



**Financial Services
Commission**

Guidance Notes

Concentration Risk

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1. Application

1.1. This Guidance Note applies to all locally incorporated credit institutions and investment firms to assist them in the treatment of large exposures for the purposes of the Capital Adequacy Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC which have been implemented in Gibraltar via the Banking (Capital Adequacy of Credit Institutions) Regulations, and Financial Services (Capital Adequacy of Investment Firms) Regulations. The aim of the Guidance Note is to supplement the Regulations and it applies irrespective of what approach(es) the firm adopts. The EU Commission has asked CEBS to produce some advice in respect of Large Exposures, once this is available, this guidance may be revised.

1.2.

1.2.1. This Guidance Note sets out rules and guidance for large exposures and implements the large exposures requirements of articles 106 to 118 and paragraph 7 of Annex V of Directive 2006/48/EC and articles 28 to 32 of the Capital Adequacy Directive (2006/49/EC).

1.2.2. A large exposure may be in the form of a loan to a single borrower, or it may arise across many transactions involving different types of financial instruments with several counterparties within the same group of companies. Where a firm's exposure to its counterparty is large, it risks a large loss should the counterparty default. Such a loss may be sufficient on its own to threaten the solvency of the firm.

1.2.3. The purpose of this Guidance Note is to ensure that a firm manages its exposure to counterparties within appropriate limits, set in relation to its capital resources.

2. Identification of exposures

2.1.

2.1.1. Unless paragraphs 2.2 or 2.3 applies, an exposure is any of the items included in Guidance Note Credit Risk Standard Approach, section 2, whether held in the trading book or the non-trading book, without application of the risk weight or degrees of risk there provided for.

2.1.2. An exposure includes a trading book position in accordance with paragraph 4 and a notional position as described in paragraph 4.1.7.

2.2. An exposure does not include:

2.2.1. An exposure which is entirely deducted from a firm's capital resources;

2.2.2. in the case of foreign currency transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment; or

2.2.3. in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is earlier.

2.3. An exposure does not include:

2.3.1. A transaction entered into by a firm as trustee or agent without personal liability on the part of the firm;

2.3.2. indemnities for lost share certificates; or

2.3.3. (where the firm acts as lesser, mortgagee or owner of goods under a hire-purchase arrangement) contingent liabilities for injuries, damage or loss on the part of the counterparty to that arrangement in respect of the goods that are the subject of that arrangement.

3. Identification of counterparties

3.1. An individual counterparty may be a natural or legal person.

3.2. Examples of a counterparty include:

3.2.1. the customer or borrower; this includes governments, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses (whether as sole traders or partnerships) and non-profit making bodies;

3.2.2. where the firm is providing a guarantee, the person guaranteed;

3.2.3. for a derivatives contract, the person with whom the contract was made;

3.2.4. for exchange traded contracts novated through a central clearing mechanism, that central clearing mechanism;

3.2.5. where a bill held by a firm has been accepted by a credit institution, the acceptor; and

3.2.6. where a firm is funding the activities of a company that trades on an exchange (whether as principal or on behalf of clients), that company.

3.3. Identification of counterparties for guaranteed exposures

3.3.1. Subject to a firm meeting the conditions in relation to credit risk management, in the credit risk mitigation section of the Guidance Note on credit risk standardised approach, where an exposure to a counterparty is guaranteed by a third party, a firm may treat the exposure as an exposure to the third party and not to the counterparty.



- 3.3.2. In deciding whether or not to treat the exposure as an exposure to the third party, a firm must ensure that the identification of counterparties for concentration risk purposes is applied in a consistent manner.
- 3.3.3. Where the guarantee is denominated in a currency different from that in which the exposure is denominated, the amount of the exposure deemed to be covered must be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection, in the credit risk mitigation section in the Guidance Note on credit risk standardised approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach.
- 3.3.4. A mismatch between the maturity of the exposure and the maturity of the protection must be treated in accordance with the provisions on the treatment for maturity mismatch, the credit risk mitigation section in the Guidance Note on credit risk standardised approach and, if applicable, paragraph 10 of the Guidance Note on Credit Risk IRB Approach.
- 3.3.5. Partial coverage must be treated in accordance with the Guidance Note Credit Risk Standardised Approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach.
- 3.3.6. A guarantee may only be treated in accordance with 3.3.1 if the firm complies with the eligibility requirements and other minimum requirements set out in Guidance Note Credit Risk Standardised Approach for the purposes of calculating risk-weighted exposure amounts under the standardised approach.
- 3.3.7. For the purpose of this rule, guarantee includes a credit derivative recognised under Guidance Note Credit Risk Standardised Approach and, if applicable, paragraph 10 of the Guidance Note Credit Risk IRB Approach, other than a credit linked note.

3.4. Groups of connected clients

- 3.4.1. The glossary defines a group of connected clients.
- 3.4.2. Relationships between individual counterparties which might be considered to constitute a single risk for the purposes of the definition of group of connected clients include:
- 3.4.2.1. undertakings in the same group;
 - 3.4.2.2. companies whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure;
 - 3.4.2.3. companies having common directors or management; and
 - 3.4.2.4. counterparties linked by cross guarantees.
- 3.4.3. The FSC would not regard the normal business relationships between companies which are competitors, and to which none of the relationships listed in 3.4.2.1 apply, as falling within the definition of group of connected clients.



3.5. Connected counterparties

3.5.1. For the purposes of this Guidance Note, and in relation to a firm, a connected counterparty means another person ('P') to whom the firm has an exposure and who fulfils at least one of the following conditions:

- 3.5.1.1. P is closely related to the firm; or
- 3.5.1.2. P is an associate of the firm; or
- 3.5.1.3. the same persons significantly influence the governing body of P and the firm; or
- 3.5.1.4. the firm has an exposure to P that was not incurred for the clear commercial advantage of the firm or the firm's group and which is not on an arm's length basis.

3.6. Exposures to counterparties, groups of connected clients and connected counterparties

3.6.1. A firm's total exposure to a counterparty must be calculated by summing its exposures to that counterparty.

3.6.2. A firm's total exposure to a group of connected clients must be calculated by summing its exposures to the individual persons within that group of connected clients.

3.6.3. A firm's total exposure to connected counterparties must be calculated by summing its exposures to all the firm's connected counterparties.

3.7. Exposures to trustees

3.7.1. If a firm has an exposure to a person ('A') when A is acting on his own behalf, and also an exposure to A when A acts in his capacity as trustee of an investment trust or unit trust or venture capital fund or pension fund, the firm may treat the latter exposure as if it was an exposure to a different person, unless such a treatment would be misleading.

3.7.2. When considering whether the treatment described in paragraph 3.1 is misleading, factors a firm should consider include:

- 3.7.2.1. the degree of independence of control of the fund, including the relation of the fund's board and senior management to the firm or to other funds or to both;
- 3.7.2.2. whether the beneficial owners of the fund are connected to the firm, or related to other funds managed within the group, or both; and
- 3.7.2.3. for a connected counterparty, whether the loan is made on an arm's length basis.

3.7.3. In deciding whether a transaction is at arm's length for the purposes of paragraph 3.5.1.4 and paragraph 3.6.3, the following factors should be taken into account:

- 3.7.3.1. the extent to which the person to whom the firm has an exposure ('A') can influence a firm's operations, through e.g. the exercise of voting rights;
- 3.7.3.2. the management role of A, where A is also a director of the firm; and
- 3.7.3.3. whether the loan would be subject to the firm's usual monitoring and recovery procedures if repayment difficulties emerged.

4. Measurement of exposures to counterparties and issuers.

- 4.1. Unless specifically mentioned, paragraph 4 applies both to non-trading book and trading book exposures.
- 4.2. Unless paragraph 4.3 applies, when calculating an exposure, a firm must include accrued interest and dividends due.
- 4.3. A firm may use the following method of calculating the total amount of a firm's total exposures in the non-trading book to a counterparty, connected counterparties, or group of connected clients as an alternative.
 - 4.3.1. If the total amount of the exposures is less than 20% of the firm's capital resources, the accrued interest element need not be included in the calculation of the amount of the exposures in the non-trading book;
 - 4.3.2. If the total amount of the exposures is more than 20% (but less than 25%) of the firm's capital resources, the firm must be able to demonstrate that the total amount of the exposures, including the accrued interest element, is below the 25% limit in paragraph 5.3.1 and that the 25% limit in paragraph 5.4.1 has not been exceeded.
- 4.4. The reason for paragraph 4.2 is the systems difficulties of including accrued interest in the total amount of exposures in the non-trading book.
- 4.5. A firm must not offset non-trading book and trading book exposures.
- 4.6. The exposures to an individual counterparty which arise on the trading book must be calculated by summing the following items:
 - 4.6.1. The excess where positive of the firm's long positions over its short positions in all the CRD financial instruments issued by the counterparty in question, in accordance with paragraph 4.9.6
 - 4.6.2. The firm's net underwriting exposure to that counterparty; and
 - 4.6.3. The exposures due to the transactions, agreements and contracts referred to with the counterparty in question.
- 4.7. For the purpose of calculating the value of an exposure, exposures are divided into counterparty exposures and issuer exposures.
 - 4.7.1. For the purposes of this guidance note, an issuer exposure means:
 - 4.7.1.1. any exposure in the trading book that gives rise to a position that is subject to the market risk capital requirement under the standard market risk PRR rules; and
 - 4.7.1.2. any exposure in the non-trading book that, if it were in the trading book and subject to the standard market risk PRR rules:

- 4.7.1.2.1. (in the case of a derivative in relation to a CRD financial instrument) Would give rise to a notional position in the CRD financial instrument underlying that derivative; or
 - 4.7.1.2.2. would give rise to a similar notional position in a CRD financial instrument other than the one that the firm actually holds.
- 4.7.2. For the purposes of this Guidance Note, the counterparty or issuer with respect to an exposure falling into 4.7.1.2.2 is the person who is or would be treated as the obligor under the standard market risk PRR rules in question.
- 4.7.3. For the purposes of this Guidance Note, a counterparty exposure means any exposure not within 4.7.1.2.2.

4.8. Counterparty Exposures

4.8.1.

- 4.8.1.1. Subject to 4.8.1.2 and 4.8.1.3, the value of a firm's counterparty exposures, whether in its non-trading book or its trading book, is the amount at risk.
- 4.8.1.2. A firm which has a trading book must calculate the value of its exposures in its trading book due to the transactions, agreements and contracts for the calculation of exposure values.
- 4.8.1.3. Exposures arising from the items referred to in the definition of financial derivative instruments must be calculated in accordance with one of the methods set out in the Guidance Note on financial derivatives, SFTs and long settlement transactions.

4.9. Issuer Exposures

- 4.9.1. Paragraph 4.9.2 applies to issuer exposures.
- 4.9.2. A firm must calculate the value of an exposure to the issuer of a security which is held in the firm's non-trading book as the sum of the excess, where positive, of the book value of all long positions over all short positions (the net long position), for each identical instrument issued by that issuer.
- 4.9.3. For the purposes of paragraph 4.9.2, short positions in one security may be used to offset long positions in a non-identical security issued by the same issuer if both the securities are denominated in the same currency, and:
- 4.9.3.1. where both the securities are fixed rate, they are within the same residual maturity time band, one year or less, or over one year; or
 - 4.9.3.2. where both the securities are index linked, they are within the same residual maturity time band referred to in 4.9.3.1; or
 - 4.9.3.3. both the securities are floating rate.
- 4.9.4. For the purposes of paragraph 4.9.2, a firm may, when calculating its net position in any security in the non-trading book, take into account counterparty exposures. However any counterparty exposure used in this way is still subject to the provisions of this Guidance Note about counterparty exposures.



4.9.5. This paragraph illustrates how the distinction between counterparty exposures and issuer exposures in paragraph 4.6 works. Say that a firm has a holding of shares in its non-trading book and it has bought a put option over those shares, which it also holds in its non-trading book. The holding of shares gives rise to a counterparty exposure to the issuer of those shares and the option gives rise to a counterparty exposure to the person who wrote the option. The option also gives rise to an issuer exposure to the issuer of the shares. The firm may use paragraph 4.9.4 to eliminate that issuer exposure by netting its position to zero by taking into account its long non-trading book position in those shares. If it does so, the firm will still have counterparty exposures to the issuer of the shares and the counterparty under the option.

4.9.6. A firm must calculate the value of an exposure to the issuer of a security which is held in the firm's trading book by calculating the excess of the current market value of all long positions over all short positions in all the securities issued by that issuer.

4.9.7. For the purposes of paragraph 4.9.3, the short positions must be netted against the long positions in securities with the highest specific risk PRAs.

4.9.8. A firm must not offset an exposure to one issuer against an exposure to another issuer even where:

4.9.8.1. the issuers are a group of connected clients; and

4.9.8.2. the exposures are non-identical exposures which meet the conditions.

4.10. Forward agreements

4.10.1. A firm must include as a long position a commitment by it to buy:

4.10.1.1. a debt security or an equity at a future date; and

4.10.1.2. under a note issuance facility, at the request of the issuer, a security which is unsold on the issue date.

4.10.2. A firm must include as a short position a commitment by it to sell a debt security or an equity at a future date.

Interest rate, foreign currency and equity swaps

4.10.3. An interest rate leg of an equity swap, or an interest rate or currency swap, does not generate an issuer exposure.

4.10.4. Where the equity leg of an equity swap is based on the change in value of an individual equity, it must be treated as giving rise to an exposure to the issuer of the equity.

4.11. Option positions

4.11.1. When determining its exposure to an issuer arising from an option, a firm must value the notional principal of an option as the amount of principal underlying the option.



4.11.2. A firm must treat:

- 4.11.2.1. a written put option as a long position in the underlying security valued at the strike price or the market price of the underlying security, whichever is lower;
- 4.11.2.2. a purchased put option as a short position in the underlying security valued at the strike price or the market price of the underlying security, whichever is lower; and
- 4.11.2.3. a purchased call option as a long position in the underlying security equal to the book value of the option provided that the contract has been given a book value in the firm's accounts.

4.11.3. A written call option does not generate exposure to an issuer.

- 4.11.3.1. This rule applies in relation to an option if a firm has a waiver that covers the option and has option risk aggregation as described in paragraph 9.7 of the Guidance Note on market risk.
- 4.11.3.2. This rule also applies in relation to an option if a firm:
 - 4.11.3.2.1. has been allowed to use a VAR model; and
 - 4.11.3.2.2. the scope of the VAR model permission covers that option.
 - 4.11.3.2.3. The firm may use the model described in 4.11.3.1 and 4.11.3.2 for the purpose of calculating the market value of that option to the extent that those values are relevant for the calculations.

4.12. Indices and baskets of equities or securities

- 4.12.1. Subject to paragraph 4.12.2, a firm must treat an index or basket of debt securities or equities as giving rise to a series of exposures to the issuers of the underlying securities or equities in accordance with the provisions of paragraphs 2 or 3 of the Guidance Note on Market Risk.
- 4.12.2. A qualifying equity index does not generate an exposure of the type described paragraph 4.12.1.

4.13. Securities financing transactions

- 4.13.1. A firm with securities financing transactions in its trading book or its non-trading book must calculate its exposure to:
 - 4.13.1.1. the issuer of the security it has sold in a repurchase agreement; and

4.13.1.2. the counterparty (subject to paragraph 3.3.1 and paragraph 6).

Underwriting

4.13.2. In accordance with paragraph 8.31 of the Guidance Note on Market Risk, for the purposes of calculating the concentration risk capital component, a firm should include net underwriting exposures to an issuer in the calculation of its total exposure to that issuer.

4.14. Exposures to undisclosed counterparties

4.14.1. A firm must not incur an exposure to an undisclosed counterparty unless:

4.14.1.1. It has satisfied itself that it will continue to meet the limits in paragraph 5 for non-trading book exposures and trading book exposures; and

4.14.1.2. It has made and retained a record of the steps it has taken to comply with 4.8.1.1.

5. Limits on exposures and large exposures

5.1. Definition of large exposure

5.1.1. A large exposure of a firm means its total exposure to a counterparty, connected counterparties, or a group of connected clients, whether in the firm's non-trading book or trading book or both, which in aggregate equals or exceeds 10% of the firm's capital resources.

5.2. Capital resources

5.2.1. For the purposes of the large exposure limits in paragraph 5 in the trading book and the non-trading book, a firm's capital resources means total tier one capital resources plus tier two capital resources after deductions.

5.2.2. For the purposes of monitoring against the trading book limits and charge regime, as set out in paragraphs 5.4.1 to 5.4.4, and calculating a firm's Concentration Risk Capital Component (CNCOM) in accordance with paragraph 5.4.6, a firm's capital resources may include tier three capital resources.

5.3. Non-trading book limits

5.3.1. A firm must ensure that the total amount of its exposures to the following does not exceed 25% of its capital resources:

5.3.1.1. a counterparty; or

5.3.1.2. a group of connected clients; or

5.3.1.3. its connected counterparties.

5.3.2. Paragraph 5.3.1 creates a single limit for each of the types of exposure listed in paragraph 5.3.1. Accordingly, if a connected counterparty is also a member of a group of connected clients the limit in paragraph 5.3.1 covers the aggregate of the total amount of the firm's exposures to its connected counterparties and of the total amount of its exposures to that group of connected clients.

5.3.3. A firm must not incur large exposures which in total exceed 800% of its capital resources.

5.3.4. If a firm exceeds (or is aware that it will exceed) the limits in paragraphs 5.3.1 to 5.3.3 it must notify the FSC without delay.

5.3.5. A report under paragraph 5.3.4 should be made in exceptional circumstances only. A firm which makes such a report should also provide the FSC with an explanation as to how the limits came to be exceeded, and a plan of action for bringing its exposures within the limits. The FSC may, where the circumstances warrant it, allow a firm a limited period of time in which to comply with the limits.

5.4. Trading book limits

5.4.1. Exposures in a firm's trading book are exempt from the 25% and 800% limits in paragraph 5.1.3 and paragraph 5.3.3 if:

5.4.1.1. the total amount of the exposures on the firm's non- trading book to the same counterparty or group of connected clients does not exceed the limits laid down in those rules, calculated with reference to the definition of capital resources set out in paragraph 5.1.1, so that the excess arises entirely on the trading book; and

5.4.1.2. the firm meets the additional capital requirements relating to the CNCOM in relation to the relevant trading book exposures.

5.4.2. A trading book concentration risk excess arises if the total amount of a firm's trading book exposure to a counterparty or to a group of connected clients, when added to any non-trading book exposure to that counterparty or group of connected clients, exceeds 25% of the firm's capital resources and that excess is permitted by paragraph 5.4.1.

5.4.3. If a trading book concentration risk excess with respect to a counterparty or to a group of connected clients has existed for 10 business days or less, the firm must ensure that the total amount of its trading book exposures to that counterparty or group of connected clients does not exceed 500% of the firm's capital resources.

5.4.4. A firm must ensure that the total amount of its trading book concentration risk excesses that have persisted for more than 10 business days does not exceed 600% of its capital resources.

5.4.5. Credit Institutions should within 14 days of the end of each third month, notify the FSC all cases in the three month period ending at the end of that third month of each trading book concentration risk excess that existed in



that period, giving the amount of the excess and the name of the counterparty. Investment firms must report this within 21 days.

5.5. How to calculate the concentration risk capital component

5.5.1. A firm's CNCOM must be calculated as part of its credit risk capital requirement (CRCR).

5.5.2. A firm's CNCOM is the sum of its individual counterparty CNCOMs.

5.5.3. An individual counterparty CNCOM is the amount a firm must calculate in accordance with paragraph 5.5.5 with respect to its exposures to a particular counterparty or a group of connected clients.

5.5.4. A CNCOM calculation on a trading book exposure is in addition to, and not instead of, any capital requirement arising under the market risk capital requirement or counterparty risk capital component.

5.5.5. A firm must calculate its individual counterparty CNCOM on its exposures to a counterparty or group of connected clients that give rise to a trading book concentration risk excess as follows:

5.5.5.1. break down its total exposure into its component parts;

5.5.5.2. calculate 25% of the firm's capital resources and deduct those parts of the total exposure which are in the non-trading book;

5.5.5.3. if the non-trading book exposures deducted in 5.5.5.2 equal 25% of the firm's capital resources, steps 5.5.5.4 and 5.5.5.5 do not apply;

5.5.5.4. if the total amount of the non-trading book exposures deducted in 5.5.5.2 is less than 25% of the firm's capital resources, take out from the calculation (in the order set out in 5.5.5.5) the component parts of the firm's total trading book exposure until the total amount deducted equals 25% of the firm's capital resources;

5.5.5.5. for the purposes of 5.5.5.4, take out first those component parts of the firm's total trading book exposure with the lowest capital requirements for specific risk under the market risk capital requirement or the lowest capital requirements under the counterparty risk capital component and those with the highest capital requirements last;

5.5.5.6. the individual counterparty CNCOM is the sum of the capital requirements for each individual exposure in the firm's remaining total trading book exposure in accordance with 5.5.5.7 and 5.5.5.8;

5.5.5.7. if the trading book concentration risk excess has persisted for 10 business days or less (irrespective of the age of each component part), the individual CNCOMs must be calculated in accordance with this formula:

Each individual CNCOM = capital requirement referred to in 5.5.5.5 x 200%;



5.5.5.8. if the trading book concentration risk excess has persisted for more than 10 business days (irrespective of the age of each component part), the individual CNCOMs must be calculated in accordance with this formula:

Each individual CNCOM = capital requirement referred to in 5.5.5.5 x appropriate percentage in paragraph 5.6

5.5.6. The appropriate percentage referred to in paragraph 5.5.5.8 must be established in accordance with the following:

5.5.6.1. The component parts of the firm's total trading book exposure remaining after the procedure in paragraph 5.5.5 must be assigned to the bands in the first column of the table in paragraph 5.5.7;

5.5.6.2. The maximum amount that may be put in any band other than the last equals the percentage of the firm's capital resources in column 1 of that table;

5.5.6.3. No amount may be allocated to the second or any later band unless the one before has been filled;

5.5.6.4. Exposures must be assigned to the bands in the order established by paragraph 5.5.5.5;

5.5.6.5. For the purposes of 5.5.6.4, those exposures with the lowest capital requirements (as referred to in paragraph 5.5.5.5) must be assigned first and those with the highest must be assigned last.

5.6. Percentage applicable under paragraph 5.5.6

5.6.1.

Excess exposure (as a percentage of the firm's capital resources)	Percentage
0% up to 40%	200%
Portion from 40% - 60%	300%
Portion from 60% - 80%	400%
Portion from 80% - 100%	500%
Portion from 100% - 250%	600%
Portion over 250%	900%

5.7. Example of a CNCOM calculation.

Capital resources position



5.7.1. An institution's capital resources comprises:

Tier one and tier two capital resources	£1000
Eligible tier three capital resource	£100
Amended capital resources	£1100

5.7.2. The components of the large exposure comprise:

5.7.2.1. Counterparty exposure £200

5.7.2.2. Mark to market value of trading book securities:

	<i>% specific risk weight</i>	
Short: qualifying bond	1.00	(20)
Long: qualifying commercial Paper	0.25	100
Long: equity	4.00	150
Long: qualifying convertible	1.60	30
Total net long securities position:		200
Total net large exposures position [(a) + (b)]		460

Calculating the exposure for which incremental capital is needed

5.7.2.3. The short position in the qualifying bond is offset against the highest specific risk weight items, in this case equities:

Net long equity position (£150- £20) £130

5.7.2.4. The remaining items are ranked according to specific risk weight.

	<i>% Specific Security</i>	£
<i>risk weight</i>		
0.25	Qualifying commercial paper	100
1.60	Qualifying convertible	30
4.00	Equity (net)	130



5.7.2.5. The 'headroom' between the non-securities exposure and 25% of the amended capital resources is calculated.

	£
25% of amended capital base (1100)	275
Non securities exposure	200
Headroom	75

5.7.2.6. Applying the securities positions in ascending order of specific risk weight, £75 of the £100 qualifying commercial paper may be counted before 25% of the amended capital base is reached.

5.7.2.7. The remaining £25 of qualifying commercial paper, along with £30 qualifying convertible and £130 equity (net) are traded securities exposures in excess of the limit and should therefore be covered by incremental capital. The amount of incremental capital should be included in the calculation for determining how much trading book capital an institution should have.

5.7.2.8. If the excess exposure has been outstanding for 10 days or less, the specific risk weights for the elements over 25% of amended capital resources should be doubled.

The 25% limit (£275) is taken up by £200 counterparty exposure and £75 securities exposure within the limit. These two items, when added to the items in bold below, total £460. £460 is the total net large exposures position as set out in (2) above.

		£
Qualifying commercial paper	£25 x 0.25% x 200% =	0.125
Qualifying convertible	£30 x 1.60% x 200% =	0.960
Equity	£130 x 4% x 200% +	10.400
Additional capital requirement		11.485

5.7.2.9. If the excess exposure has been outstanding for more than 10 days, the 25% limit (£275) is taken up by £200 counterparty exposure and £75 securities exposure within the limit. These two items, when added to the items in bold below, total £460. £460 is the total net large exposures position as set out in 5.7.2.2 above

5.7.2.9.1. Over 25% and up to 40% of amended capital base at 200% (40% of £1100 = £440)

£25 x 0.25% x 200% =	0.125
£30 x 1.60% x 200% =	0.960



$£110 \times 4.00\% \times 200\% =$	8.800
5.7.2.9.2. Excess exposure 40% - 60% of amended capital base at 300%	
$£20 \times 4.00\% \times 300\% =$	2.400
Additional capital requirement [(a)+(b)]	11.485

6. Exemptions

6.1. General exemptions

6.1.1. The exposures listed in paragraph 6.1.3, whether trading book exposures or non-trading book exposures, are exempt from the limits described in paragraph 5, provided that the exposures are to counterparties which are not connected counterparties.

6.1.2. In paragraph 6.1.3 and paragraph 6.1.4, references to guarantees include credit derivatives recognised under the Guidance Note on Credit Risk Standardised Approach and, if applicable, the Guidance Note on IRB approach, other than credit linked notes. For this purpose paragraph 3.3.1.6 applies.

6.1.3. The exposures referred to in paragraph 6.1.1 are as follows:

6.1.3.1. Asset items constituting claims on central governments or central banks which claims would unsecured receive a 0% risk weight under the standardised approach;

6.1.3.2. Asset items constituting claims on international organisations or multilateral development banks which claims would unsecured receive a 0% risk weight under the standardised approach;

6.1.3.3. Asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations or multilateral development banks, where unsecured claims on the entity providing the guarantee would achieve a 0% risk weight under the standardised approach;

6.1.3.4. Other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, or multilateral development banks where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would receive a 0% risk weight under the standardised approach;

6.1.3.5. Asset items constituting claims on and other exposures to central governments or central banks not within 6.1.3.1, which are denominated and, where applicable, funded in the national

- currencies of the borrowers;
- 6.1.3.6. Asset items constituting claims on and other exposures to institutions, with a maturity of one year or less, but not constituting such institutions' capital resources or which would not constitute such institutions' capital resources if they were locally incorporated credit institutions and investment firms;
- 6.1.3.7. Asset items constituting claims on EEA States' regional governments and local authorities which claims would receive a 0% risk weight under the standardised approach;
- 6.1.3.8. Other exposures to or guaranteed by EEA States' regional governments and local authorities claims on which would receive a 0% risk weight under the standardised approach;
- 6.1.3.9. Asset items constituting claims and other exposures on recognised third-country investment firms, recognised clearing houses, designated clearing houses, recognised investment exchanges, and designated investment exchanges;
- 6.1.3.10. Covered bonds within the meaning of the second paragraph of that definition;
- 6.1.3.11. Loans secured by mortgages on residential property and leasing transactions under which the lesser retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase, in all cases up to 50% of the value of the residential property concerned;
- 6.1.3.12. The following, where they would receive a 50% risk weight under the standardised approach, and only up to 50% of the value of the property concerned:
- 6.1.3.12.1. Exposures secured by mortgages on offices or other commercial premises;
- 6.1.3.12.2. Exposures related to property leasing transactions concerning offices or other commercial premises; or
- 6.1.3.13. Bill endorsements on bills with a maturity of 1 year or less already endorsed by another firm.
- 6.1.3.14. For the purposes of paragraph 6.1.3.11, the value of the property must be calculated on the basis of strict valuation standards laid down by law, regulation or administrative provisions. Valuation must be carried out at least once a year. For these purposes, residential property means a residence to be occupied or let by the borrower.

6.2. Parental guarantees

6.2.1. A firm may treat as exempt from the limits in paragraph 5 an exposure to a counterparty or to a group of connected clients if the following conditions are met:

- 6.2.1.1. The parent undertaking of the firm guarantees that exposure;
- 6.2.1.2. The total exposure to that counterparty or group of connected clients does not exceed 100% of the firm's capital resources;
- 6.2.1.3. The total amount of the firm's exposures to connected counterparties does not exceed 200% of the firm's capital resources;
- 6.2.1.4. The firm complies with international standards on group risk ;
- 6.2.1.5. Both the firm and the parent undertaking of the firm satisfy guidance laid out in the central principles of the standardised approach to credit risk.

6.2.2. For the purposes of paragraph 6.2.1, paragraphs 3.3.1.3 to 3.3.1.6 apply.

6.3. Capital maintenance arrangements

6.3.1. A firm may treat as exempt, from the limits in paragraph 5, an exposure to a counterparty which is not a connected counterparty if the following conditions are met:

- 6.3.1.1. the exposure is subject to a legally binding agreement by the parent undertaking of the firm that it will promptly on demand by the firm increase the firm's capital resources by;
 - 6.3.1.1.1. an amount that is sufficient to reverse completely the effect of any loss the firm may sustain in connection with that exposure; or
 - 6.3.1.1.2. the amount required to ensure that the firm complies with its financial obligations, this guidance note and any other requirements relating to capital resources or concentration risk imposed on the firm by or under the regulatory system;
- 6.3.1.2. the firm notifies the FSC in writing one month in advance of its intention to enter into the agreement, and provides details of the terms of the agreement before the firm enters into it;
- 6.3.1.3. The conditions in paragraph 3.3.1.6 and paragraphs 6.2.1.2 to 6.2.1.6 are met.

6.4. Collateral exemptions

6.4.1.

- 6.4.1.1. The FSC does not condone the practice of 'top slicing', by which a firm systematically collateralises only part of an exposure to bring it within the limits in paragraph 5.
- 6.4.1.2. If a firm 'top slices' its exposures, the FSC takes such activity into account when carrying out the SREP.

Exemptions for firms using the financial collateral simple method under the standardised approach

6.4.2.A firm which uses the financial collateral simple method under the standardised approach may treat the following exposures secured by collateral as exempt from the limits described in paragraph 5, provided that the exposures are to counterparties which are not connected counterparties:

6.4.2.1. Asset items and other exposures secured by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, EEA States' regional governments, local authorities, which securities constitute claims on their issuer which would receive a 0% risk weight under the standardised approach;

6.4.2.2. Asset items and other exposures secured by collateral in the form of cash deposits placed with the lending firm or with a credit institution which is the parent undertaking or a subsidiary undertaking of the lending firm;

6.4.2.3. Asset items and other exposures secured by collateral in the form of certificates of deposit issued by the lending firm or by a credit institution which is the parent undertaking or a subsidiary undertaking of the lending firm and lodged with either of them;

6.4.2.4. Exposures secured by collateral in the form of securities other than those referred to in 6.4.2.1.

6.4.3. Cash received under a credit linked note issued by the firm and loans and deposits of a counterparty to or with the firm which are subject to an on-balance sheet netting agreement recognised under the section on credit risk mitigation of the Guidance Note on Credit Risk Standardised Approach must be treated as falling paragraph 6.4.2.2.

6.4.4.

6.4.4.1. For the purposes of paragraph 6.4.2.4, securities used as collateral must be valued at market price, have a value that exceeds the exposures guaranteed, and be either traded or effectively negotiable and regularly quoted on a recognised investment exchange or a designated investment exchange.. The excess value required must be 100%. It must, however, be 150% in the case of shares and 50% in the case of debt securities issued by institutions, EEA States' regional governments or local authorities other than those referred to in 6.4.2.1), and in the case of debt securities issued by multilateral development banks other than those receiving a 0% risk weight under the standardised approach. Where there is a mismatch between the maturity of the exposure and the maturity of the credit protection, the collateral must not be recognised. Where the issuer of securities used as collateral is an institution, such collateral may not constitute the institution's capital resources or be of a type which would have constituted capital resources if the institution were a locally incorporated credit institutions and investment firms.

6.4.4.2. A firm may not recognise collateral for the purpose of 6.4.4.1 if it is not eligible under the financial collateral simple method.

6.4.5. The financial collateral simple method will be available only to firms using the standardised approach and only in relation to exposures for which they adopt the standardised approach.

Exemptions for firms using the financial collateral comprehensive method

6.4.6.

6.4.6.1. A firm which uses the financial collateral comprehensive method under the standardised approach or the IRB approach (but not the advanced IRB approach) must calculate the fully-adjusted value of the exposure to a counterparty or to a group of connected clients in accordance with guidance note credit risk standardised approach and, if relevant, this guidance note, taking into account the credit risk mitigation, volatility adjustments and any maturity mismatch (E*) in accordance with those rules. The firm must use that amount to compare against the limits set out in paragraph 5, instead of the nominal value of that exposure.

6.4.6.2. Where 6.3.6.1 applies, paragraph 6.4.2 does not apply.

6.5. Exemptions for firms using own estimates of LGDs and conversion factors under the IRB approach

6.5.1. A firm that uses own estimates of LGDs and conversion factors under the IRB approach for an IRB exposure class, and is able to satisfy the FSC that it can estimate the effects of financial collateral on its exposures separately from other LGD-relevant aspects, may take these effects into account in calculating its exposures for the purposes of paragraph 5. If it does so, the recognition of credit protection is subject to the relevant requirements under the IRB approach.

6.5.2. A firm that wishes to take advantage of paragraph 6.5.1 must:

6.5.2.1. Inform the FSC of its intention to do so; and

6.5.2.2. Demonstrate the suitability of the estimates produced.

6.5.3. If a firm that uses own estimates of LGDs and conversion factors under the IRB approach uses its own estimates of the effects of financial collateral on its exposures for large exposures purposes, it must do so on a consistent basis and on a basis consistent with the approach adopted in the calculation of capital requirements. In particular, this approach must be adopted for all exposures the nominal value of which would be a large exposure. A firm must be able to satisfy the FSC that it is complying with this rule.

6.5.4. A firm to which paragraph 6.5.3 applies must still report to the FSC the gross value of its exposures.

6.5.5. If a firm relies on paragraph 6.5.1 to paragraph 6.5.3 the recognition of credit protection is subject to the relevant requirements of the IRB approach.

Stress testing of credit risk concentrations

6.5.5.1. A firm which calculates the value of its exposures in accordance with paragraph 6.9.6 to paragraph 6.5.3 must conduct periodic stress



tests of its credit risk concentrations including in relation to the realisable value of any collateral taken.

6.5.5.2. The stress tests must address:

6.5.5.2.1. Risks arising from potential changes in market conditions that could adversely impact the firm's adequacy of capital resources; and

6.5.5.2.2. Risks arising from the realisation of collateral in stressed situations.

6.5.5.3. A firm must be able to satisfy the FSC that the stress tests are adequate and appropriate for the assessment of such risks.

6.5.5.4. In the event that a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account under paragraphs 6.9.6 to 6.5.3 as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of paragraph 5 is the lower value.

6.5.5.5. A firm to which this rule applies must include in its strategy to address concentration risk:

6.5.5.5.1. policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;

6.5.5.5.2. policies and procedures in the event that a stress test indicates a lower realisable value of collateral than taken into account under paragraphs 6.9.6 6.5.3; and

6.5.5.5.3. Policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures (e.g. to a single issuer of securities taken as collateral).

7. Treasury Concession

7.1. Subject to 7.1.2 and to paragraph 11.1, a firm may treat as exempt from the limits in paragraph 5 an exposure to a counterparty provided that:

7.1.1. the exposure satisfies the exposure conditions in paragraph 7.3;

7.1.2. the counterparty is a concentration risk group counterparty; and

7.2. The firm is subject to international best practices on dealing with group risk.

7.3. The total amount of the exposures that a firm may treat as exempt under this rule must not exceed 50% of the firm's capital resources.

7.4. Any exposures that would, but for paragraph 7.1.2, fall to be treated in accordance with paragraph 7 remain subject to the limits in paragraph 5.

7.5. The exposure conditions referred to in paragraph 7.1.1. are as follows:

7.5.1. The exposure must satisfy one or more of the following conditions:

7.5.1.1. It is a loan made by the firm with a maturity of one year or less in the course of the firm carrying on a treasury role for other members of its group;

7.5.1.2. It is a loan to the parent undertaking of the firm made in the course of a business carried on by the firm of lending to its parent undertaking cash that is surplus to the needs of the firm, provided that the amount of the surplus fluctuates regularly; or

7.5.1.3. It arises from the firm or a counterparty operating a central risk management function for members of the firm's group for exposures arising from derivatives; and

7.5.2. The exposure must be held in the firm's non-trading book.

8. Integrated Groups

8.1. This paragraph applies to a firm if it is part of a local integrated group and it gives notice in accordance with paragraph 11.1 that it will apply paragraph 8.

8.2. If paragraph 8 applies to a firm, it must apply paragraph 8 to all exposures coming within the scope of paragraph 8 and not just some of them.

8.3. If paragraph 8 applies to a firm, then subject to paragraph 10, it may, on a solo basis, treat an exposure to a concentration risk group counterparty as exempt from the limits in paragraph 5.

8.4. An undertaking is a member of a firm's integrated group if, in relation to the firm, that undertaking satisfies the following conditions:

8.4.1. it is a concentration risk group counterparty;

8.4.2. it is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking;

8.4.3. it is subject to the same risk evaluation, measurement and control procedures as the firm;

8.4.4. It is incorporated in Gibraltar and the centre of its main interests is situated within Gibraltar; and

8.4.5. There is no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm.

8.5.

8.5.1. This rule defines own funds for the purposes of paragraph 8.4.4.

8.5.2. In the case of a locally incorporated credit institution and investment firm, own funds means capital resources.

8.5.3. In the case of any other undertaking own funds means any item that would be capital resources if the undertaking were a locally incorporated credit institution and investment firm.

- 8.6. Firms should refer to the Guidance Note on the standardised approach to credit risk (guidance relating to 0% risk weights for intra-group exposures under the standardised approach).
- 8.7. A firm must ensure that the rules listed in paragraph 8.7 are complied with on a consolidated basis in accordance with the following:
- 8.7.1. The rules apply in relation to the firm's local integrated group rather than in relation to the firm;
 - 8.7.2. The rules apply in relation to exposures of members of the local integrated group to members of the residual block; and
 - 8.7.3. The local integrated group and the residual block must each be treated as a single undertaking.
- 8.8. The rules referred to in paragraph 8.6 are:
- 8.8.1. paragraph 5.3.1;
 - 8.8.2. paragraph 5.4.1 (other than paragraph 5.4.1.2);
 - 8.8.3. paragraph 5.4.3 (with the deletion of the time limit set out in paragraph 5.4.1; and
 - 8.8.4. paragraph 7.
- 8.9. A firm must comply with paragraph 8 and applies paragraph 5 on a consolidated basis.
- 8.10. For the purposes of paragraph 8, and in relation to a firm, a member of the residual block means a concentration risk group counterparty which is not a member of the firm's locally integrated group.
- 8.11. For the purposes of paragraph 8, a firm must calculate the capital resources of the locally integrated group in accordance with (Method 2 of Annex I of the Financial Groups Directive (Deduction and Aggregation Method)) and apply the limits set out in paragraph 8 to those capital resources rather than the capital resources of the firm.
- 8.12. The combined effect of paragraph 8.2 and paragraph 8.6.3 is that exposures between members of the locally integrated group are exempt.

9. Wider Integrated Group

- 9.1. Paragraph 9 applies to a firm if:
- 9.1.1. It has a wider integrated group waiver; and
 - 9.1.2. It is a member of a locally integrated group (as per section 8).
- 9.2.
- 9.2.1. If Paragraph 9 applies, paragraph 8 does not apply.
 - 9.2.2. If paragraph 9 applies to a firm, it must apply paragraph 9 to all exposures coming within the scope of paragraph 9 and not just some of them.

- 9.3. If paragraph 9 applies to a firm, then subject to paragraph 10, it may, on a solo basis, treat an exposure to a concentration risk group counterparty as exempt from the limits in paragraph 5.
- 9.4. For the purposes of paragraph 9:
- 9.4.1. the wider integrated group of a firm consists of each concentration risk group counterparty that satisfies all the conditions for membership of the firm's locally integrated group except for paragraph 8.3.4;
 - 9.4.2. a diverse block means all undertakings in the wider integrated group designated as a single diverse block by a wider integrated group permission; and
 - 9.4.3. in relation to a firm, a member of the residual block means a concentration risk group counterparty which is not a member of the firm's locally integrated group or wider integrated group.
- 9.5. A firm to which paragraph 9 applies must ensure that the rules listed in paragraph 9.6 are complied with on a consolidated basis on the following basis:
- 9.5.1. The rules apply in relation to the firm's locally integrated group rather than in relation to the firm;
 - 9.5.2. The rules apply in relation to exposures of the members of the locally integrated group to members of each of the following:
 - 9.5.2.1. Each diverse block; and
 - 9.5.2.2. The residual block; and
 - 9.5.3. The locally integrated group, each diverse block, and the residual block must each be treated as separate single undertakings
- 9.6. The rules referred to in paragraph 9.5 are:
- 9.6.1.1. Paragraph 5.3.1;
 - 9.6.1.2. Paragraph 5.4.1 (other than BIPRU paragraph 5.4.1.2);
 - 9.6.1.3. Paragraph 5.4.3 (with the deletion of the time limit set out in paragraph 5.4.3); and
 - 9.6.1.4. Paragraph 7.
- 9.6.2. Paragraph 8.9 and paragraph 8.11 apply for the purposes of paragraph 9 in the same way that they apply to paragraph 8.
- 9.6.3. As part of the process of applying for a wider integrated group waiver, a firm should agree with the FSC the number, nature and size of the diverse blocks. The basis of the diverse blocks will depend on the nature, scale and diversity of the business of the firm, its locally integrated group and its wider integrated group. In general, the FSC will expect to permit a firm to establish no more than four diverse blocks. However, there may be circumstances in which the nature and scale of a firm, its locally integrated group and its wider integrated group would warrant the creation of additional diverse blocks. Each member of a firm's wider integrated group will be allocated to a diverse block. Blocks may be diverse according to geography, business or a combination of both.

10. Trading Book Excess

- 10.1. Paragraph 10 applies to a firm applying the treatments set out in paragraph 8.

- 10.2. A firm must calculate the CNCOM that would have applied if the list in paragraph 8.8 or, as the case may be, paragraph 9.6 had applied paragraph 5.4.1.2 in relation to the locally integrated group.
- 10.3. A firm must then calculate the percentage of the amount calculated under paragraph 10.2 which is attributable to exposures of the firm.
- 10.4. A firm must add the result of the calculation in paragraph 10.3 to the CNCOM applied to the firm on a solo basis in accordance with paragraph 5.4.6 to paragraph 5.2.1.

11. Notification Procedures

- 11.1.
 - 11.1.1. A firm may not apply paragraph 7 or paragraph 8 unless it has given one month's prior notice to the FSC that it intends do so.
 - 11.1.2. The written notice referred to in 11.1.1 must explain how the firm meets the relevant conditions and how it will ensure that it will still meet the requirements of this Guidance Note on a continuing basis when using the relevant treatment.
 - 11.1.3. A firm may stop applying paragraph 7 or paragraph 8 if it has given one month's prior notice to the FSC that it intends do so.
 - 11.1.4. If a firm stops applying paragraph 7 or paragraph 8 it may start to apply it again if it notifies the FSC under 11.1.1 that it intends do so.
 - 11.1.5. A firm need only give the FSC the notice required in 11.1.1 once and not with respect to each exposure.
- 11.2. A firm must notify the FSC if it becomes aware that any exposure that it has treated as exempt under paragraph 7, or any counterparty that it has been treating as a member of its locally integrated group, or, if paragraph 9 applies, its wider integrated group has ceased to meet the conditions for application of the relevant treatment. A firm may give that notification in the first report due in the large exposures sheet after the obligation to notify arises.

12. Systems and controls and general

- 12.1. A firm must be able to demonstrate to the FSC that it has written policies and procedures to address and control the concentration risk arising from exposures to counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, including in particular risks associated with large indirect credit exposures (for example to a single collateral issuer) and that its policies and procedures are implemented.
- 12.2. Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, exposures must be reported on a gross basis, not including the recognition of credit risk mitigation.

- 12.3. A firm must have sound administrative and accounting procedures and adequate internal control mechanisms for (a) the purposes of identifying and recording all large exposures and subsequent changes to them, and (b) for monitoring those large exposures in the light of the firm's own exposure policies.
- 12.4. A firm must take reasonable care to establish and maintain adequate systems and controls to identify, monitor, and control exposures to apparent undertaking of the firm, a subsidiary undertaking of the firm, or a subsidiary undertaking of the firm's parent undertaking,
- 12.5. In line with the general principle, a firm must not:
- 12.5.1. treat an exposure as having been transferred to another person if that transfer is temporary; or
 - 12.5.2. treat an exposure as having been closed out by a transaction or arrangement if that transaction or arrangement is artificial;
 - 12.5.3. if that transfer, transaction or arrangement would otherwise have the effect of reducing the CNCOM or preventing or reducing a breach of the limits in this Guidance Note.
- 12.6. A firm must notify the FSC if it enters into a transfer, transaction or arrangement of the type mentioned in paragraph 12.5.

Exemption to Large Exposures Position for Performance Fees or Management Fees

13. Formal dispensation from the large exposure position will be provided where an exposure is strictly in relation to performance fees or management fees due in respect of portfolio management services provided by a firm only, subject to the following 4 criteria being met:
- 13.1. There is a time limit on the exposure of 30 days i.e. the fees due must be paid/received within 30 days and there is certainty regarding this; and
 - 13.2. The client agreement in place permits the firm to take the fees due from the account(s) of the client and to liquidate any positions which it needs to in order to take said fees; and
 - 13.3. The firm has either by physical control of the client's assets, or by other legal mechanisms, the ability to recover its fees from the client's assets and the client has sufficient liquid assets to cover those fees (the cash and market value of the assets must be at least twice that of the fee due); and
 - 13.4. At least one of the following is applied -
 - 13.4.1. the exposure is subject to the 800% aggregate limit set by the legislation and does not breach this, or
 - 13.4.2. where the 800% aggregate limit is breached, the funds due have not been irrevocably committed in any way or for any use by the firm, and the firm's own funds will not be detrimentally affected in any way.



14. This policy will remain in place until such time as further guidance on this matter is issued by CESR and/or the EU Commission and is publicly available.
15. Where a firm intends to apply the above, it must advise the FSC of this in each instance and must indicate in the relevant reporting return the date on which the FSC has acknowledged receipt of said notification under "date approved" in column P of the Large Exposures sheet.