlying assets of the underlying funds.

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\(^{15}\) A report by S&P, 16 Feb 2009, for example, shows “that there is a significant similarity or “overlap” between CLO portfolios with an average pair of transactions having 28% of their portfolios in common.”

\(^{16}\) Such interconnections may arise due to “servicer risk” or “originator risk” in e.g. securitisations, or due to reliance on a central manager in the case of CIUs.
• Monitoring shall be carried out on an ongoing basis, but at least once every month.

• If an institution is aware of interconnections between the underlying assets of a scheme, they shall be recognised for the purposes of establishing the existence of a “group of connected clients”. However, there is no requirement to intensively analyse interconnections between those underlying assets.

• The respective exposure amounts only need to be included in proportion to the institutions’ share of interests in the scheme.

• CEBS proposes a transitional period: until 31 December 2015, institutions may treat schemes acquired before the 31 January 2010 according to the treatment of schemes that was required prior to the 31 December 2010.

76. Illustrative examples, “individual unknown clients” (partial look-through / granular portfolios / structure-based approach):

77. The above examples show on the left-hand side a scheme to which partial look-through is applied. The institution identified the counterparts (exposures) A, B, and C of the scheme. Because the institution has also an exposure to A in its portfolio, it must add these two exposures (the small and the large circle with “A”) for large exposure purposes. Exposures B and C have no correspondence in the institution’s portfolio; they may be treated as single exposures. The other unknown exposures of the scheme (grey circles in the scheme on the left) shall be treated as an unknown client. The scheme on the right-hand side represents an example where the institution applies the “structure-based approach”. In this example, the institution is not aware of the counterparties in the scheme, but can, nevertheless, ensure, that they are not connected with any direct or indirect exposures in the institution’s portfolio (including other schemes) that are higher than 2% of the institution’s own funds. In this case, the institution may treat the scheme as a separate unconnected client. Please note, that nevertheless the general rule applies for both schemes, and that single schemes are, in general subject to the 25% limit.
78. Illustrative example “treat as one unknown client”:

79. The above example shows two schemes. For the scheme on the left-hand side a partial look-through is applied. The institution identified counterpart (exposure) B of the scheme. Exposures B has no correspondence in the institution’s portfolio, therefore it may be treated as a single exposure. For the other exposures in both schemes (white circles) there is no information available. Therefore they shall be considered together and be treated as one unknown client. Please note, that nevertheless for both schemes the general rule applies, that single schemes are in general subject to the 25% limit.

C. Treatment of tranched products

80. In cases of non-structured finance exposures, the losses derived from the default of counterparty in the scheme is proportionate to a direct investment in the underlying assets. In the case of structured finance/structured finance vehicles, the calculation of the losses also depends on the credit enhancements linked with the specific tranches. As far as these enhancements are legally enforceable, CEBS considers that they should be taken into account for large exposure purposes in a way consistent with the large exposure mitigation framework. The proposed treatment recognises the credit risk mitigation that subordination of tranches provides to the structure, which is consistent with the general requirement for institutions to use the most risk sensitive approach feasible. The tranches benefit from large exposures reduction by credit enhancement.17

81. The thinking behind the proposed treatment is the following: for any given position that an investor may hold in a securitisation, there is a protection stemming from subordinated tranches equal to the size of this subordination. No matter which underlying exposure defaults first, a given position will always be protected by the junior tranches, by an amount equal to their size. Thus, the initial exposure to a given name should be “adjusted” and reduced by an amount equal to the size of all junior tranches. The adjustment will, of course, also depend on the share that is invested in the tranche.

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17 This section is only about the mitigation provided by a tranched structure and does not refer to other credit enhancements that could also be attached to the scheme such as guarantees or credit lines. This is because the recognition of these types of enhancements is not exclusive of these products but more general and, therefore, the general rules for recognition would apply.
82. For granular portfolios, where the size of each counterparty is smaller than the size of first loss tranches, the proposal would require for the investors in the first loss tranche to recognise a large exposure equal to each underlying name, and for the investors into the senior tranche, no large exposure at all.

83. The analysis will have to be conducted for every tranche (T) in which an institution holds a position.

84. The proposal has to be dynamic because the limits vary as losses affect the underlying pool. Continuous evaluation of the scheme’s performance would, therefore, be necessary (see example 1 below).

85. However, there are two concerns that could make it advisable to add a conservative layer in the recognition of the mitigation. First, it is not always easy to reassess the portfolio on a continuous basis. It is possible that the first loss tranche is exhausted, but the institution that invests in the more senior tranche has not yet recognised this fact for large exposures purposes. For that reason, it is worth exploring the need to clarify the risk management standards that banks should comply with in order to benefit from any such mitigation effect.

86. Second, there is a risk that as a consequence of the reassessment once the first loss is exhausted, some of the positions in certain names could result in sudden large exposures breaches (as the mitigation effect of the first loss tranche disappears). The institution may then be forced to reduce their exposure to comply with the limits regardless of the market conditions, they, therefore, run the risk of selling at a loss (this may depend on how liquid the instrument is). The offset of tranches held by the institution protects it to a certain degree from taking losses. CEBS recognises the existence of the mentioned risk, and therefore deems it necessary to investigate further the application of specific haircuts, similar to what happens with the recognition of mitigation for direct exposures.\(^\text{18}\)

87. The following examples illustrate how this would work under the different approaches. The examples only refer to the credit risk arising from the underlying assets and do not refer to the risk arising from the scheme itself.

\(^{18}\) CEBS notes that up to now, practical experience with the proposed treatment is limited and that the calibration of haircuts in this context needs further investigation in light also of the need to limit the “cliff effect” referred to in the text. Therefore, CEBS will include in its future work plan further work on this issue.
EXAMPLE 1

A. FULL LOOK-THROUGH (this example illustrates the case where the look-through is applied)

The structure of the product is as follows:

<table>
<thead>
<tr>
<th>UNDERLYING PORTFOLIO</th>
<th>SECURITISATION TRANCHES</th>
</tr>
</thead>
<tbody>
<tr>
<td>name</td>
<td>amount</td>
</tr>
<tr>
<td>A</td>
<td>20</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
</tr>
<tr>
<td>C</td>
<td>15</td>
</tr>
<tr>
<td>D</td>
<td>10</td>
</tr>
<tr>
<td>E</td>
<td>5</td>
</tr>
<tr>
<td>F</td>
<td>5</td>
</tr>
<tr>
<td>G</td>
<td>5</td>
</tr>
<tr>
<td>H</td>
<td>5</td>
</tr>
<tr>
<td>I</td>
<td>5</td>
</tr>
<tr>
<td>J</td>
<td>5</td>
</tr>
<tr>
<td>K</td>
<td>5</td>
</tr>
</tbody>
</table>

Assuming that Institution 1 has invested 90 in the Senior tranche and Institution 2 has invested 10 in the first loss tranche.

The treatment for large exposures purposes should be the following:

**Institution 1, on the senior tranche must recognise:**
- 0 with debtors D to K
- 5 with debtor C
- 10 with A and B

**Institution 2, on the first loss tranche:**
- 5 with debtors E to K
- 10 with debtors A to D

Assuming that in the next period counterparty K defaults and a loss of 5 is registered. Then, once this loss is known institutions 1 and 2 must reassess the exposures. Therefore, just after the default:

**Institution 1, on the senior tranche must recognise:**
- 0 with debtors E to J
- 5 with debtor D
10 with debtor C
15 with A and B

Institution 2, on the first loss tranche:
5 with debtors A to J

B. PARTIAL LOOK-THROUGH
This example assumes that only the names A and B are known, for the rest, the institutions only know that the maximum amount invested is 20.

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:
10 with A and B
10 to add to the rest of the unknown exposures

Institution 2, on the first loss tranche:
10 with debtors A and B
10 to add to the rest of the unknown exposures

C. STRUCTURE-BASED APPROACH
This example assumes that no names are known, institutions only know that the maximum amount which can be invested in each counterparty is 20 and counterparties can only belong to the UK pharmaceutical sector, and the institution has no other direct or indirect investments in that sector.

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:
10 to the scheme (no effect because an exposure to the scheme of 90 is already recognised)

Institution 2, on the first loss tranche:
10 to the scheme (no effect because an exposure to the scheme of 10 is already recognised)

D. RESIDUAL APPROACH
This example assumes that no names are known and the institutions do not know the maximum amount invested in each counterparty nor have any clue as to the nature of the investments (structure).

The treatment for large exposures purposes should be the following:

Institution 1, on the senior tranche must recognise:
90 to add to the unknown exposures

Institution 2, on the first loss tranche:
10 to add to the unknown exposures
More examples on how the full look-through approach could be implemented for more complex structures are provided below:

**EXAMPLE 2**

In this example a mezzanine tranche is added to the structure and a haircut of 50% is used to compute the mitigation effect for the mezzanine tranche. Since CEBS is not in a position to recommend the use of a specific haircut, the haircut used in this example is just an illustration of how a haircut could be used, but of course the haircut in each specific case should depend on the risks outlined above: 1) lags in the reassessment and 2) losses that can stem from the required re-composition of the portfolio once the first loss is exhausted, given the sudden emergence of large exposures breaches.

**UNDERLYING PORTFOLIO**

<table>
<thead>
<tr>
<th>name</th>
<th>amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>20</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
</tr>
<tr>
<td>C</td>
<td>15</td>
</tr>
<tr>
<td>D</td>
<td>10</td>
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<tr>
<td>E</td>
<td>5</td>
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<tr>
<td>F</td>
<td>5</td>
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<td>G</td>
<td>5</td>
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<tr>
<td>H</td>
<td>5</td>
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<tr>
<td>I</td>
<td>5</td>
</tr>
<tr>
<td>J</td>
<td>5</td>
</tr>
<tr>
<td>K</td>
<td>5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SECURITISATION TRANCHE</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
</tr>
<tr>
<td>Senior tranche</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>Mezzanine</td>
</tr>
<tr>
<td>10</td>
</tr>
<tr>
<td>First loss</td>
</tr>
<tr>
<td>(1250%)</td>
</tr>
</tbody>
</table>

The treatment for large exposures purposes should be the following:

**Institution 1 on the Senior tranche:**

0 with A to K

**Institution 2 on Mezzanine tranche:**

0 with E to K

5 with D

10 with C

15 with A and B

**Institution 3 on First Loss tranche:**

5 with E to K

10 with A to D
EXAMPLE 3

<table>
<thead>
<tr>
<th>UNDERLYING PORTFOLIO</th>
<th>SECURITISATION TRANCHE</th>
</tr>
</thead>
<tbody>
<tr>
<td>name</td>
<td>amount</td>
</tr>
<tr>
<td>from i = 1</td>
<td></td>
</tr>
<tr>
<td>....</td>
<td></td>
</tr>
<tr>
<td>to 1000</td>
<td></td>
</tr>
<tr>
<td>Amount name i = 0.1 €</td>
<td></td>
</tr>
</tbody>
</table>

The treatment for large exposures purposes should be the following:

_Institution 1 on the Senior tranche:_

0 with debtors I = 1 to 1000

_Institution 2 on the First loss tranche:_

0.1 with debtors I = 1 to 1000

88. CEBS recognises that the variety and diversity of structured finance/structured finance vehicles can be large and therefore case by case specificities should be properly accounted for when implementing these principles. However, CEBS firmly believes that the convergent application of the principles stated in this paper will be a valuable contribution to the effectiveness of the prudential framework.