

Variances for exposures to group counterparties

Document overview

This document sets out the matters that should be addressed when considering or processing a request for approval of a variance for group counterparties.

All requests for a variance must be accompanied by a completed application form for Group Variance approval*.

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*The application form for Group Variance approval will be linked once this application form is live.

1 Purpose and scope

- 1.1 This guidance note sets out the matters that should be addressed by a Jersey incorporated bank (JIB) in any application for a variance in respect of exposures to a connected bank.

2 General guidelines

- 2.1 Requests must be accompanied by the JIB's comprehensive credit assessment of the counterparty, which we will use as part of our process for determining approval. This will be subject to:
- 2.1.1 the JIB carrying out regular credit assessments in respect of the counterparty at least annually
 - 2.1.2 the annual credit assessment, and any intermediate review necessitated by a material decline in creditworthiness, we provide
- 2.2 We will not apply timescales to variances.
- 2.3 A variance for group counterparties establishes the total of all exposures to a relevant counterparty that a JIB may enter into, including the upstreaming of deposits and reliance being placed on guarantees provided by the counterparty.
- 2.4 A variance request should be for specific amounts, which are expected to be sufficient to cover all known exposures and allow for projected growth over a period of one year.
- 2.5 A JIB may request changes at any time but it is expected that, ordinarily, requests will coincide with the routine submission of its internal capital adequacy assessment process (**ICAAP**) document.

3 Group variances

- 3.1 A JIB may request a group variance in respect of one or more banks within the group controlled by its ultimate shareholder controller. This request should specify a limit for the group and for each relevant bank within the group. Exposures to other group companies (including all non-banking subsidiaries and holding companies) will remain, in aggregate, subject to the normal limit of 25% of capital, unless supported by a specific guarantee from a group bank for which a group variance has been agreed.
- 3.2 It is anticipated that, normally, a single request will be made for the group, specifying the overall group limit and sub-limits for individual banks within the group.
- 3.3 The assessment should address each of the following risk factors:
- 3.3.1 the counterparty's stand-alone financial strength
 - 3.3.2 the nature of the exposure, including any collateral
 - 3.3.3 any group support
 - 3.3.4 any government support
 - 3.3.5 the risk controls relevant to the exposure

- 3.4 We will not normally approve a group variance to a bank that is below investment grade. This determination should be made by the applicant, taking into account all relevant factors, including credit ratings published by eligible External Credit Assessment Institutions (ECAIs).
- 3.5 The riskiness of exposures should be assessed taking into account both the likelihood of resolution being invoked and the potential impact of resolution. With regard to the potential impact of resolution, we expect banks to take into account:
 - 3.5.1 the extent to which loss-absorbing capacity, (i.e. capital and any liabilities that are subordinated to exposures covered by the variance) provides protection against loss in the event of resolution
 - 3.5.2 conversely, the extent to which exposures covered by the variance might need to be bailed-in to preserve operations or improve outcomes for preferred creditors (such as retail depositors) in the event of resolution
- 3.6 Where the combination of default probability and impact is too high, approval might still be provided if:
 - 3.6.1 appropriate collateral arrangements are in place and confirmed by legal advice and/or
 - 3.6.2 robust risk controls are in place
- 3.7 In general, it is expected that exposures to the safest banks will be uncollateralised and subject to relatively light risk controls.
- 3.8 As credit quality deteriorates, tighter risk controls and/or collateral should be put in place such that there is a clear path for managing the exposure down to below 25% of capital in the event that the counterparty became non-investment grade (as assessed through the applicant's ongoing monitoring processes, which should take into account, but not solely rely on, eligible ECAI actions such as downgrades and 'watch-list' announcements).
- 3.9 The following objective measures are typically relevant to the assessment of a counterparty's standalone financial strength and should be considered for the purpose of establishing ongoing monitoring and contingency plans, particularly where counterparties are judged to be more risky:
 - 3.9.1 The levels and trends in ratios reflecting the counterparty's capital adequacy, such as:
 - 3.9.1.1 risk asset ratios
 - 3.9.1.2 leverage ratios (Basel III leverage ratio or the ratio of capital/equity as a proportion of non-risk weighted assets) and/or
 - 3.9.1.3 loss-absorbency ratios (e.g. total level of non-capital liabilities and capital items that are subordinated to the exposure, as a proportion of either risk weighted assets or non-risk weighted assets)
 - 3.9.2 The levels and trends in ratios reflecting the quality of the counterparty's assets, such as:
 - 3.9.2.1 impaired assets ratios (ratio of impaired assets to all assets)
 - 3.9.2.2 non-performing loans (NPL) ratios (ratio of NPLs, gross or net of provisions, as a proportion of all loans)
 - 3.9.2.3 NPL coverage ratios (provisions made on NPLs as a percentage of NPLs)

- 3.9.3 The levels and trends in ratios reflecting the counterparty's profitability, such as:
 - 3.9.3.1 profit volatility (change in profits over time)
 - 3.9.3.2 proportion of profits from volatile categories, such as proprietary trading
 - 3.9.3.3 profit concentration (e.g. net interest income as a proportion of all profits)
 - 3.9.4 Ratings, trends in ratings, and 'watch list' announcements from eligible ECAs, both for the group and the counterparty bank. It is expected that the counterparty will provide the JIB with copies of relevant rating agency reports, which may contain useful information regarding the basis of the rating, including support factors and standalone financial strength.
- 3.10 The following factors might be relevant in assessing the nature of the exposure:
- 3.10.1 **Its ranking (senior/subordinated etc):** the extent to which there are more senior and/or subordinated claims
 - 3.10.2 **Whether it is 'bail-inable':** in particular, whether the contract is subject to statutory bail-in processes or contractually subject to bail-in. The assessment should outline the relevant statutory provisions and any changes that will or may come into force before the maturity of the exposures. Where the exposure is governed by the laws of another jurisdiction (for example, where the contract is to an overseas branch of the counterparty), the impact should be explored. For example, BRRD contains provisions requiring firms subject to BRRD to ensure that contracts that are drawn up under foreign law are made contractually subject to the bail-in provisions in BRRD.
 - 3.10.3 **Its maturity:** this might be either a single date (being the maximum term) or a maturity profile.
 - 3.10.4 **Key features:** for example, if part of the exposure relates to derivatives then it would be appropriate to provide relevant key details.
 - 3.10.5 **Any collateral provided by the counterparty:** this might include margin received on derivative or reverse-repo transactions, floating or fixed charges over assets and bi-lateral netting agreements. Where offsetting is relevant (i.e. where there are also liabilities to the counterparty), the level of liabilities should be assessed to the extent they are relied upon as a risk mitigant.
- 3.11 The following factors are relevant to the assessment where group support is relied on:
- 3.11.1 analysis of the financial strength of the group
 - 3.11.2 consideration of the strength of the explicit/implicit support provided, including how it is established, how it could be varied or removed and the extent of support
 - 3.11.3 impediments to the movement of capital, including an assessment of the impact of regulatory constraints
- 3.12 The following factors might be relevant to the assessment if government support is relied on:
- 3.12.1 the extent to which the resolution framework in the counterparty's jurisdiction is designed to enable support to be biased towards retail depositors, at the expense of wholesale creditors, including whether wholesale creditors are:

- 3.12.1.1 subordinated to retail depositors (directly or via depositor protection scheme preference)
 - 3.12.1.2 subject to 'bail-in' powers that might allow the exposures to be written down
 - 3.12.2 the recovery plans (and resolution plans, to the extent known) of its group, insofar as they are relevant to the exposures covered by the variance. Where such plans incorporate the write-down of any relevant exposures, the circumstances where this might occur should be detailed
 - 3.12.3 the likelihood that the counterparty is considered to be systemically important. This should include assessment of whether the bank is domestically systemic (including by reference to any published list or criteria) or globally systemic (i.e. whether the bank is part of a group that has been designated as a G-SIB by the FSB)
 - 3.12.4 the ability of the government to support the counterparty. Evidence may include the scale of the counterparty relative to the country's GDP, the financial stability of the government, as evidenced by the lowest credit rating assigned by any eligible ECAI, whether the exposure is in domestic currency or not and whether the government is a member of the OECD/IMF.
- 3.13 The following factors are relevant to the assessment of risk controls:
- 3.13.1 a description of the monitoring processes established. This should detail the frequency and nature of on-going assessment, including the parties responsible. Where group resources are used, please explain how that potential conflict of interest is addressed
 - 3.13.2 the establishment of early warning signs, which would be expected to span a range of objective and subjective criteria that would lead to contingent actions being taken. These should include specific credit rating levels and/or financial ratios. Contingency actions should be expected to be effective in reducing the risk posed by the exposure in relevant circumstances. Examples of actions might be:
 - 3.13.2.1 increased monitoring
 - 3.13.2.2 withdrawing funds on maturity
 - 3.13.2.3 shortening the term of facilities or individual exposures
 - 3.13.2.4 selling securities (where relevant)
 - 3.13.2.5 putting collateral in place
 - 3.13.2.6 hedging the exposure
- 3.14 We require an undertaking to be provided to the JIB by the counterparty that it will make available to the JIB information regarding its capital adequacy, liquidity profile, resolution plans and such other information as may be requested by the applicant to enable it to conduct a regular review of the counterparty's financial standing and confirms that such information may be provided to us as part of the review process.
- 3.15 It remains the responsibility of the requesting bank to decide what information is required to carry out a credit assessment to support a variance request. This may vary depending on circumstances and the availability of relevant public information relating to the entity in question. But it is likely that this may include seeking the provision of information that is not publicly available.

- 3.16 We will seek initial confirmation and ongoing, annual reconfirmation from the authority that undertakes prudential regulation of the counterparty bank, that:
 - 3.16.1 it will notify us of any material or persistent breaches by the counterparty of capital adequacy and liquidity rules applicable to it, or of risks that such breaches are imminent
 - 3.16.2 it is satisfied with the adequacy of the counterparty bank's capital adequacy and liquidity risk management
- 3.17 We will seek sight of the relevant resolution authority's resolution plans and an understanding of how these plans might impact the exposure.
- 3.18 In relation to 3.15 and 3.16, we consider that it is likely that we will need to provide that authority with information that explains why we consider that the financial standing of the counterparty is relevant to its supervision of the requesting bank. This information would be provided initially and might be refreshed if circumstances warranted it. The information would need to cover all relevant matters but it is expected that this would normally include:
 - 3.18.1 a description of the variance
 - 3.18.2 a summary of the JIB's capital and liquidity positions, which might include information regarding its actual and required minimum RAR levels, liquidity ratios and any agreed behavioural adjustments