SECOND SUPPLEMENT TO THE GIBRALTAR GAZETTE

No. 3965 of 22 November, 2012

LEGAL NOTICE NO. 181 OF 2012.

FINANCIAL SERVICES (INVESTMENT AND FIDUCIARY SERVICES) ACT

FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) (AMENDMENT) (NO.2) REGULATIONS 2012

In exercise of the powers conferred on him by section 53 of the Financial Services (Investment and Fiduciary Services) Act and all other enabling powers, the Minister with responsibility for financial services has made the following Regulations to transpose into the law of Gibraltar Article 2 and Annex II of Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies−

Title and commencement.

1. These Regulations may be cited as the Financial Services (Capital Adequacy of Investment Firms) (Amendment) (No.2) Regulations 2012 and come into operation on the day of publication.

Amendments to regulation 2 of the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007.

2. Regulation 2(1) of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 (the principal Regulations) is amended by inserting the following definitions after the definition of "recognised non-European investment firm"−

""securitisation position" and "re-securitisation position" mean, respectively, securitisation position and re-securitisation position as defined in the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007;".

Amendment to regulation 13.

3. Regulation 13 of the principal Regulations is amended by substituting the following paragraph for the first paragraph of subregulation (1)−

"(1) An institution which, for the purposes of Schedule 2, calculates risk-weighted exposure amounts in accordance with the provisions of regulations 34 to 39 of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007, the following shall apply for the purposes of the calculation provided for in point 36 of Part I of Schedule 7 of those Regulations−".

Amendment to regulation 14.

4. Regulation 14 of the principal Regulations is amended by inserting "and points 1 to 4 of Schedule 2 for their non-trading book business" in paragraph (a) of subregulation (1) after "for their trading-book business".

Amendment to Schedule 1.

5. Schedule 1of the principal Regulations is amended−

(a) by substituting the following subparagraph for the first subparagraph of introductory part in point 8−

"8. When calculating the capital requirement for market risk of the party who assumes the credit risk (the "protection seller"), unless specified differently, the notional amount of the credit derivative contract shall be used. Notwithstanding the first sentence, the institution may elect to replace the notional value by the notional value, minus any market value changes of the credit derivative since trade inception. For the purpose of calculating the specific risk charge, other than for total return swaps, the maturity of the credit derivative contract, rather than the maturity of the obligation, shall apply. Positions are determined as follows:";

(b) by substituting the following subparagraph for the third subparagraph in clause (v) of point 8−

"Where an n-th-to-default credit derivative is externally rated, the protection seller shall calculate the specific

risk capital charge using the rating of the derivative and apply the respective securitisation risk weights as applicable.";

(c) by substituting the following subparagraph for the first subparagraph in point 14-

"14. The institution shall assign its net positions in the trading book in instruments that are not securitisation positions as calculated in accordance with point 1 to the appropriate categories in Table 1 on the basis of their issuer/obligor, external or internal credit assessment, and residual maturity, and then multiply them by the weightings shown in that table. It shall sum its weighted positions resulting from the application of this point (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk. It shall calculate its capital requirement against specific risk for positions that are securitisation positions in accordance with point 16a.

For the purposes of this point and points 14a and 16a, the institution may cap the product of the weight and the net position at the maximum possible default-risk related loss. For a short position, that limit may be calculated as a change in value due to the underlying names immediately becoming default risk-free.";

(d) by inserting the following points after point 14–

"14a. By way of derogation from point 14, an institution may determine the larger of the following amounts as the specific risk capital charge for the correlation trading portfolio:

(a) the total specific risk capital charges that would apply just to the net long positions of the correlation trading portfolio;

(b) the total specific risk capital charges that would apply just to the net short positions of the correlation trading portfolio.

14b. The correlation trading portfolio shall consist of securitisation positions and n-th-to-default credit derivatives that meet the following criteria:

(a) the positions are neither re-securitisation positions, nor options on a securitisation tranche, nor any other derivatives of securitisation exposures that do not provide a pro-rata share in the proceeds of a securitisation tranche; and

(b) all reference instruments are either single-name instruments, including single-name credit derivatives for which a liquid two-way market exists, or commonly-traded indices based on those reference entities. A two-way market is deemed to exist where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within 1 day and settled at such price within a relatively short time conforming to trade custom.

14c. Positions which reference either of the following shall not be part of the correlation trading portfolio:

(a) an underlying that is capable of being assigned to the exposure classes referred to in regulation 29 (1)(h) and (i) of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 in an institution's non-trading book; or

(b) a claim on a special purpose entity.

An institution may include in the correlation trading portfolio positions which are neither securitisation positions nor n-th-to-default credit derivatives but which hedge other positions of that portfolio, provided that a liquid two-way market as described in point 14b(b) exists for the instrument or its underlyings.";

(e) by inserting the following point after point 16-

"16a. For instruments in the trading book that are securitisation positions, the institution shall weight with the following its net positions as calculated in accordance with point 1:

(a) for securitisation positions that would be subject to the Standardised Approach for credit risk in the same institution's non-trading book, 8 % of the risk weight under the Standardised Approach as set out in Part 4 of Schedule 9 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007;

(b) for securitisation positions that would be subject to the Internal Ratings Based Approach in the same institution's non-trading book, 8 % of the risk weight under the Internal Ratings Based Approach as set out in Part 4 of Schedule 9 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007.

For the purpose of points (a) and (b), the Supervisory Formula Method may be used only with supervisory approval by institutions other than an originator institution that may apply it for the same securitisation position in its non-trading book. Where relevant, estimates of PD and LGD as inputs to the Supervisory Formula Method shall be determined in accordance with regulations 34 to 39 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 or alternatively and subject to separate supervisory approval, based on estimates that are derived from an approach set out in point 5a of Schedule 5 of these Regulations and that are in line with the quantitative standards for the Internal Ratings Based Approach. The Committee of European Banking Supervisors shall establish guidelines in order to ensure a convergent use of estimates of PD and LGD as inputs when those estimates are based on the approach set out in point 5a of Schedule 5 of these Regulations.

Notwithstanding points (a) and (b), for securitisation positions that would be subject to a risk weight in accordance with regulation 78A of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 if they were in the same institutions' non-trading book, 8 % of the risk weight in accordance with that regulation shall be applied.

The institution shall sum its weighted positions resulting from the application of this point (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk.

By way of derogation from the fourth paragraph, for a transitional period ending 31 December 2013, the institution shall sum separately its weighted net long positions and its weighted net short positions. The larger of those sums shall constitute the specific risk capital requirement. The institution shall, however, report to the home Member State competent authority the total sum of its weighted net long and net short positions, broken down by types of underlying assets.";

(f) by substituting the following point for point 34−

"34. The institution shall sum all its net long positions and all its net short positions in accordance with point 1. It shall multiply its overall gross position by 8 % in order to calculate its capital requirement against specific risk."; and

(g) by deleting point 35;

Amendment to Schedule 2.

6. Schedule 2 of the principal Regulations is amended by substituting the following subparagraph for the second subparagraph of point 7−

"However, in the case of a credit default swap, an institution the exposure of which arising from the swap represents a long position in the underlying shall be permitted to use a figure of 0 % for potential future credit exposure, unless the credit default swap is subject to closeout upon insolvency of the entity the exposure of which arising from the swap represents a short position in the underlying, even though the underlying has not defaulted, in which case the figure for potential future credit exposure of the institution shall be limited to the amount of premia which are not yet paid by the entity to the institution.".

Amendment to Schedule 5.

7. Schedule 5 of the principal Regulations is amended–

(a) by substituting the following point for point 1−

“1. The competent authority shall, subject to the conditions laid down in this Schedule, allow institutions to calculate their capital requirements for position risk, foreign-exchange risk and/or commodities risk using their own internal risk-management models instead of or in combination with the methods described in Schedules 1, 3 and 4. Explicit recognition by the competent authority of the use of models for supervisory capital purposes shall be required in each case.”;

(b) by substituting the following subparagraph for the second subparagraph in point 4-

“1. The competent authority shall, subject to the conditions laid down in this Schedule, allow institutions to calculate their capital requirements for position risk, foreign-exchange risk and/or commodities risk using their own internal risk-management models instead of or in combination with the methods described in Schedules 1, 3 and 4. Explicit recognition by the competent authority of the use of models for supervisory capital purposes shall be required in each case.”;

(c) by substituting the following point for point 5-

“5. For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions, the competent authority shall recognise the use of an institution’s internal model if, in addition to compliance with the conditions in the remainder of this Schedule, the internal model meets the following conditions:

(a) it explains the historical price variation in the portfolio;

(b) it captures concentration in terms of magnitude and changes of composition of the portfolio;

(c) it is robust to an adverse environment;

(d) it is validated through back-testing aimed at assessing whether specific risk is being accurately captured. If the competent authority allow such back-testing to be performed on the basis of relevant sub-portfolios, these must be chosen in a consistent manner;

(e) it captures name-related basis risk, namely institutions shall demonstrate that the internal model is sensitive to material idiosyncratic differences between similar but not identical positions;

(f) it captures event risk.

The institution's internal model shall conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios. In addition, the internal model shall meet minimum data standards. Proxies shall be appropriately conservative and may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio.

An institution may choose to exclude from the calculation of its specific risk capital requirement using an internal model those positions in securitisations or n-th-to-default credit derivatives for which it meets a capital requirement for position risks in accordance with Schedule 1with the exception of those positions that are subject to the approach set out in point 5l.

As techniques and best practices evolve, institutions shall avail themselves of those new techniques and practices.

An institution shall not be required to capture default and migration risks for traded debt instruments in its internal model where it is capturing those risks through the requirements set out in points 5a to 5k.";

(d) by inserting the following points after point 5–

"5a. Institutions subject to point 5 for traded debt instruments shall have an approach in place to capture, in the calculation of their capital requirements, the default and migration risks of its trading book positions that are incremental to the risks

captured by the value-at-risk measure as specified in point 5. An institution shall demonstrate that its approach meets soundness standards comparable to the approach set out in regulations 34 to 39 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality.

Scope

5b. The approach to capture the incremental default and migration risks shall cover all positions subject to a capital charge for specific interest rate risk but shall not cover securitisation positions and n-th-to-default credit derivatives. Subject to supervisory approval, the institution may choose to consistently include all listed equity positions and derivatives positions based on listed equities for which such inclusion is consistent with how the institution internally measures and manages risk. The approach shall reflect the impact of correlations between default and migration events. The impact of diversification between, on the one hand, default and migration events and, on the other hand, other market risk factors shall not be reflected.

Parameters

5c. The approach to capture the incremental risks shall measure losses due to default and internal or external ratings migration at the 99,9 % confidence interval over a capital horizon of 1 year.

Correlation assumptions shall be supported by analysis of objective data in a conceptually sound framework. The approach to capture the incremental risks shall appropriately reflect issuer concentrations. Concentrations that can arise within and across product classes under stressed conditions shall also be reflected. The approach shall be based on the assumption of a constant level of risk over the one-year capital horizon, implying that given individual trading book positions or sets of positions that have experienced default or migration over their liquidity horizon are re-balanced at the end of their liquidity horizon to attain the initial level of risk. Alternatively, an

institution may choose to consistently use a one-year constant position assumption.

5d. The liquidity horizons shall be set according to the time required to sell the position or to hedge all material relevant price risks in a stressed market, having particular regard to the size of the position. Liquidity horizons shall reflect actual practice and experience during periods of both systematic and idiosyncratic stresses. The liquidity horizon shall be measured under conservative assumptions and shall be sufficiently long that the act of selling or hedging, in itself, would not materially affect the price at which the selling or hedging would be executed.

The determination of the appropriate liquidity horizon for a position or set of positions is subject to a floor of 3 months.

The determination of the appropriate liquidity horizon for a position or set of positions shall take into account an institution's internal policies relating to valuation adjustments and the management of stale positions. When an institution determines liquidity horizons for sets of positions rather than for individual positions, the criteria for defining sets of positions shall be defined in a way that meaningfully reflects differences in liquidity. The liquidity horizons shall be greater for positions that are concentrated, reflecting the longer period needed to liquidate such positions. The liquidity horizon for a securitisation warehouse shall reflect the time to build, sell and securitise the assets, or to hedge the material risk factors, under stressed market conditions.

5e. Hedges may be incorporated into an institution's approach to capture the incremental default and migration risks. Positions may be netted when long and short positions refer to the same financial instrument. Hedging or diversification effects associated with long and short positions involving different instruments or different securities of the same obligor, as well as long and short positions in different issuers, may only be recognised by explicitly modelling gross long and short positions in the different instruments. Institutions shall reflect the impact of material risks that could occur during the interval between the hedge's maturity and the liquidity horizon as well as the potential for significant basis risks in hedging strategies

by product, seniority in the capital structure, internal or external rating, maturity, vintage and other differences in the instruments. An institution shall reflect a hedge only to the extent that it can be maintained even as the obligor approaches a credit or other event.

For trading book positions that are hedged via dynamic hedging strategies, a rebalancing of the hedge within the liquidity horizon of the hedged position may be recognised provided that the institution:

(i) chooses to model rebalancing of the hedge consistently over the relevant set of trading book positions,

(ii) demonstrates that the inclusion of rebalancing results in a better risk measurement, and

(iii) demonstrates that the markets for the instruments serving as hedges are liquid enough to allow for such rebalancing even during periods of stress. Any residual risks resulting from dynamic hedging strategies must be reflected in the capital charge.

5f. The approach to capture the incremental default and migration risks shall reflect the nonlinear impact of options, structured credit derivatives and other positions with material nonlinear behaviour with respect to price changes. The institution shall also have due regard to the amount of model risk inherent in the valuation and estimation of price risks associated with such products.

5g. The approach to capture the incremental default and migration risks shall be based on data that are objective and up-to-date.

Validation

5h. As part of the independent review of their risk measurement system and the validation of their internal models as required in this Schedule, institutions shall, with a view to the approach to capture incremental default and migration risks, in particular:

(i) validate that its modelling approach for correlations and price changes is appropriate for its portfolio, including the choice and weights of its systematic risk factors;

(ii) perform a variety of stress tests, including sensitivity analysis and scenario analysis, to assess the qualitative and quantitative reasonableness of the approach, particularly with regard to the treatment of concentrations. Such tests shall not be limited to the range of events experienced historically;

(iii) apply appropriate quantitative validation including relevant internal modelling benchmarks.

The approach to capture the incremental risks shall be consistent with the institution's internal risk management methodologies for identifying, measuring, and managing trading risks.

Documentation

5i. An institution shall document its approach to capturing incremental default and migration risks so that its correlation and other modelling assumptions are transparent to the competent authority.

Internal approaches based on different parameters

5j. If the institution uses an approach to capturing incremental default and migration risks that does not comply with all requirements of this point but that is consistent with the institution's internal methodologies for identifying, measuring and managing risks, it shall be able to demonstrate that its approach results in a capital requirement that is at least as high as if it was based on an approach in full compliance with the requirements of this point. The competent authority shall review compliance with the previous sentence at least annually.

Frequency of calculation

5k. An institution shall perform the calculations required under its chosen approach to capture the incremental risk at least weekly.

5l. The competent authority shall recognise the use of an internal approach for calculating an additional capital charge instead of a capital charge for the correlation trading portfolio in accordance with point 14a of Schedule 1 of these Regulations provided that all conditions in this point are fulfilled.

Such an internal approach shall adequately capture all price risks at the 99,9 % confidence interval over a capital horizon of 1 year under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality. The institution may incorporate any positions in the approach referred to in this point that are jointly managed with positions of the correlation trading portfolio and may then exclude those positions from the approach required under point 5a.

The amount of the capital charge for all price risks shall not be less than 8 % of the capital charge that would be calculated in accordance with point 14a of Schedule 1 of these Regulations for all positions incorporated in the charge for all price risks.

In particular, the following risks shall be adequately captured:

(a) the cumulative risk arising from multiple defaults, including the ordering of defaults, in tranched products;

(b) credit spread risk, including the gamma and cross-gamma effects;

(c) volatility of implied correlations, including the cross effect between spreads and correlations;

(d) basis risk, including both:

(i) the basis between the spread of an index and those of its constituent single names, and

(ii) the basis between the implied correlation of an index and that of bespoke portfolios;

(e) recovery rate volatility, as it relates to the propensity for recovery rates to affect tranche prices; and

(f) to the extent the comprehensive risk measure incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing such hedges.

For the purpose of this point, an institution shall have sufficient market data to ensure that it fully captures the salient risks of those exposures in its internal approach in accordance with the standards set out in this point, demonstrates through back testing or other appropriate means that its risk measures can appropriately explain the historical price variation of those products, and is able to separate the positions for which it holds approval in order to incorporate them in the capital charge in accordance with this point from those positions for which it does not hold such approval.

With regard to portfolios subject to this point, the institution shall regularly apply a set of specific, predetermined stress scenarios. Such stress scenarios shall examine the effects of stress to default rates, recovery rates, credit spreads, and correlations on the profit and loss of the correlation trading desk. The institution shall apply such stress scenarios at least weekly and report at least quarterly to the competent authority the results, including comparisons with the institution's capital charge in accordance with this point. Any instances where the stress tests indicate a material shortfall of this capital charge shall be reported to the competent authority in a timely manner. Based on those stress testing results, the competent authority shall consider a supplemental capital charge against the correlation trading portfolio as set out in regulation 83 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007.

An institution shall calculate the capital charge to capture all price risks at least on a weekly basis.;

(e) by substituting the following point for point 6–

“6. Institutions using internal models which are not recognised in accordance with point 5 shall be subject to a separate capital charge for specific risk as calculated in accordance with Schedule 1.”;

(f) by substituting the following point for point 7–

“7. For the purposes of points 10b(a) and (b), the results of the institution’s own calculation shall be scaled up by the multiplication factors (mc) and (ms). Those factors shall be at least 3.”;

(g) by substituting the following subparagraph for the first subparagraph in point 8–

“For the purposes of points 10b(a) and (b), the multiplication factors (mc) and (ms) shall be increased by a plus-factor of between 0 and 1 in accordance with Table 1, depending on the number of overshootings for the most recent 250 business days as evidenced by the institution’s back-testing of the value-at-risk measure as set out in point 10. The competent authority shall require the institutions to calculate overshootings consistently on the basis of back-testing on hypothetical and actual changes in the portfolio’s value. An overshooting is a one-day change in the portfolio’s value that exceeds the related one-day value-at-risk measure generated by the institution’s model. For the purpose of determining the plus-factor the number of overshootings shall be assessed at least quarterly and shall be equal to the higher of the number of overshootings under hypothetical and actual changes in the value of the portfolio.”;

(h) by deleting point 9;

(i) by substituting the following clause for clause (c) in point 10-

“(c) a 10-day equivalent holding period (institutions may use value-at-risk numbers calculated according to shorter holding periods scaled up to 10 days by, for example, the square root of time. An institution using that approach shall periodically justify the reasonableness of its approach to the satisfaction of the competent authority);”;

(j) by substituting the following clause for clause (e) in point 10–

“(e) monthly data set updates.”;

(k) by inserting the following points after point 10–

“10a. In addition, each institution shall calculate a “stressed value-at-risk” based on the 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of the current portfolio, with value-at-risk model inputs calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the institution’s portfolio. The choice of such historical data shall be subject to approval by the competent authority and to annual review by the institution.

10b. Each institution shall meet, on a daily basis, a capital requirement expressed as the sum of points (a) and (b) and an institution that uses its internal model to calculate the capital requirement for specific position risk shall meet a capital requirement expressed as the sum of points (c) and (d), as follows:

(a) the higher of:

(i) its previous day’s value-at-risk number calculated in accordance with point 10 (VaRt-1); and

(ii) an average of the daily value-at-risk measures in accordance with point 10 on each of the preceding sixty business days (VaRavg), multiplied by the multiplication factor (mc);

(b) the higher of:

(i) its latest available stressed-value-at-risk number in accordance with point 10a (sVaRt-1); and

(ii) an average of the stressed value-at-risk numbers calculated in the manner and frequency specified in point 10a during the preceding sixty business

days (sVaRavg), multiplied by the multiplication factor (ms);

(c) a capital charge calculated in accordance with Schedule 1 for the position risks of securitisation positions and nth to default credit derivatives in the trading book with the exception of those incorporated in the capital charge in accordance with point 5l;

(d) the higher of the institution's most recent and the institution's 12 weeks average measure of incremental default and migration risk in accordance with point 5a and, where applicable, the higher of the institution's most recent and its 12-week-average measure of all price risks in accordance with point 5l.

10c. Institutions shall also carry out reverse stress tests."; and

(l) by substituting the following subparagraph for the first subparagraph in point 12−

"12. The risk-measurement model shall capture a sufficient number of risk factors, depending on the level of activity of the institution in the respective markets. Where a risk factor is incorporated into the institution's pricing model but not into the risk-measurement model, the institution shall be able to justify such an omission to the satisfaction of the competent authority. In addition, the risk-measurement model shall capture nonlinearities for options and other products as well as correlation risk and basis risk. Where proxies for risk factors are used they shall show a good track record for the actual position held. In addition, the following shall apply for individual risk types:".

Amendments to Schedule 7.

8. Part B of schedule 7 of the principal Regulations is amended−

(a) by substituting the following clause for clause (a) in point 2−

"(a) documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the institution's assumptions of what market participants would use in pricing the position, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures;";

(b) by substituting the following point for point 3–

"3. Institutions shall mark their positions to market whenever possible. Marking to market is the at least daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers.";

(c) by substituting the following point for point 5–

"5. Where marking to market is not possible, institutions shall conservatively mark to model their positions/portfolios before applying trading book capital treatment. Marking to model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input.";

(d) by substituting the following clause for clause (a) in point 6–

"(a) senior management shall be aware of the elements of the trading book or of other fair-valued positions which are subject to mark to model and shall understand the materiality of the uncertainty thereby created in the reporting of the risk/performance of the business;";

(e) by substituting the following points for points 8 and 9–

"Valuation adjustments

8. Institutions shall establish and maintain procedures for considering valuation adjustments.

General standards

9. The competent authority shall require the following valuation adjustments to be formally considered: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where relevant, model risk.";

(f) by substituting the following points for points 11 to 15-

"11. Institutions shall establish and maintain procedures for calculating an adjustment to the current valuation of less liquid positions. Such adjustments shall where necessary be in addition to any changes to the value of the position required for financial reporting purposes and shall be designed to reflect the illiquidity of the position. Under those procedures, institutions shall consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. Those factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes including trading volumes during periods of market stress, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

12. When using third party valuations or marking to model, institutions shall consider whether to apply a valuation adjustment. In addition, institutions shall consider the need for establishing adjustments for less liquid positions and on an ongoing basis review their continued suitability.

13. With regard to complex products including, but not limited to, securitisation exposures and n-th-to-default credit derivatives, institutions shall explicitly assess the need for valuation adjustments to reflect the model risk associated with using a possibly incorrect valuation methodology and the model risk

associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model.”.

Dated 22nd November, 2012.

G H LICUDI QC,
Minister for financial Services.

EXPLANATORY MEMORANDUM

These Regulations transpose into the law of Gibraltar Article 2 and Annex 2 of Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.