ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

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GUIDANCE NOTE FOR DEPOSIT TAKERS (Class 1(1) and Class 1(2))

Large Exposures

March 2017

STATUS OF GUIDANCE

The Isle of Man Financial Services Authority ("the Authority") issues guidance for various purposes including to illustrate best practice, to assist licenceholders to comply with legislation and to provide examples or illustrations. Guidance is, by its nature, not law, however it is persuasive. Where a person follows guidance this would tend to indicate compliance with the legislative provisions, and vice versa.

Version 1.1

Contents

Part 1 – Deposit takers incorporated in the Isle of Man

1. Rationale/Introduction

1.1 This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence, jointly referred to in this document as both 'deposit takers' and 'banks'.

1.2 Excessive exposure to a single customer/counterparty or to a group of closely related customers/counterparties is a significant risk incurred by deposit takers.

1.3 Where excessive concentrations exist, it is important that a bank fully understands the resultant risks and that these are in line with the bank's strategic appetite for risk and mitigated as far as possible.

1.4 The Isle of Man Financial Services Authority's ("the Authority") approach to Large Exposures is based on Principle 10 of the Basel Core Principles for Effective Banking Supervision. This states that "Banking supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties".

1.5 The Authority requires a bank to comply with certain explicit ("hard") limits in relation to large exposures. These compare the size of the exposures to a single customer / counterparty (or a group of closely related customers / counterparties) to the bank's capital base, and are designed to ensure that the bank has sufficient capital in the event of failure / default by a customer / counterparty (or group of closely related customers / counterparties). The limits are not designed to help ensure a bank has sufficient capital (or liquidity) in the event of a single catastrophic event such as the failure of the parent / group.

2. Main Features of the Authority's Approach

2.1 Any exposure that is 10% or more of a bank's *Large Exposures Capital Base* ("LECB") is defined as a large exposure.

2.2 The LECB is interpreted in accordance with the Financial Services Rule Book ("the Rule Book").

2.3 A bank should be able to monitor its exposures on a daily basis. It must not incur an exposure to an individual customer/counterparty or group of closely related customers/counterparties that exceeds 25% of its LECB except in limited circumstances where the exposure falls within the definition of an *exempt exposure*.

2.4 A bank should notify the Authority of all new large exposures by the submission of a Large Exposures Card **(*See Appendix 4*)** when the exposure is incurred and on form SR-2B to be submitted quarterly. Large exposure cards are not required to be submitted in respect of exposures to other credit institutions as part of a bank's normal treasury book, or for exposures to parent banks / groups that are exempted. An updated Large Exposures Card should be submitted whenever there is a change in the facility and at least annually when there has been no change.

2.5 A bank must limit the total of its large exposures, other than its exempt exposures, to individual customers/counterparties or groups of closely related customers/counterparties to a maximum of 800% of its LECB. Any breach must be notified immediately to the Authority. A bank must notify the Authority in advance before the total of its large exposures, excluding exempt exposures, exceeds 300% of its LECB. If the Authority does not agree with the bank exceeding the 300% limit it may issue a Direction.

2.6 A bank is required to provide the Authority with a statement of its large exposures policy. The Authority will not prescribe exactly the format of the policy statement although it must address the treatment of country, sectoral and counterparty risk (see ***Section 7***). The policy statement must be reviewed annually by the Board and significant changes to this should be pre notified and discussed with the Authority. A copy of the amended policy statement should be provided to the Authority within 20 business days of the change being made and with the changes highlighted.

3. Definition of Exposure

3.1 An exposure is the maximum loss a bank might suffer if a customer/counterparty or a group of closely related customers/counterparties fails to meet its obligations, or the maximum loss that might be experienced as a result of the bank realising assets or off-balance sheet positions.

3.2 A bank should calculate an exposure as the gross amount at risk (subject to 3.4 and 3.5 below) arising from:

(a) claims on a customer/counterparty or group of closely related customers/counterparties including actual and potential claims that would arise from the drawing down in full of undrawn advised facilities (revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide, and claims that the bank has committed itself to purchase or underwrite. Typically these will be in the form of:

- Loans, advances, overdrafts
- Finance leases, less deferred tax
- Discounted bills held outright
- Bonds, acceptances, promissory notes, loan stocks & other paper held outright
- Margin held with investment exchanges, clearing houses or other customers/counterparties
- OTC futures (including forwards), options, swaps & similar contracts on interest rates, foreign currencies, equities, securities & commodities
- Claims arising in the course of settlement of marketable securities and investments
- Claims arising in the case of forward sales and purchases of marketable securities and investments that either settle on a date beyond the market norm for that instrument or where the payment due is deferred until some future date
- Any commitment with a certain or uncertain drawdown entered into by the bank. This includes amounts outstanding under:
  - Repos and Reverse Repos
  - Forward asset purchase agreement
  - Buy back agreement
  - Forward deposit placed (i.e. where a credit institution contracts to make a deposit with another party on a future date at a pre-determined rate)
  - Unpaid part of partly paid shares
- Any other claims arising from similar transactions entered into by the bank.

Exclusions are as follows:-

- Claims and other assets already deducted from capital base for capital adequacy and large exposures purposes
- In the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the 5 business days following payment or delivery of the securities, whichever is the earlier

- In the case of foreign currency transactions, exposures incurred in the ordinary course of settlement during the two business days following payment
- In the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day
- In the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services
- Customer/counterparty risk on futures & options contracts where the contracts are traded on an exchange and are subject to daily margining requirements. However, except where contracts relate to a broadly based cash settled index, issuer risk on any underlying bonds/equities should be included, the value of the contracts depending on the issuer's financial soundness.

(b) contingent liabilities arising in the normal course of business, and those contingent liabilities that would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide. This includes amounts outstanding under:-

- Direct credit substitutes (including guarantees, standby letters of credit serving as financial guarantees, bills accepted but not held by the bank, per aval endorsements and equivalent endorsements)
- Claims sold with recourse where credit remains with the bank
- Transaction related contingent items not having the character of direct credit substitutes (including performance bonds, bid bonds, warranties, standby letter of credit relating to particular transactions, retention money guarantees, import and export excise duty bonds, VAT bonds)
- Undrawn documentary letters of credit issued or confirmed
- Those arising from similar transactions entered into by the bank.

Exclusions are as follows:-

- Indemnities for lost share certificates and export/import carnets
- Bill endorsements on bills already endorsed by another credit institution
- Contingent liabilities resulting from injuries, damage or loss suffered by third parties and caused by goods where the bank

acts as lessor, mortgagee or owner of goods under a hire-purchase agreement.

(c) Assets, including assets that the bank has committed itself to purchase or underwrite, whose value depends wholly or mainly on a customer/counterparty performing its obligations, or whose value otherwise depends on that customer/counterparty's financial soundness but that do not represent a claim on the customer/counterparty. This includes equities, equity warrants and options that do not represent a claim on the issuer but whose value depends, principally, on the issuer's financial soundness.

3.3 ***Accrued interest***

Generally a bank should, where possible, include accrued interest in the exposure being reported, see rule 8.39 of the Rule Book. However, for an exposure well below the 25% limit, the accrued interest element need not be reported. Where, however, the exposure is close to the 25% limit, the bank should be able to demonstrate that the 25% limit would not be breached if accrued interest were included.

3.4 ***Bad debt provisions (impairments)***

An exposure reported at book value should be gross of specific/individual provisions (impairments) for bad and doubtful debts. Similarly, where an exposure is marked to market the valuation is gross of any provisions (impairment). *However, for monitoring against limits, a specific/individual provision made against a loan should be set off against the gross amount of the exposure*.

3.5 ***Eligible Collateral***

An exposure reported at book value should be gross of any eligible collateral. Similarly, where an exposure is marked to market the valuation is gross of any eligible collateral. *However, for monitoring against limits, eligible collateral can be recognised in order to reduce the value of an exposure, provided that:*

(i) the collateral complies with the eligibility requirements and other minimum requirements for the purposes of calculating the risk weighted exposure amounts under the standardised approach using the financial collateral simple method; or

(ii) the collateral complies with the eligibility requirements and other minimum requirements for the purposes of calculating the risk weighted exposure amounts under the standardised approach using the financial collateral comprehensive method.

3.6 ***Guaranteed exposures***

Where a third party has provided an explicit unconditional irrevocable guarantee (in relation to an exposure to a counterparty), the bank may be permitted to report the exposure as being to the guarantor, provided that the unsecured exposure to the guarantor would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the counterparty under the standardised approach to credit risk. In this case, such situations should be addressed in the bank's large exposures policy statement. The Authority expects the bank to apply its credit approval procedures to the guarantor and to the terms of the guarantee.

3.7 ***Netting***

It is important to note that a bank should not calculate the size of its exposure to a customer/counterparty by netting its various claims and obligations relating to that customer/counterparty unless there is a legally enforceable contract which provides a right of set-off and this has been agreed in writing with the Authority.

4. Definition of Customers/Counterparties

4.1 A customer/counterparty is any party on which a bank, directly or indirectly, has a claim.

4.2 An individual customer/counterparty comprises natural and legal persons and includes government, local authorities, public sector entities, credit institutions, individual trusts, corporations, unincorporated businesses (whether sole traders or partnerships) and non-profit making bodies.

4.3 ***Identity of a customer/counterparty***

The identity of a customer/counterparty will generally be one of the following:

(a) The borrower (customer)

(b) The person whose obligations the bank is guaranteeing (where the bank is providing such a guarantee)

(c) In the case of a derivatives contract, the party with whom the contract was made or

(d) In the case of a security held, the issuer of the security. There are a number of non-straightforward cases:

i) Where bills are held by a bank that have been accepted by another credit institution, the claim should be reported as on that other credit institution

ii) Where per aval endorsements on bills are held by a bank, the claim should be reported as a claim of over one year's maturity on the avalising credit institution

iii) Where a bank is funding the activities of a company that trades on an exchange (whether for that company's own account or on behalf of clients), the full amount of such funding should be reported as an exposure to that company unless an alternative reporting method has been agreed with the Authority in writing, and

iv) If a third party has provided an explicit unconditional irrevocable guarantee, a bank may report the exposure as being to the guarantor if its large exposures policy statement includes a section on guaranteed exposures to that effect.

4.4 ***A group of closely related customers/counterparties***

A group of closely related customers/counterparties exists either where:

(a) Unless it can be shown otherwise, two or more individual customers/counterparties constitute a single risk because one of them has, directly or indirectly, control over the other(s) or

(b) Individual customers/counterparties are related in such a way that the financial soundness of any of them may affect the financial soundness of the other(s) or the same factors may affect the financial soundness of both or all of them. Relationships between individual customers/counterparties that might give rise to common risks include group undertakings, companies whose ultimate owner is the same and that do not have a formal structure, companies having common directors or management and customers/counterparties linked by cross guarantees.

4.5 ***Connected customers/counterparties***

Exposures to companies or persons connected to the bank, its senior management (as interpreted in the Rule Book), key persons, directors or controllers require special care to ensure that a proper credit risk assessment is undertaken. This is due to possible contagion and the risk that the consideration of proposed loans to customers/counterparties connected to the bank may be obscured by subjective considerations. Such exposures may be justified only when there is a clear commercial advantage for the lending bank and when they are negotiated and agreed on an arm's length basis.

4.5.1 Factors to take into account when considering whether an exposure has been agreed on an arm's length basis are:

(a) The extent to which shareholders can influence a bank's operations, for example, through voting rights

(b) The management role of shareholders where they are also, for example, directors, and

(c) Whether the loan would be subject to the bank's usual monitoring and recovery procedures if repayment difficulties emerged.

4.5.2 Staff loans other than to senior management (as interpreted in the Rule Book), key persons, controllers or directors are not normally treated as connected.

4.5.3 Parties connected to a bank comprise:

(a) Group undertakings

Group undertakings include subsidiaries and related companies.

A 'related company' in relation to a bank or the parent of a bank, means a body corporate (other than a subsidiary undertaking) in which the bank or parent undertaking holds a qualifying capital interest.

A qualifying capital interest means an interest in relevant shares of the body corporate that the bank or the parent undertaking holds on a long-term basis for the purpose of securing a contribution to its own activities by the exercise of control or influence arising from that interest.

Relevant shares means shares comprised in the equity share capital of the body corporate of a class carrying rights to vote in all circumstances at general meetings of that body.

A holding of 20% or more of nominal value of the relevant shares of a body corporate should be presumed to be a qualifying interest unless the contrary is shown.

(b) Associated Companies (as defined in the Rule Book)

(c) Directors, controllers and their associates (as defined in the Financial Services Act 2008)

(d) Non-group companies with which the bank's directors and controllers are associated. A director (including an alternate director) and / or controller of a bank is deemed to be associated with another company in the following circumstances:

(i) he holds the position of director in his own right, or

(ii) as a result of a loan granted by the bank to a company and which is not made on an arm's length basis, or

(iii) as a result of a financial interest taken by the bank in that company, or

(iv) by virtue of a professional interest unconnected with the bank, or

(v) he and/or his associates together hold 20% or more of the equity share capital of that company.

4.5.3 Exposures to companies or persons connected to a bank may be deducted from the bank's capital base if they are of the nature of a capital investment or are made other than on an arm's length basis.

4.6 ***Lending to investment trusts, unit trusts, OEICs and venture funds managed within banking groups***

Where a bank has exposures to funds managed within the same banking group or exposures to several different funds managed within the same third party group, it must examine each case carefully to assess whether the funds need to be treated as related or connected exposures (respectively).

4.6.1 The following points should be considered when assessing whether an exposure to the fund should be treated as a connected exposure, or whether exposure to several different funds within the same third party group should be treated as a related exposure:

(a) Whether the beneficial owners of the fund, i.e. the shareholders, are connected to the bank and/or related to other funds managed within its group

(b) The degree of independence of control of the fund, for example, the composition of the fund's board and its relation to the bank and/or other funds

(c) Whether the fund is subject to any other relevant statutory or regulatory requirements controlling independence and quality of management and systems and controls, and whether, as far as can reasonably be ascertained from publicly available information, it is meeting these requirements to the satisfaction of the relevant regulatory bodies

(d) Whether the fund has an audit committee and is subject to internal and external audit

(e) Whether the loan is made on an arm's length basis

(f) Whether the bank has the necessary systems and controls to monitor the above criteria on an on-going basis.

4.6.2 Even where a bank can satisfy itself that such funds do not need to be treated as either a connected customer/counterparty or as a related exposure, there remains some aggregate risk.

For example, where a bank lends to several funds within its own group or within a third party group, there remains the risk that a run on fund A will prompt runs on funds B and C where all three are managed within the same group, thereby conceivably precipitating problems for the bank.

4.6.3 A bank should include within its large exposures policy statement its limits for:

(a) The aggregate of lending to funds within the same banking group

(b) The aggregate of lending to two or more funds within a third party group.

5. The 25% Limit & Exempt Exposures

5.1 ***The 25% limit***

A bank must not enter into an exposure in excess of 25% of its LECB except in limited circumstances where the exposure falls within the definition of an "exempt exposure".

5.2 A bank should only have a total exposure to an individual customer/counterparty or to a group of closely related customers/counterparties that exceeds 25% of the LECB if the exposure or those parts of the exposure that exceed the 25% limit are exempt from the limit.

5.3 ***Exempt exposures***

Exposures may be considered exempt in the following cases:-

5.3.1 ***Exposures under 3 months to credit institutions which receive (unsecured) a 20% risk weighting under the standardised approach*** (not connected to the bank) provided the placing(s) is/are not subject to any form of charge or pledge. This applies to the situation where such exposures are part of the normal activities of the bank for example, treasury, funding and other cash management. The bank is not required to pre-notify the Authority if such exposures exceed the 25% limit. The maximum exposure that can be incurred is limited to 500% of the bank's LECB, or £100m, whichever is the lower (unless the requirements set in the Rule Book have been modified).

With reference to the exclusions for correspondent banking (refer section 3.2) if the above limits are exceeded due to unforeseen client activity and the excess position is corrected within one business day, then the exposure which gave rise to the excess is excluded for regulatory purposes, and notification to the Authority is not required.

However, if a regulatory limit is exceeded for more than one business day, even if the excess is due to correspondent banking activity, the Authority should be notified immediately (as at this point the exposure is not excluded).

5.3.2 ***Exposures of more than 3 months but less than 12 months to credit institutions which receive (unsecured) a risk weighting of 50% or less under the standardised approach*** (not connected to the bank) provided the placing(s) is/are not subject to any form of charge or pledge. This applies to the situation where such exposures are part of the normal activities of the bank for example, treasury, funding and other cash management. The bank is not required to pre-notify the Authority if such exposures exceed the 25% limit. The maximum exposure that can be incurred is limited to 200% of the bank's LECB (where a risk weighting of 20% applies) or 100% of the bank's LECBB (where a risk weighting of 50% applies). Irrespective of these limits an exposure cannot exceed £100m (unless the requirements set in the Rule Book have been modified).

In relation to the limits explained 5.3.1 and 5.3.2 above, the maximum exposure to any one individual counterparty or group of closely related counterparties cannot exceed 500% of the bank's LECB, or £100m, whichever is the lower (unless the requirements set in Rule Book have been modified).

5.3.3 ***Exposures to central governments (including PSEs), central banks, international organisations or multilateral development banks which receive (unsecured) a 0% risk weighting under the standardised approach***. If the bank proposes to exceed the 25% limit, the Authority should be given prior notification in writing of at least 2 business days. If the Authority does not agree with the proposed course of action, it may issue a Direction.

5.3.4 ***Exposures carrying the explicit guarantees of central governments (including PSEs), central banks, international organisations or multilateral development banks where unsecured claims on the entity providing the guarantee would receive a 0% risk weighting under the standardised approach.*** This may also include an exposure guaranteed by a country's export credit agency (or equivalent) provided the Authority has notified the bank that it is satisfied that the bank has sufficient expertise and systems in place to ensure that the terms of the guarantee are met fully. If the bank proposes to exceed the 25% limit, the Authority should be given prior notification in writing of at least 2 business days. If the Authority does not agree with the proposed course of action, it may issue a Direction. The following points must be considered in relation to exposures guaranteed by securities:

(a) While the Authority takes such security into account when considering the acceptability of a bank's exposure up to 25% of LECB, the presence of security on its own generally is not considered by the Authority to be an acceptable reason for an exposure to exceed 25%

(b) The exposure is only exempt to the proportion that is fully covered by the securities and where the bank has a full right of set-off over the central government or central bank securities

(c) The exposure may be fully or partially collateralised and the lender's legal title should be fully protected. There should also be an appropriate margin to cover possible currency fluctuation if the collateral is in a different currency to the exposure; in the case of securities, the margin should also cover any fall in their market value from the start of the loan

(d) A bank should take legal advice in all relevant jurisdictions, generally from an external legal advisor

(e) A similar treatment may be applied in the case of certain exposures that are partially guaranteed (e.g. by Export Credit Guaranteed Department), where the element of the exposure that is guaranteed can be viewed as an exposure to the guarantor.

5.3.5 ***Exposures to central banks (not in 5.3.3 above) which are in the form of required minimum reserves or statutory liquidity requirements held at those central banks*** which are denominated in national currency and funded by liabilities in the same currency. If the bank proposes to exceed the 25% limit, the Authority should be given prior notification in writing of at least 2 business days. If the Authority does not agree with the proposed course of action, it may issue a Direction.

5.3.6 ***Exposures secured by collateral in the form of cash deposits (including CDs issued by the lending bank held by the lender).*** If the bank proposes to exceed the 25% limit the Authority should be given prior notification in writing of at least 2 business days. If the Authority does not agree with the proposed course of action, it may issue a Direction. The following points must be considered:

(a) A single such exposure (before taking the collateral into account) will be limited to a maximum of 100% of LECB

(b) While the Authority takes such security into account when considering the acceptability of a bank's exposure up to 25% of LECB, the presence of security on its own generally is not considered by the Authority to be an acceptable reason for an exposure to exceed 25%

(c) The exposure is only exempt to the proportion that is fully covered by the cash and where the bank has a full right of set-off over the cash

(d) The exposure may be fully or partially collateralised and the lender's legal title should be fully protected. There should also be an appropriate margin to cover possible currency fluctuation if the collateral is in a different currency to the exposure

(e) A bank should take legal advice in all relevant jurisdictions, generally from an external legal advisor.

5.3.7 ***Exposures to other group companies***

In certain cases the Authority may agree that it is appropriate for a bank to have (an) exposure(s) over 25% of LECB to another credit institution within the same group. In all cases before entering into the initial arrangement, the bank must obtain the prior consent of the Authority. On an ongoing basis, at least annually, the bank must assess the level and nature of the exempt exposure and provide evidence of that assessment to the Authority.

The maximum exposure that will be permitted is the equivalent of up to 100% of deposit liabilities plus capital surplus to regulatory requirements.

The following ***minimum*** criteria apply as specified in the Rule Book, and the absence of any of these would result in the exposure being limited to 25% of LECB:-

(a) the group company is the parent, or a wholly owned subsidiary of the parent

(b) the group company is managing surplus liquidity across the group or takes on a treasury role on behalf of the group

(c) both the group company and the bank are included within the scope of consolidated supervision for the group by a competent authority

(d) there is no current or foreseen material practical or legal impediment to the repayment of liabilities from the group company to the bank.

In order for the Authority to be able to consider giving consent to a bank to incur an exposure above 25% of LECB to its parent / group company, meeting the minimum criteria specified above, a bank must assess the level and nature of the exempt exposure and provide evidence of the assessment to the Authority. As specified in the Rule Book this assessment must be undertaken at least annually. The assessment can be submitted as part of an ICAAP, large exposures / liquidity policy annex, or as a separate document.

The Authority considers that, for a bank to adequately assess such exposures, it should take into account the factors specified in ***appendix 2***.

The Authority considers it is prudent for all banks that incur large intra-group exposures to put in place documented contingency plans to articulate measures that would be taken if the parent / group to which they have a material exposure becomes under stress.

A plan that is agreed by the local board, the group, and the Authority would help to better manage a situation if a stress subsequently materialises, rather than trying to put together arrangements once a stress event has occurred. It may also be useful for banks to consider alternatives to their current up-streaming arrangements in case of legislative change outside the Island that could impact on intra-group funding in the future (for example the treatment of intra-group flows in resolution arrangements, ranking in insolvency, funding limits in the home state, liquidity treatment). The framework for each bank will be agreed with the Authority as part of considering ongoing consent. Matters which the Authority would expect to be included in an intra-group large exposure contingency plan are specified in ***appendix 2a***.

The Authority will review a bank's assessment submitted to it and will assess the proposed level and nature of the exposure(s). In undertaking this assessment the Authority will take into account the criteria specified in ***appendix 3***.

If consent is provided the annual assessment is still required to be submitted to the Authority for review and an internal decision will be made in relation to consent being allowed to continue. This does not mean that formal written consent will be required annually but the Authority has the right to withdraw or modify the consent it has previously granted, either as part of its annual review process or at any other time.

The Authority may wish to formalise its consent or otherwise through issuing a direction to a bank.

5.3.8 ***Exposures with parental guarantees***

A bank may undertake exposures of any maturity in excess of 25% of LECB to unconnected customers/counterparties if there is a suitable guarantee in place. The bank should give the Authority at least 2 business days' prior notification in writing if they wish to enter into such exposures. If the Authority does not agree with the proposed course of action, it may issue a Direction. The following conditions must be met:-

(a) The bank's group is subject to regulation of an equivalent standard to that of the Isle of Man

(b) The guarantee is from a group company which is the parent, or a wholly owned subsidiary of the parent, and which must be a credit institution

(c) The total exposure to a counterparty or group of connected clients does not exceed 100% of the LECB

(d) The total aggregated exposure to all counterparties under such guarantees is considered alongside exposures to group companies under 5.3.7 above

(e) The exposures are entered into within the terms of a policy agreed by the group credit institution:-

(i) The Authority may request written confirmation from the group credit institution that the exposure is retained in the subsidiary's balance sheet at the group credit institution's request in order to meet group objectives. The Authority may also need to be satisfied as to the nature of the exposure concerned

(ii) This policy recognises that there can often be a sound reason for certain commercial business to be booked in one part of a banking group, e.g. an on-going client relationship

(iii) A suitable guarantee is either a *parental guarantee* or a *capital maintenance agreement*

(iv) Any guarantee arrangement should be legally enforceable by the subsidiary, since its purpose is to prevent the subsidiary bank's capital from becoming deficient if a loss is incurred on the exposure

(v) It may be necessary to ask for evidence that the guarantee is enforceable, for example, an external legal opinion.

(f) The group credit institution should ensure that its Home Regulator is aware of, and has no objection to, what is proposed when such an exposure is being considered. The Authority may request a written confirmation from the Home Regulator, including confirmation that the group is subject to consolidated supervision

(g) In some instances the Authority may require the guarantor credit institution to deposit monies with the bank in support of the parental guarantee

(h) An individual exposure covered by the guarantee cannot exceed 10% of the guarantor's regulatory capital base. The aggregate of all individual exposures covered by the guarantee must never exceed 25% of the guarantor's regulatory capital base

(i) Only those capital maintenance agreements in which the guarantor credit institution gives an undertaking to ensure that the bank will not be in breach of its large exposures requirements will be acceptable.

5.3.9 ***Exposures arising from undrawn credit facilities which may be cancelled unconditionally at any time without notice.*** The bank should give the Authority at least 2 business days' prior notification in writing if they wish to enter into such exposures. If the Authority does not agree with the proposed course of action, it may issue a Direction. Such exposures may only exceed 25% of a bank's LECB if an agreement has been concluded with the counterparty under which the facility may be drawn only if such drawing will not cause the standard limit of 25% of a bank's LECB to be exceeded.

5.3.10 ***Exposures to overseas countries and economic sectors***

Exposures to overseas countries and economic sectors that exceed 25% of the LECB are not covered by the pre-notification requirements. However, where a proposed transaction will result in an exposure which represents a significant departure from the bank's large exposures policy statement, the Authority expects the proposed transaction to be notified in advance and discussed with the Authority.

The Authority may request information on such exposures and discuss with the bank as required.

6. Large Exposure Limits & Notification Requirements

6.1 A bank must report all exposures equalling or exceeding 10% of its LECB, including exempt exposures, on a quarterly basis on form SR-2B. A bank must also report its ten largest exposures to non-banks and credit institutions, if there are less than 10 such exposures that exceed 10% of LECB. A bank should not adopt a policy that will lead to 10% being exceeded as a matter of course.

6.2 A bank should notify the Authority of all large exposures at the time when the exposure is incurred by the submission of a Large Exposures Card. Large exposure cards are not required to be submitted in respect of exposures to other credit institutions as part of a bank's normal treasury book. An updated Large Exposure Card should be submitted whenever there is a change in the facility and at least annually when there has been no change.

6.3 A bank must pre-notify the Authority of any exposure exceeding 25% of LECB before becoming committed to the transaction, apart from those as detailed in section 5.3.1 and 5.3.2. Exposures detailed in section 5.3.7 require the Authority's prior consent. The Authority normally expects to be informed of any such plans at least 2 business days in advance to allow time for discussion of the issues involved; longer notice should be given if a bank believes that a case is likely to raise complex or difficult issues.

6.4 A bank should notify the Authority immediately of any breach of the 25% limit.

6.5 The limited circumstances in which a bank may exceed the 25% limit are set out in 5.3 above. As indicated above, in all instances except two, pre-notification or consent is required.

6.6 If a bank has a number of large exposures and their aggregate, excluding exempt exposures, exceeds 100% of LECB, the Authority may consider whether the bank's capital ratio should be increased.

Factors the Authority will consider are

- Consistency with the bank's large exposures policy statement
- The number of exposures, their individual size and nature
- The characteristics of the bank including the nature of its business and the experience of its management.

6.7 Should a bank wish the aggregate of its large exposures, excluding exempt exposures, to exceed 300% of its LECB, it must provide the Authority with adequate prior notification in writing.

6.8 A bank should limit the total of its large exposures, other than its exempt exposures, to a maximum of 800% of its LECB. This is an explicit ("hard") limit and must not be breached.

6.9 Any breach of the 800% limit should be notified immediately to the Authority.

6.10 The Authority does not condone the practice of "top slicing". Top slicing is the practice:-

- By which a bank systematically collateralises only the element of its exposure that exceeds the 25% limit to bring it within the limit, or collateralises just more than the element of an exposure that equals or exceeds 10% of the bank's large exposures capital base in order to bring the sum below the clustering limit; and/or

- By which a bank systematically uses a parental guarantee for the element of its exposure that exceeds the 25% limit to bring it within the limit or uses a parental guarantee for the element of an exposure that equals or exceeds 10% of the bank's large exposures capital base in order to bring the sum below the clustering limit.

The Authority takes such activity into account when assessing a bank's individual capital ratio(s) accordingly.

7. Large Exposures Policy Statement

7.1 The bank must provide the Authority with a copy of its large exposures policy statement ("the Statement"). The Statement must be reviewed at least

annually by the Board and any significant changes should be provided to the Authority within 20 business days of the Board's approval of the changes.

7.2 The bank should confirm within four months of its year end that it has reviewed the Statement during the year and that the Statement has been assessed as being up to date and appropriate. This confirmation should be made via the Annual Regulatory Return.

7.3 The Statement should take into account limits and exposures incurred under the bank's other risk management policies.

7.4 The detail contained in the Statement will depend on the type of bank and the nature of its business but it must address the following areas:

7.4.1 ***Exposure limits***

- Exposure limits for different types of customers
- Exposure limits to be considered separately for exposures up to one year, exposures over one year and exposures to governments
- Policy towards related and connected exposures including intra-group exposures
- Clustering – the number and value of non-exempt large exposures that may exist at any one time
- Approach to lending to individual economic sectors
- Approach to sovereign lending
- Country exposure limits
- Economic sector exposure limits.

7.4.2 ***Authorisation***

- Circumstances in which the above limits may be exceeded
- Approvals required for any breach of the limits
- Sanctioning limits for individuals
- Exposure approval procedures (evaluation of customer/counterparty, nature and extent of security for exposure, maturity of exposure, bank's expertise in this type of transaction, bank's relationship with customer/counterparty).

7.4.3 ***Security***

- Differentiation between secured and unsecured exposures, together with any definitions necessary on permissible forms of security.

7.4.4 ***Guarantees***

- Procedures for guarantees
- Credit approval process for exposure to a guarantor.

7.4.5 ***Monitoring & control***

- Procedures and systems for reviewing, monitoring and controlling exposures
- These should include the composition and terms of reference of the main credit committee, delegated authority and the nature and frequency of the bank's review and monitoring procedures, including exception reports
- Procedures should detail how the bank monitors its large exposures relative to the LECB and ensures that limits are not exceeded.

7.4.6 ***Regulatory reporting to the Authority***

- Allocation of responsibility for reporting large exposures and any breaches to the Authority.

8. Measurement & Control

A bank must implement the necessary control systems to enable it to monitor exposures on a daily basis and ensure adherence to its policy on large exposures.

9. Additional Capital Requirements

The Authority may require a bank to maintain higher capital ratios than would otherwise be the case when it considers it to be exposed to particular concentrations of risk. Where a bank's total non-exempt large exposures exceed 100% of its LECB, the Authority will consider if such measures are necessary.

Part 2 – Deposit takers operating in or from the Isle of Man which are incorporated outside the Isle of Man ("branches")

1. Rationale/Introduction

1.1 This guidance applies to deposit takers holding either a Class 1(1) or Class 1(2) licence, jointly referred to in this document as both 'deposit takers' and 'banks'.

1.2 Excessive exposure to a single customer/counterparty or to a group of closely related customers/counterparties is a significant risk incurred by banks.

1.3 Where excessive concentrations exist, it is important that a bank fully understands the resultant risks and that these are in line with the bank's strategic appetite for risk and mitigated as far as possible.

1.4 The Authority's approach to Large Exposures is based on Principle 10 of the Basel Core Principles for Effective Banking Supervision. This states that "Banking supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties".

2. Main Features of the Authority's Approach

2.1 A branch is required to report as at each calendar quarter-end the ten largest exposures to credit and non-credit institutions relating to its operations on the Isle of Man. Such reporting should be on form SR-2B and within 1 month of the reporting date.

2.2 It is appreciated that Head Office will normally formulate a Large Exposures policy that will include the operations of the Isle of Man branch. It is, however, expected that the branch will have and comply with documented controls and procedures in accordance with that policy.

3. Definition of Exposure

3.1 An exposure is the maximum loss a bank might suffer if a customer/counterparty or a group of closely related customers/counterparties fails to meet its obligations, or the maximum loss that might be experienced as a result of the bank realising assets or off-balance sheet positions.

3.2 A bank should calculate an exposure as the gross amount at risk arising from:

(a) claims on a customer/counterparty or group of closely related customers/counterparties including actual and potential claims that

would arise from the drawing down in full of undrawn advised facilities (revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide, and claims that the bank has committed itself to purchase or underwrite. Typically these will be in the form of:

- Loans, advances, overdrafts
- Finance leases, less deferred tax
- Discounted bills held outright
- Bonds, acceptances, promissory notes, loan stocks & other paper held outright
- Margin held with investment exchanges, clearing houses or other customers/counterparties
- OTC futures (including forwards), options, swaps & similar contracts on interest rates, foreign currencies, equities, securities & commodities
- Claims arising in the course of settlement of marketable securities and investments
- Claims arising in the case of forward sales and purchases of marketable securities and investments that either settle on a date beyond the market norm for that instrument or where the payment due is deferred until some future date
- Any commitment with a certain or uncertain drawdown entered into by the bank. This includes amounts outstanding under:
    - Repos and Reverse Repos
    - Forward asset purchase agreement
    - Buy back agreement
    - Forward deposit placed (i.e. where a credit institution contracts to make a deposit with another party on a future date at a pre-determined rate)
    - Unpaid part of partly paid shares
- Any other claims arising from similar transactions entered into by the bank.

Exclusions are as follows:-

- Claims and other assets already deducted from capital base for capital adequacy and large exposures purposes
- In the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the 5 business days following payment or delivery of the securities, whichever is the earlier
- In the case of foreign currency transactions, exposures incurred in the ordinary course of settlement during the two business days following payment
- In the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments

clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day

- In the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services
- Customer/counterparty risk on futures & options contracts where the contracts are traded on an exchange and are subject to daily margining requirements. However, except where contracts relate to a broadly based cash settled index, issuer risk on any underlying bonds/equities should be included, the value of the contracts depending on the issuer's financial soundness.

(b) contingent liabilities arising in the normal course of business, and those contingent liabilities that would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) that the bank has committed itself to provide. This includes amounts outstanding under:-

- Direct credit substitutes (including guarantees, standby letters of credit serving as financial guarantees, bills accepted but not held by the bank, per aval endorsements and equivalent endorsements)
- Claims sold with recourse where credit remains with the bank
- Transaction related contingent items not having the character of direct credit substitutes (including performance bonds, bid bonds, warranties, standby letter of credit relating to particular transactions, retention money guarantees, import and export excise duty bonds, VAT bonds)
- Undrawn documentary letters of credit issued or confirmed
- Those arising from similar transactions entered into by the bank.

Exclusions are as follows:-

- Indemnities for lost share certificates and export/import carnets
- Bill endorsements on bills already endorsed by another credit institution
- Contingent liabilities resulting from injuries, damage or loss suffered by third parties and caused by goods where the bank acts as lessor, mortgagee or owner of goods under a hire-purchase agreement.

(c) Assets, including assets that the bank has committed itself to purchase or underwrite, whose value depends wholly or mainly on a customer/counterparty performing its obligations, or whose value

otherwise depends on that customer/counterparty's financial soundness but that do not represent a claim on the customer/counterparty. This includes equities, equity warrants and options that do not represent a claim on the issuer but whose value depends, principally, on the issuer's financial soundness.

3.3 ***Guaranteed exposures***

Where a third party has provided an explicit unconditional irrevocable guarantee (in relation to an exposure to a counterparty), the branch may be permitted to report the exposure as being to the guarantor, provided that the unsecured exposure to the guarantor would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the counterparty under the standardised approach to credit risk. In this case, it is expected that such situations would be addressed in the bank's Large Exposures policy statement with which the branch is expected to comply. The Authority expects the branch to apply its credit approval procedures to the guarantor and to the terms of the guarantee.

3.4 ***Netting***

The Authority would not expect the branch to calculate the size of its exposure to a customer/counterparty by netting its various claims and obligations relating to that customer/counterparty unless there is a legally enforceable contract which provides a right of set-off and this has been agreed in writing with the Authority. It is expected that the bank's Large Exposures policy (with which the branch should comply) would address such situations.

4. Definition of Customers/Counterparties

4.1 A customer/counterparty is any party on which a bank, directly or indirectly, has a claim.

4.2 An individual customer/counterparty comprises natural and legal persons and includes government, local authorities, public sector entities, credit institutions, individual trusts, corporations, unincorporated businesses (whether sole traders or partnerships) and non-profit making bodies.

4.3 ***Identity of a customer/counterparty***

The identity of a customer/counterparty will generally be one of the following:

(a) The borrower (customer)

(b) The person whose obligations the bank is guaranteeing (where the bank is providing such a guarantee)

(c) In the case of a derivatives contract, the party with whom the contract was made or

(d) In the case of a security held, the issuer of the security. There are a number of non-straightforward cases:

(i) Where bills are held by a bank that have been accepted by another credit institution, the claim should be reported (if booked in the branch) as on that other credit institution;

(ii) Where per aval endorsements on bills are held by a bank, the claim should be reported (if booked in the branch) as a claim of over one year's maturity on the avalising credit institution;

(iii) Where a bank is funding the activities of a company that trades on an exchange (whether for that company's own account or on behalf of clients), the full amount of such funding should be reported (if booked in the branch) as an exposure to that company unless an alternative reporting method has been agreed with the Authority in writing; and

(iv) If a third party has provided an explicit unconditional irrevocable guarantee, a branch may report the exposure as being to the guarantor if the Large Exposures policy statement (with which the branch should comply) includes a section on guaranteed exposures to that effect.

4.4 ***A group of closely related customers/counterparties***

A group of closely related customers/counterparties exists either where:

(a) Unless it can be shown otherwise, two or more individual customers/counterparties constitute a single risk because one of them has, directly or indirectly, control over the other(s) or

(b) Individual customers/counterparties are related in such a way that the financial soundness of any of them may affect the financial soundness of the other(s) or the same factors may affect the financial soundness of both or all of them. Relationships between individual customers/counterparties that might give rise to common risks include group undertakings, companies whose ultimate owner is the same and that do not have a formal structure, companies having common directors or management and customers/counterparties linked by cross guarantees.

4.5 ***Connected customers/counterparties***

Exposures to companies or persons connected to the bank, its senior management (as interpreted in the Rule Book), key persons, directors or

controllers require special care to ensure that a proper credit risk assessment is undertaken. This is due to possible contagion and the risk that the consideration of proposed loans to customers/counterparties connected to the bank may be obscured by subjective considerations. Such exposures may be justified only when there is a clear commercial advantage for the lending bank (in this case the branch) and when they are negotiated and agreed on an arm's length basis.

4.5.1 Factors to take into account when considering whether an exposure has been agreed on an arm's length basis are:

(a) The extent to which shareholders can influence a bank's operations, for example, through voting rights

(b) The management role of shareholders where they are also, for example, directors, and

(c) Whether the loan would be subject to the bank's usual monitoring and recovery procedures if repayment difficulties emerged.

4.5.2 Staff loans other than to senior management (as interpreted in the Rule Book), key persons, controllers or directors are not normally treated as connected.

4.5.3 Parties connected to a bank comprise:

(a) Group undertakings

Group undertakings include subsidiaries and related companies.

A 'related company' in relation to a bank or the parent of a bank, means a body corporate (other than a subsidiary undertaking) in which the bank or parent undertaking holds a qualifying capital interest.

A qualifying capital interest means an interest in relevant shares of the body corporate that the bank or the parent undertaking holds on a long-term basis for the purpose of securing a contribution to its own activities by the exercise of control or influence arising from that interest.

Relevant shares means shares comprised in the equity share capital of the body corporate of a class carrying rights to vote in all circumstances at general meetings of that body.

A holding of 20% or more of nominal value of the relevant shares of a body corporate should be presumed to be a qualifying interest unless the contrary is shown.

(b) Associated Companies (as defined in the Rule Book)

(c) Directors, controllers and their associates (as defined in the Financial Services Act 2008)

(d) Non-group companies with which the bank's directors and controllers are associated. A director (including an alternate director) and / or controller of a bank is deemed to be associated with another company in the following circumstances:

(i) he holds the position of director in his own right, or

(ii) as a result of a loan granted by the bank to a company and which is not made on an arm's length basis, or

(iii) as a result of a financial interest taken by the bank in that company, or

(iv) by virtue of a professional interest unconnected with the bank, or

(v) he and/or his associates together hold 20% or more of the equity share capital of that company.

4.6 ***Lending to investment trusts, unit trusts, OEICs and venture funds managed within banking groups***

Where a bank has exposures (booked in the branch) to funds managed within the same banking group or exposures to several different funds managed within the same third party group, it must examine each case carefully to assess whether the funds need to be treated as related or connected exposures (respectively).

4.6.1 The following points should be considered when assessing whether an exposure to the fund should be treated as a connected exposure, or whether exposure to several different funds within the same third party group should be treated as a related exposure:

(a) Whether the beneficial owners of the fund, i.e. the shareholders, are connected to the bank and/or related to other funds managed within its group

(b) The degree of independence of control of the fund, for example, the composition of the fund's board and its relation to the bank and/or other funds

(c) Whether the fund is subject to any other relevant statutory or regulatory requirements controlling independence and quality of management and systems and controls, and whether, as far as can reasonably be ascertained from publicly available information, it is

meeting these requirements to the satisfaction of the relevant regulatory bodies

(d) Whether the fund has an audit committee and is subject to internal and external audit

(e) Whether the loan is made on an arm's length basis

(f) Whether the bank has the necessary systems and controls to monitor the above criteria on an on-going basis.

4.6.2 Even where a bank can satisfy itself that such funds do not need to be treated as either a connected customer/counterparty or as a related exposure, there remains some aggregate risk.

For example, where a bank lends to several funds within its own group or within a third party group, there remains the risk that a run on fund A will prompt runs on funds B and C where all three are managed within the same group, thereby conceivably precipitating problems for the bank.

5. Regulatory reporting to the Authority

The branch should ensure that responsibility for reporting the ten largest exposures to credit and non-credit institutions to the Authority is clearly allocated.

6. Measurement & Control

6.1 A branch must implement the necessary control systems to enable it to monitor exposures on a daily basis and ensure adherence to the bank's policy on large exposures (with which the branch is expected to comply).

6.2 The branch's controls and procedures should ensure compliance with the relevant legislation.

Appendix 1 – Glossary

"bank" is the Isle of Man incorporated deposit taker (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

"branch" means a branch in the Isle of Man of a deposit taker incorporated outside the Isle of Man.

"capital maintenance agreement" is a legally enforceable undertaking by the guarantor credit institution to provide a sufficient amount of capital of the appropriate kind to restore the Isle of Man subsidiary bank's capital ratio to above its minimum target level if exposures covered by the agreement subsequently become non-performing.

"credit institution" is another bank or building society to which the bank has an exposure.

"exempt exposure" is interpreted in accordance with the Rule Book.

"large exposures capital base" ("LECB") is interpreted in accordance with the Rule Book.

"ICAAP" is interpreted in accordance with the Rule Book.

"parental guarantee" is a legally enforceable undertaking from the parent credit institution, or another credit institution in the group acceptable to the Authority. Where a parental guarantee is in place, the Authority recognises the risk transfer to the guarantor credit institution.

NB. Further guidance on when a claim on the Isle of Man Government may be treated as zero risk weighted and therefore also exempt for large exposure purposes is provided in Annex B to chapters 3 and 4 of the Authority's guidance note on quarterly prudential returns.

Appendix 2 – factors for banks to consider when assessing the proposed level and nature of intra-group exposures

Banks should consider the following factors where relevant and appropriate to the proposed size and nature of the intra-group exposure:-

(a) the extent to which the parent / group is likely to have / has access to central bank funding

(b) in relation to the entity or entities on which it relies for liquidity support, the legal and regulatory regime to which that entity or entities is subject (in particular re liquidity regulation)

(c) the contractual arrangements governing any agreed forms of intra-group liquidity support (including committed funding lines) which should include an assessment of the ability of the counterparty to repay its liabilities to the bank in the Isle of Man, including under times of stress

(d) obligations (of the parent / group) to transfer liquidity resources to other parts of its group

(e) the standing of the parent bank in its local domestic market place (including its importance to the system of banking in that market, for example retail banking)

(f) the economic conditions of the home jurisdiction of the parent bank / group

(g) the level of liquidity resources held centrally

(h) the asset quality and financial position of the parent bank / group, having regard to external credit ratings

(i) the terms of the pricing structure in place in relation to the intra-group loan, including consideration of risk versus reward

(j) the actual amount, or availability or otherwise, of appropriate collateral / security in respect of the whole, or part, of the exposure (commentary should be provided even if the bank considers that it is satisfied to incur an unsecured exposure, taking into account the position of the bank as per point k below)

(k) the standing of the Isle of Man bank's claim on its parent bank / group in the event of a resolution or insolvency situation (e.g. creditor preference and priority), details of the levels of asset encumbrance / secured funding taken at the parent bank level, and how the bank in the Isle of Man fits, or would fit, into any group resolution plans[1]

[1] The Authority understands that this is an area of international policy that continues to be developed.

(l) contingency arrangements in place for the bank in the Isle of Man in the event of it having a liquidity shortage.

Appendix 2a – intra-group large exposure contingency plan

Matters which the Authority would expect to be included in an intra-group large exposure contingency plan:

- Trigger events (and early warning signs) that would correspond to the bank having to take documented steps to reduce its net exposure to the parent / group.

- Articulation of the steps required to be taken when different trigger events occur (for example this may range from an initial discussion at committee level or similar to consider the current position, to formal action to reduce the exposure to the parent / group at different levels, such as a 20%, 50% and 100% reduction).

- Articulation of the event(s) when full disengagement (100%) from parent / group (or full protection for the exposure) would occur.

- For actions that would result in a reduction in the exposure to parent / group, what the proposed options would be; for example the repayment of part or all of the intra-group loan (and resultant holding of third party assets) and / or security for the loan of sufficient quality.

- Operational issues and barriers that may exist and how these would be overcome (for example group limits on third party counterparty exposures, legal certainty for any collateral / security arrangements, reliance on group treasury functions, tenor of current intra-group loan arrangements).

- The governance process in place in relation to decision making (e.g. committees / personnel / board involvement).

- Interaction with group in the event that actions would be required.

- Consideration of how group recovery plans and resolution plans in the home state would address unsecured intra-group funding, and also how any mitigating steps (above) could impact on those plans. It is noted that the current position may not be clear, and if so, this should be highlighted.

The requirement for banks to put in place an agreed contingency plan is to ensure that there is a clear strategy to deal with defined stress events, whether that be at the bank level or because of future legislative change outside the Island that could negatively impact on intra-group arrangements without mitigating actions.

Appendix 3 – criteria that the Authority will consider in reviewing a bank's assessment of the proposed intra-group exposure

The Authority considers that banks operating in the Island can be broadly categorised into three groups:

- those which are part of large groups that are themselves of systemic importance in their home country and to which the Isle of Man bank is intrinsically linked (e.g. a clearing group) (***category 1***)
- those which form an intrinsic part of a group's deposit raising activities (where the source of deposits in the Isle of Man is retail / corporate and the bank is of a material size), and in such cases the Isle of Man bank may be the only, or one of only a small number of, overseas entities (***category 2***)
- other banks including smaller private banks, and those that are part of groups which are not normally of systemic importance and / or the Isle of Man bank is not intrinsically linked (i.e. could be separated operationally from the parent / group) (***category 3***).

For the avoidance of doubt category 1 includes groups which are classified as G-SIFIs[2] and which may also be classified as D-SIFIs[3] as supervisory practice develops. Category 2 could also include parent banks that may be classified as D-SIFIs.

In assessing the case for a bank to incur a significant large exposure (normally relating to liquidity and funding) to its parent / group the Authority may provide its consent provided that certain criteria are (normally) met. These criteria are designed to ensure that there is sufficient support for a bank in the Isle of Man, and to demonstrate that the parent / group can meet its obligations to the subsidiary under the intra-group arrangement and in times of stress.

An intra-group exposure will also be considered taking into account which of the three broad categories the bank fits into using the following methodology:-

- Category 1: intra-group exposures will be permitted of up to 100% of deposit liabilities plus capital surplus to regulatory requirements, on the assumption that the parent / group remains of sufficient standing and the exposure is to an acceptable bank in the group. The exposure could be unsecured, although if the parent (and / or group) subsequently develops signs of stress additional protection may be considered such as a more diversified asset base and / or collateral for part or all of the exposure. Further, if the home supervisor is unable to provide the appropriate confirmations to the Authority, additional protection may need to be sought.
- Category 2: if the parent bank is classified as a D-SIFI the same approach as per category 1 may be permitted. Otherwise, the Authority will expect a lower level of (net) intra-group exposures to be incurred at the outset, or collateral to be provided for part or all of the exposure.

[2] Global systemically important financial institutions
[3] Domestic systemically important financial institutions

- Category 3: intra-group exposures will be limited to either less than 25% of capital or to levels considered appropriate based on the parent bank strength, size and standing, and practical operational arrangements that may be required. The nature of the customer base will also be taken into account.

Where banks are permitted to incur significant large unsecured intra-group exposures (being those primarily in categories 1 and 2 above) but the parent / group subsequently moves to being under financial stress, the Authority will seek to engage with the bank to consider whether the current arrangements remain appropriate. Depending on how the intra-group claim would be treated in a restructure / resolution / insolvency, and taking into account how the subsidiary fits, or would fit, into a group resolution process, escalating measures to protect depositors and mitigate the concentrated single exposure may be needed. As part of this process the Authority would also consult with the supervisor and, where relevant, the resolution authority, of the parent / group. These measures could include the following, depending on the severity of the situation:-

- Removal or reduction in permitted behavioural adjustments to deposits (if used), resulting in requirements to hold a higher proportion of amounts due from parent / group on shorter term (or a pool of independent high quality liquidity assets as a buffer);
- Requiring the intra-group loan to be secured / collateralised using assets of appropriate quality, with valuation haircuts to be applied;
- Requiring repayment of part, or all, of the intra-group loan over a period of time (depending on the maturity of the loan), with assets then being held independently.

The criteria that should normally be met are:-

- that the amount and availability of liquidity (and longer term) support required to support the liabilities of the bank in the Isle of Man is adequate having regard to the total liquidity resources of the parent / group entity on which it is proposed reliance should be placed
- that the parent / group entity to which the exposure is should be subject to an adequate regime of regulation (and consolidated supervision), including that for liquidity
- that there is clarity as to any legal constraints imposed by the authority which regulates the parent / group entity for liquidity purposes on the availability and provision of liquidity from that parent / group to the bank in the Isle of Man
- that the bank in the Isle of Man is not the only source, or the main material source, of retail deposits within the group or sub group
- that the past and proposed flows of funds between the counterparty and the bank in the Isle of Man demonstrate the ability of the counterparty to repay its liabilities on a timely basis to the bank in the Isle of Man
- that the method of transfer of funds from the counterparty to the bank in the Isle of Man is simple and can be made promptly when required
- that the legal structure and purpose of the counterparty does not prejudice the ability of the counterparty to repay its liabilities to the bank in the Isle of Man.

Home / host regulatory relationships

The Authority will seek confirmations, at least annually, from the regulatory authority that undertakes prudential supervision of the counterparty bank that:-

- it will notify the Authority of any material or persistent breaches by the parent / group entity of that authority's liquidity rules, or of risks if such breaches are imminent
- it is satisfied with the adequacy of the parent / group entity's arrangements for capital adequacy and liquidity risk management
- it is satisfied as to the adequacy of the parent / group entity's liquidity resources and liquidity contingency arrangements (including how these relate to the bank in the Isle of Man, if applicable)
- it recognises the contractual intra-group arrangement in place between the bank in the Isle of Man and the counterparty bank (parent / group)
- it does not object to any undertakings given by the parent / group entity in respect of the bank in the Isle of Man (for example including any relating to the provision of liquidity support that may be required outside of contractual intra-group terms).

In relation to the above the Authority may also provide the regulatory authority with a summary of the bank's intra-group exposures, liquidity arrangements (including behavioural adjustments to deposits), capital adequacy and other relevant matters.

Undertakings from the counterparty (parent / group) bank

The Authority may also require an undertaking to be provided to the bank in the Isle of Man by the counterparty (parent / group) bank. This undertaking should state that the counterparty bank will make available to the bank in the Isle of Man information regarding its capital adequacy, liquidity profile and arrangements, and such other information as may be requested by the bank in the Isle of Man to enable it to conduct a regular review of the counterparty bank's financial standing. Other information in this respect could include copies of detailed credit rating agency reports. Confirmation should also be provided within such an undertaking that the information may be provided to the Authority as part of the review.

APPENDIX 4 – LARGE EXPOSURE CARD

Name of Licenceholder _____ **LECB £**_____

Date Card Submitted_____ **New / Renewal** _____ **Loan Ref** _____

Facility £[4] _____ **Current exposure £** _____ **LTV** ____ **%** **Currency** _____

Interest Rate _____ **Current/Rolled** _____ **Related Party** _____

Term of Facility_____

Source of Repayment _____

Other Loans to the Same Borrower: (Ref/Amount) _____

Customer_____

Beneficial Owner _____

Security _____

_____

Purpose of Loan _____

Loan History_____

_____

[4] This should be the maximum amount that has been agreed in the sanctioning process. If in currency this should be converted to sterling for assessment of the LECB (If security is in a different currency to the exposure a suitable margin should be maintained)