Financial Services Commission

Guidance Note

Capital Requirements Directive Credit Risk Standardised Approach

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V5

Please be advised that this Guidance Note is dated and does not take into account any changes arising from the Capital Requirements Directive (2013/36/EU), transposed into local legislation as the Financial Services (Capital Requirements Directive IV) Regulations ("Gibraltar Regulations"), or the Capital Requirements Regulations (575/2013) ("EU Regulations") of the European Parliament and of the Council of 26 June 2013. Where there is a discrepancy between the contents of the Guidance Note and the requirements set in the Gibraltar and/or EU Regulations, the entity is to refer to and comply with the requirements set in the Gibraltar Regulations and the EU Regulations.

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Table of Contents

1. Application & Purpose

1.1 This Guidance Note applies to all locally incorporated subsidiaries who are adopting the Standardised Approach to Credit Risk for 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, 2006 and Financial Services (Capital Adequacy of Investment Firms) Regulations 2007. The aim of the Guidance Note is to supplement the Regulations in setting the standards for the measurement of credit risk and how firms must calculate this. The second part of this Guidance note refers to credit risk mitigation.

1.2 This guidance note sets out how a firm should calculate the credit risk capital component of the own funds calculation, this partly involves calculating risk weighted exposure amounts for exposures in the firm's non-trading book.

1.3 When referring to this guidance note, please note that the Commission has also issued guidance on the IRB approach to credit risk, on financial derivatives, SFTs and long settlement transactions and the legislation.

1.4 The credit risk capital component of a firm is equal to the sum of:

1.4.1. 8% of the total of its risk weighted exposure amounts for exposures calculated in accordance with this guidance note and:

1.4.2. the amount calculated in respect of a firm's non-trading book.

1.5. An exposure as described in 1.4.1 has to be:

1.5.1 in a firm's non-trading book; and

1.5.2 has not been deducted from the firm's capital resources.

2. Central Principles of the Standardised Approach to Credit Risk

(this section is subject to the guidance note on Financial derivatives, SFTs and long settlement transactions)

2.1 The exposure value of an asset item must be its balance-sheet value; and the exposure value of an off-balance sheet item listed in table 6.2 (Classification of off-balance-sheet items), must be the percentage of its value set out in that table.

The off-balance sheet items listed in table 6.2 must be assigned to the risk categories as indicated in the table.

2.2 Where an exposure is subject to funded credit protection, a firm may modify the exposure value applicable to that item in accordance with regulations 41 to 43 of the BCACI regulations.

2.3 The Guidance Note on financial derivatives, SFTs and long settlement transactions sets out the method for determination of the exposure value of a financial derivative instrument, with the effects of contracts of novation and other netting agreements taken into account for the purposes of that method.

2.4 Sections 2 and 7 of the Guidance Note on financial derivatives, SFTs and long settlement transactions sets out the provisions applying to the treatment and determination of the exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending (SFTs).

2.4.1 The guidance note on financial derivatives, SFTs and long settlement transactions also sets out the methods for the determination of exposure values for long settlement transactions.

2.5 The Guidance Note on financial derivatives, SFTs and long settlement transactions provides that, in the case of a firm using the financial collateral comprehensive method under regulations 41 to 43 of the BCACI regulations where an exposure takes the form of an SFT, the exposure value should be increased by the volatility adjustment appropriate to such securities or commodities set out in Regulations 41 to 43 of the BCACI regulations.

2.6 Paragraphs 2.1 to 2.11 and 7.9 to 7.10 of the Guidance Note on financial derivatives, SFTs and long settlement transactions sets out the provisions in relation to determination of the exposure of certain credit risk exposures outstanding with a central counterparty, where the central counterparty's counterparty credit risk exposures with all participants in its arrangements, are fully collateralised on a daily basis.

Exposure Classes

2.7 A firm must assign each exposure to one of the following exposure classes:

2.7.1 Claims or contingent claims on central governments or central banks;

2.7.2 Claims or contingent claims of regional governments or local authorities;

2.7.3 Claims or contingent claims on administrative bodies and non-commercial undertakings;

2.7.4 Claims or contingent claims on multilateral development banks;

2.7.5 Claims or contingent claims on international organisations;

2.7.6 Claims or contingent claims on institutions;

2.7.7 Claims or contingent claims on corporates;

2.7.8 Retail claims or contingent retail claims;

2.7.9 Claims or contingent claims secured on real estate property;

2.7.10 Past due items;

2.7.11 Items belonging to regulatory high-risk categories;

2.7.12 Claims in the form of covered bonds;

2.7.13 Securitisation positions;

2.7.14 Short-term claims on institutions and corporates;

2.7.15 Claims in the form of CIUs; and

2.7.16 Other items

2.8 To be eligible for a retail exposure class, an exposure must meet the following conditions;

2.8.1 the exposure must be either to an individual person or persons, or to a small or medium sized entity;

2.8.2 the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced, and

2.8.3 the total amount owed to the firm, its parent undertakings and its subsidiary undertakings, including any past due exposure, by the obligor client or group of connected clients, but excluding claims or contingent claims secured on residential real estate collateral, must not, to the knowledge of the firm, exceed Euros 1 million.

2.9 The firm must take reasonable steps to acquire the knowledge referred to in paragraph 2.8.3 above. In deciding what steps are reasonable, a firm may take into account complexity and cost, as well as the materiality of the impact upon its capital calculation. A firm should be in a position to explain to the Commission why its actions in this regard can be considered reasonable.

2.10 Securities are not eligible for the retail exposure class.

2.11 The present value of retail minimum lease payments is eligible for the retail exposure class.

Retail exposures

2.12 A key driver of the preferential risk weight afforded to retail exposures is the lower correlation and systematic risk associated with such exposures. This aspect is unrelated to the absolute number of retail exposures. Accordingly in defining what constitutes a significant number of retail exposures, a firm need only satisfy itself that the number of retail exposures is sufficiently large to diversify away idiosyncratic risk. This assessment will be subject to supervisory review and part of a firm's Supervisory Review and Evaluation Process (SREP). It will be looked at as one of the issues relating to overall diversification.

2.13 The definition of a group of connected clients is set out below:

2.13.1 in accordance with Article 4(45) of the Banking Consolidation Directive, one of the following;

2.13.1.1 two or more persons who, unless it is shown otherwise, constitute a single risk because one of them is the parent undertaking, direct or indirect, of the other or others; or

2.13.1.2 two or more persons between whom there is no relationship as set out in 2.13.1.1 but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties.

Part 2.13.1.2 requires the interconnection to be reciprocal. So for the purposes of this part of the definition, it is not enough that the fact that, for example, A is experiencing financial difficulties is likely to mean that B will as well. In addition, the fact that B is experiencing financial difficulties should mean that it is likely that A will as well.

2.14 An exposure to an owner of retail, Small or Medium-Sized Enterprise (SME) in his personal capacity (other than a claim or contingent claims secured on residential real estate collateral) should be aggregated with an exposure to the retail SME. In deciding what steps are reasonable, in the case of this aggregation a firm may take into account the materiality of that personal exposure. A firm should be able to demonstrate to the FSC, if asked, that its policy on materiality in this context is reasonable.

2.14.1 Where an exposure is denominated in other currencies, a firm may calculate the Euro equivalent for purposes of paragraph 2.8 using any appropriate set of exchange rates provided its choice has no obvious bias and that the firm is consistent in its approach to choosing rates.

2.15 A firm may monitor compliance with the Euro 1 million threshold as mentioned in 2.8 of this guidance note on the basis of approved limits provided it has internal control procedures that are sufficient to ensure that amounts owed cannot diverge from approved limits to such an extent as to give rise to a material breach of the Euro 1 million threshold.

2.16 To calculate risk weighted exposure amounts, risk weights must be applied to all exposures, unless deducted from capital resources, in accordance with the provisions of section 4.

2.17 The application of risk weights must be based on the standardised credit risk exposure class to which the exposure is assigned and, to the extent specified in section 4, its credit quality.

2.18 Credit quality may be determined by reference to:

2.18.1 the credit assessments of eligible External Credit Assessment Institutions (ECAIs) in accordance with the provisions of the Credit Risk Standardised Approach; or

2.18.2 the credit assessments of export credit agencies as described in paragraph 4.

2.19 For the purposes of applying a risk weight, the exposure value must be multiplied by the risk weight specified or determined in accordance with the standardised approach.

2.20 Notwithstanding, where an exposure is subject to credit protection the risk weight applicable to that item may be modified in accordance with regulations 41 to 43 of the BCACI Regulations.

2.21 Risk weighted exposure amounts for the securitised exposures must be calculated in accordance with the Guidance Note on Securitisation.

2.22 Exposures, the calculation of risk weighted exposure amounts for which is not otherwise provided for under the standardised approach, must be assigned a risk weight of 100%.

Zero risk-weighting for intra-group exposures

2.23 Subject to paragraph 2.29, and with the exception of exposures giving rise to liabilities in the form of the items referred to in paragraph 2.26, a firm is not required to comply with paragraphs 2.16 & 2.17 in the case of the exposures of the firm to a counterparty which is its parent undertaking, its subsidiary undertaking or to which the firm is linked by a consolidation Article 12.1 relationship of the Banking Consolidation Directive provided that the following conditions are met:

2.23.1 the counterparty is:

2.23.1.1 An institution whose head office is in an EEA State; or

2.23.1.2 An institution not within 2.23.1.1, financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements;

2.23.2 the conditions set out in paragraphs 2.23.2.1 to 2.23.2.3 should be satisfied by both the counterparty and the firm,

2.23.2.1 included within the scope of consolidation on a full basis (as a parent institution in a Member State, a parent financial holding company in a Member State) with respect to the same consolidation group and applies to the firm with respect to that consolidation group; or

2.23.2.2 included within the scope of consolidation on a full basis (as a parent institution in a Member State, a parent financial holding company in a Member State or as referred to in Article 133 of the Banking Consolidation Directive) with respect to the same group by a Competent Authority in an EEA State other than Gibraltar under the CRD implementation measures about consolidated supervision for that EEA State; or

2.23.2.3 included within the scope of consolidation on a full basis (provided that this consolidation is carried out to standards equivalent to those in 2.23.1 and 2.23.2) with respect to the same group by a third country Competent Authority under prudential rules for the banking sector or investment services sector of, or administered by, that third country Competent Authority.

2.23.2.4 A group is subject to consolidation to equivalent standards for the purpose of 2.23.3, only if the firm or another

EEA firm in that group has been notified in writing by the FSC, or a Competent Authority of another EEA State pursuant to Article 143 of the Banking Consolidation Directive, that that group is subject to equivalent supervision.

2.23.2.5 Being included within the scope of consolidation on a full basis as referred to in 2.28.3 above, must be interpreted in accordance with the principles that apply to the interpretation of that phrase in 2.23.1 and 2.23.2 above.

2.23.3 the counterparty is subject to the same financial risk evaluation, measurement and control procedures as the firm;

2.23.3.1 it is the risk management functions of the group that should be integrated, rather than the group's operational management; and

2.23.3.2 the FSC should be capable of undertaking qualitative supervision of the management of the integrated risk management function;

2.23.4 the counterparty is established in Gibraltar and the centre of its main interests are situated with Gibraltar; and

2.23.5 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.

For this purpose of this paragraph own funds is defined as follows: In the case of a firm that is affected by the CRD; own funds means capital resources. In the case of any other undertaking own funds means any item that would be capital resources if the undertaking were a firm affected by the CRD.

2.24 Where a firm chooses not to apply paragraph 2.16, it must apply a risk weight of 0% to the exposure.

2.25 A firm need not apply the treatment in paragraph 2.23 or 2.24 to every exposure that is eligible for that treatment.

2.26 A firm must not apply the treatment in paragraph 2.23 to exposures giving rise to liabilities in the form of any of the following items:

2.26.1 in the case of a firm, any tier one capital or tier two capital; and

2.26.2 in the case of any other undertaking, any item that would be tier one or tier two capital if the undertaking were a firm.

2.27 A firm may not apply the provisions of paragraph 2.23 unless it has given one month's prior notice to the FSC that it intends to do so.

2.28 A firm need only give the FSC the notice once rather than with respect to each exposure.

2.29 A firm may stop applying the provisions in paragraph 2.23 or may stop applying it to some exposures to which it has been applying paragraph 2.23.

2.30 If a firm stops applying paragraph 2.23 it may start to apply it again if it notifies the Commission under 2.27 that it intends do so.

2.31 A firm must notify the Commission if it becomes aware that any exposure that it has treated as exempt under paragraph 2.23 has ceased to meet the conditions for exemption or if the firm ceases to treat an exposure under this.

2.32 In the case of an undertaking that is a firm the requirement in paragraph 2.23.5 for the prompt transfer of own funds refers to own funds in excess of the capital and financial resources requirements to which it is subject under the regulatory system.

2.33 The requirement in paragraph 2.23.5 for the prompt repayment of liabilities refers to the prompt repayment of liabilities when due.

2.34 The guidance in paragraphs 2.32 and 2.31 does not apply to solo consolidation even though those provisions have similar wording. This is because the purpose of the provisions in solo consolidation is to define the conditions under which two undertakings should be treated as a single undertaking. The purpose of paragraph 2.23 is to define the circumstances in which it is appropriate to apply a zero risk weight.

2.35 The Commission may discuss with a firm that makes the notification required in paragraph 2.28 the reasons why the firm believes it meets the conditions in paragraph 2.23.

2.36 A firm that has chosen to apply the treatment in paragraph 2.23 should monitor the exposures to which a 0% risk weight is applied under that treatment and report these to the FSC as required.

2.37 If a firm is using the IRB approach and exposures are exempted from the IRB approach as per the guidance note on the IRB approach the firm may apply a 0% risk weight to them under paragraph 2.23 if the conditions are satisfied.

Exposures to recognized third-country investment firms, clearing houses and investment exchanges

2.40 For the purposes of the standardised approach (including as it applies for the purposes of settlement and counterparty risk) and without prejudice to the guidance note on financial derivatives, securities financing transactions and long settlement transactions exposures to recognised third-country investment firms and exposures incurred to recognised clearing houses, designated clearing houses, recognised investment exchanges and designated investment exchanges must be treated as exposures to institutions.

3. The use of the Credit Assessments of Rating Agencies

3.1 An external credit assessment may be used to determine the risk weight of an exposure in accordance with paragraphs 2.16 to 2.23 only if the ECAI which provides it is recognised by the FSC as an eligible ECAI for the purposes of paragraphs 2.16 to 2.23.

For further guidance than that provided on this guidance note in respect of ECAIs, please see the relevant guidance note.

4. Risk weights under the standardised approach to credit risk

Risk weights: Exposures to central governments or central banks: Treatment

4.1 Without prejudice to paragraph 4.2 to 4.9, exposures to central governments and central banks must receive a 100% risk weight.

4.2 Subject to paragraph 4.4, exposures to central governments and central banks and exposures to corporates for which a short-term credit assessment by a nominated ECAI is available shall be assigned a risk weight according to the following Table, in accordance with the mapping by the FSC of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.3 Table: Exposures to central governments and central banks for which a credit assessment by a nominated ECAI is available.

Credit Quality Step	1	2	3	4	5	6
Risk Weight	0%	20%	50%	100%	100%	150%

4.4 Exposures to the European Central Bank must be assigned a 0% risk weight.

Exposures in the national currency of the borrower

4.5 Exposures to EEA States' central governments and central banks denominated and funded in the domestic currency of that central government and central bank must be assigned a risk weight of 0%.

4.6 When the Competent Authorities of a third country which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA assign a risk weight which is lower than that indicated in paragraphs 4.1 to 4.3 to exposures to its central government and central bank which are denominated and funded in the domestic currency, a firm may risk weight such exposures in the same manner.

Use of credit assessments by export credit agencies

4.7 An export credit agency credit assessment may be recognised by a firm for the purpose of determining the risk weight to be applied to an exposure under the standardised approach if either of the following conditions are met:

4.7.1 The credit assessment is a consensus risk score from export credit agencies participating in the OECD "Arrangement on Guidelines for Officially Supported Export Credits"; or

4.7.2 The export credit agency publishes its credit assessments, and the export credit agency subscribes to the OECD agreed methodology, and the credit assessment is associated with one of the eight minimum export insurance premiums (MEIP) that the OECD agreed methodology establishes.

4.8 Exposures for which a credit assessment by an export credit agency is recognised for risk weighting purposes must be assigned a risk weight according to the table in paragraph 4.9.

4.9 Table: Exposure for which a credit assessment by an export credit agency is recognised.

MEIP	0	1	2	3	4	5	6	7
Risk Weight	0%	0%	20%	50%	100%	100%	100%	150%

Exposures to regional governments or local authorities

4.10 Without prejudice to paragraphs 4.15 to 4.19 (and in accordance with the requirement in paragraph 9 of Annex VI of the Banking Consolidation Directive to treat exposures to regional governments and local authorities as exposures to institutions):

4.10.1 A firm must risk weight exposures to regional governments and local authorities in accordance with paragraphs 4.11 to 4.14; and

4.10.2 The preferential treatment for short-term exposures specified in paragraphs 4.38, 4.40 and 4.44 must not be applied.

4.11 Exposures to regional governments and local authorities must be assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the regional government or local authority is established are assigned in accordance with the table in paragraph 4.12.

4.12 **Table: Central government risk weight risk based method**

Credit quality step to which central government is assigned	1	2	3	4	5	6
Risk weight of exposure	20%	50%	100%	100%	100%	150%

4.13 For exposures to regional governments and local authorities established in countries where the central government is unrated, the risk weighting must be not more than 100%.

4.14 For exposures to regional governments and local authorities established in countries where the central government is unrated, with an original effective duration of three months or less, the weighting must be 20%.

4.15 A firm must treat an exposure to a regional government or local authority of an EEA State other than Gibraltar as an exposure to the central government in whose jurisdiction that regional government or local authority is established if that regional government or local authority is included on the list of regional governments and local authorities drawn up by the Competent Authority in that EEA State under a CRD implementation measure with respect to paragraph 10 of Part 1 of Annex VI of the Banking Consolidation Directive.

4.16 Exposures to churches or religious communities constituted in the form of a legal person under public law must, in so far as they raise taxes in accordance with legislation conferring on them the right to do so, be treated as exposures to regional governments and local authorities, except that paragraph 4.15 does not apply.

4.17 When Competent Authorities of a third country jurisdiction which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA, treat exposures to regional governments and local authorities as exposures to their central government, a firm may risk weight exposures to such regional governments and local authorities in the same manner.

Exposures to administrative bodies and non-commercial undertakings

4.18 Paragraphs 4.19 to 6.27 set out the provisions applying to exposures to administrative bodies and non-commercial undertakings.

4.19 Without prejudice to paragraphs 4.20 and 4.25, exposures to administrative bodies and non-commercial undertakings must receive a 100% risk weight.

4.20 Without prejudice to paragraphs 4.21 to 4.24, exposures to public sector entities must receive a 100% risk weight.

4.21 A firm may treat an exposure to a public sector entity as an exposure to a regional government or local authority in accordance with paragraphs 4.11 to 4.14 the preferential treatment for short-term exposures specified in paragraphs 4.37, 4.39 and 4.44 must not be applied.

4.22 In exceptional circumstances a firm may treat an exposure to a public sector entity established in Gibraltar as an exposure to the central government of Gibraltar if there is no difference in risk between exposures to that body and exposures to the Government of Gibraltar because of the existence of an appropriate guarantee by the Government.

4.23 Where a Capital Requirements Directive implementation measure, with respect to paragraph 15 or 15a of Part 1 of Annex VI of the Banking Consolidation Directive, exercises the discretion under those paragraphs to treat exposures to public sector entities as exposures to institutions or as exposures to the central government of the EEA State concerned, a firm may risk weight exposures to the relevant public sector entities in the same manner.

4.24 When Competent Authorities of a third country jurisdiction, which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA, treat exposures to public sector entities as exposures to institutions, a firm may risk weight exposures to the relevant public sector entities in the same manner.

Exposures to multilateral development banks

4.25 Without prejudice to paragraph 4.27 to 4.28 a firm must treat exposures to multilateral development banks in the same manner as exposures to institutions in accordance with paragraph 4.35 and 4.40, and

4.26 the preferential treatment for short-term exposures specified in paragraphs 4.37, 4.39 and 4.44 must not be applied.

4.27 An exposure to a multilateral development bank –

4.27.1 African Development Bank;

4.27.2 Asian Development Bank;

4.27.3 Caribbean Development Bank;

4.27.4 Council of Europe Development Bank;

4.27.5 European Bank for Reconstruction & Development;

4.27.6 European Investment Bank;

4.27.7 European Investment Fund;

4.27.8 Inter-American Development Bank;

4.27.9 International Bank for Reconstruction & Development;

4.27.10 International Financial Corporation;

4.27.11 Multilateral Investment Guarantee Agency; and

4.27.12 Nordic Investment Bank;

attract a 0% risk weighting

4.28 And for the purposes of the standardised approach to credit risk the following:

4.28.1 the Inter-American Investment Corporation;

4.28.2 the Black Sea Trade and Development Bank; and

4.28.3 the Central American Bank for Economic Integration.

attract a 0% risk weighting.

4.29 A risk weight of 20% must be applied to the portion of unpaid capital subscribed to the European Investment Fund.

Exposures to international organisations

4.30 Exposures to the following international organisations must be assigned a 0% risk weight:

4.31 the European Community;

4.32 the International Monetary Fund; and

4.33 the Bank for International Settlements.

Exposures to institutions

4.31 Paragraphs 4.44 to 4.47 set out the treatment to be accorded to exposures to institutions.

4.32 Without prejudice to paragraphs 4.35 to 4.47, exposures to financial institutions, authorised and supervised by the Competent Authorities responsible for the authorisation and supervision of credit institutions and subject to prudential requirements equivalent to those applied to credit institutions, must be risk weighted as exposures to institutions.

4.33 Exposures to an unrated institution must not receive a risk weight lower than that applied to exposures to its central government.

4.34 Exposures to institutions with an original effective maturity of more than three months for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in paragraph 4.34 in accordance with the assignment by the FSC of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.35 Table: Exposures to institutions with an original effective maturity of more than three months for which a credit assessment by a nominated ECAI is available

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	50%	100%	100%	150%

4.36 Exposures to unrated institutions must be assigned a risk weight of 50%.

4.37 Exposures to an institution with an original effective maturity of three months or less for which a credit assessment by a nominated ECAI is available must receive a risk weight according to the table in paragraph 4.38 in accordance with the assignment by the FSC of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.38 Table: Exposures to an institution with an original effective maturity of three months or less for which a credit assessment by a nominated ECAI is available.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	20%	20%	50%	50%	150%

4.39 Exposures to unrated institutions having an original effective maturity of three months or less must be assigned a 20% risk weight.

4.40 If there is no short-term exposure assessment, the general preferential treatment for short-term exposures as specified in paragraph 4.37 applies to all exposures to institutions of up to three months residual maturity.

4.41 If there is a short-term assessment and such assessment determines the application of a more favourable or identical risk weight than the use of the general preferential treatment for short-term exposures, as specified in paragraph 4.37, then the short-term assessment and risk weighting specified in paragraph 4.100 must be used for that specific exposure only.

4.42 Other short-term exposures must follow the general preferential treatment for short-term exposures, as specified in paragraph 4.37.

4.43 If there is a short-term assessment and such assessment determines a less favourable risk weight than the use of the general preferential treatment for short-term exposures, as specified in paragraph 4.37, then the general preferential treatment for short-term exposures must not be used and all unrated short term claims must receive the same risk weight as that applied by the specific short-term assessment and specified in paragraph 4.100.

4.44 A firm may assign to an exposure to an institution, formed under the law of Gibraltar, of a residual maturity of 3 months or less denominated and funded in pounds sterling, a risk weight that is one category less favourable than the preferential risk weight, as described in paragraph 4.14 to 4.16, assigned to exposures to the central government of Gibraltar.

4.45 Where a CRD implementation measure in another EEA State, with respect to paragraph 36 of Part 1 of Annex VI of the Banking Consolidation Directive, exercises the discretion to allow the treatment in that paragraph, a firm may assign to the relevant national currency exposures the risk weight permitted by that CRD implementation measure.

No exposures of a residual maturity of 3 months or less denominated and funded in the national currency of the borrower may be assigned a risk weight less than 20%.

4.46 Investments in equity or regulatory capital instruments issued by institutions must be risk weighted at 100%, unless deducted from capital resources.

4.47 Where an exposure to an institution is in the form of minimum reserves required by the European Central Bank or by the central bank of an EEA State to be held by the firm, a firm may apply the risk weight that would be applied to exposures to the central bank of the EEA State in question provided that:

4.47.1 the reserves are held in accordance with Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 or a subsequent replacement regulation or in accordance with national requirements in all material respects equivalent to that regulation: and

4.47.2 in the event of the bankruptcy or insolvency of the institution where the reserves are held, the reserves will be fully repaid to the firm in a timely manner and will not be available to meet other liabilities of the institution.

Exposures to Corporates

4.48 Paragraphs 4.49 to 4.51 set out the treatment to be accorded to exposures to corporates.

4.49 Exposures for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in paragraph 4.50 in accordance with the assignment by the FSC of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.50 Table: Exposures for which a credit assessment by a nominated ECAI is available.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

4.51 Exposures for which such a credit assessment is not available must receive a 100% risk weight or the risk weight of its central government whichever is the higher.

Retail Exposures

4.52 Exposures that comply with the criteria listed in paragraph 2.8 must be assigned a risk weight of 75%. However a firm may treat such an exposure under paragraph 2.22 (100% risk weight).

4.53 Paragraph 4.54 to 4.83 set out the treatment to be accorded to exposures secured by real estate property.

4.54 Without prejudice to paragraph 4.55 to 4.83, exposures fully secured by real estate property must be assigned a risk weight of 100%.

4.55 Exposures or any part of an exposure fully and completely secured, to the satisfaction of the firm, by mortgages on residential property which is or shall be occupied or let by the owner or the beneficial owner in the case of personal investment companies, must be assigned a risk weight of 35%.

4.56 Exposures fully and completely secured, to the satisfaction of the firm, by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of residential property which is or shall be occupied or let by the owner must be assigned a risk weight of 35%.

4.57 Exposures or any part of an exposure to a tenant under a property leasing transaction concerning residential property under which the firm is the lessor and the tenant has an option to purchase, must be assigned a risk weight of 35% provided that the firm is satisfied that the exposure of the firm is fully and completely secured by its ownership of the property.

4.58 In the exercise of its judgement for the purposes of paragraph 4.55 or 4.57, a firm may be satisfied only if conditions below are met.

4.58.1 The value of the property does not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macroeconomic factors affect both the value of the property and the performance of the borrower.

4.58.2 the risk of the borrower does not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral.

4.58.3 the minimum requirements about:

4.58.3.1 legal certainty in paragraph 4.62;

4.58.3.2 monitoring property values in paragraph 4.63;

4.58.3.3 documentation in paragraph 4.64; and

4.58.3.4 insurance in paragraph 4.65;

are met

4.58.4 the valuation rules set out in paragraph 4.67 to paragraph 4.70 are met.

4.58.5 the value of the property exceeds by a substantial margin the exposures.

4.59 Paragraph 4.58.3 does not apply to exposures fully and completely secured by mortgages on residential property which are situated within Gibraltar.

4.60 The Banking Consolidation Directive permits a Competent Authority to disapply the condition in paragraph 4.58.3, if it has evidence that a well-developed and long established residential real estate market is present in its territory with loss rates which are sufficiently low to justify such treatment. The FSC has taken up that option by including paragraph 4.59. However, if the evidence changes so that these conditions are no longer satisfied, the FSC may be obliged to revoke paragraph 4.59.

4.61 If a CRD implementation measure in another EEA State, with respect to paragraph 46 of Part 1 of Annex VI of the Banking Consolidation Directive, implements the discretion in that paragraph, a firm may apply the treatment provided under that CRD implementation measure to exposures fully and completely secured by mortgages on residential property situated in that EEA State falling within the scope of that CRD implementation measure.

4.62 The requirements about legal certainty referred to in 4.58.4.1 are as follows:

4.6.2.1 the mortgage or charge must be legally enforceable in all relevant jurisdictions which are relevant at the time of conclusion of the credit agreement, and the mortgage or charge must be properly filed on a timely basis;

4.6.2.2 the arrangements must reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled); and

4.6.2.3 the protection agreement and the legal process underpinning it must enable the firm to realise the value of the protection within a reasonable timeframe.

4.63 The requirements about monitoring of property values referred to in paragraph 4.58.4.2 are as follows:

4.63.1 the value of the property must be monitored on a frequent basis and at a minimum once every three years for residential real estate;

4.63.2 more frequent monitoring must be carried out where the market is subject to significant changes in conditions;

4.63.3 statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;

4.63.4 the property valuation must be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and

4.63.5 for loans exceeding Euros 3 million or 5% of the capital resources of the firm, the property valuation must be reviewed by an independent valuer at least every three years.

For the purposes of 4.63, 'independent valuer' means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

4.64 The requirements about documentation referred to in paragraph 4.58.3.3 are that the types of residential real estate accepted by the firm and its lending policies in this regard must be clearly documented.

4.65 The requirements about insurance referred to in paragraph 4.58.3.4 are that the firm must have procedures to monitor that the property taken as protection is adequately insured against damage.

4.66 The valuation rules referred to in paragraph 4.58.5 are set out in paragraph 4.67 to 4.70.

4.67 The property must be valued by an independent valuer at or less than the market value. In those EEA States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value.

4.68 Market value means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after the proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value must be documented in a transparent and clear manner.

Mortgage lending value means the value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements must not be taken into account in the assessment of the mortgage lending value. The mortgage lending value must be documented in a transparent and clear manner.

4.70 The value of the collateral must be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under (Annex

VIII Part 2, paragraph 8 of the Banking Consolidation Directive) and to take account of any prior claims on the property.

4.71 A firm may not treat an exposure as fully and completely secured by residential property located in Gibraltar for the purpose of paragraphs 4.55 or 4.57 unless the amount of the exposure or of the secured part of the exposure referred to in paragraphs 4.55 or 4.57, as the case may be, is 80% or less of the amount of the residential property collateral on which it is secured.

4.72.1 The application of paragraph 4.71 may be illustrated by an example. If a firm has a mortgage exposure of £100,000 secured on residential property in Gibraltar that satisfies the criteria listed in paragraph 4.55 to 4.61 and the value of that property is £100,000, then £80,000 of that exposure may be treated as fully and completely secured and risk weighted at 35%. The remaining £20,000 may be risk weighted at 75% provided the exposure meets the criteria in paragraph 2.8. The portion risk weighted at 75% should be treated as a retail exposure for the purposes of the aggregation calculations specified in paragraph 2.8.3.

472.2 The same approach applies to exposures described in paragraph 4.57. On initiation a 35% risk weight should be applied to the first 80% of the principal/"purchase price" outstanding, with a 75% risk weight being applied to the remainder of the principle (assuming that the exposure meets the requirements in paragraph 3.2 to be treated as a retail exposure). An Ijara mortgage is an example of an exposure described in paragraph 4.57.

4.73 A property will need to be re-valued over time to ensure that the original purchase price does not overstate the degree of security provided by the property. Ijara providers should undertake revaluations in the same way as providers of conventional mortgages.

4.74 A firm may not treat an exposure as fully and completely secured by residential property situated in another EEA State for the purposes of paragraph 4.55 or 4.57 unless the relevant conditions are satisfied. The relevant conditions for this purpose are the conditions that must be satisfied under the CRD implementation measures for Annex VI of the Banking Consolidation Directive for that EEA State in order for an institution to treat an exposure as fully and completely secured by residential property situated in that EEA State for the purpose of the CRD implementation measure for paragraphs 43 and 44a of Part 1 of Annex VI of the Banking Consolidation Directive.

4.75 This measure applies to exposures which satisfy the following conditions:

4.75.1 the exposure is of a type described in paragraph 4.55 to 4.57;

4.75.2 the residential property in question is situated in the territory of a third country Competent Authority; and

4.75.3 the exposure would be subject to a risk weight under the requirements for credit risk of (or administered by) that third country Competent Authority if it were held by an institution which had its head office in that territory and which was authorised by that third country Competent Authority.

4.75.4 Additionally, the risk weight of an exposure to which this measure applies is the higher of the risk weight that would apply but for this measure and the risk weight in 4.75.3.

4.76 If a firm has more than one exposure secured on the same property they should be aggregated and treated as if they were a single exposure secured on the property for the purposes of paragraph 4.55 and paragraph 4.71, paragraph 4.74 and paragraph 4.75.

4.77 If an exposure is secured on property that is used in part for residential purposes in accordance with paragraph 4.55 and partly for commercial purposes (such as a farm, public house, guest house or shop) it may be treated as secured by residential real estate if the firm can demonstrate that the property's main use is, or will be, residential and that the value of the property is not significantly affected by its commercial use.

Exposures secured by mortgages on commercial real estate

4.78 Exposures or any part of an exposure secured by mortgages on offices or other commercial premises situated within:

4.78.1 Gibraltar; or

4.78.2 (unless paragraph 4.80 to 4.83 apply) any other state or territory;

must be assigned a risk weight of 100%.

4.79 Exposures fully and completely secured by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises may be assigned a risk weight of 50%.

4.80 If a CRD implementation measure in another EEA State implements the discretion in paragraph 48 of Part 1 of Annex VI of the Banking Consolidation Directive, a firm may apply the same treatment as that CRD implementation measure to exposures falling within the scope of that CRD implementation measure which are fully and completely secured by mortgages on offices or other commercial premises situated in that EEA State.

4.81 If a CRD implementation measure in another EEA State implements the discretion in paragraph 50 of Part 1 of Annex VI of the Banking Consolidation Directive, a firm may apply the same treatment as that CRD implementation measure to exposures related to property leasing transactions concerning offices or other commercial premises situated in that EEA State and governed by statutory provisions whereby the lessor retains full ownership of the rented assets until the tenant exercises his option to purchase, as long as that exposure falls within the scope of that CRD implementation measure.

4.82 In particular, if a firm applies paragraph 4.80 or 4.81, it must comply with the corresponding CRD implementation measures in relation to paragraphs 51-53 of Part 1 of Annex VI of the Banking Consolidation Directive.

4.83.1 If a CRD implementation measure in another EEA State implements the discretion in paragraph 55 of Part 1 of Annex VI of the Banking Consolidation Directive, a firm may apply the same treatment as the CRD implementation measure to exposures fully and completely secured by mortgages on commercial property situated in that EEA State falling with the scope of the CRD implementation measure.

4.83.2 However a firm may not apply the treatment in 4.83.1 if the eligibility to use that treatment under the CRD implementation measure referred to in 4.83.1 ceased as contemplated under paragraph 56 of Annex VI of the Banking Consolidation Directive (application of condition in paragraph 51.2 where conditions in paragraph 55 are not satisfied).

Past due items

4.84 Paragraphs 4.85 to 4.88 set out the treatment to be accorded to past due items.

4.85 Without prejudice to the provisions contained in paragraphs 4.86 to 4.88, the unsecured portion of any item that is past due for more than 90 days (irrespective of the amount of that item or of the secured portion of that item) must be assigned a risk weight of:

4.85.1 150% if value adjustments are less than 20% of the unsecured part of the exposure gross of value adjustments value; or

4.85.2 100% if value adjustments are no less than 20% of the unsecured part of the exposure gross of value adjustments.

4.86 For the purpose of defining the secured portion of the past due item, eligible collateral and guarantees must be those eligible for credit risk mitigation purposes under regulations 41 to 43 of the BCACI Regulations.

4.87 Exposures indicated in paragraphs 4.55 to 4.61 must be assigned a risk weight of 100% net of value adjustments if they are past due for more than 90 days. If value adjustments are no less than 20% of the exposures gross of value adjustments, the risk weight applicable to the remainder of the exposure is 50%.

4.88 Exposures indicated in paragraph 4.78 to 4.83 must be assigned a risk weight of 100% if they are past due for more than 90 days.

Items belonging to regulatory high-risk categories

4.89 Paragraphs 4.90 to 4.92 set out the treatment to be accorded to items belonging to regulatory high-risk categories. High risk exposures can be:

4.89.1 Exposures arising out of venture capital business (whether or not the firm itself carries on the venture capital business)

4.89.2 Any exposures of the type referred to in paragraph 4.118 that is illiquid and held with a view to long-term sale or realisation.

4.90 Exposures listed in this guidance note must be assigned a risk weight of 150%

4.91 For the purposes of paragraph 63 of Part 1 of Annex VI of the Banking Consolidation Directive, the exposures listed in this guidance note are in the view of the FSC associated with particularly high risk.

4.92 Non past due items receiving a 150% risk weight under section 4 of this guidance note, and for which values adjustments have been established may be assigned a risk weight of:

4.92.1 100% if value adjustments are no less than 20% of the exposure value gross of value adjustments; or

4.92.2 50% if value adjustments are no less than 50% of the exposure value gross of value adjustments.

4.93 Paragraphs 4.94 to 4.98 set out the treatment to be accorded to exposures in the form of covered bonds.

Exposures in the form of covered bonds

4.94 Covered bonds means bonds as defined in Article 22(4) of the UCITS Directive and collateralised by any of the following eligible assets:

4.94.1 exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EEA;

4.94.1.1 exposures to or guaranteed by non-EEA central governments, non-EEA central banks, multilateral development banks, international organisations that qualify for the credit quality assessment step 1;

4.94.1.2 exposures to or guaranteed by non-EEA public sector entities, non-EEA regional governments and non-EEA local authorities that are risk weighted as exposures to institutions or central governments and central banks according to paragraphs 4.23 and 4.24, paragraph 4.10 or 4.16 to paragraph 4.17 respectively and that qualify for the credit quality assessment step 1: and

4.94.1.3 exposures in the sense of paragraphs 4.94.1.1 to 4.94.1.3 that qualify as a minimum for the credit quality assessment step 2, provided that they do not exceed 20% of the nominal amount of outstanding covered bonds of issuing institutions;

4.94.2 exposures to institutions that qualify for the credit quality assessment step 1 where:

4.94.2.1 the total exposure of this kind must not exceed 15% of the nominal amount of the outstanding covered bonds of the issuing credit institutions;

4.94.2.2 exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by real estate to the holders of covered bonds must not be comprised by the 15% limit; and

4.94.2.3 exposures to institutions in the EEA with a maturity not exceeding 100 days are not comprised by the step 1 requirement but those institutions must as a minimum qualify for credit quality assessment step 2;

4.94.3 Loans secured:

4.94.3.1 by residential real estate or shares in Finnish residential housing companies up to the lesser of the principle amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties; or

4.94.3.2 by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of an EEA State securitising residential real estate exposures provided that at least 90% of the assets of such Fonds Communs de Créances or of equivalent securitisation entities governed by the laws of an EEA State are composed of mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 80% of the value of the pledged properties and the units qualify for credit quality assessment step 1 where such units do not exceed 20% of the nominal amount of the outstanding issue;

4.94.4.1 loans secured by commercial real estate or shares in Finnish housing companies as referred to in paragraph 4.56 up to the lesser of the principle amount of the liens that are combined with any prior liens and 60% of the value of the pledged properties; or

4.94.4.2 loans secured by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of an EEA State securitising commercial real estate exposures provided that, at least 90% of the assets of such Fonds Communs de Créances or of equivalent securitisation entities governed by the laws of an EEA State are composed of mortgages that are combined with any prior liens up to the lesser of the principal amounts of the liens, and 60% of the value of the pledged properties and the units qualify for credit quality assessment step 1 where such units do not exceed 20% of the nominal amount of the outstanding issue; or

4.94.4.3 a firm may recognise loans secured by commercial real estate as eligible where the loan to value ratio of 60% is exceeded up to a maximum level of 70% if the value of total assets pledged as collateral for the covered bonds exceed the nominal amount outstanding on the covered bond by at least 10% and the bondholders' claim meets the legal certainty requirements set out in section 3 and regulations 41 to 43 of this guidance note, the bondholders' claim must take priority over all other claims on the collateral;

4.94.5 loans secured by ships where only liens that are combined with any prior liens within 60% of the value of the pledged ship.

4.94.6 For the purposes of 4.94.3.2 and 4.94.4.2 exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of loans secured by pledged properties of the senior units or debt securities must not be compromised in calculating the 90% limit.

4.94.7 For the purposes of paragraph 4.94 to 4.98 "collateralised" includes situations where the assets described in subparagraphs 4.94.1 to 4.94.5 are exclusively dedicated in law to the protection of the bond-holders against losses.

4.94.8 Unit 31st December 2010 the 20% limit for senior units issued by Fonds Communs de Créances or by equivalent securitisation entities specified in subparagraphs 4.94.3.2 and 4.94.4.2 does not apply, provided that those senior units have a credit assessment by a nominated ECAI which is the most favourable category of credit assessment made by the ECAI in respect of covered bonds.

4.94.9 Until 31st December 2010 the figure of 60% in 4.94.5 can be replaced with a figure of 70%.

4.95 Before the end of 31st December 2010, the derogations in paragraph 4.94.4 and 4.94.5 will be reviewed by the European Commission. Following that review, the Commission will determine whether or not to extend the period of derogation and may do so with or without a further review clause.

4.96 A firm must for real estate collateralising covered bonds meet the minimum requirements set out in paragraph 4.62 to paragraph 4.65 and the valuation rules set out in paragraphs 4.67 to 4.70.

4.97 Notwithstanding paragraph 4.94 to 4.96, covered bonds meeting the definition of Article 22(4) of the UCITS Directive and issued before 31st December 2007 are also eligible for the preferential treatment until their maturity.

4.98 Covered bonds must be assigned a risk weight on the basis of the risk weight attributed to senior unsecured exposures to the credit institution which issues them. The following correspondence between risk weights applies:

4.98.1 if the exposures to the institution receive a risk weight of 20%, the covered bond must receive a risk weight of 10%;

4.98.2 if the exposures to the institution receive a risk weight of 50%, the covered bond must receive a risk weight of 20%;

4.98.3 if the exposures to the institution receive a risk weight of 100%, the covered bond must receive a risk weight of 50%; and

4.98.4 if the exposures to the institution receive a risk weight of 150%, the covered bond must receive a risk weight of 100%.

Items representing securitisation positions

4.99 Risk weighted exposure amounts for securitisation positions must be determined in accordance with the provisions of the Guidance Note on Securitisation.

Short term exposures on credit institutions and corporates

4.100 Short term exposures on a credit institution or corporate for which a short term credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in paragraph 4.102 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.101 Table: Short term exposures on an institution or corporate for which a short term credit assessment by a nominated ECAI is available.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	150%	150%	150%

Exposures in the form of collective investment undertakings (CIUs)

4.102 Paragraph 4.103 to 4.113 set out the treatment to be accorded to exposures in the form of CIUs.

4.103 Without prejudice to paragraph 4.104 to 4.113, exposures in CIUs must be assigned a risk weight of 100%.

4.104 Exposures in the form of CIUs for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in paragraph 4.106 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

4.105 Table: Exposures in the form of CIUs for which a credit assessment by a nominated ECAI is available

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

4.106 Where a firm considers that a position in a CIU is associated with particularly high risks it must assign that position a risk weight of 150%.

4.107 A firm should consider a CIU as being high risk where there is no external credit assessment from an eligible ECAI and where the CIU has specific features (such as high levels of leverage or lack of transparency) that prevent it from meeting the eligibility criteria laid out in paragraph 4.109

4.108 Other examples of high risk CIUs are: one in which a substantial element of the CIU's property is made up of items that would attract a risk weight of over 100%; or one whose mandate (as referred to in paragraph 4.112) would permit it to invest in a substantial amount of such items.

4.109 Where paragraph 4.104 does not apply, a firm may determine the risk weight for a CIU as set out in paragraph 4.111 to 4.113, if the following eligibility criteria are met:

4.109.1 one of the following conditions is satisfied:

4.109.2 the CIU is managed by a company which is subject to supervision in an EEA State; or

4.109.3 the following conditions are satisfied:

4.109.3.1 the CIU is managed by a company which is subject to supervision that is equivalent to that laid down in Community Law; and

4.109.3.4 co-operation between Competent Authorities is sufficiently ensured; and

4.109.4 the CIU's prospectus or equivalent document includes:

4.109.4.1 the categories of assets the CIU is authorised to invest in; and

4.109.4.2 if the investment limits apply, the relative limits and the methodologies to calculate them; and

4.109.5 the business of the CIU is reported on at least an annual basis to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period.

4.110 If another EEA Competent Authority approves a third country CIU as eligible under a CRD implementation measure with respect to paragraph 74 point (a) of Part 1 of Annex VI of the Banking Consolidation Directive then a firm may make use of this recognition.

4.111 Where a firm is aware of the underlying exposures of a CIU, it may look through to those underlying exposures in order to calculate an average risk weight for the CIU in accordance with the standardised approach.

4.112 Where a firm is not aware of the underlying exposures of a CIU, it may calculate an average risk weight for the CIU in accordance with the standardised approach subject to the following measures: it will be assumed that the CIU first invests, to the maximum extent allowed under its mandate, in the standardised credit risk exposure classes attracting the highest capital requirement, and then continues making investments in descending order until the maximum total investment limit is reached.

4.113 A firm may rely on a third party to calculate and report, in accordance with the methods set out in paragraphs 4.111 to 4.112, a risk weight for the CIU provided that the correctness of the calculation and report is adequately ensured.

Other Items

4.114 Paragraphs 4.115 to 4.121 set of the treatment to be accorded to other items as referred to in paragraph 2.7.

4.115 Tangible assets within the meaning of Article 4(10) of the Bank Accounts Directive must be assigned a risk weight of 100%.

4.116 Prepayments and accrued income for which a firm is unable to determine the counterparty in accordance with the Bank Accounts Directive must be assigned a risk weight of 100%.

4.117 Cash items in the process of collection must receive a 20% risk weight. Cash in hand and equivalent cash items must receive a 0% risk weight.

4.118 Holdings of equity and other participations except where deducted from capital resources must be assigned a risk weight of at least 100%.

4.119 Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities must receive a 0% risk weight.

4.120 In the case of asset sale and repurchase agreements and outright forward purchases, the risk weight must be those attached to the assets in question and not the counterparties to the transactions.

4.121 Where a firm provides credit protection for a number of exposures under terms that the nth default among the exposure triggers payment and that this credit event terminates the contract, if the product has an external credit assessment from an eligible ECAI the risk weights prescribed in the Guidance Note on Securitisation must be applied. If the product is not rated by an eligible ECAI, the risk weights of the exposures included in the basket must be aggregated, excluding n-1 exposures, up to a maximum of 1250% and multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk weighted amount. The n-1 exposures to be excluded from the aggregation must be determined on the basis that they include those exposures each of which produces a lower risk weighted exposure amount than the risk weighted exposure amount of any of the exposures included in the aggregation.

Simplified method of calculating risk weights

4.122 Paragraphs 4.122 to 4.125 set out a simplified approach to calculating risk weights. This approach is only likely to be relevant for a limited licence firm or a limited activity firm that has only incidental credit exposures and for whom it would be prohibitively costly to establish the systems needed to include the credit assessments of ECAIs and export credit agencies in its regulatory capital calculations.

4.123 The approach in paragraph 4.122 is only relevant to an exposure class for which risk weights are determined by the ratings of a nominated ECAI of an export credit agency. For other exposure classes a firm should use the normal approach under the standardised approach. It does not apply to a securitisation position.

4.124 Rather than risk weighting exposures individually, a firm eligible to apply the simplified approach should apply a single risk weight to all exposures in each exposure class. The simplified risk weight for exposures in a particular class will be the risk weighting for unrated entities for each exposure class in which the external credit assessments influence risk weights.

4.125 If a firm does not nominate one or more eligible ECAIs as referred to in the guidance note on ECAIs the firm must not use the financial collateral comprehensive method.

5. Use of Rating Agencies' Assessments or the determination of risk weights under the standardised approach to credit risk

5.1 The use of ECAI credit assessments for the calculation of a firm's risk weighted exposure amounts must be consistent and in accordance with this section. Credit assessments must not be used selectively.

5.2 A firm may use an unsolicited credit assessment of an eligible ECAI for the calculation of a firm's risk weighted exposure amounts.

5.3 A firm should assess the quality of the unsolicited credit assessments that it proposes to use. The FSC would expect a firm not to use the unsolicited credit assessments which are inferior to the general quality of solicited assessments. A firm's decision whether or not to make use of an unsolicited credit assessment should not be influenced by the obtaining of a lower risk weight.

5.4 A firm may nominate one or more eligible ECAIs to be used for the determination of risk weights applicable to asset and off-balance sheet items.

5.5 A firm which decides to use the credit assessments produced by an eligible ECAI for a certain class of items must use those credit assessments consistently for all exposures belonging to that class.

5.6 A firm which decides to use the credit assessments produced by an eligible ECAI must use them in a continuous and consistent way over time.

5.7 A firm can only use ECAIs' credit assessments that take into account all amounts, both in principal and in interest owed to it.

5.8 If only one credit assessment is available from a nominated ECAI for a rated item, that credit assessment must be used to determine the risk weight for that item.

5.9 If two credit assessments are available from nominated ECAIs and the two correspond to different risk weights for a rated item, the higher risk weight must be applied.

5.10 If more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest risk weights must be referred to. If the two lowest risk weights are different, the higher risk weight must be applied. If the two lowest risk weights are the same, that risk weight must be applied.

5.11 When risk weighting exposures to central governments or central banks, if two or more credit assessments are available to a firm from export credit agencies or if credit assessments are available to a firm from both nominated ECAIs and export credit agencies, the firm must adopt the following approach:

5.11.1 if two credit assessments are available and correspond to different risk weights for a rated item, the higher risk weight must be applied;

5.11.2 if more than two credit assessments are available for a rated item, the assessments generating the two lowest risk weights must be referred to:

5.11.2.1 if the lowest risk weights are the same, that risk weight must be applied; or

5.11.2.2 if the two lowest risk weights are different, the higher of the two must be applied.

Issuer and credit assessment

5.12 Where a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure belongs, this credit assessment must be used to determine the risk weight applicable to that item.

5.13 Where no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure does not belong or a general credit exists for the issuer, then the credit assessment must be used if it produces a higher risk weight than would otherwise be the case or if it produces a lower risk weight and the exposure in question ranks pari passu or senior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer as relevant.

5.14 Paragraphs 5.12 and 5.13 are not to prevent the application of paragraphs 4.94 to 4.98.

5.15 Credit assessments for issuers within a corporate group cannot be used as credit assessments of another issuer within the same corporate group.

Long term and short term credit assessments

5.16 Short term credit assessments may only be used for short term asset and off-balance sheet items constituting exposures to institutions and corporates.

5.17 Any short term credit assessment may only apply to the item the short term credit assessment refers to, and it must not be used to derive risk weights for any other item.

5.18 Notwithstanding paragraph 5.17, if a short term rated facility receives a 150% risk weight, then all unrated unsecured exposures on that obligor whether short or long term must also receive a 150% risk weight.

5.19 Notwithstanding paragraph 5.17, if a short term rated facility attracts a 50% risk weight, no unrated short term exposure may attract a risk weight lower than 100%.

Domestic and foreign currency items

5.20 A credit assessment that refers to an item denominated in the obligor's domestic currency cannot be used to derive a risk weight for another exposure on that same obligor that is denominated in a foreign currency.

5.21 Notwithstanding paragraph 5.20, when an exposure arises through a firm's participation in a loan that has been extended by a multilateral development bank whose preferred creditor status is recognised in the market, the credit assessment on the obligor's domestic currency item may be used for risk weighting purposes.

6. Classification of off-balance sheet items

6.1 In accordance with paragraph 2.1 a firm must:

6.1.1 assign an off-balance sheet item listed in table 6.2 to the risk category indicated in the category column of that table; and

6.1.2 determine the exposure value of that item as the percentage of its value for the appropriate risk category as set out in column 3 of the table in

6.2 Table: Classification of off-balance sheet items

Category	Item	Percentage
Full Risk	Guarantees having the character of credit substitutes Credit derivatives Acceptances	100%

	Endorsements on bills not bearing the name of another credit institution Transactions with recourse Irrevocable standby letters of credit having the character of credit substitutes Assets purchased under outright forward purchase agreements Forward forward deposits The unpaid portion of partly-paid shares and securities Asset sale and repurchase agreements as defined in Article 12(3) and (5) of the Bank Accounts Directive Other items also carrying full risk	
Category	Item	Percentage
Medium Risk	Documentary credits issued and confirmed (see also medium/low risk). Warranties and indemnities (including tender, performance, customs and tax bonds) and guarantees not having the character of credit substitutes Irrevocable standby letters of credit not having the character of credit substitutes. Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year. Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).	50%
Category	Item	Percentage
Medium/Low Risk	Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions. Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year which may not be cancelled or that do not effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness	20%
Category	Item	Percentage
Low risk	Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) which may be cancelled unconditionally at any time without notice, or that do effectively provide for automatic cancellation due to	0%

	deterioration in a borrower's creditworthiness. Retail credit lines may be considered as unconditionally cancellable if the terms permit the firm to cancel them to the full extent allowable under consumer protection and related legislation.	

7. Credit risk mitigation

7.1 This section of the guidance notes sets out the principles for the recognition of credit risk mitigation in the calculation of risk weighted exposure amounts for the purposes of the calculation of the credit risk capital component. In certain cases provisions specific to the IRB approach have been kept in this guidance note to reduce duplication.

The central principles of credit risk mitigation

7.2 A firm using the standardised approach may recognise credit risk mitigation in the calculation of risk weighted exposure amounts for the purposes of the calculation of the credit risk capital component.

7.3 The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by a lending firm must be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.

7.4 Before it recognises the effect of credit protection as referred to in paragraph 7.3, a firm must have conducted sufficient legal review confirming that, in accordance with paragraph 7.3, credit protection arrangements are legally effective and enforceable in all relevant jurisdictions. The firm must re-conduct such review as necessary to ensure continuing enforceability and effectiveness

7.5 A lending firm must take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

Funded credit protection

7.6 In the case of funded credit protection:

7.6.1 to be eligible for recognition the assets relied upon must be sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk weighted exposure amounts and to the degree of recognition allowed; eligibility is limited to the assets set out in the CRM eligibility conditions.

7.6.2 the lending firm must have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy of the obligor - or other credit event set out in the transaction documentation - and, where applicable, of the custodian holding the collateral; the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor must not be undue.

Treatment of credit linked notes

7.7 A credit linked note should be treated, to the extent of its cash funding, as funded credit protection. Therefore the conditions in this guidance note regulating the eligibility of protection providers for unfunded credit protection do not apply. However the other provisions about the requirements for the recognition of unfunded credit protection do apply.

Unfunded credit protection

7.8 In the case of unfunded credit protection:

7.8.1 to be eligible for recognition the party giving the undertaking must be sufficiently reliable, and the protection agreement legally effective in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed;

7.8.2 eligibility is limited to the protection providers and types of protection agreement set out in the CRM eligibility conditions.

7.9 The minimum requirements set out in this guidance note must be complied with.

7.10 A firm must be able to satisfy the Commission that it has adequate risk management processes to control those risks to which the firm may be exposed as a result of carrying out credit risk mitigation.

7.11 Notwithstanding the presence of credit risk mitigation taken into account for the purposes of calculating risk-weighted exposure amounts and as relevant expected loss amounts, a firm must continue to undertake full credit risk assessment of the underlying exposure and must be in a position to demonstrate to the FSC the fulfilment of this requirement. In the case of repurchase transactions and/or securities or commodities lending or borrowing transactions the underlying exposure must, for the purposes of this rule only, be deemed to be the net amount of the exposure.

Calculating the effects of the credit risk mitigation

7.12 Where the requirements of paragraph 7.3 to paragraph 7.9 are met the calculation of risk-weighted exposure amounts, must be modified in accordance with this Guidance note, these should be reflected on the return as specified in the notes to the return.

7.13 No exposure in respect of which credit risk mitigation is obtained may produce a higher risk weighted exposure amount than an otherwise identical exposure in respect of which there is no credit risk mitigation.

8. On Balance sheet netting

8.1 A firm may recognise the on-balance sheet netting of mutual claims between the firm and its counterparty.

8.2 Without prejudice to paragraph 9.75, eligibility is limited to reciprocal cash balances between a firm and a counterparty. Only loans and deposits of the lending firm may be subject to a modification of risk weighted exposure amounts and, as relevant, expected loss amounts as a result of an on-balance sheet netting agreement.

8.3 For on-balance sheet netting agreements - other than master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions and/or other capital market-driven transactions - to be recognised for the purposes of this guidance note the following conditions must be satisfied:

8.3.1 they must be legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;

8.3.2 the firm must be able to determine at any time those assets and liabilities that are subject to the netting agreement;

8.3.3 the firm must monitor and control the risks associated with the termination of the credit protection; and

8.3.4 the firm must monitor and control the relevant exposures on a net basis.

Calculating the effects of credit risk mitigation

8.4 Loans and deposits with a lending firm subject to on-balance sheet netting are to be treated as cash collateral.

9. Financial Control

9.1

9.1.1 Where the credit risk mitigation used relies on the right of a firm to liquidate or retain assets, eligibility depends upon whether risk-weighted exposure amounts, and, as relevant, expected loss amounts, are calculated under the standardised approach or the IRB approach.

9.1.2 Eligibility further depends upon whether the financial collateral simple method is used or the financial collateral comprehensive method.

9.1.3 In relation to repurchase transactions and securities or commodities lending or borrowing transactions, eligibility also depends upon whether the transaction is booked in the non-trading book or the trading book.

9.2 The following financial items may be recognised as eligible collateral under all approaches and methods:

9.2.1 cash on deposit with, or cash assimilated instruments held by, the lending firm;

9.2.2 debt securities issued by central governments or central banks which securities have a credit assessment by an eligible ECAI or export credit agency recognised as eligible for the purposes of the standardised approach, which is associated with credit quality step 4 or above under the rules for the risk weighting of exposures to central governments and central banks under the standardised approach;

9.2.3 debt securities issued by institutions which securities have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of exposures to a credit institution under the standardised approach;

9.2.4 debt securities issued by other entities which securities have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under the standardised approach;

9.2.5 debt securities with a short-term credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of short term exposures under the standardised approach;

9.2.6 equities or convertible bonds that are included in a main index; and

9.2.7 gold.

9.3 For the purposes of paragraph 9.2.2, 'debt securities issued by central governments or central banks include –

9.3.1 debt securities issued by regional governments or local authorities exposures to which are treated as exposures to the central government in whose jurisdiction they are established under the standardised approach;

9.3.2 debt securities issued by public sector entities which are treated as exposures to central governments in accordance with the guidance on the standardised approach to credit risk.

9.3.3 debt securities issued by multilateral development banks to which a 0% risk weight is applied under the standardised approach;

9.3.4 debt securities issued by international organisations which are assigned a 0% risk weight under the standardised approach.

9.4 For the purposes of paragraph 9.2.3, 'debt securities issued by institutions' include:

9.4.1 debt securities issued by regional governments or local authorities other than those exposures to which are treated as exposures to the central government in whose jurisdiction they are established under the standardised approach;

9.4.2 debt securities issued by public sector entities, exposures to which are treated as exposures to a credit institution under the standardised approach;

9.4.3 debt securities issued by multilateral development banks other than those to which a 0% risk weight is applied under the standardised approach.

9.5 Debt securities issued by institutions which securities do not have a credit assessment by an eligible ECAI may be recognised as eligible collateral if they fulfil the following criteria:

9.5.1 they are listed on a recognised investment exchange or a designated investment exchange;

9.5.2 they qualify as senior debt:;

9.5.3 all other rated issues by the issuing institution of the same seniority having a credit assessment by a recognised ECAI have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions or short term exposures under the standardised approach;

9.5.4 the lending firm has no information to suggest that the issue would justify a credit assessment below that indicated in 9.5.3; and

9.5.5 the firm can demonstrate to the FSC that the market liquidity of the instrument is sufficient for these purposes.

9.6

9.6.1 Units in CIUs may be recognised as eligible collateral if the following conditions are satisfied:

9.6.1.1 they have a daily public price quote; and

9.6.1.2 the CIU is limited to investing in instruments that are eligible for recognition under paragraphs 9.2.2 to 9.2.5.

9.6.2 The use (or potential use) by a CIU of derivative instruments to hedge permitted investments shall not prevent units in that CIU from being eligible.

9.6.3 If the collective investment undertaking is not limited to investing in instruments that are eligible for recognition under points 7 and 8 of Annex VII, Part 1 of the 2006/48/EC, units may be recognised with the value of the eligible assets as collateral under the assumption that the CIU has invested to the maximum extent allowed under its mandate in non-eligible assets. In cases where non-eligible assets can have a negative value due to liabilities or contingent liabilities resulting from ownership, the credit institution shall calculate the total value of the non-eligible assets and shall reduce the value of the eligible assets by that of the non-eligible assets in case the latter is negative in total.

9.7 In relation to paragraphs 9.5.2 to 9.5.5:

9.7.1 where a security has two credit assessments by eligible ECAIs, the less favourable assessment must be deemed to apply;

9.7.2 in cases where a security has more than two credit assessments by eligible ECAIs:

9.7.2.1 the two most favourable assessments must be deemed to apply; or

9.7.2.2 if the two most favourable credit assessments are different, the less favourable of the two must be deemed to apply.

9.8 In addition to the collateral set out in paragraphs 9.2.2 to 9.2.7, where a firm uses the financial collateral comprehensive method, the following financial items may be recognised as eligible collateral:

9.8.1 Equities or convertible bonds not included in a main index but traded on a recognised investment exchange or a designated investment exchange;

9.8.2 units in CIUs if the following conditions are met:

9.8.2.1 they have a daily public price quote; and

9.8.2.2 the CIU is limited to investing in instruments that are eligible for recognition under paragraphs 9.22 to 9.24 and the items mentioned in 9.8.1.

9.8.3 The use (or potential use) by a CIU of derivative instruments to hedge permitted investments shall not prevent units in that CIU from being eligible.

9.8.4 If the collective investment undertaking is not limited to investing in instruments that are eligible for recognition under paragraphs 7 and 8 of the section entitled Funded Credit Protection of the FSCACI regulations, units may be recognised with the value of the eligible assets as collateral under the assumption that the CIU has invested to the maximum extent allowed under its mandate in non-eligible assets. In cases where non-eligible assets can have a negative value due to liabilities or contingent liabilities resulting from ownership, the credit institution shall calculate the total value of the non-eligible assets and shall reduce the value of the eligible assets by that of the non-eligible assets in case the latter is negative in total.

9.9 For the recognition of financial collateral and gold, the following conditions must be met:

9.9.1 the low correlation conditions in paragraph 9.10

9.9.2 the legal certainty conditions in paragraph 9.11; and

9.9.3 the operational requirements in paragraph 9.12.

9.10 The low correlation conditions referred to in paragraph 9.9.1 are as follows:

9.10.1

9.10.1.1 the credit quality of the obligor and the value of the collateral must not have a material positive correlation; and

9.10.1.2 securities issued by the obligor, or any related group entity are not eligible.

9.10.2 notwithstanding 9.10.1.2, the obligor's own issues of covered bonds falling within the terms of the first part of this guidance note on credit risk, may be recognised as collateral for repurchase transactions,
provided that 9.10.1.1 is complied with.

9.11 The legal certainty conditions are as follows:

9.11.1 a firm must fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of the collateral arrangements under the law applicable to its interest in the collateral.

9.11.2 in accordance with the general principle in paragraph 9.2.2, a firm must have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions; and

9.11.3 a firm must re-conduct such review as necessary to ensure continuing enforceability.

9.12 The operational requirements are as follows:

9.12.1 the collateral arrangements must properly document the collateral arrangements must be properly documented, with a clear and robust procedure for the timely liquidation of collateral;

9.12.2 a firm must employ robust procedures and processes to control risks arising from the use of collateral – including risks of failed or reduced credit protection, valuation risks, risks associated with the termination of the credit protection, concentration risk arising from the use of collateral and the interaction with the firm's overall risk profile;

9.12.3 a firm must have documented policies and practices concerning the types and amounts of collateral accepted;

9.12.4 a firm must calculate the market value of the collateral, and revalue it accordingly, with a minimum frequency of once every six months and whenever the firm has reason to believe that there has occurred a significant decrease in its market value; and

9.12.5 where the collateral is held by a third party, a firm must take reasonable steps to ensure that the third party segregates the collateral from its own assets.

9.13 In addition to the requirements set out in paragraph 9.4.9, for the recognition of financial collateral under the financial collateral simple method the residual maturity of the protection must be at least as long as the residual maturity of the exposure.

The financial collateral simple method:

9.14 Paragraphs 9.15 to 9.22 set out the calculation of the effects of credit risk mitigation under the financial collateral simple method.

9.15 The financial collateral simple method is available only where risk-weighted exposure amounts are calculated under the standardised approach.

9.16 A firm must not use both the financial collateral simple method and the financial collateral comprehensive method unless for the purposes of Articles 85(1) and 89(1) of the Capital Requirements Directive. Credit institutions shall demonstrate to the FSC that this exceptional application of both methods is not used selectively with the purpose of achieving reduced minimum capital requirements and does not lead to regulatory arbitrage.

9.17 Under the financial collateral simple method, recognised financial collateral is assigned a value equal to its market value as determined in accordance with paragraphs 9.9 to 9.12.

9.18 The risk weight that would apply under the standardised approach if the lending firm had a direct exposure to the collateral instrument applies to those portions of exposure values collateralised by the market value of recognised collateral. For this purpose, the exposure value of an off-balance sheet item listed in Annex II of the 2006/48/EC Directive shall be 100% of its value rather than the risk exposure value indicated in Article 78(1) of the Capital Requirements Directive. The risk weight of the collateralised portion must be a minimum of 20% except as specified in paragraphs 9.19 to 9.21. The remainder of the exposure value receives the risk weight that would be assigned to an unsecured exposure to the counterparty under the standardised approach.

9.19 A risk weight of 0% must be applied to the collateralised portion of the exposure arising from transactions which fulfil the criteria enumerated in paragraph 9.61 or 9.64. If the counterparty to the transaction is not a core market participant a risk weight of 10% must be applied.

9.20 A risk weight of 0% must, to the extent of the collateralisation, be applied to the exposure value determined under the guidance note on financial derivative instruments and subject to daily marking-to -market, collateralised by cash or cash-assimilated instruments where there is no currency mismatch. A risk weight of 10% applies to the extent of the collateralisation to the exposure values of such transactions collateralised by debt securities issued by central governments or central banks which receive a 0% risk weight under the standardised approach.

9.21 A 0% risk weight may be applied where the exposure and the collateral are denominated in the same currency, and either:

9.21.1 the collateral is cash on deposit or a cash assimilated instrument;

or

9.21.2 the collateral is in the form of central government or central bank debt securities eligible for a 0% risk weight under the standardised approach, and its market value has been discounted by 20%.

9.22 For the purposes of this paragraph 9.20 and 9.21, debt securities issued by central governments or central banks must be deemed to include:

9.22.1 debt securities issued by regional governments or local authorities exposures to which are treated as exposures to the central government in whose jurisdiction they are established under the standardised approach;

9.22.2 debt securities issued by multilateral development banks to which a 0% risk weight is applied under or by virtue of the standardised approach; and

9.22.3 debt securities issued by international organisations which are assigned a 0% risk weight under the standardised approach.

The financial collateral comprehensive method

9.23 Paragraphs 9.24 to 9.27 set out the calculation of the effects of credit risk mitigation under the financial collateral comprehensive method.

9.24 In valuing financial collateral for the purposes of the financial collateral comprehensive method, volatility adjustments must be applied to the market value of collateral, as set out in paragraphs 9.29 to 9.65, in order to take account of price volatility.

9.25 Subject to the treatment for currency mismatches in the case of financial derivative instruments set out in paragraph 9.26, where collateral is denominated in a currency that differs from that in which the underlying exposure is denominated, an adjustment reflecting currency volatility must be added to the volatility adjustment appropriate to the collateral as set out in paragraphs 9.29 to 9.62.

9.26 In the case of financial derivative instruments covered by netting agreements, a volatility adjustment reflecting currency volatility must be applied when there is a mismatch between the collateral currency and the settlement currency. Even in the case where multiple currencies are involved in the transactions covered by the netting agreement, only a single volatility adjustment may be applied.

9.27 For the relevant formulas, refer to paragraph 33, part 3, Schedule 8, BCACI Regulations.

9.28 Paragraphs 9.9 – 9.62 set out the calculation of volatility adjustments under the financial collateral comprehensive method.

9.29 Volatility adjustments may be calculated in two ways: the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach.

9.30 A firm may choose to use the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach independently of the choice it has made between the standardised approach and the IRB approach for the calculation of risk-weighted exposure amounts. However, if a firm seeks to use the own estimates of volatility adjustments approach, it must do so for the full range of instrument types, excluding immaterial portfolios where it may use the supervisory volatility adjustments approach.

9.31 Where the collateral consists of a number of recognised items, the volatility adjustment must be the formula set out in regulation 35 of part 3, schedule 8 of the BCACI regulations.

9.32 Para9.32 Paragraphs 9.33 to- 9.39 set out the calculation of volatility adjustments under the supervisory volatility adjustments approach.

9.33 The volatility adjustments to be applied under the supervisory volatility adjustments approach (assuming daily revaluation) are those set out in the tables 1 to 4 of Schedule 8 part 3 of the BCACI Regulations.

9.34

9.34.1 For secured lending transactions the liquidation period is 20 business days.

9.34.2 For repurchase transactions (except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities) and securities lending or borrowing transactions the liquidation period is 5 business days.

9.34.3 For other capital market driven transactions, the liquidation period is 10 business days.

9.35 In tables 1 to 4 of Schedule 8 part 3 of the BCACI Regulations and in paragraphs 9.36 to 9.38, the credit quality step with which a credit assessment of the debt security is associated is the credit quality step with which the external credit assessment is associated under the standardised approach. For these purposes paragraph 9.43 also applies.

9.36 For non-eligible securities or for commodities lent or sold under repurchase transactions or securities or commodities lending or borrowing transactions, the volatility adjustment is the same as for non-main index equities listed on a recognised investment exchange or a designated investment exchange.

9.37 For eligible units in CIUs the volatility adjustment is the weighted average volatility adjustments that would apply, having regard to the liquidation period of the transaction as specified in paragraph 9.34, to the assets in which the fund has invested. If the assets in which the fund has invested are not known to the firm, the volatility adjustment is the highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.

9.38 For unrated debt securities issued by institutions and satisfying the eligibility criteria in paragraph 9.5 the volatility adjustments are the same as for securities issued by institutions or corporates with an external credit assessment associated with credit quality steps 2 or 3

9.39 Paragraphs 9.39 to 9.58 deal with the calculation of volatility adjustments under the own estimates of volatility adjustments approach.

9.40 A firm complying with the requirements set out in paragraphs 9.45 to 9.57 may use the own estimates of volatility adjustments approach for calculating the volatility adjustments to be applied to collateral and exposures.

9.41 When debt securities have a credit assessment from an eligible ECAI equivalent to investment grade or better, a firm may calculate a volatility estimate for each category of security.

9.42 In determining relevant categories, a firm must take into account the type of issuer of the security the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates must be representative of the securities included in the category by the firm.

9.43 For debt securities having a credit assessment from an eligible ECAI equivalent to below investment grade and for other eligible collateral the volatility adjustments must be calculated for each individual item.

9.44 A firm using the own estimates of volatility adjustments approach must estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral and/or exchange rates.

9.45 In calculating the volatility adjustments, a 99th percentile one-tailed confidence interval must be used.

9.46 The liquidation period is 20 business days for secured lending transactions; 5 business days for repurchase transactions except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities and securities lending or borrowing transactions; and 10 business days for other capital market driven transactions.

9.47 A firm may use volatility adjustment numbers calculated according to shorter or longer liquidation periods, scaled up or down to the liquidation period set out in paragraph 9.46 for the type of transaction in question, using the square root of time formula set out in paragraph 49, part 3, schedule 8, BACAI Regulations.

9.48 A firm must take into account the illiquidity of lower-quality assets. The liquidation period must be adjusted upwards in cases where there is doubt concerning the liquidity of the collateral.

9.49 A firm must also identify where historical data may understate potential volatility, e.g. a pegged currency. Such cases must be dealt with by means of a stress scenario.

9.50 The historical observation period (sample period) for calculating volatility adjustments must be a minimum length of one year.

9.51 For a firm that uses a weighting scheme or other methods for the historical observation period, the effective observation period must be at least one year (that is, the weighted average time lag of the individual observations must not be less than 6 months).

9.52 The FSC may also require a firm to calculate its volatility adjustments using a shorter observation period if, in the FSC's judgement, this is justified by a significant upsurge in price volatility.

9.53 A firm must update its data sets no less frequently than once every three months and must also reassess them whenever market prices are subject to material changes. This implies that volatility adjustments must be computed at least every three months.

9.54 The volatility estimates must be used in the day-to-day risk management process of a firm including in relation to its internal exposure limits.

9.55 If the liquidation period used by a firm in its day-to-day risk management process is longer than that set out in paragraphs 5.4 to 9.67 for the type of transaction in question, the firm's volatility adjustments must be scaled up in accordance with the square root of time formula set out in paragraph 9.47.

9.56 A firm must have established procedures for monitoring and ensuring compliance with a documented set of policies and controls for the operation of its system for the estimation of volatility adjustments and for the integration of such estimations into its risk management process.

9.57 An independent review of a firm's system for the estimation of volatility adjustments must be carried out regularly in the firm's own internal auditing process. A review of the overall system for the estimation of volatility adjustments and for integration of those adjustments into the firm's risk management process must take place at least once a year and must specifically address, at a minimum:

9.57.1 the integration of estimated volatility adjustments into daily risk management;
9.57.2 the validation of any significant change in the process for the estimation of volatility adjustments;
9.57.3 the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of volatility adjustments, including the independence of such data sources; and
9.57.4 the accuracy and appropriateness of the volatility assumptions.

9.58 The volatility adjustments set out in paragraph 9.33 are the volatility adjustments to be applied where there is daily revaluation. Similarly where a firm uses its own estimates of the volatility adjustments in accordance with paragraphs 9.40 to 9.57, these must be calculated in the first instance on the basis of daily revaluation. If the frequency of revaluation is less than daily, larger volatility adjustments must be applied. These must be calculated by scaling up the daily revaluation volatility adjustments, using the following 'square root of time' as per paragraph 49 of part 3, schedule 8 of the BCACI Regulations.

9.59 In relation to repurchase transactions and securities lending or borrowing transactions, where a firm uses the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach and where the conditions set out in 9.59.1 to 9.59.8 are satisfied, a firm may, instead of applying the volatility adjustments calculated under paragraphs 9.29 to 9.58, apply a 0% volatility adjustment:

9.59.1 both the exposure and the collateral are cash or debt securities issued by central governments or central banks within the meaning of paragraph 9.1.2 and eligible for a 0% risk weight under the standardised approach;

9.59.2 both the exposure and the collateral are denominated in the same currency;

9.59.3 either the maturity of the transaction is no more than one day or both the exposure and the collateral are subject to daily marking-to-market or daily remargining;

9.59.4 it is considered that the time between the last marking-to-market before a failure to remargin by the counterparty and the liquidation of the collateral is no more than four business days;

9.59.5 the transaction is settled across a settlement system proven for that type of transaction;

9.59.6 the documentation covering the agreement is standard market documentation for repurchase transactions or securities lending or borrowing transactions in the securities concerned;

9.59.7 the transaction is governed by documentation specifying that if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction is immediately terminable; and

9.59.8 the counterparty is a core market participant.

9.60 The option in paragraph 9.59 is not available in respect of a firm using the master netting agreement internal models approach.

9.61 Core market participant means the following entities:

9.61.1 the entities mentioned in paragraph 9.1.3 exposures to which receive a 0% risk weight under the standardised approach;

9.61.2 institutions;

9.61.3 other financial companies (including insurance companies) exposures to which receive a 20% risk weight under the standardised approach;

9.61.4 regulated CIUs that are subject to capital or leverage requirements;

9.61.5 regulated pension funds; and

9.61.6 a recognised clearing house or designated clearing house.

9.62 If under the CRD implementation measure for a particular EEA State with respect to paragraph 59 of Part 3 of Annex VIII of the Banking Consolidation Directive (Conditions for applying the 0% volatility adjustment) the treatment set out in that paragraph is permitted to be applied in the case of repurchase transactions or securities lending or borrowing transactions in securities issued by the domestic government of that EEA State, then a firm may adopt the same approach to the same transactions.

9.63 Under the standardised approach E* as calculated under paragraph 9.27 must be taken as the exposure value. In the case of off-balance sheet items listed in section 6, E* must be taken as the value to which the percentages indicated in this guidance note must be applied to arrive at the exposure value.

Other funded credit risk mitigation

Deposits with third parties

9.64 Cash on deposit with, or cash assimilated instruments held by, a third party institution in a non-custodial arrangement and pledged to a lending firm may be recognised as eligible credit protection.

9.65 To be eligible for the treatment set out at paragraph 9.66, the protection referred to in paragraph 9.64 must satisfy the following conditions:

9.65.1 the borrower's claim against the third party institution is openly pledged or assigned to the lending firm and such pledge or assignment is legally effective and enforceable in all relevant jurisdictions;

9.65.2 the third party institution is notified of the pledge or assignment;

9.65.3 as a result of the notification, the third party institution is able to make payments solely to the lending firm or to other parties with the lending firm's consent; and

9.65.4 the pledge or assignment is unconditional and irrevocable.

9.66 Where the conditions set out in paragraph 9.64 are satisfied, credit protection falling within the terms of paragraph 9.64 may be treated as a guarantee by the third party institution.

Life insurance policies

9.67 Life insurance policies pledged to a lending firm may be recognised as eligible credit protection.

9.68 For life insurance policies pledged to the lending credit institution to be recognised, all the following conditions shall be met:

9.68.1 the life insurance policy is openly pledged or assigned to the lending credit institution;

9.68.2 the company providing the life insurance is notified of the pledge or assignment and as a result may not pay amounts payable under the contract without the consent of the lending credit institution;

9.68.3 the lending credit institution has the right to cancel the policy and receive the surrender value in the event of the default of the borrower;

9.68.4 the lending credit institution is informed of any non-payments under the policy by the policy-holder;

9.68.5 the credit protection is provided for the maturity of the loan. Where this is not possible because the insurance relationship ends before the loan relationship expires, the credit institution must ensure that the amount deriving from the insurance contract serves the credit institution as security until the end of the duration of the credit agreement;

9.68.6 the pledge or assignment is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement;

9.68.7 the surrender value is declared by the company providing the life insurance and is non-reducible;

9.68.8 the surrender value is to be paid in a timely manner upon request

9.68.9 the surrender value cannot be requested without the consent of the credit institution;

9.68.10 the company providing the life insurance is subject to Directive 2002/83/EC and Directive 2001/17/EC of the European Parliament and of the Council or is subject to supervision by a competent authority of a third country which applies supervisory and regulatory arrangements at least equivalent to those applied in the EEA.

9.69 Where the conditions set out in Part 2, point 13 of Directive 2006/48/EC are satisfied, the portion of the exposure collateralised by the current surrender value of credit protection falling within the terms of Part 1, point 24 of Directive 2006/48/EC shall be either of the following:

9.69.1 subject to the risk weights specified in point 80a of Directive 2006/48/EC where the exposure is subject to Articles 78 to 83;

9.69.2 assigned an LGD of 40 % where the exposure is subject to Articles 84 to 89 of the CRD but not subject to the credit institution's own estimates of LGD.

9.70 In case of a currency mismatch, the current surrender value shall be reduced according to point 84, the value of the credit protection being the current surrender value of the life insurance policy.';

9.71 For purposes of point 9.69.1, the following risk weights shall be assigned on the basis of the risk weight assigned to a senior unsecured exposure to the company providing the life insurance:

9.71.1 a risk weight of 20 %, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 20 %;

9.71.2 a risk weight of 35 %, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight or 50 %;

9.71.3 a risk weight of 70 %, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 100 %;

9.71.4 a risk weight of 150 %, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 150 %.

Instruments purchased on request

9.71 Instruments issued by third party institutions which will be repurchased by that institution on request may be recognised as eligible credit protection.

9.72 Instruments eligible under paragraph 9.71 may be treated as a guarantee by the issuing institution.

9.73 For the purposes of paragraph 9.7.2 the value of the credit protection recognised is the following:

9.73.1 where the instrument will be repurchased at its face value, the value of the protection is that amount; or

9.73.2 where the instrument will be repurchased at market price, the value of the protection is the value of the instrument valued in the same way as the debt securities specified in paragraph 9.5.

Credit linked notes

9.74 Investments in credit linked notes issued by a lending firm may be treated as cash collateral.

Master netting agreements

9.75 For a firm adopting the financial collateral comprehensive method, the effects of bilateral netting contracts covering repurchase transactions, securities or commodities lending or borrowing transactions, and/or other capital market-driven transactions with a counterparty may be recognised.

Without prejudice to capital requirements for settlement and counterparty risk, to be recognised the collateral taken and securities or commodities borrowed within such agreements must comply with the eligibility requirements for collateral set out at paragraphs 9.2 to 9.8.

9.76 For master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions to be recognised for the purposes of credit risk mitigation, they must:

9.76.1 be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;

9.76.2 give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty; and

9.76.3 provide for the netting of gains and losses on transactions closed out under a master agreement so that a single net amount is owed by one party to the other.

9.77 In addition the minimum requirements for the recognition of financial collateral under the *financial collateral comprehensive method* set out in paragraph 9.9 must be fulfilled.

Calculation of the fully adjusted exposure value

9.78 Paragraphs 9.79 to 9.85 set out the calculation of the fully adjusted exposure value under the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach.

9.79 In calculating the 'fully adjusted exposure value' (E*) for the exposures subject to an eligible master netting agreement covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions, a firm must calculate the volatility adjustments to be applied in the manner set out in paragraphs 9.80 to 9.85 either using the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach as set out in paragraphs 9.29 to 9.63 for the financial collateral comprehensive method. For the use of the own estimates of volatility adjustments approach the same conditions and requirements apply as under the financial collateral comprehensive method.

9.80 A firm must calculate the net position in each type of security or commodity by subtracting from the total value of the securities or commodities of that type lent, sold or provided under the master netting agreement, the total value of securities or commodities of that type borrowed, purchased or received under the agreement.

9.81 Type of security means securities which are issued by the same entity, have the same issue date, the same maturity and are subject to the same terms and conditions and are subject to the same liquidation periods as indicated in paragraphs 9.30 to 9.63.

9.82 A firm must calculate the net position in each currency other than the settlement currency of the master netting agreement by subtracting from the total value of securities denominated in that currency lent, sold or provided under the master netting agreement added to the amount of cash in that currency lent or transferred under the agreement, the total value of securities denominated in that currency borrowed, purchased or received under the agreement added to the amount of cash in that currency borrowed or received under the agreement.

9.83 A firm must apply the volatility adjustment appropriate to a given type of security or cash position to the positive or negative net position in the securities of that type.

9.84 A firm must apply the foreign exchange risk (fx) volatility adjustment to the net positive or negative position in each currency other than the settlement currency of the master netting agreement.

9.85 *E** must be calculated according to the following formula set out in paragraph 11 of part 3 of Schedule 8 of the BCACI Regulations.

9.86 Paragraphs 9.87 to 9.102 apply to a firm that has a master netting agreement internal models approach and set out the calculation of the effects of credit risk mitigation under the master netting agreement internal models approach.

9.87 A firm that wishes to use the master netting agreement internal models approach will need to apply to the FSC to use the master netting agreement internal models approach.

9.88 A master netting agreement internal models approach will amend, to the extent set out in the master netting agreement internal models approach, paragraph 9.75 so as to provide that, with the exceptions provided in paragraphs 9.75 to 9.102, a firm must use the master netting agreement internal models approach for the purposes of the calculations specified in paragraphs 9.75 to 9.102.

9.89 A firm which has been granted a VaR model waiver will still need to make an application to the FSC to apply the master netting agreement internal models approach. However, the application should generally be straightforward as a firm which is able to satisfy the requirements for a VaR model waiver should usually also be able to satisfy the requirements for a master netting agreement internal models approach

The *master netting agreement internal models approach*

9.90 *The* master netting agreement internal models approach is an alternative to using the supervisory volatility adjustments approach or the own estimates volatility adjustments approach in calculating volatility adjustments for the purpose of calculating the 'fully adjusted exposure value' (E*) resulting from the application of an eligible master netting agreement covering repurchase transactions, securities or commodities lending or borrowing transactions and/or other capital market-driven transactions other than derivative transactions. The master netting agreement internal models approach takes into account correlation effects between security positions subject to a master netting agreement as well as the liquidity of the instruments concerned. The internal model used for the master netting agreement internal model approach must provide estimates of the potential change in value of the unsecured exposure amount (£E -£C).

9.91 A firm may also use the internal model used for the master netting agreement internal model approach for margin lending transactions if the transactions are covered under the firm's master netting agreement internal models approach permission and the transactions are covered by a bilateral master netting agreement that meets the requirements set out in the guidance note on financial derivatives, securities financial transactions and long settlement transactions.

9.92 A firm may use the master netting agreement internal models approach independently of the choice it has made between the standardised approach and the IRB approach for the calculation of risk weighted exposure amounts. However, if a firm uses the master netting agreement internal models approach, it must do so for all counterparties and securities, excluding immaterial portfolios where it may use the supervisory volatility adjustments approach or the own estimates volatility adjustments approach as set out in paragraph 9.103.

9.93

9.93.1 A firm must be able to satisfy the FSC that the firm's risk management system for managing the risks arising on the transactions covered by the master netting agreement is conceptually sound and implemented with integrity and that, in particular, the **minimum** qualitative standards in 9.93.2 – 9.93.11 are met.

9.93.2 The internal risk-measurement model used for calculation of potential price volatility for the transactions is closely integrated into the daily risk-management process of the firm and serves as the basis for reporting risk exposures to senior management of the firm.

9.93.3 The firm has a risk control unit that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the firm's risk-management system. It must produce and analyse daily reports on the output of the risk-measurement model and on the appropriate measures to be taken in terms of position limits.

9.93.4 The daily reports produced by the risk-control unit are reviewed by a level of management with sufficient authority to enforce reductions of positions taken and of overall risk exposure.

9.93.5 The firm has sufficient numbers of staff skilled in the use of sophisticated models in the risk control unit.

9.93.6 The firm has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk-measurement system.

9.93.7 The firm's models have a proven track record of reasonable accuracy in measuring risks demonstrated through the back-testing of its output using at least one year of data.

9.93.8 The firm frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets.

9.93.9 The firm must conduct, as part of its regular internal auditing process, an independent review of its risk-measurement system. This review must include both the activities of the business trading units and of the independent risk-control unit.

9.93.10 At least once a year, the firm must conduct a review of its risk management system.

9.93.11 The internal model used for the master netting agreement internal model approach must meet the requirements.

9.94 The FSC will not grant a master netting agreement internal models approach permission if it is not satisfied that the standards in paragraph 9.93 are met.

9.95 The calculation of potential change in value must be subject to the following minimum standards:

9.95.1 at least daily calculation of potential change in value;

9.95.2 a 99th percentile, one-tailed confidence interval;

9.95.3 a 5-day equivalent liquidation period, except in the case of transactions other than securities repurchase transactions or securities lending or borrowing transactions when a 10-day equivalent liquidation period should be used;

9.95.4 an effective historical observation period of at least one year except where a shorter observation period is justified by a significant upsurge in price volatility; and

9.95.5 three-monthly data set updates.

9.96 The internal risk-measurement model must capture a sufficient number of risk factors in order to capture all material price risks.

9.97 A firm may use empirical correlations within risk categories and across risk categories provided that it is able to satisfy the FSC that the firm's system for measuring correlations is sound and implemented with integrity.

9.98 The fully adjusted exposure value (E*) for a firm using the master netting agreement internal models approach must be calculated according to the formula contained in paragraph 20 of part3, Schedule 8, BCACI Regulations:

9.99 In calculating risk weighted exposure amounts using the master netting agreement internal models approach, a firm must use the previous business day's model output.

9.100 No changes should be made to the internal model used for the master netting agreement internal model approach unless the change is not material. Material changes to such a model will require a variation of the master netting agreement internal models approach permission. Materiality is measured against the model as it was at the time that the master netting agreement internal models approach was originally granted or, any later date set out in the FSC's approval for this purpose. If a firm is considering making material changes to such a model then it should notify the FSC at once.

9.101 If a firm ceases to meet the requirements of this guidance note in relation to the master netting agreement internal models approach, the firm should notify the FSC at once.

9.102 The FSC is likely to revoke a master netting agreement internal models approach permission if a firm ceases to meet the requirements of section 9 of this guidance note in relation to the master netting agreement internals models approach.

Calculation of risk weighted exposure amounts under the standardised approach

9.103 A firm must under the standardised approach calculate risk-weighted exposure amounts for repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions covered by master netting agreements under this rule.

9.104 E* as calculated under paragraphs 9.79 to 9.101 must be taken as the exposure value of the exposure to the counterparty arising from the transactions subject to the master netting agreement.

Unfunded credit protection

9.105 The following parties may be recognised as eligible providers of unfunded credit protection:

9.105.1 central governments and central banks;

9.105.2 regional governments or local authorities;

9.105.3 multilateral development banks;

9.105.4 international organisations exposures which receive a 0% risk weight under the standardised approach;

9.105.5 public sector entities, claims on which are treated as claims on institutions or central governments under the standardised approach;

9.105.6 institutions;

9.105.7 other corporate entities, including parent undertakings, subsidiary undertakings and affiliate corporate entities of the firm, that have a credit assessment by an eligible ECAI associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under the standardised approach.

Types of credit derivatives

9.106 The following types of credit derivatives, and instruments that may be composed of such credit derivatives or that are economically effectively similar, may be recognised as eligible;

9.106.1 credit default swaps;

9.106.2 total return swaps; and

9.106.3 credit linked notes to the extent of their cash funding.

9.107 Where a firm buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection must not be recognised.

Internal hedges

9.108 When a firm conducts an internal hedge using a credit derivative, i.e. hedges the credit risk of an exposure in the non-trading book with a credit derivative booked in the trading book - in order for the protection to be recognised for the purposes of this guidance note, no counterparty risk shall be deemed to arise from the position in the credit derivative. Alternatively, an institution may consistently include for the purposes of calculating capital requirements for counterparty credit risk all credit derivatives included in the trading book forming part of internal hedges or purchased as protection against a CCR exposure where the credit protection is recognised under Directive 2006/48/EC.

9.109 Paragraphs 9.107 to 9.15 deal with requirements common to guarantees and credit derivatives. Subject to paragraph 9.11, for the credit protection deriving from a guarantee or credit derivative to be recognised the following conditions must be met:

9.109.1 the credit protection must be direct;

9.109.2 the extent of the credit protection must be clearly defined and incontrovertible;

9.109.3 the credit protection contract must not contain any clause, the fulfilment of which is outside the direct control of the lender, that:

9.109.3.1 would allow the protection provider unilaterally to cancel the protection;

9.109.3.2 would increase the effective cost of protection as a result of deteriorating credit quality of the protected exposure;

9.109.3.3 could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due; or

9.109.3.4 could allow the maturity of the credit protection to be reduced by the protection provider; and

9.109.4 it must be legally effective and enforceable in all jurisdictions relevant at the time of the conclusion of the credit agreement.

9.110 For the purposes of paragraph 9.109.3.1, payment of premiums and other monies due under the contract is within the control of the lending firm. Hence a clause that allows the protection provider unilaterally to cancel the contract after a reasonable period due to non-payment of such monies will not mean that the condition in that rule is not met.

9.111 A firm must be able to satisfy the FSC that it has systems in place to manage potential concentration of risk arising from the firm's use of guarantees or credit derivatives. The firm must be able to demonstrate how its strategy in respect of its use of credit derivatives and guarantees interacts with its management of its overall risk profile.

9.112 Where an exposure is protected by a guarantee which is counter-guaranteed by a central government or central bank, a regional government or local
authority or a public sector entity claims on which are treated as claims on the central government in whose jurisdiction they are established under the standardised approach, a multilateral development bank to which a 0% risk weight is applied under or by virtue of the standardised approach, or a public sector entity claims on which are treated as claims on credit institutions under the standardised approach, the exposure may be treated as protected by a guarantee provided by the entity in question provided the following conditions are satisfied:

9.112.1 the counter-guarantee covers all credit risk elements of the claim;

9.112.2 both the original guarantee and the counter-guarantee meet the requirements for guarantees set out in paragraph 9.108, 9.110 and 9.113, except that the counter-guarantee need not be direct; and

9.112.3 the firm is able to satisfy the FSC that the cover is robust and that nothing in the historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct guarantee by the entity in question.

9.113 The treatment of paragraph 9.112 applies, also, to an exposure counter-guaranteed not by the entities listed there if the exposure's counter-guarantee is in its turn directly guaranteed by one of the listed entities and the conditions listed in paragraph 9.112 are met.

9.114 For a guarantee to be recognised the following conditions must also be met:

9.114.1 on the qualifying default of and/or non-payment by the counterparty, the lending firm must have the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided;

9.114.2 payment by the guarantor must not be subject to the lending firm first having to pursue the obligor;

9.114.3 in the case of unfunded credit protection covering residential mortgage loans, the requirements in paragraph 9.109.3.3 and in this rule have only to be satisfied within an overall period of 24 months;

9.114.4 the guarantee must be an explicitly documented obligation assumed by the guarantor;

9.114.5 subject to this paragraph, the guarantee must cover all types of payments the obligor is expected to make in respect of the claim; and

9.114.6 where certain types of payment are excluded from the guarantee, the recognised value of the guarantee must be adjusted to reflect the limited coverage.

9.115 In the case of guarantees provided in the context of mutual guarantee schemes recognised for these purposes by another EEA competent authority under a CRD implementation measure with respect to paragraph 18 of Part 2 of Annex VIII of the Banking Consolidation Directive or provided by or counter-guaranteed by entities referred to in paragraph 9.112, the requirements in 9.114.1-3 shall be considered to be satisfied where either of the following conditions are met:

9.115.1 the lending firm has the right to obtain in a timely manner a provisional payment by the guarantor calculated to represent a robust estimate of the amount of the economic loss, including losses resulting from the non-payment of interest and other types of payment which the borrower is obliged to make, likely to be incurred by the lending firm proportional to the coverage of the guarantee; and

9.115.2 the lending firm is able to demonstrate to the FSA that the loss-protecting effects of the guarantee, including losses resulting from the non-payment which the borrower is obliged to make, justify such treatment.

9.116 For a credit derivative to be met the following conditions must also be met.

9.116.1 Subject to 9.116.2, the credit events specified under the credit derivative must at a minimum include:

9.116.1.1 the failure to pay the amounts due under the terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with or shorter than the grace period in the underlying obligation);

9.116.1.2 the bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

9.116.1.3 the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. value adjustment or other similar debit to the profit and loss account).

9.116.2 Where the credit events specified under the credit derivative do not include restructuring of the underlying obligation as described in 9.116.1.3, the credit protection may nonetheless be recognised subject to a reduction in the recognised value as specified in paragraph 9.119.

9.116.3 In the case of credit derivatives allowing for cash settlement a robust valuation process must be in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit-event valuations of the underlying obligation.

9.116.4 If the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.

9.116.5 The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.

9.117 A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for the purposes of determining cash settlement value or the deliverable obligation) or between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible only if the following conditions are met:

9.117.1 the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be ranks pari passu with or is junior to the underlying obligation; and

9.117.2 the underlying obligation and the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be, share the same obligor (i.e., the same legal entity) and there are in place legally enforceable cross-default or cross-acceleration clauses.

Unfunded credit protection: Valuation

9.118 Paragraphs 9.119 to 9.121 set out the provisions applying to the valuation of unfunded credit protection.

9.119

9.119.1 The value of unfunded credit protection (G) is the amount that the protection provider has undertaken to pay in the event of the default or non-payment of the borrower or on the occurrence of other specified credit events.

9.119.2 In the case of credit derivatives which do not include as a credit event restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that result in a credit loss event (e.g. value adjustment, the making of a value adjustment or other similar debit to the profit and loss account):

9.119.3 where the amount that the protection provider has undertaken to pay is not higher than the exposure value, the value of the credit protection calculated under 9.119.1 must be reduced by 40%; or

9.119.4 where the amount that the protection provider has undertaken to pay is higher than the exposure value, the value of the credit protection must be no higher than 60% of the exposure value.

9.120 Where unfunded credit protection is denominated in a currency different from that in which the exposure is denominated (a currency mismatch) the value of the credit protection must be reduced by the application of a volatility adjustment H_{FX} as per the formula set out in paragraph 84, part 3, Schedule 8, BCACI Regulations.

9.121 The volatility adjustments to be applied for any currency mismatch may be calculated based on the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach as set out in paragraphs 9.29 to 9.63.

Calculating risk weighted exposure amounts

9.122 Where a firm transfers a portion of the risk of a loan in one or more tranches. Materiality thresholds on payments below which no payment shall be made in the event of loss are considered to be equivalent to retained first loss positions and to give rise to a tranched transfer of risk.

9.123 Paragraphs 9.124 to 9.126 set out the provisions applying to the calculation of risk weighted exposure amounts under the standardised approach in the case of unfunded credit protection.

9.124 For the purposes of the standardised approach to credit risk the risk weight to be assigned to an exposure which is fully protected by unfunded credit protection (GA), where:

9.124.1

g is the risk weight of exposures to the protection provider as specified under the standardised approach; and

9.124.2

E is the exposure value according to the Standardised Approach; for this purpose, the exposure value of an off-balance sheet item listed in Annex II shall be 100 % of its value rather than the exposure value indicated in the Standardised Approach

9.124.3

g is the risk weight of exposures to the protection provider as specified under regulations 28-33 of the FSCACI Regulations and

9.124.2

GA is the value of G* as calculated under paragraph 84 of Part 3 of Schedule 8 of the FSCACI Regulations further adjusted for any maturity mismatch as laid down in Part 4 of the FSCACI Regulations.

9.125 Where the protected amount is less than the exposure value and the protected and unprotected portions are of equal seniority – ie the firm and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief is afforded. For the purposes of this guidance note risk weighted exposure amounts must be calculated in accordance with the formula set out in paragraph 88 of part 3, Schedule 8, BCACI Regulations:

9.126 A firm may apply the treatment provided to exposures or portions of exposures guaranteed by the central government or central bank, where the guarantee is denominated in the domestic currency of the borrower and the exposure is funded in that currency.

9.127 Paragraphs 9.128 to 9.129 set out the provisions applying to the calculation of risk weighted exposure amounts and expected loss amounts where basket credit risk mitigation techniques are used.

First-to-default credit derivatives

9.128 Where a firm obtains credit protection for a number of exposures under terms that the first default among the exposures will trigger payment and that this credit event will terminate the contract, the firm may modify the calculation of the risk weighted exposure amount and, as relevant, the expected loss amount of the exposure which would in the absence of the credit protection produce the lowest risk weighted exposure amount under the standardised approach or the IRB approach as appropriate in accordance with this guidance note and the guidance not on the IRB approach to credit risk, but only if the exposure value is less than or equal to the value of the credit protection.

Nth-to-default credit derivatives

9.129 In the case where the nth default among the exposures triggers payment under the credit protection provided by a credit derivative, a firm purchasing the protection may only recognise the protection for the calculation of risk weighted exposure amounts and, as relevant, expected loss amounts if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases the methodology must follow that set out in paragraph 9.128 for first-to-default derivatives appropriately modified for nth-to-default products.

Maturity mismatches

9.130 For the purposes of calculating risk weighted exposure amounts, a maturity mismatch occurs when the residual maturity of the credit protection is less than that of the protected exposure. Protection of less than three months residual maturity, the maturity of which is less than the maturity of the underlying exposure, must not be recognised.

9.131 Where there is a maturity mismatch the credit protection must not be recognised where the original maturity of the protection is less than 1 year.

Definition of maturity

9.132 Subject to a maximum of 5 years, the effective maturity of the underlying is the longest possible remaining time before the obligor is scheduled to fulfil its obligations. Subject to paragraph 9.133, the maturity of the credit protection is the time to the earliest date at which the protection may terminate or be terminated.

9.133 Where there is an option to terminate the protection which is at the discretion of the protection seller, the maturity of the protection must be taken to be the time to the earliest date at which that option may be exercised. Where there is an option to terminate the protection which is at the discretion of the protection buyer and the terms of the arrangement at origination of the protection contain a positive incentive for the firm to call the transaction before contractual maturity, the maturity of the protection must be taken to be the time to the earliest date at which that option may be exercised; otherwise such an option may be considered not to affect the maturity of the protection.

9.134 Where a credit derivative is not prevented from terminating prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay the maturity of the protection must be reduced by the amount of the grace period.

Valuation of protection:

9.135 Paragraph 9.136 sets out the calculation for the valuation of transactions subject to funded credit protection under the financial collateral simple method.

9.136 Where there is a mismatch between the maturity of the exposure and the maturity of the protection, the collateral must not be recognised.

9.137 The calculation for the valuation of transactions subject to funded credit protection under the financial collateral comprehensive method is set out in this paragraph. The maturity of the credit protection and that of the exposure must be reflected in the adjusted value of the collateral according to the formula set out in paragraph 8, Part 4, Schedule 8 BCACI Regulations.

9.138 Paragraph 8, part 4, schedule 8, BCACI regulations sets out the calculation for the valuation of transactions subject to unfunded credit protection.

Combinations of credit risk mitigation in the standardised approach

9.139 In the case where a firm calculating risk-weighted exposure amounts under the standardised approach has more than one form of credit risk mitigation covering a single exposure (e.g. a firm has both collateral and a guarantee partially covering an exposure), the firm must subdivide the exposure into portions covered by each type of credit risk mitigation tool (e.g. a portion covered by collateral and a portion covered by guarantee) and the risk-weighted exposure amount for each portion must be calculated separately in accordance with the provisions of the standardised approach and this guidance note.

9.140 When credit protection provided by a single protection provider has differing maturities, a similar approach to that described in 9.139 must be applied.

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