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Implementation guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC recast

Executive summary

1. The amendments to the Capital Requirements Directive¹ by Directive 2009/111/EC (CRD II) relating to the large exposures' (LE) regime – limits and applicable exemptions – necessitated a few targeted provisions to exempt very short-term exposures related to money transmission or financial instruments clearing, settlement and custody services to clients in order to facilitate the smooth functioning of financial markets and the related infrastructure.
2. The amendments have to be transposed into Member States' national law by 31 October 2010 and to be applied from 31 December 2010.
3. Article 106(2) (c) and (d) of the CRD provides exemptions from the large exposures rules for certain short-term exposures arising from the provision of money transmission, correspondent banking, clearing and settlement and custody activities.
4. These guidelines are structured in **two main parts** covering the provisions of (i) Article 106(2) (c) and (ii) Article 106(2) (d) of the CRD.
5. Institutions that provide services related to the provision of money transmission, clearing, settlement and asset servicing of financial instruments or securities financing services deal with very large volumes of inflows and outflows within short timeframes. The cash activities related to

¹ Capital Requirements Directive (CRD) is a technical expression which comprises Directive 2006/48/EC and Directive 2006/49/EC. Please note that general references to "Directive 2006/48/EC" and "Directive 2006/49/EC" or the "CRD" refer to the amended versions of the Directives and references in these Guidelines to a particular Article of the CRD refer to the amended Directives. The amending Directive (Directive 2009/111/EC) was published on 17 November 2009 and can be found under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>. The consolidated Version of the amended Directive 2006/48/EC can be found under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20091207:EN:PDF>.

these services are highly volatile, making the end of day positions uncertain and creating the possibility for large exposures to arise.

6. The aim of the exemption from the large exposure regime provided by **Article 106(2) (c)** of the CRD is to facilitate the smooth functioning of financial markets and the related infrastructure.
7. To be eligible for the exemption in Article 106(2) (c) of the CRD, exposures shall meet 3 conditions (eligibility criteria): first, the exposure arises from the provision of specific types of services; second, the exposure arises from client activity; and third, the exposure does not last longer than the following business day.
8. As the provision of payment services is a bilateral relationship, **Article 106(2) (d)** of the CRD provides a further exemption to the large exposure regime for intra-day exposures to institutions providing services related to the provision of money transmission, clearing and settlement and correspondent banking.
9. To be eligible for the exemption in Article 106(2) (d) of the CRD, exposures shall meet 3 conditions (eligibility criteria): first, the exposure arises from the provision of specific types of services; second, the exposure is to specific services providers; and third, the exposure is intra-day.
10. These guidelines provide further clarification of the eligibility criteria to be met to qualify exposures for exemption from the large exposure regime under the provisions of Article 106(2) (c) and (d) of the CRD.

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Introduction

11. The amendments to the Capital Requirements Directive by Directive 2009/111/EC relating to the large exposures' (LE) regime – limits and applicable exemptions – necessitated a few targeted provisions to exempt very short-term exposures related to money transmission or financial instruments clearing, settlement and custody services to clients in order to facilitate the smooth functioning of financial markets and the related infrastructure.
12. Providing guidance on the scope and the eligibility conditions of the exemption provisions in Article 106(2)(c) and (d) of the CRD is seen as important for safeguarding a level playing field for all institutions providing money transmission or financial instruments clearing, settlement and custody services to clients, including single-purpose institutions such as (International) Central Securities Depositories [(I)CSDs] and Central Counterparties (CCPs) that are regulated as credit institutions according to national law (thus falling under the LE regime).

I. Background

13. A revised large exposures regime is included in the amended Capital Requirement Directive. The amendments have to be transposed into Member States' national law by 31 October 2010 and to be applied from 31 December 2010.
14. The revised provisions on large exposures comprise specific provisions allowing exemptions from the large exposures regime for very short-term exposures related to targeted services (money transmission, financial instruments clearing and settlement and custody services).
15. These guidelines respond to the provision in Article 106(2), last subparagraph, of the CRD, that CEBS shall elaborate guidelines in order to enhance the convergence of supervisory practices in applying the exemptions in points (c) and (d) of that Article.

II. Implementation date

16. CEBS expects its Members to transpose the guidelines into their national legal framework by 31 October 2010 and apply them by 31 December 2010 at the latest.

III. Guidelines on Article 106(2)(c) of the CRD

17. Background: An important part of the payments related to money transmission, clearing, settlement and asset servicing of financial instruments or securities financing services is executed in commercial bank money. Such payments take place around the world, in different time zones, with different market practices, holiday regimes and currencies. The payments take place across a network of commercial banks and involve custodian banks, CCPs, (I)CSDs and their related cash correspondent banks. To ensure that the markets function properly and efficiently, the institutions involved have to manage the time gaps between inflows and outflows on their inter-bank accounts related to client transactions (i.e. the movement of large volumes within short timeframes).
18. As the cash activity related to money transmission, clearing and settlement as well as asset servicing of financial instruments or securities financing services is highly volatile and dependent on client behaviour, expected inflows or outflows do not always materialise and incoming funds are often not pre-advised (in pure payment processing, funds are typically never pre-advised), i.e. the end of day positions are uncertain until the end of the business day. Thus, large exposures may unexpectedly arise especially towards the end of the business day, at a time when further reduction of the exposures can no longer reasonably be achieved and they are expected to be resolved by the next business day.

In the same vein, when additional collateral is requested to cover exposures (e.g. margin calls are issued to cover the exposures that a CCP faces on its participants), the collateral requirements may arise late and – depending on the time of the day – there may be no other choice than to cover them with cash.

To take account of such cases, Article 106(2)(c) of the CRD provides for certain very short-term exposures to be exempted from the large exposures regime. The aim is to facilitate the smooth functioning of financial markets and the related infrastructure.

Recital 22 of Directive 2009/111/EC (CRD II) provides further guidance on the character of the exempted exposures: *“The related exposures include exposures, which might not be foreseeable and are therefore not under the full control of a credit institution, inter alia, balances on inter-bank accounts resulting from client payments, including credited or debited fees and interest, and other payments for client services, as well as collateral given or received.”*

19. Eligibility criteria: To be eligible for the exemption in Article 106(2) (c) of the CRD, exposures shall meet all of the following three conditions: A.) the exposure arises from the provision of specific types of services; B.) the exposure arises from client activity; and C.) the exposure does not last longer than the following business day.
 - A. Types of services: The exemption has no limitation regarding specific counterparties or entities but does in relation to exposures

arising from specific types of services which are eligible. The requirement in Article 106(2) (c) of the CRD stipulates the following types of services and exposures arising from the provision of such services:

1. provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking services;
2. financial instruments clearing, settlement and custody services for clients. Custody services include incoming payments of income (e.g. interest or dividend payments), redemption of principal amounts and other payments arising from life-cycle events related to financial instruments. Exempted exposures may arise from exposures to clients, cash correspondents or entities active in the custody services chain (mainly issuers or paying agents).

B. Client activity: Exposures arising from the types of services listed under A. above are only covered by the exemption clause if they arise from client activity. In this context client activity shall comprise both direct and indirect activity, i.e. activity on the initiative of the client but also "indirect" client activity in the form of payments or withdrawals by agents or contracting partners of the client (including the account-keeping institution) covering the crediting and debiting of payments, fees and interest, and the provision or withdrawal of cash collateral. Exposures arising from proprietary trading activities are not covered by this exemption.

The following exposures shall be exempt:

1. exposures which stem from delayed receipts in funding; and
2. other exposures. CEBS considers that the term "other exposures" covers the following exposures:
 - (a) exposures which stem from unexpected incoming flows or exposures which are the result of expected in- or outflows which have not materialised where the credit institution, as a consequence of technical or external limitations (e.g. time of the day, market practice) is not in a position to reduce these exposures with reasonable efforts before the end of the business day;
 - (b) cash collateral given or received in the context of services under A.2, or other financial markets transactions for clients (i.e. cash collateral placed for

participation on regulated financial markets or for securities financing transactions); and

(c) exposures arising on the same day as a consequence of further diversification of exposures. That is, the scope of the exemption should also cover cases where the institution re-deposits parts of exempted exposures with third party banks or enters into (reverse) repurchase agreements with third party banks and thereby is not able – due to technical or external limitations (e.g. time of the day, market practice) – to diversify the exposures in such a way that the consequent exposures fall below the LE limit. Exempted exposures shall meet all of the following conditions:

- i. the original exposure was covered by points 1. or 2.(a) above;
- ii. the diversified exposure(s) result(s) solely from the institution's efforts to reduce its risk vis-à-vis one counterparty by diversifying parts of the original exposure away to one or more other counterparties; and
- iii. the credit institution with which the diversified exposures are placed shall have a credit assessment by an eligible External Credit Assessment Institution (ECAI) which has been determined by the competent authority to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions under Articles 78 to 83 of the CRD (i.e. under the standardised approach for the calculation of minimum capital requirements for credit risk)².

C. Short-term (overnight): Only exposures that are reduced below the LE limit within the following business day are covered by the exemption in Article 106(2) (c) of the CRD, i.e. the reporting institution shall reduce the exposure below the LE limit before the end of the following business day. Otherwise, the exposure is no longer exempted from the LE regime and a breach of the limit shall be reported. However, although the maximum time span for such an exempted exposure lasts until the end of the next business day, CEBS's expectation is that it will be reduced below the LE limit without delay, i.e. as soon as possible within the next business day.

² Irrespective of the approach used to determine the risk weighted exposure amounts for exposures to institutions by the institution which is diversifying its exposures.

Article 106(2) (c) of the CRD refers to “exposures arising from client activity”, not to account balances. The balance on an account with a counterparty at the end of the day (“aggregate exposure”) may be the consequence of various movements from multiple clients during the day, giving rise to “single exposures”. Therefore, even if the balance on an account on consecutive days (“aggregate exposure”) may be above the large exposure limit, this does not automatically imply that it is not covered by the exemption because of condition C.

Cash collateral referred to under B. 2. (b) above is exempted, provided it is not requested to be held for a fixed or minimum period exceeding the next business day.

20. Institutions should put in place robust procedures and control mechanisms to provide adequate assurance that conditions A. to C. above are fulfilled. In particular, institutions shall be able to demonstrate that the exposures they exempt in accordance with Article 106(2) (c) of the CRD arose in full from client activity.

IV. Guidelines on Article 106(2)(d) of the CRD

21. As the provision of payment services is a bilateral relationship, a further exemption to the LE regime was created for intra-day exposures to institutions providing money transmission services, i.e. in contrast to the exception given in Article 106(2) (c) of the CRD, Article 106(2) (d) of the CRD deals with exposures vis-à-vis such service providers.
22. Eligibility criteria: To be eligible for the exemption in Article 106(2) (d) of the CRD, exposures shall meet all of the following three conditions: A.) the exposure arises from the provision of specific types of services; B.) the exposure is to specific services providers; and C.) the exposure is intra-day.
 - A. Types of services: Article 106(2) (d) of the CRD provides a list of exposures to be exempted: exposures arising from the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking. These exposures are exempted irrespective of the origin of the exposures (i.e. they could be the result of cash movements from financial instrument transactions, payments for purchases, plain cash transfers between accounts etc.) or the means of payments (cash transfer, cheque clearing, direct debiting, etc.).
 - B. Specific service providers: The exemption is limited to exposures to institutions providing services listed under A. However, such service providers do not need to be payment institutions as defined by the Payment Service Directive (Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC Text with EEA relevance) nor is it necessary that the services listed under A are a major part of the services offered. In any case, the service providers shall be subject to prudential or market supervision or oversight in a Member State or by legislation that is considered to be equivalent to that laid down in Community law.
 - C. Short-term (intra-day): Only exposures that are reduced below the LE limit within the same business day are covered by the exemption in Article 106(2) (d) of the CRD, i.e. the reporting institution shall reduce the exposure below the LE limit before the end of the business day. Otherwise, the exposure is not exempted from the LE regime and a breach of the limit shall be reported. However, although the maximum time span for such an exempted exposure lasts until the end of the business day, CEBS's expectation is that it will be reduced below the LE limit without delay, i.e. as soon as possible within the business day.
23. Institutions should put in place robust procedures and control mechanisms to provide adequate assurance that the conditions A. to C. above are fulfilled.

ANNEX I: Requirements of the CRD

Recital 22 of Directive 2009/111/EC (CRD II):

"[...] In addition, very short-term exposures related to money transmission including the execution of payment services, clearing, settlement and custody services to clients are exempt to facilitate the smooth functioning of financial markets and of the related infrastructure. Those services cover, for example, the execution of cash clearing and settlement and similar activities to facilitate settlement. The related exposures include exposures which might not be foreseeable and are therefore not under the full control of a credit institution, inter alia, balances on inter-bank accounts resulting from client payments, including credited or debited fees and interest, and other payments for client services, as well as collateral given or received."

Article 106(2) of Directive 2006/48/EC recast:

"Exposures shall not include any of the following: [...]"

c) 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; or

(d) 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.

The Committee of European Banking Supervisors shall provide for guidelines in order to enhance the convergence of supervisory practises in applying the exemptions in points (c) and (d).";