

Response to feedback received
Single Counterparty Exposure Limit (SCEL)

Introduction

The Bank, on 28 February 2013, issued the policy on Single Counterparty Exposure Limit for commercial, investment and Islamic banks, taking into account comments from industry focus group discussions, as well as written feedback received during the consultation process following the issuance of the Concept Paper in February 2012.

The Bank received responses from individual banking institutions as well as the consolidated industry responses from the Association of Banks in Malaysia and the Malaysian Investment Banking Association indicating broad support for the proposals while highlighting the importance of giving due consideration to the practical challenges in the implementation of the policy. Key comments received during the consultation period and the Bank's responses are set out in this document.

Bank Negara Malaysia
5 April 2013

1. Compliance of the SCEL at the consolidated level

- 1.1. The Concept Paper proposed that the SCEL continue to be applied at the consolidated level, in addition to compliance at an entity level. Computation at the consolidated level is essential to ensure exposures taken by a banking institution's financial subsidiaries are also aggregated to safeguard against banking institution's total risk to a single counterparty. The application of SCEL on entity and consolidated basis is consistent with international practices, and is in line with the expectations in the Core Principles for Effective Banking Supervision¹ issued by the Basel Committee on Banking Supervision.
- 1.2. A number of banking institutions highlighted the difficulty to apply SCEL on a consolidated basis as certain jurisdictions impose legal restriction which prohibits overseas subsidiaries or branches from sharing customer data with the parent bank in Malaysia, unless consent is granted by their customers.
- 1.3. The Bank recognises these operational constraints and where relevant, will work to resolve these issues through engagements with the relevant regulatory bodies. As an interim measure, banking institutions are expected to adopt appropriate internal policies to facilitate compliance including providing in loan agreements for borrowers to give consent for sharing of information for regulatory purposes.

2. Prudential Limits

a. Single Counterparty Exposure Limit

- 2.1. Some banking institutions suggested that the additional 10% SCEL for investment in private debt securities should be retained to facilitate banking institutions' role as capital market intermediaries and support the development of the domestic bond market.

¹ The *Core Principles for Effective Banking Supervision* are the *de facto* minimum standard for sound prudential regulation and supervision of banks and banking systems.

2.2. The domestic financial system has developed significantly over the past decade both in terms of the size and diversity of its participants, and the investor base. The series of successful corporate finance exercises and sizeable bond issuance which were highly oversubscribed over the recent years reflect the increased capacity of the domestic capital market to complement the banking sector in supporting the economic transformation process. This assessment was also supported by the Bank's own analysis based on the projected financing needs of the economy over the immediate and medium term. As such, there is no longer a compelling need to retain the additional 10% SCEL in the final policy.

b. Large Exposures Limit

2.3. The Concept Paper proposed for the large exposures limit to be set at six times of a banking institution's total capital. Some banking institutions requested for an increase to this limit due to the expansion in the scope of exposures captured and the change in the definition of large exposures (from 15% of banking institution's capital funds to 10% of banking institution's total capital) which result in more exposures being classified as a large exposure compared to the previous single customer limit framework.

2.4. Following industry's feedback, the Bank further validated the relevance and need for the large exposures limit, taking into account the enhanced overall risk management standards within the banking industry. It was concluded that the significantly strengthened internal practices by banking institutions in managing large exposures provided the necessary conditions to review the need for a prescriptive large exposure limit. The large exposure limit is therefore removed in the final policy and replaced by formalising the requirement for the Board and senior management to establish internal policies on risk concentration which include setting an internal large exposures limit that is reflective of the banking institution's risk appetite and risk bearing capacity.

3. Definition of a Single Counterparty

a. Aggregation based on power of control

3.1. Some banking institutions commented that the process to determine power of control between counterparties, for all its counterparties will be operationally onerous. To facilitate compliance, banking institutions suggested that a minimum shareholding threshold be defined for automatic aggregation of counterparties connected due to power of control.

3.2. The Bank views that parties with 50% or more equity holding in another counterparty would be deemed to have power of control and any exposures to such counterparties should be automatically aggregated as connected counterparties. In addition, for equity holding less than 50%, banking institutions are expected to aggregate exposures to connected counterparties if the banking institution has other information that indicates existence of the power of control. This can include knowledge gained from past experience or dealings with the counterparty(s).

b. Aggregation based on economic dependence

3.3. The Concept Paper proposed that at a minimum, banking institutions must aggregate counterparties that are connected due to economic dependence arising from:

- i. counterparties having the same expected source of repayments; or
- ii. the existence of cross-guarantees, under which two counterparties provide guarantees for each other's obligations.

3.4. Some banking institutions suggested that some flexibility should be provided for the use of judgement in determining the materiality of economic dependence in these two scenarios instead of requiring mandatory aggregation, while other banking institutions highlighted concerns on the subjectivity of such exercise of judgement.

3.5. In the final policy, the Bank has clarified that mandatory aggregation for counterparties that are connected due to economic dependence will be required where:

- i. exposures are material between counterparties; and
- ii. the relationship between the counterparties is not easily substitutable in the short term,

to the extent that failure or financial difficulties experienced by one counterparty is likely to significantly affect and impair the ability of another counterparty to honour its financial obligations.

The scenarios articulated in Appendix 5 of the policy document are indicators of economic dependence.

4. Exposures Subject to the SCEL

a. Interbank exposures

4.1. The Concept Paper proposed for interbank exposures to be included in the SCEL as the recent crisis provided clear evidence that exposures between banking institutions, cannot be assumed to be of low risk. In fact, over dependence of banking institutions on one another for liquidity and other services can be a source of contagion risk within the domestic financial system.

4.2. In response to specific questions raised in the Concept Paper on the implications of the proposal, the industry provided feedback on the likely constraints that banking institutions will face in managing short term liquidity and the potential impact on the efficient functioning of the domestic money market.

4.3. Taking the feedback into account, the final policy provides a limited exclusion for exposures to a banking institution licensed by the Bank or a development financial institution (prescribed under the Development Financial Institutions Act 2002), arising from interbank money market transactions. This exclusion does not apply to a banking institution's (including development financial institution prescribed

under the Development Financial Institutions Act 2002) exposure that is entered into outside of the money market or to another bank outside Malaysia.

- 4.4. The non-exclusion of cross-border interbank exposures in the revised SCEL is premised on the fact that there remains foreign currency convertibility and liquidity risks associated with such exposures, in addition to credit risks, particularly during times of stress. As such, all cross-border exposures managed on a global basis must always be kept within the SCEL limits, applying the measurement principles set out in the SCEL policy document. However, the Bank acknowledges there are international developments in progress which will potentially contribute towards mitigating these risks, including developments relating to cross-border recovery and resolution planning and advances being made in the area of supervisory cooperation across borders. The Bank will take into account these developments for future enhancements of the SCEL.
- 4.5. To further facilitate banking institution's hedging activities, the final policy also allows banking institutions to compute their exposure arising from derivatives transactions with the same counterparty on a net basis, subject to satisfying the conditions and requirements on bilateral netting set out in the *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)*.
- b. Other issues raised related to exclusion from SCEL**
- 4.6. Some banking institutions requested for exposures arising from investment in shares, interest-in-shares and collective investment schemes to be excluded from the SCEL as they are already subject to a prudential limit in the *Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes*.
- 4.7. The Bank wishes to clarify that the objective of the investment in shares, interest-in-shares and collective investment schemes limit is to address concentration by type of exposure while the objective of the SCEL is to address name risk concentration. Hence, these exposures should not be excluded from the SCEL.

5. Methods of Measuring Exposures

a. On-balance sheet exposures

- 5.1. The Concept Paper requires banking institutions to measure on-balance sheet exposures on a gross basis before provision, in accordance with the applicable Financial Reporting Standards. Some banking institutions requested for the exposures to be measured net of provisions as these provisions have already been reflected in the Total Capital computation.
- 5.2. The Bank acknowledges that the computation of exposures on a gross basis may result in a double impact on the banking institutions. However, the Bank is of the view that as the purpose of this policy is to manage concentration to a single counterparty, it would be inappropriate to apply the limit net of provisions.

b. Off-balance sheet exposures

- 5.3. The Concept Paper proposed for a 100% credit conversion factor (CCF) for all off-balance sheet exposures except for underwriting commitments. Some banking institutions responded that credit conversion factors should be applied similarly to the capital framework, especially for items such as trade finance.
- 5.4. As a back-stop measure whose objective is to prevent overexposure to any single counterparty, the SCEL proposal by design, adopts a more conservative approach compared to the capital framework. Furthermore, the 24 months implementation timeline would accord sufficient time for banking institutions to manage their relationship with clients that may be affected as a result of the revised policy.
- 5.5. As such, the final policy retains a 100% CCF for the majority of off-balance sheet exposures with the exception of:
- a. underwriting commitments (50% CCF); and
 - b. unconditionally cancellable facilities subject to these facilities fulfilling the criteria set out under the *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* (0% CCF).

c. Off-balance sheet exposure: Underwriting arrangements

- 5.6. The Concept Paper proposed for underwriting commitments to be subject to 50% CCF from commitment date up to 60 days after issuance (grace period) and 100% CCF thereafter. After a one-year implementation period, the grace period of 60 days is to be reduced to 30 days.
- 5.7. Some banking institutions expressed concerns that a 60-day grace period may not be sufficient to facilitate smooth sell-down of securities. Consequently, it will also limit banking institutions' capacity to underwrite debt securities, thus potentially stifling the growth of the domestic bond market or encourage off-shore financing, especially for large projects.
- 5.8. Based on observations of past issuances, securities that cannot be sold within the first few weeks of issuance are considerably more difficult to be sold down thereafter, thus remaining as exposures of the banking institution. As such, it would be prudent to recognise such exposures in full for purposes of controlling excessive concentrations to a single counterparty.
- 5.9. The final policy therefore maintains the treatment in the Concept Paper, including the flexibility to facilitate the management of underwriting exposures through the use of sub-underwriters and back-to-back underwriting arrangements.

d. Collective Investment Schemes (CIS)

- 5.10. Banking institutions requested clarification on the application of the CIS aggregation rule in the case where a banking institution is exposed directly to the fund manager as well as to the CIS it manages.
- 5.11. If there is obligation for the fund manager to repay the fund investors (i.e. losses are not ring-fenced), banking institutions are required to aggregate these counterparties using the principles of economic dependence set out in the final policy.

e. Credit Risk Mitigation Measures

5.12. Banking institutions requested for a broader range of credit risk mitigation measures to be allowed, consistent with the capital adequacy framework.

5.13. The final policy maintains eligible collateral to include only cash, gold, and securities issued by Federal Government of Malaysia and Bank Negara Malaysia in view that the SCEL should serve as a back-stop measure and hence adopt a more conservative approach. Limited recognition of credit risk mitigation measures would also reduce the risk of a banking institution potentially understating the actual amount of exposures to its counterparty.

6. Compliance with the SCEL and Transitional Arrangements

6.1. The Concept Paper proposed for a phased implementation over a period of 18 months. Some banking institutions requested for an extension of the implementation period as additional time is needed to develop enhanced policies, procedures and systems to monitor compliance, and to re-assess capital management and business strategies.

6.2. The final policy extends the implementation timeline to 24 months beginning 1 March 2013, to allow time for banking institutions to implement the necessary changes.