

# CENTRAL BANK OF NIGERIA



## GUIDELINES ON LARGE EXPOSURES (LEX)

SEPTEMBER 2021

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## Abbreviations

Acronym	Description
BCBS	Basel Committee on Banking Supervision
BOFIA	Banks and Other Financial Institutions Act
CCF	Credit Conversion Factors
CCPs	Central Counterparties
CCR	Counterparty Credit Risk
CDS	Credit Default Swap
CIU	Collective Investment Undertakings
CPSS	Committee on Payment and Settlement Systems
D-SIBs	Domestic Systematically Important Banks
IOSCO	International Organization of Securities Commissions
LE	Large Exposures
LTA	Look Through Approach
NDIC	Nigeria Deposit Insurance Corporation
QCCP	Qualifying Central Counterparties
SA-CCR	Standardised Approach for Counterparty Credit Risk
SCEL	Single Counterparty Exposure Limit
SFT	Securities Financing Transactions
SOL	Single Obligor Limit

## 1. Introduction

### 1.1 Background

1. The global financial crisis of 2007 revealed that banks did not always consistently measure, aggregate and control exposures to single counterparties or to groups of connected counterparties across their books and operations.
2. The impact of the crisis created a need for banks to measure and limit the size of large exposures in relation to their capital. The Central Bank of Nigeria (CBN) has previously issued various guidelines on the recognition and treatment of large exposures and exposures to single counterparties.
3. The previous supervisory guidelines however did not specifically set out how banks should measure and aggregate exposures to a single counterparty or the factors to be taken into consideration when assessing whether separate legal entities form a group of connected counterparties. This has resulted in a considerable variation in practice across banks.
4. This Guideline is aimed at aligning the supervisory practice in Nigeria with the expectation of the Basel Committee on Banking Supervision (BCBS) Standards on Large Exposures (LEs)<sup>1</sup> and ensuring a more consistent supervisory approach to dealing with large exposures in Nigeria.
5. This Guideline will complement the existing guidelines on risk-based capital requirements and is also aimed at:
  - a) Restricting the level of exposures to a single counterparty or group of connected counterparties so as to ensure that the maximum possible losses in the event of sudden default of a counterparty would not endanger a bank's survival as a going concern;
  - b) Reducing the vulnerability of the Nigerian banking system to idiosyncratic risk due to large exposures to individual counterparties; and
  - c) Contributing to the stability of the Nigerian financial system.

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<sup>1</sup> Basel Committee on Banking Supervision, Supervisory Framework for Measuring and Controlling Large Exposures, April 2014

## 1.2 Scope of Application

6. The Guideline shall apply to all commercial, merchant, and non-interest banks operating in Nigeria at both the entity and consolidated levels.
7. In the application of this Guideline at the consolidated level, banks should capture all exposures to third parties across all the entities falling within the scope of regulatory consolidation for the risk-based capital requirement and should compare the aggregate of these exposures with the eligible regulatory capital at the consolidated (group) level.

## 1.3 Scope of Counterparties and Exemptions

8. The Guideline applies to all banks' exposures to single counterparties and groups of connected counterparties irrespective of their performance or the quality of any pledged collateral, with the exception of the following exposures:
  - a) Exposures to the Federal Government of Nigeria and State Governments (guaranteed by the Federal Government of Nigeria) which are eligible for a zero percent Risk Weight<sup>2</sup>;
  - b) Exposures to the Central Bank of Nigeria;
  - c) Exposures where the principal and interest are fully guaranteed by the Federal Government of Nigeria;
  - d) Exposures secured by financial instruments issued by the Government of Nigeria;
  - e) Exposures of an overseas branch or subsidiary of a banking institution to the sovereign government or central banks in the jurisdiction where it is located and where the exposure is denominated and funded in local currency and held to meet regulatory requirements imposed by the central bank in that jurisdiction;
  - f) Credit facilities (both funded and non-funded) granted against the security of a bank's own term deposit, to the extent that the bank has a specific lien on such deposits;
  - g) Intra-day interbank exposures;
  - h) Intra-group exposures which have been recognized in the computation of eligible capital;

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<sup>2</sup> Circular - Re: Review of Risk Weights on Certain Industry Exposures in The Computation of Capital Adequacy BSD/DIR/GEN/LAB/06/017 April 2013

- i) Borrowers with limits authorized by the CBN in various intervention facilities; and
  - j) Banks' clearing activities related exposures to Qualifying Central Counterparties (QCCPs), till further notification as detailed in Section 7 of this Guidance Notes;
9. Where applicable, exposures to exempted entities which are hedged by a credit derivative shall be treated as an exposure to the counterparty providing the credit protection.
10. Banks are required to report all exempted exposures that meet the criteria for definition of Large Exposures as required under regulatory reporting specified in **Section 1.4** below.

#### 1.4 Definition of a Large Exposure and Regulatory Reporting

11. A large exposure is defined as the sum of all exposures of a bank to a single counterparty or to a group of connected counterparties that are equal to or above 10% of shareholders' funds unimpaired by losses<sup>3</sup>
12. Banks should report their Large Exposures to the CBN on a monthly basis as per the templates provided in **Appendix 1**:
- a) The one hundred (100) largest exposures to counterparties measured as specified in this Guidance Note and included in the scope of application, irrespective of the values of these exposures.

#### 2. The Large Exposure Limit

13. The sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 20% or 50% of the bank's shareholders funds unimpaired by losses for a commercial or merchant bank respectively.
14. The total outstanding exposure (on and off-balance sheet) by a bank to all tiers of government and their agencies shall not at any point in time exceed 10% of the total credit portfolio.

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<sup>3</sup> Subject to any change in prevailing regulations and guidelines as may be issued by the CBN from time to time.

15. Aggregate large exposures in any bank should not exceed eight times the shareholders' funds unimpaired by losses.
16. Breaches of the limit, which must remain the exception, should be communicated immediately to the CBN and must be rectified quickly.

### 3. Definition of Connected Counterparties

17. In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this Guideline as a group of connected counterparties, must be treated as a single counterparty.
18. The sum of the bank's exposures to all the individual entities included within a group of connected counterparties should be subject to the large exposure limit and to the regulatory reporting requirements as specified above.
19. Two or more natural or legal persons shall be deemed to be a group of connected counterparties if at least one of the following criteria is satisfied:
  - a) **Control relationship:** one of the counterparties, directly or indirectly, has control over the other(s);
  - b) **Economic interdependence:** if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties<sup>4</sup>; and
  - c) Common Directorship across entities.
20. Banks should assess the relationship amongst counterparties with reference to **Paragraph 19** above in order to establish the existence of a group of connected counterparties.
21. The control relationship between counterparties exists when one entity owns more than 50% of the voting rights of the other entity. Banks should also assess the existence of control relationship between counterparties based on the following criteria:

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<sup>4</sup> See Supervisory Framework for measuring and Controlling Large Exposures pg. 5 note 24 (April 2014) for details on establishing connectedness based on economic interdependence

- a) Voting agreements, e.g. control of a majority of voting rights pursuant to an agreement with other shareholders;
- b) Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;
- c) Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g., through consent rights over key decisions).

22. Banks are also expected to refer to the criteria specified in appropriate internationally recognized accounting standards for further qualitative guidance for determining the existence of control relationship.

23. In establishing connectedness based on economic interdependence, banks should consider, at a minimum, the following qualitative criteria:

- a) Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty;
- b) Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
- c) Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- d) When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
- e) Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
- f) Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); and
- g) When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found.

## **4. Values of Exposures and Definitions of Exposure Value**

### **4.1 Exposure Values**

24. The exposure values to be considered in the identification of large exposures to a counterparty should include all the exposures defined under the risk-based capital framework. An exposure amount to a counterparty that is deducted from capital should not be added to other exposures to that counterparty for the purpose of the large exposure limit.
25. Banks should consider both on- and off-balance sheet exposures included in either the banking or trading book and instruments with Counterparty Credit Risk (CCR). The definitions and measurements of such exposures should be consistent with the expectation of this Guidance Note. For the purpose of determining the exposure amount of OBS items, the Credit Conversion Factors as specified in the Guidance note on the calculation of Capital Requirement for Credit Risk
26. The exposure value must be the accounting value of the exposure (gross of specific provisions and value adjustments).
27. Banks should have in place appropriate limits aimed at constraining their exposures to large single or connected counterparties. In setting such limits, specific considerations should be given to:
- a) The prevailing statutory and prudential limits on exposure to a single obligor;
  - b) The quality of the bank's processes for its management of credit concentration risk; and
  - c) The bank's risk taking capacity including its capital and liquidity position.

### **4.2 Calculation of Exposure Value for Trading Book Positions**

28. Banks must aggregate all the exposures to a single counterparty arising in the trading book to any other exposures to that counterparty in the banking book in the calculation of the total exposure to that counterparty.
29. Exposures in financial instruments such as bonds and equities must be constrained by the large exposure limit including concentrations in a particular commodity or currency.

30. Banks must define the exposure value of straight debt instruments and equities as the accounting value of the exposure (i.e. the market value of the respective instruments)
31. Banks with instruments such as swaps, futures, forwards, and credit derivatives must convert such positions following the risk based capital requirements. The instruments should be decomposed into individual legs and only transaction legs representing exposures in the scope of the large exposures should be considered.
32. In the case of credit derivatives that represent sold protection, the exposure to the referenced name must be the amount due in the case that the respective referenced name triggers the instrument, minus the absolute value of the credit protection. For credit-linked notes, the protection seller needs to consider positions both in the bond of the note issuer and in the underlying referenced by the note.
33. In determination of exposures in options, banks are required to use the change(s) in option prices that would result from a default of the respective underlying instrument. The resulting positions should in all cases be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.
34. Exposure values of banks' investments in transactions<sup>5</sup> should be calculated on the same rules as for similar instruments in the banking book. The amount invested in a particular structure may hence be assigned to: (i) the structure itself, which is defined as a distinct counterparty, (ii) the counter parties corresponding to the underlying assets, or (iii) the unknown client, following the rules described in **Section 6** below.

### 4.3 Offsetting Long and Short Positions in the Trading Book

35. Banks should use the net position in a specific issue for the purpose of calculating their exposure to a particular counterparty for the same issue. Banks should offset long and short positions in the same issue (two issues are defined as the same if the issuer, coupon, currency, and maturity are identical).
36. Banks should offset positions in different issues from the same counterparty only when the short position is junior to the long position, or if the positions are of the same seniority.

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<sup>5</sup> That is, index positions, securitisations, hedge funds or investment funds.

37. Banks may recognize positions hedged by credit derivatives, provided the underlying of the hedge and the position hedged fulfil the specified provision (the short position is junior or of equivalent seniority to the long position).
38. In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, "Equity", "Subordinated Debt" and "Senior Debt").
39. Banks that find it excessively burdensome to allocate securities to different buckets based on relative seniority may recognise no offsetting of long and short positions in different issues relating to the same counterparty in calculating exposures.
40. Banks must not net across the banking and trading books, i.e., offsetting short positions in the trading book against long positions in the banking book.
41. When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for large exposure purposes.

## **5 Treatment of Specific Exposures**

### **5.1 Sovereign exposures and entities connected with sovereigns**

42. Banks' exposures to sovereigns and their central banks are exempted. This exemption also applies to Public Sector Entities (PSEs) treated as sovereigns according to the risk-based capital requirement. Any portion of an exposure guaranteed by, or secured by financial instruments issued by, sovereigns would be similarly excluded from the scope of this Guidance Note to the extent that the eligibility criteria for recognition of the credit risk mitigation are met.
43. Banks must however report exposures subject to the sovereign exemption if these exposures meet the criteria for definition as a large exposure.

### **5.2 Interbank exposures**

44. Intraday Interbank exposures are not subject to the large exposure framework, either for reporting purposes or for application of the large exposure limit; this is to avoid disturbing the payment and settlement processes.

## 6. Collective Investment Undertakings and Other Structures

45. Banks should consider exposures even when a structure lies between the bank and the exposures, i.e., even when the bank invests in structures through an entity which itself has exposures to assets (hereafter referred to as the “underlying assets”). Banks must assign the exposure amount, i.e. the amount invested in a particular structure, to specific counterparties following the approach set out in **Appendix 2**. Such structures include funds, securitisations and other structures with underlying assets.

## 7. Exposures to Central Counterparties (CCPs)

46. Banks’ exposures to qualifying central counterparties (QCCPs) related to clearing activities are exempted from the large exposure framework. However, these exposures will be subject to the regulatory reporting requirements as specified in this Guidance Note.

47. The definition of QCCP for large exposures is the same as that used for the risk-based requirement purposes. A QCCP is an entity that is licensed to operate as a CCP and is permitted by the appropriate regulator to operate as such with respect to the products offered. This is subject to the provision that the CCP is based in, and prudentially supervised in, a jurisdiction where the relevant regulator has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

48. Banks should measure their exposure to non-QCCPs as the sum of both the clearing exposures described in **Section (a)** below and the non-clearing exposures described in **Section (b)** below and must comply with the general large exposure limit as specified in the Prudential Guidelines.

49. The concept of connected counterparties described in this Guidance Note does not apply in the context of exposures to CCPs that are specifically related to clearing activities.

### a) Calculation of exposures related to clearing activities

50. Banks must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below together with the exposure value to be used:

Trade exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in other parts of this Guidance Note for the respective type of exposures.
Segregated initial margin	The exposure value is zero.
Non-segregated initial margin	The exposure value is the nominal amount of initial margin posted.
Pre-funded default fund contributions	Nominal amount of the funded contribution. <sup>6</sup>
Unfunded default fund contributions	The exposure value is zero.

51. Banks must determine the counterparty to which exposures must be assigned by applying the provisions of the risk-based capital requirements for exposures subject to clearing services (the bank acting as a clearing member or being a client of a clearing member).

## b) Other exposures

52. Other types of exposures that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees etc., will be added together, and subjected to the large exposure limit. Such exposures must be measured according to the rules set out in **Sections 4 and 5** of this Guidance Note, as for any other type of counterparty.

53. Banks must determine the counterparty to which exposures should be assigned by applying the provisions of the risk-based capital requirements for exposures subject to clearing services.

## 8. Risk Management Requirements

54. The board of directors (Board) of a bank must ensure that:

- a) The bank establishes and adheres at all times to the approved internal policies governing risk concentrations.
- b) The internal policies are reviewed regularly (at least annually) to ensure that they remain current, adequate, and appropriate.

<sup>6</sup> The exposure value for pre-funded default fund contributions may need to be revised if applied to QCCPs and not only to non QCCPs.

- c) Independent reviews are conducted regularly to verify ongoing compliance with the prudential limit and standards set by the CBN as well as the established internal policies.

55. Senior management of a bank must:

- a) Establish and implement internal policies, processes and procedures governing risk concentrations.
- b) Clearly communicate and monitor compliance with the internal policies throughout the bank.
- c) Establish and maintain adequate systems that are able to identify, measure, monitor and aggregate exposures to single counterparties in a timely manner.

56. The internal policies on risk concentration must at a minimum include the following:

- a) Procedures for identifying, measuring, monitoring, controlling, and reporting single counterparty exposures of the institution.
- b) Detailed internal parameters for identifying persons or legal entities connected to a single counterparty.
- c) Internal exposure limits (including limits on total large exposures) that are reflective of the bank's risk appetite and risk bearing capacity, and which also takes into consideration the potential changes to the market value of the underlying exposures.
- d) Clearly defined roles and accountability for ensuring compliance and effective communication of the policies, procedures, and internal limits throughout the bank.
- e) Measures to manage and address compliance with the single counterparty exposure limit (SCEL) including authority and procedures for approving exceptions to the internal limits which in any case, must not exceed the SCEL; and
- f) Nature and frequency of reporting to the Board and senior management.

57. Banks should have adequate procedures and controls in place for monitoring the exposures and counterparties excluded from the Large Exposure Framework.

## 9. Transition Arrangement

58. This Large Exposures Guideline is focused on, and applicable to, a bank's counterparties. It does not address other types of concentration risks such as sectoral and geographical concentrations which are covered in other Guidelines<sup>7</sup> issued by the CBN.

59. The extant provisions in the Prudential Guidelines and other circulars of the CBN will continue to be applicable, except to the extent superseded by the provisions of this Guidance Note.

60. Banks should continue to compute the single obligor limits (SOL)<sup>8</sup>.

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<sup>7</sup> Guidelines on the Management of Credit Concentration Risk

<sup>8</sup> BOFIA 2014 and Prudential Guidelines, 2010

## APPENDIX I – Returns on Large Exposures

<b>Name of the Bank</b>	
<b>Return for the Month</b>	
<b>Shareholders' Funds</b>	<b>(NGN)</b>

**Table A:** Bank's 100 Largest Exposures to counterparties (single as well as group of connected counterparties) irrespective of their values relative to bank's shareholders' funds unimpaired by losses.

S/ No.	Name of the Counterparty	Whether Single (S) or Group (G) of connected counterparties	Sector	Sub-sector	Exposure Amount	Exposure as % of Shareholders Funds
1.						
2.						
3.						
--						
--						
98.						
99.						
100.						

**Table B.** Bank's exposures with values equal to or above 10% of shareholders' funds unimpaired by losses.

SI No.	Name of the Counterparty	Whether Single (S) or Group (G) of connected counterparties	Exposure Amount	Exposure as % of Shareholders' fund
1.				
2.				
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n				

**Table C.** Bank's other exposures with values equal to or above 10% of shareholders' funds unimpaired by losses (not including exposures reported in B already).

SI No.	Name of the Counterparty	Whether Single (S) or Group (G) of connected counterparties	Exposure Amount	Exposure as % of Shareholders' fund
1.				
2.				
3.				
n				

**Table D.** Bank's exempted exposures with values equal to or above 10% of shareholders' funds unimpaired by losses.

S/ No.	Name of the Counterparty	Whether Single (S) or Group (G) of connected counterparties	Exposure Amount	Exposure as % of Shareholders' fund
1.				
2.				
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n.				

## APPENDIX II – Collective Investment Undertaking and Other Structures

### a) Determination of the relevant counterparties to be considered

1. A bank may assign the exposure amount to the structure itself, defined as a distinct counterparty, if it can demonstrate that the bank's exposure amount to each underlying asset of the structure is smaller than 0.25% of its eligible capital base, considering only those exposures to underlying assets that result from the investment in the structure itself and using the exposure value calculated according to paragraphs 6 and 7 below<sup>9</sup>. In this case, a bank is not required to look through the structure to identify the underlying assets.
2. A bank must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 0.25% of its eligible capital base. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The bank's exposure amount to the underlying assets that are below 0.25% of the bank's eligible capital base may be assigned to the structure itself (i.e. partial look-through is permitted).
3. If a bank is unable to identify the underlying assets of a structure:
  - where the total amount of its exposure does not exceed 0.25% of its eligible capital base, the bank must assign the total exposure amount of its investment to the structure;
  - otherwise, it must assign this total exposure amount to the unknown client.

The bank must aggregate all unknown exposures as if they related to a single counterparty (the unknown client), to which the large exposure limit would apply.

4. When the look-through approach (LTA) is not required according to paragraph 1 above, a bank must nevertheless be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – e.g. that the bank has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.

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<sup>9</sup> By definition, this required test will be passed if the bank's whole investment in a structure is below 0.25% of its eligible capital base.

**b) Calculation of underlying exposures - bank's exposure amount to underlying assets**

5. If the LTA need not be applied, a bank's exposure to the structure must be the nominal amount it invests in the structure.

*Any structure where all investors rank pari passu (e.g. CIU)*

6. When the LTA is required according to the paragraphs above, the exposure value assigned to a counterparty is equal to the pro rata share that the bank holds in the structure multiplied by the value of the underlying asset in the structure. Thus, a bank holding a 1% share of a structure that invests in 20 assets each with a value of 5 must assign an exposure of 0.05 to each of the counterparties. An exposure to a counterparty must be added to any other direct or indirect exposures the bank has to that counterparty.

*Any structure with different seniority levels among investors (e.g. securitisation vehicles)*

7. When the LTA is required according to the paragraphs above, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, a bank must:
- first, consider the lower of the value of the tranche in which the bank invests and the nominal value of each underlying asset included in the underlying portfolio of assets
  - second, apply the pro rata share of the bank's investment in the tranche to the value determined in the first step above.