OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK

of 29 December 2010

regarding the prudential rules for banks, credit unions and investment firms

Determining the Value of Underlying Exposures for the Purposes of Large Exposures

The Czech National Bank hereby provides the following information with regard to Article 180 (6) of Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms, as amended (hereinafter the "Decree"):

1. When assessing large exposures to economically connected groups of persons, banks, credit unions and investment firms (hereinafter the "liable entity") shall take into account not only direct exposures, but also exposures belonging to so-called "schemes", which shall in this case be understood as collective investment undertakings (hereinafter "CIUs"), structured financial instruments (e.g. securitisation) or other similar exposures. These schemes are composed of underlying exposures.

I. Schemes Containing Unstructured Underlying Exposures

2. If investing in schemes, a liable entity will be exposed to the risks associated with the given scheme on the one part and the risks associated with the underlying exposures on the other part. This is why the liable entity, for the purposes of large exposures to economically connected groups of persons, shall assess whether the scheme in question and its underlying exposures are interconnected with any other exposures or, as the case may be, clients, including other schemes. Pursuant to the Decree, the liable entity shall assess its large exposures with respect to both the scheme and the underlying exposures. However, the economic nature of a particular scheme and the risks associated with the scheme may imply that it is sufficient to assess large exposures with respect to the scheme only. The risk associated with the underlying exposures is significantly affected by the degree of diversification, whereas the risk associated with a particular scheme is primarily affected by the legal framework applied to the manager of the scheme (e.g. to a fund).

3. When taking into account the underlying exposures contained in schemes, the following approaches shall be used:
   a) full look-through approach, which is regarded to be the most risk-sensitive and most prudent; a liable entity shall identify and monitor all of the underlying exposures contained in a given scheme and allocate them to appropriate persons or to appropriate economically connected groups of persons;
   b) partial look-through approach, where a liable entity shall only apply the full look-through approach to that part of the underlying exposures which it identifies, monitors and allocates to appropriate persons or to appropriate economically connected groups of persons; whereas the remaining exposures contained in the scheme shall be treated by the liable entity as unknown exposures pursuant to subparagraphs (c) or (d) below based on the evaluation of the requirements met by the remaining exposures;
   c) residual approach used with respect to the aggregate of the unknown exposures, where a liable entity shall regard all unidentified exposures as a single risk, and thus as a single unknown entity; the aggregate of the unknown exposures shall also include

those schemes with respect to which the liable entity uses none of the approaches referred to in subparagraphs (a) or (b) above and which simultaneously cannot be divided into sufficiently small underlying exposures (i.e., their granularity is not sufficient); the granularity of a scheme may be considered sufficient, providing its largest underlying exposure represents less than 5 % of the total scheme; and

d) structure-based approach, where a liable entity may treat the schemes as exposures to mutually unconnected persons, providing that the liable entity does not know the detailed composition of the underlying exposures contained in a scheme, but is able to ensure and prove (e.g. by means of the statutes of a collective investment undertaking) that the underlying exposures are connected neither with each other (mutually) nor with any other direct or indirect exposure in the liable entity's portfolio (including other schemes) exceeding 2 % of the liable entity's capital determined pursuant to Part Five of the Decree (i.e., capital for the purposes of large exposures).

4. The approach to the recognition of the underlying exposures may be selected by the liable entity. However, the liable entity shall be able to prove to the Czech National Bank at any time that the selected approach is sufficiently risk-sensitive and that the selection has not been affected by regulatory arbitrage. The Czech National Bank prefers the use of the full look-through approach.

5. The use of the full or partial look-through approach shall always depend on the ongoing monitoring of the composition of a scheme. The ongoing monitoring means that the frequency of the monitoring shall be adjusted to the frequency and significance of changes to the underlying exposures contained in the scheme as well as to potential interconnections between the underlying exposures contained in different schemes; and the frequency of the monitoring shall be at least once a month.

6. If mutual interconnections exist between the underlying exposures contained in a certain scheme, a monitoring of the appropriate economically connected group of persons shall be implemented. However, no intensive analysis of the mutual interconnection between these underlying exposures is required.

7. With respect to a fund of funds, the granularity criterion shall be applied at the level of the underlying exposures of the underlying funds.

8. The relevant values of the exposures shall be taken into account only to the extent that is proportionate to the liable entity's investment in the particular scheme.

9. Examples of the application of the principle for the formation of an economically connected group of persons in the case of schemes are given in Annex No. 1.

II. Schemes Containing Structured Underlying Exposures (Tranches[1])

[1] The reference to a *tranche* shall be understood, for instance, as a reference to a certain part of an issue of securities or of some other financial transaction. Individual tranches bear different risks for investors to receive the cash flows that they are entitled to. Tranches with better protection and thus lower risk (i.e., higher priority of redemption) are referred to as "senior tranches", whereas tranches subordinated to them and bearing a higher risk and a lower degree of protection are usually referred to as "junior tranches"; the highest risk is borne by so-called "first-loss tranche" (or "share tranche"). The tranches bearing medium risk (positioned in the middle of the given structure) are known as "mezzanine tranches". This system makes it possible to create a structure of instruments (usually debt securities) with different risk and return profiles.

10. In the case of structured financial instruments, the losses associated with these instruments also depend on the credit enhancement relating to certain tranches. If such credit enhancement that results from the subordination of tranches is legally enforceable, it may be recognised as protection (risk mitigation) for the purposes of large exposures, providing that the conditions of approvability are met.

11. It is assumed that, irrespective of which underlying exposure defaults earlier, any position in a securitization held by an investor shall be protected by the subordinate tranches by an amount equal to their size. The liable entity shall adjust the amount of large exposures to a certain underlying exposure (person) by the amount of such protection that is represented by all subordinate tranches, but at the most by the amount invested in the given position.

12. For portfolios with a sufficient degree of granularity of the individual underlying exposures where the size of each underlying exposure is smaller than the size of the first-loss tranche, a liable entity that has invested in the first-loss tranche shall recognise the amount of large exposures to every individual underlying exposure (person). A liable entity that holds a position in an unsubordinated (senior) tranche shall not recognise large exposures to the underlying exposures at all.

13. The assessment of the amount and volume of protection shall be carried out separately for every tranche in which the liable entity holds a position. The assessment shall be carried out on an ongoing basis, since the losses occurring in the underlying portfolio affect the available protection resulting from the subordinated tranches.

14. When taking into account the protection resulting from subordinated tranches, a certain conservative margin (a discount or, as the case may be, a haircut) shall be considered by the liable entity to respect the risk of inaccuracies. For instance, it might happen that the first-loss tranche has already been exhausted, but the liable entity that holds a position in some other (senior) tranche has not captured this fact in the amount of large exposures yet due to a time lag. Exhaustion of the first-loss tranche eliminates the protection effect, as a result of which exposures to certain persons may even breach the appropriate large exposures limit and the liable entity may be forced to reduce its exposures regardless of the current market conditions (a risk of sale at a loss). The conservative margin and the manner of its application shall be stipulated by the liable entity as part of its internal procedures for risk management, and the liable entity shall be able to justify such procedures to the Czech National Bank. Within the framework of these procedures, the liable entity shall take into account the time lag before it learns that the first-loss tranche has been exhausted and that it is necessary to reassess the underlying portfolio of exposures as well as the losses resulting from the necessity to newly structure the portfolio due to breached large exposures limits.

15. Annex No. 2 contains examples that illustrate the treatment of structured underlying exposures. The examples are organised according to the individual approaches to underlying exposures described in paragraph 3 above.

III. Final Provisions

16. Within the meaning of Article 9 of the Decree, the *Guidelines on the Implementation of the Revised Large Exposures Regime* issued by the Committee of European Banking Supervisors (CEBS) in December 2009 (www.c-ebs.org) are considered by the Czech

National Bank to rank among the acknowledged standards for the purposes of determining the value of underlying exposures for the purposes of large exposures.

17. This Official Information shall be followed from 31 December 2010.

Vice-Governor:

prof. PhDr. Ing. Vladimír Tomšík, Ph.D., signed

Financial Market Regulation and Analyses Department
Responsible:
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Annex No. 1

Example

The illustrative example of the application of the principles for the formation of an economically connected group of persons with respect to schemes containing underlying exposures which is given in Fig. 1, shows an instance where a liable entity has identified persons (or, as the case may be, debtors or exposures) A, B and C in the schemes which it invested in. Since the liable entity has other exposures to A in its portfolio (in addition to the schemes), it shall add the exposures to A together for the purposes of large exposures. Exposures to B and C are not represented in the portfolio of the liable entity (apart from the schemes), which is why they may be treated as exposures to individual persons. The other unknown exposures are treated as the aggregate of exposures to unknown persons. With respect to a scheme where the liable entity has a certain amount of information at its disposal (i.e., it does not know the underlying exposures, but is able to ensure that they meet the requirements pursuant to paragraph 3 (d) above), the liable entity treats the underlying exposures as a separate person. In addition to that, the liable entity applies the large exposures limit pursuant to Article 181 of the Decree (25 %) to every scheme.

The illustrative example which is given in Fig. 2 shows a liable entity's investment in two schemes. With respect to the scheme on the left-hand side, the liable entity uses the partial look-through approach. In this scheme, the liable entity has identified person (exposure) B, which is not represented anywhere else in the portfolio of the liable entity and is therefore treated a separate person. Since no detailed information is known about the other exposures in both the schemes, they are treated as the aggregate of the exposures to unknown persons. In addition to that, the liable entity applies the large exposures limit pursuant to Article 181 of the Decree (25 %) to every scheme.

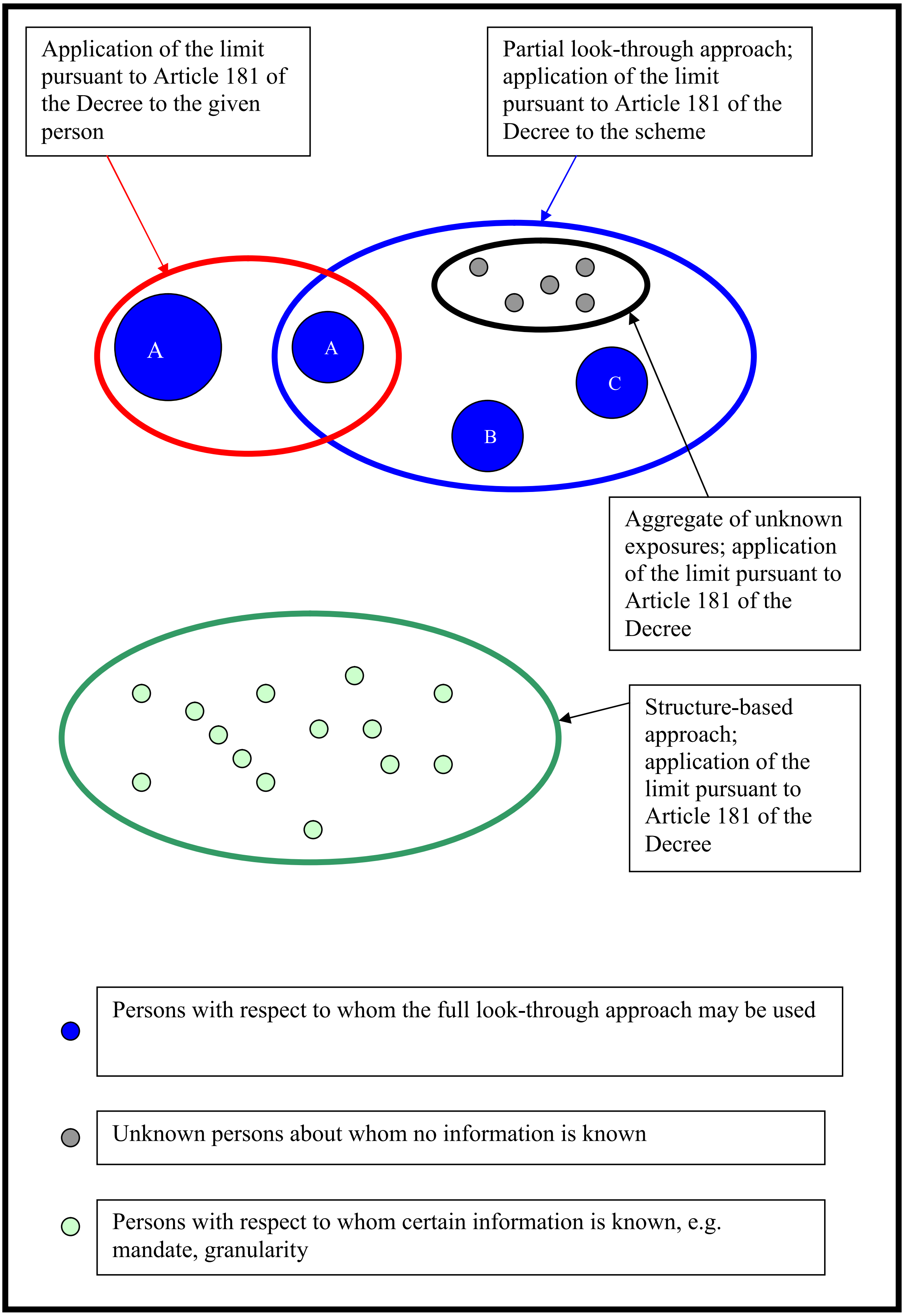

Application of the limit pursuant to Article 181 of the Decree to the given person
Partial look-through approach; application of the limit pursuant to Article 181 of the Decree to the scheme
A
A
C
B
Aggregate of unknown exposures; application of the limit pursuant to Article 181 of the Decree
Structure-based approach; application of the limit pursuant to Article 181 of the Decree
Persons with respect to whom the full look-through approach may be used
Unknown persons about whom no information is known
Persons with respect to whom certain information is known, e.g. mandate, granularity

Fig. 1

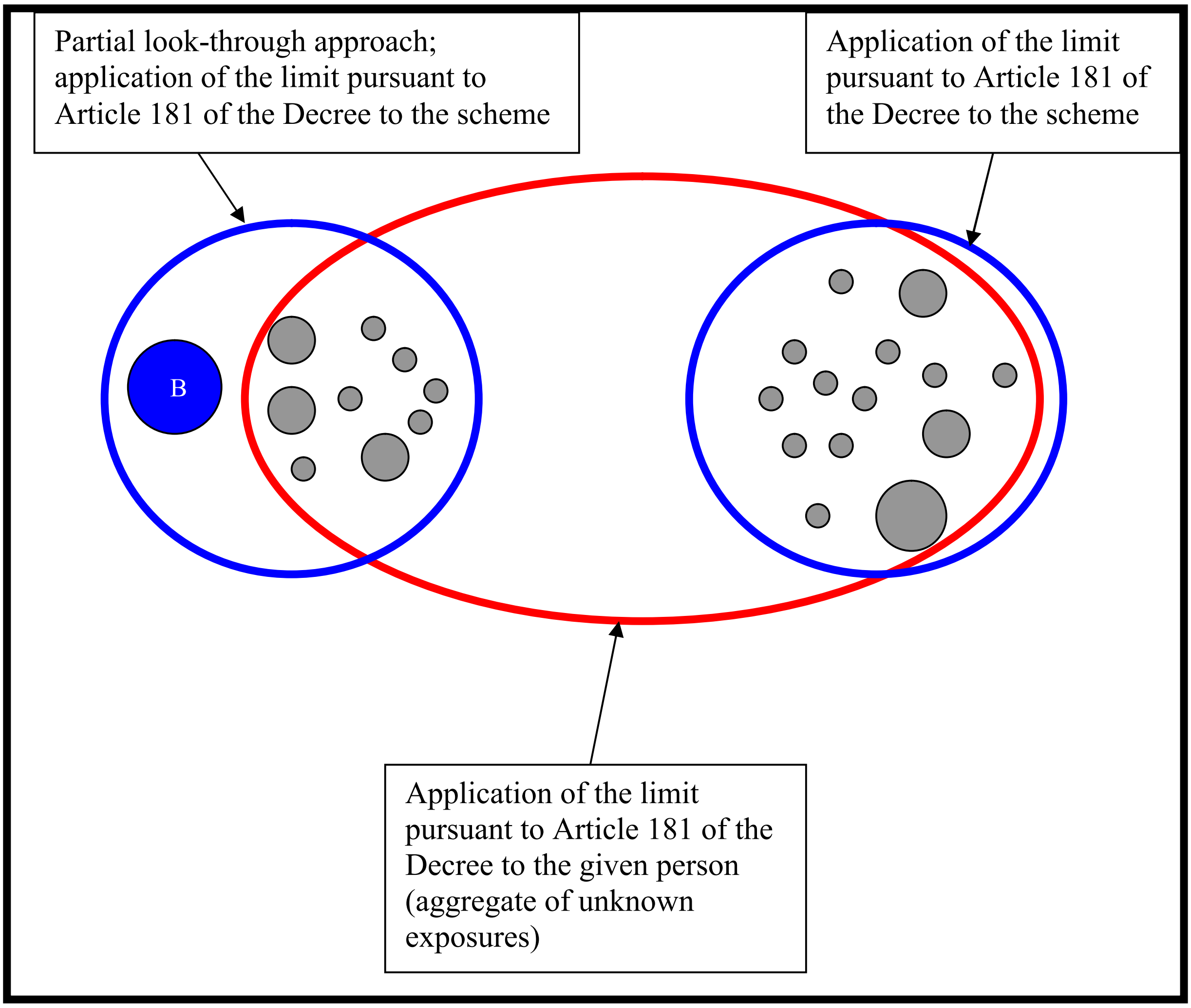
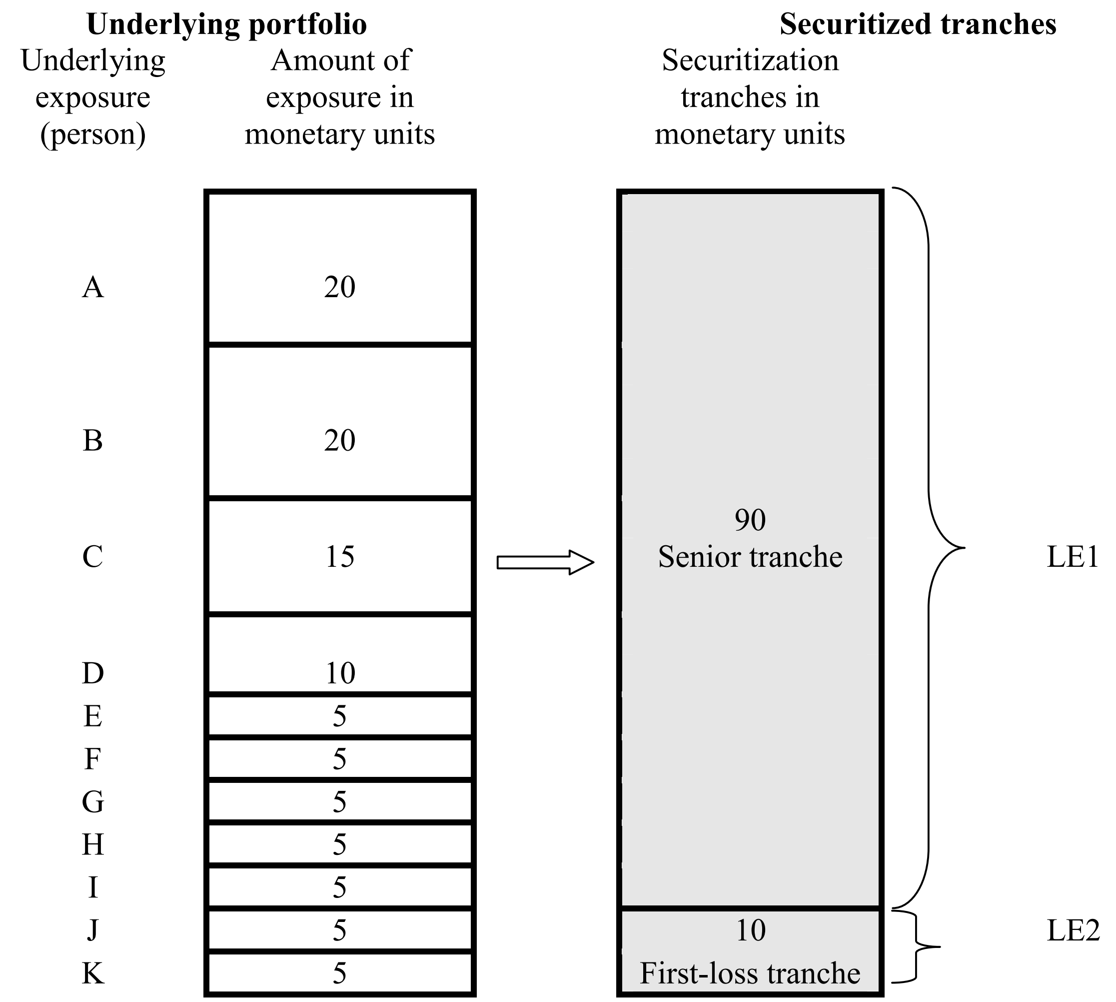

Partial look-through approach; application of the limit pursuant to Article 181 of the Decree to the scheme
Application of the limit pursuant to Article 181 of the Decree to the scheme
B
Application of the limit pursuant to Article 181 of the Decree to the given person (aggregate of unknown exposures)

Fig. 2

Annex No. 2

Example 1

It is assumed that Liable Entity 1 (hereinafter the "LE1") invested 90 monetary units in a senior tranche, and Liable Entity 2 (hereinafter the "LE2") invested 10 monetary units in a first-loss tranche, of a product with the following structure:



In this example, the first-loss tranche provides protection for the senior tranche in the amount of 10 monetary units.

A) Full look-through approach

The treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:
- 0 monetary units of large exposures to persons (debtors) D to K (the underlying exposures to persons D to K do not exceed 10 monetary units, and are thus covered by the first-loss tranche to the full extent);
- 5 monetary units of large exposures to person C (the underlying exposure to person C amounts to 15 monetary units, from which the protection provided by the first-loss tranche (amounting to 10 monetary units) shall be subtracted);
- 10 monetary units of large exposures to person A and to person B (the underlying exposure to persons A and B amounts to 20 monetary units, from which the protection provided by the first-loss tranche (amounting to 10 monetary units) shall be subtracted);

b) for the LE2 (the LE2 invested only in the first-loss tranche to which any protection effect following from subordinated tranches no longer applies; the amount of large exposures to individual persons is limited by the 10 monetary units invested in total):

- 5 monetary units of large exposures to persons E to K;
- 10 monetary units of large exposures to persons A to D.

B) Partial look-through approach

It is assumed that only the underlying exposures A and B are known to the investing liable entities. The other underlying exposures are unknown to them; the liable entities only know that the amounts of the individual underlying exposures do not exceed 20 monetary units and that these underlying exposures meet the requirements pursuant to paragraph 3 (d) above.

The treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:
- 10 monetary units of large exposures to person A and to person B;
- 10 monetary units of large exposures to the other unknown underlying exposures;

b) for the LE2:
- 10 monetary units of large exposures to person A and to person B;
- 10 monetary units of large exposures to the other unknown underlying exposures.

C) Structure-based approach

This approach assumes that the investing liable entities do not know the specific underlying exposures. However, the liable entities know that the amounts of individual underlying exposures do not exceed 20 monetary units and that these underlying exposures meet the requirements pursuant to paragraph 3 (d) above (e.g. these are underlying exposures to sectors in which the liable entities have no direct or indirect exposures).

The treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:

- 10 monetary units of large exposures to the scheme (in this particular case, however, such fact has no actual effect, since large exposures amounting to 90 monetary units have already been set off against the scheme as a whole);

b) for the LE2:

- 10 monetary units of large exposures to the scheme (in this particular case, however, such fact has no actual effect, since large exposures amounting to 10 monetary units have already been set off against the scheme as a whole).

D) Residual approach used with respect to the aggregate of unknown exposures

It is assumed that the liable entities do not know the underlying exposures contained in the scheme and have no information about their maximum amount and/or about their nature and interconnectedness.

The treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:

- 90 monetary units of large exposures to a hypothetical unknown person;

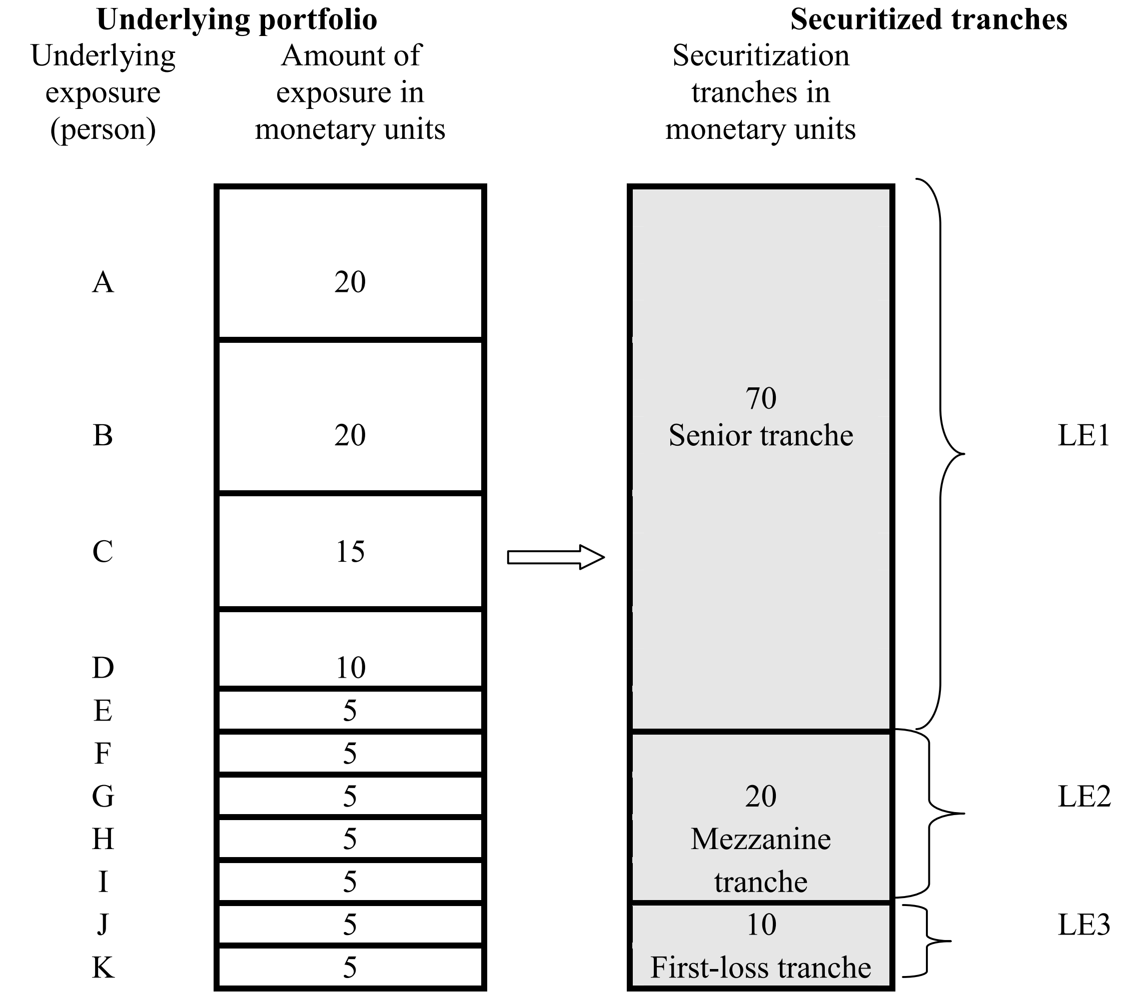
b) for the LE2:

- 10 monetary units of large exposures to a hypothetical unknown person.

Example 2

In this example, it is assumed that (unlike in Example 1 above) the structure also contains a mezzanine tranche. In addition to that, it is assumed that the protection effect of the mezzanine tranche is not full (unlike the protection effect of the first-loss tranche), which is why a conservative margin (discount) of 50 % is applied. The aforesaid conservative margin represents no specific recommendation, but is given for illustration only. Its amount shall be determined by the liable entity in accordance with paragraph 16 of this Official Information.

The LE1 holds the entire senior tranche in the amount of 70 monetary units, the LE2 holds the mezzanine tranche in the amount of 20 monetary units, and Liable Entity 3 (hereinafter the “LE3”) holds the first-loss tranche in the amount of 10 monetary units.



Pursuant to the full look-through approach, the treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:

- 0 monetary units of large exposures to persons A to K (the protection effect of subordinated tranches in the amount of 20 monetary units in total has been considered, of which 10 monetary units are the protection effect of the first-loss tranche and 10 monetary units (i.e., 50 % of 20 monetary units) are the protection effect of the mezzanine tranche);

b) for the LE2:

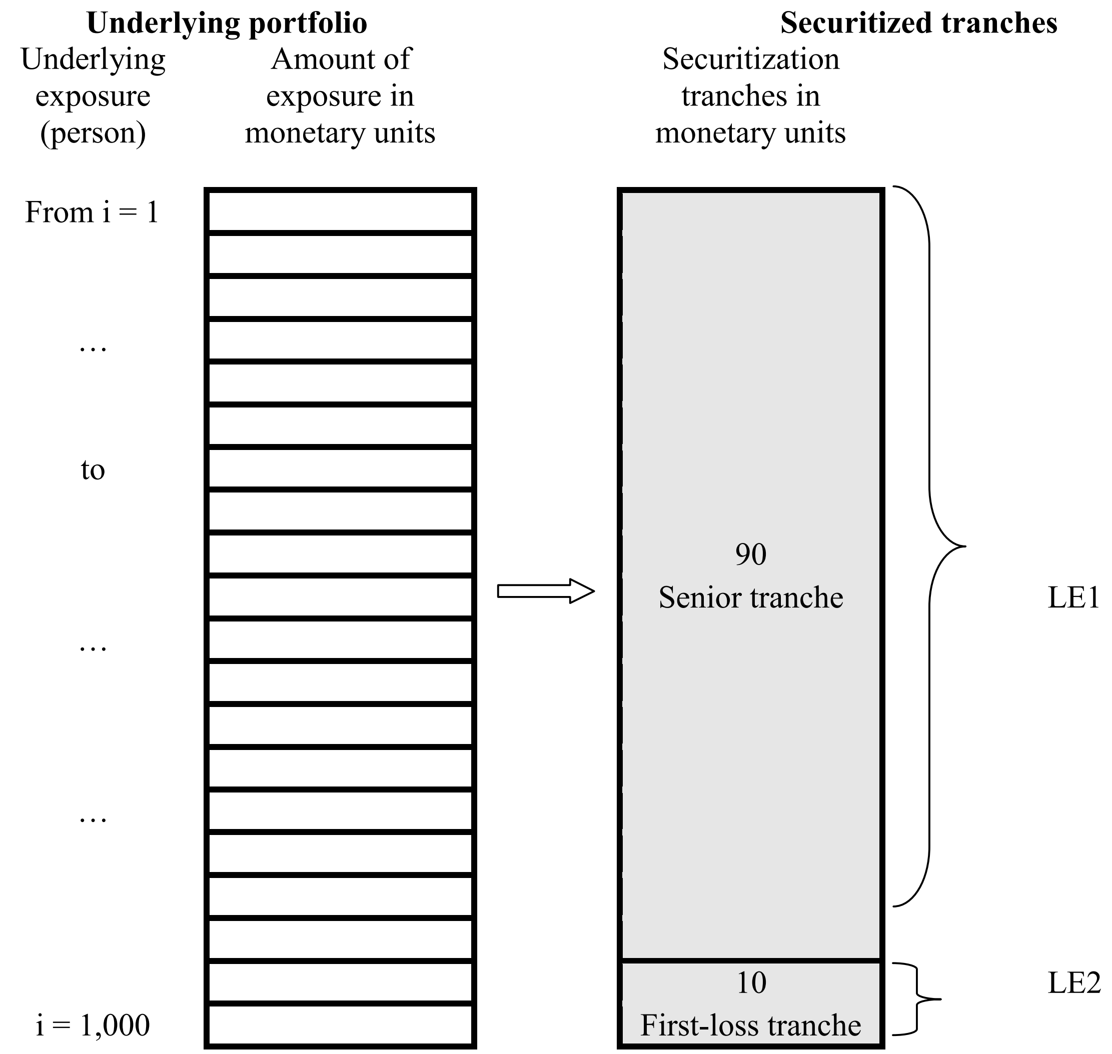
- 0 monetary units of large exposures to persons D to K;
- 5 monetary units of large exposures to person C;
- 10 monetary units of large exposures to persons A and B;

c) for the LE3:

- 5 monetary units of large exposures to persons E to K;
- 10 monetary units of large exposures to persons A to D.

Example 3

We assume the existence of a diversified portfolio consisting of 1,000 underlying exposures, where every exposure amounts to 0.1 monetary units, thus 100 monetary units in total.



Every underlying exposure (*i*) amounts to 0.1 monetary units.

Pursuant to the full look-through approach, the treatment of the exposures for the purposes of large exposures shall be as follows:

a) for the LE1:

- 0 monetary units of large exposures to all underlying exposures (persons) – i.e., from i =1 to i = 1,000;

b) for the LE2:

- 0.1 monetary units of large exposures to all underlying exposures (persons) – i.e., from i = 1 to i = 1,000.