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DIRECTIVE DI144-2007-05 OF 2012
OF THE CYPRUS SECURITIES AND EXCHANGE COMMISSION
FOR THE CAPITAL REQUIREMENTS OF INVESTMENT FIRMS

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DIRECTIVE OF THE COMMISSION
FOR THE CAPITAL REQUIREMENTS OF INVESTMENT FIRMS

The Commission exercising its powers pursuant to section 73 of the Investment Services, Activities and Regulated Markets Law and for the purpose of harmonization with the actions of the European Community titled:

OJ No L 145, 30.4.2004, p.1.

(a) «Directive 2004/39/EC of the European Parliament and the Council of 21st of April on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC»

OJ No L 114, 27.4.2006, p.60.

(b) «Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines»·

OJ No L 177, 30.6.2006, p.1.

(c) «Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)»·

OJ No L 177, 30.6.2006, p.201.

(d) «Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast)»·

OJ No L 302, 17.11.2009, p.97.

(e) «Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC and 2006/49/EC»·

OJ No L 329, 14.12.2010, p.3

(f) «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»· and

(g) «Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC,

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OJ No L 331, 15.12.2010, p.120

2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC»·

issues the following Directive to the Cypriot Investment Firms and the branches of Investment Firms of third countries that have received an authorisation from the Commission:

Part A

Definitions and scope of application

Chapter 1

Definitions

Definitions

1. In this Directive, except where it follows otherwise from the context:

"recognised exchanges" means exchanges which are recognised as such by the Commission and which meet the following conditions:

(a) They function regularly;

(b) They have rules, issued or approved by the appropriate authorities of the home country of the exchange, defining the conditions for the operation of the exchange, the conditions of access to the exchange as well as the conditions that shall be satisfied by a contract before it can effectively be dealt on the exchange; and

(c) They have a clearing mechanism whereby contracts listed in Part C, Annex IV are subject to daily margin requirements which, in the opinion of the competent authorities, provide appropriate protection.

"recognised third-country investment firms" means firms meeting the following conditions:

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(a) Firms which, if they were established within a member state, would be covered by the definition of investment firm;

(b) Firms which are authorised in a third country; and

(c) Firms which are subject to and comply with prudential rules considered by the Commission as at least as stringent as those laid down by this Directive;

"sponsor" means an investment firm other than an originator investment firm that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities;

"Directive 83/349/EEC" means the act of the European Community entitled “Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts”, as amended from time to time;

"expected loss (EL)", for the purposes of paragraph 12, Chapter 3, of this Part and paragraphs 1 to 25 of Part C, shall mean the ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one year period to the amount outstanding at default;

"European Supervisory Authority (European Banking Authority)" or "EBA" means the European Supervisory Authority (European Banking Authority), established by Regulation 1093/2010;

"consolidating supervisor" means the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent investment firms and investment firms controlled by EU parent financial holding companies;

"securities or commodities lending" and "securities or commodities borrowing" mean any transaction in which an institution or its counterparty transfers securities or commodities against appropriate collateral, subject to a commitment that the borrower will return equivalent securities or commodities at some future date or when requested to do so by the transferor, that transaction being securities or commodities lending for the institution transferring the securities or commodities and being securities or commodities borrowing for the institution to which they are transferred;

"public sector entities" means non-commercial administrative bodies responsible to central governments, regional governments or local authorities, or authorities that in the view of the competent authorities exercise the same responsibilities as regional and local authorities, or non-commercial undertakings owned by central governments that have explicit guarantee arrangements, and may include self administered bodies governed by law that are under public supervision;

"over-the-counter (OTC) derivative instruments" means the items falling within the list in Part C, Annex IV other than those items to which an exposure value of zero is attributed under point 6 of Part 2 of Annex III of that Part;

"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;

"Commission" means the Cyprus Securities and Exchange Commission that is established and operating pursuant to the Cyprus Securities and Exchange Commission (Constitution and Terms of Reference) Act 2001-2007

"ancillary services undertaking" means an undertaking the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more investment firms;

"EU" means the European Union

"loss", for the purposes of paragraph 12, Chapter 3, of this Part and paragraphs 1 to 25 of Part C, means economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument;

"loss given default (LGD)" means the ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default;

"Regulation 1093/2010" means the act of the European Union entitled "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", as amended from time to time;

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

"securitisation position" means an exposure to a securitisation;

"subsidiary" means

(a) A subsidiary company within the meaning of sections 2 and 148 of Company Law, as well as having meaning attributed to the term “subsidiary undertaking” by articles 1 and 2 of Directive 83/349/EEC, and includes every subsidiary of a subsidiary undertaking of an ultimate parent undertaking

(b) For the purposes of paragraphs 5 to 7 of Chapter 2 of this Part and paragraphs 32 to 33 of Chapter 6 of Part C, a subsidiary means a subsidiary within the meaning of point (a) and any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence;

"institutions" means credit institutions and investment firms;

"central banks" include the European Central Bank unless otherwise indicated;

"capital" means own funds.

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

"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;

"mixed-activity holding company" means a parent undertaking, other than a financial holding company or an investment firm or a mixed financial holding company within the meaning of the Commission Directive 1/2005, Financial Conglomerates Directive, Chapter 1, paragraph 2 (8), the subsidiaries of which include at least one investment firm;

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

"clearing member" means a member of the exchange or the clearing house which has a direct contractual relationship with the central counterparty (market guarantor);

"cash assimilated instrument" means a certificate of deposit or other similar instrument issued by the lending investment firm;

"originator" means either of the following:

(a) An entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or

(b) An entity which purchases a third party's exposures onto its balance sheet and then securitises them;

"convertible" means a security which, at the option of the holder, may be exchanged for another security;

"unfunded credit protection" means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an 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;

"parent investment firm in the Republic " means an investment firm which has an institution or a financial institution as a subsidiary or which holds a participation in one or both of such entities, and which is not itself a subsidiary of another institution authorised in the Republic , or of a financial holding company set up in the Republic ;

"EU parent investment firm" means a parent investment firm in a Member State which is not a subsidiary of another institution authorised in any Member State, or of a financial holding company set up in any Member State;
"parent undertaking" means:

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(a) the parent company within the meaning of sections 2 and 148 of Company Law, as well as having the meaning attributed to the term “parent undertaking” by Articles 1 and 2 of Directive 83/349/EEC.

(b) For the purposes of this Directive and of paragraphs 5 to 7 of Chapter 2 of this Part, the Large Exposures Directive, and paragraphs 32 and 33 of Chapter 6 of Part C, a parent undertaking means a parent undertaking within the meaning of (a) above and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;

"parent financial holding company in the Republic" means a financial holding company which is not itself a subsidiary of an investment firm authorised in the Republic, or of a financial holding company set up in the Republic;

"EU parent financial holding company" means a parent financial holding company in a Member State which is not a subsidiary of an investment firm authorised in any Member State or of another financial holding company set up in any Member State;

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"Law" means the Investment Services, Activities and Regulated Markets Law of 2007 as applicable from time to time;

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"Directive for Large Exposures" means the Directive DI144-2007-06 of the Commission for Large Exposures of CIFs, and its amending directives DI144-2007-06(A) and DI144-2007-06(B);

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"group of connected persons" means the persons defined in the Directive of the Commission for Large Exposures;

"securitisation special purpose entity (SSPE)" means a corporation trust or other entity, other than an investment firm, organised for carrying on a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator investment firm, and the holders of the beneficial interests in which have the right to pledge or exchange those interests without restriction;

"traditional securitisation" means a securitisation involving the economic transfer of the exposures being securitised to a securitisation special purpose entity which issues securities. This shall be accomplished by the transfer of

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ownership of the securitised exposures from the originator investment firm or through sub-participation. The securities issued do not represent payment obligations of the originator investment firm;

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

"warrant" means a security which gives the holder the right to purchase an underlying asset at a stipulated price until or at the expiry date of the warrant and which may be settled by the delivery of the underlying itself or by cash settlement;

"credit enhancement" means a contractual arrangement whereby the credit quality of a position in a securitisation is improved in relation to what it would have been if the enhancement had not been provided, including the enhancement provided by more junior tranches in the securitisation and other types of credit protection;

"repurchase transaction" means any transaction governed by an agreement falling within the definition of "repurchase agreement" or "reverse repurchase agreement" as defined in this paragraph;

“discretionary pension benefits” means enhanced pension benefits granted on a discretionary basis by an investment firm 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;

"main index" for the purposes of this Directive means, means the general index and FTSE 20 as announced by the Cyprus Stock Exchange.

In respect of financial instruments listed in recognised exchanges of other member states of EU, the Commission adopts the definition of main index as this has been determined by the appropriate authorities of these states.

In respect of financial instruments listed in recognised exchanges of third countries, the Commission may adopt the definition of main index as this has been determined by the appropriate authorities of these states.

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"participation" for the purposes of points (n) and (o) of paragraph 2 (1) of Part B, paragraphs 5 to 7 of Chapter 2 of this Part and paragraphs 32 to 33 of Chapter 6 of Part C means:

(a) rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the investment firm's activities.

(b) the ownership, direct or indirect, of 20% or more of the voting rights or capital of an undertaking;

"repurchase agreement" and "reverse repurchase agreement" mean any agreement in which an institution or its counterparty transfers securities or commodities or guaranteed rights relating to title — to securities or commodities where that guarantee is issued by a recognised exchange which holds the rights to the securities or commodities and the agreement does not allow an institution to transfer or pledge a particular security or commodity to more than one counterparty at one time, subject to a commitment to repurchase them — or substituted securities or commodities of the same description — at a specified price on a future date specified, or to be specified, by the transferor, being a repurchase agreement for the institution selling the securities or commodities and a reverse repurchase agreement for the institution buying them;

"synthetic securitisation" means a securitisation where the tranching is achieved by the use of credit derivatives or guarantees, and the pool of exposures is not removed from the balance sheet of the originator investment firm;

"delta" means the expected change in an option price as a proportion of a small change in the price of the instrument underlying the option;

"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;

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

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(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;

"tranche" means a contractually established segment of the credit risk associated with an exposure or number of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments;

"local firm" means a firm dealing for its own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets, or dealing for the accounts of other members of those markets and being guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such a firm is assumed by clearing members of the same markets;

"stock financing" means positions where physical stock has been sold forward and the cost of funding has been locked in until the date of the forward sale;

"financial holding company" means a financial institution the subsidiary undertakings of which are either exclusively or mainly credit institutions or other financial institutions, at least one of which is an investment firm, and which is not a mixed financial holding company within the meaning of the Commission Directive 1/2005, Financial Conglomerates Directive, Chapter 1, paragraph 2 (8);

"financial institution" means an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in Annex XIII;

"funded credit protection" means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the right of the institution — in the event of the default of the counterparty or on the occurrence of other specified credit events relating to the counterparty — 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

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the amount of a claim on the institution;

"financial instrument" for the purposes of this Directive means any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party;

Financial instruments shall include 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, a rate, an index or the price of another underlying item, and include as a minimum the instruments specified in the Third Annex, Part II of the Law;

Without prejudice to the above, any terms used in the present Directive and are not otherwise defined, have the meaning as stated in the Law.

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Chapter 2

Scope of application

Individual basis

2. (1) Investment firms shall comply with the obligations laid down in articles 18(2)(e), 18(2)(f), 67 and 69 of the Law, paragraph 11 of Chapter 3 of this Part, and the Large Exposures Directive, on an individual basis.

(2) Every investment firm which is neither a subsidiary in Cyprus where it is authorised and supervised by the Commission, nor a parent undertaking, and every investment firm not included in the consolidation pursuant to paragraph 7 of this Part, shall comply with the obligations laid down in Section 68 of the Law and Part C, Chapter 6, paragraph 31 on an individual basis.

(3) Every investment firm which is neither a parent undertaking, nor a subsidiary, and every investment firm not included in the consolidation pursuant to paragraph 7 of this Part, shall comply with the obligations laid down in Part C, Chapter 7, paragraphs 34 to 38 on an individual basis.

Exemption of subsidiaries from obligation on an individual basis.

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3. (1) The Commission may choose not to apply paragraph 2 (1), on a case by case basis, to any subsidiary of an investment firm, where both the subsidiary and the investment firm are subject to authorisation and supervision by the Commission, and the subsidiary is included in the supervision on a consolidated basis of the investment firm which is the parent undertaking, and all of the following conditions are satisfied, in order to ensure that own funds are distributed adequately among the parent undertaking and the subsidiaries:

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

(b) Either the parent undertaking satisfies the Commission regarding the prudent management of the subsidiary and has declared, with the consent of the Commission, that it guarantees 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 cover the subsidiary; and

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

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(2) The Commission allows the application of subparagraph (1) in the cases where the parent undertaking is a financial holding company which, as the subsidiary firm, is incorporated in the Republic and is subject to the same supervision as the investment firms, especially with regards to the standards set out in paragraph 5(1) of Chapter 2 of this Part concerning supervision on a consolidated basis.

Partial consolidation.

4. (1) Subject to paragraphs 4(2) to 4 (4) below, the Commission may allow on a case by case basis parent investment firms to incorporate in the calculation of their requirement under paragraph 2 (1) of this Part subsidiaries which meet the conditions laid down in points (c) and (d) of paragraph 3 of this Part, and whose material exposures or material liabilities are to that parent investment firm.

(2) The treatment in paragraph 4(1) shall be allowed only where the parent investment firm demonstrates fully to the Commission the circumstances and arrangements, including legal arrangements, by virtue of which there is no material practical or legal impediment, and none are foreseen, to the prompt transfer of own funds, or repayment of liabilities when due by the subsidiary to its parent undertaking.

(3) The Commission shall on a regular basis and not less than once a year inform the competent authorities of all the other Member States of the use made of paragraph 4 (1) and of the circumstances and arrangements referred to in paragraph 4 (2). Where the subsidiary is in a third country, the Commission shall provide the same information to the competent authorities of that third country as well.

(4) The Commission shall publicly disclose the following:

(a) The criteria it 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 investment firms which benefit from the exercise of the discretion laid down in paragraph 4 (1) and the number of

these which incorporate subsidiaries in a third country; and

(c) On an aggregate basis for the Republic:

(i) The total amount of own funds of parent investment firms which benefit from the exercise of the discretion laid down in paragraph 4(1) which are held in subsidiaries in a third country;

(ii) The percentage of total own funds of parent investment firms which benefit from the exercise of the discretion laid down in paragraph 4 (1) represented by own funds which are held in subsidiaries in a third country; and

(iii) The percentage of total minimum own funds required under paragraph 11 of Chapter 3 of this Part of parent investment firms which benefit from paragraph 4 (1) represented by own funds which are held in subsidiaries in a third country.

Consolidated basis.

5. (1) Without prejudice to paragraphs 2 to 4 above, parent investment firms in the Republic shall comply with the obligations laid down in paragraph 8 of Part E, in articles 67, 68 and 69 of the Law, in paragraph 11 of Chapter 3 of this Part, in paragraph 31 of Part C, Chapter 6 and the Large Exposures Directive on the basis of their consolidated financial situation.

(2) Without prejudice to paragraphs 2 to 4, investment firms controlled by a parent financial holding company in the Republic shall comply with the obligations laid down in paragraph 8 of Part E, in articles 67, 68 and 69 of the Law, in paragraph 11 of Chapter 3 of this Part, in paragraph 31 of Part C, Chapter 6 and the Large Exposures Directive on the basis of the consolidated financial situation of that financial holding company.

Where more than one investment firm is controlled by a parent financial holding company in the Republic, the first subparagraph shall apply only to the investment firm to which supervision on a consolidated basis applies in accordance with paragraphs 2 to 3 of Part E.

Disclosure of information from investment firms.

6. (1) EU parent investment firms shall comply with the obligations laid down in Part C, Chapter 7, paragraphs 34 to 38 on the basis of their consolidated financial situation.

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Significant subsidiaries of EU parent investment firms shall make public the information specified in Annex XII, Part 1, point 5, on an individual or sub-consolidated basis. For the purposes of this paragraph "significant subsidiary company" shall mean the company of which the total assets represents 10% or more of the consolidated total assets of the group it belongs to, unless the Commission directs otherwise.

(2) Investment firms controlled by an EU parent financial holding company shall comply with the obligations laid down in Part C, Chapter 7, paragraphs 34 to 38 on the basis of the consolidated financial situation of that financial holding company.

Significant subsidiaries of EU parent financial holding companies shall make public the information specified in Annex XII, Part 1, point 5 of Part C, on an individual or sub-consolidated basis.

Exemptions from consolidation.

7. (1) The Commission, that has the consolidated supervisions by virtue of paragraphs 2 to 3 of Part E, shall decide in the following cases that an investment firm, financial institution or ancillary services undertaking which is a subsidiary or in which a participation is held need not be included in the consolidation:

(a) Where the undertaking concerned is situated in a third country where there are legal impediments to the transfer of the necessary information;

(b) Where, in the opinion of the Commission, the undertaking concerned is of negligible interest only with respect to the objectives of monitoring investment firms and in any event where the balance-sheet total of the undertaking concerned 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, in the opinion of the Commission responsible for exercising supervision on a consolidated basis, the consolidation of the financial situation of the undertaking concerned would be inappropriate or misleading as far as the objectives of the supervision of investment firms are concerned.

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If, in the cases referred to in point (b) of the first subparagraph, several undertakings meet the above criteria set out therein, they shall nevertheless be included in the consolidation where collectively they are of non-negligible interest with respect to the specified objectives.

(2) The Commission shall require subsidiary investment firms to apply the requirements laid down in paragraph 11 of Chapter 3 of this Part, articles 67 and 68 of the Law, paragraph 31 of Part C, Chapter 6 and the Large Exposures Directive on a sub-consolidated basis if those investment firms, or the parent undertaking where it is a financial holding company, have an investment firm or a financial institution or an asset management company as defined in the Commission Directive 1/2005, Financial Conglomerates Directive, Chapter 1, paragraph 7 as a subsidiary in a third country, or hold a participation in such an undertaking.

(3) The Commission shall require the parent undertakings and subsidiaries subject to this Directive to meet the obligations laid down in articles 18(2)(e) and (f) of the Law on a consolidated or sub-consolidated basis, to ensure that their arrangements, processes and mechanisms are consistent and well-integrated and that any data and information relevant to the purpose of supervision can be produced.

Calculation of consolidated requirements

8. (1) The Commission shall, for the purpose of calculating the capital requirements set out in Part D, Annexes I and V and the exposures to persons set out in Part D, Chapter 2 and Annex VI of Part D on a consolidated basis, permit positions in the trading book of one investment firm to offset positions in the trading book of another institution according to the rules set out in Part D, Chapter 2, Annexes I, V and VI of Part D.

In addition, the Commission shall allow foreign-exchange positions in one investment firm to offset foreign-exchange positions in another institution in accordance with the rules set out in Annex III and/or Annex V of Part D. It shall also allow commodities positions in one investment firm to offset commodities positions in another institution in accordance with the rules set out in Annex IV and/or Annex V of Part D.

(2) The Commission shall permit offsetting of the trading book and of the foreign-exchange and commodities positions, respectively, of undertakings located in third countries, subject to the simultaneous fulfilment of the

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following conditions:

(a) Such undertakings have been authorised in a third country and either satisfy the definition of credit instituion as stated in section 2 of the Law or are recognised third-country investment firms;

(b) Such undertakings comply, on an individual basis, with capital adequacy rules equivalent to those laid down in this Directive; and

(c) No regulations exist in the third countries in question which might significantly affect the transfer of funds within the group.

(3) The Commission shall also allow the offsetting provided for in paragraph 8 (1) between institutions within a group that have been authorised in the Member State in question, provided that:

(a) There is a satisfactory allocation of capital within the group; and

(b) The regulatory, legal or contractual framework in which the institutions operate is such as to guarantee mutual financial support within the group.

(4) Furthermore, the Commission shall allow the offsetting provided for in paragraph 8 (1) between investment firms within a group that fulfil the conditions imposed in paragraph 8 (3) and any investment firm included in the same group which has been authorised in Cyprus or in another Member State provided that that investment firm is obliged to fulfil the capital requirements imposed in Chapter 3, paragraph 13 of this Part and Part D, Chapter 2, paragraph 3 on an individual basis.

Calculation of own funds on a consolidated basis

9. (1) In the calculation of own funds on a consolidated basis paragraph 8 of Part B shall apply.

(2) The Commission responsible for exercising supervision on a consolidated basis of investment firms may recognise the validity of the specific own-funds definitions applicable to the institutions concerned under Part B of this Directive in the calculation of their consolidated own funds.

Chapter 3

Minimum capital requirement - ***Calculation and reporting requirements***

Valuation of assets and off balance sheet items

10. Save where otherwise provided, the valuation of assets and off-balance-sheet items shall be effected in accordance with the International Financial Reporting Standards.

For the communication of those calculations by investment firms, the Commission shall apply, from 31 December 2012, uniform formats, frequencies and dates of reporting, which will be common in all Member States.

Minimum level of own funds

11. Without prejudice to paragraph 33, Chapter 6 of Part C, the Commission shall require investment firms to provide own funds which are at all times more than or equal to the sum of the following capital requirements:

(a) For credit risk and dilution risk in respect of all of their business activities with the exception of their trading book business, 8% of the total of their risk-weighted exposure amounts calculated in accordance with paragraph 12 of this Part and paragraphs 1 to 25 of Part C;

(b) In respect of their trading-book business, for position risk and counter-party risk and, in so far as the limits laid down in the Large Exposures Directive, paragraphs 5 to 10 are exceeded, for large exposures exceeding such limits, the capital requirements determined in accordance with paragraph 13 of this Part and Chapter 2 of Part D, and Annexes I, II and VI of Part D and, as appropriate, Annex V of Part D;

(c) In respect of all of their business activities, for foreign-exchange risk, for settlement risk and for commodities risk, the capital requirements determined in accordance with the methods and options laid down in Annexes II, III and IV and, as appropriate, Annex V, of Part D and paragraph 13 of this Part; and

(d) In respect of all of their business activities, for operational risk, the capital requirements determined in accordance with Part C, Chapter 5.

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Methods for calculating credit risk

12. Investment firms shall apply either the Standardised Approach provided for in Part C, Chapter 1, paragraphs 2 to 7 or, if permitted by the Commission in accordance with Part C, Chapter 2, paragraph 8, the Internal Ratings Based Approach provided for in Part C, Chapter 2 to calculate their risk-weighted exposure amounts for the purposes of paragraph 11(a) of this Part.

Calculation of trading book capital requirement under specific circumstances

13. (1) By way of derogation from paragraphs 11 (b) and 11 (c) above, the Commission may allow investment firms to calculate the capital requirements for their trading book business in accordance with paragraph 11 (a) and points 6, 7, and 9 of Annex II of Part D, where the size of the trading book business meets the following requirements:

(a) The trading-book business of such investment firms does not normally exceed 5% of their total business;

(b) Their total trading-book positions do not normally exceed EUR 15 million; and

(c) The trading-book business of such investment firms never exceeds 6% of their total business and their total trading-book positions never exceed EUR 20 million.

(2) In order to calculate the proportion that trading-book business bears to total business for the purposes of points (a) and (c) of paragraph 13 (1), the Commission shall refer to the size of the combined on- and off-balance-sheet business, of the investment firms in question. When the size of on- and off-balance-sheet business is assessed, debt instruments shall be valued at their market prices or their principal values, equities at their market prices and derivatives according to the nominal or market values of the instruments underlying them. Long positions and short positions shall be summed regardless of their signs.

(3) If an investment firm should happen for more than a short period (i.e. more than 20 working days) to exceed either or both of the limits imposed in paragraph 13 (1) (a) and (b) or either or both of the limits imposed in paragraph 13 (1) (c), it shall be required to meet the requirements imposed in paragraph 11 (b) in respect of its trading-book business and to notify the Commission for this action within 10 days from date of excess.

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Calculation for the purposes of Annex I, Part D.

14. (1) For the purposes of point 14 of Annex I of Part D, the Commission shall allow, a 0% weighting to be assigned to debt securities issued by central goverments or central banks, where these debt securities are denominated and funded in domestic currency.

    (2) If, as set out in point 51 of Annex I, Part D a competent authority approves a third country's collective investment undertaking (CIU) as eligible, the Commission may make use of this approval without conducting its own assessment.

Exposures to recognised third-country investment firms, exposures to recognised clearing houses and exchanges.

15. For the purposes of the calculation of minimum capital requirements for counterparty risk under this Directive, and for the calculation of minimum capital requirements for credit risk under paragraph 12 of this Part and paragraph 1 of Chapter 1 of Part C, and without prejudice to the provisions of Part 2, point 6 of Annex III, of Part C, exposures to recognised third-country investment firms and exposures to recognised clearing houses and exchanges shall be treated as exposures to institutions.

Part B

Meaning and the calculation of own funds

Chapter 1

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Own Funds

Meaning of own funds

1. For the purpose of this Directive, the term or reference to the concept of own funds, shall bring this term or concept into line with the definition given in paragraphs 2 to 9 of this Part. Briefly, the own funds of investment firms constitute of original own funds (Tier 1) and additional own funds (Tier 2). Items (a) to (ca) less items (h) to (j) of paragraph 2 (1) below, constitute original own funds and items (d) to (g) of paragraph 2 (1) constitute additional own funds. The own funds of investment firms are subject to capital deductions and prudential filters that are referred to in paragraph 2 (1) below. Apart from the above items, investment firms may be permitted to include in their own funds items of special form of capital (alternative own funds- tier 3) for the provisions of the capital requirement that arises exclusively from the

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trading book, according to the provisions of paragraph 11 (1) of this Part.

Unconsolidated own funds.

2. (1) Subject to the limits imposed in paragraph 9 of this Chapter, the unconsolidated own funds of investment firms shall consist of the following items:

(a) Capital, 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) Reserves excluding revaluation reserves, the profits and losses brought forward as a result of the application of the final profit or loss, as well as interim profits provided these profits have been audited by certified auditors and it is proved to the satisfaction of the Commission that the amount thereof has been evaluated in accordance with the principles set out in the International Financial Reporting Standards and is net of any foreseeable charge or dividend.

(c) Funds for general investment firm risks which the investment firm decides to put aside to cover such risks, where that is required due to prudence, by the particular risks that are inherent to investment services or activities or other business conducted by an investment firm. It is clarified that this item does not include the collective impairment that is made in accordance to the provisions of International Accounting Standards 39, nor any general provisions for bad debts;

(ca) instruments other than those referred to in point (a), which meet the requirements set out in points (a), (c), (d) and (e) of paragraph 6 (2) of this Chapter and in paragraph 6 (4);

(d) Revaluation reserves of fixed assets;

(e) Value adjustments which arise from the mark-to-market of financial instruments in accordance with the International Financial Reporting Standards;

(f) Other items within the meaning of paragraph 6 of this Part, as follows:

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(i) Items, whatever their legal or accounting designations might be, which have the characteristics referred to in paragraph 6 (1) below.

(ii) Securities of indeterminate duration, provided the conditions of paragraph 6 (2) of this Chapter are fulfilled.

(iii) For the investment firms which calculate risk weighted exposure amounts under Part C, Chapter 2, the positive amounts (sum of value adjustments and provisions, less amounts of expected loss) which arise under Part C, Annex VII, Part 1, paragraph 36, up to 0,6% of the risk weighted exposure amounts.

(iv) For the investment firms which calculate their capital requirement under Part C, Chapter 1, paragraphs 2 to 7 for credit risk, the general provisions for bad debts in accordance with the International Financial Reporting Standards. These provisions must be specifically verified by the external auditors to the investment firms and the investment firm will have the responsibility to disclose such to the Commission. The amount of general provisions that can be included in the additional own funds, is restricted to 1,25% of the sum of the following:

- The sum of the risk weighted assets with respect to credit risk under Part C, Chapter 1, paragraphs 2 to 7.

- The sum of the capital requirements for market risk and operational risk multiplied by a coefficient of 12,5.

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(g) Fixed-term cumulative preferential shares and subordinated loan capital as referred to in paragraph 7 (1) of this Chapter.

The following items shall be deducted from original own funds in accordance with paragraph 9 of this Chapter:

(h) Own shares at book value held by an investment firm;

(i) Intangible assets including goodwill, formation and software expenses;

(j) Material losses of the current financial year;

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(k) Holdings in other investment firms and financial institutions amounting to more than 10% of their capital;

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(l) Subordinated claims and instruments referred to in paragraphs 6 and 7 (1) of this Chapter which an investment firm holds in respect of investment firms and financial institutions in which it has holdings exceeding 10% of the capital in each case;

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(m) Holdings in other investment firms and financial institutions of up to 10% of their capital, the subordinated claims and the instruments referred to in paragraphs 6 and 7 (1) of this Chapter which an investment firm holds in respect of investment firms and financial institutions other than those referred to in points (k) and (l) in respect of the amount of the total of such holdings, subordinated claims and instruments which exceed 10% of that investment firm's own funds calculated before the deduction of items in points (k) to (o);

35(I)/2002
141(I)/2003
165(I)/2003
69(I)/2004
70(I)/2004
136(I)/2004
152(I)/2004
153(I)/2004
240(I)/2004
17(I)/2005

(n) Participations within the meaning of paragraph 1 (4) of Chapter 1 of Part A, which an investment firm holds in:

(i) Insurance undertakings within the meaning of Section 2 of the Insurance Services and Other Related Issues Law

(ii) Reinsurance undertakings within the meaning of Section 2 of the Insurance Services and Other Related Issues Law, or

(iii) Insurance holding companies within the meaning of Section 2 of the Insurance Services and Other Related Issues Law;

(o) Each of the following items which the investment firm holds in respect of the entities defined in point (n) in which it holds a participation:

(i) Instruments referred to in paragraphs 7 and 8 of Annex V, Part A of the Insurance Services and Other Related Issues Law, and

(ii) Instruments referred to in paragraphs 6 and 7 of Annex V, Part A of the Insurance Services and Other Related Issues Law;

(p) For investment firms calculating risk-weighted exposure amounts under Part C, Chapter 2, negative amounts resulting from the calculation in Part C,

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Annex VII, Part 1, point 36 and expected loss amounts calculated in accordance with Part C, Annex VII, Part 1 points 32 and 33;

(q) The exposure amount of securitisation positions which receive a risk weight of 1250% under this Directive and the exposure amount of securitisation positions in the trading book that would receive a 1250% risk weight if they were in the same investment firm's non-trading book;

(r) Any lending of a capital nature in companies of the same group of the investment firm

"Lending of a capital nature" are considered exposures that present characteristics same as those of capital and/or the terms and conditions of their duration and repayment put the investment firm at a disadvantage in relation to other creditors of the borrowing company and/or are not provided with the same terms / conditions that the investment firm imposes on its clients for similar exposures according to standard business practice;

(s) Any excess of holdings in illiquid shares from the number of shares transacted in that company in a month in a regulated market;

(t) Free deliveries that fall within the category of the fourth column of Table 2 of Annex II of Part D;

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(u) Holdings of share and loan capital of firms which are not subject to supervision on a consolidated basis with the investment firm;

(v) The exposures on the non-trading book to the persons or group of connected persons, which exceeds the limit of paragraph 6(1) as specified in the Directive for the Large Exposures.

(2) In the case of an investment firm which is the originator of a securitisation, net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisation shall be excluded from the item specified in paragraph 2 (1), point (b) above.

Waivers from the provisions for deductions

3. (1) Where shares in another investment firm, credit institution, financial institution, insurance or reinsurance undertaking or insurance holding company are held temporarily for the purposes of a financial assistance operation designed

to reorganise and save that entity, the Commission shall waive the provisions on deduction referred to in points (k) to (o) and (r) of paragraph 2 (1) above, provided that prior approval is obtained in each individual case.

(2) The shares that are held temporarily according to paragraph 3 (1) above are not permitted to be held for a period that exceeds two years. The temporary period may, in exceptional circumstances, be extended following prior approval from the Commission.

Alternative method of deduction.

4. As an alternative to the deduction of the items referred to in points (n) and (o) of paragraph 2 (1) above, the Commission shall allow their investment firms to apply mutatis mutandis methods 1, 2 or 3 of Annex I of the Commission Directive 1/2005, Financial Conglomerates Directive. Method 1 (accounting consolidation) may be applied only if the competent authority is confident about the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The method chosen shall be applied in a consistent manner over time.

Required characteristics of elements (a) to (e) of paragraph 2(1)

5. The items listed in points (a) to (e) of paragraph 2 above shall be available to an investment firm for unrestricted and immediate use to cover risks or losses as soon as these occur. The amount shall be net of any foreseeable tax charge at the moment of its calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses.

Inclusion of other items in own funds and regulatory adjustments

6. (1) The concept of own funds used by the Commission may include other items according to paragraph 2(1)(f) provided that, whatever their legal or accounting designations might be, they have the following characteristics:

   (i) They are freely available to the investment firm to cover normal risks where revenue or capital losses have not yet been identified;

   (ii) Their existence is disclosed in internal accounting records; and

   (iii) Their amount is determined by the management of the investment firm, verified by independent auditors, made known to the Commission and placed under the supervision of the latter.

   (2) Securities of indeterminate duration and other instruments that fulfil the

following conditions may also be accepted as other items:

(a) They may not be reimbursed on the bearer's initiative or without the prior agreement of the Commission;

(b) The debt agreement shall provide for the investment firm to have the option of deferring the payment of interest on the debt;

(c) The lender's claims on the investment firm 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 investment firm in a position to continue trading; and

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

To these securities and other instruments may be added cumulative preferential shares other than those referred to in point (g) of paragraph 2 (1) above.

Instruments referred to in paragraph 2 subparagraph 1 (ca), of Chapter 1, Part B, shall comply with the requirements set out in points (a), (c), (d) and (e) above;

(3) For investment firms calculating risk-weighted exposure amounts under Part C, Chapter 2, positive amounts resulting from the calculation in Part C, Annex VII, Part 1, point 36, may, up to 0,6% of risk weighted exposure amounts calculated under Part C, Chapter 2 be accepted as other items. For these investment firms value adjustments and provisions included in the calculation referred to in Part C, Annex VII, Part 1, point 36 and value adjustments and provisions for exposures referred to in point (e) of paragraph 2 (1) shall not be included in own funds other than in accordance with this paragraph. For these purposes, risk-weighted exposure amounts shall not include those calculated in respect of securitisation positions which have a risk weight of 1250%.

(4) Instruments referred to in paragraph 2, subparagraph 1 (ca), shall comply with the requirements set out in points (a) to (d) below:

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

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years. 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 dateof issue. If the provisions governing undated instruments provide for a moderate incentive for the investment firm to redeem as determined by the Commission, such incentive shall not occur within 10 years of the date of issue. The provisions governing dated instruments shall not permit an incentive to redeem on a date other than the maturitydate.

Dated and undated instruments may be called or redeemed only with the prior consent of the Commission. The Commission may grant permission provided the request is made at the initiative of the investment firm and either financial or solvency conditions of the investment firm are not unduly affected. The Commission may require institutions to replace the instrument by items of the same or better quality referred to in point (a) or (ca) of paragraph 2 (1) of this Chapter.

The Commission shall require the suspension of the redemption for dated instruments if the investment firm does not comply with paragraph 11 of Chapter 3, Part A and may require such suspension at other times based on the financial and solvency situation of investment firms.

The Commission may at any time grant permission for early redemption of dated or undated instruments in the event that there is a change in the applicable tax treatment or regulatory classification of such instruments which was unforeseen at the date of issue.

(b) The provisions governing the instrument shall allow the investment firm to cancel, when necessary, the paymentof interest or dividends for an unlimited period of time, on an on-cumulative basis.

However, the investment firm shall cancel such payments if it does not comply with the capital requirements set out in paragraph 11 of Cahpter 3, Part A.

The Commission may require the cancellation of such payments based on the financial and solvency situation of the investment firm. Any such cancellation shall not prejudice the right of the investment firm to substitute the payment of interest or dividend by a payment in the form of an instrument referred to in paragraph 2, subparagraph 1 (a), of Chapter 1, Part B, provided that any such mechanism allows the investment firm to preserve financial resources. Such

substitution may be subject to specific conditions established by the Commission.

(c) The provisions governing the instrument shall provide for principal, unpaid interest or dividend to be such as to absorb losses and to not hinder the recapitalisation of the investment firm through appropriate mechanisms.

(d) In the event of the bankruptcy or liquidation of the investment firm, the instruments shall rank after the items referred to in paragraph 6(2) of this Chapter.

Requirements of fixed-term cumulative preference shares and subordinated loan capital-Prudential filters

7. (1) The Commission shall include fixed-term cumulative preferential shares referred to in point (g) of paragraph 2 (1) above and subordinated loan capital referred to in that provision in own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the investment firm, 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 shall fulfil the following additional criteria:

(a) Only fully paid-up funds may be taken into account;

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

(c) The extent to which they 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 clause providing that in specified circumstances, other than the winding-up of the investment firm, the debt shall become repayable before the agreed repayment date.

For the purposes of point (b) of the second subparagraph, if the maturity of the debt is not fixed, the loans involved shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the Commission is specifically required for early repayment. The Commission may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the

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investment firm in question is not affected.

(3) Investment firms shall not include in own funds either the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost, or any gains or losses on their liabilities valued at fair value that are due to changes in the investment firms own credit standing.

(4) Investment Firms shall apply the requirements of Part B of Annex VII of Part D to all their assets measured at fair value when calculating the amount of own funds and shall deduct from the total of the items (a) to (ca) minus (h) to (j) of paragraph 2(1) of Chapter 1, Part B, the amount of any additional value adjustments necessary.

(5) For the portfolio of investments available for sale, unrealized losses after taxes are deducted from the original own funds (Tier 1), whereas, the unrealized profits after taxes are included in the additional own funds (Tier 2). The same treatment applies for other financial assets which have been classified into the available for sale category, except for the items referred to in paragraph 7(6) below. It is clarified that, if any unrealized profits from the aforementioned assets have already been posted to the profit and loss account then these must be deducted for the purposes of calculation of original own funds (Tier 1).

(6) For loans and receivables which are classified as available for sale, the unrealized profits or losses apart from those that relate to impairment, are ignored during the calculation of own funds. If any of these unrealized profits or losses have been posted to the profit and loss account, then these must be deducted accordingly (if profits) or cancelled out (if losses) during the calculation of original own funds.

(7) For investment properties and own use properties, the unrealized losses after taxes are deducted from the original own funds (Tier 1), whereas, the unrealized profits after taxes are included in the additional own funds (Tier 2). It is clarified that if any unrealized profits from the aforementioned assets have already been posted to the profit and loss account then these must be deducted for the purposes of calculation of original own funds.

Consolidated own funds.

8. (1) Where the calculation is to be made on a consolidated basis, the consolidated amounts relating to the items listed under paragraph 2 above shall be used in accordance with the rules laid down in Part C, Chapter 6, paragraphs 32 and 33.

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Moreover, the following shall, when they are credit ("negative") items, be regarded as consolidated reserves for the calculation of own funds:

(a) Any minority interests where the global integration method is used. Any instruments referred to in paragraph 2 subparagraph 1 (ca), which give rise to minority interests shall meet the requirements under points (a), (c), (d) and (e) of paragraph 6 (2) and paragraphs 6 (4) and 9 of this Part;

(b) The first consolidation difference (negative goodwill) provided that:

(i) Where that difference corresponds to the expectation, at the date of acquisition, of unfavourable future results in that undertaking , or to the expectation of costs which that undertaking would incur , in so far as such an expectation materializes ; or

(ii) Such a difference corresponds to a realized gain.

(c) The translation differences included in consolidated reserves; and

(d) Any difference resulting from the inclusion of certain participating interests in accordance with the equity method.

(2) Where the items referred to in points (a) to (d) of paragraph 8 (1) above are debit ("positive") items, they shall be deducted in the calculation of consolidated own funds.

Restrictions for recognition of additional capital.

9. (1) The items referred to in points (d) to (g) of paragraph 2 (1) above, shall be subject to the following limits:

(a) The total of the items in points (d) to (g) must not exceed a maximum of 100% of the items in points (a) to (ca) minus (h), (i) and (j) of this Chapter; and

(b) The total of the item in point (g) must not exceed a maximum of 50% of the items in points (a) to (ca) minus (h), (i) and (j) of this Chapter.

(1a) Notwithstanding paragraph 9 (1), the total of the items in paragragrph 2, subparagraph 1 (ca) shall be subject to the following limits:

(a) instruments that must be converted during emergency situations and may be converted at the initiative of the Commission, at any time, based on the financial and solvency situation of the issuer into items referred to in paragraph 2 subparagraph 1(a) within a pre-determined range must in total not exceed a maximum of 50% of the items in points (a) to (ca) minus (h), (i) and (j) of this Chapter;

(b) within the limit referred to in point (a) of this paragraph, all other instruments must not exceed a maximum of 35% of the items in points (a) to (ca) minus (h), (i) and (j) of paragraph 2 Chapter 1, Part B;

(c) within the limits referred to in points (a) and (b) of this paragraph, dated instruments and instruments with provisions that provide for an incentive for the investment firm to redeem must not exceed a maximum of 15% of the items in points (a) to (ca) minus (h), (i) and (j) of paragraph 2 Chapter 1, Part B;

(d) the amount of items exceeding the limits set out in points (a), (b) and (c) must be subject to the limit set out in paragraph 9 (1) of this Part.

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(2) Half of the total of the items in points (k) to (u) of paragraph 2 (1) above shall be deducted from the total of the items (a) to (ca) minus (h), (i) and (j), and half from the total of the items (d) to (g) of paragraph 2 (1) above, after application of the limits laid down in paragraph 9 (1) above. To the extent that half of the total of the items (k) to (u) exceeds the total of the items (d) to (g) of paragraph 2 (1) above, the excess shall be deducted from the total of the items (a) to (ca) minus (h), (i) and (j) of paragraph 2 (1) above. Items in point (q) of paragraph 2 (1) above shall not be deducted if they have been included for the purposes of paragraph 11 of Chapter 3 of Part A, in the calculation of risk-weighted exposure amounts as specified in this Directive or in the calculation of capital requirements as specified in Annex I or V of Part D.

(3) For the purposes of the Large Exposures Directive and Articles 120-122 of the European Directive 2006/48/EC, the provisions laid down in this Part shall be read without taking into account the items referred to in points (p) and (q) of paragraphs 2 (1) and 6 (3) above.

(4) The Commission may authorise investment firms to exceed the limits laid down in paragraphs 9 (1) and 9 (1a) temporarily during emergency sutuations.

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Proof of compliance.

10. Compliance with the conditions laid down in this Part shall be proved to the satisfaction of the Commission.

Alternative determination of own funds.

11. (1) The Commission shall permit those investment firms which are obliged to meet the capital requirements calculated in accordance with Chapter 2 and Annexes I and III to VI of Part D to use, for that purpose only, an alternative determination of own funds. No part of the own funds used for that purpose may be used simultaneously to meet other capital requirements.

Such an alternative determination shall be the sum of the items set out in points (a) to (c) of this subparagraph:

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(a) Own funds as defined in paragraph 2 above;

(b) An investment firm's net trading-book profits net of any foreseeable charges or dividends, less net losses on its other business, provided that none of those amounts has already been included in item (a) of this paragraph as one of the items set out in points (b) or (j) of paragraph 2 above;

(c) Subordinated loan capital, subject to the conditions set out in paragraphs 11(2) and 11 (3).

(2) The subordinated loan capital referred to in paragraph 11(1)(c) above shall have an initial maturity of at least two years. It shall 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 investment firm, the debt will become repayable before the agreed repayment date, unless the Commission approve the repayment. Neither the principal nor the interest on such subordinated loan capital may be repaid if such repayment would mean that the own funds of the investment firm in question would then amount to less than 100% of that investment firm's overall capital requirements.

In addition, an investment firm shall notify the Commission of all repayments on such subordinated loan capital as soon as its own funds fall below 120% of its overall capital requirements.

(3) The subordinated loan capital referred to in paragraph 11(1)(c) above may not exceed a maximum of 150% of the original own funds left to meet the requirements calculated in accordance with Chapter 2 and Annexes I to VI of

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Part D and may approach that maximum only in particular circumstances acceptable to the Commission.

Calculation of exposures for the purposes of Annex II, Part D

12. (1) Where an investment firm calculates risk-weighted exposure amounts for the purposes of Part D, Annex II in accordance with Chapter 2 of Part C, the following shall apply for the purposes of the calculation provided for in point 36 of Part 1 of Annex VII of Part C:

(a) Value adjustments made to take account of the credit quality of the counterparty may be included in the sum of value adjustments and provisions made for the exposures indicated in Part D, Annex II; and

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

For the purposes of point (a), for such investment firms, such value adjustments shall not be included in own funds other than in accordance with the provisions of this paragraph.

(2) For the purposes of this paragraph, paragraphs 42 and 43 of Chapter 9 of Part C shall apply.

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Part C

The calculation of the capital requirement for credit and operational risk, supervisory review and disclosure.

Chapter 1

Standardised Approach

"Exposure" for the purpose of this Part

1. "Exposure" for the purposes of this Part means an asset or off-balance sheet item.

Value of exposure.

Part C, Annex II

Part C, Annex VIII

2. (1) Subject to paragraph 2 (2), the exposure value of an asset item shall be its balance-sheet value and the exposure value of an off-balance sheet item listed in Annex II shall be the following percentage of its value: 100% if it is a full-risk item, 50% if it is a medium-risk item, 20% if it is a medium/low-risk item, 0% if it is a low-risk item. The off-balance sheet items referred to in the first sentence of this paragraph shall be assigned to risk categories as indicated in Annex II of this Part. In the case of an investment firm using the Financial Collateral Comprehensive Method under Annex VIII, Part 3, 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 as prescribed in Annex VIII, Part 3, points 34 to 59 of this Part.

Part C, Annex IV
Part C, Annex III

Part C, Annex VIII

(2) The exposure value of a derivative instrument listed in Annex IV of this Part shall be determined in accordance with Annex III of this Part with the effects of contracts of novation and other netting agreements taken into account for the purposes of those methods in accordance with Annex III of this Part. 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 Annex III or Annex VIII of this Part.

(3) Where an exposure is subject to funded credit protection, the exposure value applicable to that item may be modified in accordance with Chapter 3, of this Part.

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Part C, Annex III

(4) Notwithstanding paragraph 2 (2), the exposure value of credit risk exposures outstanding, as determined by the Commission, with a central counterparty shall be determined in accordance with Annex III, Part 2, point 6 of this Part, provided that the central counterparty's counterparty credit risk exposures with all participants in its arrangements are fully collateralised on a daily basis.

Exposure classes - Retail exposure classes

3. (1) Each exposure shall be assigned to one of the following exposure 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) 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 corporates;

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(o) Claims in the form of collective investment undertakings ("CIU"); or

(p) Other items.

(2) To be eligible for the retail exposure class referred to in point (h) of paragraph 3 (1), an exposure shall meet the following conditions:

(a) The exposure shall be either to an individual person or persons, or to a small or medium sized entity;

(b) The exposure shall be 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 investment firm and parent undertakings and its subsidiaries, including any past due exposure, by the obligor person or group of connected persons, but excluding claims or contingent claims secured on residential real estate collateral, shall not, to the knowledge of the investment firm, exceed EUR 1 million. The investment firm shall take reasonable steps to acquire this knowledge.

Securities shall not be eligible for the retail exposure class.

(3) The present value of retail minimum lease payments is eligible for the retail exposure class.

Risk weighted exposures.

Part C, Annex VI

4. (1) To calculate risk-weighted exposure amounts, risk weights shall be applied to all exposures, unless deducted from own funds, in accordance with the provisions of Annex VI, Part 1 of this Part. The application of risk weights shall be based on the exposure class to which the exposure is assigned and, to the extent specified in Annex VI, Part 1 of this Part, its credit quality. Credit quality may be determined by reference to the credit assessments of External Credit Assessment Institutions ("ECAIs") in accordance with the provisions of paragraphs 5 to 7 of this Chapter or the credit assessments of Export Credit Agencies as described in Annex VI, Part 1 of this Part.

(2) For the purposes of applying a risk weight, as referred to in subparagraph (1) above, the exposure value shall be multiplied by the risk weight specified or determined in accordance with this Chapter.

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Part C, Annex VI

(3) For the purposes of calculating risk-weighted exposure amounts for exposures to institutions, the method based on the credit quality of the Central Government in accordance with Annex VI will be adopted.

(4) Notwithstanding subparagraph (1) above, where an exposure is subject to credit protection the risk weight applicable to that item may be modified in accordance with Chapter 3 of this Part.

(5) Risk-weighted exposure amounts for securitised exposures shall be calculated in accordance with Chapter 4 of this Part.

(6) Exposures the calculation of risk-weighted exposure amounts for which is not otherwise provided for under this Chapter shall be assigned a risk-weight of 100%.

(7) With the exception of exposures giving rise to liabilities in the form of the items referred to in Part B, Chapter 1, paragraphs 2 (1) (a) to (g), the Commission shall exempt from the requirements of subparagraph (1) above the exposures of an investment firm to a counterparty which is its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking, which is not linked by a relationship within the meaning of section 148 of the Company Law, that has been placed along with the parent undertaking under single management following an agreement concluded by the parent undertaking or according to the terms of their articles of association or their administrative or management or supervisory bodies consist in their majority of the same persons holding office during the financial year and until the consolidated financial statements are drawn up, provided that the following conditions are met:

(a) The counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements;

(b) The counterparty is included in the same consolidation as the investment firm on a full basis;

(c) The counterparty is subject to the same risk evaluation, measurement and control procedures as the investment firm;

(d) The counterparty is established in the same Member State as the investment firm; and

(e) There is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the investment firm.

In such a case, a risk weight of 0% shall be assigned.

(8) With the exception of exposures giving rise to liabilities in the form of the items referred to in points (a) to (h) of subparagraph 7, the Commission may exempt from the requirements of subparagraph 1 of paragraph 4 the exposures to counterparties which are members of the same institutional protection scheme as the lending investment firm, provided that the following conditions are met:

(a) the requirements set out in points (a), (d) and (e) of subparagraph 7;

(b) the investment firm and the counterparty have entered into a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary (referred to below as an institutional protection scheme);

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

Part C, Annex VII

(d) the institutional protection scheme disposes of suitable and uniformly stipulated systems for the monitoring and classification of risk (which gives a complete overview of the risk situations of all the individual members and theinstitutional protection scheme as a whole) with corresponding possibilities to take influence; those systems shall suitably monitor defaulted exposures in accordance with Annex VII, Part 4, point 44;

(e) the institutional protection scheme conducts its own risk review which is communicated to the individual members;

(f) the institutional protection scheme draws up and publishes once in a year either, a consolidated report comprising the balance sheet, the profit-and-loss account, the situation report and the risk report, concerning the institutional protection scheme as a whole, or a report comprising the aggregated balance sheet, the aggregated profit-and-loss account, the

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situation report and the risk report, concerning the institutional protection scheme as a whole;

(g) members of the institutional protection scheme are obliged to give advance notice of at least 24 months if they wish to end the arrangements;

(h) the multiple use of elements eligible for the calculation of own funds (‘multiple gearing’) as well as any inappropriate creation of own funds between the members of the institutional protection scheme shall be eliminated;

(i) the institutional protection scheme shall be based on a broad membership of credit institutions of a predominantly homogeneous business profile; and

(j) the adequacy of the systems referred to in point (d) is approved and monitored at regular intervals by the Commission.

In such a case, a risk weight of 0% shall be assigned.

External credit assessments.

5. (1) An external credit assessment may be used to determine the risk weight of an exposure in accordance with paragraph 4 of this Part only if the ECAI which provides it has been recognised as eligible for those purposes by the Commission ("an eligible ECAI" for the purposes of this Chapter).

Part C, Annex VI

(2) The Commission shall recognise an ECAI as eligible for the purposes of paragraph 4 of this Part only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency. For those purposes, the Commission shall take into account the technical criteria set out in Annex VI, Part 2 of this Part . Where an ECAI is registered as a credit rating agency in accordance with Regulation (EC) No 1060/2009 of 16 September 2009 of the European Parliament and of the Council on credit rating agencies, the Commission shall consider the requirements of objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied.

(3) For the purposes of paragraph 5(1) above, the Commission shall announce the eligible ECAIs to the investments firms. At the moment, the following organisations have been recognised as eligible ECAIs:

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(a) Fitch Ratings

(b) Standard & Poors Rating Services

(c) Moodys Investors Service

Mapping of credit assessments into the credit quality steps.

Part C, Annex VI and XII

6. (1) The Commission shall determine, taking into account the technical criteria set out in Annex VI, Part 2, with which of the credit quality steps set out in Part 1 of that Annex the relevant credit assessments of an eligible ECAI are to be associated. The mapping of each credit assessment of the eligible ECAIs, according to paragraph 5(1) and 5(3) above, into the credit quality steps referred to in Part 1 of Annex VI of this Part can be found in Annex XII of this Part.

   (2) When the competent authorities of a Member State have made a determination under paragraph 6 (1), the Commission may recognise that determination without carrying out its own determination process.

Use of credit assessments.

Part C, Annex VI

7. (1) The use of ECAI credit assessments for the calculation of an investment firm's risk-weighted exposure amounts shall be consistent and in accordance with Annex VI, Part 3 of this Part. Credit assessments shall not be used selectively.

   (2) Investment firms shall use solicited credit assessments. However, with the permission of the Commission, they may use unsolicited assessments.

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Chapter 2

Internal Ratings Based Approach

Permission for the use of IRB Approach - Fulfilment of minimum requirements on a consolidated basis- Application requirements.

8. (1) In accordance with this Chapter, the Commission may permit investment firms to calculate their risk-weighted exposure amounts using the Internal Ratings Based Approach ("IRB Approach"). Explicit permission shall be required in the case of each investment firm.

Part C, Annex VII

(2) Permission shall be given only if the Commission is satisfied that the investment firm's systems for the management and rating of credit risk exposures are sound and implemented with integrity and, in particular, that they meet the following standards in accordance with Annex VII, Part 4 of this Part:

(a) The investment firm's rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk;

(b) Internal ratings and default and loss estimates used in the calculation of capital requirements and associated systems and processes play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the investment firm;

(c) The investment firm has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence;

(d) The investment firm collects and stores all relevant data to provide effective support to its credit risk measurement and management process; and

(e) The investment firm documents its rating systems and the rationale for their design and validates its rating systems.

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Where an EU parent investment firm and its subsidiaries or an EU parent financial holding company and its subsidiaries use the IRB Approach on a unified basis, the Commission shall allow minimum requirements of Annex VII, Part 4 of this Part to be met by the parent and its subsidiaries considered together.

Part C, Annex VII

(3) An investment firm applying for the use of the IRB Approach shall demonstrate that it has been using for the IRB exposure classes in question rating systems that were broadly in line with the minimum requirements set out in Annex VII, Part 4 of this Part for internal risk measurement and management purposes for at least three years prior to its qualification to use the IRB Approach.

Part C, Annex VII

(4) An investment firm applying for the use of own estimates of LGDs and/or conversion factors shall demonstrate that it has been estimating and employing own estimates of LGDs and/or conversion factors in a manner that was broadly consistent with the minimum requirements for use of own estimates of those parameters set out in Annex VII, Part 4 of this Part for at least three years prior to qualification to use own estimates of LGDs and/or conversion factors.

Part C, Annex VII

(5) If an investment firm ceases to comply with the requirements set out in this Chapter, it shall either present to the Commission a plan for a timely return to compliance or demonstrate that the effect of non-compliance is immaterial.

Sequential implementation of the IRB Approach.

9. (1) Without prejudice to paragraph 13 of this Chapter, investment firms and any parent undertaking and its subsidiaries shall implement the IRB Approach for all exposures.

Subject to the approval of the Commission, implementation shall be carried out sequentially across the different exposure classes, referred to in paragraph 10 of this Chapter, within the same business unit, across different business units in the same group or for the use of own estimates of LGDs or conversion factors for the calculation of risk weights for exposures to corporates, institutions, and central governments and central banks.

In the case of the retail exposure class referred to in paragraph 10 of this Chapter, implementation may be carried out sequentially across the categories of exposures to which the different correlations in Annex VII, Part 1, points 10 to 13 of this Part correspond.

Part C, Annex VII

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(2) Implementation as referred to in paragraph 9 (1) shall be carried out within a reasonable period of time to be agreed with the Commission. The implementation shall be carried out subject to strict conditions determined by the Commission. Those conditions shall be designed to ensure that the flexibility under paragraph 9 (1) is not used selectively with the purpose of achieving reduced minimum capital requirements in respect of those exposure classes or business units that are yet to be included in the IRB Approach or in the use of own estimates of LGDs and/or conversion factors.

(3) Investment firms using the IRB Approach for any exposure class shall at the same time use the IRB Approach for the equity exposure class.

(4) Subject to paragraphs 9 (1) to 9 (3) and paragraph 13 of this Chapter, investment firms which have obtained permission under paragraph 8 of this Chapter to use the IRB Approach shall not revert to the use of Chapter 1 of this Part for the calculation of risk-weighted exposure amounts except for demonstrated good cause and subject to the approval of the Commission.

(5) Subject to paragraphs 9 (1) and 9 (2) and paragraph 13 of this Chapter, investment firms which have obtained permission under paragraph 11(9) below to use own estimates of LGDs and conversion factors, shall not revert to the use of LGD values and conversion factors referred to in paragraph 11 (8) of this Chapter except for demonstrated good cause and subject to the approval of the Commission.

Assigning exposures to exposure classes - Retail exposures class - Equity exposures - Specialised lending exposures - Residual value of leased properties.

10. (1) Each exposure shall be assigned to one of the following exposure classes:

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

(b) Claims or contingent claims on institutions;

(c) Claims or contingent claims on corporates;

(d) Retail claims or contingent retail claims;

(e) Equity claims;

(f) Securitisation positions; or

(g) Other non credit-obligation assets.

(2) The following exposures shall be treated as exposures to central governments and central banks:

(a) Exposures to regional governments, local authorities or public sector entities which are treated as exposures to central governments under, Chapter 1 of this Part; and

(b) Exposures to Multilateral Development Banks and International Organisations which attract a risk weight of 0% under Chapter 1 of this Part.

(3) The following exposures shall be treated as exposures to institutions:

(a) Exposures to regional governments and local authorities which are not treated as exposures to central governments under Chapter 1 of this Part;

(b) Exposures to Public Sector Entities which are treated as exposures to institutions under Chapter 1 of this Part; and

(c) Exposures to Multilateral Development Banks which do not attract a 0% risk weight under Chapter 1 of this Part.

(4) To be eligible for the retail exposure class referred to in point (d) of paragraph 10 (1) of this Chapter, exposures shall meet the following criteria:

(a) They shall be either 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 investment firm and parent undertakings and its subsidiaries, including any past due exposure, by the obligor person or group of connected persons, but excluding claims or contingent claims secured on residential real estate collateral, shall not, to the knowledge of the investment firm, which shall have taken reasonable steps to confirm the situation, exceed EUR 1 million;

(b) They are treated by the investment firm in its risk management consistently over time and in a similar manner;

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

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(d) They each represent one of a significant number of similarly managed exposures.

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

(5) The following exposures shall be classed as equity exposures:

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

(b) Debt exposures the economic substance of which is similar to the exposures specified in point (a) of this paragraph.

(6) Within the corporate exposure class, investment firms shall separately identify as specialised lending exposures, exposures which possess the following characteristics:

(a) The exposure is to an entity which was created specifically to finance and/or operate physical assets;

(b) The contractual arrangements 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, rather than the independent capacity of a broader commercial enterprise.

(7) Any credit obligation not assigned to the exposure classes referred to in points (a), (b) and (d) to (f) of paragraph 10 (1) above shall be assigned to the exposure class referred to in point (c) of that paragraph.

(8) The exposure class referred to in point (g) of paragraph 10 (1) above shall include the residual value of leased properties if not included in the lease exposure as defined in Annex VII, Part 3, point 4 of this Part.

Part C, Annex VII

(9) The methodology used by the investment firm for assigning exposures to different exposure classes shall be appropriate and consistent over time.

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Calculation of risk weighted exposures by exposure class.

Part C, Annex VII

11. (1) The risk-weighted exposure amounts for credit risk for exposures belonging to one of the exposure classes referred to in points (a) to (e) or (g) of paragraph 10(1) above shall, unless deducted from own funds, be calculated in accordance with Annex VII, Part 1, points 1 to 27 of this Part.

Part C, Annex VII

(2) The risk-weighted exposure amounts for dilution risk for purchased receivables shall be calculated according to Annex VII, Part 1, point 28 of this Part. Where an investment firm has full recourse in respect of purchased receivables for default risk and for dilution risk, to the seller of the purchased receivables, the provisions of paragraphs 11 and 12 of this Part in relation to purchased receivables need not be applied. The exposure may instead be treated as a collateralised exposure.

Part C, Annex VII

(3) The calculation of risk-weighted exposure amounts for credit risk and dilution risk shall be based on the relevant parameters associated with the exposure in question. These shall include probability of default (PD), LGD, maturity (M) and exposure value of the exposure. PD and LGD may be considered separately or jointly, in accordance with Annex VII, Part 2 of this Part.

Part C, Annex VII

(4) Notwithstanding paragraph 11 (3) above, the calculation of risk-weighted exposure amounts for credit risk for all exposures belonging to the exposure class referred to in point (e) of paragraph 10 (1) above shall be calculated in accordance with Annex VII, Part 1, points 17 to 26 of this Part subject to approval of the Commission. The Commission shall only allow an investment firm to use the approach set out in Annex VII, Part 1, points 25 and 26 of this Part if the investment firm meets the minimum requirements set out in Annex VII, Part 4, points 115 to 123 of this Part.

Part C, Annex VII

(5) Notwithstanding paragraph 11(3) above, the calculation of risk weighted exposure amounts for credit risk for specialised lending exposures may be calculated in accordance with Annex VII, Part 1, point 6 of this Part. The Commission shall publish guidance on how investment firms should assign risk weights to specialised lending exposures under Annex VII, Part 1, point 6 of this Part and shall approve investment firm assignment methodologies.

Part C, Annex VII

(6) For exposures belonging to the exposure classes referred to in points (a) to (d) of paragraph 10 (1) above, investment firms shall provide their own estimates of PDs in accordance with paragraph 8 and Annex VII, Part 4 of this Part.

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(7) For exposures belonging to the exposure class referred to in point (d) of paragraph 10 (1) above, investment firms shall provide own estimates of LGDs and conversion factors in accordance with paragraph 8 and Annex VII, Part 4 of this Part.

Part C, Annex VII

(8) For exposures belonging to the exposure classes referred to in points (a) to (c) of paragraph 10 (1) above, investment firms shall apply the LGD values set out in Annex VII, Part 2, point 8, and the conversion factors set out in Annex VII, Part 3, point 9(a) to (d) of this Part.

Part C, Annex VII

(9) Notwithstanding paragraph 11 (8) above, for all exposures belonging to the exposure classes referred to in points (a) to (c) of paragraph 10 (1) above, the Commission may permit investment firms to use own estimates of LGDs and conversion factors in accordance with paragraph 8 and Annex VII, Part 4 of this Part.

Part C, Annex VII

(10) The risk-weighted exposure amounts for securitised exposures and for exposures belonging to the exposure class referred to in point (f) of paragraph 10 (1) above shall be calculated in accordance with Chapter 4 of this Part.

(11) Where exposures in the form of a collective investment undertaking (CIU) meet the criteria set out in Annex VI, Part 1, points 75 and 76 and the investment firm is aware of all or parts of the underlying exposures of the CIU, the investment firm shall look through to those underlying exposures in order to calculate risk-weighted exposure amounts and expected loss amounts in accordance with the methods set out in this Chapter.

Part C, Annex VI

Paragraph 11 (12)_ shall apply to the part of the underlying exposures of the CIU the investment firm is not aware of or could not reasonably be aware of. In particular, paragraph 11 (12) shall apply where it would be unduly burdensome for the investment firm to look through the underlying exposures in order to calculate risk-weighted exposure amounts and expected loss amounts in accordance with methods set out in this Chapter.

Where the investment firm does not meet the conditions for using the methods set out in this Chapter for all or parts of the underlying exposures of the CIU, risk weighted exposure amounts and expected loss amounts shall be calculated in accordance with the following approaches:

(a) For exposures belonging to the exposure class referred to in point (e) of paragraph 10 (1) above, the approach set out in Annex VII, Part 1,

Part C, Annex VII

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points 19 to 21 of this Part.

(b) For all other underlying exposures, the approach set out in paragraphs 2 to 7 of Chapter 1 of this Part, 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 must be multiplied by a factor of two but must not be higher than 1250%, and

(ii) for all other exposures, the risk weight must be multiplied by a factor of 1,1 and must be subject to a minimum of 5%.

Where, for the purposes of point (a), the investment firm is unable to differentiate between private equity, exchange-traded and other equity exposures, it shall treat the exposures concerned as other equity exposures. Where those exposures, taken together with the investment firm's direct exposures in that exposure class, are not material within the meaning of 13 (2) of this Chapter, paragraph 13 (1) may be applied subject to the approval of the Commission.

Part C, Annex VI

Part C, Annex VII

(12) Where exposures in the form of a CIU do not meet the criteria set out in Annex VI, Part 1, points 75 and 76, or the investment firm is not aware of all of the underlying exposures of the CIU, the investment firm shall look through to the underlying exposures and calculate risk-weighted exposure amounts and expected loss amounts in accordance with the approach set out in Annex VII, Part 1, points 19 to 21 of this Part. If, for those purposes, the investment firm is unable to differentiate between private equity, exchange-traded and other equity exposures, it shall treat the exposures concerned as other equity exposures. For these purposes, non equity exposures are assigned to one of the classes (private equity, exchange traded equity or other equity) set out in Annex VII, Part 1, point 19 of this Part and unknown exposures are assigned to other equity class.

Alternatively to the method described in the first subparagraph, investments firms may calculate themselves or may rely on a third party to calculate and report the average risk weighted exposure amounts based on the CIU's underlying exposures in accordance with the approaches referred to in points (a) and (b) of paragraph 11 (11), provided that the correctness of the calculation and the report is adequately ensured.

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Calculation of expected loss

Part C, Annex VII

12. (1) The expected loss amounts for exposures belonging to one of the exposure classes referred to in points (a) to (e) of paragraph 10 (1) above shall be calculated in accordance with the methods set out in Annex VII, Part 1, points 29 to 35 of this Part.

Part C, Annex VII

(2) The calculation of expected loss amounts in accordance with Annex VII, Part 1, points 29 to 35 of this Part shall be based on the same input figures of PD, LGD and the exposure value for each exposure as being used for the calculation of risk-weighted exposure amounts in accordance with paragraph 11 above. For defaulted exposures, where investment firms use own estimates of LGDs, expected loss ("EL") shall be the investment firm's best estimate of EL ("ELBE,") for the defaulted exposure, in accordance with Annex VII, Part 4, point 80 of this Part.

(3) The expected loss amounts for securitised exposures shall be calculated in accordance with Chapter 4 of this Part.

(4) The expected loss amount for exposures belonging to the exposure class referred to in point (g) of paragraph 10 (1) above shall be zero.

Part C, Annex VII

(5) The expected loss amounts for dilution risk of purchased receivables shall be calculated in accordance with the methods set out in Annex VII, Part 1, point 35 of this Part.

Part C, Annex VII

(6) The expected loss amounts for exposures referred to in paragraphs 11 (11) and (12) above shall be calculated in accordance with the methods set out in Annex VII, Part 1, points 29 to 35 of this Part.

Exemption from the IRB Approach for certain exposure classes

13. (1) Subject to the approval of the Commission, investment firms permitted to use the IRB Approach in the calculation of risk-weighted exposure amounts and expected loss amounts for one or more exposure classes may apply Chapter 1 of this Part for the following:

(a) The exposure class referred to in point (a) of paragraph 10 (1), where the number of material counterparties is limited and it would be unduly burdensome for the investment firm to implement a rating system for these counterparties;

(b) The exposure class referred to in point (b) of paragraph 10 (1), where the number of material counterparties is limited and it would be unduly burdensome for the investment firm to implement a rating system for

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these counterparties;

(c) Exposures in non-significant business units as well as exposure classes that are immaterial in terms of size and perceived risk profile;
(for the purpose of this point, "non-significant" and "immaterial" exposures, are defined as those exposures that do not exceed 10% of the total capital requirements for credit risk).

(d) Exposures to central governments of the Member States and to their regional governments, local authorities and administrative bodies, provided that:

(i) There is no difference in risk between the exposures to that central government and those other exposures because of specific public arrangements, and

(ii) Exposures to the central government are assigned a 0% risk weight under Chapter 1 of this Part;

(e) Exposures of an investment firm to a counterparty which is its parent undertaking, its subsidiary or a subsidiary of its parent undertaking provided that the counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements or an undertaking linked by a relationship within the meaning of Section 148, Company Law;

(f) Equity exposures to entities whose credit obligations qualify for a 0% risk weight under Chapter 1 of this Part (including those publicly sponsored entities where a zero risk weight can be applied);

(g) Equity exposures incurred under legislative programmes to promote specified sectors of the economy that provide significant subsidies for the investment to the investment firm and involve some form of government oversight and restrictions on the equity investments. This exclusion is limited to an aggregate of 10% of original own funds plus additional own funds;

Part C, Annex VIII

(h) State and State-reinsured guarantees pursuant to Annex VIII, Part 2, point 19 of this Part.

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This paragraph shall not prevent the Commission to allow the application of the rules of Part A, Chapter 2, paragraphs 2 to 7 for equity exposures which have been allowed for this treatment in other Member States.

(2) For the purposes of paragraph 13 (1) above, the equity exposure class of an investment firm shall be considered material if their aggregate value, excluding equity exposures incurred under legislative programmes as referred to in paragraph 13 (1), point (g) above, exceeds, on average over the preceding year, 10% of the investment firm's own funds. If the number of those equity exposures is less than 10 individual holdings, that threshold shall be 5% of the investment firm's own funds.

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Chapter 3

Credit risk mitigation

Definition of "lending investment firm".

14. For the purposes of this Chapter, "lending investment firm" shall mean the investment firm which has the exposure in question, whether or not deriving from a loan.

Recognition of credit risk mitigation.

15. Investment firms using the Standardised Approach under paragraphs 2 to 7 of Chapter 1, of this Part or using the IRB Approach under Chapter 2 of this Part, but not using their own estimates of LGD and conversion factors under paragraphs 11 and 12 of Chapter 2 of this Part, may recognise credit risk mitigation in accordance with this Chapter in the calculation of risk-weighted exposure amounts for the purposes of Part A, Chapter 3, paragraph 11, point (a) or as relevant expected loss amounts for the purposes of the calculation referred to in point (p), paragraph 2, and paragraph 6 (3) of Part B.

Requirements for credit risk mitigation.

16. (1) The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by the lending investment firm shall be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.

(2) The lending investment firm shall take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

(3) In the case of funded credit protection, to be eligible for recognition the assets 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. Eligibility shall be limited to the assets set out in Annex VIII, Part 1 of this Part.

Part C, Annex VIII

(4) In the case of funded credit protection, the lending Investment firm shall have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy of the obligor — or other credit event set out in the transaction documentation — and, where applicable, of the custodian holding the collateral. The degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be undue.

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(5) In the case of unfunded credit protection, to be eligible for recognition the party giving the undertaking shall be sufficiently reliable, and the protection agreement legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed. Eligibility shall be limited to the protection providers and types of protection agreement set out in Annex VIII, Part 1 of this Part.

Part C, Annex VIII

(6) The minimum requirements set out in Annex VIII, Part 2 of this Part shall be complied with.

Part C, Annex VIII

Requirements for modification of risk weighted assets

Part C, Annex VIII

17. (1) Where the requirements of paragraph 16 of this Chapter are met the calculation of risk-weighted exposure amounts, and, as relevant, expected loss amounts, may be modified in accordance with Annex VIII, Parts 3 to 6 of this Part.

(2) No exposure in respect of which credit risk mitigation is obtained shall produce a higher risk-weighted exposure amount or expected loss amount than an otherwise 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 paragraphs 2 to 7 of Chapter 1 or Chapter 2 of this Part, as relevant, the calculation of the credit protection shall not be further recognised under this Chapter.

Chapter 4

Securitisation

Calculation of risk weighted assets for securitisation positions

Part C, Annex IX

18. Where an investment firm uses the Standardised Approach set out in paragraphs 2 to 7 of Chapter 1 of this Part for the calculation of risk-weighted exposure amounts for the exposure class to which the securitised exposures would be assigned under paragraph 3 of Chapter 1 of this Part, it shall calculate the risk-weighted exposure amount for a securitisation position in accordance with Annex IX, Part 4, points 1 to 35 of this Part.

Part C, Annex IX

In all other cases, it shall calculate the risk-weighted exposure amount in accordance with Annex IX, Part 4, points 1 to 5 and 36 to 73 of this Part.

Transfers of credit risk of securitised exposures

Part C, Annex IX

19. (1) Where significant credit risk associated with securitised exposures has been transferred from the originator investment firm in accordance with the terms of Annex IX, Part 2 of this Part, that investment firm may:

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

    (b) In the case of a synthetic securitisation, calculate risk-weighted exposure amounts, and, as relevant, expected loss amounts, in respect of the securitised exposures in accordance with Annex IX, Part 2 of this Part.

Part C, Annex IX

(2) Where paragraph 19(1) above applies, the originator investment firm shall calculate the risk-weighted exposure amounts prescribed in Annex IX of this Part for the positions that it may hold in the securitisation.

Part C, Annex IX

Where the originator investment firm fails to transfer significant credit risk in accordance with paragraph 19 (1) above, it need not calculate risk-weighted exposure amounts for any positions it may have in the securitisation in question.

Risk weights of securitised exposures

Part C, Annex IX

20. (1) To calculate the risk-weighted exposure amount of a securitisation position, risk weights shall be assigned to the exposure value of the position in accordance with Annex IX of this Part, based on the credit quality of the position, which may be determined by reference to an ECAI credit assessment or otherwise, as set out in Annex IX of this Part.

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(2) Where there is an exposure to different tranches in a securitisation, the exposure to each tranche shall be considered a separate securitisation position. The providers of credit protection to securitisation positions shall be considered to hold positions in the securitisation. Securitisation positions shall include exposures to a securitisation arising from interest rate or currency derivative contracts.

Part C, Annex IX

(3) 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 paragraphs 14 to 17 of Chapter 3 of this Part, read in conjunction with Annex IX of this Part.

(4) Subject to Part B, paragraph 2, point (q) and Part B, paragraph 9 (2), the risk-weighted exposure amount shall be included in the investment firm's total of risk-weighted exposure amounts for the purposes of Part A, Chapter 3, paragraph 11(a).

Use of external credit assessments

21. (1) An ECAI credit assessment may be used to determine the risk weight of a securitisation position in accordance with paragraph 20 only if the ECAI has been recognised as eligible by the Commission for this purpose (hereinafter "an eligible ECAI").

(2) The Commission shall recognise an ECAI as eligible for the purposes of paragraph 21 (1) above only if they are satisfied as to its compliance with the requirements laid down in paragraph 5 of Chapter 1 of this Part, and that it has a demonstrated ability in the area of securitisation, which may be evidenced by a strong market acceptance. Where an ECAI is registered as a credit rating agency in accordance with Regulation (EC) No 1060/2009, the Commission shall consider the requirements of objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied.

(3) If an ECAI has been recognised as eligible by the competent authorities of a Member State for the purposes of paragraph 21 (1) above, the Commission shall recognise that ECAI as eligible for those purposes without carrying out their own evaluation process.

(4) The Commission shall make publicly available an explanation of the recognition process and a list of eligible ECAIs.

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(5) To be used for the purposes of paragraph 21 (1) above, a credit assessment of an eligible ECAI shall comply with the principles of credibility and transparency as elaborated in Annex IX, Part 3 of this Part.

Part C, Annex IX

Credit quality steps of securitisations

Part C, Annex I and IX

22. For the purposes of applying risk weights to securitisation positions, the Commission determines in Annex I which of the credit quality steps set out in Annex IX the relevant credit assessments of an eligible ECAI are to be associated.

Consistent use of ECAI credit assessments

Part C, Annex IX

23. The use of ECAI credit assessments for the calculation of an investment firm's risk-weighted exposure amounts under paragraph 20 above shall be consistent and in accordance with Annex IX, Part 3 of this Part. Credit assessments shall not be used selectively.

Securitisation of revolving exposures subject to early amortisation provision

Part C, Annex IX

24. (1) Where there is a securitisation of revolving exposures subject to an early amortisation provision, the originator investment firm shall calculate, in accordance with Annex IX of this Part, 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) For those purposes, a "revolving exposure" shall be an exposure whereby customers' outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to an agreed limit, and an early amortisation provision shall be 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.

Non-contractual support for securitisation.

25. (1) A sponsor investment firm, or an originator investment firm which, in respect of a securitisation, has made use of paragraph 19 of this Chapter 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 investment firm or a sponsor investment firm fails to comply with paragraph 25 (1) above in respect of a securitisation, the Commission shall require it at a minimum, to hold capital against all of the

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securitised exposures as if they had not been securitised. The investment firm shall disclose publicly that it has provided non-contractual support and the regulatory capital impact of having done so.

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Chapter 5

Minimum own funds requirements for operational risk

Methods of calculation of own funds for operational risk

26. (1) The Commission shall require investment firms to hold own funds against operational risk in accordance with the approaches set out in paragraphs 27, 28 and 29 of this Chapter.

(2) Investment firms that use the approach set out in paragraph 28 of this Chapter shall not revert to the use of the approach set out in paragraph 27 of this Chapter, except for demonstrated good cause and subject to approval by the Commission.

(3) Investment firms that use the approach set out in paragraph 29 of this Chapter shall not revert to the use of the approaches set out in paragraph 27 or 28 of this Chapter except for demonstrated good cause and subject to approval by the Commission.

(4) The Commission shall not allow investment firms to use a combination of approaches. However, the Commission will consider, on a case by case basis, the use of different methods between different investment firms within the same group.

Basic Indicator Approach

Part C, Annex X

27. The capital requirement for operational risk under the Basic Indicator Approach shall be a certain percentage of a relevant indicator, in accordance with the parameters set out in Annex X, Part 1 of this Part.

The Standardised Approach

Part C, Annex X

28. (1) Under the Standardised Approach, investment firms shall divide their activities into a number of business lines as set out in Annex X, Part 2 of this Part.

Part C, Annex X

(2) For each business line, investment firms shall calculate a capital requirement for operational risk as a certain percentage of a relevant indicator, in accordance with the parameters set out in Annex X, Part 2 of this Part.

(3) The 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.

Part C, Annex X

(4) The parameters for the Standardised Approach are set out in Annex X, Part 2 of this Part.

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(5) To qualify for use of the Standardised Approach, investment firms shall meet the criteria set out in Annex X, Part 2 of this Part.

Part C, Annex X

Advanced Measurement Approach.

29. (1) Investment firms may use Advanced Measurement Approaches based on their own operational risk measurement systems, provided that the Commission expressly approves the use of the models concerned for calculating the own funds requirement.

(2) Investment firms shall satisfy to the Commission that they meet the qualifying criteria set out in Annex X, Part 3 of this Part.

Part C, Annex X

(3) Where an EU parent investment firm and its subsidiaries or the subsidiaries of an EU parent financial holding company use an Advanced Measurement Approach on a unified basis, the Commission shall allow the qualifying criteria set out in Annex X, Part 3 of this Part to be met by the parent and its subsidiaries considered together.

Part C, Annex X

Chapter 6

Supervisory Review Process (SREP)

Sub-Chapter A: Risk management and investment firms' capital assessment process

Risk management and internal governance

30. The Commission shall require that every investment firm, as well as meeting the requirements set out in articles 18(2)(f) και 68 of the Law and paragraph 31 below, subject to the provisions on level of application set out in Part A, Chapter 2, paragraphs 2 to 7 for the purpose of complying with this Directive.

Internal Capital Adequacy Assessment Process (ICAAP).

31. According with section 68 of the Law investment firms shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed.

These strategies and processes 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 investment firm concerned.

Sub-Chapter B: Supervision

Supervisory examination and assessment (SREP).

Part C, Annex XI

32. (1) Taking into account the technical criteria set out in Annex XI of this Part, the Commission shall review the arrangements, strategies, processes and mechanisms implemented by the investment firms to comply with this Directive and evaluate the risks to which the investment firms are or might be exposed.

(2) The scope of the review and evaluation referred to in paragraph 32(1) above shall be that of the requirements of this Directive.

(3) On the basis of the review and evaluation referred to in paragraph 32 (1) above, the Commission shall determine whether the arrangements, strategies, processes and mechanisms implemented by the investment firms and the own funds held by these ensure a sound management and coverage of their risks.

(4) The Commission establishes the frequency and intensity of the review and evaluation referred to in paragraph 32 (1) above having regard to the size, systemic importance, nature, scale and complexity of the activities of the

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investment firm concerned and taking into account the principle of proportionality. The review and evaluation shall be updated at least on an annual basis.

(5) The review and evaluation performed by the Commission shall include the exposure of investment firms to the interest rate risk arising from non-trading activities. Measures shall be required in the case of investment firms whose economic value declines by more than 20% of their own funds as a result of a sudden and unexpected change in interest rates the size of which is prescribed by the Commission as 200 basis points and shall not differ between investment firms.

Supervisory measures.

33. (1) The Commission shall require any investment firm that does not meet the requirements of this Directive to take the necessary actions or steps at an early stage to address the situation.

For those purposes, the measures available to the Commission shall include the following:

(a) Obliging investment firms to hold own funds in excess of the minimum level laid down in Part A, Chapter 3, paragraph 11;

(b) Requiring the reinforcement of the arrangements, processes, mechanisms and strategies implemented to comply with articles 18(2)(e), 18(2)(f) and 68 of the Law and paragraph 31 of this Chapter, regarding internal governance and the Internal Capital Adequacy Assessment Process (ICAAP);

(c) Requiring investment firms to apply a specific provisioning policy or treatment of assets in terms of own funds requirements;

(d) Restricting or limiting the business, operations or network of investment firms;

(e) Requiring the reduction of the risk inherent in the activities, products and systems of investment firms;

(f) Requiring investment firms to limit variable remuneration as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and

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(g) Requiring investment firms to use net profits to strengthen the capital base.

The adoption of these measures shall be subject to articles 129 and 132 of the Law.

(2) A specific own funds requirement in excess of the minimum level laid down in Part A, Chapter 3, paragraph 11 shall be imposed by the Commission at least on the investment firms which do not meet the requirements laid down in articles 18(2)(e), 18(2)(f) and 68 and 69(3) of the Law and paragraph 31 of this Chapter, or in respect of which a negative determination has been made on the issue described in paragraph 32 (3) above, if the sole application of other measures is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within an appropriate timeframe.

For the purposes of determining the appropriate level of own funds on the basis of the review and evaluation carried out in accordance with paragraph 32 above, the Commission shall assess whether any imposition of a specific own funds requirement in excess of the minimum level is required to capture risks to which an investment firm is or might be exposed, taking into account the following:

(a) The quantitative and qualitative aspects of the investment firms' assessment process referred to in paragraph 31 above;

(b) The investment firms' arrangements, processes and mechanisms referred to in Section 18(2)(e) and (f) of the Law;

(c) The outcome of the review and evaluation carried out in accordance with paragraph 32 above.

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Chapter 7

Disclosure and Market Discipline

Sub-Chapter A: Disclosure by investment firms

Obligation for public disclosure of information

Part C, Annex XII

34. (1) For the purposes of this Directive, investment firms shall publicly disclose the information laid down in Annex XII, Part 2 of this Part, subject to the provisions laid down in paragraph 35 below.

Part C, Annex XII

(2) Recognition by the Commission under Chapters 2 and 3 and paragraph 29 of Chapter 5 of this Part of the instruments and methodologies referred to in Annex XII, Part 3 of this Part shall be subject to the public disclosure by investment firms of the information laid down therein.

(3) Investment firms shall adopt a formal policy to comply with the disclosure requirements laid down in paragraphs 34(1) and 34(2) above, and have policies for assessing the appropriateness of their disclosures, including their verification and frequency. Investment firms shall also have policies for assessing whether their disclosures convey their risk profile comprehensively to market participants.

Where those disclosures do not convey the risk profile comprehensively to market participants, investment firms shall publicly disclose the information necessary in addition to that required in accordance with paragraph 34(1) above. However, they shall only be required to disclose information which is material and not proprietary or confidential in accordance with the technical criteria set out in Part 1 of Annex XII of this Part.

Deviation from the provisions of paragraph 34

Part C, Annex XII

35. (1) Notwithstanding paragraph 34, investment firms may omit one or more of the disclosures listed in Annex XII, Part 2 of this Part if the information provided by such disclosures is not, in the light of the criterion specified in Annex XII, Part 1, point 1 of this Part, regarded as material.

Part C, Annex XII

(2) Notwithstanding paragraph 34 above, investment firms may omit one or more items of information included in the disclosures listed in Annex XII, Parts 2 and 3 of this Part if those items include information which, in the light of the criteria specified in Annex XII, Part 1, points 2 and 3 of this Part, is

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regarded as proprietary or confidential.

(3) In cases referred to in paragraph 35 (2) above, the investment firm concerned shall state in its disclosures the fact that the specific items of information are not disclosed, the reason for non-disclosure, and publish more general information about the subject matter of the disclosure requirement, except where these are to be classified as proprietary or confidential under the criteria set out in Annex XII, Part 1, points 2 and 3 of this Part.

Part C, Annex XII

Frequency of disclosure of information

36. (1) Investment firms shall publish the disclosures required under paragraph 34 above on an annual basis at a minimum. Disclosures shall be published as soon as practicable and the latest within five months from the end of each financial year.

(2) Investment firms shall also determine whether more frequent publication than is provided for in subparagraph (1) above is necessary in the light of the criteria set out in Annex XII, Part 1, point 4 of this Part.

Part C, Annex XII

Method and place of disclosure of information

37. (1) Investment firms may determine the appropriate medium, location and means of verification to comply effectively with the disclosure requirements laid down in paragraph 34 above. Disclosures may be done either in the financial statements of the investment firms if these are published, or on their websites. To the degree feasible, all disclosures shall be provided in one medium or location. These disclosures must be verified by the external auditors of the investment firm. The investment firm will be responsible to submit its external auditors' verification report to the Commission the latest within five months from the end of each financial year.

(2) Equivalent disclosures made by investment firms under accounting like for example throught the implementation of International Financial Reporting Standards 7 which refers to disclosure of financial instruments, listing or other requirements may be deemed to constitute compliance with paragraph 34 above. If disclosures are not included in the financial statements, investment firms must state in the financial statements that they are included in their website.

Change of frequency of disclosures

38. Notwithstanding paragraphs 35 to 37 of this Chapter, the Commission may require investment firms to publish one or more disclosures more frequently than annually, and to set deadlines for publication.

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Sub-Chapter B: Reporting to the Commission

Submission of information

39. (1) Investment firms shall provide the Commission with all the information necessary for the assessment of their compliance with the rules adopted in accordance with this Directive. The Commission shall also ensure that internal control mechanisms and administrative and accounting procedures of the investment firms permit the verification of their compliance with such rules at all times.

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(2) Investment firms shall report to the Commission, duly completed, the Commission's Form 144-05-06, at least once a month in the case of firms covered by section 10 (3) of the Law, at least once every three months (i.e. 31/3, 30/6, 30/9, 31/12) in the case of firms covered by sections 10 (1) and 10 (4) of the Law and at least every six months (i.e. 30/6, 31/12) in the case of firms covered by section 10 (2) of the Law.

Investment firms should submit to the Commission, within five months from the end of each financial year, the Commission's revised Form 144-05-06, and revised Form 144-06-08 which should be based on the results of their audited financial statements.

(3) Notwithstanding subparagraph (2), investment firms covered by articles 10(1) and (3) of the Law shall be required to provide the information on a consolidated or sub-consolidated basis only once every six months (30/6, 31/12).

(4) The Commission shall oblige investment firms to report to them immediately any case in which their counter parties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

(5) Investment firms shall report to the Commission the results and all necessary documents in accordance with the above subparagraphs within one month after the end of the period concerned.

(6) Investment firms shall be covered by the uniform formats, frequencies and dates of reporting referred to the second subparagraph of paragraph 10 of Chapter 3 of Part A.

(7) The form of subparagraph (2) is prepared according to the reporting currency of the audited financial statements of the investment firms.

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Chapter 8

Exposures to transferred credit risk

Exposed to the credit risk of a securitisation position

40. (1) An investment firm, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book 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 which, in any event, shall not be less than 5%.

For the purpose of this paragraph, "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 the 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 securitized exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; 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 securitized exposures.

Net economic interest is measured at the origination and shall be maintained on an ongoing basis. It shall not be subject to any credit risk mitigation or any short positions or anyother hedge. The net economic interest shall be determined by the notional value for off-balance sheet items.

For the purpose of this paragraph, "ongoing basis" means that retained positions, interest or exposures are not hedged or sold.

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

(2) Where an EU parent investment firm or an EU financial holding company, or one of its subsidiaries, as an originator or a sponsor, securitises exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis, the requirement referred to in subparagraph (1) may be satisfied on the basis of the consolidated situation of therelated EU parent investment firm or EU financial holding company. This subparagraph 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 subparagraph (5) and deliver, in a timely manner, to the originator or sponsor and to the EU parent investment firm or an EU financial holding company the information needed to satisfy the requirements referred to in subparagraph (6).

(3) Subparagraph (1) shall not apply where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by:

(a) central governments or central banks;

(b) regional governments, local authorities and public sector entities of Member States;

(c) institutions to which a 50% risk weight or less is assigned under paragraphs 1 to 7 of Chapter 1 of this Part or

(d) multilateral development banks.

Subparagraph (1) shall not apply to:

(a) 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 that is widely traded, or are other tradable securities other than securitisation positions; or

(b) syndicated loans, purchased receivables or credit default swaps where

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these instruments are not used to package and/or hedge a securitisation that is covered by subparagraph (1).

(4) Before investing, and as appropriate thereafter, investment firms, shall be able to demonstrate to the Commission for each of their individual securitisation positions, that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures appropriate to their trading book and non-tradingbook and commensurate with the risk profile of their investments in securitised positions for analysing and recording:

(a) information disclosed under subparagraph (1), 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 securitized 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 the performance of the investment firm's securitisation position.

Investment firms shall regularly perform their own stresstests appropriate to their securitisation positions. To this end, investment firms may rely on financial models developed by an ECAI provided that investment firms can demonstrate, when requested, that they took due care prior to investing

tovalidate the relevant assumptions in and structuring of the models and to understand methodology, assumptions and results.

(5) Investment firms, other than when acting as originators or sponsors or original lenders, shall establish formal procedures appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions to monitor on an ongoing basis and in a timely manner performance information on the exposures underlying their securitisation positions. Where relevant, this shall include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, and frequency distribution of creditscores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, investment firms shall have the information set out in this subparagraph 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.

Investment firms shall have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of their 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.

Part C, Annex IX

Where the requirements in subparagraphs (4), (7) and this subparagraph are not met in any material respect by reason of the negligence or omission of the investment firms, Member States shall ensure that the Commission imposes aproportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%) which would, but for this subparagraph, apply to the relevant securitisation positions under Annex IX, Part 4, and shall progressively increase the risk weight with each subsequent infringement of the due diligence provisions. The Commission shall take into account the exemptions for certain securitisations provided in subparagraph (3) by reducing the risk weight it would otherwise impose under this Chapter in respect of a securitisation to which subparagraph (3) applies.

Part C, Annex V

(6) Sponsor and originator investment firms shall apply the same sound and well-defined criteria for credit-granting in accordance with the requirements of Annex V, point 3 to exposures to be securitized as they apply to exposures

to be held on their book. To this end the same processes for approving and, where relevant, amending, renewing and re-financing credits shall be applied by the originator and sponsor investment firms. Investment firms shall also apply the same standards of analysis to participations or underwritings in securitization issues purchased from third parties, whether such participations or underwritings are to be held on their trading or non-trading book.

Where the requirements referred to in the first subparagraph of this paragraph are not met, paragraph 19 (1) of Chapter 4 of this Part shall not be applied by an originator investment firm and that originator investment firm shall not be allowed to exclude the securitized exposures from the calculation of its capital requirements under this Directive.

(7) Sponsor and originator investment firms shall disclose to investors the level of their commitment under subparagraph (1) to maintain a net economic interest in the securitisation. Sponsor and originator investment firms shall ensure that prospective investors have readily available access to allmaterially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature ofthe securitisation thereafter.

(8) Subparagraphs (1) to (7) shall apply to new securitisations issued on or after 1 January 2011. Subparagraphs (1) to (7) shall, after 31 December 2014, apply to existing securitisations where new underlying exposures are added or substituted after that date. The Commission may decide to suspend temporarily the requirements referred to in subparagraphs (1) and (2) during periods of general market liquidity stress.

(9) The Commission discloses the following information:

(a) by 31 December 2010, the general criteria and methodologies adopted to review the compliance with subparagraphs (1) to (7);

(b) a summary description of the outcome of the supervisory review and description of the measures imposed in cases of non-compliance with subparagraphs (1) to (7) identified on an annual basis from31 December 2011.

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Chapter 9
Transitional and Final Provisions

Exposures to Member States' Central Governments and Central Banks

Part C, Annex VI

41. In the calculation of risk weighted exposure amounts for the purposes of Annex VI, Part 1, point 4 of this Part, until 31 December 2015 the same risk weight shall be assigned in relation to exposures to central governments or central banks denominated and funded in the domestic currency of any Member State as would be applied to such exposures denominated and funded in their domestic currency.

Transitional provisions

Part C, Annex VI

42. (1) The Commission will set the number of days past due up to a figure of 180 for exposures indicated in Annex VI, Part 1, points 12 to 17 and 39 to 41, to counterparties situated in the territories of other Member States, the competent authorities of which have exercised the discretion and set a higher number of days past due.

(2) 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%.

(3) Investment firms which do not comply by 31 December 2010 with the limits set out in paragraph 9 (1)(a) of Chapter 1, Part B shall develop strategies and processes on the necessary measures to resolve this situation before the dates set out in paragraph 43 (4) of this Chapter.

Those measures shall be reviewed under Part C, Chapter 6, Sub-Chapter B.

(4) Instruments that by 31 December 2010, according to national law were deemed equivalent to the items referred to in points (a), (b) and (c) of paragraph 2 (1), Chapter 1, Part B, but do not fall within point (a) of that paragraph or do not comply with the criteria set out in paragraph 6 (4), Chapter 1, Part B, shall be deemed to fall within paragraph 2 (1)(ca) of Chapter 1, Part B until 31 December 2040, subject to the following limitations:

(a) up to 20% of the sum of points (a) to (ca) of paragraph 2 (1), Chapter 1, Part B, less the sum of points (h), (i) and (j) of paragraph 2 (1) between 10 and 20 years after 31 December 2010;

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(b) up to 10% of the sum of points (a) to (ca) of paragraph 2 (1), less the sum of points (h) (i) and (j) of paragraph 2 (1) between 20 and 30 years after 31 December 2010.

The Committee of European Banking Supervisors shall monitor, until 31 December 2010, the issuance of those instruments.

(5) For the purpose of the Large Exposures Directive, assets 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 paragraphs 15(3) and 15(4), Part IV of the Large Exposures Directive DI144-2007-06, as they stood prior to 7 December 2009, however not longer than until 31 December 2012.

Exemption of provisions of this Directive to certain investment firms

43. The provisions on capital requirements as laid down in this Directive shall not apply to investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in the Third Annex, Part III, paragraphs 5, 6, 7, 9 and 10 of the Law and to whom the Investment Firms' Laws 2002-2005 did not apply on 31 December 2006. This exemption is available until 31 December 2014.

Continuation of the Directive IF 7/2003

Κ.Δ.Π. 324/2008

44. The Investment Firms Directive 7/2003, as amended, on (a) the monitoring and control of large exposures to clients or directors of an investment firm and their connected persons, (b) the computation of the capital base of investment firms, (c) the calculation of their capital adequacy ratio, and (d) the calculation of the capital adequacy of investment firms, continues to be in force until 1 September 2008.

Repeal of the Directive DI144-2007-05, Directive DI 144-2007-05 of 2011 and Directive DI144-2007-05(A) of 2012

Official Gazette of the Republic Annex III (I): 19.12.2007 17.10.2011

45. The Directives for the Own funds of the Cypriot Investment Firms with references Regulatory Administrative Decisions (Κ.Δ.Π.) 556/2007, 388/2011 and 356/2012 are hereby repealed and replaced by this Directive.

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05.10.2012

Entry into force

46. The current Directive shall apply from the date of its publishment in the Official Newspaper of the Republic.

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ANNEX I

MAPPING OF EXTERNAL CREDIT ASSESSMENT INSTITUTIONS CREDIT ASSESSMENTS TO CREDIT QUALITY STEPS

THE STANDARDISED APPROACH: LONG TERM MAPPING

Credit Quality Step	Fitch's assessments	Moody's assessments	S&Passessments	Corporate	Institutions (includes banks)			Sovereign
					Sovereign method	Credit Assessment method		
						Maturity > 3 Months	Maturity 3 months or less	
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%	20%	20%	20%	0%
2	A+ to A-	A1 to A3	A+ to A-	50%	50%	50%	20%	20%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%	100%	50%	20%	50%
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	100%	100%	100%	50%	100%
5	B+ to B-	B1 to B3	B+ to B-	150%	100%	100%	50%	100%
6	CCC+ and below	Caa1 and below	CCC+ and below	150%	150%	150%	150%	150%

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THE STANDARDISED APPROACH: SHORT TERM MAPPING

Credit Quality Step	Fitch	Moody’s	S&P	Risk Weight
1	F1+,F1	P-1	A-1+,A-1	20%
2	F2	P-2	A-2	50%
3	F3	P-3	A-3	100%
4	Below F3	NP	All short-term ratings below A-3	150%
5				150%
6				150%

SECURITISATION: LONG TERM MAPPING: STANDARDISED APPROACH

Credit Quality Step	Risk Weight	Fitch	Moody’s	S&P
1	20%	AAA to AA-	Aaa to Aa3	AAA to AA-
2	50%	A+ to A-	A1 to A3	A+ to A-
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	350%	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
5	1250%	B+ and below	B1 and below	B+ and below

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SECURITISATION: LONG TERM MAPPING: INTERNAL RATINGS BASED APPROACH

Credit Quality Step	Risk Weight			Credit Assessments		
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P
1	7%	12%	20%	AAA	Aaa	AAA
2	8%	15%	25%	AA	Aa	AA
3	10%	18%	35%	A+	A1	A+
4	12%	20%	35%	A	A2	A
5	20%	35%	35%	A-	A3	A-
6	35%	50%	50%	BBB+	Baa1	BBB+
7	60%	75%	75%	BBB	Baa2	BBB
8	100%	100%	100%	BBB-	Baa3	BBB-
9	250%	250%	250%	BB+	Ba1	BB+
10	425%	425%	425%	BB	Ba2	BB
11	650%	650%	650%	BB-	Ba3	BB-
Below 11	1250%	1250%	1250%	Below BB-	Below Ba3	Below BB-

SECURITISATION: SHORT TERM MAPPING: STANDARDISED APPROACH

Credit Quality Step	Risk Weight	Fitch	Moody's	S&P
1	20%	F1+, F1	P-1	A-1+, A-1
2	50%	F2	P-2	A-2
3	100%	F3	P-3	A-3
All other Credit Assessment	1250%	Below F3	NP	All short-term ratings below A-3

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SHORT-TERM MAPPING: IRB APPROACH

Credit Quality Step	Risk Weight			Credit Assessments		
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P
1	7%	12%	20%	F1+, F1	P-1	A-1+, A-1
2	12%	20%	35%	F2	P-2	A-2
3	60%	75%	75%	F3	P-3	A-3
All other Credit assessmen ts	1250%	1250%	1250%	Below F3	All short-term ratings below A3, P3 and F3	All short-term ratings below A-3

COLLECTIVE INVESTMENT UNDERTAKINGS (CIUS)

The mapping for CIUs is the same as the mapping for long-term fundamental credit ratings. Fitch and Moody's use the same rating scale for their Managed Funds Credit Quality Ratings as for their fundamental credit ratings, while S&P uses a slightly different rating scales for Principal Stability Fund Ratings and for Fund Credit Quality Ratings, the rating scales are identical in terms of number of rating categories.

Credit Quality Steps	Risk Weight	Fitch	Moody’s	S&P Principal stability fund ratings	S&P Fund credit quality ratings
1	20%	AAA to AA-	Aaa to Aa3	AAA m to AA- m	AAA f to AA- f
2	50%	A+ to A-	A1 to A3	A+m to A-m	A+f to A-f
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+m to BBB-m	BBB+f to BBB-f
4	100%	BB+ to BB-	Ba1 to Ba3	BB+m to BB-m	BB+f to BB-f
5	150%	B+ to B-	B1 to B3	B+m to B-m	B+f to B-f
6	150%	CCC+ and below	Caa1 and below	CCC+m and below	CCC+f and below

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ANNEX II

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 institution,
- Transactions with recourse,
- Irrevocable standby letters of credit having the character of credit substitutes,
- Assets purchased under outright forward purchase agreements,
- Forward forward deposits,
- The unpaid portion of partly-paid shares and securities,
- The following Asset sale and repurchase agreements

  (a) Asset sale and repurchase transactions, i.e. transactions which involve the transfer from one party (the 'transferor') to another (the 'transferee') of assets, subject to an agreement that the same assets will subsequently be transferred back to the transferor at a specified price;

  (b) Asset sale with an option to repurchase, i.e. transactions under which the transferee is merely entitled to return the assets at the purchase price or for a different amount agreed in advance on a date specified or to be specified, and the transferor shall not be entitled to show in his balance sheet the assets transferred; those items shall be shown as assets in the transferee's balance sheet.

- Other items also carrying full risk.

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Medium risk:

- Documentary credits issued and confirmed (see also "Medium/low risk"),
- Warranties and indemnities (including tender, performance, customs and tax bonds) and guarantees not having the character of credit substitutes,
- Irrevocable standby letters of credit not having the character of credit substitutes,
- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year,
- Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs), and
- Other items also carrying medium risk and as communicated to the Commission.

Medium/low risk:

- Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions,
- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year which may not be cancelled unconditionally at any time without notice or that do not effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, and
- Other items also carrying medium/low risk and as communicated to the Commission.

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 investment firm to cancel them to the full extent allowable under consumer protection and related legislation, and
- Other items also carrying low risk and as communicated to the Commission.

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ANNEX III

THE TREATMENT OF COUNTERPARTY CREDIT RISK OF DERIVATIVE INSTRUMENTS, REPURCHASE TRANSACTIONS, SECURITIES ORCOMMODITIES LENDING OR BORROWING TRANSACTIONS, LONG SETTLEMENT TRANSACTIONS AND MARGIN LENDING TRANSACTIONS

PART 1

Definitions

For the purposes of this Annex the following definitions shall apply:

General terms

1. "Counterparty Credit Risk (CCR)" means the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

2. "Central counterparty" means an entity that legally interposes itself between counterparties 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" mean transactions where a counterparty 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 investment firm enters into the transaction.

4. "Margin Lending Transactions" mean transactions in which an investment firm 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 counterparty that are subject to a legally enforceable bilateral netting arrangement and for which netting is recognised under

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Part 7 of this Annex and Chapter 3 of this Part. Each transaction that is not subject to a legally enforceable bilateral netting arrangement, which is recognised under Part 7 of this Annex, should be interpreted as its own netting set for the purpose of this Annex.

Under the method set out in Part 6 of this Part (IMM), all netting sets with a single counterparty may be treated as single netting set if negative simulated maret 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 of this Annex 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 of this Annex.

8. "Margin Agreement" means a contractual agreement or provisions of an agreement under which one counterparty shall supply collateral to a second counterparty when an exposure of that second counterparty to the first counterparty 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 Annex.

13. For the purposes of Part 5 of this Annex,"Current Market Value (CMV)" refers to the net market value of the portfolio of transactions within the netting set with the counterparty. 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 counterparty that would be lost upon the default of the counterparty, 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 one year, over the time period of the longest maturity contract in the netting set.

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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 counterparty. This adjustment reflects the market value of the credit risk due to any failure to perform on contractual agreements with a counterparty. This adjustment may reflect the market value of the credit risk of the counterparty or the market value of the credit risk of both the investment firm and the counterparty.

25. "One-Sided Credit Valuation Adjustment" means a credit valuation adjustment that reflects the market value of the credit risk of the counterparty to the investment firm, but does not reflect the market value of the credit risk of the investment firm to the counterparty.

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 counterparties is positively correlated with general market risk factors.

28. "Specific Wrong-Way Risk" arises when the exposure to a particular counterparty is positively correlated with the PD of the counterparty due to the nature of the transactions with the counterparty. An investment firm shall be considered to be exposed to Specific Wrong-Way Risk if the future exposure to a specific counterparty is expected to be high when the counterparty's PD is also high.

PART 2

Choice of the method

1. Subject to points 2 to 7 below, investment firms shall determine the exposure value for the contracts listed in Annex IV of this Part with one of the methods set out in Parts 3 to 6 of this Annex. Investment firms which are not eligible for the treatment set out in Part A, Chapter 3, paragraph 13 (1) are not permitted to use the method set out in Part 4 of this Annex. To determine the exposure value for the contracts listed in point 3 of Annex IV of this Part,

investment firms are not permitted to use the method set out in Part 4 of this Annex.

The combined use of the methods set out in Parts 3 to 6 of this Annex 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 of this Annex within a legal entity shall be permitted where one of the methods is used for the cases set out in Part 5, point 19 of this Annex.

2. Subject to the approval of the Commission, investment firms may determine the exposure value for:

   (i) The contracts listed in Annex IV of this Part,

   (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 of this Annex.

3. When an investment firm 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 Annex VIII, Part 3, points 81 to 90 of this Part, or subject to the approval of the Commission, in accordance with Annex VII, Part 1, point 4 or Annex VII, Part 4, points 96 to 104 of this Part.

   In those cases, and where the option in the second sentence of point 11 in Annex II of Part D is not applied, the exposure value for CCR for those credit derivatives is set to zero.

   However, investment firms may choose consistently to include for the purposes of 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 recognised under this Directive.

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 investment firm and subject to a capital requirement for credit risk for the full notional amount, is set to zero.

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5. Under all methods set out in Parts 3 to 6 of this Annex, the exposure value for a given counterparty is equal to the sum of the exposure values calculated for each netting set with that counterparty.

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 counterparty and that have not been rejected by the central counterparty. Furthermore, an exposure value of zero can be attributed to credit risk exposures to central counterparties 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 Commission, that the investment firm has outstanding with the central counterparty. The central counterparty 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 of this Annex, 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, investment firms that use the approach set out in Chapter 2 of this Part, may assign the risk weights under the approach set out in paragraphs 2 to 7 of Chapter 1 of this Part on a permanent basis and irrespective of the materiality of such positions.

8. For the methods set out in Parts 3 and 4 of this Annex the Commission must ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where, for instance, the contract provides for a multiplication of cash flows, the notional amount must 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 will be calculated, the notional principal amounts or underlying values are multiplied by the

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percentages in Table 1:

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%

Step (c): the sum of current replacement cost and potential future credit exposure is the exposure value.

PART 4

Original Exposure Method

Step (a): the notional principal amount of each instrument is multiplied by the percentages given in Table 2.

Table 2

Original maturity ([4])	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%

([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. 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%

([4])In the case of interest-rate contracts, investment firms may, subject to the consent of the Commission, choose either original or residual maturity.

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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 =

$$\beta * \max\left(CMV - CMC; \sum_{j} \left| \sum_{i} RPT_{ij} - \sum_{l} RPC_{lj} \right|^{*} CCRM_{j} \right)$$

where:

CMV = current market value of the portfolio of transactions within the netting set with a counterparty gross of collateral, that is, where:

$$CMV = \sum_{i} CMV_{i}$$

where:

CMV_{i} = the current market value of transaction i;

CMC = the current market value of the collateral assigned to the netting set, that is, where:

$$CMC = \sum_{l} CMC_{l}$$

where

CMC_{l} = the current market value of collateral l;

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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;

RPT_{ij} = risk position from transaction i with respect to hedging set j;

RPC_{lj} = risk position from collateral l with respect to hedging set j;

$CCRM_{j}$ = CCR Multiplier set out in Table 4 with respect to hedging set j;

β = 1.4.

Collateral received from a counterparty has a positive sign and collateral posted to a counterparty has a negative sign.

Collateral that is recognised for this method is confined to the collateral that is eligible under point 11 of Part 1 of Annex VIII of this Part and point 9 of Annex II, Part D.

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 that 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. Investment firms 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. Investment firms 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 applies 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 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 is additionally mapped to a risk position in the respective currency.

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4. Transactions with a linear risk profile with a debt instrument as the underlying instrument are 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 that stipulate the exchange of payment against payment, including foreign exchange forwards, are 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 is again mapped to a risk position in this currency. The exposure value assigned to a foreign exchange basis swap transaction is zero.

5. The size of a risk position from a transaction with linear risk profile is the effective notional value (market price multiplied by quantity) of the underlying financial instruments (including commodities) converted to the investment firm's domestic currency, except for debt instruments.

6. For debt instruments and for payment legs, the size of the risk position is the effective notional value of the outstanding gross payments (including the notional amount) converted to the investment firm'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 is 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, is equal to the delta equivalent effective notional value of the financial instrument that 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, is 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 counterparty is to be treated as a claim on the counterparty under a derivative contract (long position) that is due today, while collateral posted is to be treated like an obligation to the counterparty (short position) that is due today.

11. Investment firms may use the following formulae to determine the size and sign of a risk position:

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for all instruments other than debt instruments:

effective notional value, or delta equivalent notional value = $p_{ref} \dfrac{\partial V}{\partial p}$

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 $\dfrac{\partial V}{\partial r}$

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 are to be grouped into hedging sets. For each hedging set, the absolute value amount of the sum of the resulting risk positions is computed. This sum is termed the "net risk position" and is represented by:

$$\left| \sum_i RPT_{ij} - \sum_l RPC_{lj} \right|$$

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in the formulae set out in point 1 above.

13. For interest rate risk positions from money deposits received from the counterparty as collateral, from payment legs and from underlying debt instruments, to which according to Table 1 of Annex I, Part D a capital charge of 1,60% or less applies, there are six hedging sets for each currency, as set out in Table 3 below. Hedging sets are defined by a combination of the criteria 'maturity' and 'referenced interest rates'.

Table 3

	Government referenced interest rates	Non-government referenced interest rates
Maturity	← 1 year	← 1 year
Maturity	>1 — ← 5 years	>1 — ← 5 years
Maturity	> 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 is the length of the time interval up to the next re-adjustment of the interest rate. In all other cases, it is the remaining life of the underlying debt instrument or in the case of a payment leg, the remaining life of the transaction.

15. There is one hedging set for each issuer of a reference debt instrument that underlies a credit default swap. "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; risk positions from different "nth to default" credit default 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 ECAI equivalent to credit quality step 1 to 3, and 0,6% for other debt instruments.

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16. For interest rate risk positions from money deposits that are posted with a counterparty as collateral when that counterparty does not have debt obligations of low specific risk outstanding and from underlying debt instruments, to which according to Table 1 of Annex I, Part D a capital charge of more than 1,60% applies, there is one hedging set for each issuer. When a payment leg emulates such a debt instrument, there is also one hedging set for each issuer of the reference debt instrument. Investment firms may assign risk positions that arise from debt instruments of a certain issuer, or from reference debt instruments of the same issuer that 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 4 below:

Table 4

	Hedging set categories	CCRM
1.	Interest Rates	0,2%
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 Annex I, Part D	0,3%
3.	Interest Rates for risk positions from a debt instrument or reference debt instrument to	0,6%

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	which a capital charge of more than 1,60% applies under Table 1 of Annex I, Part D	
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 point 10 of Table 4 above, 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 investment firm cannot determine the delta or the modified duration, respectively, with an instrument model that the Commission has approved for the purposes of determining the minimum capital requirements for market risk, the Commission shall determine the size of the risk positions and the applicable CCRMjs conservatively. Alternatively, the Commission may require the use of the method set out in Part 3 of this Annex. 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. An investment firm 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 of this Annex.

21. An investment firm that 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 Annex VIII of this Annex.

PART 6

Internal Model Method

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1. Subject to the approval of the Commission, an investment firm may use the Internal Model Method (IMM) to calculate the exposure value for the transactions in Part 2, point 2(i) of this Annex, or for the transactions in Part 2, point 2(ii), (iii) and (iv) of this Annex, or for the transactions in Part 2, point 2(i) to (iv) of this Annex. In each of these cases the transactions in Part 2, point 2(v) of this Annex may be included as well. Notwithstanding Part 2, point 1, second paragraph of this Annex, investment firms may choose not to apply this method to exposures that are immaterial in size and risk. To apply the IMM, an investment firm shall meet the requirements set out in this Part.

2. Subject to the approval of the Commission, implementation of the IMM may be carried out sequentially across different transaction types, and during this period an investment firm may use the methods set out in Part 3 or Part 5 of this Annex. Notwithstanding the remainder of this Part, investment firms shall not be required to use a specific type of model.

3. For all OTC derivative transactions and for long settlement transactions for which an investment firm has not received approval to use the IMM, the investment firm shall use the methods set out in Part 3 or Part 5 of this Annex. 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, point 19 of this Annex.

4. Investment firms 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 of this Annex except for demonstrated good cause and subject to approval of the Commission. If an investment firm ceases to comply with the requirements set out in this Part, it shall either present to the Commission 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 exposure value for the netting set at each future date given the changes in the market variables. For margined counterparties, the model may also capture future collateral movements.

6. Investment firms may include eligible financial collateral as defined in point 11 of Part 1 of Annex VIII of this Part and point 9 of Annex II of Part D 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.

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7. The exposure value shall be calculated as the product of (alpha) α times Effective EPE, as follows:

   Exposure value = α *Effective EPE

   where alpha (α) shall be 1.4, but the Commission 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 t_1, t_2, t_3, etc.

8. Effective EE shall be computed recursively as:

   $$\text{Effective EE}_{tk} = \max(\text{Effective EE}_{tk-1}; \text{EE}_{tk})$$

   where the current date is denoted as t_0 and Effective EEt_0 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:

   $$EffectiveEPE = \sum_{k=1}^{\min(1\,year;maturity)} EffectiveEE_{tk} * \Delta t_k$$

   where the weights $\Delta_{t_k} = t_k - t_{k-1}$ allow for the case when future exposure is calculated at dates that are not equally spaced over time.

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. Investment firms may use a measure that is more conservative than α multiplied by Effective EPE as calculated according to the equation above for every counterparty.

12. Where appropriate, volatilities and correlations of market risk factors used in the joint simulation of market and credit risk should be conditioned on the credit risk factor to reflect potential increases in volatility or correlation in an economic downturn.

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13. If the netting set is subject to a margin agreement, investment firms 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 is 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 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 point 8 above subject to the approval of the Commission.

Minimum requirements for EPE models

14. An investment firm's EPE model shall meet the operational requirements set out in points 15 to 39 below.

CCR control

15. The investment firm 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 investment firm'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 investment firm. The work of this unit shall be closely integrated into the day-to-day credit risk management process of the investment firm. Its output shall, accordingly, be an integral part of the process of planning, monitoring and controlling the investment firm's credit and overall risk profile.

16. An investment firm 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.

17. An investment firm's risk management policies shall take account of market, liquidity, and legal and operational risks that can be associated with CCR. The investment firm shall not undertake business with a counterparty 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 counterparty level (aggregating CCR exposures with other credit exposures) and at the firm-wide level.

18. An investment firm'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 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.

19. The daily reports prepared on an investment firm'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 investment firm's overall CCR exposure.

20. An investment firm's CCR management system shall be used in conjunction with internal credit and trading limits. Credit and trading limits shall be related to the investment firm's risk measurement model in a manner that is consistent over time and that is well understood by credit managers, traders and senior management.

21. An investment firm's measurement of CCR shall include measuring daily and intra-day usage of credit lines. The investment firm shall measure current exposure gross and net of collateral. At portfolio and counterparty level, the investment firm shall calculate and monitor peak exposure or PFE at the confidence interval chosen by the investment firm. The investment firm shall take account of large or concentrated positions, including by groups of related counterparties, by industry, by market, etc.

22. An investment firm 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 investment firm'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.

23. An investment firm 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 investment firm's CCR management system shall be well documented and shall provide an explanation of the empirical techniques used to measure CCR.

24. An investment firm 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 point 15 above 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

25. 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 investment firm. The model's output shall accordingly play an essential role in the credit approval, CCR

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management, internal capital allocation and corporate governance of the investment firm.

26. An investment firm shall have a track record in the use of models that generate a distribution of exposures to CCR. Thus, the investment firm 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 Commission.

27. The model used to generate a distribution of exposures to CCR shall be part of a CCR management framework that 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, an investment firm shall measure and manage current exposures. Where appropriate, the investment firm shall measure current exposure gross and net of collateral. The use test is satisfied if an investment firm uses other CCR measures, such as peak exposure or PFE, based on the distribution of exposures generated by the same model to compute EPE.

28. An investment firm shall have the systems capability to estimate EE daily if necessary, unless it demonstrates to the Commission that its exposures to CCR warrant less frequent calculation. The investment firm 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.

29. 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 investment firm shall have procedures in place to identify and control the risks for counterparties where the exposure rises beyond the one-year horizon. The forecast increase in exposure shall be an input into the investment firm’s internal capital model.

Stress testing

30. An investment firm 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 investment firm as part of the process set out in paragraph 31 of Chapter 6 of this Part. Stress testing shall also involve identifying possible events or future changes in economic conditions that could have unfavourable effects on an investment firm’s credit exposures and an assessment of the investment firm’s ability to withstand such changes.

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31. The investment firm 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 counterparty or groups of counterparties), correlation risk across market and credit risk, and the risk that liquidating the counterparty's positions could move the market. Stress tests shall also consider the impact on the investment firm's own positions of such market moves and integrate that impact in its assessment of CCR.

Wrong-Way Risk

32. Investment firms shall give due consideration to exposures that give rise to a significant degree of General Wrong-Way Risk.

33. Investment firms 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 modelling process

34. 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 that 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.

35. 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. An investment firm 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

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available, internal policies shall identify suitable proxies and the investment firm 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 investment firm shall have adequate historical data to model the volatility of the collateral.

36. The model shall be subject to a validation process. The process shall be clearly articulated in investment firm'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 may result in an understatement of EPE. The validation process shall include a review of the comprehensiveness of the model.

37. An investment firm 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 investment firm shall identify and manage its exposures to specific wrong-way risk;

    (b) For exposures with a rising risk profile after one year, the investment firm 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 investment firm 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.

38. An investment firm 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 that meets the requirements set out in Part 7 of this Annex.

39. An investment firm that 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 Annex VIII of this Part.

Validation requirements for EPE models

40. An investment firm's EPE model shall meet the following validation requirements:

    (a) The qualitative validation requirements set out in Annex V, Part D;

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(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 options shall account for the nonlinearity 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. An investment firm 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 counterparties 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 investment firm 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 Annex VIII of this Part; and

(f) Static, historical back-testing on representative counterparty portfolios shall be part of the model validation process. At regular intervals, an investment firm shall conduct such back-testing on a number of representative counterparty portfolios (actual or hypothetical). These representative portfolios shall be chosen based on their sensitivity to the material risk factors and correlations to which the investment firm is exposed.

If back-testing indicates that the model is not sufficiently accurate, the Commission 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 investment firms pursuant to paragraph 33 of Chapter 6 of this Part.

PART 7

Contractual netting (contracts for novation and other netting agreements)

(a) Types of netting that the Commission may recognise

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For the purpose of this Part, "counterparty" 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 an investment firm and a counterparty which creates a single legal obligation covering all included bilateral master agreements and transactions belonging to different product categories. Contractual cross product netting agreements do 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 Annex IV, of this Part.

The Commission may recognise as risk-reducing the following types of contractual netting:

(i) Bilateral contracts for novation between an investment firm and its counterparty 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 an investment firm and its counterparty, and

(iii) Contractual cross product netting agreements for investment firms that have received approval by the Commission to use the method set out in Part 6 of this Annex, for transactions falling under the scope of that method. Netting across transactions entered by members of a group is not recognised for the purposes of calculating capital requirements.

(b) Conditions for recognition

The Commission may recognise contractual netting as risk-reducing only under the following conditions:

(i) An investment firm must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the investment firm would have a claim to receive or

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an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions,

(ii) An investment firm must have made available to the Commission 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 investment firm's claims and obligations would be limited to the net sum, as described in (i), under:

- The law of the jurisdiction in which the counterparty 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) An investment firm must 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 investment firm maintains all required documentation in its files,

(v) The effects of netting shall be factored into the investment firm's measurement of each counterparty's aggregate credit risk exposure and the investment firm's manages its CCR on such a basis, and

(vi) Credit risk to each counterparty 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 Commission must 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 the Commission is not satisfied in that respect, the contractual netting agreement will not be recognised as risk-reducing for either of the counterparties.

The Commission may accept reasoned legal opinions drawn up by types of contractual netting.

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No contract containing a provision which permits a non-defaulting counterparty 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.

In addition, for contractual cross-product netting agreements the following criteria shall be met:

(a) The net sum referred to in subpoint (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 subpoint (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 Member State in which the investment firm is authorised or a memorandum of law that addresses all relevant issues in a reasoned manner;

(c) The investment firm shall have procedures in place under subpoint (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 investment firm shall continue to comply with the requirements for the recognition of bilateral netting and the requirements of Chapter 3 of this Part 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 of this Annex 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 of this Annex, in:

- Step (a): the current replacement cost, and in

- Step (b): the notional principal amounts or underlying values

may be obtained taking account of the contract for novation. In the application of Part 4 of this Annex, in step (a) the notional principal amount may be calculated taking account of the contract for novation; the percentages of Table 2 of this Annex must 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 investment firm 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 counterparty 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 counterparty 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 of this Annex

- NGR = ‘net-to-gross ratio’: at the discretion of the Commission 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 counterparty (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counterparty (denominator), or

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(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).

If the Commission permit investment firms a choice of methods, the method chosen is to 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 of this Annex, 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 2 of this Annex, and

- For all other contracts included in a netting agreement, the percentages applicable may be reduced as indicated in Table 5:

Table 5

Original maturity ([5])	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%

([5])In the case of interest-rate contracts, investment firms may, subject to the consent of the Commission, choose either original or residual maturity.

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ANNEX IV

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) Oher 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) above concerning other reference items or indices. This includes as a minimum all instruments specified in paragraphs 4 to 7, 9 and 10 of Part III of the Thrid Annex of the Law not otherwise included in points 1 or 2 above.

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ANNEX V

TECHNICAL CRITERIA CONCERNING THE ORGANISATION AND TREATMENT OF RISKS

1. GOVERNANCE

1. Arrangements shall be defined by the management body described in section 12(3) of the Law concerning the segregation of duties in the organisation and the prevention of conflicts of interest.

2. TREATMENT OF RISKS

2. The management body described in section 12(3) of the Law shall approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the investment firm 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 COUNTERPARTY 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 investment firm's target markets and overall credit strategy.

4. RESIDUAL RISK

6. The risk that recognised credit risk mitigation techniques used by the investment firm 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 counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, and including in particular risks associated with large indirect credit exposures (e.g. to a single 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 investment firms 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 is 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 investment firms 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 an investment firm’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 laid down in Part A, Chapter 1, paragraph 1(16), investment firms 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 an investment firm‘s ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

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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 investment firms maintain adequate levels of liquidity buffers. 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.'

    (a) The strategies, policies, processes and systems referred to in paragraph 14 shall be proportionate to the complexity, risk profile, scope of operation of the investment firm and risk tolerance set by the management body and reflect the investment firm's importance in each Member State, in which it carries on business. Investment firms shall communicate risk tolerance to all relevant business lines.

15. Investment firms shall develop methodologies for the identification, measurement, management and monitoring of funding positions. Those methodologies shall 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. Investment firms shall distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. They shall also 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. Investment firms shall also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the EEA.

18. Investment firms shall consider different liquidity risk mitigation tools, including a system of limitsand liquidity buffers in order to be able to withstand a range of different stress events and anadequately diversified funding structure and access to funding sources. Those arrangements shall be reviewed regularly.

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. For these purposes, alternative scenarios shall address, in particular, off-balance sheet items and other contingent liabilities, including those of SSPEs or other special

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purpose entities, in relation to which the investment firm acts as sponsor or provides material liquidity support.

20. Investment firms shall consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time horizons and varying degrees of stressed conditions shall be considered.

21. Investment firms shall adjust their 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, investment firms shall have in place contingency plans setting out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls. Those plans shall be regularly tested, updated on the basis of the outcome of the alternative scenarios set out in paragraph 19, be reported to and approved by senior management, 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, investment firms 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 investment firm;

    (b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the investment firm, and incorporates measures to avoid conflicts of interest;

    (c) the management body, in its supervisory function, of the investment firm adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;

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(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 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 paragraphs 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 investment firm 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 investment firm and its business risks;

(i) the total variable remuneration does not limit the ability of the investment firm 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 investment firms 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 Commission requires investment firms to restructure remuneration in a manner aligned with sound risk management and long-term growth, including,

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where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the investment firm within the meaning of paragraph 12 (3) of the Law;

(iii) no variable remuneration is paid to the persons who effectively direct the business of the investment firm within the meaning of paragraph 12 (3) of the Law 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.

Investment fimrs 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 investment firm 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 investment firm concerned or share-linked instruments or equivalent non-cash instruments, in case of a non- listed investment firm, and

(ii) where appropriate, other instruments within the meaning of paragraph 9(1a), point (a), Chapter 1 of Part B, that adequately reflect the credit quality of the investment firm 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 investment firm. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit certain instruments as 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 investment firm as a whole, and justified according to the performance of the investment firm, the business unit and the individual concerned.

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the investment firm 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 investment firm.

If the employee leaves the investment firm before retirement, discretionary pension benefits shall be held by the investment firm 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 insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

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(t) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of this Directive.

The principles set out in this paragraph shall be applied by investment firm at group, parent company and subsidiary levels, including those established in offshore financial centres.

The Commission shall collect information on the number of individuals per investment firm in pay brackets of at least EUR 1 million including the business area involved and the main elements of salary, bonus, long-term award and pension contribution. That information shall be forwarded to the EBA, which shall disclose it.

24. Investment firms 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 investment firm 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 investment firm concerned. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the investment firm.

ANNEX VI

STANDARDISED APPROACH

PART1

RISK WEIGHTS

1. EXPOSURES TO CENTRAL GOVERNMENTS OR CENTRAL BANKS

1.1. Treatment

1. Without prejudice to points 2 to 7 below, exposures to central governments and central banks shall be assigned a 100% risk weight.

2. Subject to point 3 below, 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 of this Annex in accordance with the assignment of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale, as this is determined in paragraph 6(1) of Chapter 1 of this Part.

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 Member 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 third country which apply supervisory and regulatory arrangements at least equivalent to those applied in the Community assign a risk weight which is lower than that indicated in point 1 and 2 above to exposures to their central

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government and central bank denominated and funded in the domestic currency, the Commission shall allow their investment firms to risk weight such exposures in the same manner.

For the purposes of this Annex, “third countries which apply supervisory and regulatory arrangements at least equivalent to those applied in the Community” are considered to be Australia, Canada, Japan, Switzerland, USA and Russia.

1.3. Use of credit assessments by Export Credit Agencies

6. Export Credit Agency credit assessments shall be recognised by the Commission 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 recognised 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%

The investment firms that wish to use Export Credit Agency assessments must prove to the Cyprus Securites and Exchange Commission that one of the two conditions of point 6 above is fulfilled.

The rules provided for in points 2, 3, 6 and 7 of Part 2 of this Annex shall also be implemented when an investment firm uses the assessments of Export Credit Agencies for the calculation of risk weights.

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2. EXPOSURES TO REGIONAL GOVERNMENTS OR LOCAL AUTHORITIES

8. Without prejudice to points 9, 10 and 11 below, exposures to regional governments and local authorities shall be risk weighted as follows:

   (a) Exposures to regional governments and local authorities shall be assigned a risk weight that corresponds to the credit quality step of the exposure to the central government in whose jurisdiction they are established, according to Table 3, based on the assignment of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale, as this is determined in paragraph 6(1) of Chapter 1 of this Part.

Table 3

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

   (b) Exposures to regional governments and local authorities which are in countries of which the central government is unrated shall be assigned a risk weight of 100%.

   (c) Exposures to regional governments and local authorities with original effective maturity of three months or less shall be assigned a risk weight of 20%.

9. Member States 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 institutional arrangements the effect of which is to reduce their risk of default.

   The Commission shall draw up and make public the list of the regional governments and local authorities to be risk-weighted like central governments.

   The Commission believes, at the moment, that the local authorities of Cyprus do not fulfill the requirements of this paragraph. If in the future these requirements are fulfilled, the Commission will draw up and make public a relevant list.

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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 point 9 above shall not apply. In this case for the purposes of paragraph 13 (1) (a) of Chapter 1 of this Part, permission to apply paragraphs 2 to 7 of Chapter 1 of this Part shall not be excluded.

11. When competent authorities of a third country 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 Commission shall allow their investment firms 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 regional governments and local authorities of the Member States denominated and funded in the domestic currency of that regional government and local authority shall be assigned a risk weight of 20%.

3. EXPOSURES TO ADMINISTRATIVE BODIES AND NON-COMMERCIAL UNDERTAKINGS

3.1. Treatment

12. Without prejudice to points 13 to 17 below, exposures to administrative bodies and non-commercial undertakings shall be assigned a 100% risk weight.

3.2. Public Sector Entities

13. Without prejudice to points 14 to 17 below, exposures to public sector entities shall be assigned a 100% risk weight.

14. (a) Exposures to public sector entities in Cyprus, which fall within the scope of the definition specified in paragraph 1 of Part A, shall be risk weighted based on the risk weight of the central government, according to Table 3 in point 8 of this Part.

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(b) The following public sector entities in Cyprus fall within the scope of the definition specified in paragraph 1 of Part A, and are risk weighted according to this paragraph:

(i) Cyprus Antidrugs Council (Αντιναρκωτικό Συμβούλιο Κύπρου)

(ii) Cyprus Radio Television Authority (Αρχή Ραδιοτηλεόρασης Κύπρου)

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(iii) Cyprus Sport Organisation (Κυπριακός Οργανισμός Αθλητισμού)

(iv) Cyprus Organisation for Storage and Management of Oil Stocks (Κυπριακός Οργανισμός Διαχείρισης Αποθεμάτων Πετρελαιοειδών)

(v) Cyprus Agricultural Payments Organisation (Οργανισμός Αγροτικών Πληρωμών)

(vi) Youth Board (Οργανισμός Νεολαίας)

(vii) University of Cyprus (Πανεπιστήμιο Κύπρου)

(viii) Cyprus Energy Regulatory Authority (Ρυθμιστική Αρχή Ενέργειας Κύπρου)

(ix) Cyprus University of Technology (Τεχνολογικό Πανεπιστήμιο Κύπρου)

The Commission will examine the inclusion of other entities on the above list, after receiving the relevant application from investment firms which is accompanied with proof that the specific entity falls within the scope of the definition of public sector entities as specified in paragraph 1 of Part A.

(c) Exposures to public sector entities in Cyprus, which fall within the scope of the definition secified in paragraph 1 of Part A, with original effective maturity of three months or less shall be assigned a risk weight of 20%.

The Commission should allow the above treatment only if the Public Sector Entities meet the following criteria:

(a) They are responsible to the public sector,

(b) They carry out non commercial functions, and

(c) They are, according to their memorandum of association, bankruptcy remote.

15. In exceptional circumstances, exposures to public-sector entities in Cyprus may be treated as exposures to the central government of Cyprus where in the opinion of the Commission there is no difference of the risk between such exposures because of the existence of an appropriate guarantee by the central government of Cyprus.

16. When the discretion to treat exposures to public-sector entities as exposures to institutions or as exposures to the central government in whose jurisdiction they are established is exercised

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by the competent–authorities of one Member State, the Commission shall allow their investment firms to risk-weight exposures to such public-sector entities in the same manner.

17. When competent authorities of a third country jurisdiction, which apply supervisory and regulatory arrangements at least equivalent to those applied in the Community, treat exposures to public sector entities as exposures to institutions, the Commission shall allow their investment firms 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 paragraphs 2 to 7 of Chapter 1 of this Part, the Inter-American Investment Corporation, the Black Sea Trade and Development Bank and the Central American Bank for Economic Integration are considered to be Multilateral Development Banks (MDB).

4.2. Treatment

19. Without prejudice to points 20 and 21 below, exposures to multilateral development banks shall be treated in the same manner as exposures to institutions in accordance with points 26 to 29 below. The preferential treatment for short-term exposures as specified in points 28, 29 and 34 below 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;

(l) The Multilateral Investment Guarantee Agency.

(m) International Finance Facility for Immunisation

(n) Islamic Development Bank

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 INSTITUTIONS

6.1. Treatment

23. The method described in points 26 to 29 below shall apply in determining the risk weights for exposures to institutions.

24. Without prejudice to the other provisions of points 23 to 38 below, exposures to financial institutions authorised and supervised by the competent authorities responsible for the authorisation and supervision of institutions and subject to prudential requirements equivalent to those applied to investment firms shall be risk-weighted as exposures to institutions.

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6.2. Risk-weight floor on exposures to unrated institutions

25. Exposures to an unrated institution shall not be assigned a risk weight lower than that applied to exposures to its central government.

6.3. Central government risk weight based method

26. Exposures to 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 institution is incorporated are assigned in accordance with Table 4.

Table 4

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

27. Exposures to an institution established in a third country where their central government is unrated a risk weight of 100% .

28. Exposures to an institution with an original effective maturity of three months or less a risk weight of 20% is assigned.

29. Point deleted.

6.4. Interaction with short-term credit assessments

30. Point deleted.
31. Point deleted.
32. Point deleted.
33. Point deleted.

6.5. Short-term exposures in the national currency of the borrower

34. Exposures to institutions that have been established in the Rebuplic of a residual maturity of 3 months or less denominated and funded in the national currency shall be assigned, under the method described in points 26 to 29 above, a risk weight that is one category less favourable than the preferential risk weight assigned to exposures to the Government of Cyprus, as described in points 4 and 5 above, i.e. a risk weight of 20%.

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35. When the competent authorites of other Member States allow exposures to institutions that have been established in their jurisdiction with a residual maturity of three months or less that are funded and denominated in their national currency to be assigned a risk weight that is one category less favourable than the preferential risk weight assigned to exposures to their central governments that are funded and denominated in their local currency, as described in points 4 and 5 above, i.e. 0%, then investment firms may assign to such exposures a risk weight that is one category less favourable, i.e. 20%.

36. When the competent authorities of a third country jurisdiction that applies supervisory and regulatory arrangements at least equivalent to those applied in the Community treat exposures to institutions that have been established in their jurisdiction with residual maturity of three months or less funded and denominated in their national currency to be assigned a risk weight one category less favourable than the preferential risk weight assigned to exposures to its central government funded and denominated in its local currency, then investment firms may assign to such exposures a risk weight that is one category less favourable than the preferential risk weight, i.e. 20%.

37. 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%.

6.6. Investments in regulatory capital instruments

38. Investments in equity or regulatory capital instruments issued by institutions shall be risk weighted at 100%, unless deducted from the own funds.

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7. EXPOSURES TO CORPORATES

7.1. Treatment

39. Exposures for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 6 in accordance with the assignment of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale, as this is determined in paragraph 6(1) of Chapter 1 of this Part.

Table 6

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

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40. 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

41. Exposures that comply with the criteria listed in paragraph 3 (2) of Chapter 1 of this Part shall be assigned a risk weight of 75%.

9. EXPOSURES SECURED BY REAL ESTATE PROPERTY

42. Without prejudice to points 43 to 57, exposures fully secured by real estate property shall be assigned a risk weight of 100%.

9.1. Exposures secured by mortgages on residential property

43. Exposures or any part of an exposure fully and completely secured 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%.

44. Exposures fully and completely secured 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%.

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

46. In the exercise of their judgement for the purposes of points 43 to 45 above, the Commission 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 does 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 does not materially depend on any cash flow generated by the underlying property serving as collateral;

(c) The minimum requirements set out in Annex VIII, Part 2, point 8 and the valuation rules set out in Annex VIII, Part 3, points 62 to 65 of this Part are met; and

(d) The value of the property exceeds the exposures by a substantial margin, as specified in point 47 below.

47. For the application of points 43 to 45 above, the risk weight of 35% shall apply only to the part of the loan with a loan to value ratio (LTV) of 75%. Any part of the loan not covered by the above ratio shall be risk weighted at 75%, provided that the criteria of paragraph 3(2) of Chapter 1 of this Part are met which relates to retail exposures, or if the criteria are not met, shall be risk weighted in accordance to the exposure class it belongs to.

48. The Commission shall allow investment firms to apply the risk weight of 35% to exposures secured by mortgages on residential property that are situated in another Member State provided that these exposures meet the requirements that have been determined by the competent authorities of the Member State concerned, in order for these exposures secured by mortgages on residential property to be considered as fully and completely secured.

    It is clarified that if a Competent Authority of another Member State exercises the discretion to dispence with the condition in point 46 (b) above, the Commission shall allow a risk weight of 35% on exposures fully and completely secured by mortgages on residential property situated in the territory of the Member State concerned.

9.2. Exposures secured by mortgages on commercial real estate

49. Exposures or any part of an exposure fully and completely secured by mortgages on offices or other commercial premises or building ground in which the borrower builds a commercial property situated within the Republic shall be assigned a risk weight of 50%.

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

51. Exposures related to property leasing transactions concerning offices or other commercial premises situated in the Republic under which the investment firm is the lessor and the tenant has an option to purchase shall be assigned a risk weight of 50% provided that the exposure of the investment firm is fully and completely secured by its ownership of the property.

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52. The application of points 49 to 51 above is subject to the following conditions:

    (a) The value of the property must 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;

    (b) The risk of the borrower must 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 must not materially depend on any cash flow generated by the underlying property serving as collateral; and

    (c) The minimum requirements set out in Annex VIII, Part 2, point 8, and the valuation rules set out in Annex VIII, Part 3, points 62 to 65 of this Part are met.

53. The 50% risk weight shall be assigned to the part of the loan that does not exceed 50% of the market value of the property in question.

54. A 100% risk weight shall be assigned to the part of the loan that exceeds the limits set out in point 53 above.

55. When the competent authorities of another Member State assign a risk weight of 50% to exposures contained in points 49 to 51 above, the Commission shall allow their investment firms to risk weight at 50% such exposures fully and completely secured by mortgages on commercial property.

56. It is clarified that the exercise of point 55 above is subject to the conditions in points 52 to 54 above to the degree these conditions have been adopted by the competent authorities of the Member State in which the commercial real estate is situated.

57. When the competent authorities of another Member State, dispence condition (b) of point 52 above the Commission shall allow their investment firms to assign a risk weight of 50% to such exposures fully and completely secured by mortgages on such commercial property.

10. PAST DUE ITEMS

58. Without prejudice to the provisions contained in points 60 to 63 below, the unsecured part of any item that is past due for more than 90 days and which is above a threshold defined by the Commission in point 61 below 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.

59. In cases where eligible collateral covers more than one exposure of a client, for the purposes of point 58 above, its value is allocated to each individual exposure based on the proportion of the account balance of each exposure after the deduction of the collaterals that secure specifically each exposure. Furthermore, in cases where the value adjustments are calculated on a client level, these must be allocated on the account balance level proportionally to the unsecured risk exposure that is calculated after the allocation of the collaterals in the manner described above. It is clarified that the suspension of interest is included in the value adjustments.

60. 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.

61. The Commission determines the following maximum limits for the purposes of point 58 above as follows:

(a) For non revolving loans, the limit is set at 20% of the amount of one instalment, or in the case of a repayment schedule that provides for the payment only of interest, 20% of the interest of one month, three months, six months or one year according to the frequency of payment of interest that is provided by the repayment schedule.

(b) For the overdraft accounts, the limit is set at the excess by 5% of the advised limit of each account. In cases of debit balances in accounts without a limit, these are considered past due when they present a debit balance over and above the amount of €2.000 in relation to retail exposures and the equivalent amount of €20.000 in relation to other exposures.

62. Exposures indicated in points 43 to 48 above 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 value adjustments, the risk weight to be assigned to the remainder of the exposure shall be reduced to 50%.

63. Exposures indicated in points 49 to 57 above shall be assigned a risk weight of 100% if they are past due for more than 90 days.

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11. ITEMS BELONGING TO REGULATORY HIGH-RISK CATEGORIES

64. 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%.

    Private equity investment is defined as equity not listed in a stock exchange.

65. Investment firms shall be permited to assign a lower risk weight to non past due items than the 150% risk weight according to the provisions of this Part and for which value adjustments have been established i.e.:

    (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

66. "Covered bonds", shall mean bonds as defined in Section 103(6) of the Open-Ended Undertaking for Collective Investment in Transferable Securities (UCITS) and related issues Law of 2004 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 EU;

    (b) Exposures to or guaranteed by non-EU central governments, non-EU central banks, multilateral development banks, international organisations that qualify for the credit quality step 1 as set out in this Annex, and exposures to or guaranteed by non-EU public sector entities, non-EU regional governments and non-EU local authorities that are risk weighted as exposures to institutions or central governments and central banks according to points 8, 9, 14 or 15 above respectively and that qualify for the credit quality step 1 as set out in this Annex, and exposures in the sense of this point that qualify as a minimum for the credit quality step 2 as set out in this Annex, provided that they do not exceed 20% of the nominal amount of outstanding covered bonds of issuing institutions;

    (c) Exposures to institutions that qualify for the credit quality step 1 as set out in this Annex. The total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds of the issuing investment firm. 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

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comprised by the 15% limit. Exposures to institutions in the EU with a maturity not exceeding 100 days shall not be comprised by the step 1 requirement but those institutions must as a minimum qualify for credit quality step 2 as set out in this Annex;

(d) Loans secured by residential real estate or shares in Finnish residential housing companies as referred to in point 44 above 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 Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)[6] 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 Annex 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 50 above 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 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 Article 52(4) of Directive 2009/65/EC 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 Annex and that such units do not exceed 10% of the nominal amount of the outstanding issue.

[6] OJ L 302, 17.11.2009, p. 32.

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The Commission 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 Annex VIII of this Part. 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 subpoints (a) to (f) are exclusively dedicated in law to the protection of the bond-holders 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

(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.

By 31 December 2012, the European Commission shall review the appropriateness of the derogation set out in the third paragraph and, if relevant, the appropriateness of extending similar treatment to any other form of covered bond.

Until 31 December 2010 the figure of 60% indicated in subpoint (f) can be replaced with a figure of 70%.

67. Investment firms shall for real estate collateralising covered bonds meet the minimum requirements set out in Annex VIII Part 2, point 8 and the valuation rules set out in Annex

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VIII, Part 3, points 62 to 65 of this Part.

68. Notwithstanding points 66 and 67 above, covered bonds meeting the definition of Section 103(6) of the Open-Ended Undertaking for Collective Investment in Transferable Securities (UCITS) and related issues Law of 2004 and issued before 31 December 2007 are also eligible for the preferential treatment until their maturity.

69. Covered bonds shall be assigned a risk weight on the basis of the risk weight assigned to senior unsecured exposures to the investment firm which issues them. The following correspondence between risk weights shall apply:

    (a) If the exposures to the investment firm are assigned a risk weight of 20%, the covered bond shall be assigned a risk weight of 10%;

    (b) If the exposures to the investment firms are assigned a risk weight of 50%, the covered bond shall be assigned a risk weight of 20%;

    (c) If the exposures to the investment firm 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 investment firm are assigned a risk weight of 150%, the covered bond shall be assigned a risk weight of 100%.

13. ITEMS REPRESENTING SECURITISATION POSITIONS

70. Risk weight exposure amounts for securitisation positions shall be determined in accordance with Chapter 4 of this Part.

14. SHORT-TERM EXPOSURES TO INSTITUTIONS AND CORPORATES

71. Short-term exposures to an institution or corporate for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 7 as follows, in accordance with the assignment of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale, as this is determined in paragraph 6(1) of Chapter 1 of this Part.

Table 7

Credit Quality Step	1	2	3	4	5	6

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Risk weight	20%	50%	100%	150%	150%	150%

15. EXPOSURES IN THE FORM OF COLLECTIVE INVESTMENT UNDERTAKINGS (CIUS)

72. Without prejudice to points 73 to 79 below, exposures in collective investment undertakings (CIUs) shall be assigned a risk weight of 100%.

73. 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 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale, as this is determined in paragraph 6(1) of Chapter 1 of this Part.

Table 8

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

74. Where the Commission consider that a position in a CIU is associated with particularly high risks they shall require that that position is assigned a risk weight of 150%.

    A CIU is considered associated with particularly high risks if:

    (a) There is no credit assessment from an eligible ECAI; and

    (b) It has some specific charateristics (like inadequate disclosure or high levels of lending) that prevent it from meeting the conditions of point 75 below or

    (c) A significant part of its assets comprises or items with risk weights above 100% or

    (d) Its objective (as referred to in point 80 below) allows it to invest significant amounts in such items.

75. Investment firms may determine the risk weight for a CIU as set out in points 77 to 79 below, if the following eligibility criteria are met:

    (a) The CIU is managed by a company which is subject to supervision in a Member State or, subject to approval of the Commission, if:

(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 authorised 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.

76. If a competent authority of another Member State approves a third country CIU as eligible, as set out in point 75 (a) below, then the Commission shall make use of this recognition without conducting its own assessment.

77. Where the investment firm is aware of the underlying exposures of a CIU, it may look through to those underlying exposures in order to calculate an average risk weight for the CIU in accordance with the methods set out in paragraphs 2 to 7 of Chapter 1 of this Part.

78. Where the investment firm is not aware of the underlying exposures of a CIU, it may calculate an average risk weight for the CIU in accordance with the methods set out in paragraphs 2 to 7 of Chapter 1 of this Part subject to the following rules: it will 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.

79. Investment firms may rely on a third party to calculate and report, in accordance with the methods set out in points 77 and 78 below, 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

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80. The following tangible assets shall be assigned a risk weight of 100%:

    (a) Land and buildings

    (b) Plant and machinery

    (c) Fixtures and fittings

    (d) Prepayments and assets under construction

81. Prepayments and accrued income for which an investment firm is unable to determine the counterparty shall be assigned a risk weight of 100%.

82. 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.

83. Holdings of equity and other participations, except where deducted from own funds, shall be assigned a risk weight of at least 100%.

84. 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.

85. 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 counterparties to the transactions.

86. Where an investment firm 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 eligible ECAI, the risk weights prescribed in Chapter 4 of this Part shall be assigned. If the product is not rated by an eligible 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.

PART 2

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Recognition of ECAIs and mapping of their credit assessments

1. METHODOLOGY

1.1. Objectivity

1. The Commission 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 Commission 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 Commission 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 Commission 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 recognition, the Commission shall verify that the assessment methodology for each market segment is established according to standards such as the following:

   (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 the Commission; and

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(c) The Commission must be able to receive from the ECAI the extent of its contacts with the senior management of the entities which it rates.

6. The Commission 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 Commission 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 Commission 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 Commission 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 investment firms use the ECAI's individual credit assessment for bond issuing and/or assessing credit risks.

2.2. Transparency and Disclosure

10. The Commission shall verify that individual credit assessments are accessible at equivalent terms at least to all investment firms having a legitimate interest in these individual credit assessments.

11. In particular, the Commission shall verify that individual credit assessments are available to non-domestic parties on equivalent terms as to domestic investment firms having a legitimate interest in these individual credit assessments.

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3. "MAPPING"

12. In order to differentiate between the relative degrees of risk expressed by each credit assessment, the Commission 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, investment firms 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 Commission 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 Commission 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 Commission believes to present an equivalent level of credit risk.

15. When the Commission believe that the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher then the benchmark, the Commission shall assign a higher credit quality step in the credit quality assessment scale to the ECAI credit assessment.

16. When the Commission have 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, the Commission 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

1. An investment firm may nominate one or more eligible ECAIs to be used for the determination of risk weights to be assigned to asset and off-balance sheet items.

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

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

4. An investment firm 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. Points 8 and 9 above are not to prevent the application of points 66 to 69 of Part 1 of this Annex.

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

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3. LONG-TERM AND SHORT-TERM CREDIT ASSESSMENTS

12. Short-term credit assessments may 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 point 13 above, 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 a 150% risk weight.

15. Notwithstanding point 13 above, 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 point 16 above, when an exposure arises through an investment firm's participation in a loan that has been extended by a Multilateral Development Bank whose preferred creditor status is recognised in the market, the Commission shall allow the credit assessment on the obligors' domestic currency item to be used for risk weighting purposes.

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ANNEX VII

INTERNAL RATINGS 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 PD, 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 of this Annex.

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 points 5 to 9 below, the risk weighted exposure amounts for exposures to corporates, institutions and central governments and central banks shall be calculated according to the following formulae:

$$\text{Correlation (R)} = 0{,}12 * \left(\frac{1 - e^{-50*PD}}{1 - e^{-50}} \right) + 0{,}24 * \left(1 - \left(\frac{1 - e^{-50*PD}}{1 - e^{-50}} \right) \right)$$

$$\text{Maturityfactor (b)} = \left(0{,}11852 - 0{,}05478 * \ln(PD)\right)^2$$

$$\text{Risk weight (RW)} = \left(LGD * N\left[\frac{G(PD)}{\sqrt{1-R}} + \sqrt{\frac{R}{1-R}} G(0{,}999) \right] - PD * LGD \right) * \frac{\left(1 + (M - 2{,}5) * b\right)}{1 - 1{,}5 * b} * 12{,}5 * 1{,}06$$

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)

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For PD = 0, RW shall be 0.

For PD = 1:

- For defaulted exposures where investment firms apply the LGD values set out in Part 2, point 8 of this Annex, RW shall be 0; and

- For defaulted exposures where investment firms use own estimates of LGDs, RW shall be $Max\{0, \ 12{,}5*(LGD - EL_{BE})\}$;

where EL_{BE} shall be the investment firms best estimate of expected loss for the defaulted exposure according to point 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 Annex VIII, Part 1, point 25 and Annex VIII, Part 2, point 22 of this Part may be adjusted according to the following formula:

   Risk—weighted exposure amount = RW * exposure value * ((0,15 + 160*PDpp)]

   where:

   PDpp = probability of default (PD) of the protection provider.

   RW shall be calculated using the relevant risk weight formula set out in point 3 above 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 firm is a part is less than EUR 50 million, investment firms 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.

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$$\text{Correlation (R)} = 0{,}12 * \left(\frac{1 - e^{-50*PD}}{1 - e^{-50}} \right) + 0{,}24 * \left[1 - \left(\frac{1 - e^{-50*PD}}{1 - e^{-50}} \right) \right] - 0{,}04 * \left(1 - \frac{(S - 5)}{45} \right)$$

Investment firms 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.

6. For specialised lending exposures in respect of which an investment firm cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4 of this Annex 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 or more than 2,5 years	70%	90%	115%	250%	0%

The Commission shall authorise an investment firm 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 investment firm’s underwriting characteristics and other risk characteristics are substantially strong for the relevant category.

In assigning risk weights to specialised lending exposures investment firms shall take into account the following factors: financial strength, political and legal environment, transaction and/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 investment firms shall comply with the minimum requirements set out in points 105 to 109 of Part 4 of this Annex. For purchased corporate receivables that comply in addition with the conditions set out in point 14 below, and where it would be unduly burdensome for an investment firm to use the risk quantification standards for corporate exposures as set out in Part 4 of this Annex for these receivables, the risk quantification standards for retail exposures as set out in Part 4 of this Annex may be used.

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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 an investment firm 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 eligible ECAI the risk weights set out in Chapter 4 of this Part will be applied. If the product is not rated by an eligible ECAI, the risk weights of the exposures included in the basket will be aggregated, excluding n-1 exposures where the sum of the expected 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 points 12 and 13 below, the risk weighted exposure amounts for retail exposures shall be calculated according to the following formulae:

$$\text{Correlation (R)} = 0{,}03 * \left(\frac{1-e^{-35*PD}}{1-e^{-35}}\right) + 0{,}16 * \left[1-\left(\frac{1-e^{-35*PD}}{1-e^{-35}}\right)\right]$$

$$\text{Risk weighted(RW)} = \left(LGD * N\left[\frac{G(PD)}{\sqrt{1-R}} + \sqrt{\frac{R}{1-R}}G(0{,}999)\right] - PD * LGD\right) * 12{,}5 * 1{,}06$$

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 investment firm’s best estimate of expected loss for the defaulted exposure according to point 80 of Part 4 of this Annex.

Risk—weighted exposure amount = RW * exposure value.

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11. The risk weighted exposure amount for each exposure to small and medium sized entities as defined in paragraph 10 (4) of Chapter 2 of this Part which meets the requirements set out in Annex VIII, Part 1, point 25 and Annex VIII, Part 2, point 22 of this Part may be calculated according to point 4 above.

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 point 10 above.

13. For qualifying revolving retail exposures as defined in points (a) to (e), a correlation (R) of 0,04 shall replace the figure produced by the correlation formula in point 10 above.

    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 investment firm. (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 investment firm.). Undrawn commitments may be considered as unconditionally cancellable if the terms permit the investment firm 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 investment firm can demonstrate that the use of the correlation of this point 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 Commission 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 Commission concurs that treatment as a qualifying revolving retail exposure is consistent with the underlying risk characteristics of the sub-portfolio.

14. To be eligible for the retail treatment, purchased receivables shall comply with the minimum requirements set out in Part 4, points 105 to 109 of this Part and the following conditions:

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(a) The investment firm 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 investment firm itself;

(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 investment firm 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 investment firms 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. An investment firm may employ different approaches to different portfolios where the investment firm itself uses different approaches internally. Where an investment firm uses different approaches, the investment firm shall demonstrate to the Commission that the choice is made consistently and is not determined by regulatory arbitrage considerations.

18. Notwithstanding point 17 above, the Commission shall allow the attribution of risk weighted exposure amounts for equity exposures to ancillary services undertakings, in relation to investments which do not exceed the 20% of the share capital of each undertaking, 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.

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Risk weight (RW) = 290% for exchange traded equity exposures.

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 are to 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 point 15, Part 2 of Annex VII of this Part.

21. Investment firms may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in Chapter 3 of this Part.

1.3.2. PD/LGD approach

22. The risk weighted exposure amounts shall be calculated according to the formulas in point 3 above. If investment firms do not have sufficient information to use the definition of default set out in points 44 to 48 of Part 4 of this Annex, 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. Investment firms may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in Chapter 3 of this Part. 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 investment firm'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 individual exposure level shall not be less than the sum of minimum risk weighted exposure amounts required under the PD/LGD Approach and the

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corresponding expected loss amounts multiplied by 12,5 and calculated on the basis of the PD values set out in Part 2, point 23 (a) and the corresponding LGD values set out in Part 2, points 24 and 25 of this Part.

26. Investment firms 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 value in which case it should be provisioned for each year and will be calculated as follows:

$$\frac{1}{t} * 100\% * \text{exposure value},$$

where t is the number of years of the lease contract term.

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 point 3 above. The input parameters PD and LGD shall be determined as set out in Part 2 of this Annex, the exposure value shall be determined as set out in Part 3 of this Annex and M shall be 1 year. If investment firms can demonstrate to the Commission that dilution risk is immaterial, it need 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 of this Annex and the exposure value shall be determined as set out in Part 3 of this Annex.

30. The expected loss amounts for exposures to corporates, institutions, central governments and central banks and retail exposures shall be calculated according to the following formulae:

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Expected loss (EL) = PD * LGD.

Expected loss amount = EL * exposure value.

For defaulted exposures (PD =1) where investment firms use own estimates of LGDs, EL shall be EL_{BE}, the investment firm's best estimate of expected loss for the defaulted exposure according to Part 4, point 80 of this Annex.

For exposures subject to the treatment set out in point 4 above, EL shall be 0.

31. The EL values for specialised lending exposures where investment firms use the methods set out in point 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 Commission has authorised an investment firm 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 points 19 to 21 above, 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

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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 points 22 to 24 above shall be calculated according to the following formulae:

    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 points 25 to 26 above 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 points 30, 31 and 35 above 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 Part 3, point 1 of this Annex 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 of this Annex shall be those estimated by the investment firm in accordance with Part 4 of this Annex, subject to the following provisions.

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1. EXPOSURES TO CORPORATES, INSTITUTIONS AND CENTRAL GOVERNMENTS AND CENTRAL BANKS

1.1. PD

2. The PD of an exposure to a corporate or an institution shall be at least 0,03%.

3. For purchased corporate receivables in respect of which an investment firm cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4 of this Annex, the PDs for these exposures shall be determined according to the following methods: for senior claims on purchased corporate receivables PD shall be the investment firms estimate of EL divided by LGD for these receivables. For subordinated claims on purchased corporate receivables PD shall be the investment firm's estimate of EL. If an investment firm 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. Investment firms may recognise unfunded credit protection in the PD in accordance with the provisions of Chapter 3 of this Part.

6. Investment firms using own LGD estimates may recognise unfunded credit protection by adjusting PDs subject to point 10 below.

7. For dilution risk of purchased corporate receivables, PD shall be set equal to EL estimate for dilution risk. If an investment firm 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. Investment firms may recognise unfunded credit protection in the PD in accordance with the provisions of Chapter 3 of this Part. If an investment firm 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 point 10 below.

1.2. LGD

8. Investment firms shall use the following LGD values:

   (a) Senior exposures without eligible collateral: 45%;

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(b) Subordinated exposures without eligible collateral: 75%;

(c) Investment firms may recognise funded and unfunded credit protection in the LGD in accordance with Chapter 3 of this Part;

(d) Covered bonds as defined in Annex VI, Part 1, points 66 to 68 of this Part shall be assigned an LGD value of 11,25%;

(e) For senior purchased corporate receivables exposures where an investment firms cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4 of this Annex: 45%;

(f) For subordinated purchased corporate receivables exposures where an investment firm cannot demonstrate that its PD estimates meet the minimum requirements set out in Part 4 of this Annex: 100%; and

(g) For dilution risk of purchased corporate receivables: 75%.

Until 31 December 2010, covered bonds as defined in Annex VI, Part 1, points 66 to 68 of this Part may be assigned an LGD value of 11,25% if:

- Assets as set out in Annex VI, Part 1, point 66 (a) to (c) of this Part collateralising the bonds all qualify for credit quality step 1 as set out in that Annex;

- Where assets set out in Annex VI, Part 1, point 66 (d) and (e) of this Part are used as collateral, the respective upper limits laid down in each of those points is 10% of the nominal amount of the outstanding issue;

- Assets as set out in Annex VI, Part 1, point 66 (f) of this Part 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 point 8 above, for dilution and default risk if an investment firm 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 point 8 above, if an investment firm is permitted to use own LGD estimates for exposures to corporates, institutions, central governments and central banks, unfunded credit protection may be recognised by adjusting PD and/or LGD subject to minimum requirements as specified in Part 4 of this Annex and approval of the Commission. An investment firm 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 points 8 and 10 above, for the purposes of Part 1, point 4 of this Annex, 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.

1.3. Maturity

12. Subject to point 13 below, investment firms 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 Commission may require all investment firms in their jurisdiction to use M for each exposure as set out under point 13 below.

13. Investment firms permitted to use own LGDs and/or own conversion factors for exposures to corporates, institutions or central governments and central banks shall calculate M for each of these exposures as set out in (a) to (e) and subject to points 14 and 15 below. 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:

$$M = \max\left\{1; \min\left\{\frac{\sum_t t * CF_t}{\sum_t CF_t};\ 5\right\}\right\}$$

    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 Annex IV of this Part) 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;

(d) If an investment firm 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 investment firm 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 point or when an investment firm 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 investment firms using the Internal Model Method set out in Annex III, Part 6 of this Part 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:

$$M = \min\left(\frac{\sum_{k=1}^{tk \le 1 year} EffectiveEE_k * \Delta t_k * df_k + \sum_{tk > 1 year}^{maturity} EE_k * \Delta t_k * df_k}{\sum_{k=1}^{tk \le 1 year} EffectiveEE_k * \Delta t_k * df_k} \right)$$

where:

df_k = the risk-free discount factor for future time period t_k and the remaining symbols are defined in Annex III, Part 6 of this Part.

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Notwithstanding the first paragraph of point 13(f) above, an investment firm that uses an internal model to calculate a one-sided credit valuation adjustment (CVA) may use, subject to the approval of the Commission, the effective credit duration estimated by the internal model as M.

Subject to point 14 below, for netting sets in which all contracts have an original maturity of less than one year the formula in point (a) shall apply; and

(g) For the purposes of Part 1, point 4 of this Annex, M shall be the effective maturity of the credit protection but at least 1 year.

14. Notwithstanding point 13(a), (b), (d) and (e) above, M shall be at least one-day for:

- Fully or nearly-fully collateralised derivative instruments listed in Annex IV of this Part;
- 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 Commission which are not part of the investment firms 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. Maturity mismatches shall be treated as specified in Chapter 3 of this Part.

2. RETAIL EXPOSURES

2.1. PD

16. The PD of an exposure shall be at least 0,03%.

17. The PD of obligors or, where an obligation approach is used, of exposures in default shall be 100%.

18. For dilution risk of purchased receivables PD shall be set equal to EL estimates for dilution risk. If an investment firm 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.

19. Unfunded credit protection may be recognised as eligible by adjusting PDs subject to point 21 below. For dilution risk, where investment firms do not use own estimates of LGDs, this shall be subject to compliance with Chapter 3 of this Part.

2.2. LGD

20. Investment firms shall provide own estimates of LGDs subject to minimum requirements as specified in Part 4 of this Annex and approval of the Commission. For dilution risk of purchased receivables, an LGD value of 75% shall be used. If an investment firm 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.

21. Unfunded credit protection may be recognised as eligible by adjusting PD or LGD estimates subject to minimum requirements as specified in Part 4, points 99 to 104 of this Annex and approval of the Commission either in support of an individual exposure or a pool of exposures. An investment firm 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.

22. Notwithstanding point 21 above, for the purposes of Part 1, point 11 of this Annex 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

23. PDs shall be determined according to the methods for corporate exposures.

    The following minimum PDs shall apply:

    (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 Part 1, point 20 of this Annex; and

(d) 1,25% for all other equity exposures including other short positions as set out in Part 1, point 20 of this Annex.

3.2. LGD

24. Private equity exposures in sufficiently diversified portfolios may be assigned an LGD of 65%.

25. All other exposures shall be assigned an LGD of 90%.

3.3. Maturity

26. M assigned to all exposures shall be 5 years.

PART 3

Exposure value

1. EXPOSURES TO CORPORATES, INSTITUTIONS, 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 investment firms is denoted discount if the amount owed is larger, and premium if it is smaller.

2. Where investment firms 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 Chapter 3 of this Part.

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3. For on-balance sheet netting of loans and deposits, investment firms shall apply for the calculation of the exposure value the methods set out in Chapter 3 of this Part.

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 Annex VIII, Part 1, points 23 and 24 of this Part regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in Annex VIII, Part 2, points 14 to 19 of this Part should also be included in the minimum lease payments.

5. In the case of any item listed in Annex IV of this Part, the exposure value shall be determined by the methods set out in Annex III of this Part.

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 Part A, Chapter 3, paragraph 10. Where the Financial Collateral Comprehensive Method as set out under Annex VIII, Part 3 of this Part is 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 Annex III or Annex VIII, Part 3, points 12 to 21 of this Part.

8. Notwithstanding point 7 above, the exposure value of credit risk exposures outstanding, as determined by the Commission, with a central counterparty shall be determined in accordance with Annex III, Part 2, point 6 of this Part, provided that the central counterparty's counterparty 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.

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Investment firms shall use the following conversion factors:

(a) For credit lines which are uncommitted, that are unconditionally cancellable at any time by the investment firm 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%, investment firms 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 investment firm 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 investment firm without prior notice, a conversion factor of 0% shall apply. To apply a conversion factor of 0%, investment firms 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) Investment firms which meet the minimum requirements for the use of own estimates of conversion factors as specified in Part 4 of this Annex may use their own estimates of conversion factors across different product types as mentioned in points (a) to (d), subject to approval of the Commission.

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 points 1 to 9 above, 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 point the off-balance sheet items shall be assigned to risk categories as indicated in Annex II of this Part.

2. EQUITY EXPOSURES

12. The exposure value shall be the value presented in the financial statements. Admissible equity exposure measures are the following:

    (a) For investments held at fair value with changes in value flowing directly through income and into own funds, the exposure value is 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 is 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 is 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.

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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 an investment firm 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.

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 an investment firms 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, institutions 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" shall mean 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. An investment firm 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. Investment firms 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

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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 Commission 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.

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. Investment firms using the methods set out in Part 1, point 6 of this Annex for assigning risk weights for specialised lending exposures are exempt from the requirement to have an obligor rating scale which reflects exclusively quantification of the risk of obligor default for these exposures. Notwithstanding point 6 above, these investment firms 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. Investment firms 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.

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16. Investment firms 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. Investment firms shall explicitly address cases where several exposures benefit from the same collateral; and

    (c) Delinquency, unless the investment firm demonstrates to the Commission that delinquency is not a material risk drivers for the exposure;

1.2. Assignment to grades or pools

17. An investment firm 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 investment firm's internal lending standards and its policies for handling troubled obligors and facilities.

18. An investment firm shall take all relevant information into account in assigning obligors and facilities to grades or pools. Information shall be current and shall enable the investment firm to forecast the future performance of the exposure. The less information an investment firm has, the more conservative shall be its assignments of exposures to obligor and facility grades or pools. If an investment firm uses an external rating as a primary factor determining an internal rating assignment, the investment firm shall ensure that it considers other relevant information.

1.3. Assignment of exposures

1.3.1. Exposures to corporates, institutions and central governments and central banks

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19. Each obligor shall be assigned to an obligor grade as part of the credit approval process.

20. For those investment firms permitted to use own estimates of LGDs and/or conversion factors, each exposure shall also be assigned to a facility grade as part of the credit approval process.

21. Investment firms using the methods set out in Part 1, point 6 of this Annex for assigning risk weights for specialised lending exposures shall assign each of these exposures to a grade in accordance with point 12 above.

22. Each separate legal entity to which the investment firm is exposed shall be separately rated. An investment firm shall demonstrate to the Commission that it has acceptable policies regarding the treatment of individual obligor persons and groups of connected persons.

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 local or 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 investment firms 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. Investment firms shall document these overrides and the personnel responsible. Investment firms 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.

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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. Investment firms shall update assignments at least annually. High risk obligors and problem exposures shall be subject to more frequent review. Investment firms shall undertake a new assignment if material information on the obligor or exposure becomes available.

28. An investment firm 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. An investment firm shall at least annually update obligor and facility assignments or review the loss characteristics and delinquency status of each identified risk pool, whichever applicable. An investment firm 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 an investment firm uses statistical models and other mechanical methods to assign exposures to obligors or facilities grades or pools, then:

    (a) The investment firm shall demonstrate to the Commission 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 investment firm 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 investment firm shall demonstrate that the data used to build the model is representative of the population of the investment firm's actual obligors or exposures;

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(d) The investment firm 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 investment firm 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 investment firm shall document how human judgement and model results are to be combined.

1.6. Documentation of rating systems

31. The investment firm 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 investment firm shall document the rationale for and analysis supporting its choice of rating criteria. An investment firm 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 Commission. The organisation of rating assignment including the rating assignment process and the internal control structure shall also be documented.

33. The investment firms shall document the specific definitions of default and loss used internally and demonstrate consistency with the definitions set out in this Directive.

34. If the investment firm employs statistical models in the rating process, the investment firm shall document their methodologies. This material shall:

    (a) Provide a detailed outline of the theory, assumptions and/or mathematical and empirical basis of the assignment of estimates to grades, individual obligors, exposures, or pools, and the data source(s) 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.

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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 investment firm to satisfy the Commission.

1.7. Data maintenance

36. Investment firms shall collect and store data on aspects of their internal ratings as required under paragraphs 34 to 38 of Chapter 7 of this Part.

1.7.1. Exposures to corporates, institutions and central governments and central banks

37. Investment firms 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 that 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;

    Investment firms not using own estimates of LGDs and/or conversion factors shall collect and store data on comparisons of realised LGDs to the values as set out in Part 2, point 8 of this Annex and realised conversion factors to the values as set out in Part 3, point 9 of this Annex.

38. Investment firms using own estimates of LGDs and/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;

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(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 investment firms 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. Investment firms 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. An investment firm 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 an investment firm's credit exposures and assessment of the investment firm's ability to withstand such changes.

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41. An investment firm 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 investment firm, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. An investment firm shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of an investment firm's total exposure.

42. Investment firms using the treatment set out in Part 1, point 4 of this Annex 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

43. In determining the risk parameters to be associated with rating grades or pools, investment firms 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 investment firm considers that the obligor is unlikely to pay its credit obligations to the investment firm, the parent undertaking or any of its subsidiaries in full, without recourse by the investment firm 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 investment firm, 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 is material.

    An "advised limit" shall mean 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 Commission shall set a number of days past due as specified in point 48 below.

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In the case of retail exposures investment firms 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 Commission and which reflects a reasonable level of risk.

45. Elements to be taken as indications of unlikeliness to pay shall include:

    (a) The investment firm puts the credit obligation on non-accrued status,

    (b) The investment firm makes a value adjustment resulting from a significant perceived decline in credit quality subsequent to the investment firm taking on the exposure,

    (c) The investment firm sells the credit obligation at a material credit-related economic loss,

    (d) The investment firm 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/LGD Approach, distressed restructuring of the equity itself,

    (e) The investment firm has filed for the obligor's bankruptcy or a similar order in respect of an obligor's credit obligation to the investment firm, 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 investment firm, the parent undertaking or any of its subsidiaries.

46. Investment firms that use external data that is not itself consistent with the definition of default, shall demonstrate to the Commission that appropriate adjustments have been made to achieve broad equivalence with the definition of default.

47. If the investment firm considers that a previously defaulted exposure is such that no trigger of default continues to apply, the investment firm shall rate the obligor or facility as they would for a non-defaulted exposure. Should the definition of default subsequently be triggered, another default would be deemed to have occurred.

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48. For retail and PSE exposures, the Commission sets the number of days past due that all investment firms in its jurisdiction shall abide by under the definition of default set out in point 44 above, for exposures to such counterparts situated within Cyprus to 90 days. For exposures to counterparts situated in the territories of other Member States, the Commission shall set a number of days past due equal to the number set by the competent authority of the respective Member State.

2.2. Overall requirements for estimation

49. An investment firm'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 an investment firm has, the more conservative it shall be in its estimation.

50. The investment firm 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 investment firm 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 points 66, 71, 82, 86, 93 and 95 below shall be taken into account. An investment firm's estimates shall reflect the implications of technical advances and new data and other information, as it becomes available. Investment firms 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 investment firm's exposures and standards. The investment firm 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 investment firm 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 investment firm regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing investment firm, or by external sources. The purchasing investment firm shall evaluate any data relied upon which is provided by the seller.

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54. An investment firm 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 investment firms use different estimates for the calculation of risk weights and for internal purposes, it shall be documented and their reasonableness shall be demonstrated to the Commission.

56. If investment firms can demonstrate to the Commission that for data that have been collected prior to the date of implementation of this Directive appropriate adjustments have been made to achieve broad equivalence with the definitions of default or loss, the Commission shall allow the investment firms some flexibility in the application of the required standards for data.

57. If an investment firm uses data that is pooled across investment firms it shall demonstrate that:

    (a) The rating systems and criteria of other investment firms 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 investment firm for its estimates.

58. If an investment firm uses data that is pooled across investment firms, it shall remain responsible for the integrity of its rating systems. The investment firm shall demonstrate to the Commission 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. Investment firms shall estimate PDs by obligor grade from long run averages of one-year default rates.

60. For purchased corporate receivables investment firms may estimate ELs by obligor grade from long run averages of one-year realised default rates.

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61. If an investment firm 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 point 73 below.

62. Investment firms shall use PD estimation techniques only with supporting analysis. Investment firms shall recognise the importance of judgmental considerations in combining results of techniques and in making adjustments for limitations of techniques and information.

63. To the extent that an investment firm 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 investment firm shall add a greater margin of conservatism in its estimate of PD.

64. To the extent that an investment firm 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 investment firm'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 investment firm's analysis shall include a comparison of the default definitions used, subject to the requirements in points 44 to 48 above. The investment firm shall document the basis for the mapping.

65. To the extent that an investment firm 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 investment firm's use of default probability models for this purpose shall meet the standards specified in point 30 above.

66. Irrespective of whether an investment firm 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 point also applies to the PD/LGD Approach to equity. The Commission shall allow investment firms which are not permitted to use own estimates of LGDs or conversion factors to 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

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until relevant data cover a period of five years.

Retail exposures

67. Investment firms shall estimate PDs by obligor grade or pool from long run averages of one-year default rates.

68. Notwithstanding point 67 above, PD estimates may also be derived from realised losses and appropriate estimates of LGDs.

69. Investment firms shall regard internal data for assigning exposures to grades or pools as the primary source of information for estimating loss characteristics. Investment firms are permitted to use external data (including pooled data) or statistical models for quantification provided a strong link can be demonstrated between:

    (a) The investment firm's process of assigning exposures to grades or pools and the process used by the external data source; and

    (b) The investment firm's internal risk profile and the composition of the external data.

    For purchased retail receivables, investment firms may use external and internal reference data. Investment firms shall use all relevant data sources as points of comparison.

70. If an investment firm 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 point 73 below.

71. Irrespective of whether an investment firm is using external, internal or pooled data sources or a combination of the three, for their 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. An investment firm need not give equal importance to historic data if it can convince the Commission that more recent data is a better predictor of loss rates. The Commission shall allow investment firms to 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. Investment firms shall identify and analyse expected changes of risk parameters over the life of credit exposures (seasoning effects).

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2.2.2. Requirements specific to own-LGD estimates

73. Investment firms 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).

74. Investment firms 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, investment firms shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

75. An investment firm 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 investment firm'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 investment firms to expeditiously gain control of their collateral and liquidate it.

78. To the extent that LGD estimates take into account the existence of collateral, investment firms must establish internal requirements for collateral management, legal certainty and risk management that are generally consistent with those set out in Annex VIII, Part 2 of this Part.

79. To the extent that an investment firm recognises collateral for determining the exposure value for counterparty credit risk according to Annex III, Part 5 or 6 of this Part, 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 investment firm 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.

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81. To the extent that unpaid late fees have been capitalised in the investment firm's income statement, they shall be added to the investment firm'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 observation period spans a longer period for any source, and the data is relevant, this longer period shall be used.

Retail exposures

83. Notwithstanding point 73 above, LGD estimates may be derived from realised losses and appropriate estimates of PDs.

84. Notwithstanding point 89 below, investment firms may reflect future drawings either in their conversion factors or in their LGD estimates.

85. For purchased retail receivables investment firms 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 point 73 above, an investment firm needs not give equal importance to historic data if it can demonstrate to the Commission that more recent data is a better predictor of loss rates. The Commission shall allow investment firms to 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. Investment firms 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. Investment firms 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, investment firms shall make adjustments to their estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

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89. Investment firm's 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 investment firms shall consider their specific policies and strategies adopted in respect of account monitoring and payment processing. Investment firms shall also consider their ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events.

91. Investment firms 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 investment firm shall be able to monitor outstanding balances on a daily basis.

92. If investment firms 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 Commission.

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 point 89 above, investment firms 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 point 87 above, an investment firm need not give equal importance to historic data if it can demonstrate to the Commission that more recent data is a better predictor of draw downs. The Commission shall allow investment firms to 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.

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2.2.4. Minimum requirements for assessing the effect of guarantees and credit derivatives

Exposures to corporates, institutions and central governments and central banks where own estimates of LGD are used and retail exposures

96. The requirements in points 97 to 104 below shall not apply for guarantees provided by institutions and central governments and central banks if the investment firm has received approval to apply the rules of paragraphs 2 to 7 of Chapter 1 of this Part for exposures to such entities. In this case the requirements of Chapter 3 of this Part shall apply.

97. For retail guarantees, these requirements also apply to the assignment of exposures to grades or pools, and the estimation of PD.

Eligible guarantors and guarantees

98. Investment firms 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 points 17 to 29 above 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. The investment firm shall demonstrate that the assignment criteria adequately address any potential reduction in the risk mitigation effect.

Adjustment criteria

101. An investment firm 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 points 17 to 29 above.

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.

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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 requirements set out under Annex VIII Part 2, point 21 of this Part shall apply. For retail exposures and eligible purchased receivables, this point applies 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 investment firm 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 investment firm has effective ownership and control of all cash remittances from the receivables. When the obligor makes payments directly to a seller or servicer, the investment firm shall verify regularly that payments are forwarded completely and within the contractually agreed terms. "Servicer" shall mean an entity that manages a pool of purchased receivables or the underlying credit exposures on a day-to-day basis. Investment firms 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 investment firm shall monitor both the quality of the purchased receivables and the financial condition of the seller and servicer. In particular:

    (a) The investment firm 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 investment firm shall have clear and effective policies and procedures for determining seller and servicer eligibility. The investment firm or its agent shall conduct periodic reviews of sellers and servicers in order to verify the accuracy of reports from

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the seller or servicer, detect fraud or operational weaknesses, and verify the quality of the seller's credit policies and servicer's collection policies and procedures. The findings of these reviews shall be documented;

(c) The investment firm 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 investment firm 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 investment firm shall ensure that it receives from the servicer timely and sufficiently detailed reports of receivables ageings and dilutions to ensure compliance with the investment firm’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 investment firm 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 pro-actively. In particular, the investment firm 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. The investment firm 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 investment firm's internal policies and procedures

109. The investment firm 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 investment firm'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. Investment firms shall have robust systems in place to validate the accuracy and consistency of rating systems, processes, and the estimation of all relevant risk parameters. An investment firm shall demonstrate to the Commission that the internal validation process enables it to assess the performance of internal rating and risk estimation systems consistently and meaningfully.

111. Investment firms 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, investment firms shall specifically analyse the reasons for the deviation. Investment firms using own estimates of LGDs and/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 investment firm shall document the methods and data used in such comparisons. This analysis and documentation shall be updated at least annually.

112. Investment firms 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. Investment firms' 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. Investment firms 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 business cycles and similar systematic variability in

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default experience. Where realised values continue to be higher than expected values, investment firms 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 investment firms 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 investment firm'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 investment firm'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. Investment firms shall demonstrate to the Commission that the shock employed provides a conservative estimate of potential losses over a relevant long-term market or business cycle. The investment firm 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, investment firms 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 investment firm 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 investment firm'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 investment firm's equity exposures;

(c) The internal model shall be appropriate for the risk profile and complexity of an investment firm's equity portfolio. Where an investment firm 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;

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(d) Mapping of individual positions to proxies, market indices, and risk factors shall be plausible, intuitive, and conceptually sound;

(e) Investment firms 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, investment firms 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 investment firm and in the management of the non-trading book equity portfolio. Internal models shall be fully integrated into the investment firm's risk management infrastructure if they are particularly used in measuring 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. Investment firms 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. Investment firms 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. Investment firms 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 investment firm shall document the methods and data used in such comparisons. This analysis and documentation shall be updated at least annually.

121. Investment firms shall make use of other quantitative validation tools and comparisons with 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. Investment firms' internal assessments of the performance of their models shall be based on as long a period as possible.

122. Investment firms 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 investment firm'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

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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 investment firm's management body described in section 12 (3) of the Law or a designated committee thereof and senior management. These parties shall possess a general understanding of the investment firm's rating systems and detailed comprehension of its associated management reports.

125. Senior management shall provide notice to the management body described in section 12 (3) of the Law or a designated committee thereof of material changes or exceptions from established policies that will materially impact the operations of the investment firm'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 investment firm'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.

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 the credit risk control unit(s) shall include:

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(a) Testing and monitoring grades and pools;

(b) Production and analysis of summary reports from the investment firm'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 point 129 above, investment firms using pooled data according to points 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 investment firm's rating systems;

(c) Production of information relevant to review of the rating criteria to evaluate if they remain predictive of risk;

(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.

Investment firms making use of this point shall ensure that the Commission have access to all relevant information from the third party that is necessary for examining compliance with the minimum requirements and that the Commission may perform on-site examinations to

the same extent as within the investment firm.

5.3. Internal Audit

131. Internal audit or another comparable independent auditing unit shall review at least annually the investment firm'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.

ANNEX VIII

CREDIT RISK MITIGATION

PART 1

Eligibility

1. This Part sets out eligible forms of credit risk mitigation for the purposes of paragraph 16 of Chapter 3 of this Part.

2. For the purposes of this Annex:

   "Secured lending transaction" shall mean any transaction giving rise to an exposure secured by collateral which does not include a provision conferring upon the investment firm the right to receive margin frequently.

   "Capital market-driven transaction" shall mean any transaction giving rise to an exposure secured by collateral which includes a provision conferring upon the investment firm 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 investment firm and its counterparty may be recognised as eligible.

4. Without prejudice to point 5 below, eligibility is limited to reciprocal cash balances between the investment firm and the counterparty. Only loans and deposits of the lending investment firm may be subject to a modification of risk-weighted exposure amounts and, as relevant, expected loss amounts as a result of an on-balance sheet netting agreement.

1.2. Master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions

5. For investment firms adopting the Financial Collateral Comprehensive Method under Part 3 of this Annex, the effects of bilateral netting contracts covering repurchase transactions, securities or commodities lending or borrowing transactions, and/or other capital market-driven transactions with a counterparty may be recognised. Without prejudice to Annex II of Part D, to be recognised the collateral taken and securities or commodities borrowed within such agreements must comply with the eligibility requirements for collateral set out at points 7 to 11.

1.3. Collateral

6. Where the credit risk mitigation technique used relies on the right of the investment firm to liquidate or retain assets, eligibility depends upon whether risk-weighted exposure amounts, and, as relevant, expected loss amounts, are calculated under paragraphs 2 to 7 of Chapter 1, or Chapter 2 of this Part. Eligibility further depends upon whether the Financial Collateral Simple Method is used or the Financial Collateral Comprehensive Method under Part 3 of this Annex. 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 investment firm;

    (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 paragraphs 2 to 7 of Chapter 1of this Part which has been determined by the Commission 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 paragraphs 2 to 7 of Chapter 1of this Part;

    (c) Debt securities issued by institutions, which securities have a credit assessment by an eligible ECAI which has been determined by the Commission to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions under paragraphs 2 to 7 of Chapter 1 of this Part;

    (d) Debt securities issued by other entities, which securities have a credit assessment by an eligible ECAI which has been determined by the Commission to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under paragraphs 2 to 7 of Chapter 1 of this Part;

    (e) Debt securities with a short-term credit assessment by an eligible ECAI which has been determined by the Commission to be associated with credit quality step 3 or above under the rules for the risk weighting of short term exposures under paragraphs 2 to 7 of Chapter 1 of this Part;

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(f) Equities or convertible bonds that are included in a main index; and

(g) Gold.

For the purposes of point (b), 'debt securities issued by central governments or central banks' shall include:

(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 paragraphs 2 to 7 of Chapter 1 of this Part;

(ii) Debt securities issued by public sector entities which are treated as exposures to central governments in accordance with point 15 of Part 1 of Annex VI of this Part;

(iii) Debt securities issued by multilateral development banks to which a 0% risk weight is assigned under paragraphs 2 to 7 of Chapter 1 of this Part; and

(iv) Debt securities issued by international organisations which are assigned a 0% risk weight under paragraphs 2 to 7 of Chapter 1 of this Part.

For the purposes of point (c), 'debt securities issued by institutions' include:

(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 paragraphs 2 to 7 of Chapter 1 of this Part;

(ii) Debt securities issued by public sector entities, exposures to which are treated as exposures to institutions under paragraphs 2 to 7 of Chapter 1 of this Part; and

(iii) Debt securities issued by multilateral development banks other than those to which a 0% risk weight is assigned under paragraphs 2 to 7 of Chapter 1 of this Part.

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

(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 eligible ECAI which has been determined by the Commission to be

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associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions or short term exposures under paragraphs 2 to 7 of Chapter 1 of this Part;

(d) The lending investment firm has no information to suggest that the issue would justify a credit assessment below that indicated in (c); and

(e) The investment firm can demonstrate to the Commission 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 points 7 and 8 above.

   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.

10. In relation to points (b) to (e) of point 7 above, where a security has two credit assessments by eligible ECAIs, the less favourable assessment shall be deemed to apply. In cases where a security has more than two credit assessments by eligible ECAIs, the two most favourable assessments shall 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 points 7 to 10 above, where an investment firm uses the Financial Collateral Comprehensive Method under Part 3 of this Annex, 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

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(ii) The collective investment undertaking is limited to investing in instruments that are eligible for recognition under point 7 and 8 above and the items mentioned in point (a) of this point.

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.

1.3.3. Additional eligibility for calculations under Chapter 2 of this Part

12. In addition to the collateral set out above the provisions of points 13 to 19 above apply where an investment firm calculates risk-weighted exposure amounts and expected loss amounts under the approach set out in Chapter 2 of this Part:

(a) Real estate collateral

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 as eligible collateral where the following conditions are met:

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

14. Investment firms 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. Investment firms may 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. When the competent authorities of another Member State, waive the requirement for their investment firms credit institutions to comply with the condition in point 13(b) above for commercial real estate property situated within the territory of that Member State, the Commission shall allow investment firms to recognise as eligible collateral commercial real estate property situated in that Member State.

(b) Receivables

17. Investment firms 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

18. Investment firms may recognise as eligible collateral physical items of a type other than those types indicated in points 13 to 16 above 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 investment firm must be able to demonstrate that there is no evidence that the net prices it receives when collateral is realised deviates significantly from these market prices.

(d) Leasing

19. Subject to the provisions of Part 3, point 72, of this Annex where the requirements set out in Part 2, point 11 of this Annex are met, exposures arising from transactions whereby an investment firm leases property to a third party will 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 institution.

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

1.4.2. Life insurance policies pledged to the lending investment firm

21. Life insurance policies pledged to the lending investment firm may be recognised as eligible credit protection.

1.4.3. Institution instruments repurchased on request

22. 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

23. 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 paragraphs 2 to 7 of Chapter 1 of this Part is assigned;

(e) Public sector entities, claims on which are treated as claims on institutions or central governments under paragraphs 2 to 7 of Chapter 1 of this Part;

(f) Institutions; and

(g) Other corporate entities, including parent, subsidiary and affiliate corporate entities of the investment firm, that:

(i) Have a credit assessment by a recognised ECAI which has been determined by the Commission to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under paragraphs 2 to 7 of Chapter 1 of this Part; and

(ii) In the case of investment firms calculating risk-weighted exposure amounts and expected loss amounts under Chapter 2 of this Part, do not have a credit assessment by a recognised ECAI and are internally rated as having a PD equivalent to that

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associated with the credit assessments of ECAIs determined by the Commission to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporate under paragraphs 2 to 7 of Chapter 1 of this Part.

24. Where risk-weighted exposure amounts and expected loss amounts are calculated under Chapter 2 of this Part, to be eligible a guarantor must be internally rated by the investment firm in accordance with the provisions of Annex VII, Part 4 of this Part.

2.2 Eligibility of protection providers under the IRB Approach which qualify for the treatment set out in Annex VII, Part 1, point 4 of this Part.

25. Institutions, 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 Annex VII, Part 1, point 4 of this Part:

    - 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 this Directive, or had, at the time the credit protection was provided, a credit assessment by a recognised ECAI to be associated with credit quality step 3, or above, under the rules for the risk weighting of exposures to corporate under paragraphs 2 to 7 of Chapter 1 of this Part;

    - 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 paragraphs 2 to 7 of Chapter 1 of this Part; 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 paragraphs 2 to 7 of Chapter 1 of this Part.

    For the purpose of this point, credit protection provided by export credit agencies shall not benefit from any explicit central government counter-guarantee.

3. TYPES OF CREDIT DERIVATIVES

26. 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:

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(a) Credit default swaps;

(b) Total return swaps; and

(c) Credit linked notes to the extent of their cash funding.

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

3.1. Internal hedges

28. When an investment firm conducts an internal hedge using a credit derivative — i.e. hedges the credit risk of an exposure in the non-trading book with a credit derivative booked in the trading book — in order for the protection to be recognised as eligible for the purposes of this Annex 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 Annex, the rules set out in Parts 3 to 6 of this Annex for the calculation of risk-weighted exposure amounts and expected loss amounts where unfunded credit protection is acquired shall be applied.

PART 2

Minimum Requirements

1. The investment firm must satisfy the Commission that it has adequate risk management processes to control those risks to which the investment firm 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, investment firms 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 Commission. In the case of repurchase transactions and/or securities or commodities lending or borrowing transactions the underlying exposure shall, for the purposes of this point only, be deemed to be the net amount of the exposure.

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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 and/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 and/or other capital market-driven transactions — to be recognised for the purposes of Chapter 3 of this Part, the following conditions shall be satisfied:

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

   (b) The investment firm must be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;

   (c) The investment firm must monitor and control the risks associated with the termination of the credit protection; and

   (d) The investment firm must monitor and control the relevant exposures on a net basis.

1.2. Master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions

4. For master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions to be recognised for the purposes of Chapter 3 of this Part, they shall:

   (a) Be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;

   (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 counterparty; 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 point 6 below 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 must 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 Annex VI, Part 1, points 66 to 68 of this Part may be recognised as eligible when they are posted as collateral for repurchase transactions, provided that the first paragraph of this point is complied with.

   (b) Legal certainty

   Investment firms 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.

   Investment firms 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.

   Investment firms 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 investment firm 's overall risk profile.

   The investment firm shall have documented policies and practices concerning the types and amounts of collateral accepted.

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

Where the collateral is held by a third party, investment firms must 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 point 6 above, for the recognition of financial collateral under the Financial Collateral Simple Method the residual maturity of the protection must be at least as long as the residual maturity of the exposure.

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

   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 investment firm 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 investment firm, the property valuation shall be reviewed by an independent valuer at least every three years.

   "Independent valuer" shall mean 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 investment firm and its lending policies in this regard shall be clearly documented.

(d) Insurance

The investment firm 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:

(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) Investment firms must take all steps necessary to fulfil local requirements of the Republic in respect of the enforceability of security interest. There shall be a framework which allows the lender to have a first priority claim over the collateral subject to the claims of preferential creditors provided for in legislative or implementing provisions;

(iii) Investment firms shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions; and

(iv) The collateral arrangements must be properly documented, with a clear and robust procedure for the timely collection of collateral. Investment firm'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 investment firm shall have legal authority to sell or assign the receivables to other parties without consent of the receivables obligors.

(b) Risk management

(i) The investment firm must 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

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the borrower does business. Where the investment firm relies on the borrower to ascertain the credit risk of the customers, the investment firm must 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 must reflect all appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an individual borrower, and potential concentration risk within the investment firm's total exposures beyond that controlled by the investment firm's general methodology. The investment firm must 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 investment firm shall have a documented process for collecting receivable payments in distressed situations. The requisite facilities for collection shall be in place, even when the investment firm 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 investment firm to realise the value of the property within a reasonable timeframe;

(b) With the sole exception of permissible prior claims referred to in point 9(a)(ii) above, only first liens on, or charges over, collateral are permissible. As such, the investment firm shall have priority over all other lenders to the realised proceeds of the collateral;

(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;

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(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 investment firm 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 investment firm'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 must be paid in valuation and revaluation to the effects of the passage of time on fashion- or date-sensitive collateral;

(h) The investment firm must 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 investment firm must have procedures to monitor that the property taken as protection is adequately insured against damage.

1.7. Minimum requirements for treating lease exposures as collateralised

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:

    (a) The conditions set out in points 8 or 10 above 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

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(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 institution

12. To be eligible for the treatment set out at Part 3, point 77 of this Annex, the protection referred to in Part 1, point 20 of this Annex must satisfy the following conditions:

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

    (b) The third party institution is notified of the pledge or assignment;

    (c) As a result of the notification, the third party institution is able to make payments solely to the lending investment firm or to other parties with the lending investment firm’s consent; and

    (d) The pledge or assignment is unconditional and irrevocable.

1.8.2. Life insurance policies pledged to the lending investment firm.

13. For life insurance policies pledged to the lending investment firm to be recognised the following conditions shall be met:

    (a) The company providing the life insurance may be recognised as an eligible unfunded credit protection provider under Part 1, point 23 of this Annex;

    (b) The life insurance policy is openly pledged or assigned to the lending investment firm;

    (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 investment firm;

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(d) The declared surrender value of the policy is non-reducible;

(e) The lending investment firm must have the right to cancel the policy and receive the surrender value in a timely way in the event of the default of the borrower;

(f) The lending investment firm is informed of any non-payments under the policy by the policy-holder;

(g) The credit protection must be provided for the maturity of the loan. Where this is not possible because the insurance relationship ends before the loan relationship expires, the investment firm must ensure that the amount deriving from the insurance contract serves the investment firm as security until the end of the duration of the credit agreement; and

(h) The pledge or assignment must be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

2. UNFUNDED CREDIT PROTECTION AND CREDIT LINKED NOTES

2.1. Requirements common to guarantees and credit derivatives

14. Subject to point 16 below, for the credit protection deriving from a guarantee or credit derivative to be recognised the following conditions shall be met:

    The credit protection shall be direct;

    The extent of the credit protection shall be clearly defined and incontrovertible;

    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

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

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 paragraphs 2 to 7 of Chapter 1 of this Part, a multi-lateral development bank to which a 0% risk weight is assigned under or by virtue of paragraphs 2 to 7 of Chapter 1 of this Part, or a public sector entity, claims on which are treated as claims on institutions under paragraphs 2 to 7 of Chapter 1 of this Part, 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 points 14, 15 and 18 of this Part, except that the counter-guarantee need not be direct; and

    (c) The Commission 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 point 16 above also applies to an exposure which is not counter-guaranteed by an entity listed in that point if that exposure's counter-guarantee is in turn directly guaranteed by one of the listed entities and the conditions listed in that point are satisfied.

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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 and/or non-payment by the counterparty, the lending investment firm 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 investment firm first having to pursue the obligor.

    In the case of unfunded credit protection covering residential mortgage loans, the requirements in point 14(c)(iii) above and in the first subparagraph of this point 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 Commission or provided by or counter guaranteed by entities referred to in point 16 above, the requirements in point 18(a) above shall be considered to be satisfied where either of the following conditions are met:

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

    (b) The lending investment firm 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 also be met:

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(a) Subject to point (b) below, 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 that are in effect at the time of such failure (with a grace period that is closely in line with or shorter than the grace period in the underlying obligation);

(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 point (a)(iii), the credit protection may nonetheless be recognised subject to a reduction in the recognised value as specified in point 81 of Part 3 of this Annex;

(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/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 is permissible only if the following conditions are met:

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(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

(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 Annex VII, Part 1, point 4 of this Part

22. To be eligible for the treatment set out in Annex VII, Part 1, point 4 of this Part, 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 paragraph 10 of Chapter 2 of this Part, 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 paragraph 10 of Chapter 2 of this Part; or

- An exposure to a small or medium sized entity, classified as a retail exposure according to paragraph 10 (4) of Chapter 2 of this Part;

(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

- n^{th} to-default basket products — the protection obtained is only eligible for consideration under this framework if eligible $(n\text{-}1)^{th}$ default protection has also be obtained or where (n-1) of the assets within the basket has/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;

(d) The credit protection meets the requirements set out in points 14, 15, 18, 20 and 21 above;

(e) The risk weight that is associated with the exposure prior to the application of the treatment in Annex VII, Part 1, point 4 of this Part, does not already factor in any aspect of the credit protection;

(f) An investment firm shall have the right and expectation to receive payment from the protection provider without having to take legal action in order to pursue the counterparty for payment. To the extent possible, an investment firm 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 an investment firm intends to deliver an obligation other than the underlying exposure, it shall ensure that the deliverable obligation is sufficiently liquid so that the investment firm 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 investment firm;

(j) Investment firms 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

1. Subject to Parts 4 to 6 of this Annex, where the provisions in Parts 1 and 2 of this Annex are

satisfied, the calculation of risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part and the calculation of risk-weighted exposure amounts and expected loss amounts under Chapter 2 of this Part 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 investment firm may be treated as cash collateral.

1.2. On-balance sheet netting

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

1.3. Master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/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 points 12 to 21 bellow, in calculating the "fully adjusted exposure value" (E*) for the exposures subject to an eligible master netting agreement covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions, 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 points 30 to 61 below 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

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the master netting agreement, the total value of securities or commodities of that type borrowed, purchased or received under the agreement.

7. For the purposes of point 6 below, "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 points 34 to 59 below.

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:

$$\mathrm{E}^{*} = \max\left\{0, \left[\left(\sum(E) - \sum(C) + \sum\left|net\ position\ \ in\ \ each\ \ \mathrm{sec}urity\right| * H_{\mathrm{sec}}\right) + \left(\sum\left|E_{fx}\right| * H_{fx}\right)\right]\right\}$$

Where risk-weighted exposure amounts are calculated under paragraphs 2 to 7 of Chapter 1 of this Part, 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 Chapter 2 of this Part, 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.

$\sum(E)$ is the sum of all Es under the agreement.

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$\sum(C)$ 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 point 8 below.

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, and/or other capital market driven transactions other than derivative transactions, investment firms shall 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 $(\sum(E)-\sum(C))$, Investment firms 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 Annex III, Part 7 of this Part.

13. An investment firm may choose to use an internal models approach independently of the choice it has made between Chapter 1, paragraphs 2 to 7 and Chapter 2 of this Part for the calculation of risk-weighted exposure amounts. However, if an investment firm seeks to use an internal models approach, it must do so for all counterparties and securities, excluding immaterial portfolios where it may use the Supervisory volatility adjustments approach or the Own estimates volatility adjustments approach as set out in points 5 to 11 above.

14. The internal models approach is available to investment firms that have received recognition for an internal risk-management model under Part D, Annex V.

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15. Investment firms which have not received supervisory recognition from the Commission for use of such a model under Part D, may apply to the Commission for recognition of an internal risk-measurement model for the purposes of points 12 to 21 of this Part.

16. Recognition shall only be given if the Commission is satisfied that the investment firm's risk management system for managing the risks arising on the transactions covered by the master netting agreement is conceptually sound and implemented with integrity and that, in particular, the 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 investment firm and serves as the basis for reporting risk exposures to senior management of the investment firm;

    (b) The investment firm has a risk control unit that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the investment firm'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 are reviewed by a level of management with sufficient authority to enforce reductions of positions taken and of overall risk exposure;

    (d) The investment firm has sufficient staff skilled in the use of sophisticated models in the risk control unit;

    (e) The investment firm has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk-measurement system;

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

    (g) The investment firm frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets;

    (h) The investment firm must conduct, as part of its regular internal auditing process, an independent review of its risk-measurement system. This review must include both the

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activities of the business trading units and of the independent risk-control unit;

(i) At least once a year, the investment firm must conduct a review of its risk-management system; and

(j) The internal model shall meet the requirements set out in Annex III, Part 6, points 38 to 40 of this Part.

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 Commission 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 Commission shall allow investment firms to use empirical correlations within risk categories and across risk categories if they are satisfied that the investment firm's system for measuring correlations is sound and implemented with integrity.

20. The fully adjusted exposure value (E*) for investment firms using the Internal models approach shall be calculated according to the following formula:

$$E^{*} = \max\left\{0, \left[\left(\sum(E) - \sum(C)\right) + \left(VaR\ output\ of\ the\ internal\ model\right)\right]\right\}$$

Where risk-weighted exposure amounts are calculated under paragraphs 2 to 7 of Chapter 1 of this Part, E is the exposure value for each separate exposure under the agreement that would apply in the absence of the credit protection.

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Where risk-weighted exposure amounts and expected loss amounts are calculated under Chapter 2 of this Part, 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 borrowed, purchased or received or the cash borrowed or received in respect of each such exposure.

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, investment firms shall use the previous business day's model output.

1.3.2. Calculating risk-weighted exposure amounts and expected loss amounts for repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions covered by master netting agreements

Standardised Approach

22. E* as calculated under points 5 to 21 above shall be taken as the exposure value of the exposure to the counterparty arising from the transactions subject to the master netting agreement for the purposes of, paragraph 4 of Chapter 1 of this Part.

IRB Approach

23. E* as calculated under points 5 to 21 above shall be taken as the exposure value of the exposure to the counterparty arising from the transactions subject to the master netting agreement for the purposes of Annex VII of this Part.

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 paragraphs 2 to 7 of Chapter 1 of this Part. An investment firm shall not use both the Financial Collateral Simple Method and the Financial

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Collateral Comprehensive Method.

Valuation

25. Under this method, recognised financial collateral is assigned a value equal to its market value as determined in accordance with Part 2, point 6 of this Annex.

Calculating risk-weighted exposure amounts

26. The risk weight that would be assigned under paragraphs 2 to 7 of Chapter 1 of this Part if the lender had a direct exposure to the collateral instrument shall be assigned to those portions of claims collateralised by the market value of recognised collateral. The risk weight of the collateralised portion shall be a minimum of 20% except as specified in points 27 to 29 below. The remainder of the exposure shall receive the risk weight that would be assigned to an unsecured exposure to the counterparty under paragraphs 2 to 7 of Chapter 1 of this Part.

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 points 58 and 59 below. If the counterparty 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 Annex III of this Part for the derivative instruments listed in Annex IV of this Part 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 paragraphs 2 to 7 of Chapter 1 of this Part.

    For the purposes of this point 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 paragraphs 2 to 7 of Chapter 1 of this Part;

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(b) Debt securities issued by multilateral development banks to which a 0% risk weight is assigned under or by virtue of paragraphs 2 to 7 of Chapter 1 of this Part; and

(c) Debt securities issued by international organisations which are assigned a 0% risk weight under paragraphs 2 to 7 of Chapter 1 of this Part.

Other transactions

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 paragraphs 2 to 7 of Chapter 1 of this Part, and its market value has been discounted by 20%.

For the purposes of this point "debt securities issued by central governments or central banks" shall to include those indicated under point 28 above.

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 points 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 point 32 below, where collateral is denominated in a currency that 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 points 34 to 59 below.

32. In the case of OTC derivatives transactions covered by netting agreements recognised by the Commission under Annex III of this Part, 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 points 5 to 23 above are applied:

$$C_{VA} = C * (1 - H_C - H_{FX})$$

The volatility-adjusted value of the exposure to be taken into account is calculated as follows:

$E_{VA} = E * (1 + H_E)$ 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 is calculated as follows:

$$E^* = \max\{0, [E_{VA} - C_{VAM}]\}$$

where:

E is the exposure value as would be determined under paragraphs 2 to 7 of Chapter 1 or Chapter 2 of this Part as appropriate if the exposure was not collateralised. For this purpose, for investment firms calculating risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part, the exposure value of off-balance sheet items listed in Annex II of this Part shall be 100% of its value rather than the percentages indicated in paragraph 2(1) of Chapter 1 of this Part, and for investment firms calculating risk-weighted exposure amounts under Chapter 2 of this Part, the exposure value of the items listed in Annex VII, Part 3, points 9 to 11 of this Part shall be calculated using a conversion factor of 100% rather than the conversion factors or percentages indicated in those points.

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 of this Annex.

H_E is the volatility adjustment appropriate to the exposure (E), as calculated under points 34 to 59 below.

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H_C is the volatility adjustment appropriate to the collateral, as calculated under points 34 to 59 below.

H_{FX} is the volatility adjustment appropriate to currency mismatch, as calculated under points 34 to 59 below.

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

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. An investment firm may choose to use the Supervisory volatility adjustments approach or the Own estimates approach independently of the choice it has made between the paragraphs 2 to 7 of Chapter 1 and Chapter 2 of this Part for the calculation of risk-weighted exposure amounts. However, if investment firms seek to use the Own estimates approach, they must 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.

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 Part 1, point 7(b)			Volatility adjustments for debt securities issued by entities described in Part 1, point 7(c) and (d)		
		20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period (%)	20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period (%)
1	≤ 1 year	0,707	0,5	0,354	1,414	1	0,7 7
	>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 ent ties described in Part 1, point 7(b) with short-term credit assessments			Volatility adjustments for debt securities issued by entities described in Part 1, point 7(c) and (d) with short-term credit assessments		
	20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period (%)	20-day liquidation period (%)	10-day liquidation period (%)	5-day liquidation period (%)
1	0,707	0,5	0,354	1,414	1	0,707

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2-3	1,414	1	0,707	2,828	2	1,414

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 above and in points 39 to 41 below, the credit quality step with which a credit assessment of the debt security is associated is the credit quality step with which the credit assessment is determined by the Commission to be associated under paragraphs 2 to 7 of Chapter 1 of this Part. For the purpose of this point, Part 1, point 10 of this Annex 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

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same as for non-main index equities listed on a recognised exchange.

40. For eligible units in collective investment undertakings the volatility adjustment is the weighted average volatility adjustments that would apply, having regard to the liquidation period of the transaction as specified in point 37 above, to the assets in which the fund has invested. If the assets in which the fund has invested are not known to the investment firm, the volatility adjustment is the highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.

41. For unrated debt securities issued by institutions and satisfying the eligibility criteria in Part 1, point 8 of this Annex 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 Commission shall permit investment firms complying with the requirements set out in points 47 to 56 below 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 Commission shall allow investment firms to calculate a volatility estimate for each category of security.

44. In determining relevant categories, investment firms 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 must be representative of the securities included in the category by the investment firm.

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. Investment firms using the Own estimates approach must estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral and/or exchange rates.

Quantitative Criteria

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

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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.

49. Investment firms may use volatility adjustment numbers calculated according to shorter or longer liquidation periods, scaled up or down to the liquidation period set out in point 48 abovefor the type of transaction in question, using the square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}}$$

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. Investment firms 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 investment firms 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 Commission may also require an investment firm to calculate its volatility adjustments using a shorter observation period if, in the Commissions' judgement, this is justified by a significant upsurge in price volatility.

52. Investment firms 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.

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Qualitative Criteria

53. The volatility estimates shall be used in the day-to-day risk management process of the investment firm including in relation to its internal exposure limits.

54. If the liquidation period used by the investment firm 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 investment firm's volatility adjustments shall be scaled up in accordance with the square root of time formula set out in point 49 above.

55. The investment firm 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 investment firm's system for the estimation of volatility adjustments shall be carried out regularly in the investment firm's own internal auditing process. A review of the overall system for the estimation of volatility adjustments and for integration of those adjustments into the investment firm'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 points 36 to 41above are the volatility adjustments to be applied where there is daily revaluation. Similarly, where an investment firm uses its own estimates of the volatility adjustments in accordance with points 42 to 56 above, these must be calculated in the first instance on the basis of daily revaluation. If the frequency of revaluation is less than daily, larger volatility adjustments shall be applied. These shall be calculated by scaling up the daily revaluation volatility adjustments, using the following "square root of time" formula:

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$$H = H_M \sqrt{\frac{N_R + (T_M - 1)}{T_M}}$$

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 an investment firm uses the Supervisory Volatility Adjustments Approach or the Own Estimates Approach and where the conditions set out in points (a) to (h) below are satisfied, investment firms may, instead of applying the volatility adjustments calculated under points 34 to 57 above, apply a 0% volatility adjustment. This option is not available in respect of investment firms using the internal models approach set out in points 12 to 21 above:

    (a) Both the exposure and the collateral are cash or debt securities issued by central governments or central banks within the meaning of Part 1, point 7(b) of this Annex and eligible for a 0% risk weight under paragraphs 2 to 7 of Chapter 1 of this Part,

    (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) It is considered that the time between the last marking-to-market before a failure to remargin by the counterparty and the liquidation of the collateral shall be no more than four business days,

    (e) The transaction is settled across a settlement system proven for that type of transaction,

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(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 counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction is immediately terminable, and

(h) The counterparty is considered a 'core market participant' by the Commission. Core market participants shall include the following entities:

- The entities mentioned in point 7(b) of Part 1 of this Annex exposures to which are assigned a 0% risk weight under paragraphs 2 to 7 of Chapter 1 of this Part;

- Institutions;

- Other financial companies (including insurance companies) exposures to which are assigned a 20% risk weight under paragraphs 2 to 7 of Chapter 1 of this Part or which, in the case of investment firms calculating risk-weighted exposure amounts and expected loss amounts under Chapter 2 of this Part, 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 Commission to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under paragraphs 2 to 7 of Chapter 1 of this Part;

- Regulated collective investment undertakings that are subject to capital or leverage requirements;

- Regulated pension funds; and

- Recognised clearing organisations.

59. Where a competent authority of another Member State permits the treatment set out in point 58 above to be applied in the case of repurchase transactions or securities lending or borrowing transactions in securities issued by its domestic government, then the Commission shall allow investment firms incorporated in their jurisdiction to adopt the same approach to the same transactions.

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(c) Calculating risk-weighted exposure amounts and expected loss amounts

Standardised Approach

60. E* as calculated under point 33 below shall be taken as the exposure value for the purposes of paragraph 4 of Chapter 1 of this Part. In the case of off-balance sheet items listed in Annex II of this Part, E* shall be taken as the value at which the percentages indicated in paragraph 2 (1) of Chapter 1 of this Part shall be applied to arrive at the exposure value.

IRB Approach

61. LGD* (the effective LGD) calculated as set out in this point shall be taken as the LGD for the purposes of Annex VII of this Part.

$$LGD^* = LGD \times \left(E^* / E\right)$$

where:

LGD is the LGD that would apply to the exposure under Chapter 2 of this Part if the exposure was not collateralised;

E is the exposure value as described under point 33 above;

E* is as calculated under point 33 above.

1.5. Other eligible collateral for, Chapter 2 of this Part

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

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 Part 2, point 8 of this Annex and to take account of the any prior claims on the property.

(b) Receivables

66. The value of receivables shall be the amount receivable.

(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 points 69 to 72 below shall be taken as the LGD for the purposes of Annex VII of this Part.

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 Annex VII of this Part for uncollateralised exposures to the counterparty.

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

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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%

By way of derogation, until 31 December 2012 the Commission shall, subject to the levels of collateralisation indicated in Table 5:

(a) Allow investment firms to assign a 30% LGD for senior exposures in the form of Commercial Real Estate leasing;

(b) Allow investment firms to assign a 35% LGD for senior exposures in the form of equipment leasing; and

(c) Allow investment firms to assign a 30% LGD for senior exposures secured by residential or commercial real estate.

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At the end of this period, this derogation shall be reviewed.

(b) Alternative treatment for real estate collateral

73. The Commission shall authorise investment firms to assign a 50% risk weight in respect of exposures collateralised by residential real estate property or commercial real estate property respectively located in the territory of those Member States the competent authorities of which authorise this treatment subject to the same conditions as apply in that Member State.

1.6. Calculating risk-weighted exposure amounts and expected loss amounts in the case of mixed pools of collateral

74. Where risk-weighted exposure amounts and expected loss amounts are calculated under Chapter 2 of this Part, and an exposure is collateralised by both financial collateral and other eligible collateral, LGD*, to be taken as the LGD for the purposes of Annex VII of this Part, shall be calculated as follows.

75. The investment firm 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 point 33 above) into parts each covered by only one type of collateral. That is, the investment firm must 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.

76. LGD* for each part of exposure shall be calculated separately in accordance with the relevant provisions of this Annex.

1.7. Other funded credit protection

1.7.1. Deposits with third party institutions

77. Where the conditions set out in Part 2, point 12 of this Annex are satisfied, credit protection falling within the terms of Part 1, point 20 of this Annex may be treated as a guarantee by the third party institution.

1.7.2. Life insurance policies pledged to the lending investment firm

78. Where the conditions set out in Part 2, point 13 of this Annex are satisfied, credit protection falling within the terms of Part 1, point 21 of this Annex may be treated as a guarantee by the company providing the life insurance. The value of the credit protection recognised shall be

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the surrender value of the life insurance policy.

1.7.3. Institution instruments repurchased on request

79. Instruments eligible under Part 1, point 22 of this Annex may be treated as a guarantee by the issuing institution.

80. 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 Part 1, point 8 of this Annex.

2. UNFUNDED CREDIT PROTECTION

2.1. Valuation

81. 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 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 point 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.

82. 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 H_{FX} as follows:

$$G^* = G * (1 - H_{FX})$$

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

83. 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 points 34 to 57 above.

2.2. Calculating risk-weighted exposure amounts and expected loss amounts

2.2.1. Partial protection — tranching

84. Where the investment firm transfers a part of the risk of a loan in one or more tranches, the rules set out in Chapter 4 of this Part shall apply. Materiality thresholds on payments below which no payment shall be made in the event of loss are considered to be equivalent to retained first loss positions and to give rise to a tranched transfer of risk.

2.2.2. Standardised Approach

(a) Full protection

85. For the purposes of paragraph 4 of Chapter 1 of this Part, g shall be the risk weight to be assigned to an exposure which is fully protected by unfunded protection (G_A), where:

g is the risk weight of exposures to the protection provider as specified under paragraphs 2 to 7 of Chapter 1 of this Part; and

G_A is the value of G* as calculated under point 82 above further adjusted for any maturity mismatch as laid down in Part 4 of this Annex.

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(b) Partial protection — equal seniority

86. Where the protected amount is less than the exposure value and the protected and unprotected parts are of equal seniority — i.e. the investment firm and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief shall be afforded. For the purposes of paragraph 4 of Chapter 1 of this Part, risk-weighted exposure amounts shall be calculated in accordance with the following formula:

    $$(E - G_A) * r + G_A * g$$

    where:

    E is the exposure value;

    G_A is the value of G* as calculated under point 82 above further adjusted for any maturity mismatch as laid down in Part 4 of this Annex;

    r is the risk weight of exposures to the obligor as specified under paragraphs 2 to 7 of Chapter 1 of this Part; and

    g is the risk weight of exposures to the protection provider as specified under paragraphs 2 to 7 of Chapter 1 of this Part.

(c) Sovereign guarantees

87. The Commission shall extend the treatment provided for in Annex VI, Part 1, points 4 and 5 of this Part to 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

88. For the covered portion of the exposure (based on the adjusted value of the credit protection G_A), the PD for the purposes of Annex VII, Part 2 of this Part 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 Annex VII,

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Part 2 of this Part may be that associated with senior claims.

89. For any uncovered portion of the exposure the PD shall be that of the borrower and the LGD shall be that of the underlying exposure.

90. G_A is the value of G* as calculated under point 82 above further adjusted for any maturity mismatch as laid down in Part 4 of this Annex.

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 Commission as being subject to a one–day floor rather than a one-year floor in respect of the maturity value (M) under Annex VII, Part 2, point 14 of this Part.

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 point 4 below, 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 investment firm 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.

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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:

$$C_{VAM} = C_{VA} * \frac{(t - t^*)}{(T - t^*)}$$

where:

C_{VA} is the volatility adjusted value of the collateral as specified in Part 3, point 33 of this Annex 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 points 3 to 5 above, 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 points 3 to 5 above, 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, point 33 of this Annex.

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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

$$G_A = G^* * \frac{t - t^*}{T - t^*}$$

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 points 3 to 5 above, 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 points 3 to 5 above, 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 Part 3, points 81 to 90 of this Annex.

PART 5

Combinations of credit risk mitigation in the Standardised Approach

1. In the case where an investment firm calculating risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part has more than one form of credit risk mitigation covering a single exposure (e.g. an investment firm has both collateral and a guarantee partially covering an exposure), the investment firm 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 paragraphs 2 to 7 of Chapter 1 of this Part and this Annex.

2. When credit protection provided by a single protection provider has differing maturities, a

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similar approach to that described in point 1 above shall be applied.

PART 6

Basket CRM techniques

1. FIRST-TO-DEFAULT CREDIT DERIVATIVES

1. Where an investment firm 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 investment firm may modify the calculation of the risk-weighted exposure amount and, as relevant, the expected loss amount of the exposure which would, in the absence of the credit protection, produce the lowest risk-weighted exposure amount under paragraphs 2 to 7 of Chapter 1 or Chapter 2 of this Part as appropriate in accordance with this Annex, 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 investment firm purchasing the protection may only recognise the protection for the calculation of risk-weighted exposure amounts and, as relevant, expected loss amounts if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases, the methodology shall follow that set out in point 1 for first-to-default derivatives appropriately modified for n^{th} -to-default products.

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ANNEX IX

SECURITISATION

PART 1

Definitions for the purposes of Annex IX

1. For the purposes of this Annex:

- "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;

- "K_{irb}" means 8% of the risk-weighted exposure amounts that would be calculated under Chapter 2 of this Part in respect of the securitised exposures, had they not been securitised, plus the amount of expected losses associated with those exposures calculated under those Articles;

- "Ratings based method" means the method of calculating risk-weighted exposure amounts for securitisation positions in accordance with Part 4, points 45 to 48 of this Annex;

- "Supervisory formula method" means the method of calculating risk-weighted exposure amounts for securitisation positions in accordance with Part 4, points 49 to 51 of this Annex;

- "Unrated position" means a securitisation position which does not have an eligible credit assessment by an eligible ECAI as defined in paragraph 21 of Chapter 4 of this Part;

- "Rated position" means a securitisation position which has an eligible credit assessment by an eligible ECAI as defined in paragraph 21 of Chapter 4 of this Part; and

- "Asset-backed commercial paper (ABCP) programme" means a programme of securitisations the securities issued by which predominantly take the form of commercial paper with an original maturity of one year or less.

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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. The originator investment firm of a traditional securitisation may exclude securitised exposures from the calculation of risk weighted exposure amounts and expected loss amounts if significant credit risk associated with the securitised exposures has been transferred to third parties and the transfer complies with the following conditions:

   (a) The securitisation documentation reflects the economic substance of the transaction;

   (b) The securitised exposures are put beyond the reach of the originator investment firm 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 investment firm;

   (d) The transferee is a securitisation special-purpose entity (SSPE);

   (e) The originator investment firm 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 investment firm's retention of 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 are satisfied:

      (i) The clean-up call option is exercisable at the discretion of the originator investment firm;

      (ii) The clean-up call option may only be exercised when 10% or less of the

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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 investment firm 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. An originator investment firm of a synthetic securitisation may calculate risk weighted exposure amounts, and, as relevant, expected loss amounts, for the securitised exposures in accordance with points 3 and 4 below, if significant credit risk has been transferred to third parties either through funded or unfunded credit protection and the transfer complies 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 Chapter 3 of this Part for the recognition of such credit protection. For the purposes of this point, special purpose entities shall not be recognised as eligible 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

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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 investment firm;

(iv) Increase the investment firms' 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 INVESTMENT FIRMS' 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 point 2 above are met, the originator investment firm of a synthetic securitisation shall, subject to points 5 to 7 above, use the relevant calculation methodologies set out in Part 4 of this Annex and not those set out in paragraphs 2 to 7 of Chapter 1 and Chapter 2 of this Part. For investment firms calculating risk-weighted exposure amounts and expected loss amounts under Chapter 2 of this Part, the expected loss amount in respect of such exposures shall be zero.

4. For clarity, point 3 above refers to the entire pool of exposures included in the securitisation. Subject to points 5 to 7 above, the originator investment firm is required to calculate risk-weighted exposure amounts in respect of all tranches in the securitisation in accordance with the provisions of Part 4 of this Annex 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 investment firm's risk-weighted exposure amounts.

3.1. Treatment of maturity mismatches in synthetic securitisations

5. For the purposes of calculating risk-weighted exposure amounts in accordance with point 3 above, 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 points 6 to 7 below.

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 Annex VIII of this Part.

7. An originator investment firm shall ignore any maturity mismatch in calculating risk-weighted exposure amounts for tranches appearing pursuant to Part 4 of this Annex with a risk weighting of 1250%. For all other tranches, the maturity mismatch treatment set out in Annex VIII of this Part shall be applied in accordance with the following formula:

RW* is $\left[RW(SP)\dfrac{(t-t^*)}{(T-t^*)}\right]+\left[RW(Ass)\dfrac{(T-t)}{(T-t^*)}\right]$

where:

RW* is Risk-weighted exposure amounts for the purposes of Part A, Chapter 3, paragraph 11(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 point 3 above if there was no maturity mismatch;

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 of this Annex, a credit assessment of an eligible ECAI shall comply with the following conditions.

   (a) There shall be no mismatch between the types of payments reflected in the credit assessment and the types of payment to which the investment firm is entitled under the contract giving rise to the securitisation position in question; and

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(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 investment firm itself. In such case, the investment firm 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 of this Annex.

2. USE OF CREDIT ASSESSMENTS

2. An investment firm may nominate one or more eligible ECAIs the credit assessments of which shall be used in the calculation of its risk-weighted exposure amounts under Chapter 4 of this Part (a "nominated ECAI").

3. Subject to points 5 to 7 below, an investment firm must use credit assessments from nominated ECAIs consistently in respect of its securitisation positions.

4. Subject to points 5 and 6 below, an investment firm may not use an ECAI's credit assessments for its positions in some tranches and another ECAI's 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 investment firm 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 eligible under Chapter 3 of this Part 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 eligible under Chapter 3 of this Part, 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.

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(a) The Commission shall, furthermore, take the necessary measures to ensure that, with regard to credit assessments relating to structured finance instruments, the ECAI is committed to make available publicly the explanation how the performance of pool assets affects its credit assessments.

3. MAPPING

8. The Commission shall determine with which credit quality step in the tables set out in Part 4 of this Annex each credit assessment of an eligible ECAI shall be associated. These associations for the eligible ECAIs are in accordance with Annex I of this Part. In doing so the Commission shall differentiate between the relative degrees of risk expressed by each assessment. The Commission shall consider quantitative factors, such as default and/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 Commission shall seek to ensure that securitisation positions to which the same risk weight is applied on the basis of the credit assessments of eligible 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.

PART 4

Calculation

1. CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS

1. For the purposes of paragraph 20 of Chapter 4 of this Part, 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 point 3 below:

   (a) Where an investment firm calculates risk-weighted exposure amounts under points 6 to 35 below, the exposure value of an on-balance sheet securitisation position shall be its balance sheet value;

   (b) Where an investment firm calculates risk-weighted exposure amounts under points 36 to 73 below, the exposure value of an on-balance sheet securitisation

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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 Annex. This conversion figure shall be 100% unless otherwise specified.

3. The exposure value of a securitisation position arising from a derivative instrument listed in Annex IV of this Part, shall be determined in accordance with Annex III of this Part.

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 Annex VIII of this Part as further specified in this Annex.

5. Where an investment firm 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 investment firm 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 investment firm is able to calculate and compare the capital charges for the relevant positions. For the purpose of this point "overlapping" means that the positions, wholly or partially, represent an exposure to the same risk such that to the extent of the overlap there is a single exposure.

   Where point 1(c) of Part 3 of this Annex applies to positions in the ABCP, the investment firm may, subject to the approval of the Commission, 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 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 below, 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 Commission in accordance with paragraph 22 of Chapter 4 of this Part as laid down in Table 1.

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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 points 10 to 15 below, the risk-weighted exposure amount of an unrated securitisation position shall be calculated by applying a risk weight of 1250%.

2.1. Originator and sponsor investment firms

8. For an originator investment firm or sponsor investment firm, 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. Investment firms having an unrated securitisation position may apply the treatment set out in point 10 below for calculating the risk-weighted exposure amount for that position provided the composition of the pool of exposures securitised is known at all times.

10. An investment firm may apply the weighted-average risk weight that would be applied to the securitised exposures under paragraphs 2 to 7 of Chapter 1 of this Part by an investment firm holding the exposures, multiplied by a concentration ratio. This concentration ratio is 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 investment firm is unable to determine the risk weights that would be applied to the securitised exposures under paragraphs 2 to 7 of Chapter 1 of this Part, 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 points 13 to 15 below, an investment firm may apply to securitisation positions meeting the conditions set out in point 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 paragraphs 2 to 7 of Chapter 1 of this Part by an investment firm holding the exposures.

12. For the treatment set out in point 11 above 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 must provide meaningful credit enhancement to the second loss tranche;

    (b) Of a quality the equivalent of investment grade or better; and

    (c) Held by an investment firm which does not hold a position in the first loss tranche.

2.4. Treatment of unrated liquidity facilities

2.4.1. Eligible liquidity facilities

13. When the following conditions are met, to determine its exposure value a conversion figure of 20% may be applied to the nominal amount of a liquidity facility with an original maturity of one year or less and a conversion figure of 50% may be applied to the nominal amount of a liquidity facility with an original maturity of more than one year:

    (a) The liquidity facility documentation shall clearly identify and limit the circumstances under which the facility may be drawn;

    (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;

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(d) Repayment of draws on the facility shall not be subordinated to the claims of investors other than to claims 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 must 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 Chapter 2 of this Part, 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 paragraphs 2 to 7 of Chapter 1 of this Part by an investment firm holding the exposures.

2.4.2. Liquidity facilities that may be drawn only in the event of a general market disruption

14. To determine its exposure value, a conversion figure of 0% may be applied to the nominal amount of a liquidity facility that may be drawn only in the event of a general market disruption (i.e. where more than one SPE across different transactions are unable to roll over maturing commercial paper and that inability is not the result of an impairment of the SPE's credit quality or of the credit quality of the securitised exposures), provided that the conditions set out in point 13 above are satisfied.

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 point 13 above 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 investment firm shall calculate a risk-weighted exposure amount according to the method set out in points 17 to 32 below when it sells

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revolving exposures into a securitisation that contains an early amortisation provision.

17. The investment firm 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 investment firm shall apply the treatment set out in points 19 to 30 below to that portion of the underlying pool containing revolving exposures.

19. For the purposes of points 16 to 30 of this Part, "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 may 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 investment firm, 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 point 16 above:

    (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 investment firm 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 investment firm, such as material changes in tax laws or regulations.

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2.5.2. Maximum capital requirement

22. For an originator investment firm subject to the capital requirement in point 16 above 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 point 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 an investment firm 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 Part B, Chapter 1, paragraph 2, shall be treated outside the maximum amount indicated in point 22 above.

2.5.3. Calculation of risk-weighted exposure amounts

24. The risk-weighted exposure amount to be calculated in accordance with point 16 above shall be determined by multiplying the amount of the investors' interest by the product of the appropriate conversion figure as indicated in points 26 to 32 below 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 investment firm has an appropriate capital/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 points 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

(d) The speed of repayment is no more rapid than would be achieved by straight-line amortisation over the period set out in point (c) above.

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, investment firms 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 point 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 2.

Table 2

	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 2, "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.

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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 Commission shall apply a treatment which approximates closely to that prescribed in points 26 to 29 for determining the conversion figure indicated.

31. All other securitisations subject to a controlled early amortisation provision of revolving exposures shall be subject to a conversion figure of 90%.

32. 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

33. Where credit protection is obtained on a securitisation position, the calculation of risk-weighted exposure amounts may be modified in accordance with Annex VIII of this Part.

2.7. Reduction in risk-weighted exposure amounts

34. As provided in Part B, Chapter 1, paragraph 9(2), in respect of a securitisation position in respect of which a 1250% risk weight is assigned, investment firms 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 eligible funded credit protection in a manner consistent with point 33 above.

35. Where an investment firm makes use of the alternative indicated in point 34 above, 12,5 times the amount deducted in accordance with that point shall, for the purposes of point 8 above, be subtracted from the amount specified in point 8 above as the maximum risk-weighted exposure amount to be calculated by the investment firms there indicated.

3. CALCULATION OF RISK-WEIGHTED EXPOSURE AMOUNTS UNDER THE INTERNAL RATINGS BASED APPROACH

3.1. Hierarchy of methods

36. For the purposes of paragraph 20 of Chapter 4 of this Part, the risk-weighted exposure amount of a securitisation positions shall be calculated in accordance with points 37 to

73 below.

37. For a rated position or a position in respect of which an inferred rating may be used, the Ratings Based Method set out in points 45 to 48 below shall be used to calculate the risk-weighted exposure amount.

38. For an unrated position the Supervisory Formula Method set out in points 49 to 51 below shall be used except where the Internal Assessment Approach is permitted to be used as set out in points 42 and 43 below.

39. An investment firm other than an originator investment firm or a sponsor investment firm may only use the Supervisory Formula Method with the approval of the Commission.

40. In the case of an originator or sponsor investment firm unable to calculate K_{irb} and which has not obtained approval to use the Internal Assessment Approach for positions in ABCP programmes, and in the case of other investment firms 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

41. When the following minimum operational requirements are satisfied, an investment firm 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 must be subordinate in all respects to the unrated securitisation position;

    (b) The maturity of the reference positions must be equal to or longer than that of the unrated position in question; and

    (c) On an ongoing basis, any inferred rating must 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

42. When the following conditions are satisfied an investment firm may attribute to an unrated position in an ABCP programme a derived rating as laid down in point 43 below:

    (a) Positions in the commercial paper issued from the ABCP programme shall be rated positions;

    (b) The investment firm shall satisfy to the Commission that its internal assessment of the credit quality of the position reflects the publicly available assessment methodology of one or more eligible 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 the point (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 must 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 investment firm shall take into consideration relevant published ratings methodologies of the eligible ECAIs that rate the commercial paper of the ABCP programme. This consideration shall be documented by the investment firm and updated regularly, as outlined in point (g);

    (e) The investment firm's internal assessment methodology shall include rating grades. There shall be a correspondence between such rating grades and the credit assessments of eligible ECAIs. This correspondence shall be explicitly documented;

    (f) The internal assessment methodology shall be used in the investment firm's internal risk management processes, including its decision making, management information and capital allocation processes;

    (g) Internal or external auditors, an ECAI, or the investment firm'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 investment firm's exposures to an ABCP programme. If the investment firm'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 investment firm shall track the performance of its internal ratings over time

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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, is 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 that take into account the operational capability and credit quality of the servicer. The ABCP programme shall mitigate seller/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 must 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 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

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deterioration of the underlying portfolio.

The requirement for the assessment methodology of the ECAI to be publicly available may be waived by the Commission where it 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.

43. The unrated position shall be assigned by the investment firm to one of the rating grades described in point 42 above. The position shall be attributed a derived rating the same as the credit assessments corresponding to that rating grade as laid down in point 42 above. 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 eligible credit assessment by an eligible ECAI for the purposes of calculating risk-weighted exposure amounts.

3.2. Maximum risk-weighted exposure amounts

44. For an originator investment firm, a sponsor investment firm, or for other investment firms which can calculate K_{irb}, 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 Part A, Chapter 3, paragraph 11(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 investment firm plus the expected loss amounts of those exposures.

3.3. Ratings Based Method

45. 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 Commission in accordance with paragraph 22 of Chapter 4 of this Part, as set out in Table 3, multiplied by 1,06.

Table 3

Credit Quality Step	Securitisation Positions	Re-securitisation Positions

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<table>
<tr><th>Credit assessments other than short term</th><th>Short term credit assessments</th><th>A</th><th>B</th><th>C</th><th>D</th><th>E</th></tr>
<tr><td>1</td><td>1</td><td>7%</td><td>12%</td><td>20%</td><td>20%</td><td>30%</td></tr>
<tr><td>2</td><td></td><td>8%</td><td>15%</td><td>25%</td><td>25%</td><td>40%</td></tr>
<tr><td>3</td><td></td><td>10%</td><td>18%</td><td rowspan="3">35%</td><td>35%</td><td>50%</td></tr>
<tr><td>4</td><td>2</td><td>12%</td><td>20%</td><td>40%</td><td>65%</td></tr>
<tr><td>5</td><td></td><td>20%</td><td>35%</td><td>60%</td><td>100%</td></tr>
<tr><td>6</td><td></td><td>35%</td><td colspan="2">50%</td><td>100%</td><td>150%</td></tr>
<tr><td>7</td><td>3</td><td>60%</td><td colspan="2">75%</td><td>150%</td><td>225%</td></tr>
<tr><td>8</td><td></td><td colspan="3">100%</td><td>200%</td><td>350%</td></tr>
<tr><td>9</td><td></td><td colspan="3">250%</td><td>300%</td><td>500%</td></tr>
<tr><td>10</td><td></td><td colspan="3">425%</td><td>500%</td><td>650%</td></tr>
<tr><td>11</td><td></td><td colspan="3">650%</td><td>750%</td><td>850%</td></tr>
<tr><td colspan="2">All other and unrated</td><td colspan="5">1250%</td></tr>
</table>

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46. The weightings in column C of Table 3 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.

47. In calculating the effective number of exposures securitised multiple exposures to one obligor must be treated as one exposure. The effective number of exposures is calculated as:

$$N = \frac{\left(\sum_i EAD_i\right)^2}{\sum_i EAD_i^2}$$

where EAD_i represents the sum of the exposure values of all exposures to the ith obligor. If the portfolio share associated with the largest exposure, C_1, is available, the investment firm may compute N as $1/C_1$.

48. Credit risk mitigation on securitisation positions may be recognised in accordance with points 57 to 59 below.

3.4. Supervisory Formula Method

49. Subject to points 55 and 56 below, under the Supervisory Formula Method, the risk weight for a securitisation position shall be the risk weight to be applied in accordance with point 50 below. However, the risk weight shall be no less than 20% for re-securitisation positions and no less than 7% for all other sedcuritisation positions.

50. Subject to points 55 and 56 below, the risk weight to be applied to the exposure amount shall be:

$$12{,}5 * \frac{(S[L+T] - S[L])}{T}$$

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where:

$$S[x] = \begin{cases} x, & when\ K_{irb} > x \\ K_{irbr} + K[x] - K[K_{irbr}] + (\frac{d * K_{irbr}}{\omega})(1 - e^{\omega(K_{irbr} - x)/K_{irbr}}), & when\ K_{irb} < x \end{cases}$$

where:

$$h = \left(1 - K_{irbr}/ELGD\right)^N$$

$$c = \frac{K_{irbr}}{1-h}$$

$$v = \frac{(ELGD - K_{irbr}) * K_{irbr} + 0.25 * (1 - ELGD) * K_{irbr}}{N}$$

$$f = \left(\frac{v + K_{irb}^2}{1-h} - c^2\right) + \frac{(1 - K_{irbr})K_{irbr} - v}{(1-h)\tau}$$

$$g = \frac{(1-c) * c}{f} - 1$$

$$a = g * c$$

$$b = g * (1-c)$$

$$d = 1 - (1-h) * (1 - Beta[K_{irbr}; a, b]$$

$$K[x] = (1-h) * ((1 - Beta[x; a, b]) * x + Beta[x; a+1, b] * c)$$

$\tau = 1000$, 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) is 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 Annex IV of this Part shall, where the current replacement cost is not a positive value, be the potential future credit exposure calculated in accordance with Annex III of this Part.

K_{irbr} is the ratio of (a) K_{irb} to (b) the sum of the exposure values of the exposures that have been securitised. K_{irbr} is expressed in decimal form (e.g. K_{irb} equal to 15% of the pool would be expressed as K_{irbr} of 0,15).

L (the credit enhancement level) is 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 Annex IV of this Part 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 47 above. In the case of re-securitisation the investment firm 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:

$$ELGD = \frac{\sum_i LGD_i * EAD_i}{\sum_i EAD_i}$$

where LGD_i represents the average LGD associated with all exposures to the ith obligor, where LGD is determined in accordance with Chapter 2 of this Part. 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

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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 investment firm may set LGD= 50% and N equal to either:

$$N = \left(C_1 * C_m + \left(\frac{C_m - C_1}{m-1} \right) \max\{1 - m * C_1, 0\} \right)^{-1}$$

or

$$N = \frac{1}{C_1}.$$

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 investment firm.

For securitisations involving retail exposures, the Commission shall permit the Supervisory Formula Method to be implemented using the simplifications: h = 0 and v = 0.

51. Credit risk mitigation on securitisation positions may be recognised in accordance with points 57, 58 and 60 to 64 below.

3.5. Liquidity Facilities

52. The provisions in points 53 to 56 below apply for the purposes of determining the exposure value of an unrated securitisation position in the form of certain types of liquidity facility.

3.5.1. Liquidity Facilities Only Available in the Event of General Market Disruption

53. A conversion figure of 20% may be applied to the nominal amount of a liquidity facility that may only be drawn in the event of a general market disruption and that meets the conditions to be an "eligible liquidity facility" set out in point 13 above.

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3.5.2. Cash advance facilities

54. A conversion figure of 0% may be applied to the nominal amount of a liquidity facility that meets the conditions set out in point 15 above.

3.5.3. Exceptional treatment where K_{irb} cannot be calculated.

55. When it is not practical for the investment firm to calculate the risk-weighted exposure amounts for the securitised exposures as if they had not been securitised, an investment firm shall, on an exceptional basis and subject to the consent of the Commission, temporarily be allowed to apply the method set out in point 56 below 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 "eligible liquidity facility" set out in point 13 above or that falls within the terms of point 53 above.

56. The highest risk weight that would be applied under paragraphs 2 to 7 of Chapter 1 of this Part 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 point 53 above 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

57. Eligible funded protection is limited to that which is eligible for the calculation of risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part as laid down under Chapter 3 of this Part and recognition is subject to compliance with the relevant minimum requirements as laid down under those paragraphs.

3.6.2. Unfunded credit protection

58. Eligible unfunded credit protection and unfunded protection providers are limited to those which are eligible under Chapter 3 of this Part and recognition is subject to compliance with the relevant minimum requirements laid down under those Articles.

3.6.3. Calculation of capital requirements for securitisation positions with credit risk mitigation

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Ratings Based Method

59. 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 Annex VIII of this Part as they apply for the calculation of risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part.

Supervisory Formula Method — full credit protection

60. Where risk-weighted exposure amounts are calculated using the Supervisory Formula Method, the investment firm 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.

61. 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 Chapter 3 of this Part for the calculation of risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part taking the amount of the securitisation position to be E) by the effective risk weight.

62. 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 Annex VIII of this Part) 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

63. If the credit risk mitigation covers the "first loss" or losses on a proportional basis on the securitisation position, the investment firm may apply points 60 to 62 above.

64. In other cases, the investment firm 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 points 49 to 51 above 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 Annex VIII of this Part as they apply for the calculation of risk-weighted exposure amounts under paragraphs 2 to 7 of Chapter 1 of this Part 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 Annex VIII of this Part) 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

65. In addition to the risk-weighted exposure amounts calculated in respect of its securitisation positions, an originator investment firm shall be required to calculate a risk-weighted exposure amount according to the methodology set out in points 16 to 32 above when it sells revolving exposures into a securitisation that contains an early amortisation provision.

66. For the purposes of point 65 above, points 67 and 68 below shall replace points 19 and 20 above.

67. 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 point (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.

    "Investors' interest" means the exposure value of the notional part of the pool of drawn

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amounts not falling within point (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 point (b).

68. The exposure of the originator investment firm associated with its rights in respect of that part of the originator's interest described in point 67(a) above 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 point 67(a) above. The originator investment firm 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 point 67(b) above.

3.8. Reduction in risk-weighted exposure amounts

69. 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 investment firm 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 Annex VII, Part 1, point 36 of this Part.

70. 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 investment firm in respect of the position.

71. As provided in Part B, Chapter 1, paragraph 9(2), in respect of a securitisation position in respect of which a 1250% risk weight applies, investment firms 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.

72. For the purposes of point 71 above:

    (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 points 69 and 70 above;

    (b) The calculation of the exposure value may reflect eligible funded protection in a manner consistent with the methodology prescribed in points 57 to 64 above; and

    (c) Where the Supervisory Formula Method is used to calculate risk-weighted

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exposure amounts and $L < K_{irbr}$ 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.

73. Where an investment firm makes use of the alternative indicated in point 71 above, 12,5 times the amount deducted in accordance with that point shall, for the purposes of point 44 above, be subtracted from the amount specified in point 44 above as the maximum risk-weighted exposure amount to be calculated by the investment firms there indicated.

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ANNEX X

OPERATIONAL RISK

PART 1

Basic Indicator Approach

1. CAPITAL REQUIREMENT

1. Under the Basic Indicator Approach, the capital requirement for operational risk is equal to 15% of the relevant indicator defined in points 2 to 9 below.

2. RELEVANT INDICATOR

2. The relevant indicator is the average over three years of the sum of net income.

3. 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.

4. If for any given observation, the sum of net 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. The basis of calculating the relevant indicator

5. Based on the accounting categories for the profit and loss account of investment firms under International Financial Reporting Standards, 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 points 7 and 8 below.

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Table 1

1	Income and commissions/fees receivables for investment services and activities
2	Expenses and commissions/fees payables for investment services and activities
3	Income and commissions/fees receivables for non core services
4	Expenses and commissions/fees payables for non core services
5	Other 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 investment firm or a subsidiary of a parent which is also the parent of the investment firm. 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, this Directive.

8. The following elements shall not be used in the calculation of the relevant indicator:

   (a) Realised profits/losses from the sale of non-trading book items;

   (b) Income from extraordinary or irregular items;

   When revaluation of trading items is part of the profit and loss statement, revaluation shall be included.

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PART 2

Standardised Approach

1. CAPITAL REQUIREMENT

1. Under the Standardised Approach, the capital requirement for operational risk is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines referred to in Table 2. In each year, a negative capital requirement in one business line, resulting from a negative relevant indicator may be imputed to the whole. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the average 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 paragraph 3 of Chapter 1 of this Part 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%

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Commercial banking	- Lending (that does not fall within the definition of retail banking)	15%
Retail banking (Activities with a individual physical persons or with small and medium sized entities meeting the criteria set out in paragraph 3 of Chapter 1 of this Part for the retail exposure class)	- Lending,	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%

2. PRINCIPLES FOR BUSINESS LINE MAPPING

3. Investment firms must develop and document specific policies and criteria for mapping the relevant indicator for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted as appropriate for new or changing business activities and risks. The principles for business line mapping are:

   (a) All activities must 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, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective-mapping criterion must be used;

   (c) If an activity cannot be mapped into a particular business line then the business line yielding the highest percentage must be used. The same business line equally applies to any associated ancillary activity;

   (d) Investment firms 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;

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(e) The mapping of activities into business lines for operational risk capital purposes must be consistent with the categories used for credit and market risks;

(f) Senior management is responsible for the mapping policy under the control of the governing bodies of the investment firm; and

(g) The mapping process to business lines must be subject to independent review.

3. QUALIFYING CRITERIA

4. Investment firms must meet the qualifying criteria listed below, in addition to the general risk management standards set out in section 18(2)(e) and (f) of the Law and Annex V of this Part. Satisfaction of these criteria shall be determined having regard to the size and scale of activities of the investment firm and to the principle of proportionality.

   (a) Investment firms 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 must be closely integrated into the risk management processes of the investment firm. Its output must be an integral part of the process of monitoring and controlling the investment firm's operational risk profile.

   (c) Investment firms shall implement a system of management reporting that provides operational risk reports to relevant functions within the investment firm. Investment firms 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, investment firms must satisfy the Commission that they meet the qualifying criteria below, in addition to the general risk management standards in section 18 (2) (e) and (f) of the Law and Annex V of this Part.

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1.1. Qualitative Standards

2. The investment firm's internal operational risk measurement system shall be closely integrated into its day-to-day risk management processes.

3. The investment firm must have an independent risk management function for operational risk.

4. There must be regular reporting of operational risk exposures and loss experience. The investment firm shall have procedures for taking appropriate corrective action.

5. The investment firm's risk management system must be well documented. The investment firm 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 Commission 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. Investment firms 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 must 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 an investment firm must have certain key elements to meet the soundness standard set out in point 8 above. These elements must include the use of internal data, external data, scenario analysis and factors reflecting the

business environment and internal control systems as set out in points 13 to 24 below. An investment firm needs to have a well documented approach for weighting the use of these four elements in its overall operational risk measurement system.

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 investment firms can demonstrate to the satisfaction of the Commission 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 investment firm must 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 an investment firm first moves to an Advanced Measurement Approach, a three-year historical observation period is acceptable.

14. Investment firms must be able to map their historical internal loss data into the business lines defined in Part 2 of this Annex and into the event types defined in Part 4 of this Annex, and to provide these data to the Cyprus Securities and Exchnage Commission upon request. There must be documented, objective criteria for allocating losses to the specified business lines and event types. The operational risk losses that are related to credit risk and have historically been included in the internal credit risk databases must be recorded in the operational risk databases and be separately identified. Such losses will 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 that are related to market risks shall be included in the scope of the capital requirement for operational risk.

15. The investment firm's internal loss data must be comprehensive in that it captures all material activities and exposures from all appropriate sub-systems and geographic locations. The investment firm must 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 must be defined, which should not be less than the amount of €1.000 per loss event. Investment firms

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must inform the Commission about losses that arise from operational risk and are equal to or exceed 5% of their income.

16. Aside from information on gross loss amounts, investment firms 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. Investment firms must 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 investment firm's operational risk measurement system shall use relevant external data, especially when there is reason to believe that the investment firm is exposed to infrequent, yet potentially severe, losses. An investment firm must have a systematic process for determining the situations for which external data must be used and the methodologies used to incorporate the data in its measurement system. The conditions and practices for external data use must be regularly reviewed, documented and subject to periodic independent review.

1.2.4. Scenario analysis

20. The investment firm 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 re-assessed through comparison to actual loss experience to ensure their reasonableness.

1.2.5. Business environment and internal control factors

21. The investment firm's firm-wide risk assessment methodology must capture key business environment and internal control factors that can change its operational risk profile.

22. The choice of each factor needs to be justified as a meaningful driver of risk, based on experience and involving the expert judgment of the affected business areas.

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23. The sensitivity of risk estimates to changes in the factors and the relative weighting of the various factors need to be well reasoned. In addition to capturing changes in risk due to improvements in risk controls, the framework must also capture potential increases in risk due to greater complexity of activities or increased business volume.

24. This framework must be documented and subject to independent review within the investment firm and by the Commission. Over time, the process and the outcomes need to 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. Investment firms shall be able to recognise the impact of insurance subject to the conditions set out in points 26 to 29 below and other risk transfer mechanisms where the investment firm can demonstrate to the satisfaction of the Commission 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 eligible ECAI which has been determined by the Commission to be associated with credit quality step 3 or above under the rules for the risk weighting of exposures to institutions under paragraphs 2 to 7 of Chapter 1 of this Part.

27. The insurance and the investment firms' insurance framework shall meet the following conditions:

    (a) The insurance policy must have an initial term of no less than one year. For policies with a residual term of less than one year, the investment firm must 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 has a minimum notice period for cancellation of the contract of 90 days;

    (c) The insurance policy has no exclusions or limitations triggered by the Commission or, in the case of a failed investment firm, that preclude the investment firm receiver or liquidator, from recovering for damages suffered or expenses incurred by the investment firm, except in respect of events occurring after the initiation of receivership or liquidation proceedings in respect of the investment firm; provided that the insurance policy may exclude any fine, penalty, or punitive damages resulting from actions by the Commission;

(d) The risk mitigation calculations must reflect the insurance coverage in a manner that is transparent in its relationship to, and consistent with, the actual likelihood and impact of loss used in the overall determination of operational risk capital;

(e) The insurance is provided by a third party entity. In the case of insurance through captives and affiliates, the exposure has to 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 is 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 arising from the recognition of insurance 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 EU parent investment firm and its subsidiaries, or by the subsidiaries of an EU parent 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.

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PART 4

Loss event type classification

Table 3

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 counterparties and vendors

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ANNEX XI

TECHNICAL CRITERIA ON REVIEW AND EVALUATION BY THE COMMISSION

1. In addition to credit, market and operational risks, the review and evaluation performed by the Commission pursuant to paragraph 32 of Chapter 6 of this Part shall include the following:

    (a) The results of the stress test carried out by the investment firms applying an IRB approach;

    (b) The exposure to and management of concentration risk by the investment firms, including their compliance with the requirements laid down in the Large Exposures Directive, paragraphs 2(1), 2(4), 4 to 18 and section 69 (3) of the Law.

    (c) The robustness, suitability and manner of application of the policies and procedures implemented by investment firms for the management of the residual risk associated with the use of recognized credit risk mitigation techniques;

    (d) The extent to which the own funds held by an investment firm 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, measurement and management of liquidity risk by the investment firms, 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 the investment firms using an internal model to calculate market risk capital requirements under Part D, Annex V.

1a. For the purposes of point 1(e), the Commission shall regularly carry out a comprehensive assessment of the overall liquidity risk management by investment firms and promote the development of sound internal methodologies. While conducting those reviews, the Commission shall have regard to the role played by investment firms in the financial markets. The Commission shall duly consider the potential impact of its decisions on the stability of the financial system in all other Member States concerned.

2. The Commission shall monitor whether an investment firm has provided implicit support to a securitisation. If an investment firm is found to have provided implicit support on more than one occasion the Commission shall take appropriate measures reflective of the increased expectation that it will 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 paragraph 32(3) of Chapter 6 of this Part, the Commission shall consider whether the value adjustments and provisions taken for positions/portfolios in the trading book, as set out in Part B of Annex VII of Part D, enable the investment firm to sell or hedge out its positions within a short period without incurring material losses under normal market conditions.

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ANNEX XII

TECHNICAL CRITERIA ON TRANSPARECY 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 an investment firm 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 an investment firm's investments therein less valuable.

3. Information shall be regarded as confidential if there are obligations to customers or other counterparty relationships binding an investment firm to confidentiality.

4. The Commission shall require investment firms 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 Part 2, points 3(b) and 3(e) and 4(b) to 4(e) of this Annex, and information on risk exposure and other items prone to rapid change.

5. The disclosure requirement in Part 2, points 3 and 4 of this Annex shall be provided pursuant to Part A, Chapter 2, paragraph 6(1) and 6(2).

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PART 2

General requirements

1. The risk management objectives and policies of the investment firm shall be disclosed for each separate category of risk, including the risks referred to under points 1 to 14 below. 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 this Directive:

   (a) The name of the investment firm to which the requirements of this Directive 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;

   (c) 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;

   (d) 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

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such subsidiaries; and

(e) If applicable, the circumstance of making use of the provisions laid down in Part A, Chapter 2, paragraphs 3 and 4.

3. The following information shall be disclosed by the investment firms regarding their own funds:

(a) summary information on the terms and conditions ofthe main features of all own-funds items and components thereof, including instruments referred to in paragraph 2 (1) (ca) of Chapter 1, Part B, instruments the provisions of which provides an incentive for the investment firm to redeem them, and instruments subject to paragraph 43 points (3) and (4) of Chapter 9, Part C;

(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 paragraph 2 (1) (ca) of Chapter 1, Part B, and instruments the provisions of which provide an incentive for the investment firm to redeem them, shall alsobe disclosed separately; those disclosures shall each specify instruments subject to paragraph 43 points (3) and (4) of Chapter 9, Part C;

(c) The total amount of additional own funds, and own funds as defined in Part B, Chapter 1;

(d) Deductions from original and additional own funds pursuant to Part B, Chapter 1, paragraph 9 (2), with separate disclosure of items referred to in Part B, Chapter 1 paragraph 2 (1)(p); and

(e) Total eligible own funds, net of deductions and limits laid down in Part B, Chapter 1, paragraph 9.

4. The following information shall be disclosed regarding the compliance by the investment firm with the requirements laid down in paragraph 11, Chapter 3 of Part A and paragraph 31 of Chapter 6 of this Part:

(a) A summary of the investment firm's approach to assessing the adequacy of its internal capital to support current and future activities;

(b) For investment firms calculating the risk-weighted exposure amounts in accordance with paragraphs 2 to 7 of Chapter 1 of this Part, 8 per cent of the risk-weighted exposure amounts for each of the exposure classes specified in paragraph 3 of Chapter 1 of this

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Part;

(c) For investment firms calculating risk-weighted exposure amounts in accordance with Chapter 2 of this Part, 8 per cent of the risk-weighted exposure amounts for each of the exposure classes specified in paragraph 10 of Chapter 2 of this Part. For the retail exposure class, this requirement applies to each of the categories of exposures to which the different correlations in Annex VII, Part 1, points 10 to 13 of this Part correspond. For the equity exposure class, this requirement applies to:

(i) Each of the approaches provided in Annex VII, Part 1, points 17 to 26 of this Part;

(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 paragraph 11, points (b) and (c), Chapter 3 of Part A; and

(e) Minimum capital requirements calculated in accordance with paragraphs 27 to 29 of Chapter 5 of this Part, and disclosed separately.

5. The following information shall be disclosed regarding the investment firm's exposure to counterparty credit risk as defined in Annex III, Part 1 of this Part:

(a) A discussion of the methodology used to assign internal capital and credit limits for counterparty 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 investment firm 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

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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 Annex III of this Part, whichever method is applicable;

(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 investment firm'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 investment firm has received the approval of the Commission to estimate α.

6. The following information shall be disclosed regarding the investment firm'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 counterparty 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 counterparty type, the amount of:

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(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;

(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 investment firms calculating the risk weighted exposure amounts in accordance with paragraphs 2 to 7 of Chapter 1 of this Part, the following information shall be disclosed for each of the exposure classes specified in paragraph 3 of Chapter 1 of this Part:

(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;

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(d) The association of the external rating of each nominated ECAI or ECA with the credit quality steps prescribed in Annex VI, of this Part , taking into account that this information needs not be disclosed if the investment firm complies with the standard association published by the Commission; and

(e) The exposure values and the exposure values after credit risk mitigation associated with each credit quality step prescribed in Annex VI, of this Part, as well as those deducted from own funds.

8. The investment firms calculating the risk-weighted exposure amounts in accordance with Annex VII, Part 1, points 6 or 19 to 21 of this Part shall disclose the exposures assigned to each category in Table 1 in point 6 of Annex VII, Part 1 of this Part, or to each risk weight mentioned in points 19 to 21 of Annex VII, Part 1 of this Part.

9. The investment firms calculating their capital requirements in accordance with Part A, Chapter 3, paragraphs 11(b) and 11(c) 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 investment firm which calculates its capital requirements in accordance with Part D, Annex V:

(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 Annex V of Part D separately, the methodologies used and the risks measured through the use of an internal model including a description of the approach used by the investment firm 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 Commission.

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(c) A description of the extent and methodologies for compliance with the requirements set out in Part D, Annex VII, Part B.

(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 Annex V of Part D, separately over the reporting period and as per the period-end;

(e) the amount of capital in accordance with points 5a and 5l of Annex V of Part D separately, together with the weighted average liquidity horizon for each sub-portfolio covered; and

(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 the investment firms on operational risk:

(a) The approaches for the assessment of own funds requirements for operational risk that the investment firm qualifies for; and

(b) A description of the methodology set out in paragraph 29 of Chapter 5 of this Part, if used by the investment firm, including a discussion of relevant internal and external factors considered in the investment firm's measurement approach.

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;

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(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 investment firms on their 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. The investment firms calculating risk weighted exposure amounts in accordance with Chapter 4 of this Part or capital requirements in accordance with point 16a of Annex I of Part D shall disclose the following information, where relevant, separately for their trading and non-trading book:

    (a) A description of the investment firm's objectives in relation to securitisation activity;

    (b) The nature of other risks including liquidity risk inherent in securitised assets;

    (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 investment firm in the securitisation process;

    (e) An indication of the extent of the investment firm's involvement in each of the roles referred in point (d) above;

    (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-

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securitisation exposures;

(g) A description of the investment firm'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 investment firm follows for its securitisation activities including the types of securitisation exposures to which each approach applies;

(i) The types of SSPE that the investment firm, as sponsor, uses to securitise third-party exposures including whether and in what form and to what extent the investment firm has exposures to those SSPEs, separately for on- and off-balance sheet exposures, as well as a list of the entities that the investment firm manages or advises and that invest in either the securitisation positions that the investment firm has securitised or in SSPEs that the investment firm sponsors;

(j) A summary of the investment firm'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

(iv) The treatment of synthetic securitisations if this is not covered by other accounting policies;

(v) How assets awaiting securitisation are valued and whether they are recorded in the investment firm's non-trading book or the trading book;

(vi) Policies for recognising liabilities on the balance sheet for arrangements that could require the investment firm 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;

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(l) Where applicable, a description of the Internal Assessment Approach as set out in Part 4 of Annex IX, 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 investment firm, separately for traditional and synthetic securitisations and securitisations for which the investment firm 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 aggregate capital requirements incurred by the investment firm against the originator's interest and the aggregate capital requirements incurred by the investment firm 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;

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(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 investment firm, the amount of impaired/past due assets securitised and the losses recognised by the investment firm during the current period, both broken down by exposure type;

(q) For the trading book, the total outstanding exposures securitised by the investment firm 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 investment firm 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, 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 investment firm, indicating the following:

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(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

(vi) The amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

For investment firms that are significant in terms of their size, internal organisation and the nature, scope and the complexity of their activities, the quantitative information referred to in this point shall also be made available to the public at the level of persons who effectively direct the business of the investment firm within the meaning of paragraph 12(3) of the Law.

Investment firms shall comply with the requirements set out in this point in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to the provisions of the Processing of Personal Data (Protection of Individuals) Law.

The Commission shall use the information collected in accordance with the criteria for disclosure established in point 15 (f) above to benchmark remuneration trends and practices. The Commission shall provide the European Banking Authority with that information

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PART 3

Qualifying requirements for the use of particular instruments or methodologies

1. The investment firms calculating the risk-weighted exposure amounts in accordance with Chapter 2 of this Part shall disclose the following information:

    (a) The Commission'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 Chapter 2 of this Part;

    (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) Institutions;

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(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 Annex VII, Part 1, points 10 to 13 of this Part correspond; and

(v) Equities;

(d) The exposure values for each of the exposure classes specified in paragraph 10 of Chapter 2 of this Part. Exposures to central governments and central banks, institutions and corporates where investment firms 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 investment firms do not use such estimates;

(e) For each of the exposure classes central governments and central banks, institutions, corporate and equity, and across a sufficient number of obligor grades (including default) to allow for a meaningful differentiation of credit risk, investment firms shall disclose:

(i) The total exposures (for the exposure classes central governments and central banks, institutions and corporate, the sum of outstanding loans and exposure values for undrawn commitments; for equities, the outstanding amount);

(ii) For the investment firms 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

(iv) For the investment firms 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 point (c)(iv) above, 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 point (c)(iv) above and how they differ from past experience;

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(h) A description of the factors that impacted on the loss experience in the preceding period (for example, has the investment firm experienced higher than average default rates, or higher than average LGDs and conversion factors); and

(i) The investment firm'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 point (c)(iv) above 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 point (c)(iv) above. Where appropriate, the investment firms shall further decompose this to provide analysis of PD and, for the investment firms 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 point (c) above, 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 Annex VII, Part 4, points 44 to 48 of this Part, including the broad segments affected by such deviations.

2. The investment firms 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 investment firm;

(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 investment firms calculating risk-weighted exposure amounts in accordance with paragraphs 2 to 7 of Chapter 1 or Chapter 2 of this Part, but not providing own estimates of LGDs or conversion factors in respect of the exposure class, separately for each

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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 investment firms calculating risk-weighted exposure amounts in accordance with paragraphs 2 to 7 of Chapter 1or Chapter 2 of this Part, 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 Annex VII, Part 1, points 17 to 26 of this Part.

3. The investment firms using the approach set out in paragraph 29 of Chapter 5 of this Part for the calculation of their own funds requirements for operational risk shall disclose a description of the use of insurance for the purpose of mitigating the risk.

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ANNEX XIII

LIST OF ACTIVITIES SUBJECT TO MUTUAL RECOGNITION

1. Acceptance of deposits and other repayable funds

2. Lending including, inter alia: consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfeiting)

3. Financial leasing

4. Money transmission services

5. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts)

6. Guarantees and commitments

7. Trading for own account or for account of customers in:

(a) money market instruments (cheques, bills, certificates of deposit, etc.);
(b) foreign exchange;
(c) financial futures and options;
(d) exchange and interest- rate instruments; or
(e) transferable securities.

8. Participation in securities issues and the provision of services related to such issues

9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings

10. Money broking

11. Portfolio management and advice

12. Safekeeping and administration of securities

13. Credit reference services

14. Safe custody services

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The services and activities provided for in Part I and II of the third Annex of the Law, when referring to the financial instruments provided for in Part III, of the third Annex of the Law, are subject to mutual recognition according to this Directive.

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Part D

The calculation of capital base and capital adequacy of investment firms

Chapter 1

Trading Book

Trading book.

1. (1) The trading book of an investment firm 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 are either free of any restrictive covenants on their tradability or able to be hedged.

(2) Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations. The term "positions" shall include proprietary positions and positions arising from client servicing and market making.

Part D, Annex VII

(3) Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the investment firm to manage the position or portfolio in accordance with Part A of Annex VII of this Part. Furthermore, each investment firm that has a trading book is required to prepare a trading book policy statement and agree the contents with the Commission. The trading book policy statement should be consistent with the trading policies of the investment firm, as these have been approved by the Board of Directors of the investment firm, and should set out how the investment firm intends to comply with the provisions of this Part. The procedure for agreeing the contents of the trading book policy statement and the outline of its contents, which is required by the Commission, is set out in Annex VIII of this Part.

Part D, Annex VIII

Part D, Annex VII

(4) Investment firms shall establish and maintain systems and controls to manage their trading book in accordance with Parts B and D of Annex VII of this Part.

Part D, Annex VII

(5) Internal hedges may be included in the trading book, in which case Part C of Annex VII of this Part shall apply.

Valuation of trading book positions.

2. (1) All trading book positions shall be subject to prudent valuation rules as specified in Annex VII, Part B of this Part. These rules shall require

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Part D, Annex VII

investment firms to ensure that the value applied to each of its trading book positions appropriately reflects the current market value. The former value shall contain an appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of trading book positions.

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

(3) In the absence of readily available market prices, the Commission may waive the requirement imposed in paragraphs 2 (1) and 2 (2) and shall require investment firms to use alternative methods of valuation provided that those methods are sufficiently prudent and have been approved by the Commission.

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Chapter 2

Large Exposure in the Trading Book

Large Exposures.

3. (1) Investment firms shall monitor and control their large exposures in accordance with the Large Exposures Directive.

(2) By way of derogation from paragraph 3 (1), investment firms which calculate the capital requirements for their trading-book business in accordance with Annexes I and II, and, as appropriate, Annex V of this Part, shall monitor and control their large exposures in accordance with the Large Exposures Directive, subject to the amendments laid down in paragraphs 4 to 7 of this Part.

Part D, Annex I , II and V

Exposures to individual persons.

4. (1) The exposures to individual persons which arise on the trading book shall be calculated by summing the following items:

(a) The excess — where positive — of an investment firm's long positions over its short positions in all the financial instruments issued by the person in question, the net position in each of the different instruments being calculated according to the methods laid down in Annex I, of this Part;

Part D, Annex I

(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 Annex II of this Part with the person in question, such exposures being calculated in the manner laid down in that Annex, for the calculation of exposure values.

Part D, Annex II

For the purposes of point (b), the net exposure is 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 set out in point 40 of Annex I, of this Part.

Part D, Annex I

For the purposes of point (b), pending further coordination, the Commission shall require investment firms to set up systems to monitor and control their underwriting exposures between the time of the initial commitment and

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working day one in the light of the nature of the risks incurred in the markets in question.

Part D, Annex II

For the purposes of point (c), Part C, Chapter 2 shall be excluded from the reference in point 6 of Annex II of this Part.

(2) The exposures to groups of connected persons on the trading book shall be calculated by summing the exposures to individual persons in a group, as calculated in paragraph 4 (1).

Overall exposures to individual persons or group or persons.

5. (1) The overall exposures to individual persons or groups of connected persons shall be calculated by summing the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account paragraphs 2(1), 6 to 16 of the Large Exposures Directive.

(2) Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to individual persons and groups of connected persons for reporting purposes shall not include the recognition of credit risk mitigation.

(3) The sum of the exposures to an individual person or group of connected persons in paragraph 5 (1) shall be limited in accordance with paragraphs 2(1), 5 τo 16 of the Large Exposures Directive.

Exceeding of limits of large exposures.

6. The Commission may authorise the limits laid down in paragraphs 2(1), 5 to 16 of the Large Exposures Directive to be exceeded if the following conditions are met:

(a) The exposure on the non-trading book to the person or group of persons in question does not exceed the limit laid down in paragraph 6(1) of the Large Exposures Directive, those limits being calculated with reference to own funds as specified in that Directive, so that the excess arises entirely on the trading book;

(b) The investment firm meets an additional capital requirement on the excess in respect of the limit laid down in paragraph 6(1) of the Large Exposures Directive, that additional capital requirement being calculated in accordance with Part C, Annex VI of this Directive;

Part D, Annex VI

(c) Where 10 days or less has elapsed since the excess occurred, the trading-book exposure to the person or group of connected persons in

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question shall not exceed 500% of the investment firm's own funds;

(d) Any excesses that have persisted for more than 10 days must not, in aggregate, exceed 600% of the own funds; and

(e) Investment firms shall report to the Commission every three months all cases where the limit laid down in paragraph 6(1) of the Large Exposures Directive has been exceeded during the preceding three months.

In relation to point (e), in each case in which the limit has been exceeded, the amount of the excess and the name of the person concerned shall be reported.

Prohibition of deliberately avoiding additional capital requirements.

7. The Commission shall establish procedures to prevent investment firms from deliberately avoiding the additional capital requirements that they would otherwise incur, on exposures exceeding the limit laid down in paragraph 6(1) of the Large Exposures Directive once those exposures have been maintained for more than 10 days, by means of temporarily transferring the exposures in question to another company, whether within the same group or not, and/or by undertaking artificial transactions to close out the exposure during the 10-day period and create a new exposure.

Investment firms shall maintain systems which ensure that any transfer which has the effect referred to in the first subparagraph is immediately reported to the Commission.

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ANNEX I

CALCULATING CAPITAL REQUIREMENTS FOR POSITION RISK

GENERAL PROVISIONS

Netting

1. The excess of an investment firm’s long (short) positions over its short (long) positions in the same equity, debt and convertible issues and identical financial futures, options, warrants and covered warrants shall be its net position in each of those different instruments. In calculating the net position the Commission shall allow positions in derivative instruments to be treated, as laid down in points 4 to 7 below, as positions in the underlying (or notional) security or securities. Investment firms’ holdings of their own debt instruments shall be disregarded in calculating specific risk under point 14 below.

2. No netting shall be allowed between a convertible and an offsetting position in the instrument underlying it, unless the Commission adopt an approach under which the likelihood of a particular convertible's being converted is taken into account or have a capital requirement to cover any loss which conversion might entail.

3. All net positions, irrespective of their signs, must be converted on a daily basis into the investment firm’s reporting currency at the prevailing spot exchange rate before their aggregation.

Particular instruments

4. Interest-rate futures, forward rate agreements (FRAs) and forward commitments to buy or sell debt instruments shall be treated as combinations of long and short positions. Thus a long interest-rate futures position shall be treated as a combination of a borrowing maturing on the delivery date of the futures contract and a holding of an asset with maturity date equal to that of the instrument or notional position underlying the futures contract in question. Similarly a sold FRA will be treated as a long position with a maturity date equal to the settlement date plus the contract period, and a short position with maturity equal to the settlement date. Both the borrowing and the asset holding shall be included in the first category set out in Table 1 in point 14 below in order to calculate the capital required against specific risk for interest-rate futures and FRAs. A forward commitment to buy a debt instrument shall be treated as a combination of a borrowing maturing on the delivery date and a long (spot) position in the debt instrument itself. The borrowing shall be included in the first category set out in Table 1 in point 14 below for purposes of specific risk, and the

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debt instrument under whichever column is appropriate for it in the same table.

For the purposes of this point, "long position" means a position in which an investment firm has fixed the interest rate it will receive at some time in the future, and "short position" means a position in which it has fixed the interest rate it will pay at some time in the future.

5. Options on interest rates, debt instruments, equities, equity indices, financial futures, swaps and foreign currencies shall be treated as if they were positions equal in value to the amount of the underlying instrument to which the option refers, multiplied by its delta for the purposes of this Annex. The latter positions may be netted off against any offsetting positions in the identical underlying securities or derivatives. The delta used shall be that of the exchange concerned, that calculated by the Commission or, where that is not available or for OTC-options, that calculated by the investment firm itself, subject to the satisfaction of the Commission that the model used by the investment firm is reasonable.

   Other risks, apart from the delta risk, associated with options shall be safeguarded against. The requirement on a bought exchange-traded or OTC option is permitted to be the same as that for the instrument underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement against a written OTC option shall be set in relation to the instrument underlying it.

6. Warrants relating to debt instruments and equities shall be treated in the same way as options under point 5 above.

7. Swaps shall be treated for interest-rate risk purposes on the same basis as on-balance-sheet instruments. Thus, an interest-rate swap under which an investment firm receives floating-rate interest and pays fixed-rate interest shall be treated as equivalent to a long position in a floating-rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed-rate instrument with the same maturity as the swap itself.

A. TREATMENT OF THE PROTECTION SELLER

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 must be used. Notwithstanding the first sentence, the investment firm 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 is applicable instead of the maturity of the obligation. Positions are determined as follows:

(a) A total return swap creates a long position in the general market risk of the reference obligation and a short position in the general market risk of a government bond with a maturity equivalent to the period until the next interest fixing and which is assigned a 0% risk weight under Annex VI of Part C. It also creates a long position in the specific risk of the reference obligation.

(b) A credit default swap does not create a position for general market risk. For the purposes of specific risk, the investment firm must record a synthetic long position in an obligation of the reference entity, unless the derivative is rated externally and meets the conditions for a qualifying debt item, in which case a long position in the derivative is recorded. If premium or interest payments are due under the product, these cash flows must be represented as notional positions in government bonds.

(c) A single name credit linked note creates a long position in the general market risk of the note itself, as an interest rate product. For the purpose of specific risk, a synthetic long position is created in an obligation of the reference entity. An additional long position is created in the issuer of the note. Where the credit linked note has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note need only be recorded.

(d) In addition to a long position in the specific risk of the issuer of the note, a multiple name credit linked note providing proportional protection creates a position in each reference entity, with the total notional amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting determines the specific risk.

Where a multiple name credit linked note has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note need only be recorded.

(e) A first-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity. If the size of the maximum credit event payment is lower than the capital requirement under the method in the first sentence of this point, the maximum payment amount may be taken as the capital requirement for specific risk.

A second-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity less one (that with the lowest specific risk capital requirement). If the size of the maximum credit event payment is lower than the capital requirement under the method in the first sentence of this point, this amount may be

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taken as the capital requirement for specific risk.

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.

B. TREATMENT OF THE PROTECTION BUYER

For the party who transfers credit risk (the "protection buyer"), the positions are determined as the mirror image of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). If at a given moment there is a call option in combination with a step up, such moment is treated as the maturity of the protection. In the case of nth to default credit derivatives, protection buyers are allowed to offset specific risk for n-1 of the underlyings (i.e., the n-1 assets with the lowest specific risk charge).

9. Investment firms which mark to market and manage the interest rate risk on the derivative instruments covered in points 4 to 7 above on a discounted cash flow basis may use sensitivity models to calculate the positions referred to in those points and may use them for any bond which is amortised over its residual life rather than via one final repayment of principal. Both the model and its use by the investment firm must be approved by the Commission. These models should generate positions which have the same sensitivity to interest-rate changes as the underlying cash flows. This sensitivity must be assessed with reference to independent movements in sample rates across the yield curve, with at least one sensitivity point in each of the maturity bands set out in Table 2 of point 20 below. The positions shall be included in the calculation of capital requirements according to the provisions laid down in points 17 to 32 below.

10. Investment firms which do not use models under point 9 above may, with the approval of the Commission, treat as fully offsetting any positions in derivative instruments covered in points 4 to 7 above which meet the following conditions at least:

    (a) The positions are of the same value and denominated in the same currency;

    (b) The reference rate (for floating-rate positions) or coupon (for fixed-rate positions) is closely matched; and

    (c) The next interest-fixing date or, for fixed coupon positions, residual maturity corresponds with the following limits:

        (i) Less than one month hence: same day;

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(ii) Between one month and one year hence: within seven days; and

(iii) Over one year hence: within 30 days.

11. The transferor of securities or guaranteed rights relating to title to securities in a repurchase agreement and the lender of securities in a securities lending shall include these securities in the calculation of its capital requirement under this Annex provided that such securities meet the criteria laid down in Chapter 1, paragraph 1 of this Part.

Specific and general risks

12. The position risk on a traded debt instrument or equity (or debt or equity derivative) shall be divided into two components in order to calculate the capital required against it. The first shall be its specific-risk component — this is the risk of a price change in the instrument concerned due to factors related to its issuer or, in the case of a derivative, the issuer of the underlying instrument. The second component shall cover its general risk — this is the risk of a price change in the instrument due (in the case of a traded debt instrument or debt derivative) to a change in the level of interest rates or (in the case of an equity or equity derivative) to a broad equity-market movement unrelated to any specific attributes of individual securities.

TRADED DEBT INSTRUMENTS

13. Net positions shall be classified according to the currency in which they are denominated and shall calculate the capital requirement for general and specific risk in each individual currency separately.

Specific risk

14. The investment firm shall assign its net positions in the trading book in instruments that are not securitisation positions as calculated in accordance with point 1 above 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 investment firm 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

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names immediately becoming default risk-free.

Table 1

Categories	Specific risk capital charge
Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional government or local authorities which would qualify for credit quality step 1 or which would receive a 0% risk weight under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7.	0%
Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities which would qualify for credit quality step 2 or 3 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 1 or 2 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under point 31 Part 1 of Annex VI of Part C, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 1 or 2 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7. Other qualifying items as defined in point 15 below.	0,25% (residual term to final maturity 6 months or less) 1,00% (residual term to final maturity greater than 6 and up to and including 24 months) 1,60% (residual term to final maturity exceeding 24 months)
Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities or institutions which would qualify for credit quality step 4 or 5 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under point 29 of Part 1 of Annex VI of Part C, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 3 or 4 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7. Exposures for which a credit assessment by a nominated ECAI is not available.	8,00%
Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities or institutions which would qualify for credit quality step 6 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 5 or 6 under the rules for the risk weighting of exposures under Part C, Chapter 1, paragraphs 2 to 7.	12,00%

For investment firms which apply the rules for the risk weighting of exposures under Part C, Chapter 2, to qualify for a credit quality step the obligor of the exposure shall have an internal rating with a PD equivalent to or lower than that associated with the appropriate credit quality step under the rules for the risk weighting of exposures to corporates under

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Part C, Chapter 1, paragraphs 2 to 7.

Instruments issued by a non-qualifying issuer shall receive a specific risk capital charge of 8% or 12% according to Table 1. The Commission may require investment firms to apply a higher specific risk charge to such instruments and/or to disallow offsetting for the purposes of defining the extent of general market risk between such instruments and any other debt instruments.

Securitisation exposures that would be subject to a deduction treatment as set out in paragraph 9 (2) of Part B, or risk-weighted at 1,250% as set out in Part 4 of Annex IX of Part C, shall be subject to a capital charge that is no less than that set out under those treatments. Unrated liquidity facilities shall be subject to a capital charge that is no less than that set out in Part 4 of Annex IX of Part C.

14a. By way of derogation from point 14, an investment firm 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:

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(a) An underlying that is capable of being assigned to the exposure classes referred to in paragraph 3(1) (h) and (i), Chapter 1 of Part C, in an investment firm's non-trading book; or

(b) A claim on a special purpose entity.

An investment firm 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.

15. For the purposes of point 14 above qualifying items shall include:

(a) Long and short positions in assets qualifying for a credit quality step corresponding at least to investment grade in the mapping process described in paragraphs 2 to 7, Chapter 1 of Part C;

(b) Long and short positions in assets which, because of the solvency of the issuer, have a PD which is not higher than that of the assets referred to under (a), under the approach described in Chapter 2 of Part C;

(c) Long and short positions in assets for which a credit assessment by a nominated external credit assessment institution is not available and which meet the following conditions:

(i) They are considered by the investment firms concerned to be sufficiently liquid;

(ii) Their investment quality is, according to the investment firm's own discretion, at least equivalent to that of the assets referred to under point (a); and

(iii) They are listed on at least one regulated market in a Member State or on a stock exchange in a third country provided that the exchange is recognised by the Commission;

(d) Long and short positions in assets issued by investment firms subject to the capital adequacy requirements set out in this Directive which are considered by the investment firms concerned to be sufficiently liquid and whose investment quality is, according to the investment firm's own discretion, at least equivalent to that of the assets referred to under point (a); and

(e) Securities issued by investment firms that are deemed to be of equivalent, or higher,

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credit quality than those associated with credit quality step 2 under the rules for the risk weighting of exposures to institutions set out in Part C, Chapter 1, paragraphs 2 to 7 and that are subject to supervisory and regulatory arrangements comparable to those under this Directive.

The manner in which the debt instruments are assessed shall be subject to scrutiny by the Commission, which shall overturn the judgment of the investment firm if they consider that the instruments concerned are subject to too high a degree of specific risk to be qualifying items.

16. The Commission shall require the investment firm to apply the maximum weighting shown in Table 1 to point 14 above to instruments that show a particular risk because of the insufficient solvency of the issuer.

16a. For instruments in the trading book that are securitisation positions, the investment firm shall weight with the following its net positions as calculated in accordance with point 1 of this Annex:

(a) For securitisation positions that would be subject to the Standardised Approach for credit risk in the same investment firm's non-trading book, 8% of the risk weight under the Standardised Approach as set out in Part 4 of Annex IX of Part C;

(b) For securitisation positions that would be subject to the Internal Ratings Based Approach in the same investment firm's non-trading book, 8% of the risk weight under the Internal Ratings Based Approach as set out in Part 4 of Annex IX of Part C.

For the purpose of points (a) and (b), the Supervisory Formula Method may be used only with supervisory approval by investment firms other than an originator investment firms 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 Chapter 2 of Part C, or alternatively and subject to separate supervisory approval, based on estimates that are derived from an approach set out in point 5a of Annex V of this Part and that are in line with the quantitative standards for the Internal Ratings Based Approach.

Notwithstanding points (a) and (b), for securitisation positions that would be subject to a risk weight in accordance with Chapter 8 of Part C if they were in the same investment firms' non-trading book, 8% of the risk weight in accordance with Chapter 8 of Part C shall be applied.

The investment firm shall sum its weighted positions resulting from the application of this

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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 investment firm 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 investment firm 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.

General risk

(a) Maturity-based

17. The procedure for calculating capital requirements against general risk involves two basic steps. First, all positions shall be weighted according to maturity (as explained in point 18 below), in order to compute the amount of capital required against them. Second, allowance shall be made for this requirement to be reduced when a weighted position is held alongside an opposite weighted position within the same maturity band. A reduction in the requirement shall also be allowed when the opposite weighted positions fall into different maturity bands, with the size of this reduction depending both on whether the two positions fall into the same zone, or not, and on the particular zones they fall into. There are three zones (groups of maturity bands) altogether.

18. The investment firm shall assign its net positions to the appropriate maturity bands in column 2 or 3, as appropriate, in Table 2 in point 20 below. It shall do so on the basis of residual maturity in the case of fixed-rate instruments and on the basis of the period until the interest rate is next set in the case of instruments on which the interest rate is variable before final maturity. It shall also distinguish between debt instruments with a coupon of 3% or more and those with a coupon of less than 3% and thus allocate them to column 2 or column 3 in Table 2. It shall then multiply each of them by the weighing for the maturity band in question in column 4 in Table 2.

19. It shall then work out the sum of the weighted long positions and the sum of the weighted short positions in each maturity band. The amount of the former which are matched by the latter in a given maturity band shall be the matched weighted position in that band, while the residual long or short position shall be the unmatched weighted position for the same band. The total of the matched weighted positions in all bands shall then be calculated.

20. The investment firm shall compute the totals of the unmatched weighted long positions for the bands included in each of the zones in Table 2 in order to derive the unmatched weighted

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long position for each zone. Similarly, the sum of the unmatched weighted short positions for each band in a particular zone shall be summed to compute the unmatched weighted short position for that zone. That part of the unmatched weighted long position for a given zone that is matched by the unmatched weighted short position for the same zone shall be the matched weighted position for that zone. That part of the unmatched weighted long or unmatched weighted short position for a zone that cannot be thus matched shall be the unmatched weighted position for that zone.

Table 2

Zone	Maturity band		Weighting (in %)	Assumed interest rate change (in %)
	Coupon of 3% or more	Coupon of less than3 %		
One	0 ≤ 1 month	0 ≤ 1 month	0,0	—
	> 1 ≤ 3 months	> 1 ≤ 3 months	0,2	1 00
	> 3 ≤ 6 months	> 3 ≤ 6 months	0,40	1,0
	> 6 ≤ 12 months	> 6 ≤ 12 months	0,70	1,00
Two	> 1 ≤ 2 years	> 1,0 ≤ 1,9 years	1,25	0,90
	> 2 ≤ 3 years	> 1,9 ≤ 2,8 years	1,75	0,80
	> 3 ≤ 4 y ars	> 2,8 ≤ 3,6 years	,25	0,75
Three	> 4 ≤ 5 years	> 3,6 ≤ 4,3 years	2,75	0,75
	> 5 ≤ 7 years	> 4,3 ≤ 5,7 years	3,25	0,70
	> 7 ≤ 10 years	> 5,7 ≤ 7,3 years	3,75	0,65
	> 10 ≤ 15 years	> 7,3 ≤ 9,3 years	4,50	0,60
	> 15 ≤ 20 years	> 9,3 ≤ 10,6 years	5,25	0,60
	> 20 years	> 10,6 ≤ 12,0 years	6,00	0,60
		> 12,0 ≤ 20 0 yea s	8,00	0,60
		> 20 years	12,50	0,60

21. The amount of the unmatched weighted long (short) position in zone one which is matched by the unmatched weighted short (long) position in zone two shall then be computed. This shall be referred to in point 25 as the matched weighted position between zones one and two. The same calculation shall then be undertaken with regard to that part of the unmatched weighted position in zone two which is left over and the unmatched weighted position in zone three in order to calculate the matched weighted position between zones two and three.

22. The investment firm may, if it wishes, reverse the order in point 21 above so as to calculate the matched weighted position between zones two and three before calculating that position between zones one and two.

23. The remainder of the unmatched weighted position in zone one shall then be matched with what remains of that for zone three after the latter's matching with zone two in order to derive the matched weighted position between zones one and three.

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24. Residual positions, following the three separate matching calculations in points 21, 22 and 23 above, shall be summed.

25 The investment firm's capital requirement shall be calculated as the sum of:

(a) 10% of the sum of the matched weighted positions in all maturity bands;

(b) 40% of the matched weighted position in zone one;

(c) 30% of the matched weighted position in zone two;

(d) 30% of the matched weighted position in zone three;

(e) 40% of the matched weighted position between zones one and two and between zones two and three (see point 21 above);

(f) 150% of the matched weighted position between zones one and three; and

(g) 100% of the residual unmatched weighted positions.

(b) Duration-based

26. The Commission shall allow investment firms in general or on an individual basis to use a system for calculating the capital requirement for the general risk on traded debt instruments which reflects duration, instead of the system set out in points 17 to 25 above, provided that the investment firms does so on a consistent basis.

27. Under a system referred to in point 26 above the investment firm shall take the market value of each fixed-rate debt instrument and hence calculate its yield to maturity, which is implied discount rate for that instrument. In the case of floating-rate instruments, the investment firm shall take the market value of each instrument and hence calculate its yield on the assumption that the principal is due when the interest rate can next be changed.

28. The investment firm shall then calculate the modified duration of each debt instrument on the basis of the following formula:

$$\text{modified duration} = \frac{duration(D)}{(1+r)},$$

where:

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$$D = \frac{\sum_{t=1}^{m} \left(\frac{tC_t}{(1+r)^t} \right)}{\sum_{t=1}^{n} \left(\frac{C_t}{(1+r)^t} \right)}$$

where:

r = yield to maturity (see point 25 above),

C_t = cash payment in time t,

m = total maturity (see point 25 above).

29. The investment firm shall then allocate each debt instrument to the appropriate zone in Table 3. It shall do so on the basis of the modified duration of each instrument.

Table 3

Zone	Modified duration (in years)	Assumed interest (change in %)
One	> 0 ≤ 1,0	1,0
Two	> 1,0 ≤ 3,6	0,85
Three	> 3,6	0,7

30. The investment firm shall then calculate the duration weighted position for each instrument by multiplying its market price by its modified duration and by the assumed interest-rate change for an instrument with that particular modified duration (see column 3 in Table 3).

31. The investment firm shall calculate its duration-weighted long and its duration-weighted short positions within each zone. The amount of the former which are matched by the latter within each zone shall be the matched duration-weighted position for that zone.

    The investment firm shall then calculate the unmatched duration-weighted positions for each zone. It shall then follow the procedures laid down for unmatched weighted positions in points 21 to 24 above.

32. The investment firm's capital requirement shall then be calculated as the sum of:

    (a) 2% of the matched duration-weighted position for each zone;

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(b) 40% of the matched duration-weighted positions between zones one and two and between zones two and three;

(c) 150% of the matched duration-weighted position between zones one and three; and

(d) 100% of the residual unmatched duration-weighted positions.

EQUITIES

33. The investment firm shall sum all its net long positions and all its net short positions in accordance with point 1 above. The sum of the two figures shall be its overall gross position. The difference between them shall be its overall net position.

Specific risk

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

General risk

35. Its capital requirement against general risk shall be its overall net position multiplied by 8%.

Stock-index futures

36. Stock-index futures, the delta-weighted equivalents of options in stock-index futures and stock indices collectively referred to hereafter as "stock-index futures", may be broken down into positions in each of their constituent equities. These positions may be treated as underlying positions in the equities in question, and may, subject to the approval of the Commission, be netted against opposite positions in the underlying equities themselves.

37. Any investment firm which has netted off its positions in one or more of the equities constituting a stock-index future against one or more positions in the stock-index future itself must have adequate capital to cover the risk of loss caused by the future's values not moving fully in line with that of its constituent equities; this shall also be done when an investment firm holds opposite positions in stock-index futures which are not identical in respect of either their maturity or their composition or both.

38. By derogation from points 36 and 37 above, stock-index futures which are exchange traded and — in the opinion of the Commission— represent broadly diversified indices shall attract a capital requirement against general risk of 8%, but no capital requirement against specific

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risk. Such stock-index futures shall be included in the calculation of the overall net position in point 33 above, but disregarded in the calculation of the overall gross position in the same point.

39. If a stock-index future is not broken down into its underlying positions, it shall be treated as if it were an individual equity. However, the specific risk on this individual equity can be ignored if the stock-index future in question is exchange traded and, in the opinion of the Commission, represents a broadly diversified index.

UNDERWRITING

40. In the case of the underwriting of debt and equity instruments, an investment firm is permitted to use the following procedure in calculating its capital requirements. Firstly, it shall calculate the net positions by deducting the underwriting positions which are subscribed or sub-underwritten by third parties on the basis of formal agreements. Secondly, it shall reduce the net positions by the reduction factors in Table 4.

Table 4

working day 0:	100%
working day 1:	90%
working days 2 to 3:	75%
working day 4:	50%
working day 5:	25%
after working day 5:	0%.

"Working day zero" shall be the working day on which the investment firm becomes unconditionally committed to accepting a known quantity of securities at an agreed price.

Thirdly, it shall calculate its capital requirements using the reduced underwriting positions.

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The Commission shall ensure that the investment firm holds sufficient capital against the risk of loss which exists between the time of the initial commitment and working day 1.

SPECIFIC RISK CAPITAL CHARGES FOR TRADING BOOK POSITIONS HEDGED BY CREDIT DERIVATIVES

41. An allowance shall be given for protection provided by credit derivatives, in accordance with the principles set out in points 42 to 45 below.

42. Full allowance shall be given when the value of two legs always move in the opposite direction and broadly to the same extent. This will be the case in the following situations:

    (a) The two legs consist of completely identical instruments; or

    (b) A long cash position is hedged by a total rate of return swap (or vice versa) and there is an exact match between the reference obligation and the underlying exposure (i.e., the cash position). The maturity of the swap itself may be different from that of the underlying exposure.

    In these situations, a specific risk capital charge should not be applied to either side of the position.

43. An 80% offset will be applied when the value of two legs always move in the opposite direction and where there is an exact match in terms of the reference obligation, the maturity of both the reference obligation and the credit derivative, and the currency of the underlying exposure. In addition, key features of the credit derivative contract should not cause the price movement of the credit derivative to materially deviate from the price movements of the cash position. To the extent that the transaction transfers risk, an 80% specific risk offset will be applied to the side of the transaction with the higher capital charge, while the specific risk requirements on the other side shall be zero.

44. Partial allowance shall be given when the value of two legs usually move in the opposite direction. This would be the case in the following situations:

    (a) The position falls under point 42 (b) above but there is an asset mismatch between the reference obligation and the case in the following requirements:

        (i) The reference obligation ranks pari passu with or is junior to the underlying obligation; and

        (ii) The underlying obligation and reference obligation share the same obligor and

have legally enforceable cross-default or cross-acceleration clauses;

(b) The position falls under point 42 (a) or point 43 above but there is a currency or maturity mismatch between the credit protection and the underlying asset (currency mismatches should be included in the normal reporting foreign exchange risk under Annex III of this Part); or

(c) The position falls under point 43 above but there is an asset mismatch between the cash position and the credit derivative. However, the underlying asset is included in the (deliverable) obligations in the credit derivative documentation.

In each of those situations, rather than adding the specific risk capital requirements for each side of the transaction, only the higher of the two capital requirements shall apply.

45. In all situations not falling under points 42 to 44 above, a specific risk capital charge will be assessed against both sides of the positions.

Capital charges for CIUs in the trading book

46. The capital requirements for positions in CIUs which meet the conditions specified in Chapter 1, paragraph 1 of this Part for a trading book capital treatment shall be calculated in accordance with the methods set out in points 47 to 55 below.

47. Without prejudice to other provisions in this Part, positions in CIUs shall be subject to a capital requirement for position risk (specific and general) of 32%. Without prejudice to the provisions of the fourth paragraph of point 2.1 of Annex III of this Part or the sixth paragraph of point 11 of Annex V of this Part (commodity risk) taken together with the fourth paragraph of point 2.1 of Annex III of this Part, where the modified gold treatment set out in those points is used, positions in CIUs shall be subject to a capital requirement for position risk (specific and general) and foreign-exchange risk of no more than 40%.

48. Investment firms may determine the capital requirement for positions in CIUs which meet the criteria set out in point 50 below, by the methods set out in points 52 to 55 below.

49. Unless noted otherwise, no netting is permitted between the underlying investments of a CIU and other positions held by the investment firm.

GENERAL CRITERIA

50. The general eligibility criteria for using the methods in points 52 to 55 below, for CIUs issued by companies supervised or incorporated within the Community are that::

(a) The CIU's prospectus or equivalent document shall include:

(i) The categories of assets the CIU is authorised to invest in;

(ii) If investment limits apply, the relative limits and the methodologies to calculate them;

(iii) If leverage is allowed, the maximum level of leverage; and

(iv) If investment in OTC financial derivatives or repo-style transactions are allowed, a policy to limit counterparty risk arising from these transactions;

(b) The business of the CIU shall be reported in half-yearly and annual reports to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period;

(c) The units/shares of the CIU are redeemable in cash, out of the undertaking's assets, on a daily basis at the request of the unit holder;

(d) Investments in the CIU shall be segregated from the assets of the CIU manager; and

(e) There shall be adequate risk assessment of the CIU, by the investment firm.

51. Third country CIUs may be eligible if the requirements in points (a) to (e) of point 50 above are met, subject to the approval of the Commission.

SPECIFIC METHODS

52. Where the investment firm is aware of the underlying investments of the CIU on a daily basis, the investment firm may look through to those underlying investments in order to calculate the capital requirements for position risk (general and specific) for those positions in accordance with the methods set out in this Annex or, if permission has been granted, in accordance with the methods set out in Annex V of this Part. Under this approach, positions in CIUs shall be treated as positions in the underlying investments of the CIU. Netting is permitted between positions in the underlying investments of the CIU and other positions held by the investment firm, as long as the investment firm holds a sufficient quantity of units to allow for redemption/creation in exchange for the underlying investments.

53. Investment firms may calculate the capital requirements for position risk (general and specific) for positions in CIUs in accordance with the methods set out in this Annex or, if

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permission has been granted, in accordance with the methods set out in Annex V of this Part, to assumed positions representing those necessary to replicate the composition and performance of the externally generated index or fixed basket of equities or debt securities referred to in (a) below, subject to the following conditions:

(a) The purpose of the CIU's mandate is to replicate the composition and performance of an externally generated index or fixed basket of equities or debt securities; and

(b) A minimum correlation of 0.9 between daily price movements of the CIU and the index or basket of equities or debt securities it tracks can be clearly established over a minimum period of six months. "Correlation" in this context means the correlation coefficient between daily returns on the CIU and the index or basket of equities or debt securities it tracks.

54. Where the investment firm is not aware of the underlying investments of the CIU on a daily basis, the investment firm may calculate the capital requirements for position risk (general and specific) in accordance with the methods set out in this Annex, subject to the following conditions:

(a) It will be assumed that the CIU first invests to the maximum extent allowed under its mandate in the asset classes attracting the highest capital requirement for position risk (general and specific), and then continues making investments in descending order until the maximum total investment limit is reached. The position in the CIU will be treated as a direct holding in the assumed position;

(b) Investment firms shall take account of the maximum indirect exposure that they could achieve by taking leveraged positions through the CIU when calculating their capital requirement for position risk, by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the mandate; and

(c) Should the capital requirement for position risk (general and specific) according to this point exceed that set out in point 47 above, the capital requirement shall be capped at that level.

55. Investment firms may rely on a third party to calculate and report capital requirements for position risk (general and specific) for positions in CIUs falling under points 52 and 54 above, in accordance with the methods set out in this Annex, provided that the correctness of the calculation and the report is adequately ensured.

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ANNEX II

CALCULATING CAPITAL REQUIREMENTS FOR SETTLEMENT AND COUNTERPARTY CREDIT RISK

SETTLEMENT/DELIVERY RISK

1. In the case of transactions in which debt instruments, equities, foreign currencies and commodities (excluding repurchase and reverse repurchase agreements and securities or commodities lending and securities or commodities borrowing) are unsettled after their due delivery dates, an investment firm must calculate the price difference to which it is exposed. This is the difference between the agreed settlement price for the debt instrument, equity, foreign currency or commodity in question and its current market value, where the difference could involve a loss for the investment firm. It must multiply this difference by the appropriate factor of Table 1 in order to calculate its capital requirement.

Table 1

Number of working days after due settlement date	(%)
5 — 15	8
16 — 30	50
31 — 45	75
46 or more	100

FREE DELIVERIES

2. An investment firm shall be required to hold own funds, as set out in Table 2, if:

   (a) It has paid for securities, foreign currencies or commodities before receiving them or it has delivered securities, foreign currencies or commodities before receiving payment for them; and

   (b) In the case of cross-border transactions, one day or more has elapsed since it made that payment or delivery.

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Table 2

Capital treatment for free deliveries

Transaction Type	Up to first contractual payment or delivery leg	From first contractual payment or delivery leg up to four days after second contractual payment or delivery leg	From 5 business days post second contractual payment or delivery leg until extinction of the transaction
Free delivery	No capital charge	Treat as an exposure	Deduct value transferred plus current positive exposure from own funds

3. In applying a risk weight to free delivery exposures treated according to column 3 of Table 2, investment firms using the approach set out in Part C, Chapter 2, may assign PDs to counterparties, for which they have no other non-trading book exposure, on the basis of the counterparty's external rating. Investment firms using own estimates of loss given defaults ("LGDs") may apply the LGD set out in point 8 of Part 2 of Annex VII of Part C to free delivery exposures treated according to column 3 of Table 2 provided that they apply it to all such exposures. Alternatively, investment firms using the approach set out in Part C, Chapter 2 may apply the risk weights, as set out in Part C, Chapter 1, paragraphs 2 to 7 provided that they apply them to all such exposures or may apply a 100% risk weight to all such exposures.

   If the amount of positive exposure resulting from free delivery transactions is not material, investment firms may apply a risk weight of 100% to these exposures.

4. In cases of a system wide failure of a settlement or clearing system, the Commission may waive the capital requirements calculated as set out in points 1 and 2 above until the situation is rectified. In this case, the failure of a counterparty to settle a trade shall not be deemed a default for purposes of credit risk.

   COUNTERPARTY CREDIT RISK (CCR)

5. An investment firm shall be required to hold capital against the CCR arising from exposures due to the following:

   (a) OTC derivative instruments and credit derivatives;

   (b) Repurchase agreements, reverse repurchase agreements, securities or commodities

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lending or borrowing transactions based on securities or commodities included in the trading book;

(c) Margin lending transactions based on securities or commodities; and

(d) Long settlement transactions.

6. Subject to the provisions of points 7 to 10 below, exposure values and risk weighted exposure amounts for such exposures shall be calculated in accordance with the provisions of Part C, Chapters 1 to 4.

7. For the purposes of point 6 above:

Annex IV of Part C shall be considered to be amended to include paragraph 6 of Part III of the third Annex of the Law;

Annex III of Part C shall be considered to be amended to include, after the footnotes of Table 1, the following text:

'To obtain a figure for potential future credit exposure in the case of total return swap credit derivatives and credit default swap credit derivatives, the nominal amount of the instrument is multiplied by the following percentages:

- Where the reference obligation is one that if it gave rise to a direct exposure of the investment firm it would be a qualifying item for the purposes of Annex I: 5%; and

- Where the reference obligation is one that if it gave rise to a direct exposure of the investment firm it would not be a qualifying item for the purposes of Annex I: 10%.

However, in the case of a credit default swap, an investment firm 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 the 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 investment firm shall be limited to the amount of premia which are not yet paid by the entity to the investment firm.

Where the credit derivative provides protection in relation to "nth to default" amongst a number of underlying obligations, which of the percentage figures prescribed above is to be applied is determined by the obligation with the nth lowest credit quality determined by whether it is one that if incurred by the investment firm would be a qualifying item for the

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purposes of Annex I of this Part.

8. For the purposes of point 6 above , in calculating risk-weighted exposure amounts investment firms shall not be permitted to use the Financial Collateral Simple Method, set out in points 24 to 29, Part 3 , Annex VIII of Part C, for the recognition of the effects of financial collateral.

9. For the purposes of point 6 above, in the case of repurchase transactions and securities or commodities lending or borrowing transactions booked in the trading book, all financial instruments and commodities that are eligible to be included in the trading book may be recognised as eligible collateral. For exposures due to OTC derivative instruments booked in the trading book, commodities that are eligible to be included in the trading book may also be recognised as eligible collateral. For the purposes of calculating volatility adjustments where such financial instruments or commodities which are not eligible under Annex VIII of Part C are lent, sold or provided, or borrowed, purchased or received by way of collateral or otherwise under such a transaction, and the investment firm is using the Supervisory volatility adjustments approach under Part 3 of Annex VIII of that Part, such instruments and commodities shall be treated in the same way as non-main index equities listed on a recognised exchange.

   Where investment firms are using the Own Estimates of Volatility adjustments approach under Part 3 of Annex VIII of Part C in respect of financial instruments or commodities which are not eligible under Annex VIII of that Part, volatility adjustments must be calculated for each individual item. Where investment firms are using the Internal Models Approach defined in Part 3 of Annex VIII of Part C, they may also apply this approach in the trading book.

10. For the purposes of point 6 above, in relation to the recognition of master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions netting across positions in the trading book and the non-trading book will only be recognised when the netted transactions fulfil the following conditions:

    (a) All transactions are marked to market daily; and

    (b) Any items borrowed, purchased or received under the transactions may be recognised as eligible financial collateral under Part C, Chapter 3 without the application of point 9 of this Annex.

11. Where a credit derivative included in the trading book forms part of an internal hedge and the credit protection is recognised under this Directive, there shall be deemed not to be

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counterparty risk arising from the position in the credit derivative.

12. The capital requirement shall be 8% of the total risk weighted exposure amounts.

ANNEX III

CALCULATING CAPITAL REQUIREMENTS FOR FOREIGN-EXCHANGE RISK

1. If the sum of an investment firm's overall net foreign exchange position and its net gold position, calculated in accordance with the procedure set out in point 2 below, exceeds 2% of its total own funds, it shall multiply the sum of its net foreign exchange position and its net gold position by 8% in order to calculate its own funds requirement against foreign exchange risk.

2. A two stage calculation shall be used for capital requirements for foreign exchange risk.

2.1. Firstly, the investment firm's net open position in each currency (including the reporting currency) and in gold shall be calculated.

This net open position shall consist of the sum of the following elements (positive or negative):

(a) The net spot position (i.e. all asset items less all liability items, including accrued interest, in the currency in question or, for gold, the net spot position in gold);

(b) The net forward position (i.e. all amounts to be received less all amounts to be paid under forward exchange and gold transactions, including currency and gold futures and the principal on currency swaps not included in the spot position);

(c) Irrevocable guarantees (and similar instruments) that are certain to be called and likely to be irrecoverable;

(d) Net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting investment firm and with the prior consent of theCommission, net future income/expenses not yet entered in accounting records but already fully hedged by forward foreign-exchange transactions may be included here). The investment firm must implement the method chosen on a consistent basis;

(e) The net delta (or delta-based) equivalent of the total book of foreign-currency and gold options; and

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(f) The market value of other (i.e. non-foreign-currency and non-gold) options.

Any positions which an investment firm has deliberately taken in order to hedge against the adverse effect of the exchange rate on its capital ratio may be excluded from the calculation of net open currency positions. Such positions should be of a non-trading or structural nature and their exclusion, and any variation of the terms of their exclusion, shall require the consent of the Commission. The same treatment subject to the same conditions as above may be applied to positions which an investment firm has which relate to items that are already deducted in the calculation of own funds.

For the purposes of the calculation referred to in the first paragraph, in respect of CIUs the actual foreign exchange positions of the CIU shall be taken into account. Investment firms may rely on third party reporting of the foreign exchange positions in the CIU, where the correctness of this report is adequately ensured. If an investment firm is not aware of the foreign exchange positions in a CIU, it shall be assumed that the CIU is invested up to the maximum extent allowed under the CIU's mandate in foreign exchange and investment firms shall, for trading book positions, take account of the maximum indirect exposure that they could achieve by taking leveraged positions through the CIU when calculating their capital requirement for foreign exchange risk. This shall be done by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the investment mandate. The assumed position of the CIU in foreign exchange shall be treated as a separate currency according to the treatment of investments in gold, subject to the modification that, if the direction of the CIU's investment is available, the total long position may be added to the total long open foreign exchange position and the total short position may be added to the total short open foreign exchange position. There would be no netting allowed between such positions prior to the calculation.

The Commission may, subject to prior approval, allow investment firms to use the net present value when calculating the net open position in each currency and in gold.

2.2. Secondly, net short and long positions in each currency other than the reporting currency and the net long or short position in gold shall be converted at spot rates into the reporting currency. They shall then be summed separately to form the total of the net short positions and the total of the net long positions respectively. The higher of these two totals shall be the investment firm's overall net foreign exchange position.

3. Net positions in composite currencies may be broken down into the component currencies according to the quotas in force.

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ANNEX IV

CALCULATING CAPITAL REQUIREMENTS FOR COMMODITIES RISK

1. Each position in commodities or commodity derivatives shall be expressed in terms of the standard unit of measurement. The spot price in each commodity shall be expressed in the reporting currency.

2. Positions in gold or gold derivatives shall be considered as being subject to foreign exchange risk and treated according to Annex III or Annex V of this Part, as appropriate, for the purpose of calculating market risk.

3. For the purposes of this Annex, positions which are purely stock financing may be excluded from the commodities risk calculation only.

4. The interest rate and foreign exchange risks not covered by other provisions of this Annex shall be included in the calculation of general risk for traded debt instruments and in the calculation of foreign exchange risk.

5. When the short position falls due before the long position, investment firms shall also guard against the risk of a shortage of liquidity which may exist in some markets.

6. For the purpose of point 19 below, the excess of an investment firm's long (short) positions over its short (long) positions in the same commodity and identical commodity futures, options and warrants shall be its net position in each commodity.

   The Commission shall allow positions in derivative instruments to be treated, as laid down in points 8, 9 and 10 below, as positions in the underlying commodity.

7. The Commission shall regard the following positions as positions in the same commodity:

   (a) Positions in different sub-categories of commodities in cases where the sub-categories are deliverable against each other; and

   (b) Positions in similar commodities if they are close substitutes and if a minimum correlation of 0,9 between price movements can be clearly established over a minimum period of one year.

   Particular instruments

8. Commodity futures and forward commitments to buy or sell individual commodities shall be incorporated in the measurement system as notional amounts in terms of the standard unit of measurement and assigned a maturity with reference to expiry date.

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9. Commodity swaps where one side of the transaction is a fixed price and the other the current market price shall be incorporated into the maturity ladder approach, as set out in points 13 to 18 below, as a series of positions equal to the notional amount of the contract, with one position corresponding with each payment on the swap and slotted into the maturity ladder set out in Table 1 to point 13 below. The positions would be long positions if the investment firm is paying a fixed price and receiving a floating price and short positions if the investment firm is receiving a fixed price and paying a floating price.

   Commodity swaps where the sides of the transaction are in different commodities are to be reported in the relevant reporting ladder for the maturity ladder approach.

10. Options on commodities or on commodity derivatives shall be treated as if they were positions equal in value to the amount of the underlying to which the option refers, multiplied by its delta for the purposes of this Annex. The latter positions may be netted off against any offsetting positions in the identical underlying commodity or commodity derivative. The delta used shall be that of the exchange concerned, that calculated by the competent authorities or, where none of those is available, or for OTC options, that calculated by the investment firm itself, subject to the Commission being satisfied that the model used by the investment firm is reasonable.

    Other risks, apart from the delta risk, associated with commodity options shall be safeguarded against.

    The Commission shall allow the requirement on a bought exchange traded or OTC commodity option to be the same as that for the commodity underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement for a written OTC option shall be set in relation to the commodity underlying it.

11. Warrants relating to commodities shall be treated in the same way as commodity options referred to in point 10 above.

12. The transferor of commodities or guaranteed rights relating to title to commodities in a repurchase agreement and the lender of commodities in a commodities lending agreement shall include such commodities in the calculation of its capital requirement under this Annex.

    (a) Maturity ladder approach

13. The investment firm shall use a separate maturity ladder in line with Table 1 for each commodity. All positions in that commodity and all positions which are regarded as positions in the same commodity pursuant to point 7 above shall be assigned to the

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appropriate maturity bands. Physical stocks shall be assigned to the first maturity band.

Table 1

Maturity band (1)	Spread rate (in %) (2)
0 ≤ 1 on	1,50
> 1 ≤ 3 months	1,50
> 3 ≤ 6 months	1,50
> 6 ≤ 12 months	1,50
> 1 ≤ 2 years	1,50
> 2 ≤ 3 years	1,50
> 3 years	1,50

14. The Commission shall allow positions which are, or are regarded pursuant to point 7 above as, positions in the same commodity to be offset and assigned to the appropriate maturity bands on a net basis for the following:

    (a) Positions in contracts maturing on the same date; and

    (b) Positions in contracts maturing within 10 days of each other if the contracts are traded on markets which have daily delivery dates.

15. The investment firm shall then calculate the sum of the long positions and the sum of the short positions in each maturity band. The amount of the former (latter) which are matched by the latter (former) in a given maturity band shall be the matched positions in that band, while the residual long or short position shall be the unmatched position for the same band.

16. That part of the unmatched long (short) position for a given maturity band that is matched by the unmatched short (long) position for a maturity band further out shall be the matched position between two maturity bands. That part of the unmatched long or unmatched short position that cannot be thus matched shall be the unmatched position.

17. The investment firm's capital requirement for each commodity shall be calculated on the basis of the relevant maturity ladder as the sum of the following:

    (a) The sum of the matched long and short positions, multiplied by the appropriate spread rate as indicated in the second column of Table 1 to point 13, above for each maturity band and by the spot price for the commodity;

    (b) The matched position between two maturity bands for each maturity band into which an unmatched position is carried forward, multiplied by 0,6% (carry rate) and by the spot price for the commodity; and

(c) The residual unmatched positions, multiplied by 15% (outright rate) and by the spot price for the commodity.

18. The investment firm's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to point 17 above.

(b) Simplified approach

19. The investment firm's capital requirement for each commodity shall be calculated as the sum of:

(a) 15% of the net position, long or short, multiplied by the spot price for the commodity; and

(b) 3% of the gross position, long plus short, multiplied by the spot price for the commodity.

20. The investment firm's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to point 19 above.

(c) Extended Maturity ladder approach

21. The Commission may authorise investment firms to use the minimum spread, carry and outright rates set out in the following table (Table 2) instead of those indicated in points 13, 14, 17 and 18, above provided that the investment firms, in the opinion of the Commission:

(a) Undertake significant commodities business;

(b) Have a diversified commodities portfolio; and

(c) Are not yet in a position to use internal models for the purpose of calculating the capital requirement on commodities risk in accordance with Annex V of this Part.

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Table 2

	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
Spread rate (%)	1,0	1,2	1,5	1,5
Carry rate (%)	0,3	0,5	0,6	0,6
Outright rate (%)	8	10	12	15

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ANNEX V

USE OF INTERNAL MODELS TO CALCULATE CAPITAL REQUIREMENTS

1. The Commission shall, subject to the conditions laid down in this Annex, allow investment firms 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 Annexes I, III and IV of this Part. Explicit recognition by the Commission of the use of models for supervisory capital purposes shall be required in each case.

2. Recognition shall only be given if the Commission is satisfied that the investment firm's risk management system is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met:

   (a) The internal risk measurement model is closely integrated into the daily risk management process of the investment firm and serves as the basis for reporting risk exposures to senior management of the investment firm;

   (b) The investment firm has a risk control unit that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the investment firm'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 trading limits. The unit shall also conduct the initial and on-going validation of the internal model;

   (c) The investment firm's board of directors and senior management are actively involved in the risk control process and the daily reports produced by the risk control unit are reviewed by a level of management with sufficient authority to enforce both reductions of positions taken by individual traders as well as in the investment firm's overall risk exposure;

   (d) The investment firm has sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk-control, audit and back-office areas;

   (e) The investment firm has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk measurement system;

(f) The investment firm's model has a proven track record of reasonable accuracy in measuring risks;

(g) The investment firm frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets. This process shall particularly address illiquidity of markets in stressed market conditions, concentration risk, one way markets, event and jump-to-default risks, non-linearity of products, deep out-of-the-money positions, positions subject to the gapping of prices and other risks that may not be captured appropriately in the internal models. The shocks applied shall reflect the nature of the portfolios and the time it could take to hedge out or manage risks under severe market conditions; and

(h) The investment firm must conduct, as part of its regular internal auditing process, an independent review of its risk measurement system.

The review referred to in point (h) of the first paragraph shall include both the activities of the business trading units and of the independent risk-control unit. At least once a year, the investment firm must conduct a review of its overall risk management process.

The review shall consider the following:

(a) The adequacy of the documentation of the risk management system and process and the organisation of the risk-control unit;

(b) The integration of market risk measures into daily risk management and the integrity of the management information system;

(c) The process the investment firm employs for approving risk pricing models and valuation systems that are used by front and back-office personnel;

(d) The scope of market risks captured by the risk measurement model and the validation of any significant changes in the risk measurement process;

(e) The accuracy and completeness of position data, the accuracy and appropriateness of volatility and correlation assumptions, and the accuracy of valuation and risk sensitivity calculations;

(f) The verification process the investment firm employs to evaluate the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources; and

(g) The verification process the investment firm uses to evaluate back-testing that is conducted to assess the models' accuracy.

3. Investment firms shall have processes in place to ensure that their internal models have been adequately validated by suitably qualified parties independent of the development process to ensure that they are conceptually sound and adequately capture all material risks. The validation shall be conducted when the internal model is initially developed and when any significant changes are made to the internal model. The validation shall also be conducted on a periodic basis but especially where there have been any significant structural changes in the market or changes to the composition of the portfolio which might lead to the internal model no longer being adequate. As techniques and best practices evolve, investment firms shall avail themselves of these advances. Internal model validation shall not be limited to back-testing, but shall, at a minimum, also include the following:

   (a) Tests to demonstrate that any assumptions made within the internal model are appropriate and do not underestimate or overestimate the risk;

   (b) In addition to the regulatory back-testing programmes, investment firms shall carry out their own internal model validation tests in relation to the risks and structures of their portfolios; and

   (c) The use of hypothetical portfolios to ensure that the internal model is able to account for particular structural features that may arise, for example material basis risks and concentration risk.

4. The investment firm shall monitor the accuracy and performance of its model by conducting a back-testing programme. The back-testing has to provide for each business day a comparison of the one-day value-at-risk measure generated by the investment firm’s model for the portfolio's end-of-day positions to the one-day change of the portfolio's value by the end of the subsequent business day.

   The Commission shall examine the investment firm’s capability to perform back-testing on both actual and hypothetical changes in the portfolio's value. Back-testing on hypothetical changes in the portfolio's value is based on a comparison between the portfolio's end-of-day value and, assuming unchanged positions, its value at the end of the subsequent day. The Commission shall require investment firms to take appropriate measures to improve their back-testing programme if deemed deficient. As a minimum, the Commission shall require investment firms to perform back-testing on hypothetical (using changes in portfolio value that would occur were end-of-day positions to remain unchanged) outcomes.

5. For the purpose of calculating capital requirements for specific risk associated with traded

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debt and equity positions, the Commission shall recognise the use of an investment firm's internal model if, in addition to compliance with the conditions in the remainder of this Annex, 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 Commission allows 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 investment firms shall demonstrate that the internal model is sensitive to material idiosyncratic differences between similar but not identical positions;

(f) It captures event risk;

The investment firm'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 investment firm 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 Annex I of this Part, with the exception of those positions that are subject to the approach set out in point 5l.

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

An investment firm 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.

5a. Investment firms subject to point 5 for traded debt instruments shall have an approach in

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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 investment firm shall demonstrate that its approach meets soundness standards comparable to the approach set out in Chapter 2 of Part C, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality.

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 investment firm 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 investment firm 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.

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 investment firm 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.

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The determination of the appropriate liquidity horizon for a position or set of positions shall take into account an investment firm's internal policies relating to valuation adjustments and the management of stale positions. When an investment firm 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 investment firm'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. Investment firms 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 investment firm 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 investment firm:

(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 investment firm shall also have due regard to the amount of model risk inherent in the valuation and estimation of price risks

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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.

5h. As part of the independent review of their risk measurement system and the validation of their internal models as required in this Annex, investment firms 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 investment firm's internal risk management methodologies for identifying, measuring, and managing trading risks.

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

5j. If the investment firm 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 investment firm'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 Commission shall review compliance with the previous sentence at least annually. The Committee of European Banking Supervisors shall monitor the range of practices in this area and draw up guidelines in order to secure a level playing field.

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

5l. The Commission shall recognise the use of an internal approach for calculating an additional

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capital charge instead of a capital charge for the correlation trading portfolio in accordance with point 14a of Annex I of this Part, 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 investment firm 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 Annex I of this Part 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 investment firm 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

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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 investment firm 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 investment firm shall apply such stress scenarios at least weekly and report at least quarterly to the Commission the results, including comparisons with the investment firm'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 Commission in a timely manner. Based on those stress testing results, the Commission shall consider a supplemental capital charge against the correlation trading portfolio as set out in paragraph 33(2) of Chapter 6 of Part C.

An investment firm shall calculate the capital charge to capture all price risk at least on a weekly basis.

6. Investment firms using internal models which are not recognised in accordance with point 5 above shall be subject to a separate capital charge for specific risk as calculated according to Annex I of this Part.

7. For the purposes of points 9b (a) and (b), the results of the investment firm's own calculation shall be scaled up by the multiplication factors (m_c) and (m_s). Those factors shall be at least 3.

8. For the purposes of points 9b (a) and (b), the multiplication factors (m_c) and (m_s) 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 investment firm's back-testing of the value-at-risk measure as set out in point 9. The Commission shall require the investment firms 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 investment firm'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.

Table 1

Number of overshootings	Plus-factor

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Fewer than 5	0,00
5	0,40
6	0,50
7	0,65
8	0,75
9	0,85
10 or more	1,00

The Commission may, in individual cases and owing to an exceptional situation, waive the requirement to increase the multiplication factor by the "plus factor" in accordance with Table 1, if the investment firm has demonstrated to the satisfaction of the Commission that such an increase is unjustified and that the model is basically sound.

If numerous overshootings indicate that the model is not sufficiently accurate, the Commission shall revoke the model's recognition or impose appropriate measures to ensure that the model is improved promptly.

In order to allow the Commission to monitor the appropriateness of the plus-factor on an ongoing basis, investment firms shall notify promptly, and in any case no later than within five working days, the Commission of overshootings that result form their back-testing programme and that would according to the above table imply an increase of a plus-factor.

9. The calculation of the value-at-risk measure shall be subject to the following minimum standards:

   (a) At least daily calculation of the value-at-risk measure;

   (b) A 99th percentile, one-tailed confidence interval;

   (c) A 10-day equivalent holding period (investment firns 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 investment firm using that approach shall periodically justify the

reasonableness of its approach to the satisfaction of the Commission);

(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) Monthly data set updates.

9a. In addition, each investment firm 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 investment firm’s portfolio. The choice of such historical data shall be subject to approval by the Commission and to annual review by the investment firm.

9b. Each investment firm shall meet, on a daily basis, a capital requirement expressed as the sum of points (a) and (b) and an investment firm 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 9 (VaR t-1); and

(ii) an average of the daily value-at-risk measures in accordance with point 9 on each of the preceding sixty business days (VaR_{avg}), multiplied by the multiplication factor (m_c);

(b) the higher of:

(i) its latest available stressed-value-at-risk number in accordance with point 9a ($sVaR_{t-1}$); and

(ii) an average of the stressed value-at-risk numbers calculated in the manner and frequency specified in point 9a during the preceding sixty business days ($sVaR_{avg}$), multiplied by the multiplication factor (m_s);

(c) a capital charge calculated in accordance with Annex I of this Part 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 investment firm's most recent and the investment firm's 12 weeks average measure of incremental default and migration risk in accordance with point 5a and, where applicable, the higher of the investment firm's most recent and its 12-week-average measure of all price risks in accordance with point 5l.

9c. Investment firm shall also carry out reverse stress tests.

10. The Commission shall require that the model captures accurately all the material price risks of options or option-like positions and that any other risks not captured by the model are covered adequately by own funds.

11. The risk measurement model shall capture a sufficient number of risk factors, depending on the level of activity of the investment firm in the respective markets. Where a risk factor is incorporated into the investment firm's pricing model but not into the risk-measurement model, the investment firm shall be able to justify such an omission to the satisfaction of the Commission. 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:

Interest rate risk

The risk measurement system shall incorporate a set of risk factors corresponding to the interest rates in each currency in which the investment firm has interest rate sensitive on- or off-balance sheet positions. The investment firm shall model the yield curves using one of the generally accepted approaches. For material exposures to interest-rate risk in the major currencies and markets, the yield curve shall be divided into a minimum of six maturity segments, to capture the variations of volatility of rates along the yield curve. The risk measurement system must also capture the risk of less than perfectly correlated movements between different yield curves.

Foreign-exchange risk

The risk measurement system shall incorporate risk factors corresponding to gold and to the individual foreign currencies in which the investment firm's positions are denominated.

For CIUs the actual foreign exchange positions of the CIU shall be taken into account. Investment firms may rely on third party reporting of the foreign exchange position of the CIU, where the correctness of this report is adequately ensured. If an investment firm is not aware of the foreign exchange positions of a CIU, this position should be carved out and treated in accordance with the fourth paragraph of point 2.1 of Annex III, of this Part.

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Equity risk

The risk measurement system shall use a separate risk factor at least for each of the equity markets in which the investment firm holds significant positions.

Commodity risk

The risk measurement system shall use a separate risk factor at least for each commodity in which the investment firm holds significant positions. The risk measurement system must also capture the risk of less than perfectly correlated movements between similar, but not identical, commodities and the exposure to changes in forward prices arising from maturity mismatches. It shall also take account of market characteristics, notably delivery dates and the scope provided to traders to close out positions.

12. The Commission may allow investment firms to use empirical correlations within risk categories and across risk categories if it is satisfied that the investment firm's system for measuring correlations is sound and implemented with integrity.

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ANNEX VI

CALCULATING CAPITAL REQUIREMENTS FOR LARGE EXPOSURES

1. The excess referred to in paragraph 6 (b) of Chapter 2 of this Part shall be calculated by selecting those components of the total trading exposure to the person or group of persons in question which attract the highest specific risk requirements in Annex I and/or requirements in Annex II of this Part, the sum of which equals the amount of the excess referred to in paragraph 6 (a) of Chapter 2 of this Part.

2. Where the excess has not persisted for more than 10 days, the additional capital requirement shall be 200% of the requirements referred to in point 1 above, on these components.

3. As from 10 days after the excess has occurred, the components of the excess, selected in accordance with point 1, shall be allocated to the appropriate line in column 1 of Table 1 in ascending order of specific-risk requirements in Annex I and/or requirements in Annex II of this Part. The additional capital requirement shall be equal to the sum of the specific-risk requirements in Annex I and/or the Annex II requirements of this Part on these components, multiplied by the corresponding factor in column 2 of Table 1.

Table 1

Excess over the limits (on the basis of a percentage of own funds)	Factors
Up to 40%	200%
From 40% to 60%	300%
From 60% to 80%	400%
From 80% to 100%	500%
From 100% to 250%	600%
Over 250%	900%

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ANNEX VII

TRADING

Part A

Trading Intent

1. Positions/portfolios held with trading intent shall comply with the following requirements:

   (a) There must be a clearly documented trading strategy for the position/instrument or portfolios, approved by senior management, which shall include expected holding horizon;

   (b) There must be clearly defined policies and procedures for the active management of the position, which shall include the following:

   (i) Positions entered into on a trading desk;

   (ii) Position limits are set and monitored for appropriateness;

   (iii) Dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;

   (iv) Positions are reported to senior management as an integral part of the investment firm's risk management process; and

   (v) Positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge-ability of the position or its component risks, including the assessment of, the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and

   (c) There must be clearly defined policy and procedures to monitor the position against the investment firm's trading strategy including the monitoring of turnover and stale positions in the investment firm's trading book.

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Part B

Systems and Controls

1. Investment firms shall establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.

2. Systems and controls shall include at least the following elements:

   (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 investment firm'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; and

   (b) Reporting lines for the department accountable for the valuation process that are clear and independent of the front office.

   The reporting line shall ultimately be to a main board executive director.

   Prudent Valuation Methods

3. Investment firms 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.

4. When marking to market, the more prudent side of bid/offer shall be used unless the investment firm is a significant market maker in the particular type of financial instrument or commodity in question and it can close out at mid market.

5. Where marking to market is not possible, investment firms 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.

6. The following requirements must be complied with when marking to model:

   (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 this creates in the reporting of the risk/performance of the business;

(b) Market inputs shall be sourced, where possible, in line with market prices, and the appropriateness of the market inputs of the particular position being valued and the parameters of the model shall be assessed on a frequent basis;

(c) Where available, valuation methodologies which are accepted market practice for particular financial instruments or commodities shall be used;

(d) Where the model is developed by the investment firm itself, it shall be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;

(e) There shall be formal change control procedures in place and a secure copy of the model shall be held and periodically used to check valuations;

(f) Risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and

(g) The model shall be subject to periodic review to determine the accuracy of its performance (e.g. assessing the continued appropriateness of assumptions, analysis of profit and loss versus risk factors, comparison of actual close out values to model outputs).

For the purposes of point (d), the model shall be developed or approved independently of the front office and shall be independently tested, including validation of the mathematics, assumptions and software implementation.

7. Independent price verification should be performed in addition to daily marking to market or marking to model. This is the process by which market prices or model inputs are regularly verified for accuracy and independence. While daily marking to market may be performed by dealers, verification of market prices and model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/trading activity, more frequently). Where independent pricing sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

Valuation adjustments

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8. Investment firms shall establish and maintain procedures for considering valuation adjustments.

   General standards

9. The Commission 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.

   Standards for less liquid positions

10. Less liquid positions could arise from both market events and investment firm related situations e.g. concentrated positions and/or stale positions.

11. Investment firms 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, investment firms 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, investment firms shall consider whether to apply a valuation adjustment. In addition, investment firms 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, investment firms 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.

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Part C

Internal Hedges

1. An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of positions. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in Parts A and B are met. In particular:

   (a) Internal hedges shall not be primarily intended to avoid or reduce capital requirements;

   (b) Internal hedges shall be properly documented and subject to particular internal approval and audit procedures;

   (c) The internal transaction shall be dealt with at market conditions;

   (d) The bulk of the market risk that is generated by the internal hedge shall be dynamically managed in the trading book within the authorised limits; and

   (e) Internal transactions shall be carefully monitored.

   Monitoring must be ensured by adequate procedures.

2. The treatment referred to in point 1 above applies without prejudice to the capital requirements applicable to the "non-trading book leg" of the internal hedge.

3. Notwithstanding points 1 and 2 above, when an investment firm hedges a non-trading book credit risk exposure using a credit derivative booked in its trading book (using an internal hedge), the non-trading book exposure is not deemed to be hedged for the purposes of calculating capital requirements unless the investment firm purchases from an eligible third party protection provider a credit derivative meeting the requirements set out in point 19 of Part 2 of Annex VIII of Part C with regard to the non-trading book exposure. Where such third party protection is purchased and is recognised as a hedge of a non-trading book exposure for the purposes of calculating capital requirements, neither the internal nor external credit derivative hedge shall be included in the trading book for the purposes of calculating capital requirements.

Part D

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Inclusion In The Trading Book

1. Investment firms shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirements, consistent with the criteria set out in Chapter 1, paragraph 1 of this Part and taking into account the investment firm's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and subject to periodic internal audit.

2. Investment firms shall have clearly defined policies and procedures for overall management of the trading book. At a minimum these policies and procedures shall address:

   (a) The activities the investment firm considers to be trading and as constituting part of the trading book for capital requirement purposes;

   (b) The extent to which a position can be marked-to-market daily by reference to an active, liquid two-way market;

   (c) For positions that are marked-to-model, the extent to which the investment firm can:

      (i) Identify all material risks of the position;

      (ii) Hedge all material risks of the position with instruments for which an active, liquid two way market exists; and

      (iii) Derive reliable estimates for the key assumptions and parameters used in the model;

   (d) The extent to which the investment firm can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;

   (e) The extent to which legal restrictions or other operational requirements would impede the investment firm's ability to effect a liquidation or hedge of the position in the short term;

   (f) The extent to which the investment firm can, and is required to, actively risk manage the position within its trading operation; and

   (g) The extent to which the investment firm may transfer risk or positions between the

non-trading and trading books and the criteria for such transfers.

3. The Commission may allow investment firms to treat positions that are holdings in the trading book as set out in paragraph 2 (1) of Part B, points (k), (l) and (m) as equity or debt instruments, as appropriate, where an investment firm demonstrates that it is an active market maker in these positions. In this case, the investment firm shall have adequate systems and controls surrounding the trading of eligible own funds instruments.

4. Term trading-related repo-style transactions that an investment firm accounts for in its non-trading book may be included in the trading book for capital requirement purposes so long as all such repo-style transactions are included. For this purpose, trading-related repo-style transactions are defined as those that meet the requirements of Chapter 1, paragraph 1 (2) of this Part, and of Annex VII, Part A, of this Part and both legs are in the form of either cash or securities includable in the trading book. Regardless of where they are booked, all repo-style transactions are subject to a non-trading book counterparty credit risk charge.

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ANNEX VIII

TRADING BOOK POLICY STATEMENT

Each investment firm is required to agree a trading book policy statement with the Commission. The procedure for agreeing such a statement shall be as follows:

1. The investment firm shall submit a draft trading book policy statement which covers the following:

- A statement on the investment firm's policy on the allocation of positions;

- a listing of the investment firm's activities which it normally considers to be trading and includes in its trading book;
- a description of how positions are allocated at the time of trade.

- A statement of the investment firm's policy on the valuation of positions;

- a description of the process used to value positions (mark-to-market, off-market prices, bid/offer/mid prices), in particular, the valuation of positions for which independent market prices are not readily available.
- The pricing of options, in particular, the determination of appropriate deltas (from option pricing models or the use of an exchange delta).

- A statement on the investment firm's policy on hedging;

- details of the procedure for identifying hedges.
- details of the procedures used to hedge between the Banking Book and the Trading Book (identification of the reasons for transfer/setting up of an appropriate audit trail/monitoring adherence to policy).

- A policy statement on the use of models;

- a listing of all models employed to process positions in the Trading Book (e.g. option pricing models/interest rate sensitivity models).
- a brief description of all methodologies being employed in the calculation of risk in the trading book.

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In addition to the above, the trading book policy statement of an investment firm whose trading book activity is below the de minimis level must include:

- documentation supporting applications for exemption from the trading book capital requirement; based on this Directive
- details of procedures in place to monitor the size of the trading book to identify any breaches of the de minimis level.

2. The statement shall be reviewed by the Commission and agreed in draft form with the investment firm.

3. The investment firm shall arrange for external auditors to confirm the following in writing:

   - that the criteria used for the allocation of positions are reasonable and in accordance with accounting policies;
   - that the policy with regard to hedging complies with the present Directive;
   - that the policy for the valuation of positions is acceptable and in accordance with best accounting practice.

4. The statement, as agreed in draft form with the Commission, shall be approved by the investment firm Board of Directors and re-submitted to the Commission, together with the audit confirmation, for formal approval.

5. The statement should be reviewed frequently (at least annually), and, where necessary, updated subject to the agreement of the Commission. Updates should be reviewed by external auditors and approved by the Board of Directors of the investment firm.

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Part E

Consolidated supervision and cooperation with other competent authorities

Criteria under which credit institutions and investment firms are subject to consolidated supervision

1. (1) Where a credit institution has as a parent undertaking a parent investment firm in a Member State, only that parent investment firm shall be subject to requirements on a consolidated basis in accordance with paragraphs 5 to 7 of Chapter 2 of Part A.

(2) Where an investment firm has as a parent undertaking a parent credit institution in a Member State, only that parent credit institution shall be subject to requirements on a consolidated basis in accordance with paragraphs 5 to 7 of Chapter 2 of Part A.

(3) Where a financial holding company has as a subsidiary both a credit institution and an investment firm, requirements on the basis of the consolidated financial situation of the financial holding company shall apply to the credit institution.

Cases where supervision on a consolidated basis is exercised by the Commission - Investment firm in a Member State

2. (1) Where the parent of an investment firm is a parent investment firm established in a Member State or an EU parent investment firm, supervision on a consolidated basis shall be exercised by the Commission if it authorised the said parent in accordance with the provisions of Section 6(1) of the Law or the corresponding legal provisions of the other Member States.

(2) Where the parent of an investment firm is a parent financial holding company in a Member State or an EU parent financial holding company supervision on a consolidated basis shall be exercised by the Commission if it authorised the said investment firm in accordance with the provisions of Section 6(1) of the Law or the corresponding legal provisions of the other Member States.

Cases where supervision on a consolidated basis is exercised by the Commission - Investment firms in two or more Member States

3. (1) Where investment firms authorised in two or more Member States have as their parent the same parent financial holding company in a Member State or the same EU parent financial holding company, supervision on a consolidated basis shall be exercised by the Commission as the competent authority of the investment firm authorised in the Republic in which the financial holding company was set up. Where the parents of investment firms authorised in two or more Member States comprise more than one financial holding company with head offices in different Member States and there is an investment firm in each of these Member States, supervision on a consolidated basis shall be

exercised by the Commission, if it is the competent authority of the investment firm with the largest balance sheet total.

(2) Where more than one investment firm authorised in the Community has as its parent the same financial holding company and none of these investment firms has been authorised in the Member State in which the financial holding company was set up, supervision on a consolidated basis shall be exercised by the Commission if it authorised the investment firm with the largest balance sheet total, which shall be considered, for the purposes of this Directive, as the investment firm controlled by an EU parent financial holding company.

(3) In particular cases, the Commission may, by common agreement with other competent authorities, waive the criteria referred to in subparagraphs (1) and (2) above if their application would be inappropriate, taking into account the investment firms and the relative importance of their activities in different countries, and appoint a different competent authority to exercise supervision on a consolidated basis. In these cases, before taking their decision, the Commission shall give the EU parent investment firm, or EU parent financial holding company, or investment firm with the largest balance sheet total, as appropriate, an opportunity to state its opinion on that decision.

(4) The Commission shall notify the European Commission of any agreement falling within subparagraph (3) above.

Adoption of necessary measures for inclusion of financial holding companies in consolidated supervision

4. (1) The Commission shall adopt any measures necessary, where appropriate, to include financial holding companies in consolidated supervision. Without prejudice to paragraph 10 of this Part, the consolidation of the financial situation of the financial holding company shall not in any way imply that the Commission is required to play a supervisory role in relation to the financial holding company on a stand-alone basis.

(2) When the competent authorities of a Member State do not include an investment firm subsidiary in supervision on a consolidated basis under one of the cases provided for in points (b) and (c) of paragraph 7 of Chapter 2, Part A, the competent authorities of the Member State in which that investment firm subsidiary is situated may ask the parent undertaking for information which may facilitate their supervision of that investment firm.

(3) The Commission, when being responsible for the exercise of supervision on a consolidated basis, may ask the subsidiaries of an investment firm or a financial holding company, which are not included within the scope of

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supervision on a consolidated basis, for the information referred to in paragraph 11 of this Part. In such a case, the procedures for transmitting and verifying the information laid down in that paragraph shall apply.

Commission tasks when being responsible for the exercise of supervision on a consolidated basis

5. (1) In addition to the obligations imposed by the provisions of this Directive, the Commission, when acting as the supervisory authority responsible for the exercise of supervision on a consolidated basis of EU parent investment firms and investment firms controlled by EU parent financial holding companies shall carry out the following tasks:

(a) coordination of the gathering and dissemination of relevant or essential information in going concern and emergency situations;

(b) planning and coordination of supervisory activities in going-concern situations, including in relation to the activities referred to in paragraphs 31 to 33 of Chapter 6 of Part C, in Sub-Chapter A of Chapter 7 of Part C and in Annex V of Part C, in cooperation with the competent authorities involved;

(c) planning and coordination of supervisory activities in cooperation with the competent authorities involved, and if necessary with central banks, in preparation for and during emergency situations, including adverse developments in investment firms or in financial markets using, where possible, existing defined channels of communication for facilitating crisis management.

The planning and coordination of supervisory activities referred to in point (c) includes exceptional measures referred to in paragraph 7(3)(b) of this Part, the preparation of joint assessments, the implementation of contingency plans and communication to the public.

Where the Commission (the consolidating supervisor) fails to carry out the tasks referred to in the first subparagraph or where the competent authorities do not cooperate with the Commission (the consolidating supervisor) to the extent required in carrying out the tasks in the first subparagraph, any of the competent authorities concerned may refer the matter to EBA, which may act in accordance with Article 19 of Regulation 1093/2010.

(2) (a) In the case of applications for the permissions referred to in paragraphs 8(1) and 11(7) of Chapter 2, Part C, in paragraph 29 of Chapter 5 of Part C and in Annex III, Part 6 of Part C respectively, submitted by an EU parent

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investment firm and its subsidiaries, or jointly by the subsidiaries of an EU parent financial holding company, the Commission shall cooperate and consult closely with the competent authorities, to decide whether or not to grant the permission sought and to determine the terms and conditions, if any, to which such permission should be subject.

(b) An application as referred to in point (a) above shall be submitted only to the Commission.

(c) The Commission and all competent authorities involved shall do everything within their power to reach a joint decision on the application within six months. This joint decision shall be set out in a document containing the fully reasoned decision which shall be provided to the applicant by the Commission.

(d) The period referred to in point (c) above shall begin on the date of receipt of the complete application by the Commission. The Commission shall forward the complete application to the other competent authorities without delay.

(e) In the absence of a joint decision between the competent authorities within six months, the Commission shall make its own decision on the application. The decision shall be set out in a document containing the fully reasoned decision and shall take into account the views and reservations of the other competent authorities expressed during the six months period. The decision shall be provided to the applicant and the other competent authorities by the Commission. If, at the end of the six month period, any of the competent authorities concerned has referred the matter to EBA in accordance with Article 19 of Regulation 1093/2010, the consolidating supervisor shall defer its decision and await any decision that EBA may take in accordance with Article 19(3) of that Regulation on its decision, and shall take its decision in conformity with the decision of EBA. The six-month period shall be deemed the conciliation period within the meaning of that Regulation. EBA shall take its decision within 1month. The matter shall not be referred to EBA after the end of the six month period or after a joint decision has been reached.

(f) The decisions referred to in points (c) and (e) above shall be recognised as determinative and applied by the competent authorities in the Member States concerned.

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(3) (a) The Commission, when acting as the consolidating supervisor and/or when acting as the authority responsible for the supervision of subsidiaries of an EU parent investment firm or an EU parent financial holding company in a Member State shall do everything within its power to reach, together with the competent authorities in other Member States, a joint decision on the application of paragraphs 31 and 32 of Chapter 6 of Part C 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 paragraph 33(2) of Chapter 6 of Part C to each entity within the group and on a consolidated basis.

(b) The joint decision shall be reached within four months after submission by the Commission, when acting as the consolidating supervisor, of a report containing the risk assessment of the group in accordance with paragraphs 31 and 32 of Chapter 6 of Part C to the other relevant competent authorities. The joint decision shall also duly consider the risk assessment of subsidiaries performed by relevant competent authorities in accordance with paragraphs 31 and 32 of Chapter 6 of Part C.

The joint decision shall be set out in a document containing the fully reasoned decision which shall be provided to the EU parent investment firm by the Commission, in cases where it acts as the consolidating supervisor. In the event of disagreement, the Commission, if it is responsible for the exercise of consolidated supervision, shall at the request of any of the other competent authorities concerned consult the EBA. The Commission, in cases where it acts as the consolidating supervisor, may consult the EBA on its own initiative.

(c) In the absence of such a joint decision between the competent authorities within four months, a decision on the application of paragraphs 31, 32 and 33(2) of Chapter 6 of Part C shall be taken on a consolidated basis by the Commission, when acting as the consolidating supervisor, after duly considering the risk assessment of subsidiaries performed by relevant competent authorities. If, at the end of the four month period, any of the competent authorities concerned has referred the matter to EBA in accordance with Article 19 of Regulation 1093/2010, the consolidating supervisor shall defer its decision and await any decision that EBA may take in accordance with Article 19(3) of that Regulation, and shall take its decision in conformity with the decision of EBA. The four month period shall be deemed the conciliation period within the meaning of the Regulation. EBA shall take its decision within 1 month. The matter shall not be referred to EBA after the

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end of the four month period or after a joint decision has been reached.

The decision on the application of paragraphs 31, 32 and 33(2) of Chapter 6 of Part C shall be taken by the respective competent authorities responsible for supervision of subsidiaries of an EU parent investment firm or an EU parent financial holding company on an individual or sub-consolidated basis after duly considering the views and reservations expressed by the consolidating supervisor. If, at the end of the four-month period, any of the competent authorities concerned has referred the matter to EBA in accordance with Article 19 of Regulation 1093/2010, the competent authorities shall defer their decision and await any decision that EBA shall take in accordance with Article 19(3) of that Regulation, and shall take its decision in conformity with the decision of EBA. The four month period shall be deemed the conciliation period within the meaning of that Regulation. EBA shall take its decision within 1 month. The matter shall not be referred to EBA after the end of the four-month period or after a joint decision has been reached.

The decisions shall be set out in a document containing the fully reasoned decisions and shall take into account the risk assessment, views and reservations of the other competent authorities expressed during the four-month period. The document shall be provided by the Commission, in the cases where it acts as the consolidating supervisor, to all competent authorities concerned and to the EU parent investment firm.

Where the EBA has been consulted, the Commission shall consider such advice, and explain any significant deviation there from.

The joint decision referred to in point (a) of this subparagraph and the decisions taken by the Commission in the absence of a joint decision shall be recognised as determinative and shall be applied by the Commission. The Commission also recognizes as determinative and applies the decisions of other competent authorities.

(d) The joint decision referred to in point (a) and any decision taken in the absence of a joint decision in accordance with the first and second section of point (c) of this subparagraph, shall be updated on an annual basis or, in exceptional circumstances, where the Commission, when acting as the competent authority responsible for the supervision of subsidiaries of an EU parent investment firm or, an EU parent financial holding company, makes a written and fully reasoned request to the consolidating supervisor to update the decision on the application of paragraph 33(2) of Chapter 6 of Part C. In

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the latter case, the update may be addressed on a bilateral basis between the consolidating supervisor and the competent authority making the request.

(e) Regardless of point (b) and the first and third section of point (c) of this subparagraph, until the 31st December 2012, these points are applied as if they mention a deadline of six months instead of four months.

Establishment of written coordination and cooperation arrangements by the competent authorities

6. (1) In order to facilitate and establish effective supervision, the Commission, in cases where it is responsible for supervision on a consolidated basis, and the other competent authorities shall have written coordination and cooperation arrangements in place.

Under these arrangements additional tasks may be entrusted to the Commission, in case it is responsible for supervision on a consolidated basis, and procedures for the decision-making process and for cooperation with other competent authorities, may be specified.

(2) The Commission, in cases where it is responsible for authorising the subsidiary of a parent undertaking which is an investment firm may, by bilateral agreement, in accordance with Article 28 of Regulation 1093/2010, delegate its responsibility for supervision to the competent authorities which authorised and supervise the parent undertaking so that they assume responsibility for supervising the subsidiary in accordance with this Directive. EBA shall be kept informed of the existence and content of such agreements.

The competent authorities responsible for authorizing the subsidiary of a parent undertaking which is an investment firm which is authorised and supervised by the Commission, may, by bilateral agreement, delegate their responsibility for supervision to the Commission so that it assumes responsibility for supervising the subsidiary in accordance with this Directive. The European Commission shall be kept informed by the Commission of the existence and content of such agreements.

Colleges of supervisors

6a. (1) The Commission, when acting as the consolidating supervisor, shall establish colleges of supervisors to facilitate the exercise of the tasks referred to in paragraph 5 of this Part and subject to the confidentiality requirements of subparagraph 2 of this paragraph and compatibility with European Community law, ensure, where necessary, appropriate coordination and cooperation with relevant third-country competent authorities.

Colleges of supervisors shall provide a framework for the Commission (the

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consolidated supervisor), EBA and the other competent authorities concerned to carry out the following tasks:

(a) exchanging information among themselves and with EBA in accordance with Article 21 of Regulation 1093/2010;

(b) agreeing on voluntary entrustment of tasks and voluntary delegation of responsibilities where appropriate;

(c) determining supervisory examination programs based on a risk assessment of the group in accordance with paragraph 32 of Chapter 6 of Part C;

(d) increasing the efficiency of supervision by removing unnecessary duplication of supervisory requirements, including in relation to the information requests referred to in paragraph 7(2) of this Part;

(e) consistently applying the prudential requirements under this Directive across all entities within a group without prejudice to the options and discretions available in European Community legislation;

(f) applying paragraph 5(1)(c) taking into account the work of other forums that may be established in that area.

The competent authorities participating in the colleges of supervisors and EBA shall cooperate closely. The confidentiality requirements under Section 129 of the Law shall not prevent the Commission and other competent authorities from exchanging confidential information within colleges of supervisors. The establishment and functioning of colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under European Directive 2006/48/EC.

(2) (a) The establishment and functioning of the colleges shall be based on written arrangements referred to in paragraph 6, determined after consultation with competent authorities concerned by the consolidating supervisor.

(b) The competent authorities responsible for the supervision of subsidiaries of an EU parent investment firm or an EU parent financial holding company, central banks as appropriate, and third countries' competent authorities where appropriate and subject to confidentiality requirements that are equivalent, in the opinion of all competent authorities, to the requirements under Section

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129 of the Law, may participate in colleges of supervisors.

(c) The Commission, when acting as the consolidating supervisor, shall chair the meetings of the college and shall decide which competent authorities participate in a meeting or in an activity of the college. The Commission, when acting as the consolidating supervisor, shall 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. The Commission, when acting as the consolidating supervisor, shall also 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.

The decision of the Commission, when acting as the consolidating supervisor, shall take account of the relevance of the supervisory activity to be planned or coordinated for those authorities, in particular the potential impact on the stability of the financial system in the Member States concerned.

The Commission, as the consolidating supervisor, subject to the confidentiality requirements under Section 129 of the Law, shall inform EBA of the activities of the college of supervisors, including in emergency situations, and communicate to EBA all information that is of particular relevance for the purposes of supervisory convergence.

Cooperation and communication of information between competent authorities

7. (1) The competent authorities shall cooperate closely with each other. They shall provide one another with any information which is essential or relevant for the exercise of the other authorities' supervisory tasks under this Directive. In this regard, the competent authorities shall communicate on request all relevant information and shall communicate on their own initiative all essential information.

The competent authorities shall cooperate with EBA for the purposes of this Directive, in accordance with Regulation 1093/2010.

The competent authorities shall provide EBA with all information necessary to carry out its duties under this Directive and under Regulation 1093/2010, in accordance with Article 35 of that Regulation.

Information referred to in the first subparagraph shall be regarded as essential if it could materially influence the assessment of the financial soundness of a credit institution or financial institution in another Member State.

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In particular, the Commission, when acting as the competent authority responsible for consolidated supervision of EU parent investment firms and investment firms controlled by EU parent financial holding companies shall provide the competent authorities in other Member States who supervise subsidiaries of these parents with all relevant information. In determining the extent of relevant information, the importance of these subsidiaries within the financial system in those Member States shall be taken into account.

The essential information referred to in the first subparagraph shall include, in particular, the following items:

(a) identification of the group structure of all major investment firms in a group, as well as of the competent authorities of the investment firms in the group;

(b) procedures for the collection of information from the investment firms in a group, and the verification of that information;

(c) adverse developments in investment firms or in other entities of a group, which could seriously affect the investment firms; and

(d) major sanctions and exceptional measures taken by competent authorities in accordance with this Directive, including the imposition of an additional capital charge under paragraph 33(1) of Chapter 6 of Part C and the imposition of any limitation on the use of the Advanced Measurement Approach for the calculation of the own funds requirements under paragraph 29 of Chapter 5 of Part C.

The competent authorities may refer to EBA situations where:

(a) a competent authority has not communicated essential information, or

(b) a request for cooperation, in particular to exchange relevant information, has been rejected or has not been acted upon within a reasonable time.

(2) Where the Commission is responsible for the supervision of investment firms controlled by an EU parent investment firm it shall whenever possible contact the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent investment firms and investment firms controlled by EU parent financial holding companies, when it needs

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information regarding the implementation of approaches and methodologies set out in this Directive that may already be available to that competent authority.

(3) The Commission shall, prior to its decision, consult with the other competent authorities with regard to the following items, where this decision is of importance for other competent authorities' supervisory tasks:

(a) changes in the shareholder, organisational or management structure of investment firms in a group, which require the approval or authorisation of competent authorities; and

(b) major sanctions or exceptional measures taken by competent authorities, including the imposition of an additional capital charge under paragraph 33(1) of Chapter 6 of Part C and the imposition of any limitation on the use of the Advanced Measurement Approaches for the calculation of the own funds requirements under paragraph 29 of Chapter 5 of Part C.

For the purposes of point (b), the Commission, as the competent authority of the host Member State, consults always with the competent authority responsible for supervision on a consolidated basis.

(4) The Commission may decide not to consult in cases of urgency or where such consultation may jeopardise the effectiveness of the decisions. In this case, the Commission shall, without delay, inform the other competent authorities.

Requirement for consolidation of institutions for the purpose of exercising consolidated supervision

8. (1) The Commission, being the competent authority responsible for supervision on a consolidated basis shall, for the purposes of supervision, require full consolidation of all the credit institutions and financial institutions which are subsidiaries of a parent undertaking.

However, the Commission may require only proportional consolidation where, in its opinion, the liability of a parent undertaking holding a share of the capital is limited to that share of the capital in view of the liability of the other shareholders or members whose solvency is satisfactory. The liability of the other shareholders and members shall be clearly established, if necessary by means of formal signed commitments.

In the case where undertakings are linked by a relationship in accordance with

section 142 of the Company Law, or with the legislation of another Member State which aims at the harmonization with Article 12(1) of Directive 83/349/EEC, the Commission shall determine how consolidation is to be carried out.

(2) The Commission, being the competent authority responsible for supervision on a consolidated basis shall require the proportional consolidation of participations in credit institutions and financial institutions managed by an undertaking included in the consolidation together with one or more undertakings not included in the consolidation, where those undertakings' liability is limited to the share of the capital they hold.

(3) In the case of participations or capital ties other than those referred to in subparagraphs (1) and (2), the Commission shall determine whether and how consolidation is to be carried out. In particular, it may permit or require use of the equity method.

That method shall not, however, constitute inclusion of the undertakings concerned in supervision on a consolidated basis.

Requirement for consolidation in specified cases

9. (1) Without prejudice to paragraph 8 of this Part, the Commission shall determine whether and how consolidation is to be carried out in the following cases:

(a) where, in the opinion of the Commission, an investment firm exercises a significant influence over one or more credit institutions or financial institutions, but without holding a participation or other capital ties in these institutions; and

(b) where two or more credit institutions or financial institutions are placed under single management other than pursuant to a contract or clauses of their memoranda or Articles of association.

In particular, the Commission may permit, or require use of, the method provided for in section 142 of the Company Law, or with the legislation of another Member State which aims at the harmonization with Article 12 of Directive 83/349/EEC. That method shall not, however, constitute inclusion of the undertakings concerned in consolidated supervision.

(2) Where consolidated supervision is required pursuant to paragraphs 2 and 3 of this Part, ancillary services undertakings and asset management companies

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as defined in Directive 144-2007-11 for the Supplementary Supervision of Investment Firms in a Financial Conglomerate shall be included in consolidations in the cases, and in accordance with the methods, laid down in paragraph 8 of this Part and subparagraph (1) of this paragraph.

Required qualifications of persons who direct financial holding companies

10. The Commission shall require that persons who effectively direct the business of a financial holding company be of sufficiently good repute and have sufficient experience to perform those duties.

Provision of any relevant information concerning mixed-activity holding companies and their subsidiary investment firms

11. (1) Pending further coordination of consolidation methods, it is provided that, where the parent undertaking of one or more investment firms is a mixed‑activity holding company, the Commission, in the cases where it is responsible for the authorisation and supervision of those investment firms shall, by approaching the mixed‑activity holding company and its subsidiaries either directly or via investment firm subsidiaries, require them to supply any information which would be relevant for the purpose of supervising the investment firm subsidiaries.

(2) The Commission may carry out, or have carried out by external inspectors, on‑the‑spot inspections to verify information received from mixed‑activity holding companies and their subsidiaries. If the mixed‑activity holding company or one of its subsidiaries is an insurance undertaking, the procedure laid down in paragraph 14(1) of this Part may also be used. If a mixed‑activity holding company or one of its subsidiaries is situated in a Member State other than that in which the investment firm subsidiary is situated, on‑the‑spot verification of information shall be carried out in accordance with the procedure laid down in paragraph 16 of this Part.

Reporting of significant transactions between an investment firm and the mixed-activity holding company and its subsidiaries

12. (1) Without prejudice to the Large Exposures Directive, it is provided that, where the parent undertaking of one or more investment firms is a mixed‑activity holding company, the Commission, when acting as the competent authority responsible for the supervision of these investment firms, shall exercise general supervision over transactions between the investment firm and the mixed‑activity holding company and its subsidiaries.

(2) The Commission shall require investment firms to have in place adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures, in order to identify, measure, monitor and control transactions with their parent mixed‑activity holding company

and its subsidiaries appropriately. The Commission shall require the reporting by the investment firm of any significant transaction with these entities other than the one referred to in paragraph 17 of the Large Exposures Directive, within one month following the date of the transaction. These procedures and significant transactions shall be subject to overview by the Commission.

Where these intra‑group transactions are a threat to an investment firm's financial position, the Commission, as the authority responsible for the supervision of the investment firm, shall take appropriate measures.

Steps for facilitating the exercise of consolidated supervision

13. (1) The Commission shall take the necessary steps to ensure that there are no legal impediments preventing the exchange, as between undertakings included within the scope of supervision on a consolidated basis, mixed‑activity holding companies and their subsidiaries, or subsidiaries of the kind covered in paragraph 4(3) of this Part, of any information which would be relevant for the purposes of supervision in accordance with paragraphs 32 and 33 of Chapter 6 of Part C, and paragraphs 2 to 12 of this Part and this paragraph.

(2) Where a parent undertaking and any of its subsidiaries that are investment firms are situated in different Member States, the competent authorities of each Member State shall communicate to each other all relevant information which may allow or aid the exercise of supervision on a consolidated basis.

Where the competent authorities of the Member State in which a parent undertaking is situated do not themselves exercise supervision on a consolidated basis pursuant to paragraphs 2 and 3 of this Part, they may be invited by the competent authorities responsible for exercising such supervision to ask the parent undertaking for any information which would be relevant for the purposes of supervision on a consolidated basis and to transmit it to these authorities.

(3) The Commission shall exchange with the competent authorities of other Member States the information referred to in subparagraph 2, on the understanding that, in the case of financial holding companies, financial institutions or ancillary services undertakings, the collection or possession of information shall not in any way imply that the Commission or the other competent authorities concerned are required to play a supervisory role in relation to those institutions or undertakings standing alone.

Similarly, the Commission shall exchange with the competent authorities of

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other Member States the information referred to in paragraph 11 of this Part on the understanding that the collection or possession of information does not in any way imply that the Commission or the other competent authorities play a supervisory role in relation to the mixed‑activity holding company and those of its subsidiaries which are not investment firms, or to subsidiaries of the kind covered in paragraph 4(3) of this Part.

Supervision of an investment firm, financial holding company or mixed-activity holding company which controls insurance companies or other undertakings providing investment services

14. (1) Where an investment firm, financial holding company or a mixed‑activity holding company controls one or more subsidiaries which are insurance companies or other undertakings providing investment services which are subject to authorisation, the Commission and the authorities entrusted with the public task of supervising insurance undertakings or those other undertakings providing investment services shall cooperate closely. Without prejudice to their respective responsibilities, those authorities shall provide one another with any information likely to simplify their task and to allow supervision of the activity and overall financial situation of the undertakings they supervise.

(2) Information received, in the framework of supervision on a consolidated basis, and in particular any exchange of information between competent authorities which is provided for in this Directive, shall be subject to the obligation of professional secrecy defined in Section 129 of the Law.

(3) The Commission, when acting as the competent authority responsible for supervision on a consolidated basis, shall establish lists of the financial holding companies referred to in paragraph 5(2) of Chapter 2 of Part A. Those lists shall be communicated to the competent authorities of the other Member States and to the European Commission.

Supervision of an investment firm which has as parent an investment firm or a financial holding company in a third country

15. (1) Where an investment firm, the parent undertaking of which is an investment firm or a financial holding company, the head office of which is in a third country, is not subject to consolidated supervision under paragraphs 2 and 3 of this Part, the competent authorities shall verify whether the investment firm is subject to consolidated supervision by a third‑country competent authority which is equivalent to that governed by the principles laid down in this Directive.

The verification shall be carried out by the Commission, in the cases where it acts as the competent authority responsible for consolidated supervision if subparagraph 3 were to apply, at the request of the parent undertaking or of any of the regulated entities authorised in the Community or on its own

initiative. The Commission shall consult the other competent authorities involved.

(2) The Commission, when carrying out the verification referred to in the first subparagraph of paragraph 15(1), shall take into account any such guidance. For that purpose the Commission shall consult the EBA before adopting a decision.

(3) In the absence of such equivalent supervision, the Commission shall apply the provisions of this Directive to the investment firm by analogy.

Submission of request for verification of information

16. (1) Where, for the purpose of applying this Directive, the Commission, in specific cases, wishes to verify the information concerning:

(a) an investment firm

(b) a financial holding company

(c) a financial institution

(d) an ancillary services undertaking

(e) a mixed-activity holding company

(f) a subsidiary of the kind covered in paragraph 11 of this Part, or

(g) a subsidiary of the kind covered in the third subparagraph of paragraph 4 of this Part,

situated in another Member State, it submits a request to the competent authority of that other Member State to have that verification carried out.

(2) The Commission, when it receives such a request from the competent authority of a Member State for verification, shall within the framework of their competence act upon it:

(a) by carrying out the verification themselves, or

(b) by allowing the authority who made the request to carry it out, or

(c) by allowing an auditor or expert to carry it out.

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The competent authority which made the request may, if it so wishes, participate in the verification when it does not carry out the verification itself.

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