Subsidiary Legislation made under s. 79.

FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

Repealed by LN. 2013/198 as from 1.1.2014

(LN. 2007/001)

1.1.2007
Except for r. 37(14) and 55 - 1.1. 2008*

Amending enactments	Relevant current provisions	Commencement date
LN. 2007/076	*Corrigendum*	
2011/048	rr. 2, 7(1)(a), (ca) & (2), 12A, 12B, 14(2)(aa), 15(1), (1A), (2)(a), (3) & (6), 16A, 22(3), 31(2), 37(16), (17), (17)(b)(i) & (ii), (17A), (17B), (21), 56(1), 57(4)(a), (c) & (d), (5) & (6), 62(6), 63(1)-(4), 64(1), (2)-(4) & (8), 65(2) & (4), 66(2) (2)(e), (f) & (i), (j)-(t), (3)-(9), 67(2), (4) (7), (12), (13)(b) & 14, 68(1)-(7), 69, 70(1), (1A), (1B) & (2), 71(a), (b) & (e), 72(1), 78A, 80(2A), 81(2)(b) & (c), (2A), (9A)-(9J), 82(2), 82A, 82B, 87(2A), Schs. 1, 3, 5, 6, 7, 8, 9, 10, 11 & 12	12.4.2011
2012/168	rr. 2, 12A(6), 22(3), 63(3) & 64(4A)	22.11.2012
2012/180	rr. 2, 7(1)(r) & (4), 15(2), (3) & (4), 23(b) & (c), 51(1), 64(7), 66(3)(c), 83(2)(e), (f), (g) & (3A), 87(3), (3A) & (3B), Schs. 1, 5, 6, 7, 9 & 12	22.11.2012
2013/082	rr. 2, 17(3), 19(2), (3), 20(3), (4), (6), (7), (8), 21(3), 30(10)(a), 34(3), (7), 39(e), 55(3), (4), 78A(5), (6), 80(6), 81(3), (9A), (9C), (9G), (9E), (9EA), (9EB), (9EC), (9I), (10)(i)(a), (b), 82(4), 82B(1)(a), (2), 83(4), 87(6) &	

* *See r.1(2)*

Transposing:

Directive 98/26/EC
Directive 98/78/EC
Directive 2000/12/EC
Directive 2006/48/EC
Directive 2002/83/EC
Directive 2002/87/EC
Directive 2003/6/EC
Directive 2003/41/EC
Directive 2003/71/EC
Directive 2004/39/EC
Directive 2004/109/EC
Directive 2005/60/EC
Directive 2006/49/EC
Directive 2009/65/EC
Directive 2006/48/EC
Directive 2006/49/EC
Directive 2009/83/EC
Directive 2009/111/EC
Directive 2009/138/EC
Directive 2010/76/EU
Directive 2010/78/EU
Directive 2011/89/EU

EU Legislation/International Agreements involved:

Directive 86/635/EEC
Directive 73/239/EEC
Directive 78/660/EEC
Directive 83/349/EEC
Directive 93/6/EEC
Regulation (EC) No 1606/2002
Regulation (EU) No 1093/2010

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

In exercise of the powers conferred on him by section 79 of the Financial Services (Banking) Act 1992 and all other enabling powers, the Minister with responsibility for financial services has made the following regulations to transpose into the law of Gibraltar Council Directive 2006/48/EC, of the European Parliament and of the Council, of 14 June 2006 which recasts the Banking Consolidation Directive 2000/12/EC in order to establish a new way of calculating capital requirements for credit institutions.

PART I
Preliminary

Title and commencement.

1.(1) These Regulations may be cited as the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 and, subject to sub-regulation (2), shall be deemed to have come into operation on 1 January 2007.

(2) Regulations 37(14) and 55 shall come into operation on 1 January 2008.

Interpretation and applicability.

2.(1) In these Regulations, unless the context otherwise requires−

"ancillary services undertaking" means an undertaking whose principal activity consists in owning or managing property, managing data processing services or any other activity of one or more credit institutions;

"approved external credit assessment institutions ' has the meaning assigned to it in regulation 31;

"asset management company" means a management company of an undertaking for collective investment in transferable securities and an undertaking whose registered office is not in an EEA State;

"Capital Adequacy Directive" means the Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions as amended from time to time;

"conversion factor" means the ratio of the currently undrawn amount of a commitment that will be drawn and outstanding at default to the currently undrawn amount of the commitment, the extent of the commitment shall be determined by the advised limit, unless the unadvised limit is higher;

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"credit risk mitigation" means a technique used by a credit institution to reduce the credit risk associated with an exposure or exposures which the credit institution continues to hold;

"dilution risk" means risk that an amount receivable is reduced through cash or non-cash credits to the obligor;

"Directive 2002/87/EC" means Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, as the same may be amended from time to time;

"discretionary pension benefits" means enhanced pension benefits granted on a discretionary basis by a credit institution to an employee as part of that employee's variable remuneration package, which do not include accrued benefits granted to an employee under the terms of the company pension scheme;

"EBA" means the European Banking Authority established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC;

"European consolidating supervisor" means the competent authority in an EEA State responsible for the exercise of supervision on a consolidated basis of European parent credit institutions and credit institutions controlled by European parent financial holding companies or European parent mixed financial holding companies;

"European parent credit institution" means a parent credit institution in an EEA State which is not a subsidiary of another credit institution authorised in any EEA State or of a financial holding company or mixed financial holding company set up in any EEA State;

"European parent financial holding company" means a parent financial holding company in an EEA State which is not a subsidiary of a credit institution authorised in any EEA State or of another financial holding company or mixed financial holding company set up in any EEA State;

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"European parent investment firm" means an investment firm which has an investment firm or credit institution or financial institution as a subsidiary or which holds a participation in such entities, and which is not itself a subsidiary of an investment firm or credit institution authorised in the same EEA State, or of a financial holding company set up in the same EEA State;

"European parent mixed financial holding company" means a parent mixed financial holding company in an EEA State which is not a subsidiary of a credit institution authorised in any EEA State or of another financial holding company or mixed financial holding company established in an EEA State;

"expected loss" means the ratio of the amount expected to be lost on an exposure from a potential default of a counter party or dilution over a one year period to the amount outstanding at default;

"financial holding company" means a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution;

"financial instrument" includes both primary financial instruments or cash instruments, and derivative financial instruments the value of which is derived from the price of an underlying financial instrument or a rate or an index or the price of an underlying other item;

"FSCAIF Regulations" means the Financial Services (Capital Adequacy of Investment Firms) Regulations transposing Directive 2006/49/EC;

"funded credit protection" means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the right of the credit institution in the event of the default of the counter party or on the occurrence of other specified credit events relating to the counter party to liquidate, or to obtain transfer or appropriation of, or to retain certain assets or amounts, or to reduce the amount of the exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the credit institution;

"group of connected clients" means–

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(a) two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others: or

(b) two or more natural or legal persons between whom there is no relationship of control as set out in paragraph (a) 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, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties;

"institution" means a credit institution or an investment firm;

"loss" economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument;

"loss given default" means the ratio of the loss on an exposure due to the default of a counter party to the amount outstanding at default;

"mixed financial holding company" means a mixed financial holding company as defined in Article 2(15) of Directive 2002/87/EC;

"operational risk" means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk;

"original own funds" means the aggregate of the amounts in regulation 7(1)(a) to (ca) less the aggregate of the amounts in regulation 7(1)(h) to (j);

"own funds" has the meaning assigned to it by regulations 7 to 15;

"parent credit institution in an EEA State" means a credit institution which has a credit or financial institution as a subsidiary or which holds a participation in such institution and which is not itself a subsidiary of another credit institution authorised in the same EEA State, or of a financial holding company or mixed financial holding company set up in the same EEA State;

"parent financial holding company in an EEA State" means a financial holding company which is not itself a subsidiary of a credit institution authorised in the same EEA State or of a financial holding company or mixed financial holding company set up in the same EEA State;

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"parent mixed financial holding company in an EEA State" means a mixed financial holding company which is not itself a subsidiary of a credit institution authorised in the same EEA State, or of a financial holding company or mixed financial holding company set up in the same EEA State;

"probability of default" means the probability of default of a counter party over a one year period;

"recast Directive" means Directive 2006/48 of 14 June 2006 (as extended, where applicable, by the EEA Agreement);

"re-securitisation" means a securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation position;

"re-securitisation position" means an exposure to a securitisation;

"securitisation" means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme,

"unfunded credit protection" means technique of credit risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the undertaking of a third party to pay an amount in the event of the default of the borrower or on the occurrence of other specified credit events.

(2) Expressions, other than those in sub-regulation (1), used in these Regulations which are also used in the recast Directive shall have the same meaning for the purposes of these Regulations as they have for the purposes of the recast Directive.

(3) These Regulations shall apply subject to the transitional provisions set out in Schedule 1.

PART II
Trading book

Trading book.

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3.(1) The trading book of a credit institution shall consist of all positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book and which shall either be free of any restrictive covenants on their tradability or able to be hedged.

(2) For the purposes of sub-regulation (1)–

(a) positions held with trading intent shall be those held intentionally for short-term resale or with the intention of benefiting from actual or expected short-term price differences between the buying and selling prices or from other price or interest rate variations;

(b) "positions" shall include proprietary positions, positions arising from client servicing and market making.

(3) Trading intent shall be evidenced based on the strategies, policies and procedures set up by the investment firm to manage the position or portfolio in accordance with Part A of Schedule 7 of the FSCAIF Regulations.

(4) A credit institution shall establish and maintain systems and controls to manage its trading book in accordance with the provisions of Parts B and D of Schedule 7 of the FSCAIF Regulations.

(5) Internal hedges may be included in the trading book of a credit institution on condition that it shall comply with the provisions of Part C of Schedule 7 of the FSCAIF Regulations.

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PART III
Own funds

Assessment of own funds.

4.(1) A credit institution shall comply with all the requirements regarding own funds in this Part in a manner that is to the satisfaction of the Commissioner.

(2) A credit institution which is required to meet its capital requirement calculated in accordance with regulations 60 to 62, 71 and 72 below and Schedules 1 and 3 to 6 of the FSCAIF Regulations, may apply to the Commissioner for authority to use, for that purpose only, an alternative determination of own funds:

Provided that no part of the own funds used for that purpose shall be used simultaneously to meet other capital requirements.

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(3) Any alternative determination authorised under sub-regulation (2) shall be the aggregate of the amounts in paragraphs (a) to (c) less, if the Commissioner requires it, the amount in paragraph (d) below–

(a) own funds excluding those mentioned in regulation 7(k) to (p) for a credit institution which is required to deduct paragraph (d) from the total of this paragraph and paragraphs (b) and (c);

(b) net trading-book profits net of any foreseeable charges or dividends, less net losses on other business provided that none of those amounts has already been included in paragraph (a) as one of the items in regulation 7(b) or (j);

(c) subordinated loan capital or the items referred to in sub-regulation (7), subject to the conditions set out in sub-regulations (4) and (5) and in regulation 5;

(d) illiquid assets as specified in regulation 6.

(4) The subordinated loan capital referred to in sub-regulation (3)(c) shall–

(a) have an initial maturity of at least two years;

(b) be fully paid up and the loan agreement shall not include any clause providing that in specified circumstances (other than the winding-up of the credit institution) the debt will become repayable before the agreed repayment date, unless the Commissioner approves the repayment;

(c) be such that neither its principal nor the interest on it may be repaid if such repayment would mean that the own funds of the credit institution would then amount to less than 100% of that credit institution's overall requirements.

(5) The subordinated loan capital referred to in sub-regulation (3)(c) shall not exceed a maximum of 150% of the original own funds left to meet the requirements calculated in accordance with regulations 60 to 62, 71 and 72 below and Schedules 1 to 6 of the FSCAIF Regulations and shall approach that maximum in such circumstances as are acceptable to the Commissioner.

(6) The Commissioner may authorise a credit institution to replace the subordinated loan capital referred to in sub-regulation (3)(c) with that referred to in regulation 7(d) to (g).

(7) A credit institution shall report to the Commissioner all repayments on a subordinated loan capital as soon as its own funds fall below 120% of its overall capital requirements.

Subordinated loan capital.

5.(1) The Commissioner may authorise the ceiling for subordinated loan capital set out in regulation 4(5) to be exceeded by a credit institution, if it considers it prudentially adequate to do so.

(2) The Commissioner shall not grant approval under sub-regulation (1) if the total of the subordinated loan capital and that referred to in regulation 7(d) to (g) exceed 250 % of the original own funds left to meet the requirements calculated in accordance with regulations 60 to 62, 71 and 72 below and Schedules 1 and 3 to 6 of the FSCAIF Regulations.

Illiquid assets.

6.(1) Illiquid assets referred to in regulation 4(3)(d) shall include–

(a) tangible fixed assets, except to the extent that land and buildings may be allowed to count against the loans which they are securing;

(b) holdings in and subordinated claims on credit or financial institutions which may be included in the own funds of those institutions provided that they have not been deducted under regulation 7(h) to (l) or under sub-regulation (d) below;

(c) holdings and other investments in undertakings other than credit or financial institutions which are not readily marketable;

(d) deficiencies in subsidiaries;

(e) deposits made which are not available for repayment within 90 days and which do not include payments in connection with margined futures or options contracts;

(f) loans and other amounts due which are not due for repayment within 90 days;

(g) physical stocks which are not subject to capital requirements at least as stringent as those set out in regulation 26.

(2) A credit institution may apply to the Commissioner for him to waive the application of sub-regulation (1)(b) for the purposes of this regulation–

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(a) where shares in a credit or financial institution are held temporarily for the purpose of a financial assistance operation designed to reorganise and save that institution; or

(b) in respect of those shares which are included in a credit institution's trading book.

Composition of own funds.

7.(1) Subject to the limits in regulation 15, the amount of unconsolidated own funds of a credit institution shall consist of the total of the amounts represented by–

(a) the capital, which for the purposes of this regulation shall be taken to include all amounts, regardless of their actual designation, which, in accordance with a credit institution's legal structure, are regarded as equity capital subscribed by shareholders or other proprietors in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims;

(b) all types of reserves shown separately in a credit institution's balance sheet and profit and losses brought forward as a result of the application of the final profit or loss;

(c) the funds which the credit institution decides to put aside to cover particular risks associated with banking where that is required by the particular risks;

(ca) instruments other than those specified in paragraph (a) which meet the requirements of regulation 12(2)(a), (c), (d) and (e) and which comply with the requirements of regulation 12A;

(d) the revaluation reserves specified in article 33 of Directive 78/660/EEC;

(e) the value adjustments specified in article 37(2) of Directive 86/635/EEC;

(f) the instruments specified in regulation 12; and

(g) the fixed-term cumulative preferential shares and subordinated loan capital specified in regulation 13(1);

less the total of the amounts represented by–

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(h) the own shares at book value;

(i) the intangible assets specified in article 4(9) of Directive 86/635/EEC;

(j) the material losses of the current financial year;

(k) the holdings in other credit and financial institutions amounting to more than 10% of their capital;

(l) the instruments and the subordinated claims specified in regulations 12 and 13(1) which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10% of the capital in each case;

(m) the holdings in other credit and financial institutions amounting to no more than 10% of their capital;

(n) the instruments and the subordinated claims specified in regulations 12 and 13(1) which a credit institution holds in respect of credit and financial institutions other than those in paragraphs (k) and (l) in respect of the amount of the total of such holdings, instruments and subordinated claims which exceed 10% of that credit institution's own funds calculated before the deduction of items in paragraphs (k) to (p);

(o) the participations within the meaning assigned to it in regulation 2 which a credit institution holds in general business and life insurance companies, reinsurance companies and insurance holding companies to which the Insurance Companies Act applies;

(p) the following instruments in respect of the entities defined in paragraph (o) in which the credit institution holds a participation–

(i) instruments referred to in article 16(3) of Directive 73/239/EEC;

(ii) instruments referred to in article 27(3) of Directive 2002/83/EC;

(q) for a credit institution calculating risk-weighted exposure amounts under regulations 34 to 39, the negative amounts resulting from the calculation in paragraph 36 of Part I of Schedule 7 and the expected loss amounts calculated in accordance with paragraphs 32 and 33 of that Part;

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(r) the exposure amount of securitisation positions which receive a risk weight of 1250% under these Regulations and the exposure amount of securitisation positions in the trading book that would receive a 1250 % risk weight if they were in the same credit institutions non-trading book;

(s) any further reductions agreed to by the Commissioner.

(2) For the purposes of sub-regulation (1)(b), interim or end of financial year profits which have been verified by a credit institution's auditors shall be included if it is proved to the satisfaction of the Commissioner that the amount has been evaluated in accordance with Directive 86/635/EEC and is net of any foreseeable charge or dividend.

(3) A credit institution which is the originator of a securitisation shall not include in sub-regulation (1)(b) net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisation.

(4) Every credit institution shall–

(a) apply the requirements of Part B of Schedule 7 to the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 to all their assets measured at fair value when calculating the amount of own funds; and

(b) deduct from the total of the items (a) to (ca) minus (i) to (k) in regulation 7(1) the amount of any additional value adjustments necessary.

Waiving of deductions from own funds.

8. A credit institution which holds shares temporarily, in a credit or financial institution, insurance or reinsurance undertaking or insurance holding company, for the purposes of a financial assistance operation designed to reorganise and save that institution, undertaking or company, may apply to the Commissioner for authorisation to waive the deductions in regulation 7(1)(k) to (p).

Alternative to deductions from own funds.

9.(1) A credit institution may opt to apply mutatis mutandis methods 1, 2, or 3 of Annex I to Directive 2002/87/EC as an alternative to the deduction of the items specified in regulation 7(1)(o) and (p).

(2) A credit institution may apply method 1 (accounting consolidation) if it is able to satisfy the Commissioner of the adequacy of its level of

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integrated management and its internal control regarding the entities to be included in the scope of consolidation.

Option not to deduct from own funds.

10. A credit institution which calculates its own funds on a stand-alone basis which is subject to–

(a) supervision on a consolidated basis, in accordance with regulations 80 to 83; or

(b) to supplementary supervision in accordance with Directive 2002/87/EC;

need not deduct the items specified in regulation 7(1)(k) to (p) which are held in credit or financial institutions, insurance or reinsurance undertakings or insurance holding companies, which are included in a consolidated or supplementary supervision, as the case may be.

Capital and reserves to cover risks and losses.

11.(1) A credit institution shall, at all times, have available to it the capital and reserves specified in regulation 7(1)(a) to (e) for unrestricted use to cover risks or losses as soon as these occur.

(2) The amount under sub-regulation (1) shall be net of any foreseeable liability to tax at the moment of its calculation or be suitably adjusted in so far as such tax reduces the amount up to which the capital and reserves referred to in that sub-regulation, may be applied to cover such risks or losses.

Inclusion of certain securities etc. as own funds.

12.(1) A credit institution may include other securities and instruments as own funds whatever their legal or accounting designations might be, if–

(a) they are freely available to the credit institution to cover normal banking risks where it has not yet identified its revenue or capital losses;

(b) their existence is disclosed in internal accounting records; and

(c) their amount has been determined by the credit institution, verified by its auditors and that amount is reported to the Commissioner for his supervision.

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(2) A credit institution may include securities of indeterminate duration and other instruments as own funds if they satisfy the following conditions–

(a) they shall not be reimbursed on the bearer's initiative or without the prior approval of the Commissioner;

(b) the debt agreement shall provide for the credit institution to have the option of deferring the payment of interest on the debt;

(c) the lender's claims on the credit institution shall be wholly subordinated to those of all non-subordinated creditors;

(d) the documents governing the issue of the securities shall provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading; and

(e) only fully paid-up amounts shall be taken into account.

(3) Cumulative preferential shares other than those referred to in regulation 7(1)(g) may be added to the securities and other instruments referred to in sub-regulation (2).

(4) A credit institution which calculates risk-weighted exposure amounts under regulations 34 to 39, may have positive amounts resulting from the calculation in paragraph 36 of Part I of Schedule 7, accepted as other items, up to 0.6% of risk weighted exposure amounts calculated under those regulations.

(5) A credit institution to which sub-regulation (4) applies shall not have included in its own funds–

(a) value adjustments and provisions included in the calculation in paragraph 36 of Part I of Schedule 7 and value adjustments; and

(b) provisions for exposures in regulation 7(1)(e);

other than in accordance with that sub-regulation.

(6) For the purposes of sub-regulations (4) and (5), risk-weighted exposure amounts shall not include those calculated in respect of securitisation positions which have a risk weight of 1250%.

Inclusion of certain instruments as own funds.

12A.(1) Where a credit institution includes the instruments which are specified in regulation 7(1)(ca) as own funds, those instruments shall comply with the following requirements−

(a) the instruments shall be undated or have an original maturity of at least 30 years;

(b) the instruments may include one or more call options at the sole discretion of the issuer, but they shall not be redeemed before five years after the date of issue;

(c) if undated instruments provide for a moderate incentive for the credit institution to redeem them in such manner as is determined by the Commissioner, such incentive shall not occur within 10 years of the date of issue;

(e) dated instruments shall not permit an incentive to redeem on a date other than the maturity date.

(2) Dated and undated instruments shall be called or redeemed by a credit institution only with the prior consent of the Commissioner, if neither the financial state nor the solvency of the credit institution will be unduly affected.

(3) The Commissioner may require a credit institution to replace any instrument it has included as own funds by other instruments specified in regulation 7(1)(a) or (ca) which are of the same or better quality.

(4) The Commissioner shall require a credit institution to suspend the redemption of dated instruments−

(a) if the credit institution does not comply with the capital requirements in regulation 23; or

(b) where the Commissioner considers that such redemption may unduly affect the financial state and solvency of the credit institution.

(5) The Commissioner may authorise an early redemption of dated or undated instruments where there is a change in the applicable tax treatment or regulatory classification of such instruments which was unforeseen at the date of issue.

(6) The Commissioner shall ensure that instruments to which this regulation applies provide for principal, unpaid interest or dividend to be such as will absorb losses and not hinder the recapitalisation of the credit institution concerned, through appropriate mechanisms as developed by the EBA.

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Provisions governing instruments as own funds.

12B(1) The provisions governing the instrument specified in regulation 12A must–

(a) allow a credit institution to cancel the payment of interest or dividends for an unlimited period of time, on a non-cumulative basis, but the credit institution shall cancel such payments if it does not comply with the capital requirements in regulation 23;

(b) provide for principal, unpaid interest or dividend to absorb losses and must not hinder the re-capitalisation of the credit institution.

(2) The Commissioner may require a credit institution to cancel payment of interest or dividend if he considers that the financial state and solvency of the credit institution will be unduly affected by such payments.

(3) Any cancellation of the payment of interest or dividends under sub-regulation (2) shall not prejudice the right of the credit institution to substitute such payment by a payment in the form of an instrument specified in regulation 7(1)(a), provided the credit institution is allowed to preserve its financial resources and that the substitution is carried out in compliance with any conditions that the Commissioner may see fit to impose.

(4) In the event of the bankruptcy or liquidation of a credit institution, the instruments shall rank after the items specified in regulation 12(2).

Inclusion of certain shares etc. as own funds.

13.(1) A credit institution's own funds may include fixed-term cumulative preferential shares and subordinated loan capital referred to in regulation 7(1)(g) if binding agreements exist under which, in the event of its bankruptcy or liquidation, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

(2) Subordinated loan capital referred to in sub-regulation (1) shall meet the following criteria to rank as a credit institution's own funds–

(a) only fully paid-up funds shall be taken into account;

(b) the loans involved shall have an original maturity of at least five years, after which they may be repaid;

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(c) the extent to which it may rank as own funds shall be gradually reduced during at least the last five years before the repayment date; and

(d) the loan agreement shall not include any provision which in specified circumstances, other than the winding-up of the credit institution, the debt becomes repayable before the agreed repayment date.

(3) For the purposes of sub-regulation (2)(b), if the maturity of the debt is not fixed, the loans shall be repayable only subject to five years' notice unless it is no longer considered as own funds or unless the prior approval of the Commissioner is required for early repayment.

(4) The Commissioner shall not approve the early repayment of a loan under sub-regulation (3) unless the application is submitted at the initiative of the issuer and he is satisfied that the solvency of the credit institution would not thereby be affected.

(5) A credit institution shall not include in its own funds–

(a) the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost; or

(b) any gains or losses on its liabilities valued at fair value that are due to changes in its own credit standing.

Calculation of own funds.

14.(1) A credit institution which calculates on a consolidated basis, shall use the consolidated amounts relating to the items specified in regulation 7 in accordance with regulations 80 to 83.

(2) The following items may, when they are credit ("negative") items, be regarded as consolidated reserves for the calculation of a credit institution's own funds–

(a) any minority interests within the meaning of article 21 of Directive 83/349/EEC, where the global integration method is used;

(aa) any instrument specified in regulation 7(1)(ca) which gives rise to minority interests and which meets the requirements of regulations 12(2), 12A and 15;

(b) the first consolidation difference within the meaning of articles 19, 30 and 31 of that Directive;

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(c) the translation differences arising on consolidation out of the retranslation of the credit institution's capital and reserves or the share of a participating interest's capital and reserves to be included, in whole or in part, in consolidated reserves, together with the translation differences arising on the translation of any transactions undertaken to cover that capital and those reserves;

(d) any difference resulting from the inclusion of certain participating interests in accordance with article 33 of Directive 83/349/EEC.

(3) Where the items in sub-regulation (2) are debit ("positive") items, a credit institution shall deduct them in its calculation of the consolidated own funds.

Limits on own funds.

15.(1) The items in regulation 7(1)(d) to (g) shall be subject to the following limits–

(a) the total of those items shall not exceed a maximum of 100% of the total of the items in sub-regulation (1)(a) to (ca) of regulation 7 less the total of the items in sub-regulation (1)(h) to (j) of regulation 7; and

(b) the total of the item in regulation 7(1)(g) shall not exceed a maximum of 50% of the total of the items in sub-regulation (1)(a) to (ca) of regulation 7 less the total of the items in sub-regulation (1)(h) to (j) of regulation 7.

(1A) Notwithstanding sub-regulation (1), the total of the items in regulation 7(1)(ca) shall be subject to the following limits−

(a) instruments which have to be converted into items specified in regulation 7(1)(a) within a pre-determined range−

(i) during emergency situations; and

(ii) which may be converted on the Commissioner's instructions based on the financial state and solvency of the issuer;

shall not exceed a maximum of 50% of the total of the items in regulation 7(1)(a) to (ca) less the total of the items in regulation 7(1)(h) to (j);

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(b) within the limit in paragraph (a), all other instruments shall not exceed a maximum of 35% of the total of the items in regulation 7(1)(a) to (ca) less the total of the items in regulation 7(1)(h) to (j);

(c) within the limits in paragraphs (a) and (b), dated instruments and instruments which provide for an incentive for a credit institution to redeem shall not exceed a maximum of 15% of the total of the items in regulation 7(1)(a) to (ca) less the total of the items in regulation 7(1)(h) to (j);

(d) the total of the items exceeding the limits set out in paragraphs (a) to (c) shall be subject to the limit specified in sub-regulation (1).

(2) The total of the items in regulation 7(1)(h) to (r) shall be deducted–

(a) 50% from the total of the items in regulation 7(1)(a) to (ca) less the total of the items in regulation 7(1)(h) to (j); and

(b) 50% from the total of the items in regulation 7(1)(d) to (g),

after application of the limits in sub-regulation (1).

(3) If 50% of the total of the items in regulation 7(1)(h) to (r) exceeds the total of the items in regulation 7(1)(d) to (g), the excess shall be deducted from the total of the items in regulation 7(1)(a) to (ca) less those in regulation 7(1)(h) to (j).

(4) The total of the items in regulation 7(1)(r) shall not be deducted if it has been included in the calculation of risk-weighted exposure amounts for the purposes of regulation 23 as specified in these Regulations or in Schedule 1 or 5 to the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007.

(5) For the purposes of regulations 56 to 59, 63 to 70 and 75 to 78, the provisions laid down in this Part shall be read without taking into account the items in regulations 7(1)(q) and (r) and 12(4) to (6).

(6) A credit institution may apply to the Commissioner for authority to exceed the limits laid down in sub-regulation (1) and (1A) and he shall only do so if he is satisfied that the excess in the limit is a temporary measure and that it is necessary to exceed the limit in an emergency situation facing the credit institution.

PART IV

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Application to credit institutions.

16.(1) A credit institutions shall comply with the obligations laid down in regulation 23 and 56 to 59, 63 to 70 and 75 on an individual basis.

(2) A credit institution which is not–

(a) a subsidiary;

(b) a parent undertaking; nor

(c) included in the consolidation pursuant to regulation 21;

shall comply with the obligations laid down in regulations 76 and 79 on an individual basis.

(3) A credit institution which is not–

(a) a parent undertaking;

(b) a subsidiary, nor

(c) included in the consolidation pursuant to regulation 21;

shall comply with the obligations laid down in regulations 87 to 90 on an individual basis.

Application to affiliated credit institution.

16A.(1) Any credit institution to which section 35B(1) of the Act applies, may be exempted by the Commissioner from all or any of the requirements of Parts IV to IX if, and without prejudice to the application of those provisions to the central body, the central body and all its affiliated credit institutions, are subject to those provisions on a consolidated basis.

(2) Where any exemption is granted by the Commissioner under this section, Part IX shall apply to the whole as constituted by the central body and its affiliated credit institutions.

Application to subsidiaries.

17.(1) Subject to sub-regulation (3), regulation 16(1) shall not apply to a subsidiary of a credit institution, where both the subsidiary and the credit institution are licensed in Gibraltar and the subsidiary is included in the

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supervision on a consolidated basis of the credit institution which is the parent undertaking.

(2) In order to benefit from the concession in sub-regulation (1) and to ensure that own funds are distributed adequately among the parent undertaking and the subsidiaries, all of the following conditions shall be satisfied–

(a) there shall be no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by the parent undertaking;

(b) the parent undertaking shall satisfy the Commissioner regarding the adequacy of the prudent management of the subsidiary and that it has guaranteed the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest;

(c) the risk evaluation, measurement and control procedures of the parent undertaking shall cover the subsidiary; and

(d) the parent undertaking holds more than 50% of the voting rights attaching to shares in the capital of the subsidiary or has the right to appoint or remove a majority of the members of the management body of the subsidiary.

(3) Sub-regulation (1) shall apply where the parent undertaking is a financial holding company or a mixed financial holding company set up in the same EEA State as the credit institution and that it is subject to the same supervision as that exercised over credit institutions to the standards in regulation 19(1).

(4) Regulation 16(1) shall not apply to a parent credit institution which is included in supervision on a consolidated basis, and in order to ensure that own funds are distributed adequately among the parent undertaking and the subsidiaries the following conditions shall be met-

(a) there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities to the parent credit institution; and

(b) the risk evaluation, measurement and control procedures relevant for consolidated supervision cover the parent credit institution.

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(5) Where sub-regulation (4) is used by a parent credit institution, the Commissioner shall so inform the competent authorities of all other relevant EEA States.

(6) Where sub-regulation (4) is used by a parent credit institution and without prejudice to the generality of regulation 86, the Commissioner shall make public in accordance with that regulation–

(a) criteria he applies to determine that there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities;

(b) the number of parent credit institutions which have benefited from the discretion in sub-regulation (4) and the number of these which incorporate subsidiaries in a non-EEA State; and

on an aggregate basis–

(i) the total amount of own funds on the consolidated basis of the parent credit institution which benefits from the exercise of the discretion in sub-regulation (4), which are held in subsidiaries in a non-EEA States;

(ii) the percentage of total own funds on the consolidated basis of a parent credit institution which benefits from discretion in that sub-regulation, represented by own funds which are held in subsidiaries in a non-EEA State; and

(iii) the percentage of total minimum own funds required under regulation 23 on the consolidated basis of a parent credit institutions which benefits from discretion in that sub-regulation represented by own funds which are held in subsidiaries in a non-EEA State.

Authority to include subsidiaries.

18.(1) Subject to sub-regulations (2) to (5), the Commissioner may authorise a parent credit institution to incorporate in the calculation of its requirement under regulation 16(1), its subsidiaries which meet the conditions laid down in regulation 17(2)(c) and (d), and whose material exposures or material liabilities are to that parent credit institution.

(2) The Commissioner shall authorise the procedure in sub-regulation (1) only where the parent credit institution is able to demonstrate to his satisfaction that there are no current or foreseen practical or legal

impediments to the prompt transfer of own funds, or repayment of liabilities when due by the subsidiary to its parent undertaking.

(3) Where the Commissioner exercises his discretion under sub-regulation (1), he shall not less than once a year inform the competent authorities of all EEA States of the use made of sub-regulation (1) and of the circumstances and arrangements referred to in sub-regulation (2).

(4) Where a subsidiary is in a non-EEA State, the Commissioner shall in addition provide the same information to the competent authority of that State.

(5) Without prejudice to the generality of regulation 86, the Commissioner shall make public, in the manner indicated therein–

(a) the criteria he applies to determine that there are no current or foreseen material practical or legal impediments to the prompt transfer of own funds or repayment of liabilities;

(b) the number of parent credit institutions which have made use of sub-regulation (1) and the number of these which incorporate subsidiaries in non-EEA States; and

on an aggregate basis for Gibraltar–

(i) the total amount of own funds of parent credit institutions which make use of sub-regulation (1) which are held in subsidiaries in non-EEA States;

(ii) the percentage of total own funds of parent credit institutions which make use of sub-regulation (1) represented by own funds which are held in subsidiaries in non-EEA States; and

(iii) the percentage of the total minimum own funds required under regulation 23 of parent credit institutions which make use of sub-regulation (1) represented by own funds which are held in subsidiaries in non-EEA States.

Obligations on parent credit institutions.

19.(1) Without prejudice to regulations 16 to 18, a parent credit institution shall comply with the obligations laid down in regulations 56 to 59, 63 to 70, 75 to 76 and 79 on the basis of its consolidated financial situation.

(2) Without prejudice to regulations 16 to 18, a credit institution which is controlled by a parent financial holding company in an EEA State or a

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parent mixed financial holding company in an EEA State shall comply to the extent and in the manner prescribed in Article 133 of the recast Directive with the obligations laid down in regulations 56 to 59, 63 to 70, 75, 76 and 79 on the basis of the consolidated financial situation of that financial holding company or mixed financial holding company.

(3) Where more than one credit institution is controlled by a parent financial holding company in an EEA State or by a parent mixed financial holding company in an EEA State, sub-regulation (1) shall apply only to the credit institution to which supervision on a consolidated basis applies, in accordance with Articles 125 and 126 of the recast Directive.

Obligations on European parent credit institutions.

20.(1) A European parent credit institutions shall comply with the obligations laid down in regulations 87 to 90 on the basis of its consolidated financial situation.

(2) A significant subsidiary of a European parent credit institution shall disclose the information specified in paragraph 5 of Part I of Schedule 12 on an individual or sub-consolidated basis.

(3) A credit institution which is controlled by a European parent financial holding company or by a European parent mixed financial holding company shall comply with the obligations laid down in regulations 87 to 90 on the basis of the consolidated financial situation of that financial holding company or that mixed financial holding company.

(4) A significant subsidiary of a European parent financial holding company or a European parent mixed financial holding company shall disclose the information specified in paragraph 5 of Part 1 of Schedule 12, on an individual or sub-consolidated basis.

(5) The Commissioner where he is the European consolidating supervisor, may apply in full or in part sub-regulations (1) to (4) to the credit institution which is included within comparable disclosures provided on a consolidated basis by a parent undertaking established in a non-EEA State.

(6) The Commissioner, where he is the European consolidating supervisor, may, after consulting the other competent authorities responsible for the supervision of subsidiaries, apply only the relevant provisions of Directive 2002/87/EC to a mixed financial holding company which is subject to equivalent provisions under these Regulations and under Directive 2002/87/EC, in particular in terms of risk based supervision.

(7) The Commissioner, where he is the European consolidating supervisor, may, in agreement with the group supervisor in the insurance

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sector, apply only the provision of these Regulations relating to the most significant financial sector as determined under Article 3(2) of Directive 2002/87/EC to a mixed financial holding company which is subject to equivalent provisions under these Regulations and under Directive 2009/138, in particular in terms of risk based supervision.

(8) The Commissioner, where he is the European consolidating supervisor, shall inform the EBA and the European Insurance and Occupational Pensions Authority established by EU Regulation 1094/2010, of the decisions taken under sub-regulations (6) and (7).

Options on obligations.

21.(1) The Commissioner where he is the European consolidating supervisor, may decide that a credit or financial institution or ancillary services undertaking which is a subsidiary or in which a participation is held, need not be included in the consolidation, in the following cases−

(a) where the undertaking concerned is situated in a non-EEA State where there are legal impediments to the transfer of the necessary information;

(b) where the undertaking concerned is of negligible interest with respect to the objectives of the monitoring of credit institutions and in any event where the balance-sheet total of that undertaking is less than the smaller of the following two amounts-

(i) EUR 10 million; or

(ii) 1% of the balance-sheet total of the parent undertaking or the undertaking that holds the participation.

(c) where the consolidation of the financial situation of that undertaking would be inappropriate or misleading as far as the objectives of the supervision of credit institutions are concerned.

(2) If, in the cases referred to in sub-regulation (1)(b), several undertakings meet that criteria, they shall be included in the consolidation where collectively they are of non-negligible interest with respect to the specified objectives.

(3) A subsidiary credit institution shall apply the requirements of regulations 56 to 59, 63 to 70, 75, 76 and 79 on a sub-consolidated basis if it, or its parent undertaking (if it is a financial holding company or a mixed financial holding company) has a credit or financial institution or an asset

management company as a subsidiary in a non-EEA State or holds a participation in such an undertaking.

(4) A parent undertaking and any subsidiaries subject to these Regulations meet their obligations on a consolidated or sub-consolidated basis and ensure that their arrangements, processes and mechanisms are consistent and well-integrated and that any data and information can be produced to or made available for inspection by the Commissioner at any time.

Calculation and reporting requirements.

22.(1) Save where otherwise provided, the valuation of assets and off-balance-sheet items shall be effected in accordance with the accounting framework to which a credit institution is subject under Regulation (EC) No 1606/2002 and Directive 86/635/EEC.

(2) Notwithstanding regulations 16 to 20, the calculations to verify the compliance of a credit institution with regulation 23 shall be carried out not less than twice a year and those results and any component data shall be reported to the Commissioner as soon as practicable.

(3) The reports required to be submitted to the Commissioner under subregulation (2) shall, with effect from 31 December 2012, be in such form and shall be submitted with such frequency and on such dates as the technical standards developed by the EBA pursuant to Article 75(2) of the recast Directive require.

Minimum level of own funds.

23. Without prejudice to regulation 83, a credit institution shall provide own funds which are at all times not less than the sum of the following capital requirements–

(a) for credit risk and dilution risk in respect of all of its business activities with the exception of its trading book business and illiquid assets if deducted from own funds under regulation 4(2)(d), 8% of the total of its risk-weighted exposure amounts calculated in accordance with regulations 24 and 28 to 43;

(b) in respect of its trading-book business, for position risk and counter-party risk and, in so far as it is authorised that the limits laid down in regulations 64 to 70 are exceeded, for large exposures exceeding such limits, the capital requirements determined in accordance with regulations 14, 24 to 28 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007;

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(c) in respect of all of its business activities, for foreign-exchange risk, settlement risk and commodities risk, the capital requirements determined according to regulation 14 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007;

(d) in respect of all of its business activities and for operational risk, the capital requirements determined in accordance with regulations 52 to 55.

PART V
Minimum own funds requirements for credit risk

Standardised and internal ratings based approaches.

24. A credit institution shall apply–

(a) the standardised approach in regulations 28 to 33; or

(b) with the Commissioner's authorisation, in accordance with regulation 34 the internal ratings based approach in regulations 34 to 39;

to calculate its risk-weighted exposure amounts for the purposes of regulation 23(a).

(2) For the purposes of this part "exposure" means an asset or off-balance sheet item.

Calculation of risk-weighted exposure.

25.(1) A credit institution which, for the purposes of Schedule 2, calculates risk-weighted exposure amounts in accordance with the provisions of regulations 34 to 39, shall purposes of the calculation provided for in paragraph 4 of Part I of Schedule 7, the following shall apply–

(a) value adjustments made to take account of the credit quality of the counter party may be included in the sum of value adjustments and provisions made for the exposures indicated in Schedule 2 of the FSCAIF Regulations;

(b) subject to the approval of the Commissioner, if the credit risk of the counter party is adequately taken into account in the valuation of a position included in the trading book the expected loss amount for the counter party risk exposure shall be zero.

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(2) For the purposes of sub-regulation (1)(a), such value adjustments shall not be included in own funds other than in accordance with sub-regulation (1).

(3) For the purposes of this regulation, regulations 92 and 9 3 shall apply.

Provisions against risks.

26.(1) A credit institution shall, at all times, have own funds amounting to or exceeding the capital requirements, calculated in accordance with the methods and options in–

(a) regulations 60 to 62, 71 and 72 below and Schedules 1, 2 and 6 and, where appropriate, Schedule 5, of the FSCAIF Regulations for their trading-book business;

(b) Schedules 3 and 4 and, where appropriate, Schedule 5, of those Regulations for all of their other business activities.

(2) Notwithstanding sub-regulation (1), a credit institution may apply to the Commissioner to be allowed to calculate the capital requirements for its trading book business in accordance with regulation 23(a) and paragraphs 6, 7, and 9 of Schedule 2 of the FSCAIF Regulations, where the size of the trading book business–

(a) does not normally exceed 5% of its total business;

(b) does not normally exceed EUR 15 million;

(c) never exceeds 6% of its total business and its total trading-book positions never exceed EUR 20 million.

(3) For the purposes of sub-regulation (2)(a) and (c), the Commissioner may refer either to the size of the combined on- and off-balance-sheet business, to the profit and loss account or to the own funds of the credit institution, or to a combination of those measurements.

(4) When the size of on- and off-balance-sheet business is assessed–

(a) debt instruments shall be valued at their market prices or their principal values;

(b) equities shall be valued at their market prices; and

(c) derivatives shall be valued according to the nominal or market values of the instruments underlying them;

and permitting long positions and short positions to be aggregated regardless of their signs.

(5) For the purposes of sub-regulation (4) long positions and short positions shall be aggregated irrespective of their signs.

(6) A credit institution which exceeds either or both of the limits imposed-

(a) in sub-regulation (2)(a) and (b); or

(b) in sub-regulation (2)(c);

shall meet the requirements imposed in sub-regulation (1)(a) in respect of its trading-book business and shall inform the Commissioner accordingly as soon as reasonably practicable.

(7) For the purposes of the calculation of minimum capital requirements for credit risk under these Regulations and without prejudice to the provisions of paragraph 6 of Part 2 of Schedule 3, exposures to recognised non-European investment firms and exposures incurred to recognised clearing houses and exchanges shall be treated as exposures to credit institutions and investment firms.

Specific risk.

27.(1) For the purposes of paragraph 14 of Schedule 1 of the FSCAIF Regulations, a 0% weighting may be assigned to debt securities issued by the entities listed in table 1 of Schedule 1 of those Regulations, where these debt securities are denominated and funded in sterling.

(2) Notwithstanding the requirements of paragraphs 13 and 14 of Schedule 1, risk requirements for any bonds falling within paragraphs 69 to 70 of Part I of Schedule 6 of the FSCAIF Regulations may be taken as equal to the specific risk requirement for a qualifying item with the same residual maturity as such a bond, reduced in accordance with the percentages given in paragraph 71 of that Part.

(3) If in accordance with paragraph 52 of Schedule 1 of the FSCAIF Regulations, an EEA State approves a non-European collective investment undertaking as eligible, the Commissioner may make use of this recognition without conducting its own assessment.

Standardised approach.

28.(1) Subject to sub-regulations (5) and (6), the exposure value of an asset item shall be its balance-sheet value and the exposure value of an off-

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balance sheet item listed in Schedule 2 shall be the following percentage of its value–

(a) 100% if it is a full-risk item;

(b) 50% if it is a medium-risk item;

(c) 20% if it is a medium to low-risk item; and

(d) 0% if it is a low-risk item.

(2) The off-balance sheet items in sub-regulation (1) shall fall within the risk categories as indicated in Schedule 2.

(3) Sub-regulation (4) applies to a credit institution using the financial collateral comprehensive method in Part 3 of Schedule 8.

(4) Where an exposure takes the form of securities or commodities sold, posted or lent under a repurchase transaction or under a securities or commodities lending or borrowing transaction, and margin lending transactions, the exposure value shall be increased by the volatility adjustment appropriate to such securities or commodities in paragraphs 34 to 59 of Part 3 of Schedule 8.

(5) The exposure value of a derivative instrument listed in Schedule 4 shall be determined in accordance with Schedule 3 with the effects of contracts of novation and other netting agreements taken into account for the purposes of those methods in accordance with that latter schedule.

(6) The exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions may be determined either in accordance with Schedule 3 or 8.

(7) Where an exposure is subject to funded credit protection, its exposure value may be modified in accordance with regulations 40 to 43.

(8) Notwithstanding sub-regulations (5) and (6), the exposure value of credit risk exposures outstanding, as determined by the Commissioner, with a central counter party shall be determined in accordance with paragraph 6 of Part 2 of Schedule 3:

Provided that the central counter party's counter party credit risk exposures with all participants in its arrangements are fully collateralised on a daily basis.

Exposure classes.

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29.(1) For the purposes of the standardised approach, each exposure shall fall within one of the following classes–

(a) claims or contingent claims on central governments or central banks;

(b) claims or contingent claims on regional governments or local authorities;

(c) claims or contingent claims on administrative bodies and non-commercial undertakings;

(d) claims or contingent claims on multilateral development banks;

(e) claims or contingent claims on international organisations;

(f) claims or contingent claims on institutions;

(g) claims or contingent claims on corporates;

(h) subject to sub-regulation (2), retail claims or contingent retail claims;

(i) claims or contingent claims secured on real estate property;

(j) past due items;

(k) items belonging to regulatory high-risk categories;

(l) claims in the form of covered bonds;

(m) securitisation positions;

(n) short-term claims on institutions and corporate;

(o) claims in the form of collective investment undertakings; or

(p) other items.

(2) An exposure shall fall within the retail exposure class in sub-regulation (1)(h) if–

(a) the exposure is to an individual person or persons, or to a small or medium sized entity;

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(b) the exposure is one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced; and

(c) the total amount owed to the credit institution and parent undertakings and its subsidiaries, 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, does not exceed EUR 1 million or its equivalent in sterling.

(3) The present value of retail minimum lease payments shall fall within the retail exposure class.

(4) Securities shall not fall within the retail exposure class.

Calculation of risk-weighted exposure.

30.(1) The calculation of risk-weighted exposure amounts by a credit institution, risk weights shall be applied to all exposures, unless deducted from own funds, in accordance with the provisions of Part 1 of Schedule 6.

(2) The application of risk weights under sub-regulation (1) shall be based on the class of the exposure and its credit quality to the extent specified in Part 1 of Schedule 6.

(3) Credit quality under sub-regulation (2) may be determined by reference to the credit assessments of external credit assessment institutions in accordance with regulations 31 to 33 or the credit assessments determined by the export credit agencies in accordance with Part 1 of Schedule 6.

(4) For the purposes of sub-regulations (1) to (3), the exposure value shall be multiplied by the risk weight specified or determined in accordance with this regulation and regulations 28 to 29 and 31 to 33.

(5) For the purposes of calculating risk-weighted exposure amounts for exposures to credit institutions, the exposure value shall be the method based on the credit quality of the counter party credit institution in accordance with Schedule 6.

(6) Notwithstanding sub-regulations (1) to (3), where an exposure is subject to credit protection, the risk weight applicable to the exposure may be modified in accordance with regulations 40 to 43.

(7) Risk-weighted exposure amounts for securitised exposures shall be calculated in accordance with regulations 44 to 51.

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(8) Where the calculation of risk-weighted exposure amounts is not provided for in regulations 28 to 29 and 31 to 33, the exposure shall be assigned a risk-weight of 100%.

(9) With the exception of exposures giving rise to liabilities in the form of the items referred to in regulation 7(1)(a) to (g), the Commissioner may exempt the exposures of a credit institution to a counter party which–

(a) is its parent undertaking;

(b) its subsidiary or a subsidiary of its parent undertaking; or

(c) an undertaking linked by a relationship within the meaning of article 12(1) of Directive 83/349/EEC;

from the requirements of sub-regulations (1) to (3) provided that the conditions in sub-regulation (10) are met.

(10) The conditions referred to in sub-regulation (9) shall be met if–

(a) the counter party is a credit institution, an investment firm, a financial institution, a financial holding company, mixed financial holding company, asset management company or ancillary services undertaking subject to appropriate prudential requirements;

(b) the counter party is included in the same consolidation as the credit institution on a full basis;

(c) the counter party is subject to the same risk evaluation, measurement and control procedures as the credit institution;

(d) the counter party is established in the same EEA State as the credit institution; and

(e) there are no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counter party to the credit institution.

(11) In a case under sub-regulations (9) and (10), a risk weight of 0% shall be applied.

(12) With the exception of exposures giving rise to liabilities in the form of the items referred to in regulation 7(1)(a) to (g), the Commissioner may exempt from the requirements of sub-regulations (1) to (3) the exposures to counter parties which are members of the same institutional protection

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scheme as the lending credit institution, provided that the conditions in sub-regulation (13) are met.

(13) The conditions referred to in sub-regulation (12) shall be met if–

(a) the requirements of sub-regulation (10)(a), (d) and (e) are met;

(b) the credit institution and the counter party enter into a contractual or statutory liability arrangement ("an institutional protection scheme") which protects those institutions and ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary;

(c) the arrangements ensure that the institutional protection scheme will be able to grant the necessary support under its commitment from funds readily available to it;

(d) subject to sub-regulation (14), the institutional protection scheme disposes of the suitable and uniformly stipulated systems in paragraph 44 of Part 4 of Schedule 7 for the monitoring and classification of risk (which gives a complete overview of the risk situations of all the individual members and the institutional protection scheme as a whole) with corresponding possibilities to take influence;

(e) the institutional protection scheme conducts its own risk review and communicates it to the individual members;

(f) the institutional protection scheme draws-up and publishes, for the whole of its operations, once a year either–

(i) a consolidated report comprising its balance sheet, profit-and-loss account, situation report and risk report; or

(ii) a report comprising its aggregated balance sheet, aggregated profit-and-loss account, situation report and risk report;

(g) members of the institutional protection scheme need to give no less than 24 months' notice if they wish to end the arrangements;

(h) the multiple use of elements eligible for the calculation of own funds ("multiple gearing") and any inappropriate creation of own funds between the members of the scheme is eliminated;

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(i) the institutional protection scheme is based on a broad membership of credit institutions of a predominantly homogeneous business profile.

(14) The Commissioner shall approve the systems referred to in sub-regulation (13)(d) and monitor its adequacy at regular intervals.

(15) In a case under sub-regulation (12), a risk weight of 0% shall be applied.

External credit assessment institutions.

31.(1) An external credit assessment may be used to determine the risk weight of an exposure in accordance with regulation 30 if the external credit assessment institution has been approved for those purposes under sub-regulation (2).

(2) The Commissioner may, taking into account the technical criteria set out in Part 2 of Schedule 6, approve an external credit assessment institution including one which is registered as a credit rating agency under Regulation (EC) 1060/2009 if he is satisfied that its assessment methodology meets his requirements regarding objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet his further requirements regarding credibility and transparency.

(3) Notwithstanding sub-regulation (2), the Commissioner shall recognise an external credit assessment institution which has been approved by the competent authority of an EEA State, without carrying out his own evaluation process.

(4) The Commissioner shall make public details of his approval criteria and the list of approved and recognised external credit assessment institutions.

Determination of credit assessments.

32.(1) The Commissioner shall, in accordance with Part 2 of Schedule 6, determine with which of the credit quality steps set out in Part 1 of that Schedule, the credit assessments of an approved external credit assessment institutions are to be associated.

(2) The Commissioner shall recognise a determination made by the competent authority of an EEA State without carrying out his own determination process.

Use of credit assessments.

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33. The use of credit assessments for the calculation of a credit institution's risk-weighted exposure amounts by external credit assessment institutions shall be consistent and in accordance with Part 3 of Schedule 6, and not used selectively.

(2) A credit institution shall use solicited credit assessments but may apply to the Commissioner for authority to the use of unsolicited assessments.

Applications to use internal ratings based approach.

34.(1) A credit institution may apply to the Commissioner for authority to calculate its risk-weighted exposure amounts using the internal ratings based approach.

(2) The Commissioner may grant authority under sub-regulation (1) if he is satisfied that the credit institution's systems for the management and rating of credit risk exposures are sound and that the credit institution meets the standards in Part 4 of Schedule 7 as follows–:

(a) its rating systems provide for a meaningful assessment of obligor and transaction characteristics;

(b) its rating systems provide for a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk;

(c) the internal ratings and default and loss estimates it uses in the calculation of capital requirements and associated systems and processes play an essential role in its risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions;

(d) it has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence;

(e) it collects and stores all relevant data to provide effective support to its credit risk measurement and management process;

(f) it documents and validates its rating systems and the rationale for their design.

(3) Where a European parent credit institution and its subsidiaries or a European parent financial holding company and its subsidiaries or a European parent mixed financial holding company and its subsidiaries use the internal ratings based approach on a unified basis, the Commissioner

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may allow the minimum requirements in Part 4 of Schedule 7 to be met by the parent and its subsidiaries together.

(4) A credit institution which applies for the use of the internal ratings based approach shall support its application with evidence that it has been using rating systems for the internal ratings based exposure classes, which are broadly in line with the minimum requirements set out in Part 4 of Schedule 7 for its internal risk measurement and management purposes for at least three years prior to the date of submission of the application.

(5) A credit institution which applies for the use of own estimates of loss given defaults or conversion factors shall support its application with evidence that it has been using its own estimates of loss given defaults or conversion factors in a manner that was broadly consistent with the minimum requirements for use of own estimates set out in Part 4 of Schedule 7 for at least three years prior to the date of submission of the application.

(6) A credit institution which has had an application approved under this regulation and which is no longer able to comply with the requirements of this regulation and regulations 35 to 39, shall either submit a plan to the Commissioner for a timely return to compliance or demonstrate to him that the effect of non-compliance is immaterial.

(7) When the internal ratings based approach is intended to be used by the European parent credit institution and its subsidiaries, or by the European parent financial holding company and its subsidiaries, or by the European parent mixed financial holding company and its subsidiaries, the Commissioner and the competent authorities of the EEA States where the different entities are based shall co-operate closely in accordance with regulations 81 and 82.

Implementation of internal ratings based assessments.

35.(1) Without prejudice to regulation 39, a credit institution and any parent undertaking and its subsidiaries shall implement the internal ratings based approach for all exposures.

(2) The Commissioner may authorise such implementation to be carried out sequentially across the different exposure classes in regulation 36 within the same business unit, across different business units in the same group or for the use of own estimates of loss given defaults or conversion factors for the calculation of risk weights for exposures to corporates, credit institutions, investment firms, central governments and central banks.

(3) In the case of a retail exposure class in regulation 36, such implementation may be carried out sequentially across the categories of

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exposures to which the different correlations in paragraphs 10 to 13 of Part 1 of Schedule 7 correspond.

(4) The implementation of the internal ratings based approach under sub-regulations (1) to (3) shall be carried out within a reasonable period of time to be agreed with the Commissioner.

(5) The implementation of the internal ratings based approach shall be carried out in accordance with such conditions as may be imposed by the Commissioner aimed at ensuring that the flexibility in sub-regulations (1) to (3) is not used selectively for achieving reduced minimum capital requirements in those exposure classes or business units that are yet to be included in the internal ratings based approach or in the use of own estimates of loss given defaults and conversion factors.

(6) A credit institution using the internal ratings based approach for any exposure class shall at the same time use that approach for the equity exposure class.

(7) Subject to sub-regulations (1) to (6) and regulation 39, a credit institution which has authority granted under regulation 34 to use the internal ratings based approach shall not revert to the use of the provisions in regulations 28 to 33 for the calculation of risk-weighted exposure amounts except for demonstrated good cause and subject to the prior approval of the Commissioner.

(8) Subject to sub-regulations (1) to (5) and regulation 39, a credit institutions which has authority granted under regulation 37(14) to use own estimates of loss given defaults and conversion factors, shall not revert to the use of loss given default values and conversion factors referred to in regulation 37(13) except for demonstrated good cause and subject to the prior approval of the Commissioner.

Exposure classes.

36.(1) For the purposes of the internal ratings based approach, each exposure shall fall within one of the following classes–

(a) claims or contingent claims on central governments and central banks;

(b) claims or contingent claims on credit institutions and investment firms;

(c) claims or contingent claims on corporates;

(d) retail claims or contingent retail claims;

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(e) equity claims;

(f) securitisation positions; and

(g) other non credit-obligation assets.

(2) The following exposures shall be treated as exposures to central governments and central banks in regulation 36(1)(a)–

(a) exposures to regional governments, local authorities or public sector entities which are treated as exposures to central governments under regulations 28 to 33; and

(b) exposures to multilateral development banks and international organisations which attract a risk weight of 0% under any of those regulations.

(3) The following exposures shall be treated as exposures to credit institutions or investment firms in regulation 36(1)(b)–

(a) exposures to regional governments and local authorities which are not treated as exposures to central governments under regulations 28 to 33;

(b) exposures to public sector entities which are treated as exposures to credit institutions or investment firms under any of those regulations; and

(c) exposures to multilateral development banks which do not attract a 0% risk weight under any of those regulations.

(4) A retail exposure class in sub-regulation (1)(d), shall meet the following criteria–

(a) the exposure shall be to an individual person or persons, or to a small or medium sized entity, provided in the latter case, that the total amount owed to the credit institution and any parent undertaking and its subsidiaries, 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, shall not, to the knowledge of the credit institution, exceed EUR 1 million or its equivalent in sterling;

(b) the exposure shall be treated by the credit institution in its risk management consistently over time and in a similar manner;

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(c) the exposure shall not be managed just as individually as exposures in the corporate exposure class; and

(d) the exposure shall represent one of a significant number of similarly managed exposures.

(5) The present value of retail minimum lease payments shall be eligible for the retail exposure class.

(6) The following exposures shall be classed as equity exposures in regulation 36(1)(e)–

(a) non-debt exposures conveying a subordinated, residual claim on the assets or income of the issuer;

(b) debt exposures the economic substance of which is similar to the exposures in paragraph (a).

(7) Within the corporate exposure class in regulation 36(1)(c), a credit institution shall separately identify as a specialised lending exposures, an exposure which possess the following characteristics–

(a) it shall be an exposure to an entity which was created specifically to finance or operate physical assets;

(b) the contractual arrangements shall give the lender a substantial degree of control over the assets and the income that they generate and

(c) the primary source of repayment of the obligation is the income generated by the assets being financed, instead of the independent capacity of a broader commercial enterprise.

(8) Any credit obligation not falling within an exposure of a class in sub-regulation (1)(a), (b) and (d) to (f) shall fall within the class in sub-regulation (1)(c).

(9) The exposure of the class in sub-regulation (1)(g) shall include the residual value of leased properties if not included in the lease exposure in paragraph 4 of Part 3 of Schedule 7.

(10) A credit institution shall employ an adequate and consistent method of assigning its exposures to classes in sub-regulation (1).

Risk-weighted exposures.

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37.(1) The risk-weighted exposure amounts, for credit risk, of one of the classes in regulation 36(1)(a) to (e) or (g) shall, unless deducted from own funds, be calculated in accordance with paragraphs 1 to 27 of Part 1 of Schedule 7.

(2) The risk-weighted exposure amounts for dilution risk for purchased receivables shall be calculated in accordance with paragraph 28 of Part 1 of Schedule 7.

(3) A credit institution which has full recourse in respect of purchased receivables for default risk and for dilution risk, to the seller of the purchased receivables, may opt not to apply the provisions of this regulation and regulation 38 for purchased receivables and the exposure shall then be treated as a collateralised exposure.

(4) A credit institution may opt to treat the exposure under sub-regulation (3) as a collateralised exposure.

(5) The calculation of risk-weighted exposure amounts for credit risk and dilution risk shall be based on the parameters associated with the exposure which shall include probability of default, loss given default, maturity and the exposure value.

(6) For the purposes of sub-regulation (5), probability of default and loss given default may be considered separately or jointly, in accordance with Part 2 of Schedule 7.

(7) Notwithstanding sub-regulations (5) and (6), the calculation of risk-weighted exposure amounts for credit risk for all exposures of the class in regulation 36(1)(e) shall, with the approval of the Commissioner, be calculated in accordance with paragraphs 17 to 26 of Part 1 of Schedule 7.

(8) The Commissioner may authorise a credit institution to use the approach set out in paragraphs 25 and 26 of Part 1 of Schedule 7, if the credit institution meets the minimum requirements in paragraphs 115 to 123 of Part 4 of Schedule 7.

(9) Notwithstanding sub-regulations (5) and (6), the calculation of risk weighted exposure amounts for credit risk for specialised lending exposures may be calculated in accordance with paragraph 6 of Part 1 of Schedule 7.

(10) The Commissioner shall publish guidance notes on how credit institutions should assign risk weights to specialised lending exposures under paragraph 6 of Part 1 of Schedule 7 and shall approve assignment methodologies.

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(11) For exposures of the classes in regulation 36(1)(a) to (d), a credit institution shall provide its own estimates of probabilities of default in accordance with regulation 34 and Part 4 of Schedule 7.

(12) For exposures of the class in regulation 36(1)(d), a credit institution shall provide own estimates of loss given defaults and conversion factors in accordance with regulation 34 and Part 4 of Schedule 7.

(13) For exposures of the classes in regulation 36(1)(a) to (c) a credit institution shall apply the loss given default values in paragraph 8 of Part 2 of Schedule 7 and the conversion factors in paragraph 9(a) to (d) of Part 3 of Schedule 7.

(14) Notwithstanding sub-regulation (13), for exposures of the classes in regulation 36(1)(a) to (c), the Commissioner may authorise a credit institution to use own estimates of loss given defaults and conversion factors in accordance with regulation 34 and Part 4 of Schedule 7.

(15) The risk-weighted exposure amounts for securitised exposures and for exposures of the class in regulation 36(1)(f) shall be calculated in accordance with regulations 44 to 51.

(16) Where exposures in the form of a collective investment undertaking meet the criteria in paragraphs 77 and 78 of Part 1 of Schedule 6, and the credit institution is aware of all or part of the underlying exposures of that undertaking, it shall use those underlying exposures to calculate risk-weighted exposure amounts and expected loss amounts in accordance with the methods set out in this regulation and regulations 34 to 36 and 38 to 39.

(16A) Sub-regulations (18) to (20) shall apply–

(a) to the part of the underlying exposures of the collective investment undertaking that a credit institution is not aware of or could not reasonably be aware of; and

(b) where it would be unduly burdensome for the credit institution to look through the underlying exposures in order to calculate risk-weighted exposure amounts and expected loss amounts in accordance with the methods in this regulation and regulations 34 to 36, 38 and 39.

(17) Where a credit institution is unable to meet the conditions attaching to the use of the methods in this regulation and regulations 34 to 36 and 38 to 39 for all or part of the underlying exposure of the collective investment undertaking, risk weighted exposure amounts and expected loss amounts shall be calculated as follows–

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(a) for exposures of the class in regulation 36(1)(e) - the approach in paragraphs 19 to 21 of Part 1 of Schedule 7;

(b) for all other underlying exposures, the approach in regulations 28 to 33, subject to the following modifications–

(i) for exposures subject to a specific risk weight for unrated exposures or subject to the credit quality step yielding the highest risk weight for a given exposure class, the risk weight shall be multiplied by a factor of two but must not be higher than 1250 %;

(ii) for all other exposures, the risk weight shall be multiplied by a factor of 1.1 and shall be subject to a minimum of 5%.

(17A) Where, for the purposes of sub-regulation (17)(a), a credit institution is unable to differentiate between private equity, exchange-traded and other equity exposures it shall treat the exposures concerned as other equity exposures.

(17B) Without prejudice to paragraph 4(9) of Schedule 1, where the exposures under sub-regulation (17A) taken together with the credit institution’s direct exposures in that exposure class are not material within the meaning of regulation 39(3) and (4), the Commissioner may authorise the application of regulation 39(1).

(18) Where exposures in the form of a collective investment undertaking are unable to meet the criteria in paragraphs 77 and 78 of Part 1 of Schedule 6, or the credit institution is not aware of all of the underlying exposures of that undertaking, the credit institution shall use the underlying exposures and calculate risk-weighted exposure amounts and expected loss amounts in accordance with paragraphs 19 to 21 of Part 1 of Schedule 7.

(19) If the credit institution does not differentiate between private equity, exchange-traded and other equity exposures, it shall treat the exposure concerned as other equity exposure.

(20) Non-equity exposures shall fall within the private equity, exchange traded equity or other equity class in paragraph 19 of Part 1 of Schedule 7 and unknown exposures shall be assigned to other equity class.

(21) A credit institution may, as an alternative to the methods in sub-regulations (18) to (20), itself calculate or may rely on a third party to calculate and report the average risk weighted exposure amounts based on the collective investment undertaking underlying exposures in accordance with the approaches specified in subregulations (17)(a) and (b).

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Expected loss amounts.

38.(1) The expected loss amounts for exposures of the classes in regulation 36(1)(a) to (e), shall be calculated in accordance with paragraphs 29 to 35 of Part 1 of Schedule 7.

(2) The calculation of the expected loss amounts in accordance with paragraphs 29 to 35 of Part 1 of Schedule 7, shall be based on the same input figures of probability of default, loss given defaults and the exposure value for each exposure as used for the calculation of risk-weighted exposure amounts in accordance with regulation 37.

(3) For defaulted exposures, where a credit institution uses its own estimates of loss given defaults, expected loss shall be the credit institution's best estimate of expected loss for the defaulted exposure in accordance with paragraph 80 of Part 4 of Schedule 7.

(4) The expected loss amounts for securitised exposures shall be calculated in accordance with regulations 44 to 51.

(5) The expected loss amount for exposures of the class in regulation 36(1)(g) shall be zero.

(6) The expected loss amounts for dilution risk of purchased receivables shall be calculated in accordance with paragraph 35 of Part 1 of Schedule 7.

(7) The expected loss amounts for exposures of the classes in regulation 37(16) and (20) shall be calculated in accordance with paragraphs 29 to 35 of Part 1 of Schedule 7.

Calculation of certain other exposures.

39.(1) A credit institution which is permitted to use the internal rating based approach in the calculation of risk-weighted exposure amounts and expected loss amounts for one or more exposure classes may apply to the Commissioner for authority to make use of the provisions in regulations 28 to 33 for the following exposures–

(a) the exposure of the class in regulation 36(1)(a) where the number of material counter parties is limited and the credit institution would consider it unduly burdensome for it to implement a rating system for those counter parties;

(b) the exposure of the class in regulation 36(1)(b) where the number of material counter parties is limited and the credit

institution would consider it unduly burdensome for it to implement a rating system for those counter parties;

(c) exposures in non-significant business units and exposure classes which are immaterial in terms of size and perceived risk profile;

(d) exposures to the Government of Gibraltar including public bodies in Gibraltar on condition that–

(i) there is no difference in risk between the exposures to the Government of Gibraltar and those public bodies because of specific public arrangements;

(ii) exposures to the Government of Gibraltar are assigned a 0% risk weight under regulations 28 to 33;

(e) exposures to a counter party which is the credit institution's parent undertaking, its subsidiary or a subsidiary of its parent undertaking provided that the counter party is a credit or financial institution, an investment firm or a financial holding company, mixed financial holding company, asset management company or ancillary services undertaking subject to appropriate prudential requirements or an undertaking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC and exposures between credit institutions which meet the requirements set out in regulation 30(12);

(f) equity exposures to entities whose credit obligations qualify for a zero risk weight under regulations 28 to 33 and those publicly sponsored entities where a zero risk weight can be applied;

(g) equity exposures incurred under legislated programmes to promote specified sectors of the economy which provide large subsidies for investment to the credit institution and involve some form of government oversight and restrictions on the equity investments on condition that the exclusion is limited to an aggregate of 10% of original own funds plus additional own fund;

(h) the exposures of the classes in paragraph 40 of Part 1 of Schedule 6 which meet the conditions specified therein; or

(i) Government of Gibraltar reinsured guarantees pursuant to paragraph 19 of Part 2 of Schedule 8.

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(2) The Commissioner may allow the application of the rules in regulations 28 to 33 for equity exposures which have been allowed for this treatment in an EEA States.

(3) For the purposes of sub-regulation (1), the equity exposure class of a credit institution shall be considered material if its aggregate value, excluding equity exposures incurred under legislative programmes in sub-regulation (1)(g), exceeds, on average over the preceding financial year, 10% of the credit institution's own funds.

(4) If the number of equity exposures referred to in sub-regulation (3) is less than 10 individual holdings, that threshold shall be 5% of the credit institution's own funds.

Interpretation.

40. For the purposes of regulations 41 to 43, "lending credit institution" means a credit institution which has the exposure in question, whether or not deriving from a loan.

Credit risk mitigation.

41. A credit institution which uses–

(a) the standardised approach under regulations 28 to 33; or

(b) the internal rating based approach under regulations 34 to 39;

but does not use its own estimates of loss given defaults and conversion factors under regulations 37 and 38, may use credit risk mitigation in accordance with regulations 42 and 43 in the calculation of risk-weighted exposure amounts for the purposes of regulation 23(a) or as relevant expected loss amounts for the purposes of the calculation in regulations 7(2)(q) and 12(3).

Credit protection arrangements.

42.(1) A lending credit institution shall have in place credit protection arrangements which shall be sufficient to meet the risks inherent in its activities and shall be such as to ensure that those arrangements are legally effective and enforceable in all relevant jurisdictions.

(2) In the case of funded credit protection, the assets in Part 1 of Schedule 8 which are relied upon shall 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.

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(3) In the case of funded credit protection, the lending credit institution shall have the right to liquidate or retain 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.

(4) For the purposes of sub-regulation (3), the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be undue.

(5) In the case of unfunded credit protection, the party giving the undertaking shall be sufficiently reliable, and the protection agreement legally effective in the relevant jurisdictions, to provide adequate and effective credit protection having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed.

(6) For the purposes of sub-regulation (5), the protection providers and types of protection agreement shall be limited to those in Part 1 of Schedule 8.

(7) A lending credit institution shall comply with the minimum requirements in Part 2 of Schedule 8.

Modification of risk-weighted exposure calculations.

43.(1) A credit institution which is able to meet the requirements of regulation 42 may modify the calculation of risk-weighted exposure amounts, and, as relevant, expected loss amounts, in accordance with Parts 3 to 6 of Schedule 8.

(2) No exposure in respect of which there is appropriate credit risk mitigation shall produce a higher risk-weighted exposure amount or expected loss amount than an identical exposure in respect of which there is no credit risk mitigation.

(3) Where the risk-weighted exposure amount already takes account of credit protection under regulations 28 to 39, the calculation of the credit protection shall not be further recognised under regulations 40 to 43.

Securitisation.

44.(1) A credit institution which uses the standardised approach in regulations 28 to 33 for the calculation of risk-weighted exposure amounts for the exposure of a class in regulation 29 for securitised exposures, shall calculate the risk-weighted exposure amount for a securitisation position in accordance with paragraphs 1 to 36 of Part 4 of Schedule 9.

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(2) A credit institution shall calculate the risk-weighted exposure amount in accordance with paragraphs 1 to 5 and 37 to 76 of Part 4 of Schedule 9 in cases other than those in sub-regulation (1).

Transfer of securitisation.

45.(1) Where a significant credit risk associated with securitised exposures has been transferred from an originator credit institution in accordance with Part 2 of Schedule 9, that credit institution may–

(a) in the case of a traditional securitisation, exclude from its calculation of risk-weighted exposure amounts and expected loss amounts, the exposures which it has securitised; and

(b) in the case of a synthetic securitisation, calculate risk-weighted exposure amounts and expected loss amounts, in respect of the securitised exposures in accordance with Part 2 of Schedule 9.

(2) An originator credit institution to which sub-regulation (1) applies shall calculate the risk-weighted exposure amounts prescribed in Schedule 9 for the positions that it may hold in the securitisation.

(3) An originator credit institution which fails to transfer significant credit risk in accordance with sub-regulation (1), shall not calculate risk-weighted exposure amounts for any positions it may have in the securitisation.

Further provisions on securitisation.

46.(1) A credit institution which calculates the risk-weighted exposure amount of a securitisation position, shall apply risk weights to the exposure value of the position in accordance with Schedule 9, based on the credit quality of the position, which may or may not be determined by reference to an external credit assessment institution's credit assessment in accordance with that Schedule.

(2) Where there is an exposure to different tranches in a securitisation, the exposure to each tranche shall be considered a separate securitisation position.

(3) The providers of credit protection to securitisation positions shall be considered to hold positions in the securitisation.

(4) Securitisation positions shall include exposures to a securitisation arising from interest rate or currency derivative contracts.

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(5) Where a securitisation position is subject to funded or unfunded credit protection, the risk-weight to be applied to that position may be modified in accordance with regulations 40 to 43 as read with Schedule 9.

(6) Subject to regulations 7(1)(r) and 15(2), a credit institution shall include its risk-weighted exposure amount in its total amount of risk-weighted exposure amounts for the purposes of regulation 23(a)

Approved external credit assessment institutions.

47.(1) An external credit assessment institution's credit assessment may be used to determine the risk weight of a securitisation position in accordance with regulation 46 if the external credit assessment institution is approved under sub-regulation (2).

(2) The Commissioner shall approve an external credit assessment institution for the purposes of sub-regulation (1) if he is satisfied–

(a) as to its compliance with the requirements of regulation 31 taking into account the technical criteria in Part 2 of Schedule 6; and

(b) that it has an acceptable level of experience in the area of securitisation, which may be evidenced by a strong presence in the market place.

(3) If an external credit assessment institution has been approved by the competent authority of an EEA State, the Commissioner shall recognise that external credit assessment institution as an approved external credit assessment institution for those purposes without carrying out his own evaluation.

(4) The Commissioner shall make public the approval criteria he uses and a list of approved and recognised external credit assessment institutions.

(5) For the purposes of sub-regulation (1), a credit assessment of an approved or recognised external credit assessment institution shall comply with the principles of credibility and transparency in Part 3 of Schedule 9.

Credit quality steps.

48.(1) For the purposes of applying risk weights to securitisation positions, the Commissioner shall determine with which of the credit quality steps in Schedule 9 the credit assessments of an approved or recognised external credit assessment institution are to be associated.

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(2) When the competent authority of an EEA State has made a determination similar to that in sub-regulation (1), the Commissioner shall accept that decision without carrying out his own determination process.

Credit assessments to be consistent.

49. The use of an external credit assessment institution's credit assessments for the calculation of a credit institution's risk-weighted exposure amounts under regulation 46 shall be consistent, not used selectively, and used in accordance with Part 3 of Schedule 9.

Revolving exposures subject to amortisation.

50.(1) An originator credit institution shall, where there is a securitisation of revolving exposures subject to an early amortisation provision, calculate an additional risk-weighted exposure amount in respect of the risk that the levels of credit risk to which it is exposed may increase following the operation of the early amortisation provision.

(2) The calculation referred to in sub-regulation (1) shall be carried out in accordance with Schedule 9.

(3) For the purposes of sub-regulation (1)–

(a) "revolving exposure" means an exposure whereby customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to an agreed limit; and

(b) "early amortisation provision" means a contractual clause which requires, on the occurrence of defined events, investors' positions to be redeemed before the originally stated maturity of the securities issued.

Limitation of support to a securitisation.

51.(1) A sponsor credit institution, or an originator credit institution which, in respect of a securitisation, has made use of regulation 45 in the calculation of risk-weighted exposure amounts, or has sold instruments from its trading book to a securitisation special purpose entity to the effect that it is no longer required to hold own funds for the risks of those instruments, shall not, with a view to reducing potential or actual losses to investors, provide support to the securitisation beyond its contractual obligations.

(2) If an originator credit institution or a sponsor credit institution breaches the provisions of sub-regulation (1), the Commissioner shall place, as a minimal remedial requirement that the institution shall hold

capital against all of the securitised exposures as if they had not been securitised.

(3) The Commissioner may place such additional requirements on the credit institution to those in sub-regulation (2) as he thinks fit to remedy the situation.

(4) The credit institution shall make public as soon as it does so that it has provided non-contractual support and the regulatory capital impact of having done so.

PART VI

Minimum own funds requirements for operational risk

Level of own funds for operational risks.

52.(1) A credit institution shall hold minimum own funds against operational risk in accordance with regulations 53 to 55.

(2) Without prejudice to sub-regulation (3), a credit institution which uses–

(a) the standardised approach in regulation 54 shall not revert to the use of the basic indicator approach in regulation 53;

(b) the advanced measurement approach in regulation 55 shall not revert to the use of the basic indicator approach in regulation 53 or 54;

except for demonstrated good cause and with the prior approval of the Commissioner.

(3) A credit institution may apply to the Commissioner for authority to use a combination of approaches in accordance with Part 4 of Schedule 10 in lieu of the approaches in sub-regulation (2).

Capital for operational risks.

53. The capital requirement for operational risk under the basic indicator approach shall be a percentage of a relevant indicator in accordance with Part 1 of Schedule 10.

Criteria for use of standardised approach.

54.(1) A credit institution shall meet the criteria set out in Part 2 of Schedule 10 to qualify to use the standardised approach.

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(2) A credit institution using the standardised approach shall divide its activities into the business lines and within the parameters in that Part.

(3) A credit institution shall calculate a capital requirement for operational risk as a certain percentage of an indicator for each business line, in accordance with that Part.

(4) A capital requirement for operational risk under the standardised approach shall be the sum of the capital requirements for operational risk across all individual business lines in accordance with that Part.

(5) A credit institution may apply to the Commissioner for authority to use, for such business lines as he may permit, an alternative relevant indicator for determining its capital requirements for operational risks in accordance with paragraphs 5 to 11 of that Part.

Advanced measurement approach.

55.(1) A credit institution may apply to the Commissioner for authority to use an advanced measurement approach based on its own operational risk measurement systems for calculating the own funds requirements., if it can satisfy him that it meets the qualifying criteria in Part 3 of Schedule 10.

(2) An application under sub-regulation (1) shall be in accordance with the requirements of Part 3 of Schedule 10.

(3) When an advanced measurement approach is intended to be used by a European parent credit institution and its subsidiaries or by the subsidiaries of a European parent financial holding company or a European parent mixed financial holding company, the Commissioner and the competent authorities of the EEA States where the different entities are based shall cooperate closely in accordance with regulations 81 and 82, the application shall include the elements listed in Part 3 of Schedule 10.

(4) Where a European parent credit institution and its subsidiaries or the subsidiaries of a European parent financial holding company or a European parent mixed financial holding company use an advanced measurement approach on a unified basis, the Commissioner may allow the qualifying criteria in Part 3 of Schedule 10 to be met by the parent and its subsidiaries together.

PART VII

Large exposures

Interpretation.

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56.(1) For the purposes of this Part, “credit institution” shall include any private or public undertaking, including its branches, which meets the definition of “credit institution” and has been authorised in a non-EEA State.

(2) For the purposes of this Part, “exposures” means any asset or off-balance-sheet item in regulations 28 to 33 without the application of the risk weight or degrees of risk mentioned therein.

Large exposures.

57.(1) Exposures arising from the items in Schedule 4 shall be calculated in accordance with one of the methods set out in Schedule 3.

(2) For the purposes of this Part, paragraph 2 of Part 2 of Schedule 3, shall apply.

(3) The elements entirely covered by own funds may, with the approval of the Commissioner, be excluded from the determination of exposures if such own funds are not included–

(a) in the credit institution’s own funds for the purposes of regulation 23; or

(b) in the calculation of other monitoring ratios provided for in these Regulations and in any other relevant legislation transposing EU Directives.

(4) Exposures shall not include–

(a) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the two working days following payment;

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

(c) in the case of money transmissions including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custodial services, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day;

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(d) in the case of money transmissions including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services.

(5) In order to determine the existence of a group of connected clients, in respect of the exposures in regulation 29(1)(m), (o) and (p), where there is an exposure to underlying assets, a credit institution shall assess the scheme or its underlying exposures, or both.

(6) For the purposes of sub-regulation (5), a credit institution shall evaluate the economic substance and the risks inherent in the structure of the transaction.

Other large exposures.

58. A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its own funds.

Identification of large exposures.

59. A credit institution shall have sound administrative and accounting procedures and adequate internal control mechanisms–

(a) for identifying and recording all large exposures and subsequent changes to them, in accordance with these Regulations; and

(b) for monitoring those large exposures in the light of the credit institution's own exposure policies.

Monitoring of large exposures.

60. A credit institution which calculates the capital requirements for its trading-book business in accordance with Schedules 1 and 2, and, as appropriate, Schedule 5 of the FSCAIF Regulations, shall monitor and control its large exposures in accordance with this Part but may take advantage of the variations in regulations 61, 62, 71 and 72.

Exposure to individual clients.

61.(1) A credit institution's exposures to individual clients which arise on its trading book shall be the aggregate of–

(a) the excess (where positive) of its long positions over its short positions in all the financial instruments issued by a client, with

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the net position in each of the different instruments being calculated in accordance with Schedule 1 of the FSCAIF Regulations;

(b) the net exposure, in the case of the underwriting of a debt or an equity instrument; and

(c) the exposures due to the transactions, agreements and contracts referred to in Schedule 2 of the FSCAIF Regulations with the client calculated in accordance with that Schedule, for the calculation of exposure values.

(2) For the purposes of sub-regulation (1)(b)–

(a) the net exposure shall be calculated by deducting those underwriting positions which are subscribed or sub-underwritten by third parties on the basis of a formal agreement reduced by the factors in paragraph 41 of Schedule 1 of the FSCAIF Regulations;

(b) a credit institution shall monitor and control its underwriting exposures between the time of the initial commitment and working day one in the light of the nature of the risks incurred in the markets.

(3) For the purposes of sub-regulation (1)(c), regulations 34 to 39 shall be excluded from the reference in paragraph 6 of Schedule 2 of the FSCAIF Regulations.

(4) The exposures to a credit institution's group of connected clients on the trading book shall be calculated in accordance sub-regulation (1) by aggregating the exposures to individual clients in a group.

Overall exposure to individual clients.

62.(1) A credit institution's overall exposures to individual clients or groups of connected clients shall be calculated by aggregating the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account regulations 65 to 70.

(2) A credit institution's exposure on the non-trading book shall be calculated by taking the exposure arising from assets which are deducted from own funds by virtue of regulation 4(2)(d) to be zero.

(3) A credit institution shall report to the Commissioner in accordance with Regulation 63, its overall exposures to individual clients and groups of connected clients calculated in accordance with sub-regulation (6).

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(4) Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to clients and groups of connected clients for reporting purposes under sub-regulation (3) shall not include the recognition of credit risk mitigation.

(5) The sum of the exposures to an individual client or group of connected clients in sub-regulation (1) shall be limited in accordance with regulations 64 to70.

(6) The Commissioner may allow assets constituting claims and other exposures on recognised non-European credit institutions and recognised clearing houses and exchanges in financial instruments to be subject to the same treatment accorded to those credit institutions in regulations 57(4)(c) and 64(1).

Reporting of large exposures.

63.(1) A credit institution shall report the following information to the Commissioner about every large exposure including large exposures exempted from the application of regulation 64(1) to (4)−

(a) the identity of the client or the group of connected clients to which the credit institution has a large exposure;

(b) when applicable, the exposure value before taking into account the effect of the credit risk mitigation;

(c) where used, the type of funded or unfunded credit protection; and

(d) the exposure value after taking into account the effect of the credit risk mitigation calculated for the purpose of regulation 64(1) to (4).

(2) A credit institution which is subject to regulations 34 to 39 shall report to the Commissioner its 20 largest exposures on a consolidated basis excluding those exposures exempted from the requirements of regulation 64(1) to (4).

(3) The reports required under subregulations (1) and (2) shall be submitted to the Commissioner at least twice a year but with effect from 31 December 2012 such reports, be in such form and shall be submitted with such frequency and on such dates as the technical standards developed by the EBA pursuant to Article 110(2) of the recast Directive require.

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(4) A credit institution shall, in accordance with regulation 57(5), analyse its exposures to collateral issuers, providers of unfunded credit protection and underlying assets for possible concentrations and take any necessary action and report any significant findings to the Commissioner.

Exposure to a client or group of clients.

64.(1) A credit institution shall not incur an exposure, after taking into account the effect of the credit risk mitigation in accordance with regulations 65 to 70 to a client or group of connected clients the value of which exceed 25% of its own funds.

(2) For the purposes of sub-regulation (1), where the client is an institution or where a group of connected clients includes one or more institutions, that value shall not exceed 25% of the credit institution's own funds or EUR 150 million, whichever is the higher, provided that the sum of exposure values, after taking into account the effect of the credit risk mitigation in accordance with regulations 65 to 70, to all connected clients which are not institutions, does not exceed 25% of the credit institution's own funds.

(3) Where under sub-regulation (2), the amount of EUR 150 million is higher than 25 % of the credit institution's own funds, the value of the exposure, after taking into account the effect of credit risk mitigation in accordance with regulations 65 to 70, shall not exceed a reasonable limit in terms of the credit institution's own funds.

(4) The limit under sub-regulation (3) shall be determined by the credit institution, consistently with the policies and procedures in paragraph 7 of Schedule 7, to address and control concentration risk and that limit shall not be higher than 100% of the credit institution's own funds.

(4A) The Minister may, by legal notice in the Gazette, set a limit lower than the EUR 150 million referred to in subregulations (2) and (3) and where the Minister does so, he shall ensure that the European Commission and the EBA are informed.

(5) A credit institution shall at all times comply with the limits laid down in sub-regulations (1) to (4) in respect of its exposures.

(6) If an exposure exceeds any limit specified in this regulation, that fact shall be reported without delay to the Commissioner who may, where circumstance warrant it, allow the credit institution a specified short period of time in which to comply with the limits, failing which he may use his powers of intervention under the Act.

(7) *omitted*

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(8) Where the amount of EUR 150 million referred to in sub-regulation (2) is applicable, the Commissioner may, on application, allow on a case-by-case basis the 100% limit in terms of the credit institution's own funds to be exceeded.

Use of credit protection.

65.(1) For the purposes of regulations 66 to 70, the term "guarantee" includes credit derivatives, other than credit linked notes, which are recognised under regulations 40 to 43.

(2) Subject to sub-regulation (3), where, under regulations 66 to 70 the use of funded or unfunded credit protection is permitted, this shall be subject to compliance with the eligibility requirements and other minimum requirements in regulations 40 to 43.

(3) Where a credit institution relies on regulation 67(4), the recognition of credit protection shall be subject to the requirements of regulations 34 to 39.

(4) A credit institution shall not take into account the collateral specified in paragraphs 20 to 22 of Part 1 of Schedule 8.

Exempted exposures.

66.(1) For the purposes of this regulation, "relevant bodies" means central governments, central banks, international organisations, multilateral development banks or public sector entities.

(2) The following exposures shall be exempt from the restrictions in regulation 64(1) to (4)–

(a) asset items constituting claims on central governments or central banks which if unsecured, receive a 0% risk weighting under regulations 28 to 33;

(b) asset items constituting claims on international organisations or multilateral development banks which if unsecured, receive a 0% risk weight under those regulations;

(c) asset items constituting claims carrying the explicit guarantees of relevant bodies, if unsecured claims on the entity providing the guarantee, receive a 0% risk weight under those regulations;

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(d) other exposures attributable to, or guaranteed by, relevant bodies, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed receive a 0% risk weight under those regulations;

(e) asset items constituting claims on EEA States' regional governments or local authorities where those claims would be assigned a 0% risk weight under regulations 28 to 33 and other exposures to or guaranteed by those regional governments or local authorities and claims on which would be assigned a 0% risk weight under those regulations;

(f) exposures to the counterparties referred to in regulation 30(10) to (12) if they would be assigned a 0% risk weight under regulations 28 to 33; exposures that do not meet those criteria, whether or not exempted from regulation 64(1) to (3), shall be treated as exposures to a third party;

(g) asset items and other exposures secured, to the satisfaction of the Commissioner, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending credit institution;

(h) asset items and other exposures secured, to the satisfaction of the Commissioner, by collateral in the form of certificates of deposit issued by the lending credit institution or by a credit institution which is the parent undertaking or a subsidiary of the lending credit institution and lodged with either of them;

(i) exposures arising from undrawn credit facilities which are classified as low-risk off-balance sheet items in Schedule 2 provided that an agreement has been concluded with the client or group of connected clients under which the facility may be drawn only if it has been ascertained that it will not cause the limit under regulation 64(1) to (3) to be exceeded;

(3) The following exposures shall be exempt from the application of regulation 64(1) to (3)−

(a) covered bonds falling within paragraphs 68 to 70 of Part 1 of Schedule 6;

(b) asset items constituting claims on EEA States' regional governments or local authorities where those claims would be assigned a 20% risk weight under regulations 28 to 33 and other exposures to or guaranteed by those regional

governments or local authorities, claims on which would be assigned a 20% risk weight under those regulations;

(c) notwithstanding sub-regulation (2)(f), exposures (including participations or other kinds of holdings) incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the consolidated supervision to which the credit institution itself is subject or with equivalent standards in force in non-EEA States; exposures that do not meet these criteria, whether or not exempted from regulation 64(1) to (3),shall be treated as exposures to a third party;

(d) asset items constituting claims on and other exposures (including participations or other kinds of holdings) to regional or central credit institutions with which a credit institution is associated in a network which are responsible, under those provisions, for cash-clearing operations within the network;

(e) asset items constituting claims on and other exposures to credit institutions incurred by credit institutions operating on a non-competitive basis, providing loans to promote specified sectors of the economy under some form of government oversight and restrictions on the use of the loans, provided that the respective exposures arise from such loans which are passed on to the beneficiaries via other credit institutions;

(f) asset items constituting claims on and other exposures to institutions, which do not constitute such institutions' own funds, do not last longer than the following business day and are not denominated in a major trading currency;

(g) asset items constituting claims on central banks in the form of required minimum reserves held at those central banks which are denominated in their national currencies;

(h) asset items constituting claims on central governments in the form of statutory liquidity requirements held in government securities which are denominated and funded in their national currencies provided that, at the discretion of the Commissioner, the credit assessment of those central governments assigned by a nominated external credit assessment institution is investment grade;

(i) 50% of medium to low risk off-balance-sheet documentary credits and of medium to low risk off-balance sheet undrawn credit facilities referred to in Schedule 2 and, subject to the

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Commissioner's agreement, 80% of guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions;

(j) statutorily required guarantees used when a mortgage loan financed by issuing mortgage bonds is paid to the mortgage borrower before the final registration of the mortgage in the land register, provided the guarantee is not used as reducing the risk in calculating the risk weighted assets.

Fully adjusted exposures.

67.(1) For the purposes of this regulation, "fully adjusted exposure value" means the value calculated under regulations 40 to 43 taking into account the credit risk mitigation, volatility adjustments, and any maturity mismatch.

(2) Subject top subregulation (9), for the purposes of calculating the value of exposures for the purposes of regulation 64(1) to (3), a credit institution may use the fully adjusted exposure value as calculated under regulations 40 to 43, taking into account the credit risk mitigation, volatility adjustments and any maturing mismatch (E*).

(3) Where sub-regulation (1) is applied to a credit institution, regulation 66(1)(f), (g), (h), and (o) shall not apply to that credit institution.

(4) Subject to sub-regulation (9), a credit institution which uses own estimates of loss given default and conversion factors for an exposure of the classes in regulations 34 to 39 shall be permitted, where it is able to estimate to the satisfaction of the Commissioner, the effects of financial collateral on its exposures separately from other loss given default relevant aspects, to recognise such effects in calculating the value of exposures for the purposes of regulation 64 (1) to (3).

(5) The estimates produced by a credit institution for the reduction of the exposure value for the purposes of compliance with the provisions of regulation 64 shall be to the satisfaction of the Commissioner.

(6) A credit institution which is permitted to use its own estimates of the effects of financial collateral, shall do so on a basis consistent with the approach adopted in the calculation of capital requirements.

(7) A credit institution which uses own estimates of loss given defaults and conversion factors for an exposure of a class in regulations 34 to 39 and which does not calculate the value of its exposures using the method in sub-regulation (4), may use the Financial Collateral Comprehensive Method or

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the approach in regulation 70(1)(b) for calculating the value of the exposures.

(8) A credit institution shall use only one of the methods in sub-regulation (6) or (7).

(9) A credit institution which is permitted to use the methods in sub-regulations (1) to (8) for calculating the value of exposures for the purposes of regulation 64(1) to (4) shall conduct periodic stress tests of their credit risk concentrations and of the realisable value of any collateral taken.

(10) The periodic tests in sub-regulation (9) shall address risks arising from potential changes in market conditions that could adversely impact on the credit institutions' adequacy of own funds and risks arising from the realisation of collateral in stressed situations.

(11) A credit institution shall satisfy the Commissioner that the stress tests carried in accordance with sub-regulation (9) are adequate and appropriate for the assessment of the risks specified therein.

(12) In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account when making use of the Financial Collateral Comprehensive Method or the method in sub-regulations (4) to (7) as appropriate, the value of the collateral permitted to be recognised in calculating the value of exposures for the purposes of regulation 64 (1) to (3) shall be reduced accordingly.

(13) A credit institution shall, for the purposes of this regulation, include the following in their strategies to address concentration risk–

(a) policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;

(b) policies and procedures in the event that a stress test indicates a lower realisable value of collateral than taken into account while making use of the Financial Collateral Comprehensive Method or the method described in sub-regulations (4) to (7);

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

Exposures to credit institutions etc.

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68(1) In this regulation “residential property” means a residence to be occupied or let by the owner.

(2) For the purpose of this Part, a credit institution may reduce its exposure value by up to 50% of the value of a residential property, if either of the following conditions is met−

(a) the exposure is secured by mortgages on residential property or by shares in Finnish residential housing companies operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation; or

(b) the exposure relates to a leasing transaction under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase.

(3) The value of the residential property shall be calculated, to the satisfaction of the Commissioner, at least once every three years on the basis of prudent statutory or administrative valuation standards.

(4) The requirements in paragraph 8 of Part 2 and in paragraphs 62 to 65 of Part 3 of Schedule 8 shall apply for the purpose of sub-regulations (1) to (3).

(5) A credit institution may reduce its exposure value by up to 50% of the value of a commercial property only if the competent authorities concerned in the EEA State where the commercial property is situated allow the following exposures to receive a 50% risk weight in accordance with regulations 28 to 33−

(a) exposures secured by mortgages on offices or other commercial premises, or 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; or

(b) exposures related to property leasing transactions concerning offices or other commercial premises.

(6) The value of the property shall be calculated, to the satisfaction of the Commissioner, on the basis of statutory or administrative prudent valuation standards.

(7) Commercial property shall be fully constructed, leased and shall produce appropriate rental income.

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69. *Omitted*

Exposures guaranteed by third parties etc.

70.(1) Where an exposure to a client is guaranteed by a third party, or secured by collateral issued by a third-party, a credit institution may–

(a) treat the portion of the exposure which is guaranteed as having been incurred to the guarantor rather than to the client if the unsecured exposure to the guarantor is assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client; or

(b) treat the portion of the exposure collateralised by the market value of a recognised collateral as having been incurred to the third party rather than to the client, if the exposure is secured by collateral if that collateralised portion of the exposure would be assigned an equal or lower risk weight than a risk weight of the unsecured exposure to the client.

(1A) The approach referred to in sub-regulation (1)(b) shall not be used by a credit institution where there is a mismatch between the maturity of the exposure and the maturity of the protection.

(1B) A credit institution may use both the Financial Collateral Comprehensive Method and the treatment provided for in sub-regulation (1)(b) only where it is permitted to use both the Financial Collateral Comprehensive Method and the Financial Collateral Simple Method.

(2) Where a credit institution applies sub-regulation 1(a) it shall do so subject to the following conditions–

(a) where the guarantee is denominated in a currency different from that in which the exposure is denominated, the amount of the exposure deemed to be covered shall be calculated in accordance with the provisions on the treatment of currency mismatch for unfunded credit protection in Schedule 8;

(b) a mismatch between the maturity of the exposure and the maturity of the protection shall be treated in accordance with the provisions on the treatment of maturity mismatch in that Schedule; and

(c) partial coverage maybe recognised in accordance with that Schedule.

Exposure on the non-trading book.

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71. The Commissioner may authorise a credit institution to exceed the limits laid down in regulations 64 to 70 if the following conditions are met–

(a) the exposure on the non-trading book to the client or group of clients shall not exceed the limit in regulation 64(1), calculated with reference to own funds in accordance with those regulations, so that the excess arises entirely on the trading book;

(b) the applicant meets an additional capital requirement on the excess in respect of the limits in regulation 64(1), calculated in accordance with Schedule 6 of the FSCAIF Regulations;

(c) where 10 days or less has elapsed since the excess occurred, the trading-book exposure to the client or group of connected clients shall not exceed 500% of the applicant's own funds;

(d) any excesses which have persisted for more than 10 days shall not, in aggregate, exceed 600% of the applicant's own funds; and

(e) the applicant shall report to the Commissioner every three months all cases where the limits laid down in regulation 64(1) have been exceeded during the preceding three months and the names of the clients concerned.

Control over exposures.

72.(1) The Commissioner shall establish procedures to prevent credit institutions from deliberately avoiding the additional capital requirements on exposures, exceeding the limits laid down in regulation 64(1), once those exposures have been maintained for more than 10 days–

(a) by means of temporarily transferring those exposures to another company, whether within the same group or not; or

(b) by undertaking artificial transactions to close out the exposure during the 10 day period and create a new exposure;

or both.

(2) A credit institution shall maintain systems to ensure that any transfer which has the effect referred to in sub-regulation (1) is immediately reported to the Commissioner.

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(3) The Commissioner may authorise a credit institution which is allowed to use the alternative determination of own funds under regulation 4(1) to use that determination for the purposes of regulations 62(3) to (5) and 71 provided that the applicant meets all of the obligations set out in regulations 63 to 70, in respect of the exposures which arise outside its trading book by using own funds.

Valuation of positions for reporting purposes.

73.(1) Trading book positions shall be subject to the prudent valuation rules in Part B of Schedule 7 of the FSCAIF Regulations.

(2) A credit institution shall ensure that the value applied to each of its trading book positions appropriately reflects the current market value and contains an appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness, the mode of operation and purpose of capital requirements in respect of trading book positions.

(3) Trading book positions shall be re-valued at least daily.

(4) The Commissioner may, in the absence of readily available market prices, waive the requirement imposed by this regulation and if so shall require the credit institution to use alternative methods of valuation approved by the Commissioner.

Reporting requirements.

74.(1) A credit institution shall provide the Commissioner with all the information necessary for the assessment of its compliance with these Regulations and shall maintain internal control mechanisms and administrative and accounting procedures which permit the verification of such compliance.

(2) A credit institution shall report to the Commissioner immediately any case in which its counter-parties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions, default on its obligations.

Allocation of risks within a group.

75. A credit institution shall take measures to ensure the satisfactory allocation of risks within the group where compliance on an individual or sub-consolidated basis with the obligations imposed in this Part is disapplied under regulation 17(1) or the provisions of regulation 18 are applied in the case of parent credit institutions in an EEA State.

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PART VIII

Qualifying holdings outside the financial sector

Obligation to have qualifying holdings.

76.(1) A credit institution shall not have an amount of qualifying holding which exceeds 15% of its own funds in an undertaking which is neither a credit or financial institution nor an undertaking carrying on an activity which is a direct extension of banking or concerning services ancillary to banking.

(2) The total amount of a credit institution's qualifying holdings in undertakings other than credit or financial institutions or undertakings carrying on an activity referred to in sub-regulation (1) shall not exceed 60% of its own funds.

(3) The limits laid down in sub-regulations (1) and (2) shall not be exceeded and any breach of the limits shall impose a requirement on the credit institution to either increase its own funds or take other equivalent measures to the satisfaction of the Commissioner.

Discounting of qualifying holdings.

77.(1) Shares held temporarily during a financial reconstruction or rescue operation or during the normal course of underwriting or in a credit institution's or investment firm's own name on behalf of others shall not be counted as qualifying holdings for the purpose of calculating the limits laid down in regulation 76(1) and (2).

(2) Shares which are not financial fixed assets as defined in sub-regulation (3) shall not be included as qualifying holdings for the purposes of sub-regulation (1).

(3) "Financial fixed assets", for the purposes of sub-regulation (2), shall in the case of a credit institution means participating interests, shares in affiliated undertakings and securities intended for use on a continuing basis in the normal course of its activities.

Dispensing with certain limits.

78.(1) The limits in regulation 76(1) and (2) shall not apply to holdings in insurance or reinsurance companies.

(2) The Commissioner need not apply the limits imposed by regulation 76(1) and (2) if the limits provide that 100% of the amounts by which a credit institution's qualifying holdings exceed those limits shall be covered

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by own funds and that the latter shall not be included in the calculation of the solvency ratio.

(3) If both the limits laid down in regulation 76(1) and (2) are exceeded, the amount to be covered by own funds shall be the greater of the excess amounts.

Exposures to transferred credit risk.

78A.(1) In this regulation–

"retention of net economic interest" means–

(a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to investors;

(b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;

(c) retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised, provided that the number of potentially securitised exposures is no less than 100 at the commencement; or

(d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures.

"ongoing basis" means that retained positions, interest or exposures are not hedged or sold.

(2) A credit institution (when not acting as an originator, a sponsor or original lender) shall be exposed to the credit risk of a securitisation position in its trading or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest of no less than 5%.

(3) For the purposes of sub-regulation (1), net economic interest shall–

(a) be measured at the commencement and shall be maintained on an ongoing basis;

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(b) not be subject to any credit risk mitigation or any short positions or any other hedge; and

(c) be determined by the notional value for off-balance sheet items.

(4) There shall be no multiple applications of the retention requirements for any given securitisation.

(5) Where a European parent credit institution, a European parent financial holding company or a European parent mixed financial holding company, or one of its subsidiaries–

(a) is an originator or a sponsor; and

(b) securitises exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of consolidated supervision,

it may satisfy the requirement referred to in sub-regulations (2) to (4) on the basis of the consolidated situation of the related European parent credit institution, European parent financial holding company or European parent mixed financial holding company.

(6) Sub-regulation (5) shall apply only where credit institutions, investment firms or financial institutions which created the securitised exposures have committed themselves to adhere to the requirements set out in sub-regulations (16) to (19) and deliver, in a timely manner, to the originator or sponsor and to the European parent credit institution, the European parent financial holding company or the European parent mixed financial holding company the information needed to satisfy the requirements in sub-regulations (20) to (22).

(7) Sub-regulations (2) to (4) shall not apply–

(a) where the securitised exposures are claims or contingent claims on or fully unconditionally and irrevocably guaranteed by–

(i) central governments or central banks;

(ii) regional governments, local authorities and public sector entities of EEA States;

(iii) institutions to which a 50% risk weight or less is assigned under regulations 28 to 33; or

(iv) multilateral development banks;

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(b) transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities which is widely traded, or are other tradable securities other than securitisation positions;

(c) syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package or hedge (or both) a securitisation that is covered by sub-regulations (2) to (4).

(8) A credit institution shall demonstrate, before investing, and as appropriate thereafter, to the Commissioner for each of its individual securitisation positions, that it has a comprehensive and thorough understanding of and have implemented formal policies and procedures appropriate to their trading and non-trading book and commensurate with the risk profile of its investments in securitised positions for analysing and recording–

(a) information disclosed under sub-regulations (2) to (4) by originators or sponsors to specify the net economic interest that they maintain, on an ongoing basis, in the securitisation;

(b) the risk characteristics of the individual securitisation position;

(c) the risk characteristics of the exposures underlying the securitisation position;

(d) the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;

(e) the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures;

(f) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer; and

(g) all the structural features of the securitisation that can materially impact on the performance of the credit institution's securitisation position.

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(9) A credit institution shall regularly perform its own stress tests appropriate to its securitisation positions and accordingly may rely on financial models developed by an external credit assessment institution if that credit institution can demonstrate, when requested, that it took due care prior to investing to validate the relevant assumptions in and structuring of the models and to understand methodology, assumptions and results.

(10) A credit institution (when not acting as an originator, sponsor or original lender) shall establish formal procedures appropriate to its trading and non-trading book and commensurate with the risk profile of its investments in securitised positions, to monitor on an ongoing basis and in a timely manner, performance information on the exposures underlying its securitisation positions.

(11) Where relevant, procedures under sub-regulation (10) shall include the exposure type, the percentage of loans which are more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with bandwidths which facilitate adequate sensitivity analysis.

(12) Where the underlying exposures are themselves securitisation positions, a credit institution shall have information not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitisation tranches.

(13) A credit institution shall have a thorough understanding of all structural features of a securitisation transaction which would materially impact the performance of its exposures to the transaction such as the contractual waterfall and waterfall related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definition of default.

(14) Where the requirements in sub-regulations (8), (9), (15) and (20) to (22) are not met in any material respect by reason of the negligence or omission of a credit institution, the Commissioner shall impose a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%) which would, but for this sub-regulation, apply to the relevant securitisation positions under Part 4 of Schedule 9 and shall progressively increase the risk weight with each subsequent infringement of the due diligence provisions.

(15) The Commissioner shall take into account the exemptions for certain securitisations provided in sub-regulation (7) by reducing the risk weight he

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would otherwise impose under this regulation in respect of a securitisation to which that sub-regulation applies.

(16) A sponsor and an originator credit institution shall apply the same sound and well-defined criteria for credit-granting in accordance with the requirements of paragraph 3 of Schedule 5 to exposures to be securitised as they apply to exposures to be held on their book.

(17) The same processes for approving and, where relevant, amending, renewing and re-financing credits shall be applied by the originator and the sponsor credit institution.

(18) A credit institution shall also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on its trading or non-trading book.

(19) Where the requirements referred to in sub-regulations (16) to (18) are not met, regulation 45(1) shall not be applied by an originator credit institution which shall not exclude the securitised exposures from the calculation of its capital requirements.

(20) A sponsor and an originator credit institution shall disclose to investors the level of their commitment under sub-regulations (2) to (4) to maintain a net economic interest in the securitisation.

(21) A sponsor and an originator credit institution shall ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure and such information as is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures.

(22) For the purposes of sub-regulations (20) and (21), materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter.

(23) Sub-regulations (2) to (22) shall apply to new securitisations issued on or after the entry into operation of these Regulations and shall, after 31 December 2014, apply to existing securitisations where new underlying exposures are added or substituted after that date.

(24) The Commissioner may suspend temporarily the requirements in sub-regulations (2) to (6) during periods of general market liquidity stress.

(25) The Commissioner shall publish the following information−

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(a) by no later than two weeks after the entry into operation of these Regulations, the general criteria and methodologies adopted to review the compliance with sub-regulations (2) to (22); and

(b) a summary of the outcome of the supervisory review and description of the measures imposed in cases of non-compliance with sub-regulations (2) to (22) identified on an annual basis from 31 December 2011.

(26) The requirement set out in sub-regulation (25) shall be subject to regulation 86.

PART IX

Credit institutions' assessment process

Assessment and maintenance of internal capital.

79.(1) A credit institution shall assess and maintain, on an ongoing basis, the amounts, types and distribution of internal capital which it considers adequate to cover the nature and level of the risks to which it is or might be exposed.

(2) Such assessments and maintenance procedures shall be subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the credit institution.

PART X

Supervision and disclosure

On-going supervision.

80.(1) The Commissioner shall review with such frequency as he sees fit, the arrangements, strategies, processes and mechanisms put in place by credit institutions as their compliance with these Regulations and evaluate the risks to which credit institutions are or might be exposed, taking into account the technical criteria set out in Schedule 11.

(2) The Commissioner shall determine whether the arrangements, strategies, processes and mechanisms put in place by a credit institutions and the credit institution's own funds are sufficient to ensure a sound management and coverage of its risks.

(2A) The Commissioner shall, in the exercise of his supervisory functions, consider the potential impact of his decisions on the stability of

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the financial system in any relevant EEA States, particularly in emergency situations, based on the information available at the time.

(3) The Commissioner shall establish the frequency and intensity of the review and evaluation in sub-regulations (1) and (2) having regard to the size, systemic importance, nature, scale and complexity of the activities of the credit institution and shall update that review and evaluation on an annual basis.

(4) The review and evaluation shall include the exposure of the credit institution to the interest rate risk arising from non-trading activities.

(5) A credit institution whose economic value declines by more than 20% of its own funds as a result of a sudden and unexpected change in interest rates shall take such remedial measures as the Commissioner may direct.

(6) This regulation applies to financial holding companies, mixed activities holding companies and mixed financial holding companies which have their head office in an EEA State.

Co-ordination between competent authorities.

81.(1) This regulation applies where the Commissioner is the European consolidating supervisor.

(2) The Commissioner shall take such steps, in an on-going concern and an emergency situation, as he considers appropriate–

(a) to coordinate the gathering and dissemination of relevant or essential information and information concerning intervention in such emergency situations;

(b) to plan and co-ordinate, in co-operation with the relevant competent authorities, supervisory activities and the activities in regulations 79, 80, 83, 87 to 90 and in Schedule 5;

(c) to plan and co-ordinate, in co-operation with the relevant competent authorities and central banks, supervisory activities and plans to deal with adverse developments in credit institutions or in financial markets and facilitating crisis management co-operation.

(2A) The planning and coordination referred to in sub-regulation (1)(c) shall include the imposition of measures (including the imposition of an additional capital charge under regulation 83 and the imposition of limitation on the use of the Advanced Measurement Approaches for the calculation of the own funds requirements under regulation 55), the

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preparation of joint assessments, the implementation of contingency plans and keeping the public informed.

(3) In the case of an application to the Commissioner under regulation 34(1), 37(8) or 55 or under Part 6 of Schedule 3, submitted by a European parent credit institution and its subsidiaries, or jointly by the subsidiaries of a European parent financial holding company or a European parent mixed financial holding company, the Commissioner shall fully consult, and cooperate with the competent authorities in EEA States that have authorised any subsidiaries in the determination of the application and whether the grant of the authorisation sought should be subject to any terms and conditions.

(4) An application under sub-regulation (3) shall be made in such manner at the Commissioner may direct and submitted to him and he shall forward a copy of the complete application to the relevant competent authorities without delay.

(5) The Commissioner and any other competent authorities involved under sub-regulations (2) and (3) shall reach a joint decision on the application within six months of the date of receipt of the complete application.

(6) The decision on the application shall be communicated to the applicant and the other competent authorities by the Commissioner and such communication shall include the views and reservations of the other competent authorities and a document containing the fully reasoned decision.

(7) In the absence of a joint decision between the competent authorities within six months of the date of receipt of an application, the Commissioner shall make his own determination of the application.

(8) The Commissioner shall take into consideration any views and reservations expressed by the competent authority of the relevant competent authorities during that period of time and provide the applicant and those authorities with a document containing the fully reasoned decision.

(9) Where the Commissioner has been forwarded a complete application by the European consolidating supervisor, he shall work together, in full consultation with the European consolidating supervisor and the relevant competent authorities, and do everything in his power to reach a joint decision within 6 months from the date on which the European consolidating supervisor received the complete application.

(9A) The Commissioner and the competent authorities supervising subsidiaries of a European parent credit institution, a European parent financial holding company or a European parent mixed financial holding

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company shall do everything within their power to reach a joint decision on the application of regulations 79 and 80 to determine the adequacy of the consolidated level of own funds held by the group with respect to its financial situation and risk profile and the required level of own funds for the application of regulation 83(2) to each entity within the banking group and on a consolidated basis.

(9B) The joint decision in sub-regulation (9A) shall be reached within four months after submission by the Commissioner of a report containing the risk assessment of the group in accordance with regulations 79 and 80 to the other competent authorities and shall duly consider the risk assessment of subsidiaries performed by those competent authorities.

(9C) The joint decision in sub-regulation (9A) shall be set out in a document with the reasoned decision which shall be provided to the parent credit institution by the Commissioner but in the event of any disagreement, the Commissioner shall of his own motion or at the request of any of the other competent authorities consult the European Banking Authority.

(9D) In the absence of a joint decision within four months, a decision on the application of regulations 79, 80 and 83(2) shall be taken on a consolidated basis by the Commissioner after duly considering the risk assessment of the subsidiaries performed by the relevant competent authorities.

(9E) The decision on the application of regulations 79, 80 and 83(2) shall be taken by the respective competent authorities responsible for the supervision of subsidiaries of European parent credit institutions, European parent financial holding companies or European parent mixed financial holding companies on an individual or sub-consolidated basis after consideration of the views and reservations of the Commissioner.

(9EA) If, at the conclusion of the four month period, any of the competent authorities has referred the matter to the EBA in accordance with Article 19 of EU Regulation No 1093/2010, the competent authorities shall defer their decision and await any decision that the EBA shall take in accordance with Article 19(3) of that Regulation, and shall take its decision in conformity with the decision of the EBA.

(9EB) The four month period referred to in sub-regulation (9EA) shall be deemed the conciliation period within the meaning of EU Regulation No 1093/2010.

(9EC) The matter shall not be referred to the EBA after the end of the four month period or after a joint decision has been reached.”

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(9F) The decision under sub-regulation (9E) shall be set out in a document with the reasoned decisions and shall take into account the risk assessment, views and reservations of the other competent authorities expressed during the four-month period and it shall be provided by the Commissioner to those competent authorities and to the parent credit institution.

(9G) Where the European Banking Authority has been consulted, the Commissioner shall consider such advice and explain to the Committee any significant deviation therefrom.

(9H) The joint decision and the decisions taken by the Commissioner in the absence of a joint decision shall be recognised as determinative and shall be applied by the Commissioner who shall forward copies of the decisions to the competent authorities concerned so that they too apply them.

(9I) The joint decision referred to in sub-regulation (9A) and any decision taken in the absence of a joint decision, shall be updated on an annual basis or, in exceptional circumstances, where a competent authority responsible for the supervision of subsidiaries of a European parent credit institution, a European parent financial holding company or a European parent mixed financial holding company makes a written and fully reasoned request to the Commissioner to update the decision on the application of regulation 83(2).

(9J) Any update under sub-regulation (9I) may be addressed on a bilateral basis between the Commissioner and the competent authority making the request.

(10) In this regulation, information shall be regarded as essential if it could materially influence the assessment of the financial soundness of a credit institution in an EEA State and shall include–

(a) identification of the legal structure and the governance and organisational structure of the group, including all regulated entities, non-regulated subsidiaries and significant branches belonging to the group, the parent undertakings, in accordance with section 23(2A) and 25(3) of the Act and Article 73(3) of the recast Directive, as well as identification of the competent authorities of the regulated entities in the group;

(b) *Revoked*

(c) the procedures for the collection and verification of information from credit institutions or investment firms in a group;

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(d) adverse developments in credit institutions or investment firms or in other entities of a group, which could seriously affect other credit institutions or investment firms of that group; and

(e) major sanctions and exceptional measures taken by the European consolidating supervisor or any of the relevant competent authorities.

(11) This regulation applies to financial holding companies, mixed activity holding companies and mixed financial holding companies which have their head office in an EEA State.

Duties as European consolidating supervisor.

82.(1) This regulation applies where the Commissioner is the European consolidating supervisor.

(2) The Commissioner shall alert, on becoming aware–

(a) central banks of the European System;

(b) other bodies with similar functions as monetary authorities; and

(c) central government administrations responsible for legislation on the supervision of financial entities,

to an emergency situation which has arisen, including one with adverse developments in financial markets which potentially jeopardises market liquidity and the stability of the financial system in Gibraltar and any EEA State and shall notify all essential information to facilitate their respective functions.

(3) Where the Commissioner needs information which has already been given to another competent authority in an EEA State, he shall, so far as it is possible obtain that information by requesting that the other competent authority which holds the information, discloses it to him.

(4) This regulation applies to financial holding companies, mixed activities holding companies and mixed financial holding companies which have their head office in an EEA State.

Close co-operation where a credit institution classified as significant.

82A.(1) The Commissioner may make a request to the European consolidating supervisor where regulation 81(2) and (2A) apply or to the

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competent authorities of the home EEA State, for a branch of a credit institution in Gibraltar to be considered as significant.

(2) A request under sub-regulation (1) shall provide reasons for considering the branch to be significant with regard to the following matters−

(a) whether the market share of that branch in terms of deposits exceeds 2% in Gibraltar;

(b) the likely impact of a suspension or closure of the credit institution's operations on market liquidity and the payment, clearing and settlement systems in Gibraltar; and

(c) the size and the importance of the branch in terms of number of clients within the context of the banking or financial system of Gibraltar.

(3) The Commissioner and the competent authority of the home EEA State, and the European consolidating supervisor where regulation 81(2) and (2A) apply, shall do everything within their power to reach a joint decision on the designation of a branch as being significant.

(4) If no joint decision is reached within two months of the Commissioner making a request under sub-regulation (1), the Commissioner may take a decision within a further period of two months on whether the branch is significant taking into account any views and reservations expressed by the supervisor or the competent authority of the home EEA State.

(5) A decision, under sub-regulations (3) or (4) shall be set out in a document containing the fully reasoned decision which shall be determinative and shall be applied by the Commissioner who shall forward copies of the document to the competent authorities concerned so that they too apply the decision.

(6) Where a Gibraltar credit institution has a significant branch in an EEA State, the Commissioner shall communicate to the competent authority of the host EEA State information on any adverse developments in the credit institution or in other entities within its group which could seriously affect the credit institution and carry out the tasks referred to in regulation 81(1)(c) in co-operation with that competent authority .

(7) Where the Commissioner becomes aware of an emergency situation affecting a credit institution as specified in regulation 82(2), he shall alert as soon as practicable the authorities referred to in the fourth paragraph of

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article 49 and article 50 of the recast Directive as copied in Schedule 3 of the Act.

(8) Where the Commissioner is supervising a credit institution with significant branches in EEA States he shall establish and chair a college of supervisors to facilitate the co-operation envisaged under this regulation and article 42 of the recast Directive as copied in Schedule 3 of the Act and regulation 14 of the Financial Services (Consolidated Supervision of Credit Institutions) Regulations.

(9) The decision of the Commissioner State shall take account of the relevance of the supervisory activity to be planned or coordinated for the other competent authorities, in particular the potential impact on the stability of the financial system in the Member States concerned referred to in regulation 80 and the obligations under in sub-regulations (6) and (7).

(10) The Commissioner shall−

(a) keep all members of the college fully informed, in advance, of the organisation of such meetings, the main issues to be discussed and the activities to be considered; and

(b) keep all the members of the college fully informed, in a timely manner, of the actions taken in those meetings or the measures carried out.

(11) The designation of a branch as being significant under this regulation shall not affect the rights and responsibilities of the Commissioner under the Act, these Regulations and any other subsidiary legislation made under the Act.

Supervisory tools and practices.

82B.(1) The Commissioner shall be required to−

(a) participate in the activities of the European Banking Authority; and

(b) follow the guidelines, recommendations, standards and other measures agreed by that Committee and shall give them his reasons for not doing so.

(2) Nothing in the Act, these Regulations or any other subsidiary legislation made under the Act shall inhibit the performance of the Commissioner of his duties as a member of the European Banking Authority or under the recast Directive.

Powers of intervention.

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83.(1) The Commissioner may by order direct a credit institution which does not meet the requirements of these Regulations to take such remedial action and within such period of time as he may so direct.

(2) An order under sub-regulation (1) may–

(a) impose a requirement for the holding of own funds in excess of the minimum level laid down in regulation 23;

(b) require a reinforcement of the arrangements, processes, mechanisms and strategies implemented by the credit institution to comply with regulation 79;

(c) require the introduction of a specific policy or treatment of assets in terms of own funds requirements;

(d) restrict or limit the business activities, products or systems of the credit institution;

(e) require a reduction of the risk inherent in such activities, products and systems;

(f) requiring credit institutions to limit variable remuneration as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base;

(g) requiring credit institutions to use net profits to strengthen the capital base.

(3) The Commissioner may by order impose a specific own funds requirement in excess of the minimum level laid down in regulation 23 on a credit institution–

(a) which does not meet the requirements of regulations 59 and 79; or

(b) in respect of which a negative determination has been made under regulation 80(2);

if the application of other measures under this regulation is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within the period of time he had previously imposed.

(3A) For the purposes of determining the appropriate level of own funds on the basis of the review and evaluation carried out in accordance with regulation 80, the competent authority shall assess whether any imposition

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of a specific own funds requirement in excess of the minimum level is required to capture risks to which a credit institution is or might be exposed, taking into account the following–

(a) the quantitative and qualitative aspects of the credit institutions' assessment process referred to in regulation 79;

(b) the credit institutions' arrangements, processes and mechanisms referred to in section 23(3)(cc)(iii) of the the Financial Services (Banking) Act;

(c) the outcome of the review and evaluation carried out in accordance with regulation 80.

(4) This regulation applies to financial holding companies, mixed activity holding companies and mixed financial holding companies which have their head office in an EEA State.

Supervision.

84.(1) Where a European parent financial holding company has as subsidiary both a credit institution and an investment firm, regulations 80 to 83 and 86 shall apply to its supervision.

(2) The requirements set out in regulation 81(2) shall apply to the recognition of internal models of credit institutions under Schedule 5 of the FSCAIF Regulations where the application is submitted–

(a) by a European parent credit institution and its subsidiaries;

(b) a European parent investment firm and its subsidiaries; or

(c) jointly by the subsidiaries of a European parent financial holding company.

Cooperation with other authorities.

85.(1) The Commissioner shall on request supply the competent authorities of EEA States with all information likely to facilitate the supervision of the capital adequacy of credit institutions, in particular the verification of their compliance with the rules laid down in the recast Directive.

(2) Any exchange of information between competent authorities which is provided for in the recast Directive in respect of credit institutions shall be subject to the obligations of professional secrecy imposed by the Act.

Disclosure to competent authorities.

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86. The Commissioner, when requested to do so by a competent authority in an EEA State, shall provide it with the following information–

(a) the texts of laws, regulations, administrative rules and general guidance adopted in Gibraltar in the field of capital requirements of credit institutions;

(b) the manner in which the options and discretions available to him in such legislation is exercised;

(c) the general criteria and methodologies used in the review and evaluation referred to in regulation 80;

(d) the aggregate statistical data on key aspects of the implementation of the prudential framework in Gibraltar;

in order to assist that competent authority establish a comparison of the approaches adopted by the competent authorities of the different EEA States.

Obligation to make certain information public.

87.(1) Subject to regulation 88, a credit institution shall make public at least at annual intervals the information required by Part 2 of Schedule 12.

(2) Recognition by the Commissioner under regulations 34 to 43 and 55 of the instruments and methodologies referred to in Part 3 of Schedule 12, shall be subject to a credit institution making public the information therein.

(2A) The Commissioner shall use the information obtained from credit institutions under paragraph 15(f) of Part 2 of Schedule 12 to benchmark remuneration trends and practices and shall notify that information to the European Banking Supervisors.

(3) Every credit institution shall–

(a) adopt a formal policy to comply with the disclosure requirements laid down in subregulations (1) and (2); and

(b) have policies for assessing–

(i) the appropriateness of its disclosures, including verification and frequency, and

(ii) whether their disclosures convey their risk profile comprehensively to market participants.

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(3A) Where the disclosures referred to in subregulation (3) do not convey the risk profile comprehensively to market participants, the credit institution shall publicly disclose the information necessary in addition to that required in accordance with subregulation (1).

(3B) The credit institution shall only be required to disclose information under subregulation (3A) which is material and not proprietary or confidential in accordance with the technical criteria set out in Part 1 of Schedule 12.

(4) A credit institution shall, if requested to do so, explain its rating decisions to small and medium sized enterprises and other corporate applicants for loans.

(5) The administrative costs of the explanation shall be at an appropriate rate to the size of the loan.

(6) A credit institution shall disclose publicly, at the level of the banking group, on an annual basis, either in full or by way of references to equivalent information, a description of their legal structure, and their governance and organisational structure.

Dispensation from publication of certain information.

88.(1) Notwithstanding regulation 87, a credit institution may dispense with the disclosure of–

(a) any matter in Part 2 of Schedule 12 if the information so provided is not, in the light of the criterion specified in paragraph 1 of that Part, regarded as material; or

(b) any matter in Parts 2 and 3 of Schedule 12, if those items include information which, in the light of the criteria in paragraphs 2 and 3 of Part 1 of that Schedule, is regarded as proprietary or confidential.

(2) A credit institution shall state in its disclosures the fact that specific items of information, if any, are not disclosed in pursuance of the option in sub-regulation (1)(b), the reason for non-disclosure and it shall publish more general information on the disclosure requirement, except where that information is classified information under the criteria set out in paragraphs 2 and 3 of Part 1 of Schedule 12.

Method of disclosure.

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89.(1) A credit institutions shall determine the appropriate medium, location and means of compliance with the disclosure requirements in regulation 87.

(2) Equivalent disclosures made by a credit institution under accounting, listing or other requirements may be deemed to constitute compliance with this regulation.

(3) If disclosures are not included in the financial statements, a credit institution shall indicate in a manner available to the public, where and when information can be obtained.

Instructions to publish information.

90. Notwithstanding regulations 88 to 89, the Commissioner may require a credit institution to−

(a) make one or more of the disclosures referred to in Parts 2 and 3 of Schedule 12;

(b) publish one or more disclosures more frequently than annually;

(c) use specific media and locations for disclosures other than the credit institution's financial statements;

(d) use specific means of verification for the disclosures not covered by statutory audit;

and he may set such deadlines for publication as he may think fit.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

SCHEDULE 1

Regulation 2(3)

TRANSITIONAL PROVISIONS

1. The transitional provisions in paragraphs 2 to 6 shall apply.

2.(1) A credit institution which calculates risk-weighted exposure amounts in accordance with regulations 34 to 39 shall during three consecutive years after 31 December 2006 provide own funds which are at all times at least equal to the amounts indicated in sub-regulations (3) to (5).

(2) A credit institution which uses the advanced measurement approaches in accordance with regulation 55 for the calculation of its capital requirements for operational risk shall, during the years 2008 and 2009, provide own funds which are at all times at least equal to the amounts in sub-regulations (4) and (5).

(3) For the year 2007, the amount of own funds shall be 95% of the total minimum amount of own funds that would be required to be held during that period by the credit institution under Article 4 of Directive 93/6/EEC as that Directive and Directive 2000/12/EC stood prior to 1 January 2007.

(4) For the year 2008, the amount of own funds shall be 90% of the total minimum amount of own funds that would be required to be held during that period by the credit institution under Article 4 of Directive 93/6/EEC as that Directive and Directive 2000/12/EC stood prior to 1 January 2007.

(5) For the year 2009, the amount of own funds shall be 80% of the total minimum amount of own funds that would be required to be held during that period by the credit institution under Article 4 of Directive 93/6/EEC as that Directive and Directive 2000/12/EC stood prior to 1 January 2007.

(5A) Every credit institution calculating risk-weighted exposure amounts in accordance with regulations 34 to 39 shall, until 31 December 2011, provide own funds which are at all times more than or equal to the amount indicated in subparagraph (5C) or (5D) if applicable.

(5B) Every credit institution using the Advanced Measurement Approaches as specified in regulation 55 for the calculation of its capital requirements for operational risk shall, until 31 December 2011, provide own funds which are at all times more than or equal to the amount indicated in subparagraph (5C) or (5D) if applicable.

(5C) The amount referred to in subparagraphs (5A) and (5B) shall be 80 % of the total minimum amount of own funds that the credit institutions would be required to hold under Article 4 of the Capital Adequacy Directive

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and the Financial Services (Consolidated Supervision of Credit Institutions) Regulations 2007, as applicable prior to 1 January 2007;

(5D) Subject to the approval of the competent authority, for credit institutions referred to in subparagraph (5E), the amount referred to in subparagraphs (5A) and (5B) may amount to up to 80 % of the total minimum amount of own funds that those credit institutions would be required to hold under any of regulations 28 to 33, 53 or 54 and the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007, as applicable prior to 1 January 2011.

(5E) A credit institution may apply subparagraph (5D) only if it started to use the IRB Approach or the Advanced Measurement Approaches for the calculation of its capital requirements on or after 1 January 2010.

(6) Compliance with the requirements of sub-regulations (1) to (5) shall be on the basis of amounts of own funds fully adjusted to reflect differences in the calculation of own funds under Directive 2000/12/EC and Directive 93/6/EEC as those Directives stood prior to 1 January 2007 and the calculation of own funds under these Regulations deriving from the separate treatments of expected loss and unexpected loss under regulations 34 to 39.

(7) For the purposes of sub-regulations (1) to (6), regulations 16 to 21 shall apply.

(8) Until 1 January 2008 a credit institution may continue to apply the standardised approach set out in regulations 24 and 28 to 33 as being replaced by Articles 42 to 46 of Directive 2000/12/EC as those articles stood prior to 1 January 2007.

(9) Where the discretion referred to in sub-regulation (8) is exercised by a credit institution the following shall apply concerning the provisions of Directive 2000/12/EC–

(a) the provisions of that Directive referred to in Articles 42 to 46 shall apply as they stood prior to 1 January 2007;

(b) ‘risk-adjusted value’ as referred to in Article 42(1) of that Directive shall mean ‘risk-weighted exposure amount’;

(c) the figures produced by Article 42(2) of that Directive shall be considered risk-weighted exposure amounts;

(d) ‘credit derivatives’ shall be included in the list of ‘full risk’ items in Schedule 2 of that Directive;

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the treatment set out in Article 43(3) of that Directive shall apply to derivative instruments listed in Schedule 4 of that Directive whether on- or off-balance sheet and the figures produced by the treatment set out in Schedule 2I shall be considered risk-weighted exposure amounts.

(10) Where the discretion referred to in sub-regulation (8) is exercised by a credit institution the following shall apply until 1 January 2008 in relation to the treatment of exposures for which the standardised approach is used–

(a) regulations 40 to 43 relating to the recognition of credit risk mitigation shall not apply;

(b) the Commissioner may waive the application of regulations 44 to 51 concerning the treatment of securitisation.

(11) Where the discretion referred to in sub-regulation (8) is exercised by a credit institution the capital requirement for operational risk under regulation 23(d) shall until 1 January 2008 be reduced by the percentage representing the ratio of the value of the credit institution's exposures for which risk-weighted exposure amounts are calculated in accordance with the discretion in sub-regulation (8) to the total value of its exposures.

(12) Where a credit institution calculates risk-weighted exposure amounts for all of its exposures in accordance with the discretion referred to in sub-regulation (8), Articles 48 to 50 of Directive 2000/12/EC relating to large exposures may apply as they stood prior to 1 January 2007.

(13) Where the discretion referred to in sub-regulation (8) is exercised, references to regulation 28 to 33 shall be read as references to Articles 42 to 46 of Directive 2000/12/EC as those articles stood prior to 1 January 2007.

(14) If the discretion referred to in sub-regulation (8) is exercised, regulations 79, 80, 87 and 90 shall not apply before the date referred to therein.

3.(1) In the calculation of risk-weighted exposure amounts for exposures arising from property leasing transactions concerning offices or other commercial premises situated in Gibraltar and meeting the criteria set out in paragraph 54 of Part 1 of Schedule 6, the Commissioner may, on application, until 31 December 2015 allow a 50% risk weighting to be applied without the application of paragraphs 55 and 56 of that Part.

(2) Until 31 December 2010, the Commissioner may, for the purpose of defining the secured portion of a past due loan for the purposes of Schedule 6, recognise collateral other than eligible collateral in regulations 40 to 43.

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(3) In the calculation of risk weighted exposure amounts for the purposes of paragraph 4 of Part 1 of Schedule 6, until 31 December 2012 the same risk weighting shall be applied in relation to exposures to EEA States' central governments or central banks denominated and funded in the domestic currency of any EEA State as would be applied to such exposures denominated and funded in sterling.

4.(1) Until 31 December 2011, the Commissioner may, for the purposes of paragraph 61 of Part 1 of Schedule 6, set the number of days past due up to a maximum 180 days for those exposures indicated in paragraphs 12 to 17 and 41 to 43 of that Part if local conditions make it appropriate.

(2) Sub-regulation (1) is dependent on conditions at the time the Commissioner exercises his discretion and he need not set the same number of days for all exposure classes.

(3) If the Commissioner does not exercise the discretion provided for in sub-regulation (1) in relation to exposures in Gibraltar, he may set a higher number of days for exposures to counterparts situated in the territories of EEA States if the competent authorities of which have exercised that discretion.

(4) The number of days in sub-regulation (3) shall fall within 90 days and such figures as the other competent authorities have set for exposures to such counter parties within their territory.

(5) A credit institution which applies for the use of the internal rating based approach before 1 January 2010, may apply to the Commissioner, for the three years' use requirement prescribed in regulation 34(3) to be reduced to a period not shorter than one year until 31 December 2009.

(6) A credit institution which uses own estimates of loss given defaults or conversion factors, the three year use requirement prescribed in regulation 34(4) may be reduced to two years until 31 December 2008.

(7) The Commissioner may allow a credit institution to continue to apply until 31 December 2012, to participations of the type set out in regulation 7(o) acquired before 20 July 2006, the treatment set out in Article 38 of Directive 2000/12/ECas that Article stood prior to 1 January 2007.

(8) Until 31 December 2012, the exposure weighted average LGD for all retail exposures secured by residential properties and not benefiting from guarantees from central governments shall not be lower than 10 %.

(9) The Commissioner may grant exemption from the internal rating based treatment until 31 December 2017, such equity exposures as he may

determine which are held by a credit institution and European subsidiaries of a credit institution in Gibraltar on 31 December 2007.

(10) The exempted position shall be measured as the number of shares as of 31 December 2007 and any additional arising directly as a result of owning those holdings, as long as they shall not increase the proportional share of ownership in a portfolio company.

(11) If an acquisition increases the proportional share of ownership in a specific holding the exceeding part of the holding shall not be subject to the exemption.

(12) The exemption shall not apply to holdings that were originally subject to the exemption, but have been sold and then bought back.

(13) Equity exposures covered by this transitional provision shall be subject to the capital requirements calculated in accordance with regulation 28 to 33.

(14) The Commissioner may, for corporate exposures until 31 December 2011, set the number of days past due that all credit institutions shall abide by under the definition of default set out in paragraph 44 of Part 4 of Schedule 7, for exposures to such counterparts situated within Gibraltar.

(15) The specific number shall fall between 90 and 180 days if local conditions make it appropriate.

(16) For exposures to such counterparts situated in the territories of EEA States, the Commissioner shall set a number of days past due which is not higher than the number set by the competent authority of the respective EEA State.

5.(1) Until 31 December 2012, a credit institution whose indicator for the trading and sales activities represents 50% of the total indicators for all of its activities in accordance with paragraphs 1 to 4 of Part 2 of Schedule 10, may reduce the percentage to 15%.

6.(1) Credit institutions which do not comply with the limits set out in regulation 15(1)(a) shall introduce strategies and processes on the necessary measures to resolve the situation before the dates set out in sub-paragraph (2) below.

(2) Instruments that by 31 December 2010, were deemed equivalent to the items in regulation 7(1)(a), (b) and (c) but which do not fall within regulation 7(1)(a) or do not comply with the criteria set out in regulation 12A, shall be deemed to fall within regulation 7(1)(ca) until 31 December 2040, subject to the following limitations−

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(a) up to 20% of the sum of regulation 7(1)(a) to (ca), less the sum of regulation 7(1) (h), (i) an d (j) of between 10 and 20 years after 31 December 2010;

(b) up to 10% of the sum of regulation 7(1)(a) to (ca), less the sum of regulation 7(1)(h) (i), and (j) between 20 and 30 years after 31 December 2010.

(3) For the purpose of Part VII, asset items constituting claims on and other exposures to institutions incurred prior to 31 December 2009 shall continue to be subject to the same treatment as applied in accordance with regulations 68(5) and 69 as they stood prior to 7 December 2009 but only until 31 December 2012.

(4) Until 31 December 2012, the time period referred to in regulations 9B, 9D and 9F shall be six months.

7.(1) A credit institution which calculates risk-weighted exposure amounts in accordance with regulations 34 to 39 shall until 31 December 2011 provide own funds which are at all times more than or equal to the amount indicated in sub-paragraph (3) or (4) if applicable.

(2) A credit institutions which uses the Advanced Measurement Approaches as specified in regulation 55 for the calculation of its capital requirements for operational risk shall until 31 December 2011 provide own funds which are at all times more than or equal to the amount indicated in sub-paragraph (3) or (4) if applicable.

(3) The amount referred to in sub-paragraphs (1) and (2) shall be 80% of the total minimum amount of own funds which the credit institutions would be required to hold under article 4 of Directive 93/6/EEC and Directive 2000/12/EC, as applicable prior to 1 January 2007.

(4) Subject to the Commissioner's approval, for a credit institution referred to in sub-paragraph (5), the amount referred to in sub-paragraphs (1) and (2) may amount to up to 80% of the total minimum amount of own funds that that credit institution would be required to hold under any of regulations 28 to 33, 53 or 54 and Directive 2006/49/EC, as applicable prior to 1 January 2011.

(5) A credit institution may apply sub-paragraph (4) only if it started to use the IRB Approach or the Advanced Measurement Approaches for the calculation of its capital requirements on or after 1 January 2010.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

SCHEDULE 2

Regulations 26(1), 28 and 66(2)

CLASSIFICATION OF OFF-BALANCE SHEET ITEMS

Full risk-

— Guarantees having the character of credit substitutes,

— Credit derivatives,

— Acceptances,

— 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 deposits,

— The unpaid portion of partly-paid shares and securities,

— Asset sale and repurchase agreements as defined in Article 12(3) and (5) of Directive 86/635/EEC, and

— Other items also carrying full risk.

Medium risk-

— Documentary credits issued and confirmed (see also ‘Medium to 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, and

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— Note issuance facilities and revolving underwriting facilities.

Medium to low risk-

— Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions, and

— 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 unconditionally at any time without notice or that do not effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.

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

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007
SCHEDULE 3

Regulations 26(1), 28 and 57(2)

THE TREATMENT OF COUNTER PARTY RISK OF DERIVATIVE INSTRUMENTS, REPURCHASE TRANSACTIONS, SECURITIES OR COMMODITIES LENDING OR BORROWING TRANSACTIONS, LONG SETTLEMENT TRANSACTIONS AND MARGIN LENDING TRANSACTIONS

PART 1

Definitions.

For the purposes of this Schedule the following definitions shall apply-

General terms.

1. “Counter party Credit Risk (CCR)” means the risk that the counter party to a transaction could default before the final settlement of the transaction’s cash flows.

2. “Central counter party” means an entity that legally interposes itself between counter parties to contracts traded within one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

Transaction types.

3. “Long Settlement Transactions” means transactions where a counter party undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date that is contractually specified as more than the lower of the market standard for this particular transaction and five business days after the date on which the credit institution enters into the transaction.

4. “Margin Lending Transactions” means transactions in which a credit institution extends credit in connection with the purchase, sale, carrying or trading of securities. Margin lending transactions do not include other loans that happen to be secured by securities collateral.

Netting sets, hedging sets, and related terms.

5. “Netting Set” means a group of transactions with a single counter party that are subject to a legally enforceable bilateral netting arrangement and for which netting is recognised under Part 7 of this Schedule and regulations 41

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to 43. Each transaction that is not subject to a legally enforceable bilateral netting arrangement, which is recognised under Part 7 of this Schedule, shall be interpreted as its own netting set for the purpose of this Schedule.

5A. Under the method in Part 6 of this Schedule (IMM), all netting sets with a single counterparty may be treated as single netting set if negative simulated market values of the individual netting sets are set to 0 in the estimation of expected exposure (EE).

6. “Risk Position” means a risk number that is assigned to a transaction under the standardised method set out in Part 5 following a predetermined algorithm.

7. “Hedging Set” means a group of risk positions from the transactions within a single netting set for which only their balance is relevant for determining the exposure value under the standardised method set out in Part 5.

8. “Margin Agreement” means a contractual agreement or provisions of an agreement under which one counter party shall supply collateral to a second counter party when an exposure of that second counter party to the first counter party exceeds a specified level.

9. “Margin Threshold” means the largest amount of an exposure that remains outstanding until one party has the right to call for collateral.

10. “Margin Period of Risk” means the time period from the last exchange of collateral covering a netting set of transactions with a defaulting counterpart until that counterpart is closed out and the resulting market risk is re-hedged.

11. “Effective Maturity under the Internal Model Method, for a netting set with maturity greater than one year” means the ratio of the sum of expected exposure over the life of the transactions in the netting set discounted at the risk-free rate of return divided by the sum of expected exposure over one year in a netting set discounted at the risk-free rate. This effective maturity may be adjusted to reflect rollover risk by replacing expected exposure with effective expected exposure for forecasting horizons under one year.

12. “Cross-Product Netting” means the inclusion of transactions of different product categories within the same netting set pursuant to the Cross-Product Netting rules set out in this Schedule.

13. For the purposes of Part 5, ”Current Market Value (CMV)” refers to the net market value of the portfolio of transactions within the netting set with the counter party. Both positive and negative market values are used in computing CMV.

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Distributions.

14. “Distribution of Market Values” means the forecast of the probability distribution of net market values of transactions within a netting set for some future date (the forecasting horizon), given the realised market value of those transactions up to the present time.

15. “Distribution of Exposures” means the forecast of the probability distribution of market values that is generated by setting forecast instances of negative net market values equal to zero.

16. “Risk Neutral Distribution” means a distribution of market values or exposures at a future time period where the distribution is calculated using market implied values such as implied volatilities.

17. “Actual Distribution” means a distribution of market values or exposures at a future time period where the distribution is calculated using historic or realised values such as volatilities calculated using past price or rate changes.

Exposure measures and adjustments.

18. “Current Exposure” means the larger of zero or the market value of a transaction or portfolio of transactions within a netting set with a counter party which would be lost upon the default of the counter party, assuming no recovery on the value of those transactions in bankruptcy.

19. “Peak Exposure” means a high percentile of the distribution of exposures at any particular future date before the maturity date of the longest transaction in the netting set.

20. “Expected Exposure (EE)” means the average of the distribution of exposures at any particular future date before the longest maturity transaction in the netting set matures.

21. “Effective Expected Exposure (Effective EE) at a specific date” means the maximum expected exposure that occurs at that date or any prior date. Alternatively, it may be defined for a specific date as the greater of the expected exposure at that date, or the effective exposure at the previous date.

22. “Expected Positive Exposure (EPE)” means the weighted average over time of expected exposures where the weights are the proportion that an individual expected exposure represents of the entire time interval. When calculating the minimum capital requirement, the average is taken over the first year or, if all the contracts within the netting set mature within less than

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one year, over the time period of the longest maturity contract in the netting set.

23. "Effective Expected Positive Exposure (Effective EPE)" means the weighted average over time of effective expected exposure over the first year, or, if all the contracts within the netting set mature within less than one year, over the time period of the longest maturity contract in the netting set, where the weights are the proportion that an individual expected exposure represents of the entire time interval.

24. "Credit Valuation Adjustment" means an adjustment to the mid-market valuation of the portfolio of transactions with a counter party. This adjustment reflects the market value of the credit risk due to any failure to perform on contractual agreements with a counter party. This adjustment may reflect the market value of the credit risk of the counter party or the market value of the credit risk of both the credit institution and the counter party.

25. "One-Sided Credit Valuation Adjustment" means a credit valuation adjustment which reflects the market value of the credit risk of the counter party to the credit institution, but does not reflect the market value of the credit risk of the credit institution to the counter party.

CCR related risks.

26. "Rollover Risk" means the amount by which expected positive exposure is understated when future transactions with a counterpart are expected to be conducted on an ongoing basis. The additional exposure generated by those future transactions is not included in calculation of EPE.

27. "General Wrong Way Risk" arises when the PD of counter parties is positively correlated with general market risk factors.

28. "Specific Wrong Way Risk" arises when the exposure to a particular counter party is positively correlated with the PD of the counter party due to the nature of the transactions with the counter party. A credit institution shall be considered to be exposed to Specific Wrong Way Risk if the future exposure to a specific counter party is expected to be high when the counter party's PD is also high.

PART 2

Choice of the method.

1. Subject to paragraphs 2 to 7, credit institutions shall determine the exposure value for the contracts listed in Schedule 4 with one of the methods set out in Parts 3 to 6. Credit institutions which are not eligible for

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the treatment set out in regulation 14(2) of the FSCAIF Regulations shall not be permitted to use the method set out in Part 4. To determine the exposure value for the contracts listed in paragraph 3 of Schedule 4, credit institutions shall not be permitted to use the method set out in Part 4.

The combined use of the methods set out in Parts 3 to 6 shall be permitted on a permanent basis within a group, but not within a single legal entity. Combined use of the methods set out in Parts 3 and 5 within a legal entity shall be permitted where one of the methods is used for the cases set out in Part 5, paragraph 19.

2. Subject to the approval of the Commissioner, credit institutions may determine the exposure value for–

(i) the contracts listed in Schedule 4,

(ii) repurchase transactions,

(iii) securities or commodities lending or borrowing transactions,

(iv) margin lending transactions, and

(v) long settlement transactions using the Internal Model Method as set out in Part 6.

3. When a credit institution purchases credit derivative protection against a non-trading book exposure, or against a CCR exposure, it may compute its capital requirement for the hedged asset in accordance with paragraphs 83 to 92 of Part 3 of Schedule 8, or subject to the approval of the Commissioner, in accordance with paragraph 4 of Part 1 or paragraphs 96 to 104 of Part 4 of Schedule 7. In these cases, the exposure value for CCR for these credit derivatives shall be set to zero.

3A. The exposure value for CCR for the credit derivatives under paragraph 3 is set to zero where the option in paragraph 11 of Schedule 2 of the FSCAIF Regulations is not applied but an institution may choose consistently to include for calculating capital requirements for counterparty credit risk all credit derivatives not included in the trading book and purchased as protection against a non-trading book exposure or against a CCR exposure where the credit protection is in keeping with these Regulations.

4. The exposure value for CCR from sold credit default swaps in the non-trading book, where they are treated as credit protection provided by the credit institution and subject to a capital requirement for credit risk for the full notional amount, shall be set to zero.

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5. Under all methods set out in Parts 3 to 6, the exposure value for a given counter party is equal to the sum of the exposure values calculated for each netting set with that counter party.

6. An exposure value of zero for CCR can be attributed to derivative contracts, or repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions outstanding with a central counter party and that have not been rejected by the central counter party. Furthermore, an exposure value of zero can be attributed to credit risk exposures to central counter parties that result from the derivative contracts, repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions or other exposures, as determined by the Commissioner, that the credit institution has outstanding with the central counter party. The central counter party CCR exposures with all participants in its arrangements shall be fully collateralised on a daily basis.

7. Exposures arising from long settlement transactions can be determined using any of the methods set out in Parts 3 to 6, regardless of the methods chosen for treating OTC derivatives and repurchase transactions, securities or commodities lending or borrowing transactions, and margin lending transactions. In calculating capital requirements for long settlement transactions, credit institutions which use the approach set out in Articles 84 to 89 may assign the risk weights under the approach set out in regulations 28 to 33 on a permanent basis and irrespective of the materiality of such positions.

8. For the methods set out in Parts 3 and 4 the Commissioner shall ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where the contract provides for a multiplication of cash flows, the notional amount shall be adjusted in order to take into account the effects of the multiplication on the risk structure of that contract.

PART 3

Mark-to-Market Method.

Step (a)- by attaching current market values to contracts (mark to market), the current replacement cost of all contracts with positive values is obtained.

Step (b)- to obtain a figure for potential future credit exposure, except in the case of single currency “floating/floating” interest rate swaps in which only the current replacement cost shall be calculated, the notional principal amounts or underlying values are multiplied by the percentages in Table 1-

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

Table 1 (1)(2)

Residual maturity[3]	Interest-rate contracts	Contracts concerning foreign exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities other than precious metals
One year or Less	0 %	1%	6%	7%	10%
Over one year, not exceeding five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

In the case of interest-rate contracts that meet these criteria and have a remaining maturity of over one year, the percentage shall be no lower than 0,5 %.

For the purpose of calculating the potential future credit exposure in accordance with step (b) the Commissioner may allow credit institutions to apply the percentages in Table 2 instead of those prescribed in Table 1 provided that the institutions make use of the option set out in paragraph 21 of Schedule 4 of the FSCAIF Regulations for contracts relating to commodities other than gold within the meaning of paragraph 3 of Schedule 4, to these Regulations-

Table 2

Residual maturity	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
One year or less	2%	2.5%	3%	4%
Over one year, not exceeding five years	5%	4%	5%	6%

[1] Contracts which do not fall within one of the five categories indicated in this table shall be treated as contracts concerning commodities other than precious metals.

(2) For contracts with multiple exchanges of principal, the percentages have to be multiplied by the number of remaining payments still to be made according to the contract.

[3] For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be equal to the time until the next reset date.

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Over five years	7.5%	8%	9%	10%

Step (c)- the sum of current replacement cost and potential future credit exposure shall be the exposure value.

PART 4

Original Exposure Method.

Step (a)- the notional principal amount of each instrument shall be multiplied by the percentages given in Table 3.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

Table 3

Original maturity[1]	Interest-rate contracts	Contracts concerning foreign-exchange rates and gold
One year or less	0.5%	2%
Over one year, not exceeding two years	1%	5%
Additional allowance for each additional year	1%	3%

Step (b)- the original exposure thus obtained shall be the exposure value.

PART 5

Standardised Method.

1. The Standardised Method (SM) can be used only for OTC derivatives and long settlement transactions. The exposure value shall be calculated separately for each netting set. It shall be determined net of collateral, as follows-

exposure value =

$$\beta^{*}\max(CMV - CMC; \sum_{j} \left|\sum_{i} RPT_{ij} - \sum_{l} RPC_{lj}\right|^{*} CCRM_{j})$$

where–

CMV = current market value of the portfolio of transactions within the netting set with a counter party gross of collateral, that is, where-

$$CMV = \sum_{i} CMV_i$$

where–

CMVi = the current market value of transaction i;

[1] In the case of interest-rate contracts, credit institutions may, subject to the consent of their Commissioner, choose either original or residual maturity.

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CMC = the current market value of the collateral assigned to the netting set, that is, where-

$$CMC = \sum_{l} CMV_l$$

where–

CMCl = the current market value of collateral l;

i = index designating transaction;

l = index designating collateral;

j = index designating hedging set category. These hedging sets correspond to risk factors for which risk positions of opposite sign can be offset to yield a net risk position on which the exposure measure is then based;

RPTij = risk position from transaction i with respect to hedging set j;

RPClj = risk position from collateral l with respect to hedging set j;

CCRMj = CCR Multiplier set out in Table 5 with respect to hedging set j;

β = 1.4.

Collateral received from a counter party has a positive sign and collateral posted to a counter party has a negative sign.

Collateral which is recognised for this method shall be confined to the collateral which is eligible under paragraph 11 of Part 1 of Schedule 8 and paragraph 9 of Schedule 2 of the FSCAIF Regulations.

2. When an OTC derivative transaction with a linear risk profile stipulates the exchange of a financial instrument for a payment, the payment Part is referred to as the payment leg. Transactions which stipulate the exchange of payment against payment consist of two payment legs. The payment legs consist of the contractually agreed gross payments, including the notional amount of the transaction. Credit institutions may disregard the interest rate risk from payment legs with a remaining maturity of less than one year for the purposes of the following calculations. Credit institutions may treat transactions that consist of two payment legs that are denominated in the same currency, such as interest rate swaps, as a single aggregate transaction. The treatment for payment legs shall apply to the aggregate transaction.

3. Transactions with a linear risk profile with equities (including equity indices), gold, other precious metals or other commodities as the underlying

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financial instruments are mapped to a risk position in the respective equity (or equity index) or commodity (including gold and other precious metals) and an interest rate risk position for the payment leg. If the payment leg is denominated in a foreign currency, it shall additionally be mapped to a risk position in the respective currency.

4. Transactions with a linear risk profile with a debt instrument as the underlying instrument shall be mapped to an interest rate risk position for the debt instrument and another interest rate risk position for the payment leg. Transactions with a linear risk profile which stipulate the exchange of payment against payment, including foreign exchange forwards, shall be mapped to an interest rate risk position for each of the payment legs. If the underlying debt instrument is denominated in a foreign currency, the debt instrument is mapped to a risk position in this currency. If a payment leg is denominated in foreign currency, the payment leg shall again mapped to a risk position in this currency. The exposure value assigned to a foreign exchange basis swap transaction shall be zero.

5. The size of a risk position from a transaction with linear risk profile shall be the effective notional value (market price multiplied by quantity) of the underlying financial instruments (including commodities) converted to the credit institution's domestic currency, except for debt instruments.

6. For debt instruments and for payment legs, the size of the risk position shall be the effective notional value of the outstanding gross payments (including the notional amount) converted to the credit institution's domestic currency, multiplied by the modified duration of the debt instrument, or payment leg, respectively.

7. The size of a risk position from a credit default swap shall be the notional value of the reference debt instrument multiplied by the remaining maturity of the credit default swap.

8. The size of a risk position from an OTC derivative with a non-linear risk profile, including options and swaptions, shall be equal to the delta equivalent effective notional value of the financial instrument which underlies the transaction, except in the case of an underlying debt instrument.

9. The size of a risk position from an OTC derivative with a non-linear risk profile, including options and swaptions, of which the underlying is a debt instrument or a payment leg, shall be equal to the delta equivalent effective notional value of the financial instrument or payment leg multiplied by the modified duration of the debt instrument, or payment leg, respectively.

10. For the determination of risk positions, collateral received from a counter party is to be treated as a claim on the counter party under a

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derivative contract (long position) that is due today, while collateral posted is to be treated like an obligation to the counter party (short position) that is due today.

11. Credit institutions may use the following formulae to determine the size and sign of a risk position-

for all instruments other than debt instruments-

effective notional value, or

delta equivalent notional value = $P_{ref} \frac{\partial V}{\partial p}$

where–

P_{ref} = price of the underlying instrument, expressed in the reference currency;

V = value of the financial instrument (in the case of an option this is the option price and in the case of a transaction with a linear risk profile this is the value of the underlying instrument itself);

p = price of the underlying instrument, expressed in the same currency as V;

for debt instruments and the payment legs of all transactions–

effective notional value multiplied by the modified duration, or

delta equivalent in notional value multiplied by the modified duration

$$\frac{\partial V}{\partial r}$$

where–

V = value of the financial instrument (in the case of an option this is the option price and in the case of a transaction with a linear risk profile this is the value of the underlying instrument itself or of the payment leg, respectively);
r = interest rate level.

If V is denominated in a currency other than the reference currency, the derivative must be converted into the reference currency by multiplication with the relevant exchange rate.

12. The risk positions shall be grouped into hedging sets. For each hedging set, the absolute value amount of the sum of the resulting risk positions shall

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be computed. This sum is termed the “net risk position” and is represented by–

$$\left| \sum_i RPT_{ij} - \sum_l RPC_{lj} \right|$$

in the formulae set out in paragraph 1.

13. For interest rate risk positions from money deposits received from the counter party as collateral, from payment legs and from underlying debt instruments, to which according to Table 1 of Schedule I to the FSCAIF Regulations a capital charge of 1,60 % or less applies, there are six hedging sets for each currency, as set out in Table 4 below. Hedging sets shall be defined by a combination of the criteria “maturity” and “referenced interest rates”.

Table 4

	Government referenced interest rates	Non-government referenced interest rates
Maturity Maturity Maturity	← 1 year >1 — ← 5 years > 5 years	← 1 year >1 — ← 5 years > 5 years

14. For interest rate risk positions from underlying debt instruments or payment legs for which the interest rate is linked to a reference interest rate that represents a general market interest level, the remaining maturity shall be the length of the time interval up to the next re-adjustment of the interest rate. In all other cases, it shall be the remaining life of the underlying debt instrument or in the case of a payment leg, the remaining life of the transaction.

15. There shall be one hedging set for each issuer of a reference debt instrument which underlies a credit default swap.

15A.“Nth to default” basket credit default swaps shall be treated as follows–

(a) the size of a risk position in a reference debt instrument in a basket underlying an “nth to default” credit default swap is the effective notional value of the reference debt instrument, multiplied by the modified duration of the “nth to default” derivative with respect to a change in the credit spread of the reference debt instrument;

(b) there is one hedging set for each reference debt instrument in a basket underlying a given “nth to default” credit default swap

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but risk positions from different "nth to default" credit defaults swaps shall not be included in the same hedging set;

(c) the CCR multiplier applicable to each hedging set created for one of the reference debt instruments of an "nth to default" derivative is 0.3% for reference debt instruments that have a credit assessment from a recognised external credit assessment institution equivalent to credit quality step 1 to 3 and 0.6% for other debt instruments.

16. For interest rate risk positions from money deposits which are posted with a counter party as collateral when that counter party does not have debt obligations of low specific risk outstanding and from underlying debt instruments, to which according to Table 1 of Schedule 1 of the FSCAIF Regulations a capital charge of more than 1,60 % applies, there shall be one hedging set for each issuer. When a payment leg emulates such a debt instrument, there shall be also one hedging set for each issuer of the reference debt instrument. Credit institutions may assign risk positions that arise from debt instruments of a certain issuer, or from reference debt instruments of the same issuer which are emulated by payment legs, or that underlie a credit default swap, to the same hedging set.

17. Underlying financial instruments other than debt instruments shall be assigned to the same respective hedging sets only if they are identical or similar instruments. In all other cases they shall be assigned to separate hedging sets. The similarity of instruments is established as follows-

— for equities, similar instruments are those of the same issuer. An equity index is treated as a separate issuer;

— for precious metals, similar instruments are those of the same metal. A precious metal index is treated as a separate precious metal;

— for electric power, similar instruments are those delivery rights and obligations that refer to the same peak or off-peak load time interval within any 24-hour interval; and

— for commodities, similar instruments are those of the same commodity. A commodity index is treated as a separate commodity.

18. The CCR multipliers (CCRM) for the different hedging set categories are set out in Table 5 below-

Table 5

	Hedging set categories	CCRM
1.	Interest Rates	0.2 %

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2.	Interest Rates for risk positions from a reference debt instrument that underlies a credit default swap and to which a capital charge of 1,60 %, or less, applies under Table 1 of Schedule I to FSCAIF Regulations	0.3 %
3.	Interest Rates for risk positions from a debt instrument or reference debt instrument to which a capital charge of more than 1,60 % applies under Table 1 of Schedule I to FSCAIF Regulations	0.6 %
4.	Exchange Rates	2.5 %
5.	Electric Power	4 %
6.	Gold	5 %
7.	Equity	7 %
8.	Precious Metals (except gold)	8.5 %
9.	Other Commodities (excluding precious metals and electricity power)	10 %
10.	Underlying instruments of OTC derivatives that are not in any of the above categories	10%

Underlying instruments of OTC derivatives, as referred to in paragraph 10 of Table 5, shall be assigned to separate individual hedging sets for each category of underlying instrument.

19. For transactions with a non-linear risk profile or for payment legs and transactions with debt instruments as underlying for which the credit institution cannot determine the delta or the modified duration, respectively, with an instrument model that the Commissioner has approved for the purposes of determining the minimum capital requirements for market risk, the Commissioner shall determine the size of the risk positions and the applicable CCRMjs conservatively. Alternatively, the Commissioner may require the use of the method set out in Part 3. Netting shall not be recognised (that is, the exposure value shall be determined as if there were a netting set that comprises just the individual transaction).

20. A credit institution shall have internal procedures to verify that, prior to including a transaction in a hedging set, the transaction is covered by a legally enforceable netting contract that meets the requirements set out in Part 7.

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21. A credit institution which makes use of collateral to mitigate its CCR shall have internal procedures to verify that, prior to recognising the effect of collateral in its calculations, the collateral meets the legal certainty standards set out in Schedule 8.

PART 6

Internal Model Method.

1. Subject to the approval of the Commissioner, a credit institution may use the Internal Model Method (IMM) to calculate the exposure value for the transactions in paragraph 2(i) of Part 2, or for the transactions in paragraph 2(ii), (iii) and (iv) of Part 2, or for the transactions in paragraph 2(i) to (iv) of Part 2. In each of these cases the transactions in paragraph 2(v) of Part 2 may be included as well. Notwithstanding the second sub-paragraph of paragraph 1 of Part 2, credit institutions may choose not to apply this method to exposures that are immaterial in size and risk. To apply the IMM, a credit institution shall meet the requirements set out in this Part.

2. Subject to the approval of the Commissioner, implementation of the IMM may be carried out sequentially across different transaction types, and during this period a credit institution may use the methods set out in Part 3 or Part 5. Notwithstanding the remainder of this Part, credit institutions shall not be required to use a specific type of model.

3. For all OTC derivative transactions and for long settlement transactions for which a credit institution has not received approval to use the IMM, the credit institution shall use the methods set out in Part 3 or Part 5. Combined use of these two methods is permitted on a permanent basis within a group. Combined use of these two methods within a legal entity is only permitted where one of the methods is used for the cases set out in Part 5, paragraph 19.

4. Credit institutions which have obtained permission to use the IMM shall not revert to the use of the methods set out in Part 3 or Part 5 except for demonstrated good cause and subject to approval of the Commissioner. If a credit institution ceases to comply with the requirements set out in this Part, it shall either present to the Commissioner a plan for a timely return to compliance or demonstrate that the effect of non-compliance is immaterial.

Exposure value.

5. The exposure value shall be measured at the level of the netting set. The model shall specify the forecasting distribution for changes in the market value of the netting set attributable to changes in market variables, such as interest rates, foreign exchange rates. The model shall then compute the

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exposure value for the netting set at each future date given the changes in the market variables. For margined counter parties, the model may also capture future collateral movements.

6. Credit institutions may include eligible financial collateral as defined in paragraph 11 of Part 1 of Schedule 8 and paragraph 9 of Schedule 2 of the FSCAIF Regulations in their forecasting distributions for changes in the market value of the netting set, if the quantitative, qualitative and data requirements for the IMM are met for the collateral.

7. The exposure value shall be calculated as the product of α times Effective EPE, as follows-

Exposure value = $\alpha \times$ Effective EPE

where–

alpha (α) shall be 1.4, but Commissioner may require a higher α, and Effective EPE shall be computed by estimating expected exposure (EEt) as the average exposure at future date t, where the average is taken across possible future values of relevant market risk factors. The model estimates EE at a series of future dates t1, t2, t3, etc.

8. Effective EE shall be computed recursively as-

Effective EEtk = max(Effective EEtk-1; EEtk)

where–

the current date is denoted as t0 and Effective EEt0 equals current exposure.

9. In this regard, Effective EPE is the average Effective EE during the first year of future exposure. If all contracts in the netting set mature within less than one year, EPE is the average of EE until all contracts in the netting set mature.

Effective EPE is computed as a weighted average of Effective EE–

$$\text{EffectiveEPE} = \sum_{k=1}^{\min(1\text{ year};\text{maturity})} \text{EffectiveEE}_{tk} * \Delta t_k$$

-where–

the weights Δtk = tk — tk-1 allow for the case when future exposure is calculated at dates that are not equally spaced over time.

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10. EE or peak exposure measures shall be calculated based on a distribution of exposures that accounts for the possible non-normality of the distribution of exposures.

11. Credit institutions may use a measure that is more conservative than α multiplied by Effective EPE as calculated according to the equation above for every counter party.

12. Notwithstanding paragraph 7, the Commissioner may permit credit institutions to use their own estimates of α, subject to a floor of 1,2, where α shall equal the ratio of internal capital from a full simulation of CCR exposure across counter parties (numerator) and internal capital based on EPE (denominator). In the denominator, EPE shall be used as if it were a fixed outstanding amount. Credit institutions shall demonstrate that their internal estimates of α capture in the numerator material sources of stochastic dependency of distribution of market values of transactions or of portfolios of transactions across counter parties. Internal estimates of α shall take account of the granularity of portfolios.

13. A credit institution shall ensure that the numerator and denominator of α are computed in a consistent fashion with respect to the modelling methodology, parameter specifications and portfolio composition. The approach used shall be based on the credit institution's internal capital approach, be well documented and be subject to independent validation. In addition, credit institutions shall review their estimates on at least a quarterly basis, and more frequently when the composition of the portfolio varies over time. Credit institutions shall also assess the model risk.

14. Where appropriate, volatilities and correlations of market risk factors used in the joint simulation of market and credit risk shall be conditioned on the credit risk factor to reflect potential increases in volatility or correlation in an economic downturn.

15. If the netting set is subject to a margin agreement, credit institutions shall use one of the following EPE measures–

(a) Effective EPE without taking into account the margin agreement;

(b) the threshold, if positive, under the margin agreement plus an add-on that reflects the potential increase in exposure over the margin period of risk. The add-on shall be computed as the expected increase in the netting set's exposure beginning from a current exposure of zero over the margin period of risk. A floor of five business days for netting sets consisting only of repo-style transactions subject to daily remargining and daily mark-to-market, and ten business days for all other netting sets

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is imposed on the margin period of risk used for this purpose; or

(c) if the model captures the effects of margining when estimating EE, the model's EE measure may be used directly in the equation in paragraph 8 subject to the approval of the Commissioner.

Minimum requirements for EPE models.

16. A credit institution's EPE model shall meet the operational requirements set out in paragraphs 17 to 41.

CCR control.

17. A credit institution shall have a control unit that is responsible for the design and implementation of its CCR management system, including the initial and on-going validation of the model. This unit shall control input data integrity and produce and analyse reports on the output of the credit institution's risk measurement model, including an evaluation of the relationship between measures of risk exposure and credit and trading limits. This unit shall be independent from units responsible for originating, renewing or trading exposures and free from undue influence; it shall be adequately staffed; it shall report directly to the senior management of the credit institution. The work of this unit shall be closely integrated into the day-to-day credit risk management process of the credit institution. Its output shall, accordingly, be an integral Part of the process of planning, monitoring and controlling the credit institution's credit and overall risk profile.

18. A credit institution shall have CCR management policies, processes and systems that are conceptually sound and implemented with integrity. A sound CCR management framework shall include the identification, measurement, management, approval and internal reporting of CCR.

19. A credit institution's risk management policies shall take account of market, liquidity, and legal and operational risks that can be associated with CCR. The credit institution shall not undertake business with a counter party without assessing its creditworthiness and shall take due account of settlement and pre-settlement credit risk. These risks shall be managed as comprehensively as practicable at the counter party level (aggregating CCR exposures with other credit exposures) and at the firm-wide level.

20. A credit institution's board of directors and senior management shall be actively involved in the CCR control process and shall regard this as an essential aspect of the business to which significant resources need to be devoted. Senior management shall be aware of the limitations and

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assumptions of the model used and the impact these can have on the reliability of the output. Senior management shall also consider the uncertainties of the market environment and operational issues and be aware of how these are reflected in the model.

21. The daily reports prepared on a credit institution's exposures to CCR shall be reviewed by a level of management with sufficient seniority and authority to enforce both reductions of positions taken by individual credit managers or traders and reductions in the credit institution's overall CCR exposure.

22. A credit institution's CCR management system shall be used in conjunction with internal credit and trading limits. Credit and trading limits shall be related to the credit institution's risk measurement model in a manner that is consistent over time and that is well understood by credit managers, traders and senior management.

23. A credit institution's measurement of CCR shall include measuring daily and intra-day usage of credit lines. The credit institution shall measure current exposure gross and net of collateral. At portfolio and counter party level, the credit institution shall calculate and monitor peak exposure or PFE at the confidence interval chosen by the credit institution. The credit institution shall take account of large or concentrated positions, including by groups of related counter parties, by industry, by market, etc.

24. A credit institution shall have a routine and rigorous program of stress testing in place as a supplement to the CCR analysis based on the day-to-day output of the credit institution's risk measurement model. The results of this stress testing shall be reviewed periodically by senior management and shall be reflected in the CCR policies and limits set by management and the board of directors. Where stress tests reveal particular vulnerability to a given set of circumstances, prompt steps shall be taken to manage those risks appropriately.

25. A credit institution shall have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operation of the CCR management system. The credit institution's CCR management system shall be well documented and shall provide an explanation of the empirical techniques used to measure CCR.

26. A credit institution shall conduct an independent review of its CCR management system regularly through its own internal auditing process. This review shall include both the activities of the business units referred to in paragraph 17 and of the independent CCR control unit. A review of the overall CCR management process shall take place at regular intervals and shall specifically address, at a minimum–

(a) the adequacy of the documentation of the CCR management system and process;

(b) the organisation of the CCR control unit;

(c) the integration of CCR measures into daily risk management;

(d) the approval process for risk pricing models and valuation systems used by front and back-office personnel;

(e) the validation of any significant change in the CCR measurement process;

(f) the scope of CCR captured by the risk measurement model;

(g) the integrity of the management information system;

(h) the accuracy and completeness of CCR data;

(i) the verification of the consistency, timeliness and reliability of data sources used to run models, including the independence of such data sources;

(j) the accuracy and appropriateness of volatility and correlation assumptions;

(k) the accuracy of valuation and risk transformation calculations; and

(l) the verification of the model's accuracy through frequent back-testing.

Use test.

27. The distribution of exposures generated by the model used to calculate effective EPE shall be closely integrated into the day-to-day CCR management process of the credit institution. The model's output shall accordingly play an essential role in the credit approval, CCR management, internal capital allocation and corporate governance of the credit institution.

28. A credit institution shall have a track record in the use of models that generate a distribution of exposures to CCR. Thus, the credit institution shall demonstrate that it has been using a model to calculate the distributions of exposures upon which the EPE calculation is based that meets, broadly, the minimum requirements set out in this Part for at least one year prior to approval by the Commissioner.

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29. The model used to generate a distribution of exposures to CCR shall be Part of a CCR management framework which includes the identification, measurement, management, approval and internal reporting of CCR. This framework shall include the measurement of usage of credit lines (aggregating CCR exposures with other credit exposures) and internal capital allocation. In addition to EPE, a credit institution shall measure and manage current exposures. Where appropriate, the credit institution shall measure current exposure gross and net of collateral. The use test shall be satisfied if a credit institution uses other CCR measures, such as peak exposure or (PFE), based on the distribution of exposures generated by the same model to compute EPE.

30. A credit institution shall have the systems capability to estimate EE daily if necessary, unless it demonstrates to the Commissioner that its exposures to CCR warrant less frequent calculation. The credit institution shall compute EE along a time profile of forecasting horizons that adequately reflects the time structure of future cash flows and maturity of the contracts and in a manner that is consistent with the materiality and composition of the exposures.

31. Exposure shall be measured, monitored and controlled over the life of all contracts in the netting set (not just to the one year horizon). The credit institution shall have procedures in place to identify and control the risks for counter parties where the exposure rises beyond the one-year horizon. The forecast increase in exposure shall be an input into the credit institution's internal capital model.

Stress testing.

32. A credit institution shall have in place sound stress testing processes for use in the assessment of capital adequacy for CCR. These stress measures shall be compared with the measure of EPE and considered by the credit institution as Part of the process set out in regulation 79. Stress testing shall also involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and an assessment of the credit institution's ability to withstand such changes.

33. The credit institution shall stress test its CCR exposures, including jointly stressing market and credit risk factors. Stress tests of CCR shall consider concentration risk (to a single counter party or groups of counter parties), correlation risk across market and credit risk, and the risk that liquidating the counter party's positions could move the market. Stress tests shall also consider the impact on the credit institution's own positions of such market moves and integrate that impact in its assessment of CCR.

Wrong Way Risk.

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34. Credit institutions shall give due consideration to exposures which give rise to a significant degree of General Wrong Way Risk.

35. Credit institutions shall have procedures in place to identify, monitor and control cases of Specific Wrong Way Risk, beginning at the inception of a transaction and continuing through the life of the transaction.

Integrity of the modeling process.

36. The model shall reflect transaction terms and specifications in a timely, complete, and conservative fashion. Such terms shall include at least contract notional amounts, maturity, reference assets, margining arrangements, netting arrangements. The terms and specifications shall be maintained in a database which is subject to formal and periodic audit. The process for recognising netting arrangements shall require signoff by legal staff to verify the legal enforceability of netting and be input into the database by an independent unit. The transmission of transaction terms and specifications data to the model shall also be subject to internal audit and formal reconciliation processes shall be in place between the model and source data systems to verify on an ongoing basis that transaction terms and specifications are being reflected in EPE correctly or at least conservatively.

37. The model shall employ current market data to compute current exposures. When using historical data to estimate volatility and correlations, at least three years of historical data shall be used and shall be updated quarterly or more frequently if market conditions warrant. The data shall cover a full range of economic conditions, such as a full business cycle. A unit independent from the business unit shall validate the price supplied by the business unit. The data shall be acquired independently of the lines of business, fed into the model in a timely and complete fashion, and maintained in a database subject to formal and periodic audit. A credit institution shall also have a well developed data integrity process to clean the data of erroneous and/or anomalous observations. To the extent that the model relies on proxy market data, including, for new products, where three years of historical data may not be available, internal policies shall identify suitable proxies and the credit institution shall demonstrate empirically that the proxy provides a conservative representation of the underlying risk under adverse market conditions. If the model includes the effect of collateral on changes in the market value of the netting set, the credit institution shall have adequate historical data to model the volatility of the collateral.

38. The model shall be subject to a validation process. The process shall be clearly articulated in credit institution’s policies and procedures. The validation process shall specify the kind of testing needed to ensure model integrity and identify conditions under which assumptions are violated and

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may result in an understatement of EPE. The validation process shall include a review of the comprehensiveness of the model.

39. A credit institution shall monitor the appropriate risks and have processes in place to adjust its estimation of EPE when those risks become significant. This includes the following–

(a) the credit institution shall identify and manage its exposures to specific wrong-way risk;

(b) for exposures with a rising risk profile after one year, the credit institution shall compare on a regular basis the estimate of EPE over one year with EPE over the life of the exposure; and

(c) for exposures with a residual maturity below one year, the credit institution shall compare on a regular basis the replacement cost (current exposure) and the realised exposure profile, and/or store data that would allow such a comparison.

40. A credit institution shall have internal procedures to verify that, prior to including a transaction in a netting set, the transaction is covered by a legally enforceable netting contract which meets the requirements set out in Part 7.

41. A credit institution which makes use of collateral to mitigate its CCR shall have internal procedures to verify that, prior to recognising the effect of collateral in its calculations, the collateral meets the legal certainty standards set out in Schedule 8.

Validation requirements for EPE models.

42. A credit institution's EPE model shall meet the following validation requirements–

(a) the qualitative validation requirements set out in Schedule 5 to the FSCAIF Regulations;

(b) interest rates, foreign exchange rates, equity prices, commodities, and other market risk factors shall be forecast over long time horizons for measuring CCR exposure. The performance of the forecasting model for market risk factors shall be validated over a long time horizon;

(c) the pricing models used to calculate CCR exposure for a given scenario of future shocks to market risk factors shall be tested as Part of the model validation process. Pricing models for

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options shall account for the non-linearity of option value with respect to market risk factors;

(d) the EPE model shall capture transaction-specific information in order to aggregate exposures at the level of the netting set. A credit institution shall verify that transactions are assigned to the appropriate netting set within the model;

(e) the EPE model shall also include transaction-specific information to capture the effects of margining. It shall take into account both the current amount of margin and margin that would be passed between counter parties in the future. Such a model shall account for the nature of margin agreements (unilateral or bilateral), the frequency of margin calls, the margin period of risk, the minimum threshold of unmargined exposure the credit institution is willing to accept, and the minimum transfer amount. Such a model shall either model the mark-to-market change in the value of collateral posted or apply the rules set out in Schedule 8; and

(f) static, historical back-testing on representative counter party portfolios shall be part of the model validation process. At regular intervals, a credit institution shall conduct such back-testing on a number of representative counter party portfolios (actual or hypothetical). These representative portfolios shall be chosen based on their sensitivity to the material risk factors and correlations to which the credit institution is exposed.

If back-testing indicates that the model is not sufficiently accurate, the Commissioner shall revoke the model approval or impose appropriate measures to ensure that the model is improved promptly. They may also require additional own funds to be held by credit institutions pursuant to regulation 83.

PART 7

Contractual netting (contracts for novation and other netting agreements)

(a) Types of netting that Commissioner may recognise.

For the purpose of this Part, “counter party” means any entity (including natural persons) that has the power to conclude a contractual netting agreement and “contractual cross product netting agreement” means a written bilateral agreement between a credit institution and a counter party which creates a single legal obligation covering all included bilateral master agreements and transactions belonging to different product categories.

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Contractual cross product netting agreements shall not cover netting other than on a bilateral basis.

For the purposes of cross product netting, the following are considered different product categories–

(i) repurchase transactions, reverse repurchase transactions, securities and commodities lending and borrowing transactions,

(ii) margin lending transactions, and

(iii) the contracts listed in Schedule 4.

The Commissioner may recognise as risk-reducing the following types of contractual netting–

(i) bilateral contracts for novation between a credit institution and its counter party under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts,

(ii) other bilateral agreements between a credit institution and its counter party, and

(iii) contractual cross product netting agreements for credit institutions which have received approval by the Commissioner to use the method set out in Part 6, for transactions falling under the scope of that method. Netting across transactions entered by members of a group shall not be recognised for the purposes of calculating capital requirements.

(b) Conditions for recognition

The Commissioner may recognise contractual netting as risk-reducing only under the following conditions–

(i) a credit institution shall have a contractual netting agreement with its counter party which creates a single legal obligation covering all included transactions, such that, in the event of a counter party's failure to perform wing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions,

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(ii) a credit institution shall have made available to the Commissioner written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under–

— the law of the jurisdiction in which the counter party is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located,

— the law that governs the individual transactions included, and

— the law that governs any contract or agreement necessary to effect the contractual netting,

(iii) a credit institution shall have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws,

(iv) the credit institution shall maintain all required documentation in its files,

(v) the effects of netting shall be factored into the credit institution's measurement of each counter party's aggregate credit risk exposure and the credit institution shall manage its CCR on such a basis, and

(vi) credit risk to each counter party is aggregated to arrive at a single legal exposure across transactions. This aggregation shall be factored into credit limit purposes and internal capital purposes.

The Commissioner shall be satisfied, if necessary after consulting the other competent authorities concerned, that the contractual netting is legally valid under the law of each of the relevant jurisdictions. If any of the competent authorities is not satisfied in that respect, the contractual netting agreement shall not be recognised as risk-reducing for either of the counter parties.
The Commissioner may accept reasoned legal opinions drawn up by types of contractual netting.

No contract containing a provision which permits a non-defaulting counter party to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a "walkaway" clause), may be recognised as risk-reducing.

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In addition, for contractual cross-product netting agreements the following criteria shall be met–

(a) the net sum referred to in subparagraph (b)(i) of this Part shall be the net sum of the positive and negative close out values of any included individual bilateral master agreement and of the positive and negative mark-to-market value of the individual transactions (the "Cross-Product Net Amount");

(b) the written and reasoned legal opinions referred to in subparagraph (b)(ii) of this Part shall address the validity and enforceability of the entire contractual cross-product netting agreement under its terms and the impact of the netting arrangement on the material provisions of any included individual bilateral master agreement. A legal opinion shall be generally recognised as such by the legal community in the EEA State in which the credit institution is authorised or a memorandum of law that addresses all relevant issues in a reasoned manner;

(c) the credit institution shall have procedures in place under subparagraph (b)(iii) of this Part to verify that any transaction which is to be included in a netting set is covered by a legal opinion; and

(d) taking into account the contractual cross product netting agreement, the credit institution shall continue to comply with the requirements for the recognition of bilateral netting and the requirements of regulations 40 to 42 for the recognition of credit risk mitigation, as applicable, with respect to each included individual bilateral master agreement and transaction.

(c) Effects of recognition.

Netting for the purposes of Parts 5 and 6 shall be recognised as set out therein.

(i) Contracts for novation.

The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus, in the application of Part 3, in–

— step (a)- the current replacement cost, and in

— step (b)- the notional principal amounts or underlying values

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may be obtained taking account of the contract for novation. In the application of Part 4, in step (a) the notional principal amount may be calculated taking account of the contract for novation; the percentages of Table 3 shall apply.

(ii) Other netting agreements.

In application of Part 3–

— in step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the actual hypothetical net replacement cost which results from the agreement; in the case where netting leads to a net obligation for the credit institution calculating the net replacement cost, the current replacement cost is calculated as "0", and

— in step (b) the figure for potential future credit exposure for all contracts included in a netting agreement may be reduced according to the following formula-

$PCE_{red} = 0.4 * PCE_{gross} + 0.6 * NGR * PCE_{gross}$

where-

PCE_{red} = the reduced figure for potential future credit exposure for all contracts with a given counter party included in a legally valid bilateral netting agreement

PCE_{gross} = the sum of the figures for potential future credit exposure for all contracts with a given counter party which are included in a legally valid bilateral netting agreement and are calculated by multiplying their notional principal amounts by the percentages set out in Table 1

NGR = "net-to-gross ratio"- at the discretion of the Commissioner either–

(i) separate calculation- the quotient of the net replacement cost for all contracts included in a legally valid bilateral netting agreement with a given counter party (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counter party (denominator), or

(ii) aggregate calculation- the quotient of the sum of the net replacement cost calculated on a bilateral basis for all counterparties taking into account the contracts included in legally valid netting agreements (numerator) and the gross

replacement cost for all contracts included in legally valid netting agreements (denominator).

Credit institutions which are allowed a choice of methods shall ensure that the method chosen shall be used consistently.

For the calculation of the potential future credit exposure according to the above formula perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts. Perfectly matching contracts are forward foreign-exchange contracts or similar contracts in which a notional principal is equivalent to cash flows if the cash flows fall due on the same value date and fully or partly in the same currency.

In the application of Part 4, in step (a)

— perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts, the notional principal amounts are multiplied by the percentages given in Table 3, and

— for all other contracts included in a netting agreement, the percentages applicable may be reduced as indicated in Table 6-

Table 6

Original maturity[(1)]	Interest-rate contracts	Foreign-exchange contracts
One year or less	0.35 %	1.50 %
More than one year but not more than two years	0.75 %	3.75 %
Additional allowance for each additional year	0.75 %	2.25 %

[(1)] In the case of interest-rate contracts, credit institutions may, subject to the consent of the Commissioner, choose either original or residual maturity.

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SCHEDULE 4

Regulations 26(1) and 28(5)

TYPES OF DERIVATIVES

1. Interest-rate contracts–

(a) single-currency interest rate swaps;

(b) basis-swaps;

(c) forward rate agreements;

(d) interest-rate futures;

(e) interest-rate options purchased; and

(f) other contracts of similar nature.

2. Foreign-exchange contracts and contracts concerning gold–

(a) cross-currency interest-rate swaps;

(b) forward foreign-exchange contracts;

(c) currency futures;

(d) currency options purchased;

(e) other contracts of a similar nature; and

(f) contracts concerning gold of a nature similar to (a) to (e).

3. Contracts of a nature similar to those in points 1(a) to (e) and 2(a) to (d) concerning other reference items or indices.

This includes as a minimum all instruments specified in points 4 to 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC not otherwise included in points 1 or 2.

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Regulation 26(1)

TECHNICAL CRITERIA COCERNING THE ORGANISATION AND TREATMENT OF RISK

1. Governance.

1. Arrangements shall be defined by the management of a credit institution concerning the segregation of duties in the organisation and the prevention of conflicts of interest.

2. Treatment of risks.

2. The management of a credit institution shall approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the credit institution is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

3.Credit and counter party risk.

3. Credit-granting shall be based on sound and well-defined criteria. The process for approving, amending, renewing, and re-financing credits shall be clearly established.

4. The ongoing administration and monitoring of their various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, shall be operated through effective systems.

5. Diversification of credit portfolios shall be adequate given the credit institution's target markets and overall credit strategy.

4. Residual risk.

6. The risk that recognised credit risk mitigation techniques used by the credit institution prove less effective than expected shall be addressed and controlled by means of written policies and procedures.

5. Concentration risk.

7. The concentration risk arising from exposures to counter parties, groups of connected counter parties, and counter parties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, and including in particular risks associated with large indirect credit exposures (e.g. to a single

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collateral issuer), shall be addressed and controlled by means of written policies and procedures.

6. Securitisation risk.

8. The risks arising from securitisation transactions in relation to which the credit institutions are are investor, originator or sponsor, including reputational risks such as arise in relation to complex structures or products shall be evaluated and addressed through appropriate policies and procedures, to ensure in particular that the economic substance of the transaction shall be fully reflected in the risk assessment and management decisions.

9. Liquidity plans to address the implications of both scheduled and early amortization shall exist at credit institutions which are originators of revolving securitisation transactions involving early amortisation provisions.

7. Market risk.

10. Policies and processes for the measurement and management of all material sources and effects of market risks shall be implemented.

8. Interest rate risk arising from non-trading activities.

11. Systems shall be implemented to evaluate and manage the risk arising from potential changes in interest rates as they affect a credit institution's non-trading activities.

9. Operational risk.

12. Policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high severity events, shall be implemented. Without prejudice to the definition in regulation 2, a credit institution shall articulate what constitutes operational risk for the purposes of those policies and procedures.

13. Contingency and business continuity plans shall be in place to ensure a credit institution's ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

10. Liquidity risk.

14. Robust strategies, policies, processes and systems shall exist for the identification, measurement, management and monitoring of liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that credit institutions maintain adequate levels of liquidity buffers and

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those strategies, policies, processes and systems shall be tailored to business lines, currencies and entities and shall include adequate allocation mechanisms of liquidity costs, benefits and risks.

14A. The strategies, policies, processes and systems referred to in paragraph 14 shall be proportionate to the complexity, risk profile, scope of operation of a credit institution and risk tolerance set by the management body and reflect the credit institution's importance in Gibraltar and in each EEA State in which it carries on business.

14B. A credit institution shall inform all relevant business lines about its risk tolerance

15. A credit institution shall develop methodologies for the identification, measurement, management and monitoring of funding positions which include the current and projected material cash-flows in and arising from assets, liabilities, off-balance-sheet items, including contingent liabilities and the possible impact of reputational risk.

16. A credit institution shall distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations and shall take into account the legal entity in which assets reside, the country where assets are legally recorded either in a register or in an account as well as their eligibility and shall monitor how assets can be mobilised in a timely manner.

17. A credit institution shall have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside Gibraltar and the EEA.

18. A credit institution shall consider and regularly review different liquidity risk mitigation tools, including a system of limits and liquidity buffers, in order to be able to withstand a range of different stress events and an adequately diversified funding structure and access to funding sources.

19. Alternative scenarios on liquidity positions and on risk mitigants shall be considered and the assumptions underlying decisions concerning the funding position shall be reviewed regularly and those scenarios shall address off-balance sheet items and other contingent liabilities, including those of SSPEs or other special purpose entities, in relation to which the credit institution acts as sponsor or provides material liquidity support.

20. A credit institution shall consider the potential impact of institution-specific, market-wide and combined alternative scenarios and the different time horizons and varying degrees of stressed conditions.

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21. A credit institution shall adjust its strategies, internal policies and limits on liquidity risk and develop effective contingency plans, taking into account the outcome of the alternative scenarios referred to in paragraph 19.

22. In order to deal with liquidity crises, a credit institution shall have in place contingency plans, which shall be regularly tested, setting out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls on the basis of the outcome of the alternative scenarios set out in paragraph 19, so that internal policies and processes can be adjusted accordingly.

11. REMUNERATION POLICIES.

23. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities:

(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;

(b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest;

(c) the management body, in its supervisory function, of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;

(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

(e) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the

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objectives linked to their functions, independent of the performance of the business areas they control;

(f) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in point (24) or, if such a committee has not been established, by the management body in its supervisory function;

(g) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial and non-financial criteria are taken into account;

(h) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

(i) the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;

(j) guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment;

(k) in the case of credit institutions that benefit from exceptional government intervention:

(i) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;

(ii) the relevant competent authority require credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the credit institution within the meaning of section 96(5) of the Financial Services (Banking) Act;

(iii) no variable remuneration is paid to the persons who effectively direct the business of the credit institution within the meaning of section 96(5) of the Financial Services (Banking) Act unless justified;

(l) fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component.

Credit institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration;

(m) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;

(n) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required.

The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;

(o) a substantial portion, and in any event at least 50 %, of any variable remuneration shall consist of an appropriate balance of:

(i) shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non-listed credit institution, and

(ii) where appropriate, other instruments within the meaning of regulation 15 (Ia)(a), that adequately reflect the credit quality of the credit institution as a going concern.

The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. The competent authority may place restrictions on the types and designs of those instruments or prohibit certain instruments as

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appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (p) and the portion of the variable remuneration component not deferred;

(p) a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to 5 years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.

Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

(q) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.

Without prejudice to the general principles of contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;

(r) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution.

If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of 5 years in the form of instruments referred to in point (o). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (o) subject to a five-year retention period;

(s) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related

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insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

(t) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of these Regulations.

The principles set out in this point shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

24. Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the management body in its supervisory function. The Chair and the members of the remuneration committee shall be members of the management body who do not perform any executive functions in the credit institution concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.

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Regulations 26, 30, 31, 32, 33, 37, 39, 47, 66, 92 and 93

STANDARDISED APPROACH

PART 1

RISK WEIGHTS

1. EXPOSURES TO CENTRAL GOVERNMENTS OR CENTRAL BANKS

1.1. Treatment.

1. Without prejudice to paragraphs 2 to 7, exposures to central governments and central banks shall be assigned a 100 % risk weight.

2. Subject to paragraph 3, exposures to central governments and central banks for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 1 in accordance with the assignment by the Commissioner of the credit assessments of approved ECAIs to six steps in a credit quality assessment scale.

Table 1

Credit quality step	*1*	*2*	*3*	*4*	*5*	*6*
Risk weight	0 %	*20%*	50 %	100%	100%	150%

3. Exposures to the European Central Bank shall be assigned a 0 % risk weight.

1.2. Exposures in the national currency of the borrower

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

5. When the competent authorities of a non-EEA State 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 paragraph 1 to 2 to exposures to their central government and central bank denominated and funded in the domestic currency, the Commissioner may

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allow their credit institutions to risk weight such exposures in the same manner.

1.3. Use of credit assessments by Export Credit Agencies.

6. Export Credit Agency credit assessments shall be approved by the Commissioner if either of the following conditions is met–

(a) it is a consensus risk score from Export Credit Agencies participating in the OECD 'Arrangement on Guidelines for Officially Supported Export Credits'; or

(b) 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.

7. Exposures for which a credit assessment by an Export Credit Agency is approved for risk weighting purposes shall be assigned a risk weight according to Table 2.

Table 2

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

2. EXPOSURES TO REGIONAL GOVERNMENTS OR LOCAL AUTHORITIES.

8. Without prejudice to points 9 to 11, exposures to the government shall be risk weighted as exposures to institutions, subject to point 11a. Such treatment is independent of the exercise of discretion specified in regulation 30(5). The preferential treatment for short-term exposures specified in points 31, 32 and 37 shall not be applied.

9. Exposures to regional governments and local authorities shall be treated as exposures to the central government in whose jurisdiction they are established where there is no difference in risk between such exposures because of the specific revenue-raising powers of the former, and the existence of specific credit institutional arrangements the effect of which is to reduce their risk of default.

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The Commissioner shall draw up and make public the list of the regional governments and local authorities to be risk-weighted like central governments.

10. Exposures to churches and religious communities constituted in the form of a legal person under public law shall, 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 9 shall not apply. In this case for the purposes of regulation 39(1)(a) permission to apply regulations 28 to 33 shall not be excluded.

11. When competent authorities of a non-EEA State jurisdiction which apply supervisory and regulatory arrangements at least equivalent to those applied in the Community treat exposures to regional governments and local authorities as exposures to their central government, the Commissioner may allow credit institutions to risk weight exposures to such regional governments and local authorities in the same manner.

11a. Without prejudice to points 9, 10 and 11, exposures to the Government denominated and funded in the currency of Gibraltar shall be assigned a risk weight of 20%.

3. EXPOSURES TO ADMINISTRATIVE BODIES AND NON-COMMERCIAL UNDERTAKINGS.

3.1. Treatment.

12. Without prejudice to paragraphs 13 to 17, exposures to administrative bodies and non-commercial undertakings shall be assigned a 100 % risk weight.

3.2. Public Sector Entities.

13. Without prejudice to paragraphs 14 to 17, exposures to public sector entities shall be assigned a 100 % risk weight.

14. Subject to the discretion of the Commissioner, exposures to public sector entities may be treated as exposures to credit institutions. Exercise of this discretion by the Commissioner is independent of the exercise of discretion as specified in regulation 30(5). The preferential treatment for short-term exposures specified in paragraphs 31, 32 and 37 shall not be applied.

15. In exceptional circumstances, exposures to public-sector entities may be treated as exposures to the central government in whose jurisdiction they are established where in the opinion of the Commissioner there is no difference

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in risk between such exposures because of the existence of an appropriate guarantee by the central government.

16. When the discretion to treat exposures to public-sector entities as exposures to credit institutions or as exposures to the central government in whose jurisdiction they are established is exercised by the competent authorities of one EEA State, the competent authorities of another EEA State shall allow their credit institutions to risk-weight exposures to such public-sector entities in the same manner.

17. When competent authorities of a non-EEA State 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 credit institutions, the Commissioner may allow Gibraltar credit institutions to risk weight exposures to such public sector entities in the same manner.

4. EXPOSURES TO MULTILATERAL DEVELOPMENT BANKS.

4.1. Scope.

18. For the purposes of regulations 28 to 33, the Inter-American Investment Corporation, the Black Sea Trade and Development Bank and the Central American Bank for Economic Integration shall be considered be Multilateral Development Banks (MDB).

4.2. Treatment.

19. Without prejudice to paragraphs 20 and 21, exposures to multilateral development banks shall be treated in the same manner as exposures to credit institutions in accordance with paragraphs 29 to 32. The preferential treatment for short term exposures as specified in paragraphs 31, 32 and 37 shall not apply.

20. Exposures to the following multilateral development banks shall be assigned a 0 % risk weight–

(a) the International Bank for Reconstruction and Development;

(b) the International Finance Corporation;

(c) the Inter-American Development Bank;

(d) the Asian Development Bank;

(e) the African Development Bank;

(f) the Council of Europe Development Bank

(g) the Nordic Investment Bank;

(h) the Caribbean Development Bank;

(i) the European Bank for Reconstruction and Development;

(j) the European Investment Bank;

(k) the European Investment Fund; and

(l) the Multilateral Investment Guarantee Agency.

21. A risk weight of 20 % shall be assigned to the portion of unpaid capital subscribed to the European Investment Fund.

5. EXPOSURES TO INTERNATIONAL ORGANISATIONS.

22. Exposures to the following international organisations shall be assigned a 0 % risk weight–

(a) the European Community;

(b) the International Monetary Fund;

(c) the Bank for International Settlements.

6. EXPOSURES TO CREDIT INSTITUTIONS.

6.1. Treatment.

23. One of the two methods described in paragraphs 26 to 27 and 29 to 32 shall apply in determining the risk weights for exposures to credit institutions.

24. Without prejudice to the other provisions of paragraphs 23 to 39, 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 shall be risk-weighted as exposures to credit institutions.

6.2. Risk-weight floor on exposures to unrated credit institutions.

25. Exposures to an unrated credit institution shall not be assigned a risk weight lower than that applied to exposures to its central government.

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6.3. Central government risk weight based method.

26. Exposures to credit institutions shall be assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the credit institution is incorporated are assigned in accordance with Table 3.

Table 3

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%

27. For exposures to credit institutions incorporated in countries where the central government is unrated, the risk weight shall be not more than 100 %.

28. For exposures to credit institutions with an original effective maturity of three months or less, the risk weight shall be 20 %.

6.4. Credit assessment based method.

29. Exposures to institutions with a residual maturity of more than three months for which a credit assessment by a nominated external credit assessment institution is available shall be assigned a risk weight according to Table 4 in accordance with the assignment by the competent authorities of the credit assessments of eligible external credit assessment institutions to six steps in a credit quality assessment scale–

Table 4

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

30. Exposures to unrated credit institutions shall be assigned a risk weight of 50 %.

31. Exposures to an institution of up to three months residual maturity for which a credit assessment by a nominated external credit assessment institution is available shall be assigned a risk-weight according to Table 5 in accordance with the assignment by the competent authorities of the credit assessments of eligible external credit assessment institutions six steps in a credit quality assessment scale–

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Table 5

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

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

6.5. Interaction with short-term credit assessments.

33. If the method specified in paragraphs 29 to 32 is applied to exposures to credit institutions, then the interaction with specific short-term assessments shall be as follows.

34. If there is no short-term exposure assessment, the general preferential treatment for short term exposures as specified in paragraph 31 shall apply to all exposures to credit institutions of up to three months residual maturity.

35. If there is a short-term assessment and such an 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 31, then the short term assessment shall be used for that specific exposure only. Other short-term exposures shall follow the general preferential treatment for short-term exposures, as specified in paragraph 31.

36. If there is a short term assessment and such an assessment determines a less favourable risk weight than the use of the general preferential treatment for short-term exposures, as specified in paragraph 31, then the general preferential treatment for short-term exposures shall not be used and all unrated short-term claims shall be assigned the same risk weight as that applied by the specific short-term assessment.

6.6. Short-term exposures in the national currency of the borrower.

37. Exposures to credit institutions of a residual maturity of 3 months or less denominated and funded in sterling may, subject to the discretion of the Commissioner, be assigned, under both methods described in paragraphs 26 to 27 and 29 to 32, a risk weight that is one category less favourable than the preferential risk weight, as described in paragraphs 4 and 5, assigned to exposures to the Government of Gibraltar.

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

6.7 Investments in regulatory capital instruments.

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39. Investments in equity or regulatory capital instruments issued by credit institutions shall be risk weighted at 100 %, unless deducted from the own funds.

6.8 Minimum reserves required by the ECB.

40. Where an exposure to a credit institution is in the form of minimum reserves required by the ECB or by the central bank of an EEA State to be held by the credit institution, assignment of the risk weight that would be assigned to exposures to the central bank of the EEA State in question may be permitted provided–

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

(b) in the event of the bankruptcy or insolvency of the credit institution where the reserves are held, the reserves shall be fully repaid to the credit institution in a timely manner and are not made available to meet other liabilities of the credit institution.

7. EXPOSURES TO CORPORATES.

7.1. Treatment.

41. Exposures for which a credit assessment by an approved ECAI is available shall be assigned a risk weight according to Table 6 in accordance with the assignment by the Commissioner of the credit assessments of approved ECAIs to six steps in a credit quality assessment scale.

Table 6

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

42. Exposures for which such a credit assessment is not available shall be assigned a 100 % risk weight or the risk weight of its central government, whichever is the higher.

8. RETAIL EXPOSURES.

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43. Exposures that comply with the criteria listed in regulation 29(2) and (3) shall be assigned a risk weight of 75 %.

9. EXPOSURES SECURED BY REAL ESTATE PROPERTY.

44. Without prejudice to paragraphs 45 to 60, exposures fully secured by real estate property shall be assigned a risk weight of 100 %.

9.1. Exposures secured by mortgages on residential property.

45. Exposures or any part of an exposure fully and completely secured, to the satisfaction of the Commissioner, 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, shall be assigned a risk weight of 35 %.

46. Exposures fully and completely secured, to the satisfaction of the Commissioner, 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 shall be assigned a risk weight of 35 %.

47. Exposures to a tenant under a property leasing transaction concerning residential property under which the credit institution is the lessor and the tenant has an option to purchase, shall be assigned a risk weight of 35 % provided that the Commissioner is satisfied that the exposure of the credit institution is fully and completely secured by its ownership of the property.

48. In the exercise of his judgement for the purposes of paragraphs 45 to 47, the Commissioner shall be satisfied only if the following conditions are met–

(a) the value of the property does not materially depend upon the credit quality of the obligor. This requirement shall not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower;

(b) 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 shall not materially depend on any cash flow generated by the underlying property serving as collateral;

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(c) the minimum requirements set out in paragraph 8 of Part 2 of Schedule 8 and the valuation rules set out in paragraphs 62 to 65 of Part 3 of Schedule 8, are met; and

(d) the value of the property exceeds the exposures by a substantial margin.

49. The Commissioner may dispense with the condition contained in paragraph 48(b) for exposures fully and completely secured by mortgages on residential property which is situated within Gibraltar, if he has evidence that a well-developed and long established residential real estate market is present in Gibraltar with loss rates which are sufficiently low to justify such treatment.

50. When the discretion contained in paragraph 49 is exercised by the competent authorities of an EEA State, the competent authorities of another EEA State may allow their credit institutions to assign a risk weight of 35 % to such exposures fully and completely secured by mortgages on residential property.

9.2. Exposures secured by mortgages on commercial real estate.

51. Subject to the discretion of the Commissioner, exposures or any part of an exposure fully and completely secured, to the satisfaction of the competent authorities, by mortgages on offices or other commercial premises situated within Gibraltar may be assigned a risk weight of 50 %.

52. Subject to the discretion of the Commissioner, exposures fully and completely secured, to the his satisfaction, 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 %.

53. Subject to the discretion of the Commissioner, exposures related to property leasing transactions concerning offices or other commercial premises situated in Gibraltar under which the credit institution is the lessor and the tenant has an option to purchase may be assigned a risk weight of 50 % provided that the exposure of the credit institution is fully and completely secured to his satisfaction by its ownership of the property.

54. The application of paragraphs 51 to 53 shall be subject to the following conditions–

(a) the value of the property shall not materially depend upon the credit quality of the obligor. This requirement shall not preclude situations where purely macro-economic factors

affect both the value of the property and the performance of the borrower;

(b) the risk of the borrower shall 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 shall not materially depend on any cash flow generated by the underlying property serving as collateral; and

(c) the minimum requirements set out in paragraph 8 of Part 2 of Schedule 8 and the valuation rules set out in paragraphs 62 to 65 of Part 3 of Schedule 8, shall be met.

55. The 50 % risk weight shall be assigned to the part of the loan which does not exceed a limit calculated according to either of the following conditions–

(a) 50 % of the market value of the property in question; or

(b) 50 % of the market value of the property or 60 % of the mortgage lending value, whichever is lower, in those EEA States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions.

56. A 100 % risk weigh shall be assigned to the part of the loan that exceeds the limits set out in paragraph 55.

57. When the discretion contained in paragraphs 51 to 53 is exercised by the competent authorities of one EEA State, the competent authorities of another EEA State may allow their credit institutions to risk weight at 50 % such exposures fully and completely secured by mortgages on commercial property.

58. The Commissioner may dispense with the condition contained in paragraph 54(b) for exposures fully and completely secured by mortgages on commercial property which is situated within their territory, if they have evidence that a well-developed and long established commercial real estate market is present in Gibraltar with loss-rates which do not exceed the following limits–

(a) losses stemming from lending collateralised by commercial real estate property up to 50 % of the market value (or where applicable and if lower 60 % of the mortgage lending value (MLV)) do not exceed 0,3 % of the outstanding loans

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collateralised by commercial real estate property in any given year; and

(b) overall losses stemming from lending collateralised by commercial real estate property shall not exceed 0,5 % of the outstanding loans collateralised by commercial real estate property in any given year.

59. If either of the limits referred to in paragraph 58 is not satisfied in a given year, the eligibility to use paragraph 58 shall cease and the condition contained in paragraph 54(b) shall apply until the conditions in paragraph 58 are satisfied in a subsequent year.

60. When the discretion contained in paragraph 58 is exercised by the competent authorities of an EEA State, the competent authorities of another EEA State may allow their credit institutions to assign a risk weight of 50 % to such exposures fully and completely secured by mortgages on commercial property.

10. PAST DUE ITEMS.

61. Without prejudice to the provisions contained in paragraphs 62 to 65, the unsecured part of any item that is past due for more than 90 days and which is above a threshold defined by the Commissioner and which reflects a reasonable level of risk shall be assigned a risk weight of–

(a) 150 %, if value adjustments are less than 20 % of the unsecured part of the exposure gross of value adjustments; and

(b) 100 %, if value adjustments are no less than 20 % of the unsecured part of the exposure gross of value adjustments.

62. For the purpose of defining the secured part of the past due item, eligible collateral and guarantees shall be those eligible for credit risk mitigation purposes.

63. Nonetheless, where a past due item is fully secured by forms of collateral other then those eligible for credit risk mitigation purposes, a 100 % risk weight may be assigned subject to the discretion of the Commissioner based upon strict operational criteria to ensure the good quality of the collateral when value adjustments reach 15 % of the exposure gross of value adjustments.

64. Exposures indicated in paragraphs 45 to 50 shall 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 exposure gross of

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value adjustments, the risk weight to be assigned to the remainder of the exposure may be reduced to 50 % at the discretion of the Commissioner.

65. Exposures indicated in paragraphs 51 to 60 shall be assigned a risk weight of 100 % if they are past due for more than 90 days.

11. ITEMS BELONGING TO REGULATORY HIGH-RISK CATEGORIES.

66. Subject to the discretion of the Commissioner, exposures associated with particularly high risks such as investments in venture capital firms and private equity investments shall be assigned a risk weight of 150 %.

67. The Commissioner may permit non past due items to be assigned a 150 % risk weight according to the provisions of this Part and for which value adjustments have been established to be assigned a risk weight of–

(a) 100 %, if value adjustments are no less than 20 % of the exposure value gross of value adjustments; and

(b) 50 %, if value adjustments are no less than 50 % of the exposure value gross of value adjustments.

12. EXPOSURES IN THE FORM OF COVERED BONDS.

68. ‘Covered bonds’, shall mean bonds as defined in Article 22(4) of Directive 85/611/EEC and collateralised by any of the following eligible assets–

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

(b) exposures to or guaranteed by non-EEA central governments, non-EEA central banks, multilateral development banks, international organisations that qualify for the credit quality step 1 as set out in this Schedule, and exposures to or guaranteed by non-EU public sector entities, non-EEA regional governments and non-EEA local authorities that are risk weighted as exposures to credit institutions or central governments and central banks according to paragraphs 8, 9, 14 or 15 respectively and that qualify for the credit quality step 1 as set out in this Schedule, and exposures in the sense of this paragraph that qualify as a minimum for the credit quality step 2 as set out in this Schedule, provided that they do not exceed 20 % of the nominal amount of outstanding covered bonds of issuing credit institutions;

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(c) exposures to credit institutions which qualify for the credit quality step 1 as set out in this Schedule. The total exposure of this kind shall not exceed 15 % of the nominal amount of outstanding covered bonds of the issuing credit institution. 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 shall not be comprised by the 15 % limit. Exposures to credit institutions in the EEA with a maturity not exceeding 100 days shall not be comprised by the step 1 requirement but those credit institutions must as a minimum qualify for credit quality step 2 as set out in this Schedule;

(d) loans secured by residential real estate or shares in Finnish residential housing companies as referred to in point 46 up to the lesser of the principal amount of the liens that are combined with any prior liens and 80 % of the value of the pledged properties or by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of a Member State securitising residential real estate exposures. In the event of such senior units being used as collateral, the special public supervision to protect bond holders as provided for in regulation 49(4) of the Financial Services (Collective Investment Schemes) Regulations 2011 shall ensure that the assets underlying such units shall, at any time while they are included in the cover pool be at least 90 % composed of residential 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, that the units qualify for the credit quality step 1 as set out in this Schedule and that such units do not exceed 10 % of the nominal amount of the outstanding issue.

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 shall not be comprised in calculating the 90 % limit;

(e) loans secured by commercial real estate or shares in Finnish housing companies as referred to in point 52 up to the lesser of the principal amount of the liens that are combined with any prior liens and 60 % of the value of the pledged properties or by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of

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a Member State securitising commercial real estate exposures. In the event of such senior units being used as collateral, the special public supervision to protect bond holders as provided for in regulation 49(4)of the Financial Services (Collective Investment Schemes) Regulations 2011 shall ensure that the assets underlying such units shall, at any time while they are included in the cover pool be at least 90 % composed of commercial 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 60 % of the value of the pledged properties, that the units qualify for the credit quality step 1 as set out in this Schedule and that such units do not exceed 10 % of the nominal amount of the outstanding issue.

The competent authority 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 the 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 Schedule 8. The bondholders' claim shall take priority over all other claims on the collateral. 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 shall not be comprised in calculating the 90 % limit;

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

For these purposes 'collateralised' includes situations where the assets as described in subparagraphs (a) to (f) are exclusively dedicated in law to the protection of the bondholders against losses.

Until 31 December 2013, the 10 % limit for senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities as specified in points (d) and (e) shall not apply, provided that:

(i) the securitised residential or commercial real estate exposures were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior units are made collateral for covered bonds); and

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(ii) a member of the same consolidated group of which the issuer of the covered bonds is also a member or an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated retains the whole first loss tranche supporting those senior units.

Until 31 December 2010 the figure of 60 % indicated in subparagraph (f) can be replaced with a figure of 70 %.

69. A credit institution shall for real estate collateralising covered bonds meet the minimum requirements set out in paragraph 8 of Part 2 of Schedule 8, and the valuation rules set out in paragraphs 62 to 65 of Part 3 of Schedule 8.

70. Notwithstanding paragraphs 68 and 69, covered bonds meeting the definition of Article 22(4) of Directive 85/611/EEC and issued before 31 December 2007 shall be eligible for the preferential treatment until their maturity.

71. Covered bonds shall be assigned a risk weight on the basis of the risk weight assigned to senior unsecured exposures to the credit institution which issues them. The following correspondence between risk weights shall apply–

(a) if the exposures to the credit institution are assigned a risk weight of 20 %, the covered bond shall be assigned a risk weight of 10 %;

(b) if the exposures to the credit institution are assigned a risk weight of 50 %, the covered bond shall be assigned a risk weight of 20 %;

(c) if the exposures to the credit institution are assigned a risk weight of 100 %, the covered bond shall be assigned a risk weight of 50 %; and

(d) if the exposures to the credit institution are assigned a risk weight of 150 %, the covered bond shall be assigned a risk weight of 100 %.

13. ITEMS REPRESENTING SECURITISATION POSITIONS.

72. Risk weight exposure amounts for securitisation positions shall be determined in accordance with regulations 44 to 51.

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14. EXPOSURES TO INSTITUTIONS AND CORPORATES WITH A SHORT-TERM CREDIT ASSESSMENT.

73. Exposures to institutions where paragraphs 29 to 32 apply, and exposures to corporates for which a short-term credit assessment by a nominated external credit assessment institution is available shall be assigned a risk weight according to Table 7, in accordance with the mapping by the competent authorities of the credit assessments of eligible external credit assessment institutions to six steps in a credit quality assessment scale–

Table 7

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

15. EXPOSURES IN THE FORM OF COLLECTIVE INVESTMENT UNDERTAKINGS (CIUS).

74. Without prejudice to paragraphs 75 to 81, exposures in collective investment undertakings (CIUs) shall be assigned a risk weight of 100 %.

75. Exposures in the form of CIUs for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 8, in accordance with the assignment by the Commissioner of the credit assessments of approved ECAIs to six steps in a credit quality assessment scale.

Table 8

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

76. Where the Commissioner considers that a position in a CIU is associated with particularly high risks he shall require that that position is assigned a risk weight of 150 %.

77. A credit institution may determine the risk weight for a CIU as set out in paragraphs 79 to 81, if the following eligibility criteria are met–

(a) the CIU is managed by a company which is subject to supervision in an EEA State or, subject to approval of the credit institution's competent authority, if–

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(i) the CIU is managed by a company which is subject to supervision that is considered equivalent to that laid down in Community law; and

(ii) cooperation between competent authorities is sufficiently ensured;

(b) the CIU's prospectus or equivalent document includes–

(i) the categories of assets in which the CIU is permitted to invest; and

(ii) if investment limits apply, the relative limits and the methodologies to calculate them; and

(c) 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.

78. If the Commissioner approves a non-EEA CIU, as set out in paragraph 77(a), then a competent authority in an EEA State may make use of this recognition without conducting its own assessment.

79. Where the credit institution 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 methods set out in regulations 28 to 33.

80. Where the credit institution is not aware of the underlying exposures of a CIU, it may calculate an average risk weight for the CIU in accordance with the methods set out in regulations 28 to 33 subject to the following rules. It shall be assumed that the CIU first invests, to the maximum extent allowed under its mandate, in the exposure classes attracting the highest capital requirement, and then continues making investments in descending order until the maximum total investment limit is reached.

81. A credit institution may rely on a third party to calculate and report, in accordance with the methods set out in paragraphs 79 and 80, a risk weight for the CIU provided that the correctness of the calculation and report shall be adequately ensured.

16. OTHER ITEMS.

16.1. Treatment.

82. Tangible assets within the meaning of Article 4(10) of Directive 86/635/EEC shall be assigned a risk weight of 100 %.

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83. Prepayments and accrued income for which an credit institution is unable to determine the counter party in accordance with Directive 86/635/EEC, shall be assigned a risk weight of 100 %.

84. Cash items in the process of collection shall be assigned a 20 % risk weight. Cash in hand and equivalent cash items shall be assigned a 0 % risk weight.

85. The Commissioner may allow a risk weight of 10 % for exposures to credit institutions specialising in the inter-bank and public-debt markets in Gibraltar and subject to close supervision by the competent authorities where those asset items are fully and completely secured, to the satisfaction of the Commissioner by a items assigned a 0 % or a 20 % risk weight and recognised by the latter as constituting adequate collateral.

86. Holdings of equity and other participations, except where deducted from own funds, shall be assigned a risk weight of at least 100 %.

87. Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities shall be assigned a 0 % risk weight.

88. In the case of asset sale and repurchase agreements and outright forward purchases, the risk weight shall be that assigned to the assets in question and not to the counter parties to the transactions.

89. Where a credit institution provides credit protection for a number of exposures under terms that the nth default among the exposures shall trigger payment and that this credit event shall terminate the contract, and where the product has an external credit assessment from an approved ECAI, the risk weights prescribed in regulations 44 to 51 shall be assigned. If the product is not rated by an approved ECAI, the risk weights of the exposures included in the basket will 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 asset amount. The n-1 exposures to be excluded from the aggregation shall be determined on the basis that they shall 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.

90. The exposure value for leases shall be the discounted minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in paragraphs 26 to 28 of Part 1 of Schedule 8 regarding the eligibility of protection providers as well as the

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minimum requirements for recognising other types of guarantees provided in paragraphs 14 to 19 of Part 2 of Schedule 8 shall also be included in the minimum lease payments. These exposures shall be assigned to the relevant exposure class in accordance with regulation 29. When the exposure is a residual value of leased properties, the risk weighted exposure amounts shall be calculated as: 1/t * 100% * exposure value, where “t” is the greater of 1 and the nearest number of whole years of the lease remaining.

PART 2

Recognition of ECAIs and mapping of their credit assessments

1. METHODOLOGY.

1.1. Objectivity.

1. The Commissioner shall verify that the methodology for assigning credit assessments is rigorous, systematic, continuous and subject to validation based on historical experience.

1.2. Independence.

2. The Commissioner shall verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment.

3. Independence of the ECAI’s methodology shall be assessed by the Commissioner according to factors such as the following–

(a) ownership and organisation structure of the ECAI;

(b) financial resources of the ECAI;

(c) staffing and expertise of the ECAI; and

(d) corporate governance of the ECAI.

1.3. Ongoing review.

4. The Commissioner shall verify that ECAI’s credit assessments are subject to ongoing review and shall be responsive to changes in the financial conditions. Such review shall take place after all significant events and at least annually.

5. Before any approval, the Commissioner shall verify that the assessment methodology for each market segment is established according to standards such as the following–

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(a) the back-testing must be established for at least one year;

(b) the regularity of the review process by the ECAI must be monitored by him; and

(c) the Commissioner shall be able to receive from the ECAI the extent of its contacts with the senior management of the entities which it rates.

6. The Commissioner shall take the necessary measures to be promptly informed by ECAIs of any material changes in the methodology they use for assigning credit assessments.

1.4. Transparency and disclosure.

7. The Commissioner shall take the necessary measures to assure that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are publicly available as to allow all potential users to decide whether they are derived in a reasonable way.

2. INDIVIDUAL CREDIT ASSESSMENTS.

2.1. Credibility and market acceptance.

8. The Commissioner shall verify that ECAIs' individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments.

9. Credibility shall be assessed by the Commissioner according to factors such as the following–

(a) market share of the ECAI;

(b) revenues generated by the ECAI, and more in general financial resources of the ECAI;

(c) whether there is any pricing on the basis of the rating; and

(d) at least two credit institutions use the ECAI's individual credit assessment for bond issuing or assessing credit risks.

2.2. Transparency and Disclosure.

10. The Commissioner shall verify that individual credit assessments are accessible at equivalent terms at least to all credit institutions having a legitimate interest in these individual credit assessments.

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11. In particular, the Commissioner shall verify that individual credit assessments are available to non-domestic parties on equivalent terms as to domestic credit institutions having a legitimate interest in these individual credit assessments.

3. 'MAPPING'.

12. In order to differentiate between the relative degrees of risk expressed by each credit assessment, the Commissioner shall consider quantitative factors such as the long-term default rate associated with all items assigned the same credit assessment. For recently established ECAIs and for those that have compiled only a short record of default data, the Commissioner shall ask the ECAI what it believes to be the long-term default rate associated with all items assigned the same credit assessment.

13. In order to differentiate between the relative degrees of risk expressed by each credit assessment, the Commissioner shall consider qualitative factors such as the pool of issuers that the ECAI covers, the range of credit assessments that the ECAI assigns, each credit assessment meaning and the ECAI's definition of default.

14. The Commissioner shall compare default rates experienced for each credit assessment of a particular ECAI and compare them with a benchmark built on the basis of default rates experienced by other ECAIs on a population of issuers that the competent authorities believes to present an equivalent level of credit risk.

15. If the Commissioner believes that the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher then the benchmark, he shall assign a higher credit quality step in the credit quality assessment scale to the ECAI credit assessment.

16. When the Commissioner has increased the associated risk weight for a specific credit assessment of a particular ECAI, if the ECAI demonstrates that the default rates experienced for its credit assessment are no longer materially and systematically higher than the benchmark, competent authorities may decide to restore the original credit quality step in the credit quality assessment scale for the ECAI credit assessment.

PART 3

Use of ECAIs' credit assessments for the determination of risk weights

1. TREATMENT.

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1. A credit institution may nominate one or more appproved ECAIs to be used for the determination of risk weights to be assigned to asset and off-balance sheet items.

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

3. A credit institution which decides to use the credit assessments produced by an approved ECAI must use them in a continuous and consistent way over time.

4. A credit institution can only use ECAIs credit assessments that take into account all amounts both in principal and in interest owed to it.

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

6. 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 shall be assigned.

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

2. ISSUER AND ISSUE CREDIT ASSESSMENT.

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

9. 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 assessment exists for the issuer, then that credit assessment shall be used if it produces a higher risk weight than would other wise 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.

10. Paragraphs 8 and 9 are not to prevent the application of paragraphs 68 to 71 of Part 1.

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

3. LONG-TERM AND SHORT-TERM CREDIT ASSESSMENTS.

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

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

14. Notwithstanding paragraph 13, if a short-term rated facility is assigned a 150% risk weight, then all unrated unsecured exposures on that obligor whether short-term or long-term shall also be assigned a150 % risk weight.

15. Notwithstanding paragraph 13, if a short-term rated facility is assigned a 50% risk weight, no unrated short-term exposure shall be assigned a risk weight lower than 100%.

4. DOMESTIC AND FOREIGN CURRENCY ITEMS.

16. 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.

17. Notwithstanding paragraph 16, when an exposure arises through a credit institution's participation in a loan that has been extended by a Multilateral Development Bank whose preferred creditor status is recognised in the market, the Commissioner may allow the credit assessment on the obligors' domestic currency item to be used for risk weighting purposes.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007
SCHEDULE 7

Regulations 12, 25, 30, 34, 35, 36, 37 and 38

INTERNAL BASED APPROACH

PART 1

Risk weighted exposure amounts and expected loss amounts.

1. CALCULATION OF RISK WEIGHTED EXPOSURE AMOUNTS FOR CREDIT RISK.

1. Unless noted otherwise, the input parameters probability of default (PD), loss given defaults (LGD), and maturity value (M) shall be determined as set out in Part 2 and the exposure value shall be determined as set out in Part 3.

2. The risk weighted exposure amount for each exposure shall be calculated in accordance with the following formulae.

1.1. Risk weighted exposure amounts for exposures to corporates, institutions and central governments and central banks.

3. Subject to paragraphs 5 to 9, the risk weighted exposure amounts for exposures to corporates, credit institutions, investment firms and central governments and central banks shall be calculated according to the following formulae-

Correlation(R)= 0.12x(1-EXP(-50*PD))/(1-EXP(-50))+ 0.24*[1-(1-EXP(-50*PD))/(1-EXP(-50))]

Looptijdfactor (b) = $(0.11852 – 0.05478*\mathrm{In}(PD))^2$

$(LGD*N[(1-R)^{-0.5*}G(PD)+(R/(1-R))^{0.5}G(0.999)] –PD*LGD)*(1–1.5*b)^{-1*}(1+(M–2.5)*b)*12.5*1.06$

N(x) denotes the cumulative distribution function for a standard normal random variable (i.e. the probability that a normal random variable with mean zero and variance of one is less than or equal to x). G (Z) denotes the inverse cumulative distribution function for a standard normal random variable (i.e. the value x such that N(x) z)

For PD = 0, RW shall be 0.

For PD = 1-

— for defaulted exposures where credit institutions apply the LGD values set out in paragraph 8 of Part 2, RW shall be 0; and

— for defaulted exposures where credit institutions use own estimates of LGDs, RW shall be Max{0, 12.5 *(LGD-EL_{BE})};

where EL_{BE} shall be the credit institution's best estimate of expected loss for the defaulted exposure according to paragraph 80 of Part 4.

Risk—weighted exposure amount = RW * exposure value.

4. The risk weighted exposure amount for each exposure which meets the requirements set out in paragraph 29 of Part 1 of Schedule 8 and paragraph 22 of Part 2 of that Schedule, may be adjusted according to the following formula-

Risk—weighted exposure amount = RW * exposure value * ((0,15 + 160*PDpp))

where-

PDpp = PD of the protection provider.

RW shall be calculated using the relevant risk weight formula set out in paragraph 3 for the exposure, the PD of the obligor and the LGD of a comparable direct exposure to the protection provider. The maturity factor (b) shall be calculated using the lower of the PD of the protection provider and the PD of the obligor.

5. For exposures to companies where the total annual sales for the consolidated group of which the credit institutions is a part is less than EUR 50 million, credit institutions may use the following correlation formula for the calculation of risk weights for corporate exposures. In this formula S is expressed as total annual sales in millions of Euros with EUR 5 million <= S <= EUR 50 million. Reported sales of less than EUR 5 million shall be treated as if they were equivalent to EUR 5 million. For purchased receivables the total annual sales shall be the weighted average by individual exposures of the pool.

Correlation (R) = 0.12 x (1-EXP(-50*PD))/(1-EXP(-50)) + 0.24*[1-(1-EXP(-50*PD))/(1-EXP(-50))] – 0.04*(1 – (S-5)/ 45)

Credit institutions shall substitute total assets of the consolidated group for total annual sales when total annual sales are not a meaningful indicator of firm size and total assets are a more meaningful indicator than total annual sales.

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6. For specialised lending exposures in respect of which a credit institution cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4 it shall assign risk weights to these exposures according to Table 1, as follows-

Table 1

Remaining Maturity	Category 1	Category 2	Category 3	Category 4	Category 5
Less than 2.5 years	50%	70%	115%	250%	0%
Equal to or more than 2.5 years	70%	90%	115%	250%	0%

The Commissioner may allow a credit institution generally to assign preferential risk weights of 50 % to exposures in category 1, and a 70 % risk weight to exposures in category 2, provided the credit institution's underwriting characteristics and other risk characteristics are substantially strong for the relevant category. In assigning risk weights to specialised lending exposures credit institutions shall take into account the following factors–

financial strength, political and legal environment, transaction or asset characteristics, strength of the sponsor and developer, including any public private partnership income stream, and security package.

7. For their purchased corporate receivables credit institutions shall comply with the minimum requirements set out in paragraphs 105 to 109 of Part 4. For purchased corporate receivables which comply in addition with the conditions set out in paragraph 14, and where it would be unduly burdensome for a credit institution to use the risk quantification standards for corporate exposures as set out in Part 4 for these receivables, the risk quantification standards for retail exposures as set out in Part 4 may be used.

8. For purchased corporate receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for default losses, dilution losses, or both, may be treated as first-loss positions under the IRB securitisation framework.

9. Where a credit institution provides credit protection for a number of exposures under terms that the nth default among the exposures shall trigger payment and that this credit event shall terminate the contract, if the product has an external credit assessment from an approved ECAI the risk weights set out in regulations 44 to 51 will be applied. If the product is not rated by an eligible ECAI, the risk weights of the exposures included in the basket shall be aggregated, excluding n-1 exposures where the sum of the expected

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loss amount multiplied by 12,5 and the risk weighted exposure amount shall not exceed the nominal amount of the protection provided by the credit derivative multiplied by 12,5. The n-1 exposures to be excluded from the aggregation shall be determined on the basis that they shall 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.

1.2. Risk weighted exposure amounts for retail exposures.

10. Subject to paragraphs 12 and 13, the risk weighted exposure amounts for retail exposures shall be calculated according to the following formulae-

Correlation (R) = 0.03 x (1-EXP (-35*PD))/(1-EXP(-35)) + 0.16*[1-(1-EXP (-35*PD))/(1-EXP (-35))]

Risk-weight (RW)

$(LGD*N\{(1 – R)^{-0.5}G(PD) + (R/(1-R))^{0.5}G(0.999)\} – PD*12.5*1.06)$

N(x) denotes the cumulative distribution function for a standard normal random variable (i.e. the probability that a normal random variable with mean zero and variance of one is less than or equal to x). G (Z) denotes the inverse cumulative distribution function for a standard normal random variable (i.e. the value x such that N(x)= z).

For PD = 1 (defaulted exposure), RW shall be Max {0, 12.5 *(LGD-EL_{BE})},

where EL_{BE} shall be the credit institution's best estimate of expected loss for the defaulted exposure according to paragraph 80 of Part 4.

Risk—weighted exposure amount = RW * exposure value.

11. The risk weighted exposure amount for each exposure to small and medium sized entities as defined in regulation 36(4) and (5) which meets the requirements set out in paragraphs 22 and 29 of Part 1of Schedule 8, may be calculated according to paragraph 4.

12. For retail exposures secured by real estate collateral a correlation (R) of 0,15 shall replace the figure produced by the correlation formula in paragraph 10.

13. For qualifying revolving retail exposures as defined in paragraphs (a) to (e), a correlation (R) of 0,04 shall replace the figure produced by the correlation formula in paragraph 10.

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Exposures shall qualify as qualifying revolving retail exposures if they meet the following conditions–

(a) The exposures are to individuals;

(b) The exposures are revolving, unsecured, and to the extent they are not drawn immediately and unconditionally, cancellable by the credit institution. (In this context revolving exposures are defined as those where customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to a limit established by the credit institution.). Undrawn commitments may be considered as unconditionally cancellable if the terms permit the credit institution to cancel them to the full extent allowable under consumer protection and related legislation;

(c) The maximum exposure to a single individual in the sub-portfolio is EUR 100 000 or less;

(d) The credit institution can demonstrate that the use of the correlation of this paragraph is limited to portfolios that have exhibited low volatility of loss rates, relative to their average level of loss rates, especially within the low PD bands. The Commissioner shall review the relative volatility of loss rates across the qualifying revolving retail sub-portfolios, as well the aggregate qualifying revolving retail portfolio, and intend to share information on the typical characteristics of qualifying revolving retail loss rates across jurisdictions; and

(e) The Commissioner concurs that treatment as a qualifying revolving retail exposure is consistent with the underlying risk characteristics of the sub-portfolio.

Notwithstanding paragraph (b), the Commissioner may waive the requirement that the exposure be unsecured in respect of collateralised credit facilities linked to a wage account. In this case amounts recovered from the collateral shall not be taken into account in the LGD estimate.

14. To be eligible for the retail treatment, purchased receivables shall comply with the minimum requirements in paragraphs 105 to 109 of Part 4, and the following conditions–

(a) The credit institution has purchased the receivables from unrelated, third party sellers, and its exposure to the obligor of the receivable does not include any exposures that are directly or indirectly originated by the credit institution itself;

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(b) The purchased receivables shall be generated on an arm's-length basis between the seller and the obligor. As such, inter-company accounts receivables and receivables subject to contra-accounts between firms that buy and sell to each other are ineligible;

(c) The purchasing credit institution has a claim on all proceeds from the purchased receivables or a pro rata interest in the proceeds; and

(d) The portfolio of purchased receivables is sufficiently diversified.

15. For purchased receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for default losses, dilution losses, or both, may be treated as first-loss positions under the IRB securitisation framework.

16. For hybrid pools of purchased retail receivables where purchasing credit institutions cannot separate exposures secured by real estate collateral and qualifying revolving retail exposures from other retail exposures, the retail risk weight function producing the highest capital requirements for those exposures shall apply.

1.3. Risk weighted exposure amounts for equity exposures.

17. A credit institution may employ different approaches to different portfolios where the credit institution itself uses different approaches internally. Where a credit institution uses different approaches, the credit institution shall demonstrate to the Commissioner that the choice is made consistently and is not determined by regulatory arbitrage considerations.

18. Notwithstanding paragraph 17, the Commissioner may allow the attribution of risk weighted exposure amounts for equity exposures to ancillary services undertakings according to the treatment of other non credit-obligation assets.

1.3.1. Simple risk weight approach.

19. The risk weighted exposure amount shall be calculated according to the following formula-

Risk weight (RW) = 190 % for private equity exposures in sufficiently diversified portfolios.

Risk weight (RW) = 290 % for exchange traded equity exposures.

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Risk weight (RW) = 370 % for all other equity exposures.

Risk-weighted exposure amount = RW * exposure value.

20. Short cash positions and derivative instruments held in the non-trading book are permitted to offset long positions in the same individual stocks provided that these instruments have been explicitly designated as hedges of specific equity exposures and that they provide a hedge for at least another year. Other short positions shall be treated as if they are long positions with the relevant risk weight assigned to the absolute value of each position. In the context of maturity mismatched positions, the method is that for corporate exposures as set out in paragraph 16 of Part 2 of Schedule 7.

21. Credit institutions may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in regulations 40 to 43.

1.3.2. PD/LGD approach

22. The risk weighted exposure amounts shall be calculated according to the formulae in paragraph 3. If credit institutions do not have sufficient information to use the definition of default set out in paragraphs 44 to 48 of Part 4, a scaling factor of 1.5 shall be assigned to the risk weights.

23. At the individual exposure level the sum of the expected loss amount multiplied by 12,5 and the risk weighted exposure amount shall not exceed the exposure value multiplied by 12.5.

24. Credit institutions may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in regulations 40 to 43. This shall be subject to an LGD of 90 % on the exposure to the provider of the hedge. For private equity exposures in sufficiently diversified portfolios an LGD of 65 % may be used. For these purposes M shall be 5 years.

1.3.3. Internal models approach.

25. The risk weighted exposure amount shall be the potential loss on the credit institution’s equity exposures as derived using internal value-at-risk models subject to the 99th percentile, one-tailed confidence interval of the difference between quarterly returns and an appropriate risk-free rate computed over a long-term sample period, multiplied by 12,5. The risk weighted exposure amounts at the equity portfolio level shall not be less than the total of the sums of minimum risk weighted exposure amounts required under the PD/LGD Approach and the corresponding expected loss amounts multiplied by 12.5 and calculated on the basis of the PD values set

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out in paragraph 24 of Part 2 and the corresponding LGD values set out in paragraphs 25 and 26 of Part 2.

26. Credit institutions may recognise unfunded credit protection obtained on an equity position.

1.4. Risk weighted exposure amounts for other non credit-obligation assets.

27. The risk weighted exposure amounts shall be calculated according to the formula-

Risk-weighted exposure amount = 100 % * exposure value,

except for when the exposure is a residual of leased properties in which case it shall be calculated as follows-

1/t * 100 % * exposure value,

where t is the greater of 1 and the nearest number of whole years of the lease remaining.

2. CALCULATION OF RISK WEIGHTED EXPOSURE AMOUNTS FOR DILUTION RISK OF PURCHASED RECEIVABLES.

28. Risk weights for dilution risk of purchased corporate and retail receivables-

The risk weights shall be calculated according to the formula in paragraph 3. The input parameters PD and LGD shall be determined as set out in Part 2, the exposure value shall be determined as set out in Part 3 and M shall be 1 year. If credit institutions can demonstrate to the Commissioner that dilution risk is immaterial, it may not be recognised.

3. CALCULATION OF EXPECTED LOSS AMOUNTS.

29. Unless noted otherwise, the input parameters PD and LGD shall be determined as set out in Part 2 and the exposure value shall be determined as set out in Part 3.

30. The expected loss amounts for exposures to corporates, credit institutions, investment firms, central governments and central banks and retail exposures shall be calculated according to the following formulae-

Expected loss (EL) = PD × LGD.

Expected loss amount = EL × exposure value.

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For defaulted exposures (PD =1) where credit institutions use own estimates of LGDs, EL shall be EL_{BE}, the credit institution's best estimate of expected loss for the defaulted exposure according to paragraph 80 of Part 4.

For exposures subject to the treatment set out in paragraph 4 of Part 1, EL shall be 0.

31. The EL values for specialised lending exposures where credit institutions use the methods set out in paragraph 6 for assigning risk weights shall be assigned according to Table 2.

Table 2

Remaining Maturity	Category 1	Category 2	Category 3	Category 4	Category 5
Less than 2.5 years	0%	0.4%	2.8%	8%	50%
Equal to or more than 2.5 years	0.4%	0.8%	2.8%	8%	50%

Where the Commissioner has authorised a credit institution generally to assign preferential risk weights of 50 % to exposures in category 1, and 70 % to exposures in category 2, the EL value for exposures in category 1 shall be 0 % and for exposures in category 2 shall be 0.4 %.

32. The expected loss amounts for equity exposures where the risk weighted exposure amounts are calculated according to the methods set out in paragraphs 19 to 21, shall be calculated according to the following formula-

Expected loss amount = EL × exposure value

The EL values shall be the following-

Expected loss (EL) = 0,8 % for private equity exposures in sufficiently diversified portfolios

Expected loss (EL) = 0,8 % for exchange traded equity exposures

Expected loss (EL) = 2,4 % for all other equity exposures.

33. The expected loss amounts for equity exposures where the risk weighted exposure amounts are calculated according to the methods set out in paragraphs 22 to 24 shall be calculated according to the following formulae-

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Expected loss (EL) = PD × LGD and

Expected loss amount = EL × exposure value

34. The expected loss amounts for equity exposures where the risk weighted exposure amounts are calculated according to the methods set out in paragraphs 25 to 26 shall be 0 %.

35. The expected loss amounts for dilution risk of purchased receivables shall be calculated according to the following formula-

Expected loss (EL) = PD × LGD and

Expected loss amount = EL × exposure value

4. TREATMENT OF EXPECTED LOSS AMOUNTS.

36. The expected loss amounts calculated in accordance with paragraphs 30, 31 and 35 shall be subtracted from the sum of value adjustments and provisions related to these exposures. Discounts on balance sheet exposures purchased when in default according to paragraph 1 of Part 3 shall be treated in the same manner as value adjustments. Expected loss amounts for securitised exposures and value adjustments and provisions related to these exposures shall not be included in this calculation.

PART 2

PD, LGD and Maturity.

1. The input parameters PD, LGD and maturity value (M) into the calculation of risk weighted exposure amounts and expected loss amounts specified in Part 1 shall be those estimated by the credit institution in accordance with Part 4, subject to the following provisions.

1. EXPOSURES TO CORPORATES, INSTITUTIONS AND CENTRAL GOVERNMENTS AND CENTRAL BANKS.

1.1. PD.

2. The PD of an exposure to a corporate or a credit institution or an investment firm shall be at least 0.03 %.

3. For purchased corporate receivables in respect of which a credit institution cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4, the PDs for these exposures shall be determined according to the following methods-

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For senior claims on purchased corporate receivables PD shall be the credit institutions estimate of EL divided by LGD for these receivables.

For subordinated claims on purchased corporate receivables PD shall be the credit institution's estimate of EL. If a credit institution is permitted to use own LGD estimates for corporate exposures and it can decompose its EL estimates for purchased corporate receivables into PDs and LGDs in a reliable manner, the PD estimate may be used.

4. The PD of obligors in default shall be 100 %.

5. Credit institutions may recognise unfunded credit protection in the PD in accordance with the provisions of regulations 40 to 43. For dilution risk the Commissioner may recognise as eligible unfunded credit protection providers other than those indicated in Part 1 of Schedule 8.

6. Credit institutions using own LGD estimates may recognise unfunded credit protection by adjusting PDs subject to paragraph 10.

7. For dilution risk of purchased corporate receivables, PD shall be set equal to EL estimate for dilution risk. If a credit institution is permitted to use own LGD estimates for corporate exposures and it can decompose its EL estimates for dilution risk of purchased corporate receivables into PDs and LGDs in a reliable manner, the PD estimate may be used. Credit institutions may recognise unfunded credit protection in the PD in accordance with the provisions of regulations Articles 40 to 43. The Commissioner may recognise as eligible unfunded credit protection providers other than those indicated in Part 1 of Schedule 8. If a credit institution is permitted to use own LGD estimates for dilution risk of purchased corporate receivables, it may recognise unfunded credit protection by adjusting PDs subject of paragraph 10.

1.2. LGD.

8. Credit institutions shall use the following LGD values–

(a) Senior exposures without eligible collateral- 45 %;

(b) Subordinated exposures without eligible collateral- 75 %;

(c) Credit institutions may recognise funded and unfunded credit protection in the LGD in accordance with regulations 40 to 43:

(d) Covered bonds as defined in Schedule 6, Part 1, points 68 to 70 may be assigned an LGD value of 11.25 %;

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(e) For senior purchased corporate receivables exposures where a credit institution cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4- 45 %;

(f) For subordinated purchased corporate receivables exposures where a credit institution cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4- 100 %; and

For dilution risk of purchased corporate receivables- 75 %.

Until 31 December 2010, covered bonds as defined in paragraphs 68 to 70 of Part 1 of Schedule 6 may be assigned an LGD value of 11.25 % if-

— assets as set out in paragraph 68(a) to (c) of Part 1 of Schedule 6, collateralising the bonds all qualify for credit quality step 1 as set out in that Schedule;

— where assets set out in paragraph 68(d) and (e) of Part 1 of Schedule 6, are used as collateral, the respective upper limits laid down in each of those paragraphs is 10 % of the nominal amount of the outstanding issue;

— assets as set out in paragraph 68(f) of Part 1 of Schedule 6, are not used as collateral; or

— the covered bonds are the subject of a credit assessment by a nominated ECAI, and the ECAI places them in the most favourable category of credit assessment that the ECAI could make in respect of covered bonds.

9. Notwithstanding paragraph 8, for dilution and default risk if a credit institution is permitted to use own LGD estimates for corporate exposures and it can decompose its EL estimates for purchased corporate receivables into PDs and LGDs in a reliable manner, the LGD estimate for purchased corporate receivables may be used.

10. Notwithstanding paragraph 8, if a credit institution is permitted to use own LGD estimates for exposures to corporates, credit institutions, investment firms, central governments and central banks, unfunded credit protection may be recognized by adjusting PD or LGD subject to minimum requirements as specified in Part 4 and to the approval of the Commissioner. A credit institution shall not assign guaranteed exposures an adjusted PD or LGD such that the adjusted risk weight would be lower than that of a comparable, direct exposure to the guarantor.

11. Notwithstanding paragraphs 8 and 10, for the purposes of paragraph 4 of Part 1, the LGD of a comparable direct exposure to the protection provider shall either be the LGD associated with an unhedged facility to the

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guarantor or the unhedged facility of the obligor, depending upon whether in the event both the guarantor and obligor default during the life of the hedged transaction, available evidence and the structure of the guarantee indicate that the amount recovered would depend on the financial condition of the guarantor or obligor, respectively.

1.3. Maturity.

12. Subject to paragraph 13, credit institutions shall assign to exposures arising from repurchase transactions or securities or commodities lending or borrowing transactions a maturity value (M) of 0,5 years and to all other exposures an M of 2,5 years. The Commissoner may require all credit institutions in their jurisdiction to use M for each exposure as set out under paragraph 13.

13. Credit institutions permitted to use own LGDs or own conversion factors for exposures to corporates, credit institutions, investment firms or central governments and central banks shall calculate M for each of these exposures as set out in sub-paragraphs (a) to (e) and subject to paragraphs 14 to 16. In all cases, M shall be no greater than 5 years–

(a) For an instrument subject to a cash flow schedule, M shall be calculated according to the following formula–

$$M = MAX\{1 : MIN\{\sum_t t^* CF_t / \sum_t CF_t, 5\}\}$$

where CF_t denotes the cash flows (principal, interest payments and fees) contractually payable by the obligor in period t;

(b) For derivatives subject to a master netting agreement, M shall be the weighted average remaining maturity of the exposure, where M shall be at least 1 year. The notional amount of each exposure shall be used for weighting the maturity;

(c) For exposures arising from fully or nearly-fully collateralised derivative instruments (listed in Schedule 4) transactions and fully or nearly-fully collateralised margin lending transactions which are subject to a master netting agreement, M shall be the weighted average remaining maturity of the transactions where M shall be at least 10 days. The notional amount of each transaction shall be used for weighting the maturity.

For repurchase transactions or securities or commodities lending or borrowing transactions which are subject to a master netting agreement, M shall be the weighted average remaining maturity of the transactions where M shall be at least 5 days;

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(d) If a credit institution is permitted to use own PD estimates for purchased corporate receivables, for drawn amounts M shall equal the purchased receivables exposure weighted average maturity, where M shall be at least 90 days. This same value of M shall also be used for undrawn amounts under a committed purchase facility provided the facility contains effective covenants, early amortisation triggers, or other features that protect the purchasing credit institution against a significant deterioration in the quality of the future receivables it is required to purchase over the facility"s term. Absent such effective protections, M for undrawn amounts shall be calculated as the sum of the longest-dated potential receivable under the purchase agreement and the remaining maturity of the purchase facility, where M shall be at least 90 days;

(e) For any other instrument than those mentioned in this paragraph or when a credit institution is not in a position to calculate M as set out in (a), M shall be the maximum remaining time (in years) that the obligor is permitted to take to fully discharge its contractual obligations, where M shall be at least 1 year;

(f) for credit institutions using the Internal Model Method set out in Part 6 of Schedule 3 to calculate the exposure values, M shall be calculated for exposures to which they apply this method and for which the maturity of the longest-dated contract contained in the netting set is greater than one year according to the following formula-

$$M = MIN\left(\frac{\sum_{k=1}^{tk \le 1\,year} Effective\ EE_k {}^{*} \Delta t_k {}^{*} df_k + \sum_{tk > 1\,year}^{maturity} EE_k {}^{*} \Delta t_k {}^{*} df_k}{\sum_{k=1}^{tk \le 1\,year} Effective\ EE_k {}^{*} \Delta t_k {}^{*} df_k} ;5 \right)$$

Where–

df = the risk-free discount factor for future time period tk and the remaining symbols are defined in Part 6 of Schedule 3.

Notwithstanding the first paragraph of paragraph 13(f), a credit institution that uses an internal model to calculate a one-sided credit valuation adjustment (CVA) may use, subject to the

approval of the Commissioner, the effective credit duration estimated by the internal model as M.

Subject to paragraph 14, for netting sets in which all contracts have an original maturity of less than one year the formula in paragraph (a) shall apply; and

(g) for the purposes of Part 1, paragraph 4, M shall be the effective maturity of the credit protection but at least 1 year.

14. Notwithstanding paragraph 13(a), (b), (c), (d) and (e), M shall be at least one-day for–

— fully or nearly-fully collateralised derivative instruments listed in Schedule 4;

— fully or nearly-fully collateralised margin lending transactions; and

— repurchase transactions, securities or commodities lending or borrowing transactions:

Provided the documentation requires daily re-margining and daily revaluation and includes provisions that allow for the prompt liquidation or setoff of collateral in the event of default or failure to re-margin.

In addition, for other short-term exposures specified by the Commissioner which are not part of the credit institution's ongoing financing of the obligor, M shall be at least one-day. A careful review of the particular circumstances shall be made in each case.

15. The Commissioner may allow for exposures to corporates situated in the EEA and having consolidated sales and consolidated assets of less than EUR 500 million the use of M as set out in paragraph 12. The Commissioner may replace EUR 500 million total assets with EUR 1000 million total assets for corporates which primarily invest in real estate.

16. Maturity mismatches shall be treated as specified in regulations 40 to 43.

2. RETAIL EXPOSURES

2.1. PD.

17. The PD of an exposure shall be at least 0.03 %.

18. The PD of obligors or, where an obligation approach is used, of exposures in default shall be 100 %.

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19. For dilution risk of purchased receivables PD shall be set equal to EL estimates for dilution risk. If a credit institution can decompose its EL estimates for dilution risk of purchased receivables into PDs and LGDs in a reliable manner, the PD estimate may be used.

20. Unfunded credit protection may be recognised as eligible by adjusting PDs subject to paragraph 22. For dilution risk, where credit institutions do not use own estimates of LGDs, this shall be subject to compliance with regulations 40 to 43; for this purpose the Commissioner may recognise as eligible unfunded protection providers other than those indicated in Part 1 of Schedule 8.

2.2. LGD.

21. Credit institutions shall provide own estimates of LGDs subject to minimum requirements as specified in Part 4 and with the prior approval of the Commissioner. For dilution risk of purchased receivables, an LGD value of 75 % shall be used. If a credit institution can decompose its EL estimates for dilution risk of purchased receivables into PDs and LGDs in a reliable manner, the LGD estimate may be used.

22. Unfunded credit protection may be recognised as eligible by adjusting PD or LGD estimates subject to minimum requirements as specified in paragraphs 99 to 104 of Part 4, and with the prior approval of the Commissioner either in support of an individual exposure or a pool of exposures. A credit institution shall not assign guaranteed exposures an adjusted PD or LGD such that the adjusted risk weight would be lower than that of a comparable, direct exposure to the guarantor.

23. Notwithstanding paragraph 22, for the purposes of paragraph 11 of Part 1, the LGD of a comparable direct exposure to the protection provider shall either be the LGD associated with an unhedged facility to the guarantor or the unhedged facility of the obligor, depending upon whether, in the event both the guarantor and obligor default during the life of the hedged transaction, available evidence and the structure of the guarantee indicate that the amount recovered would depend on the financial condition of the guarantor or obligor, respectively.

3. EQUITY EXPOSURES SUBJECT TO PD/LGD METHOD.

3.1. PD.

24. PDs shall be determined according to the methods for corporate exposures. The following minimum PDs shall apply–

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(a) 0.09 % for exchange traded equity exposures where the investment is part of a long-term customer relationship;

(b) 0.09 % for non-exchange traded equity exposures where the returns on the investment are based on regular and periodic cash flows not derived from capital gains;

(c) 0.40 % for exchange traded equity exposures including other short positions as set out in paragraph 20 of Part 1; and

(d) 1.25 % for all other equity exposures including other short positions as set out in paragraph 20 of Part 1.

3.2. LGD.

25. Private equity exposures in sufficiently diversified portfolios may be assigned an LGD of 65 %.

26. All other exposures shall be assigned an LGD of 90 %.

3.3. Maturity.

27. M assigned to all exposures shall be 5 years.

PART 3

Exposure value

1. EXPOSURES TO CORPORATES, CREDIT INSTITUTIONS, INVESTMENT FIRMS, CENTRAL GOVERNMENTS AND CENTRAL BANKS AND RETAIL EXPOSURES.

1. Unless noted otherwise, the exposure value of on-balance sheet exposures shall be measured gross of value adjustments. This rule also applies to assets purchased at a price different than the amount owed. For purchased assets, the difference between the amount owed and the net value recorded on the balance-sheet of credit institutions is denoted discount if the amount owed is larger, and premium if it is smaller.

2. Where credit institutions use Master netting agreements in relation to repurchase transactions or securities or commodities lending or borrowing transactions, the exposure value shall be calculated in accordance with regulations 40 to 43.

3. For on-balance sheet netting of loans and deposits, credit institutions shall apply for the calculation of the exposure value the methods set out in regulations 40 to 43.

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4. The exposure value for leases shall be the discounted minimum lease payments.

“Minimum lease payments” are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in paragraphs 26 to 28 of Part 1 of Schedule 8, regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in paragraphs 14 to 19 of Part 2 of Schedule 8, should also be included in the minimum lease payments.

5. In the case of any item listed in Schedule 4, the exposure value shall be determined by the methods set out in Schedule 3.

6. The exposure value for the calculation of risk weighted exposure amounts of purchased receivables shall be the outstanding amount minus the capital requirements for dilution risk prior to credit risk mitigation.

7. Where an exposure takes the form of securities or commodities sold, posted or lent under repurchase transactions or securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions, the exposure value shall be the value of the securities or commodities determined in accordance with regulation 22. Where the Financial Collateral Comprehensive Method as set out in Part 3 of Schedule 8, used, the exposure value shall be increased by the volatility adjustment appropriate to such securities or commodities, as set out therein. The exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions may be determined either in accordance with Schedule 3 or paragraphs 12 to 21 of Part 3 of Schedule 8.

8. Notwithstanding paragraph 7, the exposure value of credit risk exposures outstanding, as determined by the Commissioner, with a central counter party shall be determined in accordance with paragraph 6 of Part 2 of Schedule 3 provided that the central counter party’s counter party credit risk exposures with all participants in its arrangements are fully collateralised on a daily basis.

9. The exposure value for the following items shall be calculated as the committed but undrawn amount multiplied by a conversion factor.

Credit institutions shall use the following conversion factors–

(a) for credit lines which are uncommitted, that are unconditionally cancellable at any time by the credit institution

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without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness, a conversion factor of 0 % shall apply. To apply a conversion factor of 0 %, credit institutions shall actively monitor the financial condition of the obligor, and their internal control systems shall enable them to immediately detect a deterioration in the credit quality of the obligor. Undrawn retail credit lines may be considered as unconditionally cancellable if the terms permit the credit institution to cancel them to the full extent allowable under consumer protection and related legislation;

(b) for short-term letters of credit arising from the movement of goods, a conversion factor of 20 % shall apply for both the issuing and confirming institutions;

(c) for undrawn purchase commitments for revolving purchased receivables that are unconditionally cancellable or that effectively provide for automatic cancellation at any time by the credit institution without prior notice, a conversion factor of 0 % shall apply. To apply a conversion factor of 0 %, credit institutions shall actively monitor the financial condition of the obligor, and their internal control systems shall enable them to immediately detect a deterioration in the credit quality of the obligor;

(d) for other credit lines, note issuance facilities (NIFs), and revolving underwriting facilities (RUFs), a conversion factor of 75 % shall apply; and

(e) credit institutions which meet the minimum requirements for the use of own estimates of conversion factors as specified in Part 4 may use their own estimates of conversion factors across different product types as mentioned in paragraphs (a) to (d), subject to the prior approval of the Commissioner.

10. Where a commitment refers to the extension of another commitment, the lower of the two conversion factors associated with the individual commitment shall be used.

11. For all off-balance sheet items other than those mentioned in paragraphs 1 to 9, the exposure value shall be the following percentage of its value–

— 100 % if it is a full risk item,

— 50 % if it is a medium-risk item,

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— 20 % if it is a medium/low-risk item, and

— 0 % if it is a low-risk item.

For the purposes of this paragraph the off-balance sheet items shall be assigned to risk categories as indicated in Schedule 2.

2. EQUITY EXPOSURES.

12. The exposure value shall be the value presented in the financial statements. Admissible equity exposure measures shall be–

(a) For investments held at fair value with changes in value flowing directly through income and into own funds, the exposure value shall be the fair value presented in the balance sheet;

(b) For investments held at fair value with changes in value not flowing through income but into a tax adjusted separate component of equity, the exposure value shall be the fair value presented in the balance sheet; and

(c) For investments held at cost or at the lower of cost or market, the exposure value shall be the cost or market value presented in the balance sheet.

3. OTHER NON CREDIT-OBLIGATION ASSETS.

13. The exposure value of other non credit-obligation assets shall be the value presented in the financial statements.

PART 4

Minimum requirements for IRB Approach

1. RATING SYSTEMS.

1. A ”rating system” shall comprise all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to grades or pools (rating), and the quantification of default and loss estimates for a certain type of exposure.

2. If a credit institution uses multiple rating systems, the rationale for assigning an obligor or a transaction to a rating system shall be documented and applied in a manner that appropriately reflects the level of risk.

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3. Assignment criteria and processes shall be periodically reviewed to determine whether they remain appropriate for the current portfolio and external conditions.

1.1. Structure of rating systems.

4. Where a credit institution uses direct estimates of risk parameters these may be seen as the outputs of grades on a continuous rating scale.

1.1.1. Exposures to corporates, credit institutions, investment firms and central governments and central banks

5. A rating system shall take into account obligor and transaction risk characteristics.

6. A rating system shall have an obligor rating scale which reflects exclusively quantification of the risk of obligor default. The obligor rating scale shall have a minimum of 7 grades for non-defaulted obligors and one for defaulted obligors.

7. An "obligor grade" means a risk category within a rating system's obligor rating scale, to which obligors are assigned on the basis of a specified and distinct set of rating criteria, from which estimates of PD are derived. A credit institution shall document the relationship between obligor grades in terms of the level of default risk each grade implies and the criteria used to distinguish that level of default risk.

8. Credit institutions with portfolios concentrated in a particular market segment and range of default risk shall have enough obligor grades within that range to avoid undue concentrations of obligors in a particular grade. Significant concentrations within a single grade shall be supported by convincing empirical evidence that the obligor grade covers a reasonably narrow PD band and that the default risk posed by all obligors in the grade falls within that band.

9. To qualify for recognition by the Commissioner of the use for capital requirement calculation of own estimates of LGDs, a rating system shall incorporate a distinct facility rating scale which exclusively reflects LGD related transaction characteristics.

10. A "facility grade" shall mean a risk category within a rating system's facility scale, to which exposures are assigned on the basis of a specified and distinct set of rating criteria from which own estimates of LGDs are derived. The grade definition shall include both a description of how exposures are assigned to the grade and of the criteria used to distinguish the level of risk across grades.

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11. Significant concentrations within a single facility grade shall be supported by convincing empirical evidence that the facility grade covers a reasonably narrow LGD band, respectively, and that the risk posed by all exposures in the grade falls within that band.

12. Credit institutions using the methods set out in paragraph 6 of Part 1, for assigning risk weights for specialised lending exposures shall be exempt from the requirement to have an obligor rating scale which reflects exclusively quantification of the risk of obligor default for these exposures. Notwithstanding paragraph 6, these institutions shall have for these exposures at least 4 grades for non-defaulted obligors and at least one grade for defaulted obligors.

1.1.2. Retail exposures.

13. Rating systems shall reflect both obligor and transaction risk, and shall capture all relevant obligor and transaction characteristics.

14. The level of risk differentiation shall ensure that the number of exposures in a given grade or pool is sufficient to allow for meaningful quantification and validation of the loss characteristics at the grade or pool level. The distribution of exposures and obligors across grades or pools shall be such as to avoid excessive concentrations.

15. Credit institutions shall demonstrate that the process of assigning exposures to grades or pools provides for a meaningful differentiation of risk, provides for a grouping of sufficiently homogenous exposures, and allows for accurate and consistent estimation of loss characteristics at grade or pool level. For purchased receivables the grouping shall reflect the seller’s underwriting practices and the heterogeneity of its customers.

16. Credit institutions shall consider the following risk drivers when assigning exposures to grades or pools–

(a) Obligor risk characteristics;

(b) Transaction risk characteristics, including product or collateral types or both. Credit institutions shall explicitly address cases where several exposures benefit from the same collateral; and

(c) Delinquency, unless the credit institution demonstrates to its competent authority that delinquency is not a material risk drivers for the exposure;

1.2. Assignment to grades or pools.

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17. A credit institution shall have specific definitions, processes and criteria for assigning exposures to grades or pools within a rating system.

(a) The grade or pool definitions and criteria shall be sufficiently detailed to allow those charged with assigning ratings to consistently assign obligors or facilities posing similar risk to the same grade or pool. This consistency shall exist across lines of business, departments and geographic locations;

(b) The documentation of the rating process shall allow third parties to understand the assignments of exposures to grades or pools, to replicate grade and pool assignments and to evaluate the appropriateness of the assignments to a grade or a pool; and

(c) The criteria shall also be consistent with the credit institution's internal lending standards and its policies for handling troubled obligors and facilities.

18. A credit institution shall take all relevant information into account in assigning obligors and facilities to grades or pools. Information shall be current and shall enable the credit institution to forecast the future performance of the exposure. The less information a credit institution has, the more conservative shall be its assignments of exposures to obligor and facility grades or pools. If a credit institution uses an external rating as a primary factor determining an internal rating assignment, the credit institution shall ensure that it considers other relevant information.

1.3. Assignment of exposures.

1.3.1. Exposures to corporates, credit institutions, investment firms and central governments and central banks.

19. Each obligor shall be assigned to an obligor grade as part of the credit approval process.

20. For those credit institutions permitted to use own estimates of LGDs or conversion factors, each exposure shall also be assigned to a facility grade as part of the credit approval process.

21. Credit institutions using the methods set out in paragraph 6 of Part 1, for assigning risk weights for specialised lending exposures shall assign each of these exposures to a grade in accordance with paragraph 12.

22. Each separate legal entity to which the credit institution is exposed shall be separately rated. A credit institution shall demonstrate to the Commissioner that it has acceptable policies regarding the treatment of individual obligor clients and groups of connected clients.

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23. Separate exposures to the same obligor shall be assigned to the same obligor grade, irrespective of any differences in the nature of each specific transaction. Exceptions, where separate exposures are allowed to result in multiple grades for the same obligor are-

(a) country transfer risk, this being dependent on whether the exposures are denominated in sterling or a foreign currency;

(b) where the treatment of associated guarantees to an exposure may be reflected in an adjusted assignment to an obligor grade; and

(c) where consumer protection, bank secrecy or other legislation prohibit the exchange of client data.

1.3.2. Retail exposures.

24. Each exposure shall be assigned to a grade or a pool as part of the credit approval process.

1.3.3. Overrides.

25. For grade and pool assignments credit institutions shall document the situations in which human judgement may override the inputs or outputs of the assignment process and the personnel responsible for approving these overrides. Credit institutions shall document these overrides and the personnel responsible. Credit institutions shall analyse the performance of the exposures whose assignments have been overridden. This analysis shall include assessment of the performance of exposures whose rating has been overridden by a particular person, accounting for all the responsible personnel.

1.4. Integrity of assignment process.

1.4.1. Exposures to corporates, institutions and central governments and central banks.

26. Assignments and periodic reviews of assignments shall be completed or approved by an independent party that does not directly benefit from decisions to extend the credit.

27. Credit institutions shall update assignments at least annually. High risk obligors and problem exposures shall be subject to more frequent review. Credit institutions shall undertake a new assignment if material information on the obligor or exposure becomes available.

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28. A credit institution shall have an effective process to obtain and update relevant information on obligor characteristics that affect PDs, and on transaction characteristics that affect LGDs and/or conversion factors.

1.4.2. Retail exposures.

29. A credit institution shall at least annually update obligor and facility assignments or review the loss characteristics and delinquency status of each identified risk pool, whichever applicable. A credit institution shall also at least annually review in a representative sample the status of individual exposures within each pool as a means of ensuring that exposures continue to be assigned to the correct pool.

1.5. Use of models.

30. If a credit institution uses statistical models and other mechanical methods to assign exposures to obligors or facilities grades or pools, then–

(a) the credit institution shall demonstrate to the Commissioner that the model has good predictive power and that capital requirements are not distorted as a result of its use. The input variables shall form a reasonable and effective basis for the resulting predictions. The model shall not have material biases;

(b) the credit institution shall have in place a process for vetting data inputs into the model, which includes an assessment of the accuracy, completeness and appropriateness of the data;

(c) the credit institution shall demonstrate that the data used to build the model is representative of the population of the credit institution's actual obligors or exposures;

(d) the credit institution shall have a regular cycle of model validation that includes monitoring of model performance and stability; review of model specification; and testing of model outputs against outcomes; and

(e) the credit institution shall complement the statistical model by human judgement and human oversight to review model-based assignments and to ensure that the models are used appropriately. Review procedures shall aim at finding and limiting errors associated with model weaknesses. Human judgements shall take into account all relevant information not considered by the model. The credit institution shall document how human judgement and model results are to be combined.

1.6. Documentation of rating systems.

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31. The credit institutions shall document the design and operational details of its rating systems. The documentation shall evidence compliance with the minimum requirements in this part, and address topics including portfolio differentiation, rating criteria, responsibilities of parties that rate obligors and exposures, frequency of assignment reviews, and management oversight of the rating process.

32. The credit institution shall document the rationale for and analysis supporting its choice of rating criteria. A credit institution shall document all major changes in the risk rating process, and such documentation shall support identification of changes made to the risk rating process subsequent to the last review by the Commissioner. The organisation of rating assignment including the rating assignment process and the internal control structure shall also be documented.

33. The credit institutions shall document the specific definitions of default and loss used internally and demonstrate consistency with the definitions set out in these Regulations.

34. If the credit institution employs statistical models in the rating process, the credit institution shall document their methodologies. This material shall-

(a) provide a detailed outline of the theory, assumptions or mathematical and empirical basis of the assignment of estimates to grades, individual obligors, exposures, or pools, and the data source used to estimate the model;

(b) establish a rigorous statistical process (including out-of-time and out-of-sample performance tests) for validating the model; and

(c) indicate any circumstances under which the model does not work effectively.

35. Use of a model obtained from a third-party vendor that claims proprietary technology is not a justification for exemption from documentation or any other of the requirements for rating systems. The burden is on the credit institution to satisfy the Commissioner.

1.7. Data maintenance.

36. Credit institutions shall collect and store data on aspects of their internal ratings as required under regulations 87 to 90.

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1.7.1. Exposures to corporates, credit institutions, investment firms and central governments and central banks.

37. Credit institutions shall collect and store–

(a) complete rating histories on obligors and recognised guarantors;

(b) the dates the ratings were assigned;

(c) the key data and methodology used to derive the rating;

(d) the person responsible for the rating assignment;

(e) the identity of obligors and exposures which defaulted;

(f) the date and circumstances of such defaults; and

(g) data on the PDs and realised default rates associated with rating grades and ratings migration;

Credit institutions not using own estimates of LGDs or conversion factors shall collect and store data on comparisons of realised LGDs to the values as set out in paragraph 8 of Part 2, and realised conversion factors to the values as set out in paragraph 9 of Part 3.

38. Credit institutions using own estimates of LGDs or conversion factors shall collect and store–

(a) complete histories of data on the facility ratings and LGD and conversion factor estimates associated with each rating scale;

(b) the dates the ratings were assigned and the estimates were done;

(c) the key data and methodology used to derive the facility ratings and LGD and conversion factor estimates;

(d) the person who assigned the facility rating and the person who provided LGD and conversion factor estimates;

(e) data on the estimated and realised LGDs and conversion factors associated with each defaulted exposure;

(f) data on the LGD of the exposure before and after evaluation of the effects of a guarantee/or credit derivative, for those credit

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institutions that reflect the credit risk mitigating effects of guarantees or credit derivatives through LGD; and

(g) data on the components of loss for each defaulted exposure.

1.7.2. Retail exposures.

39. Credit institutions shall collect and store–

(a) data used in the process of allocating exposures to grades or pools;

(b) data on the estimated PDs, LGDs and conversion factors associated with grades or pools of exposures;

(c) the identity of obligors and exposures that defaulted;

(d) for defaulted exposures, data on the grades or pools to which the exposure was assigned over the year prior to default and the realised outcomes on LGD and conversion factor; and

(e) data on loss rates for qualifying revolving retail exposures.

1.8. Stress tests used in assessment of capital adequacy.

40. A credit institution shall have in place sound stress testing processes for use in the assessment of its capital adequacy. Stress testing shall involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and assessment of its ability to withstand such changes.

41. A credit institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test shall be one chosen by the credit institution, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A credit institution shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of a credit institution's total exposure.

42. Credit institutions using the treatment set out in paragraph 4 of Part 1 shall consider as part of their stress testing framework the impact of a deterioration in the credit quality of protection providers, in particular the impact of protection providers falling outside the eligibility criteria.

2. RISK QUANTIFICATION.

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43. In determining the risk parameters to be associated with rating grades or pools, credit institutions shall apply the following requirements.

2.1. Definition of default.

44. A "default" shall be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place–

(a) the credit institution considers that the obligor is unlikely to pay its credit obligations to the credit institution, the parent undertaking or any of its subsidiaries in full, without recourse by the credit institution to actions such as realising security (if held);

(b) the obligor is past due more than 90 days on any material credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.

For overdrafts, days past due commence once an obligor has breached an advised limit, has been advised a limit smaller than current outstandings, or has drawn credit without authorisation and the underlying amount shall be material.

An "advised limit" means a limit which has been brought to the knowledge of the obligor.

Days past due for credit cards commence on the minimum payment due date.

In the case of retail exposures and exposures to public sector entities (PSE) the Commissioner shall set a number of days past due as specified in paragraph 48.

In the case of corporate exposures the Commissioner may set a number of days past due as specified in regulation 93(14) to (16).

In the case of retail exposures credit institutions may apply the definition of default at a facility level.

In all cases, the exposure past due shall be above a threshold defined by the Commissioner and which reflects a reasonable level of risk.

45. Elements to be taken as indications of unlikeliness to pay shall include–

(a) The credit institution puts the credit obligation on non-accrued status,

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(b) The credit institution makes a value adjustment resulting from a significant perceived decline in credit quality subsequent to the credit institution taking on the exposure,

(c) The credit institution sells the credit obligation at a material credit-related economic loss,

(d) The credit institution consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees. This includes, in the case of equity exposures assessed under a PD or LGD Approach, distressed restructuring of the equity itself,

(e) The credit institution has filed for the obligor's bankruptcy or a similar order in respect of an obligor's credit obligation to the credit institution, the parent undertaking or any of its subsidiaries, and

(f) The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of a credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.

46. Credit institutions that use external data that is not itself consistent with the definition of default, shall demonstrate to the Commissioner that appropriate adjustments have been made to achieve broad equivalence with the definition of default.

47. If the credit institution considers that a previously defaulted exposure is such that no trigger of default continues to apply, the credit institution shall rate the obligor or facility as it would for a non-defaulted exposure. Should the definition of default subsequently be triggered, another default shall be deemed to have occurred.

48. For retail and PSE exposures, the Commissioner shall set the exact number of days past due that all credit institutions shall abide by under the definition of default set out in paragraph 44, for exposures to such counterparts. The specific number shall fall within 90 to 180 days and may differ across product lines. For exposures to such counterparts situated in the territories of EEA States, the Commissioner shall set a number of days past due which is not higher than the number set by the competent authority of the respective EEA State.

2.2. Overall requirements for estimation.

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49. A credit institution's own estimates of the risk parameters PD, LGD, conversion factor and EL shall incorporate all relevant data, information and methods. The estimates shall be derived using both historical experience and empirical evidence, and not based purely on judgemental considerations. The estimates shall be plausible and intuitive and shall be based on the material drivers of the respective risk parameters. The less data a credit institution has, the more conservative it shall be in its estimation.

50. The credit institution shall be able to provide a breakdown of its loss experience in terms of default frequency, LGD, conversion factor, or loss where EL estimates are used, by the factors it sees as the drivers of the respective risk parameters. The credit institution shall demonstrate that its estimates are representative of long run experience.

51. Any changes in lending practice or the process for pursuing recoveries over the observation periods referred to in paragraphs 66, 71, 82, 86, 93 and 95 shall be taken into account. A credit institution's estimates shall reflect the implications of technical advances and new data and other information, as it becomes available. Credit institutions shall review their estimates when new information comes to light but at least on an annual basis.

52. The population of exposures represented in the data used for estimation, the lending standards used when the data was generated and other relevant characteristics shall be comparable with those of the credit institution's exposures and standards. The credit institution shall also demonstrate that the economic or market conditions that underlie the data are relevant to current and foreseeable conditions. The number of exposures in the sample and the data period used for quantification shall be sufficient to provide the credit institution with confidence in the accuracy and robustness of its estimates.

53. For purchased receivables the estimates shall reflect all relevant information available to the purchasing credit institution regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing credit institution, or by external sources. The purchasing credit institution shall evaluate any data relied upon which is provided by the seller.

54. A credit institution shall add to its estimates a margin of conservatism that is related to the expected range of estimation errors. Where methods and data are less satisfactory and the expected range of errors is larger, the margin of conservatism shall be larger.

55. If a credit institution uses different estimates for the calculation of risk weights and for internal purposes, it shall be documented and their reasonableness shall be demonstrated to the Commissioner.

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56. If a credit institution can demonstrate to the Commissioner that for data that have been collected prior to the date of operation of these Regualtions appropriate adjustments have been made to achieve broad equivalence with the definitions of default or loss, the Commissioner may allow the credit institution some flexibility in the application of the required standards for data.

57. If a credit institution uses data that is pooled across credit institutions it shall demonstrate that–

(a) the rating systems and criteria of other credit institutions in the pool are similar with its own;

(b) the pool is representative of the portfolio for which the pooled data is used; and

(c) the pooled data is used consistently over time by the credit institution for its estimates.

58. If a credit institution uses data that is pooled across credit institutions, it shall remain responsible for the integrity of its rating systems. The credit institution shall demonstrate to the Commissioner that it has sufficient in-house understanding of its rating systems, including effective ability to monitor and audit the rating process.

2.2.1. Requirements specific to PD estimation.

Exposures to corporates, institutions and central governments and central banks.

59. Credit institutions shall estimate PDs by obligor grade from long run averages of one-year default rates.

60. For purchased corporate receivables credit institutions may estimate ELs by obligor grade from long run averages of one-year realised default rates.

61. If a credit institution derives long run average estimates of PDs and LGDs for purchased corporate receivables from an estimate of EL, and an appropriate estimate of PD or LGD, the process for estimating total losses shall meet the overall standards for estimation of PD and LGD set out in this Part, and the outcome shall be consistent with the concept of LGD as set out in paragraph 73.

62. Credit institutions shall use PD estimation techniques only with supporting analysis. Credit institutions shall recognise the importance of

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judgmental considerations in combining results of techniques and in making adjustments for limitations of techniques and information.

63. To the extent that a credit institution uses data on internal default experience for the estimation of PDs, it shall demonstrate in its analysis that the estimates are reflective of underwriting standards and of any differences in the rating system that generated the data and the current rating system. Where underwriting standards or rating systems have changed, the credit institution shall add a greater margin of conservatism in its estimate of PD.

64. To the extent that a credit institution associates or maps its internal grades to the scale used by an ECAI or similar organisations and then attributes the default rate observed for the external organisation's grades to the credit institution's grades, mappings shall be based on a comparison of internal rating criteria to the criteria used by the external organisation and on a comparison of the internal and external ratings of any common obligors. Biases or inconsistencies in the mapping approach or underlying data shall be avoided. The external organisation's criteria underlying the data used for quantification shall be oriented to default risk only and not reflect transaction characteristics. The credit institution's analysis shall include a comparison of the default definitions used, subject to the requirements in paragraphs 44 to 48. The credit institution shall document the basis for the mapping.

65. To the extent that a credit institution uses statistical default prediction models it is allowed to estimate PDs as the simple average of default-probability estimates for individual obligors in a given grade. The credit institution's use of default probability models for this purpose shall meet the standards specified in paragraph 30.

66. Irrespective of whether a credit institution is using external, internal, or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used shall be at least five years for at least one source. If the available observation period spans a longer period for any source, and this data is relevant, this longer period shall be used. This paragraph also applies to the PD or LGD Approach to equity. Credit institutions which are not permitted to use own estimates of LGDs or conversion factors may have, when they implement the IRB Approach, relevant data covering a period of two years. The period to be covered shall increase by one year each year until relevant data cover a period of five years.

Retail exposures.

67. Credit institutions shall estimate PDs by obligor grade or pool from long run averages of one-year default rates.

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68. Notwithstanding paragraph 67, PD estimates may also be derived from realised losses and appropriate estimates of LGDs.

69. Credit institutions shall regard internal data for assigning exposures to grades or pools as the primary source of information for estimating loss characteristics. Credit institutions are permitted to use external data (including pooled data) or statistical models for quantification provided a strong link can be demonstrated between–

(a) the credit institution's process of assigning exposures to grades or pools and the process used by the external data source; and

(b) the credit institution's internal risk profile and the composition of the external data.

For purchased retail receivables, credit institutions may use external and internal reference data. Credit institutions shall use all relevant data sources as paragraphs of comparison.

70. If a credit institution derives long run average estimates of PD and LGD for retail from an estimate of total losses and an appropriate estimate of PD or LGD, the process for estimating total losses shall meet the overall standards for estimation of PD and LGD set out in this part, and the outcome shall be consistent with the concept of LGD as set out in paragraph 73.

71. Irrespective of whether a credit institution is using external, internal or pooled data sources or a combination of the three, for its estimation of loss characteristics, the length of the underlying historical observation period used shall be at least five years for at least one source. If the available observation spans a longer period for any source, and these data are relevant, this longer period shall be used. A credit institution need not give equal importance to historic data if it can convince the Commissioner that more recent data is a better predictor of loss rates and may have, when they implement the IRB Approach, relevant data covering a period of two years. The period to be covered shall increase by one year each year until relevant data cover a period of five years.

72. Credit institutions shall identify and analyse expected changes of risk parameters over the life of credit exposures (seasoning effects).

2.2.2. Requirements specific to own-LGD estimates.

73. Credit institutions shall estimate LGDs by facility grade or pool on the basis of the average realised LGDs by facility grade or pool using all observed defaults within the data sources (default weighted average).

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74. Credit institutions shall use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver realised LGDs at a constant level by grade or pool over time, credit institutions shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

75. A credit institution shall consider the extent of any dependence between the risk of the obligor with that of the collateral or collateral provider. Cases where there is a significant degree of dependence shall be addressed in a conservative manner.

76. Currency mismatches between the underlying obligation and the collateral shall be treated conservatively in the credit institution's assessment of LGD.

77. To the extent that LGD estimates take into account the existence of collateral, these estimates shall not solely be based on the collateral's estimated market value. LGD estimates shall take into account the effect of the potential inability of credit institutions to expeditiously gain control of their collateral and liquidate it.

78. To the extent that LGD estimates take into account the existence of collateral, credit institutions shall establish internal requirements for collateral management, legal certainty and risk management that are generally consistent with those set out in Part 2 of Schedule 8.

79. To the extent that a credit institution recognises collateral for determining the exposure value for counter party credit risk according to Part 5 or 6 of Schedule 3, any amount expected to be recovered from the collateral shall not be taken into account in the LGD estimates.

80. For the specific case of exposures already in default, the credit institution shall use the sum of its best estimate of expected loss for each exposure given current economic circumstances and exposure status and the possibility of additional unexpected losses during the recovery period.

81. To the extent that unpaid late fees have been capitalised in the credit institution's income statement, they shall be added to the credit institution's measure of exposure and loss.

Exposures to corporates, institutions and central governments and central banks.

82. Estimates of LGD shall be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available

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observation period spans a longer period for any source, and the data is relevant, this longer period shall be used.

Retail exposures.

83. Notwithstanding paragraph 73, LGD estimates may be derived from realised losses and appropriate estimates of PDs.

84. Notwithstanding paragraph 89, credit institutions may reflect future drawings either in their conversion factors or in their LGD estimates.

85. For purchased retail receivables credit institutions may use external and internal reference data to estimate LGDs.

86. Estimates of LGD shall be based on data over a minimum of five years. Notwithstanding paragraph 73, a credit institution shall not be required to give equal importance to historic data if it can demonstrate to the Commissioner that more recent data is a better predictor of loss rates. Credit institutions may have, when they implement the IRB Approach, relevant data covering a period of two years. The period to be covered shall increase by one year each year until relevant data cover a period of five years.

2.2.3. Requirements specific to own-conversion factor estimates.

87. Credit institutions shall estimate conversion factors by facility grade or pool on the basis of the average realised conversion factors by facility grade or pool using all observed defaults within the data sources (default weighted average).

88. Credit institutions shall use conversion factor estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver realised conversion factors at a constant level by grade or pool over time, credit institutions shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

89. Credit institutions' estimates of conversion factors shall reflect the possibility of additional drawings by the obligor up to and after the time a default event is triggered. The conversion factor estimate shall incorporate a larger margin of conservatism where a stronger positive correlation can reasonably be expected between the default frequency and the magnitude of conversion factor.

90. In arriving at estimates of conversion factors credit institutions shall consider their specific policies and strategies adopted in respect of account monitoring and payment processing. Credit institutions shall also consider

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their ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events.

91. Credit institutions shall have adequate systems and procedures in place to monitor facility amounts, current outstandings against committed lines and changes in outstandings per obligor and per grade. The credit institution shall be able to monitor outstanding balances on a daily basis.

92. If credit institutions use different estimates of conversion factors for the calculation of risk weighted exposure amounts and internal purposes it shall be documented and their reasonableness shall be demonstrated to the Commissioner.

Exposures to corporates, institutions and central governments and central banks.

93. Estimates of conversion factors shall be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period shall be used.

Retail exposures.

94. Notwithstanding paragraph 89, credit institutions may reflect future drawings either in their conversion factors or in their LGD estimates.

95. Estimates of conversion factors shall be based on data over a minimum of five years. Notwithstanding paragraph 87, a credit institution shall not be required to give equal importance to historic data if it can demonstrate to the Commissioner that more recent data is a better predictor of draw downs. Credit institutions may have, when they implement the IRB Approach, relevant data covering a period of two years. The period to be covered shall increase by one year each year until relevant data cover a period of five years.

2.2.4. Minimum requirements for assessing the effect of guarantees and credit derivatives.

Exposures to corporates, credit institutions, investment firms and central governments and central banks where own estimates of LGD are used and retail exposures

96. The requirements in paragraphs 97 to 104 shall not apply for guarantees provided by institutions, central governments, central banks and corporate entities which meet the requirements of paragraph 26(g) of Part 1 of Schedule 8 if the credit institution has received approval to apply the rules

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of regulations 28 to 33 for exposures to such entities. In this case the requirements of regulations 40 to 43 shall apply.

97. For retail guarantees, these requirements shall apply to the assignment of exposures to grades or pools, and the estimation of PD.

Eligible guarantors and guarantees.

98. Credit institutions shall have clearly specified criteria for the types of guarantors they recognise for the calculation of risk weighted exposure amounts.

99. For recognised guarantors the same rules as for obligors as set out in paragraphs 17 to 29 shall apply.

100. The guarantee shall be evidenced in writing, non-cancellable on the part of the guarantor, in force until the obligation is satisfied in full (to the extent of the amount and tenor of the guarantee) and legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgement. Guarantees prescribing conditions under which the guarantor may not be obliged to perform (conditional guarantees) may be recognised subject to approval of the Commissioner. The credit institution shall demonstrate that the assignment criteria adequately address any potential reduction in the risk mitigation effect.

Adjustment criteria.

101. A credit institution shall have clearly specified criteria for adjusting grades, pools or LGD estimates, and, in the case of retail and eligible purchased receivables, the process of allocating exposures to grades or pools, to reflect the impact of guarantees for the calculation of risk weighted exposure amounts. These criteria shall comply with the minimum requirements set out in paragraphs 17 to 29.

102. The criteria shall be plausible and intuitive. They shall address the guarantor’s ability and willingness to perform under the guarantee, the likely timing of any payments from the guarantor, the degree to which the guarantor’s ability to perform under the guarantee is correlated with the obligor’s ability to repay, and the extent to which residual risk to the obligor remains.

Credit derivatives.

103. The minimum requirements for guarantees in this Part shall apply also for single-name credit derivatives. In relation to a mismatch between the underlying obligation and the reference obligation of the credit derivative or the obligation used for determining whether a credit event has occurred, the

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requirements set out under paragraph 21 of Part 2 of Schedule 8 shall apply. For retail exposures and eligible purchased receivables, this paragraph shall apply to the process of allocating exposures to grades or pools.

104. The criteria shall address the payout structure of the credit derivative and conservatively assess the impact this has on the level and timing of recoveries. The credit institution shall consider the extent to which other forms of residual risk remain.

2.2.5. Minimum requirements for purchased receivables.

Legal certainty.

105. The structure of the facility shall ensure that under all foreseeable circumstances the credit institution has effective ownership and control of all cash remittances from the receivables. When the obligor makes payments directly to a seller or servicer, the credit institution shall verify regularly that payments are forwarded completely and within the contractually agreed terms.

"Servicer" means an entity that manages a pool of purchased receivables or the underlying credit exposures on a day-to-day basis. Credit institutions shall have procedures to ensure that ownership over the receivables and cash receipts is protected against bankruptcy stays or legal challenges that could materially delay the lender's ability to liquidate or assign the receivables or retain control over cash receipts.

Effectiveness of monitoring systems.

106. The credit institution shall monitor both the quality of the purchased receivables and the financial condition of the seller and servicer. In particular–

(a) the credit institution shall assess the correlation among the quality of the purchased receivables and the financial condition of both the seller and servicer, and have in place internal policies and procedures that provide adequate safeguards to protect against any contingencies, including the assignment of an internal risk rating for each seller and servicer;

(b) the credit institution shall have clear and effective policies and procedures for determining seller and servicer eligibility. The credit institution or its agent shall conduct periodic reviews of sellers and servicers in order to verify the accuracy of reports from the seller or servicer, detect fraud or operational weaknesses, and verify the quality of the seller's credit policies

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and servicer's collection policies and procedures. The findings of these reviews shall be documented;

(c) the credit institution shall assess the characteristics of the purchased receivables pools, including over-advances; history of the seller's arrears, bad debts, and bad debt allowances; payment terms, and potential contra accounts;

(d) the credit institution shall have effective policies and procedures for monitoring on an aggregate basis single-obligor concentrations both within and across purchased receivables pools; and

(e) the credit institution shall ensure that it receives from the servicer timely and sufficiently detailed reports of receivables ageings and dilutions to ensure compliance with the credit institution's eligibility criteria and advancing policies governing purchased receivables, and provide an effective means with which to monitor and confirm the seller's terms of sale and dilution.

Effectiveness of work-out systems.

107. The credit institution shall have systems and procedures for detecting deteriorations in the seller's financial condition and purchased receivables quality at an early stage, and for addressing emerging problems proactively. In particular, the credit institution shall have clear and effective policies, procedures, and information systems to monitor covenant violations, and clear and effective policies and procedures for initiating legal actions and dealing with problem purchased receivables.

Effectiveness of systems for controlling collateral, credit availability, and cash.

108. A credit institution shall have clear and effective policies and procedures governing the control of purchased receivables, credit, and cash. In particular, written internal policies shall specify all material elements of the receivables purchase programme, including the advancing rates, eligible collateral, necessary documentation, concentration limits, and the way cash receipts are to be handled. These elements shall take appropriate account of all relevant and material factors, including the seller and servicer's financial condition, risk concentrations, and trends in the quality of the purchased receivables and the seller's customer base, and internal systems shall ensure that funds are advanced only against specified supporting collateral and documentation.

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Compliance with the credit institution's internal policies and procedures.

109. The credit institution shall have an effective internal process for assessing compliance with all internal policies and procedures. The process shall include regular audits of all critical phases of the credit institution's receivables purchase programme, verification of the separation of duties between firstly the assessment of the seller and servicer and the assessment of the obligor and secondly between the assessment of the seller and servicer and the field audit of the seller and servicer, and evaluations of back office operations, with particular focus on qualifications, experience, staffing levels, and supporting automation systems.

3. VALIDATION OF INTERNAL ESTIMATES.

110. Credit institutions shall have robust systems in place to validate the accuracy and consistency of rating systems, processes, and the estimation of all relevant risk parameters. A credit institution shall demonstrate to its competent authority that the internal validation process enables it to assess the performance of internal rating and risk estimation systems consistently and meaningfully.

111. Credit institutions shall regularly compare realised default rates with estimated PDs for each grade and, where realised default rates are outside the expected range for that grade, credit institutions shall specifically analyse the reasons for the deviation. Credit institutions using own estimates of LGDs or conversion factors shall also perform analogous analysis for these estimates. Such comparisons shall make use of historical data that cover as long a period as possible. The credit institution shall document the methods and data used in such comparisons. This analysis and documentation shall be updated at least annually.

112. Credit institutions shall also use other quantitative validation tools and comparisons with relevant external data sources. The analysis shall be based on data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period. Credit institutions' internal assessments of the performance of their rating systems shall be based on as long a period as possible.

113. The methods and data used for quantitative validation shall be consistent through time. Changes in estimation and validation methods and data (both data sources and periods covered) shall be documented.

114. Credit institutions shall have sound internal standards for situations where deviations in realised PDs, LGDs, conversion factors and total losses, where EL is used, from expectations, become significant enough to call the validity of the estimates into question. These standards shall take account of

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business cycles and similar systematic variability in default experience. Where realised values continue to be higher than expected values, credit institutions shall revise estimates upward to reflect their default and loss experience.

4. CALCULATION OF RISK WEIGHTED EXPOSURE AMOUNTS FOR EQUITY EXPOSURES UNDER THE INTERNAL MODELS APPROACH.

4.1. Capital requirement and risk quantification.

115. For the purpose of calculating capital requirements credit institutions shall meet the following standards–

(a) the estimate of potential loss shall be robust to adverse market movements relevant to the long-term risk profile of the credit institution's specific holdings. The data used to represent return distributions shall reflect the longest sample period for which data is available and meaningful in representing the risk profile of the credit institution's specific equity exposures. The data used shall be sufficient to provide conservative, statistically reliable and robust loss estimates that are not based purely on subjective or judgmental considerations. Credit institutions shall demonstrate to the Commissioner that the shock employed provides a conservative estimate of potential losses over a relevant long-term market or business cycle. The credit institution shall combine empirical analysis of available data with adjustments based on a variety of factors in order to attain model outputs that achieve appropriate realism and conservatism. In constructing Value at Risk (VaR) models estimating potential quarterly losses, credit institutions may use quarterly data or convert shorter horizon period data to a quarterly equivalent using an analytically appropriate method supported by empirical evidence and through a well-developed and documented thought process and analysis. Such an approach shall be applied conservatively and consistently over time. Where only limited relevant data is available the credit institution shall add appropriate margins of conservatism;

(b) the models used shall be able to capture adequately all of the material risks embodied in equity returns including both the general market risk and specific risk exposure of the credit institution's equity portfolio. The internal models shall adequately explain historical price variation, capture both the magnitude and changes in the composition of potential concentrations, and be robust to adverse market environments. The population of risk exposures represented in the data used

for estimation shall be closely matched to or at least comparable with those of the credit institution's equity exposures;

(c) the internal model shall be appropriate for the risk profile and complexity of a credit institution's equity portfolio. Where a credit institution has material holdings with values that are highly non-linear in nature the internal models shall be designed to capture appropriately the risks associated with such instruments;

(d) mapping of individual positions to proxies, market indices, and risk factors shall be plausible, intuitive, and conceptually sound;

(e) credit institutions shall demonstrate through empirical analyses the appropriateness of risk factors, including their ability to cover both general and specific risk;

(f) the estimates of the return volatility of equity exposures shall incorporate relevant and available data, information, and methods. Independently reviewed internal data or data from external sources (including pooled data) shall be used; and

(g) a rigorous and comprehensive stress-testing programme shall be in place.

4.2. Risk management process and controls.

116. With regard to the development and use of internal models for capital requirement purposes, credit institutions shall establish policies, procedures, and controls to ensure the integrity of the model and modelling process. These policies, procedures, and controls shall include the following-

(a) full integration of the internal model into the overall management information systems of the credit institution and in the management of the non-trading book equity portfolio. Internal models shall be fully integrated into the credit institution"s risk management infrastructure if they are particularly used inmeasuring and assessing equity portfolio performance (including the risk-adjusted performance), allocating economic capital to equity exposures and evaluating overall capital adequacy and the investment management process;

(b) established management systems, procedures, and control functions for ensuring the periodic and independent review of

all elements of the internal modelling process, including approval of model revisions, vetting of model inputs, and review of model results, such as direct verification of risk computations. These reviews shall assess the accuracy, completeness, and appropriateness of model inputs and results and focus on both finding and limiting potential errors associated with known weaknesses and identifying unknown model weaknesses. Such reviews may be conducted by an internal independent unit, or by an independent external third party;

(c) adequate systems and procedures for monitoring investment limits and the risk exposures of equity exposures;

(d) the units responsible for the design and application of the model shall be functionally independent from the units responsible for managing individual investments; and

(e) parties responsible for any aspect of the modelling process shall be adequately qualified. Management shall allocate sufficient skilled and competent resources to the modelling function.

4.3. Validation and documentation.

117. Credit institutions shall have a robust system in place to validate the accuracy and consistency of their internal models and modelling processes. All material elements of the internal models and the modelling process and validation shall be documented.

118. Credit institutions shall use the internal validation process to assess the performance of its internal models and processes in a consistent and meaningful way.

119. The methods and data used for quantitative validation shall be consistent through time. Changes in estimation and validation methods and data (both data sources and periods covered) shall be documented.

120. Credit institutions shall regularly compare actual equity returns (computed using realised and unrealised gains and losses) with modelled estimates. Such comparisons shall make use of historical data that cover as long a period as possible. The credit institution shall document the methods and data used in such comparisons. This analysis and documentation shall be updated at least annually.

121. Credit institutions shall make use of other quantitative validation tools and comparisons with external data sources. The analysis shall be based on

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data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period. Credit institutions' internal assessments of the performance of their models shall be based on as long a period as possible.

122. Credit institutions shall have sound internal standards for situations where comparison of actual equity returns with the models estimates calls the validity of the estimates or of the models as such into question. These standards shall take account of business cycles and similar systematic variability in equity returns. All adjustments made to internal models in response to model reviews shall be documented and consistent with the credit institution's model review standards.

123. The internal model and the modelling process shall be documented, including the responsibilities of parties involved in the modelling, and the model approval and model review processes.

5. CORPORATE GOVERNANCE AND OVERSIGHT.

5.1. Corporate Governance.

124. All material aspects of the rating and estimation processes shall be approved by the credit institution's senior management or a designated committee thereof . These parties shall possess a general understanding of the credit institution's rating systems and detailed comprehension of its associated management reports.

125. Senior management shall provide notice to the senior management or a designated committee thereof of material changes or exceptions from established policies that will materially impact the operations of the credit institution's rating systems.

126. Senior management shall have a good understanding of the rating systems designs and operations. Senior management shall ensure, on an ongoing basis that the rating systems are operating properly. Senior management shall be regularly informed by the credit risk control units about the performance of the rating process, areas needing improvement, and the status of efforts to improve previously identified deficiencies.

127. Internal ratings-based analysis of the credit institution's credit risk profile shall be an essential part of the management reporting to these parties. Reporting shall include at least risk profile by grade, migration across grades, estimation of the relevant parameters per grade, and comparison of realised default rates, and to the extent that own estimates are used of realised LGDs and realised conversion factors against expectations and stress-test results. Reporting frequencies shall depend on the significance and type of information and the level of the recipient.

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5.2. Credit risk control.

128. The credit risk control unit shall be independent from the personnel and management functions responsible for originating or renewing exposures and report directly to senior management. The unit shall be responsible for the design or selection, implementation, oversight and performance of the rating systems. It shall regularly produce and analyse reports on the output of the rating systems.

129. The areas of responsibility for a credit risk control unit shall include–

(a) testing and monitoring grades and pools;

(b) production and analysis of summary reports from the credit institution's rating systems;

(c) implementing procedures to verify that grade and pool definitions are consistently applied across departments and geographic areas;

(d) reviewing and documenting any changes to the rating process, including the reasons for the changes;

(e) reviewing the rating criteria to evaluate if they remain predictive of risk. Changes to the rating process, criteria or individual rating parameters shall be documented and retained;

(f) active participation in the design or selection, implementation and validation of models used in the rating process;

(g) oversight and supervision of models used in the rating process; and

(h) ongoing review and alterations to models used in the rating process.

130. Notwithstanding paragraph 129, credit institutions using pooled data according to paragraphs 57 and 58 may outsource the following tasks–

(a) production of information relevant to testing and monitoring grades and pools;

(b) production of summary reports from the credit institution's rating systems;

(c) production of information relevant to review of the rating criteria to evaluate if they remain predictive of risk;

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(d) documentation of changes to the rating process, criteria or individual rating parameters; and

(e) production of information relevant to ongoing review and alterations to models used in the rating process.

Credit institutions making use of this paragraph shall ensure that the Commissioner have access to all relevant information from the third party that is necessary for examining compliance with the minimum requirements and that the Commissioner may perform on-site examinations to the same extent as within the credit institution.

5.3. Internal Audit.

131. Internal audit or another comparable independent auditing unit shall review at least annually the credit institution's rating systems and its operations, including the operations of the credit function and the estimation of PDs, LGDs, ELs and conversion factors. Areas of review shall include adherence to all applicable minimum requirements.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

SCHEDULE 8

Regulations 28, 39, 42, 43 and 70

CREDIT RISK MITIGATION

PART 1

Eligibility

1. This part sets out eligible forms of credit risk mitigation for the purposes of Article 92.

2. For the purposes of this Schedule–

"Secured lending transaction" means any transaction giving rise to an exposure secured by collateral which does not include a provision conferring upon the credit institution the right to receive margin frequently;

"Capital market-driven transaction" means any transaction giving rise to an exposure secured by collateral which includes a provision conferring upon the credit institution the right to receive margin frequently.

1. FUNDED CREDIT PROTECTION.

1.1. On-balance sheet netting.

3. The on-balance sheet netting of mutual claims between the credit institution and its counter party may be recognised as eligible.

4. Without prejudice to paragraph 5, eligibility shall be limited to reciprocal cash balances between the credit institution and the counter party. Only loans and deposits of the lending credit institution 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.

1.2. Master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions.

5. For credit institutions adopting the Financial Collateral Comprehensive Method under Part 3, the effects of bilateral netting contracts covering repurchase transactions, securities or commodities lending or borrowing transactions, or other capital market-driven transactions with a counter party may be recognised. Without prejudice to Schedule 2 of the FSCAIF Regulations, to be recognised the collateral taken and securities or

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commodities borrowed within such agreements shall comply with the eligibility requirements for collateral set out at paragraphs 7 to 11.

1.3. Collateral.

6. Where the credit risk mitigation technique used relies on the right of the credit institution to liquidate or retain assets, eligibility depends upon whether risk-weighted exposure amounts, and, as relevant, expected loss amounts, are calculated under regulations 28 to 33 or regulations 34 to 39. Eligibility further depends upon whether the Financial Collateral Simple Method is used or the Financial Collateral Comprehensive Method under Part 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.

1.3.1. Eligibility under all approaches and methods.

7. The following financial items may be recognised as eligible collateral under all approaches and methods–

(a) cash on deposit with, or cash assimilated instruments held by, the lending credit institution;

(b) debt securities issued by central governments or central banks, which securities have a credit assessment by an ECAI or export credit agency recognised as eligible for the purposes of regulations 28 to 33 which has been determined by the Commissioner to be associated with credit quality step 4 or above under the rules for the risk weighting of exposures to central governments and central banks under those regulations;

(c) debt securities issued by credit institutions or investment firms which securities have a credit assessment by an approved ECAI which has been determined by the Commissioner to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under regulations 28 to 33;

(d) debt securities issued by other entities, which securities have a credit assessment by an approved ECAI which has been determined by the Commissioner to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under regulations 28 to 33;

(e) debt securities with a short-term credit assessment by an approved ECAI which has been determined by the Commissioner to be associated with credit quality step 3 or

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above under the rules for the risk weighting of short term exposures under regulations 28 to 33;

(f) equities or convertible bonds that are included in a main index; and

(g) gold.

For the purposes of paragraph (b), “debt securities issued by central governments or central banks” includes–

(i) 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 regulations 28 to 33;

(ii) debt securities issued by public sector entities which are treated as exposures to central governments in accordance with paragraph 15 of Part 1 of Schedule 6;

(iii) debt securities issued by multilateral development banks to which a 0 % risk weight is assigned under regulations 28 to 33; and

(iv) debt securities issued by international organisations which are assigned a 0 % risk weight under regulations 28 to 33.

For the purposes of paragraph (c), “debt securities issued by credit institutions or investment firms includes–

(i) 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 regulations 28 to 33;

(ii) debt securities issued by public sector entities, exposures to which are treated as exposures to credit institutions under regulations 28 to 33; and

(iii) debt securities issued by multilateral development banks other than those to which a 0 % risk weight is assigned under regulations 28 to 33.

8. Debt securities issued by credit institutions or investment firms which securities do not have a credit assessment by an approved ECAI may be recognised as eligible collateral if they fulfil the following criteria–

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(a) they are listed on a recognised exchange;

(b) they qualify as senior debt;

(c) all other rated issues by the issuing institution of the same seniority have a credit assessment by an approved ECAI which has been determined by the Commissioner to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions or investment firms or short term exposures under regulations 28 to 33;

(d) the lending credit institution has no information to suggest that the issue would justify a credit assessment below that indicated in (c); and

(e) the credit institution can demonstrate to the Commissioner that the market liquidity of the instrument is sufficient for these purposes.

9. Units in collective investment undertakings may be recognised as eligible collateral if the following conditions are satisfied–

(a) they have a daily public price quote; and

(b) the collective investment undertaking is limited to investing in instruments that are eligible for recognition under paragraphs 7 and 8.

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

If the collective investment undertaking is not limited to investing in instruments that are eligible for recognition under paragraphs 7 and 8, 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.

10. In relation to paragraph 7(b) to (e), where a security has two credit assessments by approved ECAIs, the less favourable assessment shall be deemed to apply. In cases where a security has more than two credit assessments by approved ECAIs, the two most favourable assessments shall

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be deemed to apply. If the two most favourable credit assessments are different, the less favourable of the two shall be deemed to apply.

1.3.2. Additional eligibility under the Financial Collateral Comprehensive Method.

11. In addition to the collateral set out in paragraphs 7 to 10, where a credit institution uses the Financial Collateral Comprehensive Method under Part 3, the following financial items may be recognised as eligible collateral–

(a) equities or convertible bonds not included in a main index but traded on a recognised exchange; and

(b) units in collective investment undertakings if the following conditions are met–

(i) they have a daily public price quote; and

(ii) the collective investment undertaking is limited to investing in instruments that are eligible for recognition under paragraph 7 and 8 and the items mentioned in paragraph (a).

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

If the collective investment undertaking is not limited to investing in instruments that are eligible for recognition under sub-paragraph (a) and paragraphs 7 and 8, 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.

1.3.3. Additional eligibility for calculations under regulations 34 to 39.

12. In addition to the collateral set out above the provisions of paragraphs 13 to 22 apply where a credit institution calculates risk-weighted exposure amounts and expected loss amounts under the approach set out in regulations 34 to 39.

(a) Real estate collateral

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13. Residential real estate property which is or will be occupied or let by the owner, or the beneficial owner in the case of personal investment companies, and commercial real estate property, that is, offices and other commercial premises, may be recognised all as eligible collateral where the following conditions are met–

(a) the value of the property shall not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower; and

(b) the risk of the borrower shall 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 shall not materially depend on any cash flow generated by the underlying property serving as collateral.

14. Credit institutions may also recognise as eligible collateral 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 will be occupied or let by the owner, as residential real estate collateral, provided that these conditions are met.

15. The Commissioner may also authorise their credit institutions to recognise as eligible collateral shares in Finnish housing companies operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation as commercial real estate collateral, provided that these conditions are met.

16. The Commissioner may waive the requirement for their credit institutions to comply with condition in paragraph 13(b) for exposures secured by residential real estate property situated within Gibraltar, if the Commissioner has evidence that the relevant market is well-developed and long established with loss rates which are sufficiently low to justify such action. This shall not prevent the Commissioner if this waiver is not used from recognising as eligible residential real estate property recognised as eligible in an EEA State by virtue of the waiver. The Commissioner shall publish the use he makes of this waiver.

17. The Commissioner may waive the requirement for credit institutions to comply with the condition in paragraph 13(b) for commercial real estate property situated within Gibraltar, if the Commissioner has evidence that the relevant market is well-developed and long-established and that loss-

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rates stemming from lending secured by commercial real estate property satisfy the following conditions–

(a) losses stemming from loans collateralised by commercial real estate property up to 50 % of the market value (or where applicable and if lower 60 % of the mortgage-lending-value) do not exceed 0,3 % of the outstanding loans collateralised by commercial real estate property in any given year; and

(b) overall losses stemming from loans collateralised by commercial real estate property do not exceed 0,5 % of the outstanding loans collateralised by commercial real estate property in any given year.

18. If either of these conditions is not satisfied in a given year, the eligibility to use this treatment shall cease until the conditions are satisfied in a subsequent year.

19. The Commissioner may recognise as eligible collateral commercial real estate property recognised as eligible collateral in an EEA State by virtue of the waiver provided for in paragraph 17.

(b) Receivables.

20. The Commissioner may recognise as eligible collateral amounts receivable linked to a commercial transaction or transactions with an original maturity of less than or equal to one year. Eligible receivables do not include those associated with securitisations, sub-participations or credit derivatives or amounts owed by affiliated parties.

(c) Other physical collateral.

21. The Commissioner may recognise as eligible collateral physical items of a type other than those types indicated in paragraphs 13 to 19 if satisfied as to the following–

(a) the existence of liquid markets for disposal of the collateral in an expeditious and economically efficient manner; and

(b) the existence of well-established publicly available market prices for the collateral. The credit institution shall demonstrate that there is no evidence that the net prices it receives when collateral is realised deviates significantly from these market prices.

(d) Leasing.

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22. Subject to the provisions of paragraph 72 of Part 3 where the requirements set out in paragraph 11 of Part 2 are met, exposures arising from transactions whereby a credit institution leases property to a third party shall be treated the same as loans collateralised by the type of property leased.

1.4. Other funded credit protection.

1.4.1. Cash on deposit with, or cash assimilated instruments held by, a third party credit institution or investment firm.

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

1.4.2. Life insurance policies pledged to the lending credit institution.

24. Life insurance policies pledged to the lending credit institution may be recognised as eligible credit protection.

1.4.3. Institution instruments repurchased on request.

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

2. UNFUNDED CREDIT PROTECTION.

2.1. Eligibility of protection providers under all approaches.

26. The following parties may be recognised as eligible providers of unfunded credit protection–

(a) central governments and central banks;

(b) regional governments or local authorities;

(c) multilateral development banks;

(d) international organisations exposures to which a 0 % risk weight under is assigned;

(e) public sector entities, claims on which are treated by the Commissioner as claims on institutions or central governments under regulations 28 to 33;

(f) credit institution or investment firm; and

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(g) other corporate entities, including parent, subsidiary and affiliate corporate entities of the credit institution, that–

(i) have a credit assessment by a recognised ECAI which has been determined by the Commissioner to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under regulations 28 to 33; and

(ii) in the case of credit institutions calculating risk-weighted exposure amounts and expected loss amounts under regulations 34 to 39, do not have a credit assessment by a recognised ECAI and are internally rated as having a PD equivalent to that associated with the credit assessments of ECAIs determined by the Commissioner to be associated with credit quality step 2 or above under he rules for the risk weighting of exposures to corporate under regulations 28 to 33.

27. Where risk-weighted exposure amounts and expected loss amounts are calculated under regulations 34 to 39, to be eligible a guarantor shall be internally rated by the credit institution in accordance with the provisions of Part 4 of Schedule 7.

28. Notwithstanding paragraph 26, it may also be recognised as eligible providers of unfounded credit protection, other financial institutions authorised and supervised by the competent authority responsible for the authorisation and supervision of credit institutions and subject to prudential requirements equivalent to those applied to credit institutions.

2.2 Eligibility of protection providers under the IRB Approach which qualify for the treatment set out in paragraph 4 of Part 1 of Schedule 7.

29. Credit Institutions, investment firms, insurance and reinsurance undertakings and export credit agencies which fulfil the following conditions may be recognised as eligible providers of unfunded credit protection which qualify for the treatment set out in paragraph 4 of Part 1 of Schedule 7–

— the protection provider has sufficient expertise in providing unfunded credit protection;

— the protection provider is regulated in a manner equivalent to the rules laid down in these Regulations or had, at the time the credit protection was provided, a credit assessment by a recognised ECAI which had been determined by the Commissioner to be associated with credit quality step 3,

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or above, under the rules for the risk weighting of exposures to corporate under regulations 28 to 33;

— the protection provider had, at the time the credit protection was provided, or for any period of time thereafter, an internal rating with a PD equivalent to or lower than that associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under; and

— the provider has an internal rating with a PD equivalent to or lower than that associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under Articles regulations 28 to 33.

For the purpose of this paragraph, credit protection provided by export credit agencies shall not benefit from any explicit central government counter-guarantee.

3. TYPES OF CREDIT DERIVATIVES.

30. 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–

(a) credit default swaps;

(b) total return swaps; and

(c) credit linked notes to the extent of their cash funding.

31. Where a credit institution 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 shall not be recognised as eligible.

3.1. Internal hedges.

32. When a credit institution 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 as eligible for the purposes of this Schedule the credit risk transferred to the trading book shall be transferred out to a third party or parties. In such circumstances, subject to the compliance of such transfer with the requirements for the recognition of credit risk mitigation set out in this Schedule, the rules set out in Parts 3 to 6 for the calculation of risk-weighted exposure amounts and expected loss amounts where unfunded credit protection is acquired shall be applied.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

PART 2

Minimum Requirements

1. The credit institution shall satisfy the Commissioner that it has adequate risk management processes to control those risks to which the credit institution may be exposed as a result of carrying out credit risk mitigation practices.

2. 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, credit institutions shall continue to undertake full credit risk assessment of the underlying exposure and be in a position to demonstrate the fulfilment of this requirement to the Commissioner. In the case of repurchase transactions or securities or commodities lending or borrowing transactions the underlying exposure shall, for the purposes of this paragraph only, be deemed to be the net amount of the exposure.

1. FUNDED CREDIT PROTECTION.

1.1. On-balance sheet netting agreements (other than master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions or other capital market driven transactions).

3. For on-balance sheet netting agreements — other than master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions or other capital market-driven transactions — to be recognised for the purposes of regulations 40 to 43, the following conditions shall be satisfied–

(a) they shall be legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counter party;

(b) the credit institution shall be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;

(c) the credit institution shall monitor and control the risks associated with the termination of the credit protection; and

(d) the credit institution shall monitor and control the relevant exposures on a net basis.

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1.2. Master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions and/or other capital market driven transactions.

4. For master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions or other capital market driven transactions to be recognised for the purposes of regulations 40 to 43, they shall-

(a) be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counter party;

(b) 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 counter party; and

(c) 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.

5. In addition, the minimum requirements for the recognition of financial collateral under the Financial Collateral Comprehensive Method set out in paragraph 6 shall be fulfilled.

1.3. Financial collateral.

1.3.1. Minimum requirements for the recognition of financial collateral under all Approaches and Methods.

6. For the recognition of financial collateral and gold, the following conditions shall be met.

(a) Low correlation

The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. Securities issued by the obligor, or any related group entity, are not eligible. This notwithstanding, the obligor's own issues of covered bonds falling within the terms of paragraphs 68 to 70 of Part 1 of Schedule 6, may be recognised as eligible when they are posted as collateral for repurchase transactions, provided that the first paragraph of this paragraph is complied with.

(b) Legal certainty

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Credit institutions shall 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 their interest in the collateral. Credit institutions shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions. They shall re-conduct such review as necessary to ensure continuing enforceability.

(c) Operational requirements

The collateral arrangements shall be properly documented, with a clear and robust procedure for the timely liquidation of collateral. Credit institutions shall 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 credit institution's overall risk profile. The credit institution shall have documented policies and practices concerning the types and amounts of collateral accepted.

Credit institutions shall calculate the market value of the collateral, and revalue it accordingly, with a minimum frequency of once every six months and whenever the credit institution has reason to believe that there has occurred a significant decrease in its market value. Where the collateral is held by a third party, credit institutions shall take reasonable steps to ensure that the third party segregates the collateral from its own assets.

1.3.2. Additional minimum requirements for the recognition of financial collateral under the Financial Collateral Simple Method.

7. In addition to the requirements set out in paragraph 6, for the recognition of financial collateral under the Financial Collateral Simple Method the residual maturity of the protection shall be at least as long as the residual maturity of the exposure.

1.4. Minimum requirements for the recognition of real estate collateral.

8. For the recognition of real estate collateral the following conditions shall be met.

(a) Legal certainty

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The mortgage or charge shall be enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement, and the mortgage or charge shall be properly filed on a timely basis. The arrangements shall reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall been fulfilled). The protection agreement and the legal process underpinning it shall enable the credit institution to realise the value of the protection within a reasonable timeframe.

(b) Monitoring of property values

The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be carried out where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5 % of the own funds of the credit institution, the property valuation shall be reviewed by an independent valuer at least every three years.

"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.

(c) Documentation

The types of residential and commercial real estate accepted by the credit institution and its lending policies in this regard shall be clearly documented.

(d) Insurance

The credit institution shall have procedures to monitor that the property taken as protection is adequately insured against damage.

1.5. Minimum requirements for the recognition of receivables as collateral.

9. For the recognition of receivables as collateral the following conditions shall be met−

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(a) Legal certainty

(i) The legal mechanism by which the collateral is provided shall be robust and effective and ensure that the lender has clear rights over the proceeds;

(ii) Credit institutions shall take all steps necessary to fulfil local requirements in respect of theenforceability of security interest. There shall be a framework which allows the lender to have a first priority claim over the collateral subject to national discretion to allow such claims to be subject to the claims of preferential creditors provided for in legislative or implementing provisions;

(iii) Credit institutions shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions; and

(iv) The collateral arrangements shall be properly documented, with a clear and robust procedure for the timely collection of collateral. The credit institution's procedures shall ensure that any legal conditions required for declaring the default of the borrower and timely collection of collateral are observed. In the event of the borrower's financial distress or default, the credit institution shall have legal authority to sell or assign the receivables to other parties without consent of the receivables obligors.

(b) Risk management

(i) The credit institution shall have a sound process for determining the credit risk associated with the receivables. Such a process shall include, among other things, analyses of the borrower's business and industry and the types of customers with whom the borrower does business. Where the credit institution relies on the borrower to ascertain the credit risk of the customers, the credit institution shall review the borrower's credit practices to ascertain their soundness and credibility;

(ii) The margin between the amount of the exposure and the value of the receivables shall reflect all

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appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an individual borrower, and potential concentration risk within the credit institution's total exposures beyond that controlled by the credit institution's general methodology. The credit institution shall maintain a continuous monitoring process appropriate to the receivables. Additionally, compliance with loan covenants, environmental restrictions, and other legal requirements shall be reviewed on a regular basis;

(iii) The receivables pledged by a borrower shall be diversified and not be unduly correlated with the borrower. Where there is material positive correlation, the attendant risks shall be taken into account in the setting of margins for the collateral pool as a whole;

(iv) Receivables from affiliates of the borrower (including subsidiaries and employees) shall not be recognised as risk mitigants; and

(v) The credit institution shall have a documented process for collecting receivable payments in distressed situations. The requisite facilities for collection shall be in place, even when the credit institution normally looks to the borrower for collections.

1.6. Minimum requirements for the recognition of other physical collateral.

10. For the recognition of other physical collateral the following conditions shall be met–

(a) the collateral arrangement shall be legally effective and enforceable in all relevant jurisdictions and shall enable the credit institution to realise the value of the property within a reasonable timeframe;

(b) with the sole exception of permissible prior claims referred to in paragraph 9(a)(ii), only first liens on, or charges over, collateral are permissible. As such, the credit institution shall have priority over all other lenders to the realised proceeds of the collateral;

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(c) the value of the property shall be monitored on a frequent basis and at a minimum once every year. More frequent monitoring shall be required where the market is subject to significant changes in conditions;

(d) the loan agreement shall include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation;

(e) the types of physical collateral accepted by the credit institution and policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount shall be clearly documented in internal credit policies and procedures available for examination;

(f) the credit institution's credit policies with regard to the transaction structure shall address appropriate collateral requirements relative to the exposure amount, the ability to liquidate the collateral readily, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility or a proxy of the volatility of the value of the collateral;

(g) both initial valuation and revaluation shall take fully into account any deterioration or obsolescence of the collateral. Particular attention shall be paid in valuation and revaluation to the effects of the passage of time on fashion- or date-sensitive collateral;

(h) the credit institution shall have the right to physically inspect the property. It shall have policies and procedures addressing its exercise of the right to physical inspection; and

(i) the credit institution shall have procedures to monitor that the property taken as protection is adequately insured against damage.

1.7. Minimum requirements for treating lease exposures as collateralized.

11. For the exposures arising from leasing transactions to be treated as collateralised by the type of property leased, the following conditions shall be met–

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(a) the conditions set out in paragraphs 8 or 10 as appropriate for the recognition as collateral of the type of property leased shall be met;

(b) there shall be robust risk management on the part of the lessor with respect to the use to which the leased asset is put, its age and the planned duration of its use, including appropriate monitoring of the value of the security;

(c) there shall be in place a robust legal framework establishing the lessor's legal ownership of the asset and its ability to exercise its rights as owner in a timely fashion; and

(d) where this has not already been ascertained in calculating the LGD level, the difference between the value of the unamortised amount and the market value of the security must not be so large as to overstate the credit risk mitigation attributed to the leased assets.

1.8. Minimum requirements for the recognition of other funded credit protection.

1.8.1. Cash on deposit with, or cash assimilated instruments held by, a third party credit institution or investment firm.

12. To be eligible for the treatment set out in paragraph 79 in Part 3, the protection referred to in paragraph 23 of Part 1 shall satisfy the following conditions–

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

(b) the third party credit institution or investment firm is notified of the pledge or assignment;

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

(d) the pledge or assignment is unconditional and irrevocable.

1.8.2. Life insurance policies pledged to the lending credit institution.

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13. For life insurance policies pledged to the lending credit institution to be recognised the following conditions shall be met−

(a) *omitted*

(b) the life insurance policy is openly pledged or assigned to the lending credit institution;

(c) 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;

(d) *omitted*

(e) the lending credit institution shall have the right to cancel the policy and receive the surrender value in the event of the default of the borrower;

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

(g) the credit protection shall be 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 shall 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; and

(h) the pledge or assignment shall be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

(i) the surrender value is declared by the company providing the life insurance and is non-reducible;

(j) the surrender value is to be paid in a timely manner upon request;

(k) the surrender value cannot be requested without the consent of the credit institution; and

(l) 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 non-EEA State which applies

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supervisory and regulatory arrangements at least equivalent to those applied in the EEA.

2. UNFUNDED CREDIT PROTECTION AND CREDIT LINKED NOTES.

2.1. Requirements common to guarantees and credit derivatives.

14. Subject to paragraph 16, for the credit protection deriving from a guarantee or credit derivative to be recognised the following conditions shall be met–

(a) the credit protection shall be direct;

(b) the extent of the credit protection shall be clearly defined and incontrovertible;

(c) the credit protection contract shall not contain any clause, the fulfilment of which is outside the direct control of the lender, that-

(i) would allow the protection provider unilaterally to cancel the protection;

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

(iii) 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

(iv) could allow the maturity of the credit protection to be reduced by the protection provider; and

(d) it shall be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

2.1.1. Operational requirements.

15. A credit institution shall satisfy the Commissioner that it has systems in place to manage potential concentration of risk arising from its use of guarantees and credit derivatives. The credit institution shall demonstrate

how its strategy in respect of its use of credit derivatives and guarantees risk profile.

2.2. Sovereign and other public sector counter-guarantees.

16. 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, a public sector entity, claims on which are treated as claims on the central government in whose jurisdiction they are established under regulations 28 to 33, a multi-lateral development bank or an international organisation to which a 0 % risk weight is assigned under or by virtue of those regulations, or a public sector entity, claims on which are treated as claims on credit institutions under those regulations, the exposure may be treated as protected by a guarantee provided by the entity in question, provided the following conditions are satisfied–

(a) the counter-guarantee covers all credit risk elements of the claim;

(b) both the original guarantee and the counter-guarantee meet the requirements for guarantees set out in paragraphs 14, 15 and 18, except that the counter-guarantee need not be direct; and

(c) the Commissioner is satisfied 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.

17. The treatment set out in paragraph 16 also applies to an exposure which is not counter-guaranteed by an entity listed in that paragraph if that exposure's counter-guarantee is in turn directly guaranteed by one of the listed entities and the conditions listed in that paragraph are satisfied.

2.3. Additional requirements for guarantees.

18. For a guarantee to be recognised the following conditions shall also be met–

(a) on the qualifying default of or non-payment by the counter party, the lending credit institution shall 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. Payment by the guarantor shall not be subject to the lending credit institution first having to pursue the obligor. In the case of unfunded credit protection covering residential mortgage loans, the requirements in paragraph 14(c)(iii) and in the first

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subparagraph of this paragraph have only to be satisfied within 24 months;

(b) the guarantee shall be an explicitly documented obligation assumed by the guarantor; and

(c) subject to the following sentence, the guarantee shall cover all types of payments the obligor is expected to make in respect of the claim. Where certain types of payment are excluded from the guarantee, the recognised value of the guarantee shall be adjusted to reflect the limited coverage.

19. In the case of guarantees provided in the context of mutual guarantee schemes recognised for these purposes by the Commissioner or provided by or counter-guaranteed by entities referred to in paragraph 16, the requirements in paragraph 18(a) shall be considered to be satisfied where either of the following conditions are met–

(a) the lending credit institution 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 credit institution proportional to the coverage of the guarantee; or

(b) the lending credit institution can demonstrate that the loss-protecting effects of the guarantee, including losses resulting from the non-payment of interest and other types of payments which the borrower is obliged to make, justify such treatment.

2.4. Additional requirements for credit derivatives.

20. For a credit derivative to be recognised the following conditions shall be met–

(a) subject to paragraph (b), the credit events specified under the credit derivative shall at a minimum include–

(i) the failure to pay the amounts due under the terms of the underlying obligation which 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);

(ii) 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

(iii) 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);

(b) where the credit events specified under the credit derivative do not include restructuring of the underlying obligation as described in paragraph (a)(iii), the credit protection may nonetheless be recognised subject to a reduction in the recognised value as specified in paragraph 83 of Part 3;

(c) in the case of credit derivatives allowing for cash settlement, a robust valuation process shall be in place in order to estimate loss reliably. There shall be a clearly specified period for obtaining post-credit-event valuations of the underlying obligation;

(d) 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 shall provide that any required consent to such transfer may not be unreasonably withheld; and

(e) the identity of the parties responsible for determining whether a credit event has occurred shall be clearly defined. This determination shall not be the sole responsibility of the protection provider. The protection buyer shall have the right or ability to inform the protection provider of the occurrence of a credit event.

21. 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 shall be permissible only if the following conditions are met–

(a) 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

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(b) 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.

2.5. Requirements to qualify for the treatment set out in paragraph 4 of Part 1 of Schedule 7.

22. To be eligible for the treatment set out in paragraph 4 of Part 1 of Schedule 7, credit protection deriving from a guarantee or credit derivative shall meet the following conditions–

(a) the underlying obligation shall be to–

— a corporate exposure as defined in regulation 36, excluding insurance and reinsurance undertakings;

— an exposure to a regional government, local authority or public sector Entity which is not treated as an exposure to a central government or a central bank according to regulation 36; or

— an exposure to a small or medium sized entity, classified as a retail exposure according to regulation 36(4) and (5);

(b) the underlying obligors shall not be members of the same group as the protection provider;

(c) the exposure shall be hedged by one of the following instruments-

— single-name unfunded credit derivatives or single-name guarantees,

— first-to-default basket products - the treatment shall be applied to the asset within the basket with the lowest risk-weighted exposure amount, or

— nth-to-default basket products - the protection obtained is only eligible for consideration under this framework if eligible (n-1)th default protection has also be obtained or where (n-1) of the assets within the basket has or have already defaulted. Where this is the case the treatment shall be applied to the asset within the basket with the lowest risk-weighted exposure amount;

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(d) the credit protection meets the requirements set out in paragraphs 14, 15, 18, 20 and 21;

(e) the risk weight that is associated with the exposure prior to the application of the treatment in paragraph 4 of Part 1 of Schedule 7, does not already factor in any aspect of the credit protection;

(f) a credit institution shall have the right and expectation to receive payment from the protection provider without having to take legal action in order to pursue the counter party for payment. To the extent possible, a credit institution shall take steps to satisfy itself that the protection provider is willing to pay promptly should a credit event occur;

(g) the purchased credit protection shall absorb all credit losses incurred on the hedged portion of an exposure that arise due to the occurrence of credit events outlined in the contract;

(h) if the payout structure provides for physical settlement, then there shall be legal certainty with respect to the deliverability of a loan, bond, or contingent liability. If a credit institution intends to deliver an obligation other than the underlying exposure, it shall ensure that the deliverable obligation is sufficiently liquid so that the credit institution would have the ability to purchase it for delivery in accordance with the contract;

(i) the terms and conditions of credit protection arrangements shall be legally confirmed in writing by both the protection provider and the credit institution;

(j) credit institutions shall have a process in place to detect excessive correlation between the creditworthiness of a protection provider and the obligor of the underlying exposure due to their performance being dependent on common factors beyond the systematic risk factor; and

(k) in the case of protection against dilution risk, the seller of purchased receivables shall not be a member of the same group as the protection provider.

PART 3

Calculating the effects of credit risk mitigation

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

1. Subject to Parts 4 to 6, where the provisions in Parts 1 and 2 are satisfied, the calculation of risk-weighted exposure amounts under regulations 28 to 33 and the calculation of risk-weighted exposure amounts and expected loss amounts under regulations 34 to 39 may be modified in accordance with the provisions of this Part.

2. Cash, securities or commodities purchased, borrowed or received under a repurchase transaction or securities or commodities lending or borrowing transaction shall be treated as collateral.

1. FUNDED CREDIT PROTECTION.

1.1. Credit linked notes.

3. Investments in credit linked notes issued by the lending credit institution may be treated as cash collateral.

1.2. On-balance sheet netting.

4. Loans and deposits with the lending credit institution subject to on-balance sheet netting are to be treated as cash collateral.

1.3. Master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions or other capital market-driven transactions.

1.3.1. Calculation of the fully-adjusted exposure value.

(a) Using the ‘Supervisory’ volatility adjustments or the ‘Own Estimates’ volatility adjustments approaches

5. Subject to paragraphs 12 to 21, in calculating the ‘fully adjusted exposure value’ (E*) for the exposures subject to an eligible master netting agreement covering repurchase transactions or securities or commodities lending or borrowing transactions or other capital market-driven transactions, the volatility adjustments to be applied shall be calculated either using the Supervisory Volatility Adjustments Approach or the Own Estimates Volatility Adjustments Approach as set out in paragraphs 30 to 61 for the Financial Collateral Comprehensive Method. For the use of the own estimates approach, the same conditions and requirements shall apply as apply under the Financial Collateral Comprehensive Method

6. The net position in each type of security or commodity shall be calculated 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.

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7. For the purposes of paragraph 6, “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 34 to 59.

8. The net position in each currency, other than the settlement currency of the master netting agreement, shall be calculated 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. The volatility adjustment appropriate to a given type of security or cash position shall be applied to the absolute value of the positive or negative net position in the securities of that type.

10. The foreign exchange risk (fx) volatility adjustment shall be applied to the net positive or negative position in each currency other than the settlement currency of the master netting agreement.

11. E* shall be calculated according to the following formula–

$$E^* = \max\{0, [(\Sigma(E) - \Sigma(C)) + \Sigma(|\text{nettopositie in elk effect}| \times H_{sec}) + (\Sigma|E_{fx}| \times H_{fx})]\}$$

Where risk-weighted exposure amounts are calculated under regulations 28 to 33, E is the exposure value for each separate exposure under the agreement that would apply in the absence of the credit protection.

Where risk-weighted exposure amounts and expected loss amounts are calculated under regulations 34 to 39, E is the exposure value for each separate exposure under the agreement that would apply in the absence of the credit protection.

C is the value of the securities or commodities borrowed, purchased or received or the cash borrowed or received in respect of each such exposure.

S(E) is the sum of all Es under the agreement.

S(C) is the sum of all Cs under the agreement.

E_{fx} is the net position (positive or negative) in a given currency other than the settlement currency of the agreement as calculated under paragraph 8.

H_{sec} is the volatility adjustment appropriate to a particular type of security.

H_{fx} is the foreign exchange volatility adjustment.

E* is the fully adjusted exposure value.

(b) Using the Internal Models approach

12. As an alternative to using the supervisory volatility adjustments approach or the own estimates volatility adjustments approach in 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, or other capital market driven transactions other than derivative transactions, credit institutions may be permitted to use an internal models approach which takes into account correlation effects between security positions subject to the master netting agreement as well as the liquidity of the instruments concerned. Internal models used in this approach shall provide estimates of the potential change in value of the unsecured exposure amount ($\Sigma E — \Sigma C$). Subject to the approval of the Commissioner, credit institutions may also use their internal models for margin lending transactions, if the transactions are covered under a bilateral master netting agreement that meets the requirements set out in Part 7 of Schedule 3.

13. A credit institution may choose to use an internal models approach independently of the choice it has made between regulations 28 to 33 and 34 to 39 for the calculation of risk-weighted exposure amounts. However, if a credit institution seeks to use an internal models approach, it shall do so for all counter parties 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 paragraphs 5 to 11.

14. The internal models approach is available to credit institutions that have received recognition for an internal risk management model under Schedule 5 of the FSCAIF Regulations.

15. Credit institutions which have not received supervisory recognition for use of such a model under the FSCAIF Regulations, may apply to the Commissioner for recognition of an internal risk measurement model for the purposes of paragraphs 12 to 21.

16. Recognition shall only be given if the Commissioner is satisfied that the credit institution'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 following qualitative standards are met–

(a) 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 credit institution and serves as the basis for reporting risk exposures to senior management of the credit institution;

(b) the credit institution has a risk control unit that is independent from business trading units and reports directly to senior management. The unit shall be responsible for designing and implementing the credit institution's risk management system. It shall 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;

(c) the daily reports produced by the risk control unit shall be reviewed by a level of management with sufficient authority to enforce reductions of positions taken and of overall risk exposure;

(d) the credit institution shall have sufficient staff skilled in the use of sophisticated models in the risk control unit;

(e) the credit institution shall have 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;

(f) the credit institution's models shall 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;

(g) the credit institution frequently conducts a rigorous programme of stress testing and the results of these tests shall be reviewed by senior management and reflected in the policies and limits it sets;

(h) the credit institution shall conduct, as part of its regular internal auditing process, an independent review of its risk measurement system. This review shall include both the activities of the business trading units and of the independent risk control unit;

(a) at least once a year, the credit institution shall conduct a review of its risk management system; and

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(b) the internal model shall meet the requirements set out in paragraphs 40 to 42 of Part 6 of Schedule 3.

17. The calculation of the potential change in value shall be subject to the following minimum standards–

(a) at least daily calculation of the potential change in value;

(b) a 99th percentile, one-tailed confidence interval;

(c) a 5-day equivalent liquidation period, except in the case of transactions other than securities repurchase transactions or securities lending or borrowing transactions where a 10-day equivalent liquidation period shall be used;

(d) 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

(e) three-monthly data set updates.

18. The Commissioner shall require that the internal risk-measurement model captures a sufficient number of risk factors in order to capture all material price risks.

19. The Commissioner may allow credit institutions to use empirical correlations within risk categories and across risk categories if he is satisfied that the credit institution's system for measuring correlations is sound and implemented with integrity.

20. The fully adjusted exposure value (E*) for credit institutions using the Internal models approach shall be calculated according to the following formula–

$$E^* = \max \{0, [(\Sigma E - \Sigma C) + (\text{uitkomst van het interne model})]\}$$

Where risk-weighted exposure amounts are calculated under regulations 28 to 33, E shall be the exposure value for each separate exposure under the agreement that shall apply in the absence of the credit protection.

Where risk-weighted exposure amounts and expected loss amounts are calculated under regulations 34 to 39, E shall be the exposure value for each separate exposure under the agreement that shall apply in the absence of the credit protection.

C is the value of the securities borrowed, purchased or received or the cash borrowed or received in respect of each such exposure.

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Σ(E) is the sum of all Es under the agreement.

Σ(C) is the sum of all Cs under the agreement.

21. In calculating risk-weighted exposure amounts using internal models, credit institutions shall use the previous business day's model output.

1.3.2. Calculating risk-weighted exposure amounts and expected loss amounts for repurchase transactions or securities or commodities lending or borrowing transactions or other capital market-driven transactions covered by master netting agreements.

Standardised Approach.

22. E* as calculated under paragraphs 5 to 21 shall be taken as the exposure value of the exposure to the counter party arising from the transactions subject to the master netting agreement for the purposes of regulation 30.

IRB Approach

23. E* as calculated under paragraphs 5 to 21 shall be taken as the exposure value of the exposure to the counter party arising from the transactions subject to the master netting agreement for the purposes of Schedule 7.

1.4. Financial collateral.

1.4.1. Financial Collateral Simple Method.

24. The Financial Collateral Simple Method shall be available only where risk-weighted exposure amounts are calculated under regulations 28 to 33. A credit institution shall not use both the Financial Collateral Simple Method and the Financial Collateral Comprehensive Method, unless for the purposes of regulations 35 and 39. Credit institutions shall demonstrate to the Commissioner 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.

Valuation.

25. Under this method, recognised financial collateral is assigned a value equal to its market value as determined in accordance with paragraph 6 of Part 2.

Calculating risk-weighted exposure amounts.

26. The risk weight that would be assigned under regulations 28 to 33 if the lender had a direct exposure value to the collateral instrument shall be assigned to those portions of exposure values collateralised by the market

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value of recognised collateral. The risk weight of the collateralised portion shall be a minimum of 20 % except as specified in paragraphs 27 to 29. The remainder of the exposure shall receive the risk weight that would be assigned to an unsecured exposure to the counter party under those regulations.

For this purpose, the exposure value of an off-balance sheet item in Schedule 2 shall be 100% of its value rather than the exposure value indicated in regulation 28(1).

Repurchase transactions and securities lending or borrowing transactions

27. A risk weight of 0 % shall be assigned to the collateralised portion of the exposure arising from transactions which fulfil the criteria enumerated in paragraphs 58 and 59. If the counter party to the transaction is not a core market participant a risk weight of 10 % shall be assigned.

OTC derivative transactions subject to daily mark-to-market

28. A risk weight of 0 % shall, to the extent of the collateralisation, be assigned to the exposure values determined under Schedule 3 for the derivative instruments listed in Schedule 4 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 % shall be assigned 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 are assigned a 0 % risk weight under regulations 28 to 33.

For the purposes of this paragraph debt securities issued by central governments or central banks shall include–

(a) 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 regulations 28 to 33;

(b) debt securities issued by multilateral development banks to which a 0 % risk weight is assigned under or by virtue of regulations 28 to 33; and

(c) debt securities issued by international organisations which are assigned a 0 % risk weight under regulations 28 to 33.

Other transactions.

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29. A 0 % risk weight may be assigned where the exposure and the collateral are denominated in the same currency, and either−

(a) the collateral is cash on deposit or a cash assimilated instrument; or

(b) the collateral is in the form of debt securities issued by central governments or central banks eligible for a 0 % risk weight under Articles 78 to 83, and its market value has been discounted by 20 %.

For the purposes of this paragraph "debt securities issued by central governments or central banks" includes those indicated under paragraph 28.

1.4.2. Financial Collateral Comprehensive Method.

30. In valuing financial collateral for the purposes of the Financial Collateral Comprehensive Method, volatility adjustments shall be applied to the market value of collateral, as set out in paragraphs 34 to 59 below, in order to take account of price volatility.

31. Subject to the treatment for currency mismatches in the case of OTC derivatives transactions set out in paragraph 32, where collateral is denominated in a currency which differs from that in which the underlying exposure is denominated, an adjustment reflecting currency volatility shall be added to the volatility adjustment appropriate to the collateral as set out in paragraphs 34 to 59.

32. In the case of OTC derivatives transactions covered by netting agreements recognised by the Commissioner under Schedule 3, a volatility adjustment reflecting currency volatility shall 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 shall be applied.

(a) Calculating adjusted values

33. The volatility-adjusted value of the collateral to be taken into account is calculated as follows in the case of all transactions except those transactions subject to recognised master netting agreements to which the provisions set out in paragraphs 5 to 23 are applied-

$C_{VA} = C \times (1 - H_C - H_{FX})$

The volatility-adjusted value of the exposure to be taken into account shall be calculated as follows-

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$E_{VA} = E \times (1+H_E)$, and, in the case of OTC derivative transactions, $E_{VA} = E$.

The fully adjusted value of the exposure, taking into account both volatility and the risk-mitigating effects of collateral shall be calculated as follows-

$E^* = \max \{0, [E_{VA} – C_{VAM}]\}$

Where-

E is the exposure value as would be determined under regulations 28 to 33 or 34 to 39 as appropriate if the exposure was not collateralised. For this purpose, for credit institutions calculating risk-weighted exposure amounts under regulations 28 to 33, the exposure value of off-balance sheet items listed in Schedule II shall be 100 % of its value rather than the exposure value indicated in regulation 28(1), and for credit institutions calculating risk-weighted exposure amounts under regulations 34 to 39, the exposure value of the items listed in paragraphs 9 to 11 of Part 3 of Schedule 7, shall be calculated using a conversion factor of 100 % rather than the conversion factors or percentages indicated in those paragraphs.

E_{VA} is the volatility-adjusted exposure amount.

C_{VA} is the volatility-adjusted value of the collateral.

C_{VAM} is C_{VA} further adjusted for any maturity mismatch in accordance with the provisions of Part 4.

H_E is the volatility adjustment appropriate to the exposure (E), as calculated under paragraphs 34 to 59.

H_C is the volatility adjustment appropriate to the collateral, as calculated under paragraphs 34 to 59.

H_{FX} is the volatility adjustment appropriate to currency mismatch, as calculated under paragraphs 34 to 59.

E* is the fully adjusted exposure value taking into account volatility and the risk-mitigating effects of the collateral.

(b) Calculation of volatility adjustments to be applied

For this purpose, the exposure value of the items in paragraphs 9 to 11 of Part 3 of Schedule 7 shall be calculated using a conversion factor or percentage of 100 % rather than the conversion factors or percentages indicated in those paragraphs.

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34. Volatility adjustments may be calculated in two ways- the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach (the 'own estimates' approach).

35. A credit institution may choose to use the supervisory volatility adjustments approach or the Own estimates approach independently of the choice it has made between regulations 28 to 33 and 34 to 39 for the calculation of risk-weighted exposure amounts. However, if credit institutions seek to use the own estimates approach, they shall do so for the full range of instrument types, excluding immaterial portfolios where they may use the supervisory volatility adjustments approach.

Where the collateral consists of a number of recognised items, the volatility adjustment shall be-

$$H = \sum_{i} a_i H_i$$

where a_i is the proportion of an item to the collateral as a whole and H_i is the volatility adjustment applicable to that item.

(i) Supervisory volatility adjustments

36. The volatility adjustments to be applied under the supervisory volatility adjustments approach (assuming daily revaluation) shall be those set out in Tables 1 to 4.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

VOLATILITY ADJUSTMENTS.

Table 1

Credit quality step with which the credit assessment of the debt security is associated	Residual Maturity	Volatility adjustments for debt securities issued by entities described in paragraph 7(b) of Part 1			Volatility adjustments for debt securities issued by entities described in paragraph 7(c) and (d) of Part 1		
		Liquidation Period (%)			Liquidation Period (%)		
		20-day	10-day	5-day	20-day	10-day	5-day
1	≤ 1 year	0.707	0.5	0.354	1.414	1	0.707
	>1 ≤ 5 years	2.828	2	1.414	5.657	4	2,828
	> 5 years	5.657	4	2.828	11.314	8	5.657
2-3	≤ 1 year	1.414	1	0.707	2.828	2	1.414
	>1 ≤ 5 years	4.243	3	2.121	8.485	6	4.243
	> 5 years	8.485	6	4.243	16.971	12	8.485
4	≤ 1 year	21.213	15	10.607	N/A	N/A	N/A
	>1 ≤ 5 years	21.213	15	10.607	N/A	N/A	N/A
	> 5 years	21.213	15	10.607	N/A	N/A	N/A

Table 2

Credit quality step with which the credit assessment of a short term debt security is associated	Volatility adjustments for debt securities issued by entities described in paragraph 7(b) of Part 1 with short term credit assessments			Volatility adjustments for debt securities issued by entities described in paragraph 7(c) and (d) of Part 1 with short-term credit assessments		
	Liquidation Period (%)			Liquidation Period (%)		
	20-day	10-day	5-day	20-day	10-day	5-day
1	0.707	0.5	0.354	1.414	1	0.707
2-3	1.414	1	0.707	2.828	2	1.414

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Table 3

Other collateral or exposure types			
	20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period (%)
Main Index Equities, Main Index Convertible Bonds	21.213	15	10.607
Other Equities or Convertible Bonds listed on a recognised exchange	35.355	25	17.678
Cash	0	0	0
Gold	21.213	15	10.607

Table 4

Volatility adjustment for currency mismatch		
20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period
11.314	8	5.657

37. For secured lending transactions the liquidation period shall be 20 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 the liquidation period shall be 5 business days. For other capital market driven transactions, the liquidation period shall be 10 business days.

38. In Tables 1 to 4 and in paragraphs 39 to 41, the credit quality step with which a credit assessment of the debt security is associated shall be the credit quality step with which the credit assessment is determined by the Commissioner to be associated under regulations 28 to 33. For the purpose of this paragraph, paragraph 10 of Part 1 also applies.

39. 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 exchange.

40. For eligible units in collective investment undertakings the volatility adjustment shall be the weighted average volatility adjustments that would apply, having regard to the liquidation period of the transaction as specified in paragraph 37, to the assets in which the fund has invested. If the assets in which the fund has invested are not known to the credit institution, the

volatility adjustment shall be the highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.

41. For unrated debt securities issued by credit institutions or investment firms and satisfying the eligibility criteria in paragraph 8 of Part 1 the volatility adjustments shall be the same as for securities issued by institutions or corporates with an external credit assessment associated with credit quality steps 2 or 3.

(ii) Own estimates of volatility adjustments

42. The Commissioner shall permit credit institutions complying with the requirements set out in paragraphs 47 to 56 to use their own volatility estimates for calculating the volatility adjustments to be applied to collateral and exposures.

43. When debt securities have a credit assessment from a recognised ECAI equivalent to investment grade or better, the Commissioner may allow credit institutions to calculate a volatility estimate for each category of security.

44. In determining relevant categories, credit institutions shall 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 shall be representative of the securities included in the category by the credit institution.

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

46. Credit institutions using the own estimates approach shall estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral or exchange rates.

Quantitative Criteria.

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

48. The liquidation period shall be 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.

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49. Credit institutions 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 48 for the type of transaction in question, using the square root of time formula-

$$HM = HN\sqrt{T_M / T_N}$$

where T_M is the relevant liquidation period;

H_M is the volatility adjustment under T_M and

H_N is the volatility adjustment based on the liquidation period T_N.

50. Credit institutions shall take into account the illiquidity of lower-quality assets. The liquidation period shall be adjusted upwards in cases where there is doubt concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility, e.g., a pegged currency. Such cases shall be dealt with by means of a stress scenario.

51. The historical observation period (sample period) for calculating volatility adjustments shall be a minimum length of one year. For credit institutions that use a weighting scheme or other methods for the historical observation period, the effective observation period shall be at least one year (that is, the weighted average time lag of the individual observations shall not be less than 6 months). The Commissioner may also require a credit institution to calculate its volatility adjustments using a shorter observation period if, in the Commissioner's judgement, this is justified by a significant upsurge in price volatility.

52. Credit institutions shall update their data sets at least once every three months and shall also reassess them whenever market prices are subject to material changes. This implies that volatility adjustments shall be computed at least every three months.

Qualitative Criteria.

53. The volatility estimates shall be used in the day-to-day risk management process of the credit institution including in relation to its internal exposure limits.

54. If the liquidation period used by the credit institution in its day-to-day risk management process is longer than that set out in this Part for the type of transaction in question, the credit institution's volatility adjustments shall be scaled up in accordance with the square root of time formula set out in paragraph 49.

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55. The credit institution shall 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.

56. An independent review of the credit institution's system for the estimation of volatility adjustments shall be carried out regularly in the credit institution'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 credit institution's risk management process shall take place at least once a year and shall specifically address, at a minimum–

(a) the integration of estimated volatility adjustments into daily risk management;

(b) the validation of any significant change in the process for the estimation of volatility adjustments;

(c) 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

(d) the accuracy and appropriateness of the volatility assumptions.

(iii) Scaling up of volatility adjustments

57. The volatility adjustments set out in paragraphs 36 to 41 are the volatility adjustments to be applied where there is daily revaluation. Similarly, where a credit institution uses its own estimates of the volatility adjustments in accordance with paragraphs 42 to 56, these shall be calculated in the first instance on the basis of daily revaluation. If the frequency of revaluation is less than daily, larger volatility adjustments shall be applied. These shall be calculated by scaling up the daily revaluation volatility adjustments, using the following 'square root of time' formula-

$$H = H_M \sqrt{\frac{N_R + (T_M - 1)}{T_M}}$$

where–

H is the volatility adjustment to be applied

H_M is the volatility adjustment where there is daily revaluation

N_R is the actual number of business days between revaluations

T_M is the liquidation period for the type of transaction in question.

(iv) Conditions for applying a 0 % volatility adjustment

58. In relation to repurchase transactions and securities lending or borrowing transactions, where a credit institution uses the Supervisory Volatility Adjustments Approach or the Own Estimates Approach and where the conditions set out in paragraphs (a) to (h) are satisfied, credit institutions may, instead of applying the volatility adjustments calculated under paragraphs 34 to 57, apply a 0 % volatility adjustment. This option is not available in respect of credit institutions using the internal models approach set out in paragraphs 12 to 21–

(a) Both the exposure and the collateral are cash or debt securities issued by central governments or central banks within the meaning of paragraph 7(b) of Part 1 and eligible for a 0 % risk weight under regulations 28 to 33.

(b) Both the exposure and the collateral are denominated in the same currency,

(c) 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,

(d) The time between the last marking-to-market before a failure to remargin by the counter party and the liquidation of the collateral shall be no more than four business days,

(e) The transaction is settled across a settlement system proven for that type of transaction,

(f) The documentation covering the agreement is standard market documentation for repurchase transactions or securities lending or borrowing transactions in the securities concerned,

(g) The transaction is governed by documentation specifying that if the counter party fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction shall be immediately terminable, and

(h) The counter party is considered a core market participant by the Commissioner. Core market participants shall include the following entities–

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— the entities mentioned in paragraph 7(b) of Part 1 exposures to which are assigned a 0 % risk weight under regulations 28 to 33;

— credit institutions and investment firms;

— other financial companies (including insurance companies) exposures to which are assigned a 20 % risk weight under regulations 28 to 33 or which, in the case of credit institutions calculating risk-weighted exposure amounts and expected loss amounts under regulations 33 to 39, do not have a credit assessment by a recognised ECAI and are internally rated as having a PD equivalent to that associated with the credit assessments of ECAIs determined by the Commissioner to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under regulations 28 to 33

— regulated collective investment undertakings that are subject to capital or leverage requirements;

— regulated pension funds; and

— recognised clearing organisations.

59. Where the Commissioner permits the treatment set out in paragraph 58 to be applied in the case of repurchase transactions or securities lending or borrowing transactions in securities issued by its domestic government, then other competent authorities may choose to allow credit institutions incorporated in their jurisdiction to adopt the same approach to the same transactions.

(c) Calculating risk-weighted exposure amounts and expected loss amounts

Standardised Approach.

60. E* as calculated under paragraph 33 shall be taken as the exposure value for the purposes of regulation 30. In the case of off-balance sheet items listed in Schedule 2, E* shall be taken as the value at which the percentages indicated in regulation 28(1) shall be applied to arrive at the exposure value.

IRB Approach.

61. LGD* (the effective LGD) calculated as set out in this paragraph shall be taken as the LGD for the purposes of Schedule7.

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LGD* = LGD x (E*/E)

where–

LGD is the LGD that shall apply to the exposure under regulations 34 to 39 if the exposure was not collateralised;

E is the exposure value as described under paragraph 33;

E* is as calculated under paragraph 33.

1.5. Other eligible collateral for regulations 34 to 39.

1.5.1. Valuation.

(a) Real estate collateral.

62. The property shall be valued by an independent valuer at or less than the market value. If the Commissioner has laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions he may allow the property to be valued by an independent valuer at or less than the mortgage lending value.

63. "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 proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value shall be documented in a transparent and clear manner.

64. "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 shall not be taken into account in the assessment of the mortgage lending value. The mortgage lending value shall be documented in a transparent and clear manner.

65. The value of the collateral shall be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under paragraph 8 of Part 2, and to take account of the any prior claims on the property.

(b) Receivables.

66. The value of receivables shall be the amount receivable.

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(c) Other physical collateral.

67. The property shall be valued at its market value — that is the estimated amount for which the property would exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction.

1.5.2. Calculating risk-weighted exposure amounts and expected loss amounts.

(a) General treatment.

68. LGD* calculated as set out in paragraphs 69 to 72 shall be taken as the LGD for the purposes of Schedule 7.

69. Where the ratio of the value of the collateral (C) to the exposure value (E) is below a threshold level of C* (the required minimum collateralisation level for the exposure) as laid down in Table 5, LGD* shall be the LGD laid down in Schedule 7 for uncollateralised exposures to the counter party.

70. Where the ratio of the value of the collateral to the exposure value exceeds a second, higher threshold level of C** (i.e. the required level of collateralisation to receive full LGD recognition) as laid down in Table 5, LGD* shall be that prescribed in Table 5.

71. Where the required level of collateralisation C** is not achieved in respect of the exposure as a whole, the exposure shall be considered to be two exposures — that part in respect of which the required level of collateralisation C** is achieved and the remainder.

72. Table 5 sets out the applicable LGD* and required collateralisation levels for the secured parts of exposures.

Table 5

Minimum LGD for secured parts of exposures

	LGD* for senior claims or contingent claims	LGD* for subordinated claims or contingent claims	Required minimum collateralisation level of the exposure (C*)	Required minimum collateralisation level of the exposure (C**)
Receivables	35%	65%	0%	125%
Residential real estate/commercial real estate	35%	65%	30%	140%
Other collateral	40%	70%	30%	140%

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Until 31 December 2012, the Commissioner may, subject to the levels of collateralisation indicated in Table 5-

(a) allow credit institutions to assign a 30 % LGD for senior exposures in the form of Commercial Real Estate leasing;

(b) allow credit institutions to assign a 35 % LGD for senior exposures in the form of equipment leasing; and

(c) allow credit institutions to assign a 30 % LGD for senior exposures secured by residential or commercial real estate.

At the end of this period, this derogation shall be reviewed.

(b) Alternative treatment for real estate collateral.

73. Subject to the requirements of this paragraph and paragraph 74 and as an alternative to the treatment in paragraphs 68 to 72, the Commissioner may authorise credit institutions to assign a 50 % risk weight to the Part of the exposure fully collateralised by residential real estate property or commercial real estate property situated in Gibraltar if he has evidence that the relevant markets are well developed and long-established with loss rates from lending collateralised by residential real estate property or commercial real estate property respectively that do not exceed the following limits–

(a) losses stemming from lending collateralised by residential real estate property or commercial real estate property respectively up to 50 % of the market value (or where applicable and if lower 60 % of the mortgage-lending-value) do not exceed 0.3 % of the outstanding loans collateralised by that form of real estate property in any given year; and

(b) overall losses stemming from lending collateralised by residential real estate property or commercial real estate property respectively do not exceed 0.5 % of the outstanding loans collateralised by that form of real estate property in any given year.

74. If either of the conditions in paragraph 73 is not satisfied in a given year, the eligibility to use this treatment shall cease until the conditions are satisfied in a subsequent year.

75. Where the discretion provided for in paragraph 73 is exercised by the Commissioner, the competent authorities of an EEA State may authorise their credit institutions to assign the risk weights permitted under the treatment of that paragraph in respect of exposures collateralised by

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residential real estate property or commercial real estate property located in Gibraltar subject to the same conditions as apply in Gibraltar.

1.6. Calculating risk-weighted exposure amounts and expected loss amounts in the case of mixed pools of collateral.

76. Where risk-weighted exposure amounts and expected loss amounts are calculated under regulations 34 to 39, and an exposure is collateralised by both financial collateral and other eligible collateral, LGD*, to be taken as the LGD for the purposes of Schedule 7, shall be calculated as follows.

77. The credit institution shall be required to subdivide the volatility-adjusted value of the exposure (i.e. the value after the application of the volatility adjustment as set out in paragraph 33) into parts each covered by only one type of collateral. That is, the credit institution shall divide the exposure into the part covered by eligible financial collateral, the portion covered by receivables, the portions covered by commercial real estate property collateral and/or residential real estate property collateral, the part covered by other eligible collateral, and the unsecured portion, as relevant.

78. LGD* for each part of exposure shall be calculated separately in accordance with the relevant provisions of this Schedule.

1.7. Other funded credit protection.

1.7.1. Deposits with third party credit institutions or investment firms.

79. Where the conditions set out in paragraph 12 of Part 2 are satisfied, credit protection falling within the terms of paragraph 23 of Part 1 may be treated as a guarantee by the third party credit institution or investment firm.

1.7.2. Life insurance policies pledged to the lending credit institution.

80. Where the conditions set out in paragraph 13 of Part 2 are satisfied, the portion of the exposure collateralised by the current surrender value of credit protection falling within paragraph 24 of Part 1 shall be either of the following−

(a) subject to the risk weights specified in paragraph 80A where the exposure is subject to regulations 28 to 33;

(b) assigned an LGD of 40% where the exposure is subject to regulations 34 to 39 but not subject to the credit institution's own estimates of LGD.

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

80A. For purposes of paragraph 80(a), 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–

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

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

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

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

1.7.3. Credit institution or investment firm instruments repurchased on request.

81. Instruments eligible under paragraph 25 of Part 1 may be treated as a guarantee by the issuing institution or firm.

82. The value of the credit protection recognised shall be the following–

(a) where the instrument will be repurchased at its face value, the value of the protection shall be that amount;

(b) where the instrument will be repurchased at market price, the value of the protection shall be the value of the instrument valued in the same way as the debt securities specified in paragraph 8 of Part 1.

2. UNFUNDED CREDIT PROTECTION.

2.1. Valuation.

83. The value of unfunded credit protection (G) shall be 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

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events. 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),

(a) 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 the first sentence of this paragraph shall be reduced by 40 %; or

(b) where the amount that the protection provider has undertaken to pay is higher than the exposure value, the value of the credit protection shall be no higher than 60 % of the exposure value.

84. 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 shall be reduced by the application of a volatility adjustment HFX as follows-

$G^* = G \times (1-H_{FX})$

where-

G is the nominal amount of the credit protection,

G* is G adjusted for any foreign exchange risk, and

H_{FX} is the volatility adjustment for any currency mismatch between the credit protection and the underlying obligation.

Where there is no currency mismatch
$G^* = G$

85. The volatility adjustments for any currency mismatch may be calculated based on the supervisory volatility adjustments approach or the own estimates approach as set out in paragraphs 34 to 57.

2.2. Calculating risk-weighted exposure amounts and expected loss amounts.

2.2.1. Partial protection — tranching.

86. Where a credit institution transfers a part of the risk of a loan in one or more tranches, the rules set out in regulations 44 to 51shall apply. Materiality thresholds on payments below which no payment shall be made

in the event of loss shall be considered to be equivalent to retained first loss positions and to give rise to a tranched transfer of risk.

2.2.2. Standardised Approach.

(a) Full protection.

87. For the purposes of regulation 30, g shall be the risk weight to be assigned to an exposure, the exposure value (E) of which is fully protected by unfunded protection (G_A), where-

E is the exposure value according to regulation 28. For this purpose, the exposure value of an off-balance sheet item listed in Schedule 2 shall be 100% of its value rather than the exposure value indicated in regulation 28(1);

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

G_A is the value of G* as calculated under paragraph 84 further adjusted for any maturity mismatch as laid down in Part 4.

(b) Partial protection — equal seniority.

88. Where the protected amount is less than the exposure value and the protected and unprotected parts are of equal seniority — i.e. the credit institution and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief shall be afforded. For the purposes of regulation 30, risk-weighted exposure amounts shall be calculated in accordance with the following formula-

$(E - G_A) \times r + G_A \times g$

where–

E is the exposure value according to regulation 28. For this purpose, the exposure value of an off-balance sheet item listed in Schedule 2 shall be 100 % of its value rather than the exposure value indicated in regulation 28(1);

G_A is the value of G* as calculated under paragraph 84 further adjusted for any maturity mismatch as laid down in Part 4;

r is the risk weight of exposures to the obligor as specified under regulations 28 to 33; and

g is the risk weight of exposures to the protection provider as specified under regulations 28 to 33.

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(c) Sovereign guarantees.

89. The Commissioner may extend the treatment provided for in paragraphs 4 and 5 of Part 1 of Schedule 6, exposures or parts 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.

2.2.3. IRB Approach.

Full protection/Partial protection — equal seniority.

90. For the covered portion of the exposure value (E) (based on the adjusted value of the credit protection G_A), the PD for the purposes of part 2 of Schedule 7 may be the PD of the protection provider, or a PD between that of the borrower and that of the guarantor if a full substitution is deemed not to be warranted. In the case of subordinated exposures and non-subordinated unfunded protection, the LGD to be applied for the purposes of Part 2 of Schedule VII may be that associated with senior claims.

91. For any uncovered portion of the exposure value (E) the PD shall be that of the borrower and the LGD shall be that of the underlying exposure.

92. G_A is the value of G* as calculated under paragraph 84 further adjusted for any maturity mismatch as laid down in Part 4.

E is the exposure value according to Part 3 of Schedule 7. For this purpose, the exposure value of the items listed in paragraphs 9 to 11 of Part 3 of Schedule 7 shall be calculated using a conversion factor or percentage of 100% rather than the conversion factors or percentages indicated in those paragraphs.

PART 4

Maturity Mismatches

1. 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, shall not be recognised.

2. Where there is a maturity mismatch the credit protection shall not be recognised where–

(a) the original maturity of the protection is less than 1 year; or

(b) the exposure is a short term exposure specified by the Commissioner as being subject to a one day floor rather than a one year floor in respect of the maturity value (M) under paragraph 14 of Part 2 of Schedule 7.

1. DEFINITION OF MATURITY.

3. Subject to a maximum of 5 years, the effective maturity of the underlying shall be the longest possible remaining time before the obligor is scheduled to fulfil its obligations. Subject to paragraph 4, the maturity of the credit protection shall be the time to the earliest date at which the protection may terminate or be terminated.

4. Where there is an option to terminate the protection which is at the discretion of the protection seller, the maturity of the protection shall 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 credit institution to call the transaction before contractual maturity, the maturity of the protection shall 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.

5. 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 shall be reduced by the amount of the grace period.

2. VALUATION OF PROTECTION.

2.1. Transactions subject to funded credit protection — Financial Collateral Simple Method.

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

2.2. Transactions subject to funded credit protection — Financial Collateral Comprehensive Method.

7. The maturity of the credit protection and that of the exposure must be reflected in the adjusted value of the collateral according to the following formula-

$C_{VAM} = C_{VA} \times (t-t^*)/(T-t^*)$

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where-

C_{VA} is the volatility adjusted value of the collateral as specified in paragraph 33 of Part 3 or the amount of the exposure, whichever is the lowest;

t is the number of years remaining to the maturity date of the credit protection calculated in accordance with paragraphs 3 to 5, or the value of T, whichever is the lower;

T is the number of years remaining to the maturity date of the exposure calculated in accordance with paragraphs 3 to 5, or 5 years, whichever is the lower; and

t* is 0,25.

C_{VAM} shall be taken as C_{VA} further adjusted for maturity mismatch to be included in the formula for the calculation of the fully adjusted value of the exposure (E*) set out at Part 3, paragraph 33.

2.3. Transactions subject to unfunded credit protection.

8. The maturity of the credit protection and that of the exposure must be reflected in the adjusted value of the credit protection according to the following formula

$G_A = G^* \times (t-t^*)/(T-t^*)$

where-

G* is the amount of the protection adjusted for any currency mismatch

G_A is G* adjusted for any maturity mismatch

t is the number of years remaining to the maturity date of the credit protection calculated in accordance with paragraphs 3 to 5, or the value of T, whichever is the lower;

T is the number of years remaining to the maturity date of the exposure calculated in accordance with paragraphs 3 to 5, or 5 years, whichever is the lower; and

t* is 0,25.

G_A is then taken as the value of the protection for the purposes of paragraphs 83 to 92 of Part 3.

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PART 5

Combinations of credit risk mitigation in the Standardised Approach

1. In the case where a credit institution calculating risk-weighted exposure amounts under regulations 28 to 33 has more than one form of credit risk mitigation covering a single exposure (e.g. a credit institution has both collateral and a guarantee partially covering an exposure), the credit institution shall be required to subdivide the exposure into parts covered by each type of credit risk mitigation tool (e.g. a part 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 those regulations and this Schedule.

2. When credit protection provided by a single protection provider has differing maturities, a similar approach to that described in paragraph 1 shall be applied.

PART 6

Basket CRM techniques

1. FIRST-TO-DEFAULT CREDIT DERIVATIVES.

1. Where a credit institution obtains credit protection for a number of exposures under terms that the first default among the exposures shall trigger payment and that this credit event shall terminate the contract, the credit institution 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 regulations 28 to 33 or 34 to 39 as appropriate in accordance with this Schedule, but only if the exposure value is less than or equal to the value of the credit protection.

2. N NTH-TO-DEFAULT CREDIT DERIVATIVES.

2. Where the nth default among the exposures triggers payment under the credit protection, the credit institution 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 shall follow that set out in paragraph 1 for first-to-default derivatives appropriately modified for nth-to-default products.

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SCHEDULE 9

Regulations 44 to 49

SECURITISATION

PART 1

Definitions

1. For the purposes of this Schedule–

"Excess spread" means finance charge collections and other fee income received in respect of the securitised exposures net of costs and expenses;

"Clean-up call option" means a contractual option for the originator to repurchase or extinguish the securitisation positions before all of the underlying exposures have been repaid, when the amount of outstanding exposures falls below a specified level;

"Liquidity facility" means the securitisation position arising from a contractual agreement to provide funding to ensure timeliness of cash flows to investors;

"Kirb" means 8 % of the risk-weighted exposure amounts that would be calculated under regulations 34 to 39 in respect of the securitised exposures, had they not been securitised, plus the amount of expected losses associated with those exposures calculated under those regulations;

"Ratings based method" means the method of calculating risk-weighted exposure amounts for securitisation positions in accordance with paragraphs 46 to 51 of Part 4;

"Supervisory formula method" means the method of calculating risk-weighted exposure amounts for securitisation positions in accordance with paragraphs 52 to 54 of Part 4,;

"Unrated position" means a securitisation position which does not have an approved credit assessment by an approved ECAI;

"Rated position" means a securitisation position which has an approved credit assessment by an approved ECAI; and

"Asset-backed commercial paper (ABCP) programme" means a programme of securitisations the securities issued by which

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predominantly take the form of commercial paper with an original maturity of one year or less.

PART 2

Minimum requirements for recognition of significant credit risk transfer and calculation of risk-weighted exposure amounts and expected loss amounts for securitised exposures

1. MINIMUM REQUIREMENTS FOR RECOGNITION OF SIGNIFICANT CREDIT RISK TRANSFER IN A TRADITIONAL SECURITISATION.

1(1). The originator credit institution of a traditional securitisation may exclude securitised exposures from the calculation of risk-weighted exposure amounts and expected loss amounts if significant either of the following conditions is met conditions–

(a) significant credit risk associated with the securitised exposures is considered to have been transferred to third parties;

(b) the originator credit institution applies a 1250% risk weight to all securitisation positions it holds in this securitisation or deducts these securitisation positions from own funds according to regulation 7(1)(r).

1(2) Unless the Commissioner decides in a specific instance that the possible reduction in risk weighted exposure amounts which the originator credit institution would achieve by this securitisation is not justified by a commensurate transfer of credit risk to third parties, significant credit risk shall be considered to have been transferred in the following cases–

(a) the risk-weighted exposure amounts of the mezzanine securitisation positions held by the originator credit institution in this securitisation do not exceed 50% of the risk weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;

(b) where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from own funds or a 1250% risk weight exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator credit institution does not hold more than 20% of the exposure values of the securitisation positions that would be subject to deduction from own funds or a 1250% risk weight.

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1(3) For the purposes of paragraph 1(2), mezzanine securitisation positions mean securitisation positions to which a risk weight lower than 1250% applies and that are more junior than the most senior position in this securitisation and more junior than any securitisation position in this securitisation to which–

(a) in the case of a securitisation position subject to paragraphs 6 to 36 of Part 4 a credit quality step 1; or

(b) in the case of a securitisation position subject to paragraph 76 of Part 4 a credit quality step 1 or 2 is assigned under Part 3.

1(4) As an alternative to paragraphs 1(2) and (3) significant credit risk may be considered to have been transferred if the Commissioner is satisfied that a credit institution has policies and methodologies in place, ensuring that the possible reduction of capital requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties. The Commissioner shall only be satisfied if the originator credit institution can demonstrate that such transfer of credit risk to third parties is also recognised for purposes of the credit institution's internal risk management and its internal capital allocation.

1(5) In addition to paragraphs 1(1) to (4), all of the following conditions shall be met -

(a) The securitisation documentation reflects the economic substance of the transaction;

(b) The securitised exposures are put beyond the reach of the originator credit institution and its creditors, including in bankruptcy and receivership. This shall be supported by the opinion of qualified legal counsel;

(c) The securities issued do not represent payment obligations of the originator credit institution;

(d) The transferee is a securitisation special-purpose entity (SSPE);

(e) The originator credit institution does not maintain effective or indirect control over the transferred exposures. An originator shall be considered to have maintained effective control over the transferred exposures if it has the right to repurchase from the transferee the previously transferred exposures in order to realise their benefits or if it is obligated to re-assume transferred risk. The originator credit institution's retention of

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servicing rights or obligations in respect of the exposures shall not of itself constitute indirect control of the exposures;

(f) Where there is a clean-up call option, the following conditions shall be satisfied–

(i) The clean-up call option is exercisable at the discretion of the originator credit institution;

(ii) The clean-up call option may only be exercised when 10 % or less of the original value of the exposures securitised remains unamortised; and

(iii) The clean-up call option is not structured to avoid allocating losses to credit enhancement positions or other positions held by investors and is not otherwise structured to provide credit enhancement; and

(g) The securitisation documentation does not contain clauses that–

(i) other than in the case of early amortisation provisions, require positions in the securitisation to be improved by the originator credit institution including but not limited to altering the underlying credit exposures or increasing the yield payable to investors in response to a deterioration in the credit quality of the securitised exposures; or

(ii) increase the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool.

2. MINIMUM REQUIREMENTS FOR RECOGNITION OF SIGNIFICANT CREDIT RISK TRANSFER IN A SYNTHETIC SECURITISATION.

2(1). An originator credit institution of a synthetic securitisation may calculate risk-weighted exposure amounts, and, as relevant, expected loss amounts, for the securitised exposures in accordance with paragraphs 3 and 4 below, if significant either of the following conditions is met conditions–

(a) significant credit risk is considered to have been transferred to third parties either through funded or unfunded credit protection;

(b) the originator credit institution applies a 1250% risk weight to all securitisation positions he holds in this securitisation or deducts these securitisation positions from own funds according to regulation 7(1)(r).

2(2) Unless the Commissioner decides on a case- by-case basis that the possible reduction in risk weighted exposure amounts which the originator credit institution would achieve by this securitisation is not justified by a commensurate transfer of credit risk to third parties, significant credit risk shall be considered to have been transferred if either of the following conditions is met–

(a) the risk-weighted exposure amounts of the mezzanine securitisation positions which are held by the originator credit institution in this securitisation do not exceed 50% of the risk weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;

(b) where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from own funds or a 1250% risk weight exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator credit institution does not hold more than 20% of the exposure values of the securitisation positions that would be subject to deduction from own funds or a 1250% risk weight.

2(3) For the purposes of paragraph 2(2), mezzanine securitisation positions means securitisation positions to which a risk weight lower than 1250% applies and which are more junior than the most senior position in this securitisation and more junior than any securitisation positions in this securitisation to which–

(a) in the case of a securitisation position subject to paragraphs 6 to 36 of Part 4 a credit quality step 1; or

(b) in the case of a securitisation position subject to paragraphs 37 to 76 of Part 4 a credit quality step 1 or 2 is assigned under Part 3.

2(4) As an alternative to paragraphs 2(2) and (3), significant credit risk may be considered to have been transferred if the Commissioner is satisfied that a credit institution has policies and methodologies in place to ensure that a possible reduction of capital requirements that the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties. The Commissioner shall only be satisfied if the originator

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credit institution can demonstrate that such transfer of credit risk to third parties is also recognised for purposes of the credit institutions internal risk management and its internal capital allocation.

2(5) In addition, the transfer shall comply with the following conditions–

(a) The securitisation documentation reflects the economic substance of the transaction;

(b) The credit protection by which the credit risk is transferred complies with the eligibility and other requirements under regulations 40 to 43 for the recognition of such credit protection. For the purposes of this paragraph, special purpose entities shall not be recognised as approved unfunded protection providers.

(c) The instruments used to transfer credit risk do not contain terms or conditions that–

(i) impose significant materiality thresholds below which credit protection is deemed not to be triggered if a credit event occurs;

(ii) allow for the termination of the protection due to deterioration of the credit quality of the underlying exposures;

(iii) other than in the case of early amortisation provisions, require positions in the securitisation to be improved by the originator credit institution;

(iv) increase the credit institutions' cost of credit protection or the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool; and

(d) An opinion is obtained from qualified legal counsel confirming the enforceability of the credit protection in all relevant jurisdictions.

3. ORIGINATOR CREDIT INSTITUTIONS' CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS FOR EXPOSURES SECURITISED IN A SYNTHETIC SECURITISATION.

3. In calculating risk-weighted exposure amounts for the securitised exposures, where the conditions in paragraph 2 are met, the originator credit institution of a synthetic securitisation shall, subject to paragraphs 5 to 7,

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use the relevant calculation methodologies set out in Part 4 and not those set out in regulations 28 to 39. For credit institutions calculating risk-weighted exposure amounts and expected loss amounts under Regulations 34 to 39, the expected loss amount in respect of such exposures shall be zero.

4. For clarity, paragraph 3 refers to the entire pool of exposures included in the securitisation. Subject to paragraphs 5 to 7, the originator credit institution is required to calculate risk-weighted exposure amounts in respect of all tranches in the securitisation in accordance with the provisions of Part 4 including those relating to the recognition of credit risk mitigation. For example, where a tranche is transferred by means of unfunded credit protection to a third party, the risk weight of that third party shall be applied to the tranche in the calculation of the originator credit institution's risk-weighted exposure amounts.

3.1. Treatment of maturity mismatches in synthetic securitizations.

5. For the purposes of calculating risk-weighted exposure amounts in accordance with paragraph 3, any maturity mismatch between the credit protection by which the tranching is achieved and the securitised exposures shall be taken into consideration in accordance with paragraphs 6 to 7.

6. The maturity of the securitised exposures shall be taken to be the longest maturity of any of those exposures subject to a maximum of five years. The maturity of the credit protection shall be determined in accordance with Schedule 8.

7. An originator credit institution shall ignore any maturity mismatch in calculating risk-weighted exposure amounts for tranches appearing pursuant to Part 4 with a risk weighting of 1250 %. For all other tranches, the maturity mismatch treatment set out in Schedule 8 shall be applied in accordance with the following formula-

$$RW^* \text{ is } [RW(SP) \times (t - t^*)/(T - t^*)] + [RW(Ass) \times (T - t)/(T - t^*)]$$

Where-

RW* is risk-weighted exposure amounts for the purposes of regulation 23(a);

RW(Ass) is risk-weighted exposure amounts for exposures if they had not been securitised, calculated on a pro-rata basis;

RW(SP) is risk-weighted exposure amounts calculated under paragraph 3 if there was no maturity mismatch;

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T is maturity of the underlying exposures expressed in years;

t is maturity of credit protection expressed in years; and

t* is 0,25.

PART 3
External credit assessments

1. REQUIREMENTS TO BE MET BY THE CREDIT ASSESSMENTS OF ECAIs.

1. To be used for the purposes of calculating risk-weighted exposure amounts under Part 4, a credit assessment of an approved ECAI shall comply with the following condition–

(a) There shall be no mismatch between the types of payments reflected in the credit assessment and the types of payment to which the credit institution is entitled under the contract giving rise to the securitisation position in question; and

(b) The credit assessments shall be available publicly to the market. Credit assessments are considered to be publicly available only if they have been published in a publicly accessible forum and they are included in the ECAI's transition matrix. Credit assessments that are made available only to a limited number of entities shall not be considered to be publicly available;

(c) The credit assessment shall not be based or partly based on unfunded support provided by the credit institution itself. In such case, the credit institution shall consider the relevant position as if it were not rated and shall apply the relevant treatment of unrated positions as set out in Part 4.

2. USE OF CREDIT ASSESSMENTS.

2. A credit institution may nominate one or more approved ECAIs the credit assessments of which shall be used in the calculation of its risk-weighted exposure amounts under regulations 44 to 51 (a "nominated ECAI").

3. Subject to paragraphs 5 to 7, a credit institution shall use credit assessments from nominated ECAIs consistently in respect of its securitisation positions.

4. Subject to paragraphs 5 and 6, a credit institution shall not use an ECAI's credit assessments for its positions in some tranches and another ECAI's

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credit assessments for its positions in other tranches within the same structure that may or may not be rated by the first ECAI.

5. Where a position has two credit assessments by nominated ECAIs, the credit institution shall use the less favourable credit assessment.

6. Where a position has more than two credit assessments by nominated ECAIs, the two most favourable credit assessments shall be used. If the two most favourable assessments are different, the least favourable of the two shall be used.

7. Where credit protection approved under regulations 40 to 43 is provided directly to the SSPE, and that protection is reflected in the credit assessment of a position by a nominated ECAI, the risk weight associated with that credit assessment may be used. If the protection is not approved under those regulations, the credit assessment shall not be recognised. In the situation where the credit protection is not provided to the SSPE but rather directly to a securitisation position, the credit assessment shall not be recognised.

3. MAPPING.

8. The Commissioner shall determine with which credit quality step in the tables set out in Part 4 each credit assessment of an approved ECAI shall be associated. In doing so the Commissioner shall differentiate between the relative degrees of risk expressed by each assessment. He shall consider quantitative factors, such as default or loss rates, and qualitative factors such as the range of transactions assessed by the ECAI and the meaning of the credit assessment.

9. The Commissioner shall ensure that securitisation positions to which the same risk weight is applied on the basis of the credit assessments of approved ECAIs are subject to equivalent degrees of credit risk. This shall include modifying their determination as to the credit quality step with which a particular credit assessment shall be associated, as appropriate.

10. The Commissioner shall take the necessary measures to ensure that, with regard to credit assessments relating to structured finance instruments, the external credit assessment institution is committed to make available publicly the explanation how the performance of pool assets affects its credit assessments

PART 4

Calculation

1. CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS.

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1. For the purposes of regulation 46, the risk-weighted exposure amount of a securitisation position shall be calculated by applying to the exposure value of the position the relevant risk weight as set out in this Part.

2. Subject to paragraph 3–

(a) where a credit institution calculates risk-weighted exposure amounts under paragraphs 6 to 36, the exposure value of an on-balance sheet securitisation position shall be its balance sheet value;

(b) where a credit institution calculates risk-weighted exposure amounts under paragraphs 37 to 76, the exposure value of an on-balance sheet securitisation position shall be measured gross of value adjustments; and

(c) the exposure value of an off-balance sheet securitisation position shall be its nominal value multiplied by a conversion figure as prescribed in this Schedule. This conversion figure shall be 100 % unless otherwise specified.

3. The exposure value of a securitisation position arising from a derivative instrument listed in Schedule 4, shall be determined in accordance with Schedule 3.

4. Where a securitisation position is subject to funded credit protection, the exposure value of that position may be modified in accordance with and subject to the requirements in Schedule 8 as further specified in this Schedule.

5. Where a credit institution has two or more overlapping positions in a securitisation, it will be required to the extent that they overlap to include in its calculation of risk-weighted exposure amounts only the position or portion of a position producing the higher risk-weighted exposure amounts. The credit institution may also recognise such overlap between specific risk capital charges for positions in the trading book and capital charges for positions in the banking book, provided that the credit institution is able to calculate and compare the capital charges for the relevant positions. For the purpose of this point “overlapping” occurs when the positions, wholly or partially, represent an exposure to the same risk such that the extent of the overlap there is a single exposure.

Where point 1(c) of Part 3 applies to positions in the ABCP, the credit institution may, subject to the approval of the competent authority, use the risk-weight assigned to a liquidity facility in order to calculate the risk-weighted exposure amount for the ABCP if the liquidity facility ranks pari

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passu with the ABCP so that they form overlapping positions and 100 % of the ABCP issued by the programme is covered by liquidity facilities.

2. CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS UNDER THE STANDARDISED APPROACH.

6. Subject to point 8, the risk-weighted exposure amount of a rated securitisation or re-securitisation position shall be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated by the competent authority in accordance with regulation 48 as laid down in Table 1.

Table 1

Positions other than ones with short-term credit assessments

Table 1

Credit Quality Step	1	2	3	4 (only for credit assessments other than short-term credit assessments)	all other credit quality steps
Securitisation positions	20 %	50 %	100 %	350 %	1250 %
Re-securitisation positions	40 %	100 %	225 %	650 %	1250 %

7. Subject to paragraphs 10 to 15, the risk-weighted exposure amount of an unrated securitisation position shall be calculated by applying a risk weight of 1 250 %.

2.1 Originator and sponsor credit institutions.

8. For an originator credit institution or sponsor credit institution, the risk-weighted exposure amounts calculated in respect of its positions in a securitisation may be limited to the risk-weighted exposure amounts which would be calculated for the securitised exposures had they not been securitised subject to the presumed application of a 150 % risk weight to all past due items and items belonging to “regulatory high risk categories” amongst the securitised exposures.

2.2. Treatment of unrated positions.

9. Credit institutions having an unrated securitisation position may apply the treatment set out in paragraph 10 for calculating the risk-weighted exposure amount for that position provided the composition of the pool of exposures securitised is known at all times.

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10. A credit institution may apply the weighted-average risk weight that would be applied to the securitised exposures under regulations 28 to 33 by a credit institution holding the exposures, multiplied by a concentration ratio. This concentration ratio shall be equal to the sum of the nominal amounts of all the tranches divided by the sum of the nominal amounts of the tranches junior to or pari passu with the tranche in which the position is held including that tranche itself. The resulting risk weight shall not be higher than 1250 % or lower than any risk weight applicable to a rated more senior tranche. Where the credit institution is unable to determine the risk weights that would be applied to the securitised exposures under regulations 28 to 33, it shall apply a risk weight of 1250 % to the position.

2.3. Treatment of securitisation positions in a second loss tranche or better in an ABCP programme.

11. Subject to the availability of a more favourable treatment by virtue of the provisions concerning liquidity facilities in paragraphs 13 to 15, a credit institution may apply to securitisation positions meeting the conditions set out in paragraph 12 a risk weight that is the greater of 100 % or the highest of the risk weights that would be applied to any of the securitised exposures under regulations 28 to 33 by a credit institution holding the exposures.

12. For the treatment set out in paragraph 11 to be available, the securitisation position shall be–

(a) in a tranche which is economically in a second loss position or better in the securitisation and the first loss tranche shall provide meaningful credit enhancement to the second loss tranche;

(b) of a quality the equivalent of investment grade or better; and

(c) held by a credit institution which does not hold a position in the first loss tranche.

2.4. Treatment of unrated liquidity facilities.

2.4.1. Liquidity facilities.

13. When the following conditions are met, to determine its exposure value a conversion figure of 50% may be applied to the nominal amount of a liquidity facility –

(a) The liquidity facility documentation shall clearly identify and limit the circumstances under which the facility may be drawn;

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(b) It shall not be possible for the facility to be drawn so as to provide credit support by covering losses already incurred at the time of draw. For example, by providing liquidity in respect of exposures in default at the time of draw or by acquiring assets at more than fair value;

(c) The facility shall not be used to provide permanent or regular funding for the securitisation;

(d) Repayment of draws on the facility shall not be subordinated to the claims of investors other than to arising in respect of interest rate or currency derivative contracts, fees or other such payments, nor be subject to waiver or deferral;

(e) It shall not be possible for the facility to be drawn after all applicable credit enhancements from which the liquidity facility would benefit are exhausted; and

(f) The facility shall include a provision that results in an automatic reduction in the amount that can be drawn by the amount of exposures that are in default, where “default” has the meaning given to it under regulations 34 to 39, or where the pool of securitised exposures consists of rated instruments, that terminates the facility if the average quality of the pool falls below investment grade.

The risk weight to be applied shall be the highest risk weight that would be applied to any of the securitised exposures under regulations 28 to 33 by a credit institution holding the exposures.

14. *omitted*

2.4.3. Cash advance facilities.

15. To determine its exposure value, a conversion figure of 0 % may be applied to the nominal amount of a liquidity facility that is unconditionally cancellable provided that the conditions set out at paragraph 13 are satisfied and that repayment of draws on the facility are senior to any other claims on the cash flows arising from the securitised exposures.

2.5. Additional capital requirements for securitisations of revolving exposures with early amortisation provisions.

16. In addition to the risk-weighted exposure amounts calculated in respect of its securitisation positions, an originator credit institution shall calculate a risk-weighted exposure amount according to the method set out in

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paragraphs 17 to 33 when it sells revolving exposures into a securitisation that contains an early amortisation provision.

17. The credit institution shall calculate a risk-weighted exposure amount in respect of the sum of the originator's interest and the investors' interest.

18. For securitisation structures where the securitised exposures comprise revolving and non-revolving exposures, an originator credit institution shall apply the treatment set out in paragraph 19 to 31 to that portion of the underlying pool containing revolving exposures.

19. For the purposes of paragraph 16 to 31, "originator's interest" means the exposure value of that notional part of a pool of drawn amounts sold into a securitisation, the proportion of which in relation to the amount of the total pool sold into the structure determines the proportion of the cash flows generated by principal and interest collections and other associated amounts which are not available to make payments to those having securitisation positions in the securitisation.

To qualify as such, the originator's interest shall not be subordinate to the investors' interest.

"Investors' interest" means the exposure value of the remaining notional part of the pool of drawn amounts.

20. The exposure of the originator credit institution, associated with its rights in respect of the originator's interest, shall not be considered a securitisation position but as a pro rata exposure to the securitised exposures as if they had not been securitised.

2.5.1. Exemptions from early amortisation treatment.

21. Originators of the following types of securitisation are exempt from the capital requirement in paragraph 16–

(a) securitisations of revolving exposures whereby investors remain fully exposed to all future draws by borrowers so that the risk on the underlying facilities does not return to the originator credit institution even after an early amortisation event has occurred, and

(b) securitisations where any early amortisation provision is solely triggered by events not related to the performance of the securitised assets or the originator credit institution, such as material changes in tax laws or regulations.

2.5.2. Maximum capital requirement.

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22. For an originator credit institution subject to the capital requirement in paragraph 16 the total of the risk-weighted exposure amounts in respect of its positions in the investors" interest and the risk-weighted exposure amounts calculated under paragraph 16 shall be no greater than the greater of–

(a) the risk-weighted exposure amounts calculated in respect of its positions in the investors' interest; and

(b) the risk-weighted exposure amounts that would be calculated in respect of the securitised exposures by a credit institution holding the exposures as if they had not been securitised in an amount equal to the investors' interest.

23. Deduction of net gains, if any, arising from the capitalisation of future income required under regulation 7, shall be treated outside the maximum amount indicated in paragraph 22.

2.5.3. Calculation of risk-weighted exposure amounts.

24. The risk-weighted exposure amount to be calculated in accordance with paragraph 16 shall be determined by multiplying the amount of the investors" interest by the product of the appropriate conversion figure as indicated in paragraphs 26 to 33 and the weighted average risk weight that would apply to the securitised exposures if the exposures had not been securitised.

25. An early amortisation provision shall be considered to be "controlled" where the following conditions are met–

(a) the originator credit institution has an appropriate capital or liquidity plan in place to ensure that it has sufficient capital and liquidity available in the event of an early amortisation;

(b) throughout the duration of the transaction there is pro-rata sharing between the originator's interest and the investor's interest of payments of interest and principal, expenses, losses and recoveries based on the balance of receivables outstanding at one or more reference paragraphs during each month;

(c) the amortisation period is considered sufficient for 90 % of the total debt (originator's and investors' interest) outstanding at the beginning of the early amortisation period to have been repaid or recognised as in default; and

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(d) the speed of repayment is no more rapid than would be achieved by straight-line amortisation over the period set out in paragraph (c).

26. In the case of securitisations subject to an early amortisation provision of retail exposures which are uncommitted and unconditionally cancellable without prior notice, where the early amortisation is triggered by the excess spread level falling to a specified level, credit institutions shall compare the three-month average excess spread level with the excess spread levels at which excess spread is required to be trapped.

27. Where the securitisation does not require excess spread to be trapped, the trapping paragraph is deemed to be 4.5 percentage points greater than the excess spread level at which an early amortisation is triggered.

28. The conversion figure to be applied shall be determined by the level of the actual three month average excess spread in accordance with Table 3.

Table 3

	Securitisations subject to a controlled early amortisation provision	Securitisations subject to a non-controlled early amortisation provision
3 months average excess spread	Conversion figure	Conversion figure
Above level A	0%	0%
Level A	1%	5%
Level B	2%	15%
Level C	10%	50%
Level D	20%	100%
Level E	40%	100%

29. In Table 3, "Level A" means levels of excess spread less than 133,33 % of the trapping level of excess spread but not less than 100 % of that trapping level, "Level B" means levels of excess spread less than 100 % of the trapping level of excess spread but not less than 75 % of that trapping level, "Level C" means levels of excess spread less than 75 % of the trapping level of excess spread but not less than 50 % of that trapping level, "Level D" means levels of excess spread less than 50 % of the trapping level of excess spread but not less than 25 % of that trapping level and "Level E" means levels of excess spread less than 25 % of the trapping level of excess spread.

30. In the case of securitisations subject to an early amortisation provision of retail exposures which are uncommitted and unconditionally cancellable without prior notice and where the early amortisation is triggered by a quantitative value in respect of something other than the three months average excess spread, the Commissioner may apply a treatment which approximates closely to that prescribed in paragraphs 26 to 29 for determining the conversion figure indicated.

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31. Where the Commissioner intends to apply a treatment in accordance with paragraph 30 in respect of a particular securitisation, it shall first inform the relevant competent authorities of all relevant EEA States. Before the application of such a treatment becomes part of the general policy approach of the Commissioner to securitisations containing early amortisation clauses of the type in question, the Commissioner shall consult the relevant competent authorities of all the EEA States and take into consideration the views expressed. The views expressed in such consultation and the treatment applied shall be published by the Commissioner.

32. All other securitisations subject to a controlled early amortisation provision of revolving exposures shall be subject to a conversion figure of 90 %.

33. All other securitisations subject to a non-controlled early amortisation provision of revolving exposures shall be subject to a conversion figure of 100 %.

2.6. Recognition of credit risk mitigation on securitisation positions.

34. Where credit protection is obtained on a securitisation position, the calculation of risk-weighted exposure amounts may be modified in accordance with Schedule 8.

2.7. Reduction in risk-weighted exposure amounts.

35. As provided in regulation 15(2) to (4), in respect of a securitisation position in respect of which a 1250 % risk weight is assigned, credit institutions may, as an alternative to including the position in their calculation of risk-weighted exposure amounts, deduct from own funds the exposure value of the position. For these purposes, the calculation of the exposure value may reflect approved funded credit protection in a manner consistent with paragraph 34.

36. Where a credit institution makes use of the alternative indicated in paragraph 35, 12.5 times the amount deducted in accordance with that paragraph shall, for the purposes of paragraph 8, be subtracted from the amount specified in paragraph 8 as the maximum risk-weighted exposure amount to be calculated by the credit institutions there indicated.

3. CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS UNDER THE INTERNAL RATINGS BASED APPROACH

3.1. Hierarchy of methods.

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37. For the purposes of regulation 46, the risk-weighted exposure amount of a securitisation positions shall be calculated in accordance with paragraphs 38 to 76.

38. For a rated position or a position in respect of which an inferred rating may be used, the Ratings Based Method set out in paragraphs 46 to 51 shall be used to calculate the risk-weighted exposure amount.

39. For an unrated position the Supervisory Formula Method set out in paragraphs 52 to 54 shall be used except where the Internal Assessment Approach is permitted to be used as set out in paragraphs 43 and 44.

40. A credit institution other than an originator credit institution or a sponsor credit institution may only use the Supervisory Formula Method with the approval of the Commissioner.

41. In the case of an originator or sponsor credit institution unable to calculate Kirb and which has not obtained approval to use the Internal Assessment Approach for positions in ABCP programmes, and in the case of other credit institutions where they have not obtained approval to use the Supervisory Formula Method or, for positions in ABCP programmes, the Internal Assessment Approach, a risk weight of 1250 % shall be assigned to securitisation positions which are unrated and in respect of which an inferred rating may not be used.

3.1.1. Use of inferred ratings.

42. When the following minimum operational requirements are satisfied, a credit institution shall attribute to an unrated position an inferred credit assessment equivalent to the credit assessment of those rated positions (the "reference positions") which are the most senior positions which are in all respects subordinate to the unrated securitisation position in question–

(a) the reference positions shall be subordinate in all respects to the unrated securitisation position;

(b) the maturity of the reference positions shall be equal to or longer than that of the unrated position in question; and

(c) on an ongoing basis, any inferred rating shall be updated to reflect any changes in the credit assessment of the reference positions.

3.1.2. The "Internal Assessment Approach" for positions in ABCP programmes.

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43. Subject to the approval of the Commissioner, when the following conditions are satisfied a credit institution may attribute to an unrated position in an ABCP programme a derived rating under paragraph 44-

(a) positions in the commercial paper issued from the ABCP programme shall be rated positions;

(b) the credit institution shall satisfy the Commissioner that its internal assessment of the credit quality of the position reflects the publicly available assessment methodology of one or more approved ECAIs, for the rating of securities backed by the exposures of the type securitised;

(c) the ECAIs, the methodology of which shall be reflected as required by paragraph (b), shall include those ECAIs which have provided an external rating for the commercial paper issued from the ABCP programme. Quantitative elements, such as stress factors, used in assessing the position to a particular credit quality shall be at least as conservative as those used in the relevant assessment methodology of the ECAIs in question;

(d) in developing its internal assessment methodology the credit institution shall take into consideration relevant published ratings methodologies of the approved ECAIs that rate the commercial paper of the ABCP programme. This consideration shall be documented by the credit institution and updated regularly, as outlined in paragraph (g);

(e) the credit institution's internal assessment methodology shall include rating grades. There shall be a correspondence between such rating grades and the credit assessments of approved ECAIs. This correspondence shall be explicitly documented;

(f) the internal assessment methodology shall be used in the credit institution's internal risk management processes, including its decision making, management information and capital allocation processes;

(g) internal or external auditors, an ECAI, or the credit institution's internal credit review or risk management function shall perform regular reviews of the internal assessment process and the quality of the internal assessments of the credit quality of the credit institution's exposures to an ABCP programme. If the credit institution's internal audit, credit review, or risk management functions perform the review, then these functions shall be independent of the ABCP programme business line, as well as the customer relationship;

(h) the credit institution shall track the performance of its internal ratings over time to evaluate the performance of its internal assessment methodology and shall make adjustments, as necessary, to that methodology when the performance of the exposures routinely diverges from that indicated by the internal ratings;

(i) the ABCP programme shall incorporate underwriting standards in the form of credit and investment guidelines. In deciding on an asset purchase, the ABCP programme administrator shall consider the type of asset being purchased, the type and monetary value of the exposures arising from the provision of liquidity facilities and credit enhancements, the loss distribution, and the legal and economic isolation of the transferred assets from the entity selling the assets. A credit analysis of the asset seller's risk profile shall be performed and shall include analysis of past and expected future financial performance, current market position, expected future competitiveness, leverage, cash flow, interest coverage and debt rating. In addition, a review of the seller's underwriting standards, servicing capabilities, and collection processes shall be performed;

(j) the ABCP programme's underwriting standards shall establish minimum asset eligibility criteria that, in particular–

(i) exclude the purchase of assets that are significantly past due or defaulted;

(ii) limit excess concentration to individual obligor or geographic area; and

(iii) limits the tenor of the assets to be purchased;

(k) the ABCP programme shall have collections policies and processes which take into account the operational capability and credit quality of the servicer. The ABCP programme shall mitigate the seller or servicer risk through various methods, such as triggers based on current credit quality that would preclude commingling of funds;

(l) the aggregated estimate of loss on an asset pool that the ABCP programme is considering purchasing shall take into account all sources of potential risk, such as credit and dilution risk. If the seller provided credit enhancement is sized based only on credit-related losses, then a separate reserve shall be

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established for dilution risk, if dilution risk is material for the particular exposure pool. In addition, in sizing the required enhancement level, the program shall review several years of historical information, including losses, delinquencies, dilutions, and the turnover rate of the receivables; and

(m) the ABCP programme shall incorporate structural features - for example wind down triggers -into the purchase of exposures in order to mitigate potential credit deterioration of the underlying portfolio.

The requirement for the assessment methodology of the ECAI to be publicly available may be waived by the Commissioner where he is satisfied that due to the specific features of the securitisation - for example its unique structure - there is as yet no publicly available ECAI assessment methodology.

44. The unrated position shall be assigned by the credit institution to one of the rating grades described in paragraph 43. The position shall be attributed a derived rating the same as the credit assessments corresponding to that rating grade as laid down in paragraph 43. Where this derived rating is, at the inception of the securitisation, at the level of investment grade or better, it shall be considered the same as an approved credit assessment by an approved ECAI for the purposes of calculating risk-weighted exposure amounts.

3.2. Maximum risk-weighted exposure amounts.

45. For an originator credit institution, a sponsor credit institution, or for other credit institutions which can calculate KIRB, the risk-weighted exposure amounts calculated in respect of its positions in a securitisation may be limited to that which would produce a capital requirement under regulation 23(a) equal to the sum of 8 % of the risk-weighted exposure amounts which would be produced if the securitised assets had not been securitised and were on the balance sheet of the credit institution plus the expected loss amounts of those exposures.

3.3. Ratings Based Method.

46. Under the Ratings Based Method, the risk-weighted exposure amount of a rated securitisation or re-securitisation position shall be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated by the competent authority in accordance with regulation 48, as set out in the Table 4, multiplied by 1,06.

Table 4

Credit Quality Step		Securitisation Positions			Re-securirisation Positions	
Credit assessments other than short term	Short term credit assessments	A	B	C	D	E
1	1	7%	12%	20%	20%	30%
2		8%	12%	25%	25%	40%
3		10%	18%	35%	35%	50%
4	2	12%	20%		40%	65%
5		20%	35%		60%	100%
6		35%	50%		100%	150%
7	3	60%	75%		150%	2250 %
8		100%			200%	350%
9	2	250%			300%	500%
10		425%			500%	650%
11		650%			750%	850%
All other and unrated		1250%				

47. The weightings in column C of table 4 shall be applied where the securitisation position is not a re-securitisation position and where the effective number of exposures securitised is less than six. For the remainder of the securitisation positions that are not re-securitisation positions, the weightings in column B shall be applied unless the position is in the most senior tranche of a securitisation, in which case the weightings in column A shall be applied. For re-securitisation positions the weightings in column E shall be applied unless the re-securitisation position is in the most senior tranche of the re-securitisation and none of the underlying exposures were themselves re-securitisation exposures, in which case column D shall be applied. When determining whether a tranche is the most senior, it is not required to take into consideration amounts due under interest rate or currency derivative contracts, fees due, or other similar payments.

48. *Omitted*

49. In calculating the effective number of exposures securitised multiple exposures to one obligor shall be treated as one exposure. The effective number of exposures is calculated as:

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$$N = \frac{\left(\sum_{i} EAD_i\right)^2}{\sum_{i} EAD_i^2}$$

where EAD represents the sum of the exposure values of all exposures to the ith obligor. If the portfolio share associated with the largest exposure, C1, is available, the credit institution may compute N as 1/C1.

50. *Deleted*

51. Credit risk mitigation on securitisation positions may be recognised in accordance with paragraphs 60 to 62.

3.4. Supervisory Formula Method.

52. Subject to points 58 and 59, under the Supervisory Formula Method, the risk weight for a securitisation position shall be the risk weight to be applied in accordance with point 53. However, the risk weight shall be no less than 20 % for re-securitisation positions and no less than 7 % for all other securitisation positions.

53. Subject to paragraphs 58 and 59, the risk weight to be applied to the exposure amount shall be–

$$12{,}5 \times (S[L+T] - S[L])/T$$

where–

$$S[x] = \begin{cases} x & \text{when } x \leq \text{Kirbr} \\ \text{Kirbr} = K[x] - K[\text{Kirbr}] + (d \cdot \text{Kirbr}/\omega)(1 - e^{\omega(\text{Kirbr}-x)/\text{Kirbr}}) & \text{when Kirbr} < x \end{cases}$$

where–

$$h = (1 - \text{Kirbr}/\text{ELGD})^N$$

$$c = \text{Kirbr}/(1 - h)$$

$$v = \frac{(\text{ELGD} - \text{Kirbr})\text{Kirbr} + 0.25(1 - \text{ELGD})\text{Kirbr}}{N}$$

$$f = \left(\frac{v + \text{Kirbr}^2}{1-h} - c^2\right) + \frac{(1 - \text{Kiribr})\text{Kirbr} - v}{(1-h)\tau}$$

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$$g = \frac{(1-c)c}{f} - 1$$

$a = g \cdot c$

$b = g \cdot (1 - c)$

$d = 1 - (1 - h) \cdot (1 - \text{Beta}[Kirbr;a,b])$

$K[x] = (1 - h) \cdot ((1 - \text{Beta}[x;a,b.])x + \text{Beta}[x;a + 1,].c)$
$\tau = 1\,000$, and
$\omega = 20$.

In these expressions, Beta [x; a, b] refers to the cumulative beta distribution with parameters a and b evaluated at x.

T (the thickness of the tranche in which the position is held) shall be measured as the ratio of (a) the nominal amount of the tranche to (b) the sum of the exposure values of the exposures that have been securitised. For the purposes of calculating T the exposure value of a derivative instrument listed in Schedule 4 shall, where the current replacement cost is not a positive value, be the potential future credit exposure calculated in accordance with Schedule 3.

Kirbr is the ratio of (a) Kirb to (b) the sum of the exposure values of the exposures that have been securitised. Kirbr is expressed in decimal form (e.g. Kirb equal to 15 % of the pool would be expressed as Kirbr of 0,15).

L (the credit enhancement level) shall be measured as the ratio of the nominal amount of all tranches subordinate to the tranche in which the position is held to the sum of the exposure values of the exposures that have been securitised. Capitalised future income shall not be included in the measured L. Amounts due by counterparties to derivative instruments listed in Schedule 4 that represent tranches more junior than the tranche in question may be measured at their current replacement cost (without the potential future credit exposures) in calculating the enhancement level.

N is the effective number of exposures calculated in accordance with point 49. In the case of re-securitisations, the credit institution shall look at the number of securitisation exposures in the pool and not the number of underlying exposures in the original pools from which the underlying securitisation exposures stem.

ELGD, the exposure-weighted average loss-given-default, is calculated as follows–

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$$ELGD = \frac{\sum_i LGD_i \cdot EAD_i}{\sum_i LGD_i}$$

where LGD_i represents the average LGD associated with all exposures to the ith obligor, where LGD is determined in accordance with regulations 34 to 39. In the case of resecuritisation, an LGD of 100% shall be applied to the securitised positions. When default and dilution risk for purchased receivables are treated in an aggregate manner within a securitisation (e.g. a single reserve or over-collateralisation is available to cover losses from either source), the LGD_i input shall be constructed as a weighted average of the LGD for credit risk and the 75% LGD for dilution risk. The weights shall be the stand-alone capital charges for credit risk and dilution risk respectively.

Simplified inputs

If the exposure value of the largest securitised exposure, C_1, is no more than 3 % of the sum of the exposure values of the securitised exposures, then, for the purposes of the Supervisory Formula Method, the credit institution may set LGD= 50 % and N equal to either-

$$N = \left(C_1 C_m + \left(\frac{C_m - C_1}{m-1} \right) \max\{1 - mC_1, 0\} \right)^{-1}$$

or

$N=1/C_1$.

C_m is the ratio of the sum of the exposure values of the largest "m" exposures to the sum of the exposure values of the exposures securitised . The level of "m" may be set by the credit institution.

For securitisations involving retail exposures, the Commissioner may permit the Supervisory Formula Method to be implemented using the simplifications- h = 0 and v = 0.

54. Credit risk mitigation on securitisation positions may be recognised in accordance with paragraphs 60, 61 and 63 to 67.

3.5. Liquidity Facilities.

55. The provisions in paragraphs 56 to 59 shall apply for the purposes of determining the exposure value of an unrated securitisation position in the form of certain types of liquidity facility.

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56. *omitted*

3.5.2. Cash advance facilities.

57. A conversion figure of 0% may be applied to the nominal amount of a liquidity facility that meets the conditions set out in paragraph 15.

3.5.3. Exceptional treatment where Kirb cannot be calculated.

58. When it is not practical for the credit institution to calculate the risk-weighted exposure amounts for the securitised exposures as if they had not been securitised, a credit institution may, on an exceptional basis and subject to the authority of the Commissioner, temporarily be allowed to apply the method set out in paragraph 59 for the calculation of risk-weighted exposure amounts for an unrated securitisation position in the form of a liquidity facility that meets the conditions to be an “approved liquidity facility” set out in paragraph 13 or that falls within the terms of paragraph 56.

59. The highest risk weight that would be applied under regulations 28 to 33 to any of the securitised exposures, had they not been securitised, may be applied to the securitisation position represented by the liquidity facility. To determine the exposure value of the position a conversion figure of 50% may be applied to the nominal amount of the liquidity facility if the facility has an original maturity of one year or less. If the liquidity facility complies with the conditions in paragraph 56 a conversion figure of 20% may be applied. In other cases a conversion factor of 100% shall be applied.

3.6. Recognition of credit risk mitigation in respect of securitisation positions.

3.6.1. Funded credit protection.

60. Eligible funded protection is limited to that which is approved for the calculation of risk-weighted exposure amounts under regulations 28 to 33 as laid down under regulations 40 to 43 and recognition is subject to compliance with t e relevant minimum requirements as laid down under those regulations.

3.6.2. Unfunded credit protection.

61. Approved unfunded credit protection and unfunded protection providers shall be limited to those which are approved under regulations 40 to 43 and recognition is subject to compliance with the relevant minimum requirements laid down under those regulations.

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3.6.3. Calculation of capital requirements for securitisation positions with credit risk mitigation.

Ratings Based Method.

62. Where risk-weighted exposure amounts are calculated using the Ratings Based Method, the exposure value and/or the risk-weighted exposure amount for a securitisation position in respect of which credit protection has been obtained may be modified in accordance with the provisions of Schedule 8 as they apply for the calculation of risk-weighted exposure amounts under regulations 28 to 33.

Supervisory Formula Method — full credit protection.

63. Where risk-weighted exposure amounts are calculated using the Supervisory Formula Method, the credit institution shall determine the "effective risk weight" of the position. It shall do this by dividing the risk weighted exposure amount of the position by the exposure value of the position and multiplying the result by 100.

64. In the case of funded credit protection, the risk-weighted exposure amount of the securitisation position shall be calculated by multiplying the funded protection-adjusted exposure amount of the position (E*, as calculated under regulations 40 to 43 for the calculation of risk-weighted exposure amounts under regulations 28 to 33 taking the amount of the securitisation position to be E) by the effective risk weight.

65. In the case of unfunded credit protection, the risk-weighted exposure amount of the securitisation position shall be calculated by multiplying G_A (the amount of the protection adjusted for any currency mismatch and maturity mismatch in accordance with the provisions of Schedule 8) by the risk weight of the protection provider; and adding this to the amount arrived at by multiplying the amount of the securitisation position minus G_A by the effective risk weight.

Supervisory formula method — partial protection.

66. If the credit risk mitigation covers the "first loss" or losses on a proportional basis on the securitisation position, the credit institution may apply paragraphs 63 to 65.

67. In other cases, the credit institution shall treat the securitisation position as two or more positions with the uncovered portion being considered the position with the lower credit quality. For the purposes of calculating the risk-weighted exposure amount for this position, the provisions in paragraphs 52 to 54 shall apply subject to the modifications that "T" shall be adjusted to e* in the case of funded credit protection; and to T-g in the

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case of unfunded credit protection, where e* denotes the ratio of E* to the total notional amount of the underlying pool, where E* is the adjusted exposure amount of the securitisation position calculated in accordance with the provisions of Schedule 8 as they apply for the calculation of risk-weighted exposure amounts under regulations 28 to 33 taking the amount of the securitisation position to be E; and g is the ratio of the nominal amount of credit protection (adjusted for any currency or maturity mismatch in accordance with the provisions of Schedule 8) to the sum of the exposure amounts of the securitised exposures. In the case of unfunded credit protection the risk weight of the protection provider shall be applied to that portion of the position not falling within the adjusted value of "T".

3.7. Additional capital requirements for securitisations of revolving exposures with early amortisation provisions.

68. In addition to the risk-weighted exposure amounts calculated in respect of its securitisation positions, an originator credit institution shall be required to calculate a risk-weighted exposure amount according to the methodology set out in paragraphs 16 to 33 when it sells revolving exposures into a securitisation that contains an early amortisation provision.

69. For the purposes of paragraph 68, paragraphs 70 and 71 shall replace paragraphs 19 and 20.

70. For the purposes of these provisions, "originators interest" shall be the sum of–

(a) the exposure value of that notional part of a pool of drawn amounts sold into a securitisation, the proportion of which in relation to the amount of the total pool sold into the structure determines the proportion of the cash flows generated by principal and interest collections and other associated amounts which are not available to make payments to those having securitisation positions in the securitisation; plus

(b) the exposure value of that part of the pool of undrawn amounts of the credit lines, the drawn amounts of which have been sold into the securitisation, the proportion of which to the total amount of such undrawn amounts is the same as the proportion of the exposure value described in paragraph (a) to the exposure value of the pool of drawn amounts sold into the securitisation.

To qualify as such, the originator's interest may not be subordinate to the investors' interest.

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"Investors' interest" means the exposure value of the notional part of the pool of drawn amounts not falling within paragraph (a) plus the exposure value of that part of the pool of undrawn amounts of credit lines, the drawn amounts of which have been sold into the securitisation, not falling within paragraph (b).

71. The exposure of the originator credit institution associated with its rights in respect of that part of the originator's interest described in paragraph 70(a) shall not be considered a securitisation position but as a pro rata exposure to the securitised drawn amounts exposures as if they had not been securitised in an amount equal to that described in paragraph 70(a). The originator credit institution shall also be considered to have a pro rata exposure to the undrawn amounts of the credit lines, the drawn amounts of which have been sold into the securitisation, in an amount equal to that described in paragraph 70(b).

3.8. Reduction in risk-weighted exposure amounts.

72. The risk-weighted exposure amount of a securitisation position to which a 1250% risk weight is assigned may be reduced by 12.5 times the amount of any value adjustments made by the credit institution in respect of the securitised exposures. To the extent that value adjustments are taken account of for this purpose they shall not be taken account of for the purposes of the calculation indicated in paragraph 36 of Part 1 of Schedule 7.

73. The risk-weighted exposure amount of a securitisation position may be reduced by 12.5 times the amount of any value adjustments made by the credit institution in respect of the position.

74. As provided in Regulation 15(1) and (2), in respect of a securitisation position in respect of which a 1250% risk weight applies, credit institutions may, as an alternative to including the position in their calculation of risk-weighted exposure amounts, deduct from own funds the exposure value of the position.

75. For the purposes of paragraph 74–

(a) the exposure value of the position may be derived from the risk-weighted exposure amounts taking into account any reductions made in accordance with paragraphs 72 and 73;

(b) the calculation of the exposure value may reflect approved funded protection in a manner consistent with the methodology prescribed in paragraphs 60 to 67; and

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(c) where the Supervisory Formula Method is used to calculate risk-weighted exposure amounts and $L \leq K_{IRBR}$ and $[L+T] > K_{IRBR}$ the position may be treated as two positions with L equal to K_{IRBR} for the more senior of the positions.

76. Where a credit institution makes use of the alternative indicated in paragraph 74, 12.5 times the amount deducted in accordance with that paragraph shall, for the purposes of paragraph 45, be subtracted from the amount specified in paragraph 45 as the maximum risk-weighted exposure amount to be calculated by the credit institutions there indicated.

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SCHEDULE 10

Regulations 52 to 55

OPERATIONAL RISK

PART 1

Basic Indicator Approach.

1. CAPITAL REQUIREMENT.

1. Under the Basic Indicator Approach, the capital requirement for operational risk shall be equal to 15 % of the relevant indicator defined in paragraphs 2 to 9.

2. RELEVANT INDICATOR.

2. The relevant indicator is the average over three years of the sum of net interest income and net non-interest income.

3. The three-year average shall be calculated on the basis of the last three twelve-monthly observations at the end of the financial year. When audited figures are not available, business estimates may be used.

4. If for any given observation, the sum of net interest income and net non-interest income is negative or equal to zero, this figure shall not be taken into account in the calculation of the three-year average. The relevant indicator shall be calculated as the sum of positive figures divided by the number of positive figures.

2.1. Credit institutions subject to the Banking (Accounts Directive) Regulations.

5. Based on the accounting categories for the profit and loss account of credit institutions under the Banking (Accounts Directive) Regulations, the relevant indicator shall be expressed as the sum of the elements listed in Table 1. Each element shall be included in the sum with its positive or negative sign.

6. These elements may need to be adjusted to reflect the qualifications in paragraphs 7 and 8.

Table 1

1 Interest receivable and similar income

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2 Interest payable and similar charges
3 Income from shares and other variable/fixed-yield securities
4 Commissions/fees receivable
5 Commissions/fees payable
6 Net profit or net loss on financial operations
7 Other operating income

2.1.1. Qualifications.

7. The indicator shall be calculated before the deduction of any provisions and operating expenses. Operating expenses shall include fees paid for outsourcing services rendered by third parties which are not a parent or subsidiary of the credit institution or a subsidiary of a parent which is also the parent of the credit institution. Expenditure on the outsourcing of services rendered by third parties may reduce the relevant indicator if the expenditure is incurred from an undertaking subject to supervision under, or equivalent to, these Regulations.

8. The following elements shall not be used in the calculation of the relevant indicator:

(a) Realised profits and losses from the sale of non-trading book items;

(b) Income from extraordinary or irregular items;

(c) Income derived from insurance.

When revaluation of trading items is part of the profit and loss statement, revaluation could be included in the calculation of the relevant income indicator. When the Banking (Accounts Directive) Regulations are applied, revaluation booked in the profit and loss account shall be included in the calculation of the relevant income indicator.

2.2. Credit institutions subject to a different accounting framework.

9. When credit institutions are subject to an accounting framework different from the one established by the Banking (Accounts Directive) Regulations, they shall calculate the relevant indicator on the basis of data that best reflect the definition set out in paragraphs 2 to 8.

PART 2

Standardised Approach

1. CAPITAL REQUIREMENT.

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1. The capital requirement for operational risk shall be calculated as the three-year average of the yearly summations of the capital requirements across business lines referred to in Table 2. In any given year, negative capital requirements (resulting from negative gross income) in any business line may offset positive capital requirements in other business lines without limit. However, where the aggregate capital requirements across all business lines within a given year are negative, the input to the numerator for that year shall be zero.

2. The three-year average is calculated on the basis of the last three twelve-monthly observations at the end of the financial year. When audited figures are not available, business estimates may be used.

Table 2

Business line	List of activities	Percentage
Corporate finance	Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis Services related to underwriting Investment advice Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to the mergers and the purchase of undertakings Investment research and financial analysis and other forms of general recommendation relating to transactions in financial instruments	18 %
Trading and sales	Dealing on own account Money broking Reception and transmission of orders in relation to one or more financial instruments Execution of orders on behalf of clients Placing of financial instruments without a firm commitment basis Operation of Multilateral Trading Facilities	18 %
Retail brokerage (Activities with a individual physical persons or with small and medium sized entities meeting the criteria set out in regulation 29 for the retail exposure class)	Reception and transmission of orders in relation to one or more financial instruments Execution of orders on behalf of clients Placing of financial instruments without a firm commitment basis	12 %
Commercial banking	Acceptance of deposits and other repayable funds Lending Financial leasing Guarantees and commitments	15 %

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Retail banking (Activities with a individual physical persons or with small and medium sized entities meeting the criteria set out in regulation 29 for the retail exposure class)	Acceptance of deposits and other repayable funds Lending Financial leasing Guarantees and commitments	12 %
Payment and settlement	Money transmission services, Issuing and administering means of payment	18 %
Agency services	Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management	15 %
Asset management	Portfolio management Managing of UCITS Other forms of asset management	12 %

3. The Commissioner may authorise a credit institution to calculate its capital requirement for operational risk using an alternative standardised approach, as set out in paragraphs 5 to 11.

2. PRINCIPLES FOR BUSINESS LINE MAPPING.

4. Credit institutions shall develop and document specific policies and criteria for mapping the relevant indicator for current business lines and activities into the standardised approach framework. The criteria shall be reviewed and adjusted as appropriate for new or changing business activities and risks. The principles for business line mapping are–

(a) all activities shall be mapped into the business lines in a mutually exclusive and jointly exhaustive manner;

(b) any activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, shall be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criterion shall be used;

(c) if an activity cannot be mapped into a particular business line then the business line yielding the highest percentage shall be used. The same business line equally applies to any associated ancillary activity;

(d) credit institutions may use internal pricing methods to allocate the relevant indicator between business lines. Costs generated in one business line which are imputable to a different business

line may be reallocated to the business line to which they pertain, for instance by using a treatment based on internal transfer costs between the two business lines;

(e) the mapping of activities into business lines for operational risk capital purposes shall be consistent with the categories used for credit and market risks;

(f) senior management shall be responsible for the mapping policy under the control of the senior management of the credit institution; and

(g) the mapping process to business lines shall be subject to independent review.

3. ALTERNATIVE INDICATORS FOR CERTAIN BUSINESS LINES.

3.1. Modalities.

5. The Commissioner may authorise the credit institution to use an alternative relevant indicator for the business lines: retail banking and commercial banking.

6. For these business lines, the relevant indicator shall be a normalised income indicator equal to the three-year average of the total nominal amount of loans and advances multiplied by 0.035.

7. For the retail or commercial banking business lines, the loans and advances shall consist of the total drawn amounts in the corresponding credit portfolios. For the commercial banking business line, securities held in the non trading book shall also be included.

3.2. Conditions.

8. The authorisation to use alternative relevant indicators shall be subject to the conditions in paragraphs 9 to 11.

3.2.1. General condition.

9. The credit institution shall meet the qualifying criteria set out in paragraph 12.

3.2.2. Conditions specific to retail banking and commercial banking.

10. The credit institution is overwhelmingly active in retail or commercial banking activities, which shall account for at least 90% of its income.

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11. The credit institution is able to demonstrate to the Commissioner that a significant proportion of its retail and/or commercial banking activities comprise loans associated with a high PD, and that the alternative standardised approach provides an improved basis for assessing the operational risk.

4. QUALIFYING CRITERIA.

12. Credit institutions shall meet the qualifying criteria listed below, in addition to the general risk management standards in Schedule 5. Satisfaction of these criteria shall be determined having regard to the size and scale of activities of the credit institution and to the principle of proportionality.

(a) Credit institutions shall have a well-documented assessment and management system for operational risk with clear responsibilities assigned for this system. They shall identify their exposures to operational risk and track relevant operational risk data, including material loss data. This system shall be subject to regular independent review.

(b) The operational risk assessment system shall be closely integrated into the risk management processes of the credit institution. Its output shall be an integral part of the process of monitoring and controlling the credit institution's operational risk profile.

(c) Credit institutions shall implement a system of management reporting that provides operational risk reports to relevant functions within the credit institution. Credit institutions shall have procedures for taking appropriate action according to the information within the management reports.

PART 3

Advanced Measurement Approaches

1. QUALIFYING CRITERIA.

1. To be eligible for an Advanced Measurement Approach, credit institutions shall satisfy the Commissioner that they meet the qualifying criteria below, in addition to the general risk management standards in Schedule 5.

1.1. Qualitative Standards.

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2. The credit institution's internal operational risk measurement system shall be closely integrated into its day-to-day risk management processes.

3. The credit institution shall have an independent risk management function for operational risk.

4. There shall be regular reporting of operational risk exposures and loss experience. The credit institution shall have procedures for taking appropriate corrective action.

5. The credit institution's risk management system shall be well documented. The credit institution shall have routines in place for ensuring compliance and policies for the treatment of non-compliance.

6. The operational risk management processes and measurement systems shall be subject to regular reviews performed by internal and/or external auditors.

7. The validation of the operational risk measurement system by the Commissioner shall include the following elements–

(a) verifying that the internal validation processes are operating in a satisfactory manner;

(b) making sure that data flows and processes associated with the risk measurement system are transparent and accessible.

1.2. Quantitative Standards.

1.2.1. Process.

8. Credit institutions shall calculate their capital requirement as comprising both expected loss and unexpected loss, unless they can demonstrate that expected loss is adequately captured in their internal business practices. The operational risk measure shall capture potentially severe tail events, achieving a soundness standard comparable to a 99.9 % confidence interval over a one year period.

9. The operational risk measurement system of a credit institution shall have certain key elements to meet the soundness standard set out in paragraph 8. These elements shall include the use of internal data, external data, scenario analysis and factors reflecting the business environment and internal control systems in paragraphs 13 to 24. A credit institution shall have a well documented approach for weighting the use of these four elements in its overall operational risk measurement system.

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10. The risk measurement system shall capture the major drivers of risk affecting the shape of the tail of the loss estimates.

11. Correlations in operational risk losses across individual operational risk estimates may be recognised only if credit institutions can demonstrate to the satisfaction of the Commissioner that their systems for measuring correlations are sound, implemented with integrity, and take into account the uncertainty surrounding any such correlation estimates, particularly in periods of stress. The credit institution shall validate its correlation assumptions using appropriate quantitative and qualitative techniques.

12. The risk measurement system shall be internally consistent and shall avoid the multiple counting of qualitative assessments or risk mitigation techniques recognised in other areas of the capital adequacy framework.

1.2.2. Internal data.

13. Internally generated operational risk measures shall be based on a minimum historical observation period of five years. When a credit institution first moves to an Advanced Measurement Approach, a three-year historical observation period shall be acceptable.

14. Credit institutions shall be able to map their historical internal loss data into the business lines defined in Part 2 and into the event types defined in Part 5, and to provide these data to competent authorities upon request. There shall be documented, objective criteria for allocating losses to the specified business lines and event types. The operational risk losses which are related to credit risk and have historically been included in the internal credit risk databases shall be recorded in the operational risk databases and be separately identified. Such losses shall not be subject to the operational risk charge, as long as they continue to be treated as credit risk for the purposes of calculating minimum capital requirements. Operational risk losses which are related to market risks shall be included in the scope of the capital requirement for operational risk.

Loss events which affect the entire institution may be allocated to an additional business line “corporate items” due to exceptional circumstances.

15. The credit institution’s internal loss data shall be comprehensive in that it captures all material activities and exposures from all appropriate sub-systems and geographic locations. Credit institutions shall be able to justify that any excluded activities or exposures, both individually and in combination, would not have a material impact on the overall risk estimates. Appropriate minimum loss thresholds for internal loss data collection shall be defined.

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16. Aside from information on gross loss amounts, credit institutions shall collect information about the date of the event, any recoveries of gross loss amounts, as well as some descriptive information about the drivers or causes of the loss event.

17. There shall be specific criteria for assigning loss data arising from an event in a centralised function or an activity that spans more than one business line, as well as from related events over time.

18. Credit institutions shall have documented procedures for assessing the on-going relevance of historical loss data, including those situations in which judgement overrides, scaling, or other adjustments may be used, to what extent they may be used and who is authorised to make such decisions.

1.2.3. External data.

19. The credit institution's operational risk measurement system shall use relevant external data, especially when there is reason to believe that it is exposed to infrequent, yet potentially severe, losses. A credit institution shall have a systematic process for determining the situations for which external data shall be used and the methodologies used to incorporate the data in its measurement system. The conditions and practices for external data use shall be regularly reviewed, documented and subject to periodic independent review.

1.2.4. Scenario analysis.

20. The credit institution shall use scenario analysis of expert opinion in conjunction with external data to evaluate its exposure to high severity events. Over time, such assessments need to be validated and reassessed through comparison to actual loss experience to ensure their reasonableness.
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1.2.5. Business environment and internal control factors.

21. The credit institution's firm-wide risk assessment methodology shall capture key business environment and internal control factors which can change its operational risk profile.

22. The choice of each factor shall be justified as a meaningful driver of risk, based on experience and involving the expert judgment of the affected business areas.

23. The sensitivity of risk estimates to changes in the factors and the relative weighting of the various factors shall be well reasoned. In addition to capturing changes in risk due to improvements in risk controls, the framework shall also capture potential increases in risk due to greater complexity of activities or increased business volume.

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24. This framework shall be documented and subject to independent review within the credit institution and by the Commissioner. Over time, the process and the outcomes shall be validated and re-assessed through comparison to actual internal loss experience and relevant external data.

2. IMPACT OF INSURANCE AND OTHER RISK TRANSFER MECHANISMS.

25. Credit institutions shall be able to recognise the impact of insurance subject to the conditions set out in paragraphs 26 to 29 and other risk transfer mechanisms where the credit institution can demonstrate to the satisfaction of the Commissioner that a noticeable risk mitigating effect is achieved.

26. The provider is authorised to provide insurance or re-insurance and the provider has a minimum claims paying ability rating by an approved ECAI which has been determined by the Commissioner to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to credit institutions under regulations 28 to 33.

27. The insurance and the credit institutions' insurance framework shall meet the following conditions–

(a) the insurance policy shall have an initial term of no less than one year. For policies with a residual term of less than one year, the credit institution shall make appropriate haircuts reflecting the declining residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less;

(b) the insurance policy shall have a minimum notice period for cancellation of the contract of 90 days;

(c) the insurance policy shall have no exclusions or limitations triggered by supervisory actions or, in the case of a failed credit institution, that preclude the credit institution receiver or liquidator, from recovering for damages suffered or expenses incurred by the credit institution, except in respect of events occurring after the initiation of receivership or liquidation proceedings in respect of the credit institution: provided that the insurance policy may exclude any fine, penalty, or punitive damages resulting from actions by the Commissioner;

(d) the risk mitigation calculations shall reflect the insurance coverage in a manner that is transparent in its relationship to,

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and consistent with, the actual likelihood and impact of loss used in the overall determination of operational risk capital;

(e) the insurance shall be provided by a third party entity. In the case of insurance through captives and affiliates, the exposure shall be laid off to an independent third party entity, for example through re-insurance, that meets the eligibility criteria; and

(f) the framework for recognising insurance shall be well reasoned and documented.

28. The methodology for recognising insurance shall capture the following elements through discounts or haircuts in the amount of insurance recognition–

(a) the residual term of an insurance policy, where less than one year, as noted above;

(b) a policy's cancellation terms, where less than one year; and

(c) the uncertainty of payment as well as mismatches in coverage of insurance policies.

29. The capital alleviation from the recognition of insurance and other risk transfer mechanisms shall not exceed 20% of the capital requirement for operational risk before the recognition of risk mitigation techniques.

3. APPLICATION TO USE AN ADVANCED MEASUREMENT APPROACH ON A GROUP-WIDE BASIS.

30. When an Advanced Measurement Approach is intended to be used by the European parent credit institution and its subsidiaries, or by the subsidiaries of a European parent financial holding company or a European parent mixed financial holding company, the application shall include a description of the methodology used for allocating operational risk capital between the different entities of the group.

31. The application shall indicate whether and how diversification effects are intended to be factored in the risk measurement system.

PART 4

Combined use of different methodologies

1. USE OF AN ADVANCED MEASUREMENT APPROACH IN COMBINATION WITH OTHER APPROACHES.

1. A credit institution may use an Advanced Measurement Approach in combination with either the Basic Indicator Approach or the Standardised Approach, subject to the following conditions–

(a) all operational risks of the credit institution shall be captured. The Commissioner shall be satisfied with the methodology used to cover different activities, geographical locations, legal structures or other relevant divisions determined on an internal basis; and

(b) the qualifying criteria set out in Parts 2 and 3 shall be fulfilled for the Part of activities covered by the Standardised Approach and Advanced Measurement Approaches respectively.

2. On a case-by case basis, the Commissioner may impose the following additional conditions–

(a) on the date of implementation of an Advanced Measurement Approach, a significant part of the credit institution's operational risks shall be captured by the Advanced Measurement Approach; and

(b) the credit institution shall take a commitment to roll out the Advanced Measurement Approach across a material part of its operations within a time schedule agreed with the Commissioner.

2. COMBINED USE OF THE BASIC INDICATOR APPROACH AND OF THE STANDARDISED APPROACH.

3. A credit institution may use a combination of the Basic Indicator Approach and the Standardised Approach only in exceptional circumstances such as the recent acquisition of new business which may require a transition period for the roll out of the Standardised Approach.

4. The combined use of the Basic Indicator Approach and the Standardised Approach shall be conditional upon a commitment by the credit institution to roll out the Standardised Approach within a time schedule agreed with the Commissioner.

PART 5

Loss event type classification

Table 3

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Event-Type Category	Definition
Internal fraud	Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involves at least one internal party
External fraud	Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party
Employment Practices and Workplace Safety	Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/ discrimination events
Clients, Products & Business Practices	Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product
Damage to Physical Assets	Losses arising from loss or damage to physical assets from natural disaster or other events
Business disruption and system failures	Losses arising from disruption of business or system failures
Execution, Delivery & Process Management	Losses from failed transaction processing or process management, from relations with trade counter parties and vendors

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007

SCHEDULE 11

Regulation 80(1)

TECHNICAL CRITERIA ON REVIEW AND EVALUATION BY THE COMMISSIONER

1. In addition to credit, market and operational risks, the review and evaluation performed by the Commissioner pursuant to regulation 80 shall include the following–

(a) the results of the stress test carried out by the credit institutions applying an IRB approach;

(b) the exposure to and management of concentration risk by the credit institutions, including their compliance with regulations 58, 59 63 to 70 and 75;

(c) the robustness, suitability and manner of application of the policies and procedures implemented by credit institutions for the management of the residual risk associated with the use of recognised credit risk mitigation techniques;

(d) the extent to which the own funds held by a credit institution in respect of assets which it has securitised are adequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved;

(e) the exposure to and management of liquidity risk by the credit institutions, including the development of alternative scenario analyses, the management of risk mitigants (in particular the level, composition and quality of liquidity buffers) and effective contingency plans;

(f) the impact of diversification effects and how such effects are factored into the risk measurement system; and

(g) the results of stress tests carried out by credit institutions or investment firms using an internal model to calculate market risk capital requirements under Schedule 5 of the FSCAIF Regulations.

1A. For the purposes of paragraph 1(e), the Commissioner shall regularly carry out a comprehensive assessment of the overall liquidity risk management by credit institutions and promote the development of sound internal methodologies and shall have regard to the role played by credit institutions in the financial markets.

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1B. The Commissioner shall duly consider the potential impact of his decisions on the stability of the financial system in Gibraltar and all EEA States concerned.

2. The Commissioner shall monitor whether a credit institution has provided implicit support to a securitisation. If a credit institution is found to have provided implicit support on more than one occasion the Commissioner shall take appropriate measures reflective of the increased expectation that it shall provide future support to its securitisation thus failing to achieve a significant transfer of risk.

3. For the purposes of the determination to be made under regulation 80(1) and (2), the Commissioner shall consider whether the value adjustments and provisions taken for positions or portfolios in the trading book, as set out in Part B of Schedule 7 of the FSCAIF Regulations, enable the credit institution to sell or hedge out its positions within a short period without incurring material losses under normal market conditions.

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF CREDIT INSTITUTIONS) REGULATIONS 2007
SCHEDULE 12

Regulations 20, 87, 88 and 90

TECHNICAL CRITERIA ON TRANSPARENCY AND DISCLOSURE

PART 1

General criteria

1. Information shall be regarded as material in disclosures if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

2. Information shall be regarded as proprietary to a credit institution if sharing that information with the public would undermine its competitive position. It may include information on products or systems which, if shared with competitors, would render a credit institution's investments therein less valuable.

3. Information shall be regarded as confidential if there are obligations to customers or other counter party relationships binding a credit institution to confidentiality.

4. The Commissioner shall require credit institution to assess the need to publish some or all disclosures more frequently than annually in the light of the relevant characteristics of their business such as scale of operations, range of activities, presence in different countries, involvement in different financial sectors, and participation in international financial markets and payment, settlement and clearing systems. That assessment shall pay particular attention to the possible need for more frequent disclosure of items of information laid down in paragraphs 3(b) and 3(e) and 4(b) to 4(e) of Part 2 and information on risk exposure and other items prone to rapid change.

5. The disclosure requirement in paragraphs 3 and 4 of Part 2 shall be provided pursuant to regulations 20(1) to (4).

PART 2

General requirements

1. The risk management objectives and policies of the credit institution shall be disclosed for each separate category of risk, including the risks referred to under paragraphs 1 to 14.

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These disclosures shall include–

(a) the strategies and processes to manage those risks;

(b) the structure and organisation of the relevant risk management function or other appropriate arrangements;

(c) the scope and nature of risk reporting and measurement systems; and

(d) the policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants.

2. The following information shall be disclosed regarding the scope of application of the requirements of these Regulations–

(a) the name of the credit institution to which the requirements of these Regulations apply;

(b) an outline of the differences in the basis of consolidation for accounting and prudential purposes, with a brief description of the entities that are–

(i) fully consolidated;

(ii) proportionally consolidated;

(iii) deducted from own funds; or

(iv) neither consolidated nor deducted;

(a) any current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities among the parent undertaking and its subsidiaries;

(b) the aggregate amount by which the actual own funds are less than the required minimum in all subsidiaries not included in the consolidation, and the name or names of such subsidiaries; and

(c) if applicable, the circumstance of making use of the provisions laid down in regulations 17 and 18.

3. The following information shall be disclosed by the credit institution regarding its own funds–

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"(a) summary information on the terms and conditions of the main features of all own-funds items and components thereof, including instruments referred to in regulation 7(1)(ca), instruments the provisions of which provide an incentive for the credit institution to redeem them, and instruments subject to paragraph 6(1) and (2) of Schedule 1;

(b) the amount of the original own funds, with separate disclosure of all positive items and deductions; the overall amount of instruments referred to in regulation 7(1)(ca) and instruments the provisions of which provide an incentive for the credit institution to redeem them, shall also be disclosed separately; those disclosures shall each specify instruments subject to paragraph 6(1) and (2) of Schedule 1;

(c) the total amount of additional own funds, and own funds as defined in Part IV of the FSCAIF Regulations,

(d) deductions from original and additional own funds pursuant to regulation 15(2) to (4), with separate disclosure of items referred to in regulation 7(q); and

(e) total eligible own funds, net of deductions and limits laid down in regulation 15.

4. The following information shall be disclosed regarding the compliance by the credit institution with the requirements laid down in regulations 23 and 79–

(a) a summary of the credit institution's approach to assessing the adequacy of its internal capital to support current and future activities;

(b) for credit institutions calculating the risk-weighted exposure amounts in accordance with regulations 28 to 33, 8 per cent of the risk-weighted exposure amounts for each of the exposure classes specified in regulation 29;

(c) for credit institutions calculating risk-weighted exposure amounts in accordance with regulations 34 to 39, 8 per cent of the risk-weighted exposure amounts for each of the exposure classes specified in regulation 36. For the retail exposure class, this requirement applies to each of the categories of exposures to which the different correlations in paragraphs 10 to 13 of Part 1 of Schedule 7 correspond. For the equity exposure class, this requirement shall apply to–

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(i) each of the approaches provided in paragraphs 17 to 26 of Part 1 of Schedule 7;

(ii) exchange traded exposures, private equity exposures in sufficiently diversified portfolios, and other exposures;

(iii) exposures subject to supervisory transition regarding capital requirements; and

(iv) exposures subject to grandfathering provisions regarding capital requirements;

(d) minimum capital requirements calculated in accordance with regulation 23(b) and (c); and

(e) minimum capital requirements calculated in accordance with regulations 53 to 55, and disclosed separately.

5. The following information shall be disclosed regarding a credit institution's exposure to counterparty credit risk as defined in Part 1 of Schedule 3–

(a) a discussion of the methodology used to assign internal capital and credit limits for counter party credit exposures;

(b) a discussion of policies for securing collateral and establishing credit reserves;

(c) a discussion of policies with respect to wrong-way risk exposures;

(d) a discussion of the impact of the amount of collateral the credit institution would have to provide given a downgrade in its credit rating;

(e) gross positive fair value of contracts, netting benefits, netted current credit exposure, collateral held and net derivatives credit exposure. Net derivatives credit exposure is the credit exposure on derivatives transactions after considering both the benefits from legally enforceable netting agreements and collateral arrangements;

(f) measures for exposure value under the methods set out in Parts 3 to 6 of Schedule 3, whichever method is applicable;

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(g) the notional value of credit derivative hedges, and the distribution of current credit exposure by types of credit exposure;

(h) credit derivative transactions (notional), segregated between use for the credit institution's own credit portfolio, as well as in its intermediation activities, including the distribution of the credit derivatives products used, broken down further by protection bought and sold within each product group; and

(i) the estimate of α if the credit institution has received the approval of the Commissioner to estimate α.

6. The following information shall be disclosed regarding a credit institution's exposure to credit risk and dilution risk–

(a) the definitions for accounting purposes of "past due" and "impaired";

(b) a description of the approaches and methods adopted for determining value adjustments and provisions;

(c) the total amount of exposures after accounting offsets and without taking into account the effects of credit risk mitigation, and the average amount of the exposures over the period broken down by different types of exposure classes;

(d) the geographic distribution of the exposures, broken down in significant areas by material exposure classes, and further detailed if appropriate;

(e) the distribution of the exposures by industry or counter party type, broken down by exposure classes, and further detailed if appropriate;

(f) the residual maturity breakdown of all the exposures, broken down by exposure classes, and further detailed if appropriate;

(g) by significant industry or counter party type, the amount of–

(i) impaired exposures and past due exposures, provided separately;

(ii) value adjustments and provisions; and

(iii) charges for value adjustments and provisions during the period;

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(h) the amount of the impaired exposures and past due exposures, provided separately, broken down by significant geographical areas including, if practical, the amounts of value adjustments and provisions related to each geographical area;

(i) the reconciliation of changes in the value adjustments and provisions for impaired exposures, shown separately. The information shall comprise–

(i) a description of the type of value adjustments and provisions;

(ii) the opening balances;

(iii) the amounts taken against the provisions during the period;

(iv) the amounts set aside or reversed for estimated probable losses on exposures during the period, any other adjustments including those determined by exchange rate differences, business combinations, acquisitions and disposals of subsidiaries, and transfers between provisions; and

(v) the closing balances.

Value adjustments and recoveries recorded directly to the income statement shall be disclosed separately.

7. For credit institutions calculating the risk-weighted exposure amounts in accordance with regulations 28 to 33, the following information shall be disclosed for each of the exposure classes specified in regulation 29–

(a) the names of the nominated ECAIs and ECAs and the reasons for any changes;

(b) the exposure classes for which each ECAI or ECA is used;

(c) a description of the process used to transfer the issuer and issue credit assessments onto items not included in the trading book;

(d) the association of the external rating of each nominated ECAI or ECA with the credit quality steps prescribed in Schedule 6, taking into account that this information needs not be disclosed if the credit institution complies with the standard association published by the Commissioner; and

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(e) the exposure values and the exposure values after credit risk mitigation associated with each credit quality step prescribed in Schedule 6, as well as those deducted from own funds.

8. A credit institution calculating the risk-weighted exposure amounts in accordance with paragraph 6 of Part 1 of Schedule 7 or paragraphs 19 to 21 of that Part shall disclose the exposures assigned to each category in Table 1 in paragraph 6 of that Part, or to each risk weight mentioned in paragraphs 19 to 21 of that Part.

9. The credit institutions calculating their capital requirements in accordance with regulation 23(b) and (c) of these Regulations shall disclose those requirements separately for each risk referred to in those provisions. In addition, the capital requirement for specific interest rate risk of securitisation positions shall be disclosed separately.

10. The following information shall be disclosed by each credit institution which calculates its capital requirements in accordance with Schedule 5 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007:

(a) for each sub-portfolio covered:

(i) the characteristics of the models used;

(ii) for the capital charges in accordance with points 5a and 5l of Schedule 5 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 separately, the methodologies used and the risks measured through the use of an internal model including a description of the approach used by the credit institution to determine liquidity horizons, the methodologies used to achieve a capital assessment that is consistent with the required soundness standard and the approaches used in the validation of the model;

(iii) a description of stress testing applied to the sub-portfolio;

(iv) a description of the approaches used for back-testing and validating the accuracy and consistency of the internal models and modelling processes;

(b) the scope of acceptance by the competent authority;

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(c) a description of the extent and methodologies for compliance with the requirements set out in Part B of Schedule 7 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007;

(d) the highest, the lowest and the mean of the following:

(i) the daily value-at-risk measures over the reporting period and as per the period end;

(ii) the stressed value-at-risk measures over the reporting period and as per the period end;

(iii) the capital charges in accordance with points 5a and 5l of Schedule 5 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 separately over the reporting period and as per the period-end;

(e) the amount of capital in accordance with points 5a and 5l of Schedule 5 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 separately, together with the weighted average liquidity horizon for each sub-portfolio covered;

(f) a comparison of the daily end-of-day value-at-risk measures to the one-day changes of the portfolio's value by the end of the subsequent business day together with an analysis of any important overshooting during the reporting period.

11. The following information shall be disclosed by a credit institution on operational risk–

(a) the approaches for the assessment of own funds requirements for operational risk that the credit institution qualifies for; and

(b) a description of the methodology set out in regulation 55, if used by the credit institution, including a discussion of relevant internal and external factors considered in the credit institution's measurement approach. In the case of partial use, the scope and coverage of the different methodologies used.

12. The following information shall be disclosed regarding the exposures in equities not included in the trading book–

(a) the differentiation between exposures based on their objectives, including for capital gains relationship and strategic reasons,

and an overview of the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation and any significant changes in these practices;

(b) the balance sheet value, the fair value and, for those exchange-traded, a comparison to the market price where it is materially different from the fair value;

(c) the types, nature and amounts of exchange-traded exposures, private equity exposures in sufficiently diversified portfolios, and other exposures;

(d) the cumulative realised gains or losses arising from sales and liquidations in the period; and

(e) the total unrealised gains or losses, the total latent revaluation gains or losses, and any of these amounts included in the original or additional own funds.

13. The following information shall be disclosed by a credit institution on its exposure to interest rate risk on positions not included in the trading book–

(a) the nature of the interest rate risk and the key assumptions (including assumptions regarding loan prepayments and behaviour of non-maturity deposits), and frequency of measurement of the interest rate risk; and

(b) the variation in earnings, economic value or other relevant measure used by the management for upward and downward rate shocks according to management's method for measuring the interest rate risk, broken down by currency.

14. Credit institutions calculating risk weighted exposure amounts in accordance with regulations 44 and 45 of these Regulations or capital requirements in accordance with point 16a of Schedule 1 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 shall disclose the following information, where relevant, separately for their trading and non-trading book:

(a) a description of the credit institution's objectives in relation to securitisation activity;

(b) the nature of other risks including liquidity risk inherent in securitised assets;

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(c) the type of risks in terms of seniority of underlying securitisation positions and in terms of assets underlying those latter securitisation positions assumed and retained with re-securitisation activity;

(d) the different roles played by the credit institution in the securitisation process;

(e) an indication of the extent of the credit institution's involvement in each of the roles referred to in point (d);

(f) a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures including, how the behaviour of the underlying assets impacts securitisation exposures and a description of how those processes differ for re-securitisation exposures;

(g) a description of the credit institution's policy governing the use of hedging and unfunded protection to mitigate the risks of retained securitisation and re-securitisation exposures, including identification of material hedge counterparties by relevant type of risk exposure;

(h) the approaches to calculating risk weighted exposure amounts that the credit institution follows for its securitisation activities including the types of securitisation exposures to which each approach applies;

(i) the types of SSPE that the credit institution, as sponsor, uses to securitise third-party exposures including whether and in what form and to what extent the credit institution has exposures to those SSPEs, separately for on- and off-balance sheet exposures, as well as a list of the entities that the credit institution manages or advises and that invest in either the securitisation positions that the credit institution has securitised or in SSPEs that the credit institution sponsors;

(j) a summary of the credit institution's accounting policies for securitisation activities, including:

(i) whether the transactions are treated as sales or financings;

(ii) the recognition of gains on sales;

(iii) the methods, key assumptions, inputs and changes from the previous period for valuing securitisation positions;

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(iv) the treatment of synthetic securitisations if not covered by other accounting policies;

(v) how assets awaiting securitisation are valued and whether they are recorded in the credit institution's non-trading book or the trading book;

(vi) policies for recognising liabilities on the balance sheet for arrangements that could require the credit institution to provide financial support for securitised assets;

(k) the names of the ECAIs used for securitisations and the types of exposure for which each agency is used;

(l) where applicable, a description of the Internal Assessment Approach as set out in Part 4 of Schedule 9 of these Regulations, including the structure of the internal assessment process and relation between internal assessment and external ratings, the use of internal assessment other than for IAA capital purposes, the control mechanisms for the internal assessment process including discussion of independence, accountability, and internal assessment process review, the exposure types to which the internal assessment process is applied and the stress factors used for determining credit enhancement levels, by exposure type;

(m) an explanation of significant changes to any of the quantitative disclosures in points (n) to (q) since the last reporting period;

(n) separately for the trading and the non-trading book, the following information broken down by exposure type:

(i) the total amount of outstanding exposures securitised by the credit institution, separately for traditional and synthetic securitisations and securitisations for which the credit institution acts only as sponsor;

(ii) the aggregate amount of on-balance sheet securitisation positions retained or purchased and off-balance sheet securitisation exposures;

(iii) the aggregate amount of assets awaiting securitisation;

(iv) for securitised facilities subject to the early amortisation treatment, the aggregate drawn exposures attributed to the originator's and investors' interests respectively, the

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aggregate capital requirements incurred by the credit institution against the originator's interest and the aggregate capital requirements incurred by the credit institution against the investor's shares of drawn balances and undrawn lines;

(v) the amount of securitisation positions that are deducted from own funds or risk-weighted at 1250 %;

(vi) a summary of the securitisation activity of the current period, including the amount of exposures securitised and recognised gain or loss on sale;

(o) separately for the trading and the non-trading book, the following information:

(i) the aggregate amount of securitisation positions retained or purchased and the associated capital requirements, broken down between securitisation and re-securitisation exposures and further broken down into a meaningful number of risk-weight or capital requirement bands, for each capital requirements approach used;

(ii) the aggregate amount of re-securitisation exposures retained or purchased broken down according to the exposure before and after hedging/insurance and the exposure to financial guarantors, broken down according to guarantor credit worthiness categories or guarantor name;

(p) for the non-trading book and regarding exposures securitised by the credit institution, the amount of impaired/past due assets securitised and the losses recognised by the credit institution during the current period, both broken down by exposure type;

(q) for the trading book, the total outstanding exposures securitised by the credit institution and subject to a capital requirement for market risk, broken down into traditional/synthetic and by exposure type.

15. The following information, including regular, at least annual, updates, shall be disclosed to the public regarding the remuneration policy and practices of the credit institution for those categories of staff whose professional activities have a material impact on its risk profile–

(a) information concerning the decision-making process used for determining the remuneration policy, including if applicable,

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information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

(b) information on link between pay and performance;

(c) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;

(d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

(e) the main parameters and rationale for any variable component scheme and any other non-cash benefits;

(f) aggregate quantitative information on remuneration, broken down by business area.

(g) aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the credit institution, indicating the following−

(i) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;

(ii) the amounts and forms of variable remuneration, split into cash, shares, share- linked instruments and other types;

(iii) the amounts of outstanding deferred remuneration, split into vested and unvested portions;

(iv) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;

(v) new sign-on and severance payments made during the financial year, and the number of beneficiaries of such payments; and

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(vi) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

For a credit institutions within the meaning of section 23(1) of the Financial Services (Banking) Act which is significant in terms of its size, internal organisation and the nature, scope and the complexity of its activities, the quantitative information referred to in this paragraph shall also be made available to the public at the level of persons who effectively direct the business of the credit institution.

A credit institutions shall comply with the requirements set out in this point in a manner which is appropriate to its size, internal organisation and the nature, scope and complexity of its activities and without prejudice to the Data Protection Act 2004.

16. A credit institution shall disclose to the Commissioner information on the number of its individuals in pay packets of at least EUR 1 million including the business area involved and the main elements of salary, bonus, long-term award and pension contribution and he shall send this information to the European Banking Authority.

PART 3

Qualifying requirements for the use of particular instruments or methodologies.

1. A credit institution calculating the risk-weighted exposure amounts in accordance with regulations 34 to 39 shall disclose the following information–

(a) the Commissioner's acceptance of approach or approved transition;

(b) an explanation and review of–

(i) the structure of internal rating systems and relation between internal and external ratings;

(ii) the use of internal estimates other than for calculating risk-weighted exposure amounts in accordance with regulations 34 to 39;

(iii) the process for managing and recognising credit risk mitigation; and

(iv) the control mechanisms for rating systems including a description of independence, accountability, and rating systems review;

(c) a description of the internal ratings process, provided separately for the following exposure classes–

(i) central governments and central banks;

(ii) credit institutions and investment firms;

(iii) corporate, including SMEs, specialised lending and purchased corporate receivables;

(iv) retail, for each of the categories of exposures to which the different correlations in paragraphs 10 to 13 of Part 1 of Schedule 7 correspond; and

(v) equities;

(d) the exposure values for each of the exposure classes specified in regulation 36. Exposures to central governments and central banks, credit institutions, investment firms and corporates where credit institutions use own estimates of LGDs or conversion factors for the calculation of risk-weighted exposure amounts shall be disclosed separately from exposures for which the credit institutions do not use such estimates;

(e) for each of the exposure classes central governments and central banks, credit institutions, investment firms, corporate and equity, and across a sufficient number of obligor grades (including default) to allow for a meaningful differentiation of credit risk, credit institutions shall disclose–

(i) the total exposures (for the exposure classes central governments and central banks, credit institutions, investment firms and corporate, the sum of outstanding loans and exposure values for undrawn commitments; for equities, the outstanding amount);

(ii) for a credit institution using own LGD estimates for the calculation of risk-weighted exposure amounts, the exposure-weighted average LGD in percentage;

(iii) the exposure-weighted average risk weight; and

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(iv) for a credit institution using own estimates of conversion factors for the calculation of risk-weighted exposure amounts, the amount of undrawn commitments and exposure-weighted average exposure values for each exposure class;

(f) for the retail exposure class and for each of the categories as defined under paragraph (c)(iv), either the disclosures outlined under (e) above (if applicable, on a pooled basis), or an analysis of exposures (outstanding loans and exposure values for undrawn commitments) against a sufficient number of EL grades to allow for a meaningful differentiation of credit risk (if applicable, on a pooled basis);

(g) the actual value adjustments in the preceding period for each exposure class (for retail, for each of the categories as defined under paragraph (c)(iv) and how they differ from past experience;

(h) a description of the factors which impacted on the loss experience in the preceding period (for example, has the credit institution experienced higher than average default rates, or higher than average LGDs and conversion factors); and

(i) a credit institution's estimates against actual outcomes over a longer period. At a minimum, this shall include information on estimates of losses against actual losses in each exposure class (for retail, for each of the categories as defined under paragraph (c)(iv) over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes for each exposure class (for retail for each of the categories as defined under paragraph (c)(iv). Where appropriate, the credit institution shall further decompose this to provide analysis of PD and, for the credit institution using own estimates of LGDs and/or conversion factors, LGD and conversion factor outcomes against estimates provided in the quantitative risk assessment disclosures above.

For the purposes of paragraph (c), the description shall include the types of exposure included in the exposure class, the definitions, methods and data for estimation and validation of PD and, if applicable, LGD and conversion factors, including assumptions employed in the derivation of these variables, and the descriptions of material deviations from the definition of default as set out in paragraphs 44 to 48 of Part 4 of Schedule 7 including the broad segments affected by such deviations.

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2. The credit institutions applying credit risk mitigation techniques shall disclose the following information–

(a) the policies and processes for, and an indication of the extent to which the entity makes use of, on- and off-balance sheet netting;

(b) the policies and processes for collateral valuation and management;

(c) a description of the main types of collateral taken by the credit institution;

(d) the main types of guarantor and credit derivative counterparty and their creditworthiness;

(e) information about market or credit risk concentrations within the credit mitigation taken;

(f) for a credit institution calculating risk-weighted exposure amounts in accordance with regulations 28 to 33 or 34 to 39, but not providing own estimates of LGDs or conversion factors in respect of the exposure class, separately for each exposure class, the total exposure value (after, where applicable, on- or off-balance sheet netting) that is covered - after the application of volatility adjustments - by eligible financial collateral, and other eligible collateral; and

(g) for a credit institution calculating risk-weighted exposure amounts in accordance with regulations 28 to 33 or 34 to 39, separately for each exposure class, the total exposure (after, where applicable, on- or off-balance sheet netting) that is covered by guarantees or credit derivatives. For the equity exposure class, this requirement applies to each of the approaches provided in paragraphs 17 to 26 of Part 1 of Schedule 7.

3. A credit institutions using the approach set out in regulation 55 for the calculation of its own funds requirements for operational risk shall disclose a description of the use of insurance and other risk transfer mechanisms for the purpose of mitigating the risk.

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