



GUERNSEY
FINANCIAL
SERVICES
COMMISSION

MODULE 2

Guidance to completing the Simplified Standardised Approach to Credit Risk module of
BSL/2

Glossary

The following abbreviations are used within the document:

CIS	-	C ollective I nvestment S cheme
CRM	-	C redit R isk M itigation
CCF	-	C redit C onversion F actor
CEA	-	C redit E quivalent A mount
ECA	-	E xport C redit A gency
LTV	-	L oan- T o- V alue
MDB	-	M ultilateral D evelopment B ank
OTC	-	O ver- T he- C ounter
RWA	-	R isk- W eighted A mount
SSA	-	S implified S tandardised A pproach to credit risk

CONTENTS

SECTION 1	Overview.....	5
	Introduction.....	5
	Definitions and clarifications.....	5
SECTION 2	Portfolio classification and risk weights: Balance sheet assets.....	6
	Portfolio classification.....	6
	Collective investment schemes	6
	Determination of risk weights	6
	Portfolio A: Claims on sovereigns	7
	Portfolio B: Claims on public sector entities (PSEs).....	9
	Portfolio C: Claims on corporates.....	9
	Portfolio D: Claims on banks	10
	Portfolio E: Securitisations	10
	Portfolio F: Cash and similar items.....	11
	Portfolio G: Retail exposures.....	12
	Portfolio H: Residential mortgages.....	13
	Portfolio J: Past due exposures.....	14
	Portfolio K: Capital deductions	15
	Portfolio L: Other balance sheet exposures	16
SECTION 3	Credit risk mitigation and associated calculation and reporting of risk-weighted amounts: Balance sheet assets	17
	Introduction.....	17
	CRM treatment by substitution of risk weights	17
	Credit protection by means of credit-linked notes	18
SECTION 4	Portfolio classification, determination of credit conversion factors and risk weights: Off-balance sheet exposures - excluding OTC derivatives	20
	Categorisation and determination of CCFs	20
	Determination of risk weights for off-balance sheet items excluding OTC Derivatives.....	23
SECTION 5	Credit risk mitigation and the calculation and reporting of risk- weighted amounts: Off-balance sheet exposures - excluding OTC derivatives.....	24
	Introduction.....	24
	CRM treatment by substitution of risk weights	24
SECTION 6	Portfolio classification: Off-balance sheet exposures: OTC derivatives	25
	OTC contracts summary.....	25
	OTC contract Schedules	25
	Categorisation and add-on factors for OTC derivative contracts	25

<u>SECTION 7</u>	<u>Credit risk mitigation and the calculation and reporting of risk-weighted amounts: Off-balance sheet exposures - OTC derivatives</u>	<u>27</u>
	<u>CRM treatment by substitution of risk weights</u>	<u>27</u>
<u>SECTION 8</u>	<u>Credit risk mitigation – specific issues</u>	<u>29</u>
	<u>Multiple credit risk mitigation</u>	<u>29</u>
	<u>Maturity mismatches.....</u>	<u>29</u>
<u>SECTION 9</u>	<u>Table 1 – Mapping consensus country risk scores from participating ECAs to risk weighting</u>	<u>30</u>
<u>Appendix A:</u>	<u>ECA ratings</u>	<u>31</u>
<u>Appendix B:</u>	<u>Multilateral development banks.....</u>	<u>32</u>
<u>Appendix C:</u>	<u>Exceptions to the risk weight floor of 20% for collateral</u>	<u>33</u>
<u>Appendix D:</u>	<u>Criteria for preferential treatment of repo-style transactions</u>	<u>34</u>
<u>Appendix E:</u>	<u>Requirements for recognition of collateral.....</u>	<u>36</u>
<u>Appendix F:</u>	<u>Illustrations on reporting of credit risk mitigation techniques</u>	<u>38</u>
<u>Appendix G:</u>	<u>Criteria for classification as a retail exposure and / or as a residential mortgage.....</u>	<u>42</u>

SECTION 1 OVERVIEW

Introduction

- 1.1 Every incorporated licensed bank that uses the simplified standardised approach to calculate its credit risk capital requirement will be required to complete the relevant module, as part of its prudential return. The return covers the bank's balance sheet assets and off-balance sheet exposures in its banking book, including OTC derivative contracts.

Definitions and clarifications

- 1.2 *Amounts* should be reported net of specific provisions for all balance sheet assets and off-balance sheet exposures other than OTC derivative transactions. Specific provisions for OTC derivative transactions should be deducted from the credit equivalent amount.
- 1.3 *Amount after CRM* means the reported amount, adjusted for the capital effect of recognised CRM techniques. The latter refers to techniques the bank may use to mitigate credit risk and hence reduce the capital requirement of a credit exposure. Three types of CRM techniques are recognised for this purpose:
- Collateral;
 - Guarantees; and
 - Credit derivatives.

In order to be recognised, a CRM technique should satisfy the relevant operational requirements and conditions set out in Appendix F.

- 1.4 Double counting of exposures arising from the same contract or transaction should be avoided. For example, only the undrawn portion of a loan commitment should be reported as an off-balance sheet exposure; the actual amount which has been lent will be reported as a balance sheet asset in the relevant portfolio. Trade-related contingencies such as shipping guarantees for which the exposures have already been reported as letters of credit issued or loans against import bills are not required to be reported as trade-related contingencies. In certain cases, credit exposures arising from derivative contracts may already be reflected, in part, on the balance sheet. For example, the bank may have recorded current credit exposures to counterparties (i.e. mark-to-market values) under foreign exchange and interest rate related contracts on the balance sheet, typically as either sundry debtors or sundry creditors. To avoid double counting, such exposures should be excluded from the balance sheet assets and treated as off-balance sheet exposures for the purposes of this return.
- 1.5 Accruals on a claim should be classified and weighted in the same way as the claim. Accruals that cannot be so classified, e.g. due to systems

constraints, should, with the prior consent of the Commission, be categorised within “Other, including prepayments and debtors” within Portfolio L.

SECTION 2 **PORTFOLIO CLASSIFICATION AND RISK WEIGHTS: BALANCE SHEET ASSETS**

Portfolio classification

2.1 Within the module, the balance sheet is organised as follows:

- Portfolio A - Sovereigns
- Portfolio B - Public sector entities (PSEs)
- Portfolio C - Corporates
- Portfolio D - Banks
- Portfolio E – Securitisation exposures
- Portfolio F - Cash and similar items
- Portfolio G - Retail
- Portfolio H – Residential mortgages
- Portfolio J – Past due exposures
- Portfolio K – Capital deductions
- Portfolio L – Other balance sheet exposures

2.2 Each Portfolio is mutually exclusive and each asset should be reported in only one Portfolio. For instance, any asset which is past due should only be reported in Portfolio J and not elsewhere.

Collective investment schemes

2.3 Exposures to collective investment schemes should be categorised as equity, except that:

2.3.1 Exposures to a fixed income fund should be categorised within “Other” in Portfolio L.

2.3.2 Investments in venture capital and private equity schemes should be categorised within “High Risk Assets” in Portfolio L.

Determination of risk weights

2.4 The risks weight for an asset in Portfolios A, B and D is generally determined from the consensus risk scores of ECAs participating in the “OECD Arrangement on Officially Supported Export Credits”. The consensus country risk classification is available on the OECD’s website (www.oecd.org) in the Export Credit Arrangement web page of the Trade Directorate.

- 2.5 Each of these three consensus ECA country score based Portfolios has its own risk-weighting framework. *Table 1* in Section 9 sets out how, for each Portfolio, different country scores are mapped to risk weights.
- 2.6 The following sections explain how assets in each Portfolio are risk-weighted and, where applicable, the relevant principles for reporting assets under the Portfolio.

Portfolio A: Claims on sovereigns

Item	Description of Item	Guidance														
A.1	Claims on Guernsey	Claims on the States of Guernsey, States of Alderney and the Chief Pleas of Sark are risk-weighted at 0%. This applies to all exposures but not those to government-owned trading entities (see Portfolio B).														
A.2	Claims on other sovereigns	<p>Claims on the other Crown Dependency and UK Governments are risk weighted at 0%. All claims on other sovereigns should be weighted in accordance with the consensus ECA country score as follows:</p> <table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3</th> <th>4 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>0%</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table> <p>Despite the above, where an equivalent regulator* exercises its discretion to permit banks in its jurisdiction to allocate a lower risk weight to claims on that jurisdiction's sovereign denominated in the domestic currency of that jurisdiction and funded in that currency, the same, lower risk-weight may be allocated to such claims.</p>	Country Score	0-1	2	3	4 - 6	7	Unrated	Risk Weight	0%	20%	50%	100%	150%	100%
Country Score	0-1	2	3	4 - 6	7	Unrated										
Risk Weight	0%	20%	50%	100%	150%	100%										
A.3	Claims on Multilateral Development Banks	All claims on multilateral development banks (" MDB "s) are risk weighted at 0%. Appendix B contains a list of eligible MDBs.														

* An "equivalent regulator" for the purposes of this document is one that is considered by the Commission to regulate banks under a Basel II regime in a manner that is broadly equivalent to the Commission's regulation. For example, the Commission considers the Jersey and Isle of Man Commissions and the UK Financial Services Authority to be equivalent regulators. The Commission has not published a list of regulators that it deems to be equivalent; the Commission will only assess regulators where a bank requests it.

Portfolio B: Claims on public sector entities (PSEs)

Item	Description of Item	Guidance												
B.1	Claims on Guernsey PSEs	Includes all exposures to entities owned by States of Guernsey, States of Alderney and Chief Pleas of Sark. Claims on these exposures are risk-weighted at 20%.												
B.2	Claims on other PSEs	Claims on other Crown Dependency and UK PSEs are risk weighted at 20%. All claims on other PSEs should be weighted in accordance with the consensus ECA country score as follows:												
		<table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Country Score	0-1	2	3 - 6	7	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Country Score	0-1	2	3 - 6	7	Unrated							
		Risk Weight	20%	50%	100%	150%	100%							
If claims on a foreign PSE are regarded as claims on the sovereign, for the purposes of capital adequacy calculation by an equivalent regulator of the jurisdiction in which the PSE is established, then such a claim may instead be disclosed in Portfolio A at the risk weight applicable to that sovereign.														
Where PSEs in other jurisdictions are considered equivalent to the government by the local regulator - for example where they have a guarantee from their government - and the Commission has agreed such a weighting in writing, banks may report such exposures at a 0% weight.														

Portfolio C: Claims on corporates

Item	Description of Item	Guidance
C	Claims on Corporates	All claims on Corporates should be weighted at 100%.

Portfolio D: Claims on banks

2.7 Claims on banks arising from bank guarantees received should be split from all other claims. All claims are then further divided into those with original maturity of 3 months or less from drawdown and those longer than 3 months from drawdown.

Item	Description of Item	Guidance												
D.1.1	Claims on banks, except guarantees: Maturity more than 3 months	Claims on banks should be weighted in accordance with the consensus ECA country score of the country in which they are incorporated, as follows:												
		<table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Country Score	0-1	2	3 - 6	7	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Country Score	0-1	2	3 - 6	7	Unrated							
Risk Weight	20%	50%	100%	150%	100%									
D.1.2	Claims on banks, except guarantees: Maturity less than 3 months	Sterling denominated claims on banks incorporated in Jersey, Guernsey, Isle of Man and the UK are risk weighted at 20%. Where an equivalent regulator exercises a similar discretion to allocate a lower risk weight to short term claims on that jurisdiction's sovereign denominated in the domestic currency of that jurisdiction, the same lower risk-weight may be allocated to such claims.												
D.2	Claims secured by guarantees from banks	Claims guaranteed by banks should be shown separately in this section using the mappings for a direct claim on the bank giving the guarantee (as above). The relevant maturity is that of the underlying claim. Note that such claims are shown in the "Amount after CRM" column, in accordance with Section 3.												

Portfolio E: Securitisations

Item	Description of Item	Guidance
E	Securitisation	The risk weight for securitisation exposures is 100%. For first loss positions acquired, deduction from capital will be required – disclose in Portfolio K.5.

Portfolio F: Cash and similar items

Item	Description of Item	Guidance
F.1	Notes and coins	Notes and coins are allocated a risk weight of 0%.
F.2	Cash items in the course of collection	Cash items in the course of collection refer to the amount of cheques, drafts and other items drawn on other banks that will be paid for the account of the bank immediately upon presentation and that are in the process of collection. Such items are allocated a risk weight of 20%.
F.3	Gold	Gold has a risk weight of 0%. (However, the net position in gold is subject to a market risk charge, which for the standardised approach broadly equates to a 100% weight for the net position.)
F.4	Claims fully collateralised by cash deposits	<p>The bank should report here claims collateralised by cash deposits (see Section 3). Claims secured by cash deposits should be recorded under the column headed “Amount after CRM”. These are then allocated a risk weight of 0%.</p> <p>When a cash deposit is held as collateral at a third-party bank in a non-custodial arrangement, the institution should treat the cash deposit as a claim on that third-party bank and report it within Portfolio D.2.</p>

Portfolio G: Retail exposures

Item	Description of Item	Guidance
G.1	Claims in “Regulatory Retail Portfolio”	Claims that qualify for this Portfolio are allocated a risk weight of 75%. To apply the risk weight of 75% to claims on small businesses or individuals, the bank must satisfy the relevant criteria set out in Appendix G. Claims that are not past due but do not satisfy the criteria for inclusion as regulatory retail exposures should be reported in Portfolio G.2.
G.2	Claims falling outside the “Regulatory Retail Portfolio”	Claims on small businesses or individuals other than those qualifying for inclusion in Portfolio G.1. Such claims are allocated a risk weight of 100%.

Portfolio H: Residential mortgages

Item	Description of Item and Risk Weighting	Guidance
H.1	Residential Mortgages: 35%	Residential Mortgages that meet all the criteria set out in Appendix H are assigned a weighting of 35% for that portion below 80% LTV.
H.2	Residential Mortgages: 50%	<p>Residential Mortgages that meet all the criteria set out in Appendix H except for either:</p> <ul style="list-style-type: none"> ▪ Mortgages for which the institution’s systems do not hold adequate LTV information; or ▪ Mortgages in jurisdictions other than those where the local regulator is deemed equivalent, has adopted Basel II, has evaluated the local market and deemed a weight of 35% to be appropriate. <p>Those mortgages in the above two categories are assigned a risk weighting of 50%.</p>
H.3	Residential Mortgages: 75%	Residential Mortgages that meet all the criteria set out in Appendix H are assigned a weighting of 75% for that portion above 80% LTV.
H.4	Residential Mortgages: 100%	Residential Mortgages that do not meet the criteria set out in Appendix H, other than those that qualify for inclusion in H.2, are assigned a risk weight of 100%.

Portfolio J: Past due exposures

2.8 For the purpose of defining the secured portion of a past due loan, eligible collateral and guarantees will be treated in line with the credit risk mitigation process detailed in Section 3.

Item	Description of Item	Guidance
J.1	Secured	<p>The secured part of any past due exposure i.e. that part that meets the terms for eligible CRM, as set out in Section 3, should be reported here. The risk weight is unaffected providing the terms of the CRM remain fulfilled.</p> <p>The exception is the case of qualifying residential mortgage loans. When such loans are past due for more than 90 days, they must be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50%.</p>
J.2	Unsecured	<p>The unsecured portion of any loan that is past due for more than 90 days, net of specific provisions, including partial write-offs, will be risk-weighted as follows:</p> <ul style="list-style-type: none"> • 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan; • 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan but less than 50%; • 50% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan.

Portfolio K: Capital deductions

2.9 These items require full deduction from capital and therefore do not contribute to RWA.

Item	Description of Item	Guidance
K.1	Investment in Subsidiaries	All investments in subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies. Associated companies are those with whom the bank has entered into joint ventures or where the bank owns a material shareholding. A shareholding that exceeds 20% would ordinarily be considered material.
K.2	Capital connected lending	All lending of a capital nature to subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies.
K.3	Holdings of financial services business' capital instruments	All investments in other financial service business' capital instruments not captured above.
K.4	Goodwill and other intangible fixed assets	All intangible assets should be deducted from capital, including goodwill.
K.5	Securitisations - equity tranches	Includes all first loss tranches.
K.6	Other	All items that require a full deduction as a result of specific or general guidance and that do not fall within Portfolios K.1 to K.5.

Portfolio L: Other balance sheet exposures

Item	Description of Item and Risk Weighting	Guidance
L.1	Tangible fixed assets 100%	Premises, plant and equipment, other fixed assets for own use, and other interests in realty. Included are investments in land, premises, plant and equipment and all other fixed assets of the bank which are held for its own use, including any fixed asset held by the institution as lessee under a finance lease. Other interest in land which is not occupied or used in the operation of the bank's business should also be reported here.
L.2	Equity 100%	Investments in equity of other entities and holdings of collective investment schemes. Included are investments in commercial entities, other than those where a deduction from capital base is required. Collective investment schemes should be included unless they invest in high risk assets, in which case they are categorised as such, or they are fixed income (only debt investments, not equity) in which case they are categorised as per paragraph 2.3 of Section 2.
L.3	High Risk Assets 150%	Investments in venture capital and private equity, including investments in collective investment schemes holding such investments, are weighted at 150%.
L.4	Other, including prepayments and debtors 0-150%	Accrued interest, prepayments and debtors should be classified here and weighted according to the underlying counterparty. Unallocated amounts, including unallocated interest, should be weighted at 100%. This includes unrestricted fixed income collective investment schemes (see paragraph 2.3 of Section 2).

SECTION 3 **CREDIT RISK MITIGATION AND ASSOCIATED CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: BALANCE SHEET ASSETS**

Introduction

- 3.1 For each balance sheet asset, the RWA is calculated by multiplying its “Amount after CRM” by an appropriate risk weight determined by the type of exposure, as set out in Section 2.
- 3.2 Where an asset is not covered by any recognised CRM techniques (see paragraph 1.3 of Section 1), the amounts reported under the columns headed “Amount” and “Amount after CRM” will be the same. Where an asset is covered wholly or partially by recognised CRM techniques (see paragraph 1.3 of Section 1), the amount reported under the column of “Amount after CRM” should be adjusted to reflect the CRM effect.
- 3.3 Appendix F contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

CRM treatment

- 3.4 The first step is to identify the Portfolio to which the underlying claim belongs, based on the instructions set out in Section 2, then report the whole principal of the claim under the column of “Amount” in that Portfolio, classified according to the risk weight applicable to that claim.
- 3.5 The “Amount” is divided into two portions: the portion covered by credit protection and the remaining uncovered portion.
- For guarantees and credit derivatives, the value of credit protection to be recorded is their nominal value. However, where the credit protection is denominated in a currency different from that of the underlying obligation, the covered portion should be reduced by a haircut for the currency mismatch of 10%.
 - For collateral, the value of credit protection to be recorded is its market value subject to a minimum revaluation frequency of 6 months for performing assets, and 3 months for past due assets (if this is not achieved then no value can be recognised).
 - Where the collateral involves cash deposits, certificates of deposit, cash funded credit-linked notes, or other comparable instruments which are held at a third-party bank in a non-custodial arrangement and unconditionally and irrevocably pledged or assigned to the bank, the collateral will be allocated the same risk weight as that of the third-party bank.
- 3.6 The covered and uncovered portions are reported according to the following:
- Where the asset covered by CRM is not past due, report the amount of the covered portion in the Portfolio to which the credit protection belongs,

under the column of “Amount after CRM”, classified according to the risk weight applicable to the credit protection (subject to a 20% floor, which can be reduced in situations set out in Appendix C).

- Where the asset covered by CRM is past due, the amount of the covered portion should be included in Portfolio J - Past Due Exposures and reported under the column of “Amount after CRM” in accordance with the risk weight applicable to the credit protection.

3.7 In both cases, the RWA of the covered portion is then calculated by multiplying the amount of the covered portion by the risk weight attributed to the credit protection in accordance with Section 2.

3.8 However, where the credit protection takes the form of a credit derivative contract with the following features, there are certain additional guidelines the bank should follow in determining the extent of credit protection:

3.8.1 Where the contract is a first-to-default credit derivative contract, the bank may recognise regulatory capital relief for the asset within the basket with the lowest risk weight, provided that the amount of that asset is less than or equal to the notional amount of the credit derivative. The institution may substitute the risk weight of the protection seller for the risk weight of that asset.

3.8.2 Where the contract is a second-to-default credit derivative contract, the bank may substitute the risk weight of the protection seller for the risk weight of the reference entity with the second lowest risk weight in the basket of reference entities specified in the contract, but only if:

- The institution has, as a protection buyer, entered into a first-to-default credit derivative contract relating to the same basket of reference entities; or
- A reference entity in the basket has defaulted.

3.9 Lastly, report the amount of the remaining uncovered portion in the Portfolio to which the underlying claim belongs, under the column of “Amount after CRM”, classified according to the risk weight of the underlying claim. The reported RWA of the uncovered portion will then be calculated by multiplying the amount of the uncovered portion by the risk weight of the claim.

Credit protection by means of credit-linked notes

3.10 For credit-linked notes, where the bank issues such a note to cover the credit risk of an underlying asset, the maximum amount of protection is the amount of the funds received from issuing that note. The protected amount should be treated as a claim fully collateralised by cash deposits in Portfolio F, while the remaining unprotected amount, if any, should be treated as a credit exposure to the underlying asset.

3.11 Where the bank holds a credit-linked note, it acquires credit exposure on two fronts, to the reference entity of the note and also to the note issuer. This balance sheet asset should be weighted according to the higher of the risk

weight of the reference entity or the risk weight of the note issuer and reported accordingly in the relevant Portfolio. The amount of exposure is the book value of the note.

SECTION 4 PORTFOLIO CLASSIFICATION, DETERMINATION OF CREDIT CONVERSION FACTORS AND RISK WEIGHTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES

Categorisation and determination of CCFs

- 4.1 The bank should categorise off-balance sheet exposures into the following standard items and report:
- The amount; and
 - The amount after allowing for credit risk mitigation and applying CCF, categorised by risk weight.

Item	Description of Item	Guidance	CCF
M.1	Direct credit substitutes	Direct credit substitutes almost always relate to the financial wellbeing of a third party. In this case the risk of loss to the bank from the transaction is equivalent to a direct claim on that party, i.e. the risk of loss depends on the creditworthiness of the third party.	100%
M.2	Transaction related contingencies	Transaction related contingents relate to the ongoing trading activities of a counterparty where the risk of loss to the bank depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. They are essentially guarantees that support particular financial obligations rather than supporting customers' general financial obligations.	50%
M.3	Trade-related contingencies	These comprise short-term, self liquidating trade-related items, such as documentary letters of credit issued by the bank, which are, or are to be, collateralised by the underlying shipment, i.e. where the credit provides for the bank to retain title to the underlying shipment. Such items should be risk weighted according to the counterparty on whose behalf the credit is issued whether or not the terms and conditions of the credit have yet to be complied with.	20%

Item	Description of Item	Guidance	CCF
M.4	Asset sales with recourse	<p>Asset sales with recourse (where the credit risk remains with the bank) fall into the risk weighting category determined by the asset and not the counterparty with whom the transaction has been entered into.</p> <p>Put options written where the holder of the asset is entitled to put the asset back to the bank, e.g. if the credit quality deteriorates, should be reported here, as should put options written by the bank attached to marketable instruments or other physical assets.</p>	100%
M.5	Forward asset purchases	<p>The risk weight should be determined by the asset to be purchased, not the counterparty with whom the contract has been entered into. Include commitments for loans and other balance sheet items with committed drawdown. Exclude foreign currency spot deposits with value dates one or two working days after trade date.</p>	100%
M.6	Partly paid-up shares and securities	<p>The unpaid part should only be included if there is a specific date for the call on that part of the shares and securities held.</p>	100%
M.7	Forward deposits placed	<p>These include a commitment to place a forward deposit.</p> <p>Where the bank has instead contracted to receive the deposit, failure to deliver by the counterparty will result in an unanticipated change in its interest rate exposure and may involve a replacement cost. Its exposure should therefore be treated as an interest rate contract (see Section 6).</p>	100%
M.8	Note issuance and revolving underwriting facilities	<p>Note issuance facilities and revolving underwriting facilities should include the total amounts of the bank's underwriting obligations of any maturity. Where the facility has been drawn down by the borrower and the notes are held by anyone other than the bank, the underwriting obligation should continue to be reported at the full nominal amount.</p>	50%

Item	Description of Item	Guidance	CCF
M.9a	Other commitments with original maturity of less than 1 year	The bank is regarded as having a commitment from the date the customer is advised of the facility (e.g. the date of the letter advising the customer), regardless of whether the commitment is revocable or irrevocable, conditional or unconditional and in particular whether or not the facility contains a “material adverse change” clause. Facilities subject to annual review should only be classified within M.9a if the bank is confident there is no client expectation of automatic renewal/continuation.	20%
M.9b	Other commitments with original maturity of 1 year and over		50%
M.9c	Commitments that are unconditionally cancellable without prior notice	<p>Commitments (including the undrawn portion of any binding arrangements which obligate the bank to provide funds at some future date) that are unconditionally cancellable without prior notice by it other than for “force majeure” reason, or that effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness.</p> <p>Retail credit lines may be considered as unconditionally cancellable if the terms permit the bank to cancel them to the full extent allowable under consumer protection and related legislation.</p> <p>Where a bank has entered into a so called “uncommitted facility” and it is apparent that the facility is commercially (if not legally) committed, consideration should be given to applying a capital charge to such a facility under Pillar 2 (the ICAAP) which might be equivalent to the charge that would be applicable if there was a legally enforceable commitment.</p>	0%

Determination of risk weights for off-balance sheet items excluding OTC derivatives.

4.2 Except for the following, the applicable risk weight for an off-balance sheet item is determined by reference to the risk weight allocated to the counterparty of the exposure, in accordance with the relevant instructions under Section 2. The exceptions are:

- “Direct credit substitutes”;
- “Asset sales with recourse”;
- “Forward asset purchases”;
- “Partly paid-up shares and securities”;
- and
- Exposures arising from the selling of credit derivative contracts booked in the bank’s banking book reported as “Direct credit substitutes”.

4.3 For these, the applicable risk weight to an exposure should be:

4.3.1 In the case of “Direct credit substitutes”, “Asset sales with recourse” and “Forward asset purchases”, the risk weight is determined by reference to the risk weight allocated to the underlying asset;

4.3.2 In the case of “Partly paid-up shares and securities”, use the risk weight for the equities in question (usually 100%); and

4.3.3 In the case of exposures arising from the selling of credit derivative contracts booked in the bank’s banking book reported as “Direct credit substitutes”, the risk weight is normally determined by reference to the risk weight of the relevant reference entity. However:

- Where a credit derivative contract sold is a first-to-default credit derivative contract, the institution should report as per the aggregate risk weights of the reference entities in the basket, subject to a maximum of 1000%.
- Where a credit derivative contract sold is a second-to-default credit derivative contract, the institution should aggregate the risk weights of the reference entities in the basket, but excluding that reference entity to which the lowest risk weight would be allocated, subject to a maximum of 1000%.
- Where a credit derivative contract sold provides credit protection proportionately to a basket of reference entities, in ratios set out in the credit derivative contract, the institution should calculate the risk weight of its exposure under the credit derivative contract by taking a weighted average of the risk weights attributable to the reference entities in the basket.

SECTION 5 CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES

Introduction

- 5.1 For each off-balance sheet exposure, the bank is required to identify the relevant risk weight for the counterparty by reference to what this would be for a balance sheet exposure to the same counterparty.
- 5.2 Where an exposure is not covered by any recognised CRM techniques (see 1.3), the process for calculating the capital requirement is:
- Firstly, enter the “Amount”, which is converted into a “Credit Equivalent Amount” by multiplying it by the applicable CCF;
 - Secondly, the “Credit Equivalent Amount” is classified by the applicable risk weighting, which is then used to calculate the RWA.
- 5.3 Where an exposure is covered fully or partially by recognised CRM techniques (see 1.3), the capital treatment is similar to that of balance sheet assets set out in Section 3, except that, in calculating the RWA, the “Credit Equivalent Amount” (“**CEA**”) is used instead of the “Amount”.
- 5.4 Appendix F contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

CRM treatment by substitution of risk weights

- 5.5 Report the amount of the exposure in the row “Amount”, classified according to Section 4.
- 5.6 Divide the amount into two portions: the portion covered by credit protection and the remaining uncovered portion (the value of the credit protection for different types of CRM techniques being determined in the same way as when the techniques are used to cover balance sheet assets – see Sections 3.7 to 3.10).
- 5.7 Multiply both portions by the CCF applicable to the exposure to create two CEAs (the total of which must equate to the CEA given by the sheet).
- 5.8 Classify the CEA of the uncovered portion according to the risk weight of the exposure and the CEA of the covered portion according to the risk weight of the collateral (subject to a 20% floor which can be reduced in the situations set out in Appendix C) or, for a guarantee or credit derivative, the credit protection provider. These inputs will then be used by the module to arrive at the risk weighted amount by multiplying each CEA by the appropriate weight.

SECTION 6 **PORTFOLIO CLASSIFICATION: OFF-BALANCE SHEET EXPOSURES: OTC DERIVATIVES**

OTC contracts summary

6.1 For OTC contracts, all information and calculation is performed within the relevant schedule. The OTC form is a summary of the results of the individual schedules.

Item	Description of Item	Guidance
N.1	Interest rate contracts	Summary, automatically completed from the data input in Schedule N.1
N.2	Foreign exchange and gold contracts	Summary, automatically completed from the data input in Schedule N.2
N.3	Equity contracts	Summary, automatically completed from the data input in Schedule N.3
N.4	Other precious metal contracts	Summary, automatically completed from the data input in Schedule N.4
N.5	Other commodity contracts	Summary, automatically completed from the data input in Schedule N.5

OTC contract Schedules

6.2 The following derivative contracts may be excluded from the calculation of RWA:

- Exchange rate contracts (except those which are based on gold) with an original maturity of 14 calendar days or less; or
- Forward exchange rate contracts arising from swap deposit arrangements. Under such contracts, the money deposited by the customer remains under the control of the bank at all times during the transaction and the institution will be in a position to ensure that the customer does not default on the settlement of the forward contract.

Categorisation and add-on factors for OTC derivative contracts

6.3 The add-on factors, used as set out in Section 7 to determine the Credit Equivalent Amount applicable to OTC derivative transactions, are set out in the following table according to their residual maturities:

	Interest Rate	FX and Gold	Equities	Precious Metals (except Gold)	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over 1 year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

- 6.4 For contracts structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity should be set equal to the time until the next reset date. In the case of interest rate contracts that meet these criteria, and the remaining time to final maturity of the contracts is more than one year, the add-on factor is subject to a floor of 0.5%.
- 6.5 Forwards, swaps, purchased options and similar derivative contracts other than those contracts the value of which is derived from the value of exchange rate, gold, interest rate, equity, or precious metal, should have applied the add-on factors applicable to “Other Commodities”.

SECTION 7 CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - OTC DERIVATIVES

- 7.1 The bank should use the replacement cost method to risk weight credit exposures to counterparties under OTC derivatives. OTC derivative transactions should be reported in Schedules N.1 to N.5. Where OTC derivative transactions are covered by a valid bilateral netting agreement, the bank may report the netted amount under item P in the OTC Summary page.
- 7.2 Report the “Amount” outstanding, being the total nominal value of all relevant OTC contracts classified according to type, maturity and the risk weighting of the counterparty. Insert the sum of any and all positive mark-to-market valuations relating to these contracts in the column headed “Positive Mark-to-Market”, which is the replacement cost (obtained by “marking to market”) of every contract with a positive value (where a contract has a negative value, it should be taken as zero), or where contracts are covered by a valid bilateral netting agreement, the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the bilateral netting agreement, if positive.
- 7.3 The “Credit Equivalent Amount” will then be the sum of:
- The “Positive Mark-to-Market”; and
 - The “Add-on Amount”, which is derived by multiplying the “Amount” of each contract by the appropriate “add-on factor” for that classification (as set out in Section 6.3).
- 7.4 Single currency floating/floating (basis) interest rate swaps should be classified as being less than 1 year to maturity and hence attract an add-on of 0%; the “Credit Equivalent Amount” is simply the positive mark-to-market.
- 7.5 In the absence of CRM, report the “Credit Equivalent Amount” in the column headed “Amount after CRM”. Allowance for specific provisions can be made by deducting these from the “Credit Equivalent Amount”. Note that the sheet will provide an unadjusted “Credit Equivalent Amount” that should be used if there are no provisions. This would then be multiplied by the applicable risk weight to calculate the RWA.
- 7.6 Where the (net) exposure to the counterparty is protected fully or partially by recognised CRM techniques (see 1.3), the capital treatment is similar to that of balance sheet assets explained in Section 3, albeit in calculating the RWA, the “Credit Equivalent Amount” is used instead of the “Amount”.
- 7.7 Appendix F contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

CRM treatment

- 7.8 Report the amount of the underlying transaction under the column “Amount”.
- 7.9 Convert the “Amount” into a “Credit Equivalent Amount” as set out in paragraph 7.3. Specific provisions should be deducted from the “Credit

Equivalent Amount”. Note that the sheet will provide an unadjusted “Credit Equivalent Amount” that should be used if there are no provisions.

- 7.10 Divide the “Credit Equivalent Amount” into two portions: the portion covered by credit protection and the remaining uncovered portion.
- 7.11 In the “After CRM”, column classify the “Credit Equivalent Amount” of the uncovered portion according to the applicable risk weight of the exposure and the “Credit Equivalent Amount” of the covered portion according to the applicable risk weight of the collateral (subject to a floor of 20% which can be reduced in the situations set out in Appendix C) or credit protection provider. Each amount will be multiplied by the appropriate risk weight to arrive at the risk-weighted amount.

SECTION 8 CREDIT RISK MITIGATION – SPECIFIC ISSUES

Multiple credit risk mitigation

- 8.1 An exposure covered by two or more different CRM techniques (e.g. with both collateral and guarantee partially covering the claim) should be accounted for by dividing the exposure into portions covered by each type of CRM technique. The calculation of the RWA of each portion will be done separately according to the reporting of each portion. Where there is an overlap of coverage between the CRM techniques, the bank may select, in respect of the overlapped portion, the CRM technique that will result in the lowest RWA for the exposure.
- 8.2 An exposure covered by two or more CRM techniques that are of the same form but have different maturities should likewise be divided into different portions according to the maturities. The RWA of each portion should then be calculated separately.
- 8.3 Where an exposure is in the form of a general banking facility consisting of several types of credit line, the bank may determine how any CRM techniques available under the facility should be allocated to individual claims under each line.

Maturity mismatches

- 8.4 Where the residual maturity of the CRM is less than that of the underlying credit exposure, a maturity mismatch occurs. Maturity mismatches will not be allowed; no CRM will be recognised in such cases.

SECTION 9 TABLE 1 – MAPPING CONSENSUS COUNTRY RISK SCORES FROM PARTICIPATING ECAS TO RISK WEIGHTING

Country Score	Sovereigns	Banks and securities firms	PSEs
0-1	0%	20%	20%
2	20%	50%	50%
3	50%	100%	100%
4-6	100%	100%	100%
7	150%	150%	150%

APPENDIX A: **ECA RATINGS**

A.1 **Export Credit Agencies (“ECA”s)**

- A.1.1 Under the simplified standardised approach, banks do not use External Credit Assessment Institutions’ ratings for determining risk weights associated with sovereign, central bank and other bank exposures. Instead, banks must use the consensus risk scores of ECAs participating in the “OECD Arrangement on Officially Supported Export Credits”. The consensus country risk classification is available on the OECD’s website (www.oecd.org) in the Export Credit Arrangement web page of the Trade Directorate. The mapping of the score to risk weights is shown in Table 1 (Section 9).

APPENDIX B: **MULTILATERAL DEVELOPMENT BANKS**

B.1 **List of institutions that shall be considered as MDBs:**

- European Investment Bank
- European Bank for Reconstruction and Development
- Council of Europe Development Bank
- European Investment Fund
- International Bank for Reconstruction and Development
- International Finance Corporation
- Inter-American Development Bank
- African Development Bank
- Asian Development Bank
- Caribbean Development Bank
- Nordic Investment Bank
- Islamic Development Bank

APPENDIX C: **EXCEPTIONS TO THE RISK WEIGHT FLOOR OF 20% FOR COLLATERAL**

C.1 **Introduction**

C.1.1 In general, a bank should not allocate a risk weight of less than 20% to collateral that is recognised under the “simple” approach except to those set out in paragraphs C2 to C7 below.

C.2 **Repo-style Transactions**

C.2.1 A risk weight of 0% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in paragraphs D.2.1 to D.2.9 of Appendix D.

C.2.2 A risk weight of 10% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in paragraphs D.2.2 to D.2.9 of Appendix D.

C.3 **OTC Derivative Transactions**

C.3.1 A risk weight of 0% can be allocated to the collateralised portion of an OTC derivative transaction provided that:

- The transaction is marked-to-market daily and collateralised by cash provided to the institution, and
- The settlement currency of the transaction is the same currency as the cash provided as collateral.

C.3.2 A risk weight of 10% can be allocated to the collateralised portion of an OTC derivative transaction when the transaction is collateralised by debt securities issued by a sovereign or a sovereign foreign public sector entity qualifying for a risk weight of 0% in accordance with Section 2.

C.4 **Other Transactions**

C.4.1 A 0% risk weight can be allocated to the collateralised portion of a transaction if both the transaction and the collateral are denominated in the same currency, and either:

- The collateral is cash on deposit with the bank; or
- The collateral is in the form of debt securities issued by a sovereign or a sovereign foreign public sector entity eligible for a risk weight of 0% in accordance with Section 2, and the current market value of which has been discounted by 20%.

C.4.2 A 0% risk weight can be allocated to recognised collateral in the form of gold bullion held by the bank. (see Portfolio F, F.3)

APPENDIX D: **CRITERIA FOR PREFERENTIAL TREATMENT OF REPO-STYLE TRANSACTIONS**

D.1 **Introduction**

D.1.1 Other than those covered by a valid bilateral netting agreement, the bank should adopt the “economic substance” approach for capital treatment of repo-style transactions and report them as balance sheet assets as described below.

D.1.1.1 Repos of securities - where the bank has sold securities under repo agreements, the securities sold should continue to be treated as assets with capital requirement provided for the credit risk to the securities;

D.1.1.2 Reverse repos of securities - where the bank has acquired securities under reverse repo agreements, the transaction should be treated as a collateralised lending to the counterparty, providing the securities acquired meet the relevant criteria for recognising collateral. The capital requirement should then be provided for the credit risk to the counterparty, taking into account the CRM effect of the collateral;

D.1.1.3 Securities lending - the treatment is similar to that of repo transactions. This means that the securities lent should continue to remain as an asset on the balance sheet of the institution, with the capital requirement being derived from the credit risk of the securities; and

D.1.1.4 Securities borrowing - the treatment depends on whether the collateral provided is cash or other securities:

- Where the collateral provided is cash, it should be treated as a collateralised lending to the counterparty, providing the securities received meet the relevant criteria for recognising collateral, as set out in Appendix F. The capital requirement should then be derived from the credit risk to the counterparty, taking into account the CRM effect of the collateral;
- Where the collateral provided is not cash but securities, the securities borrowed should be reported as assets on the balance sheet of the institution.

D.1.1.5 For securities lending or borrowing where the contractual agreement is made between the securities borrower/lender and the custodian (e.g. Clearstream Banking or Euroclear Bank) and the securities borrower/lender has no knowledge as from/to whom the security is borrowed/lent, the custodian becomes the “counterparty” of the stock borrower/lender.

D.1.2 The Commission will allow a preferential risk-weighting treatment for qualified repo-style transactions which satisfy all the requirements in paragraphs D.2.1 to D.2.9 below. Under the “comprehensive” approach for collateral, these qualified transactions are not required to be subject to any haircuts.

D.2 **Requirements to be satisfied**

- D.2.1 The counterparty should be a core market participant. The Commission recognises the following entities as core market participants:
- Sovereigns, central banks and PSEs;
 - Banks and securities firms;
 - Other financial companies (including insurance companies) eligible for a 20% risk weight in the standardised approach;
 - Regulated mutual funds that are subject to capital or leverage requirements;
 - Regulated pension funds; and
 - Recognised clearing organisations.
- D.2.2 Both the exposure and the collateral are cash or securities issued by sovereigns or PSEs treated as sovereigns which qualify for a risk weight of 0%.
- D.2.3 Both the exposure and the collateral are denominated in the same currency.
- D.2.4 Either the transaction is overnight or both the exposure and the collateral are subject to daily mark-to-market and daily remargining.
- D.2.5 In the case of a counterparty's failure to remargin, the time between the last mark-to-market before the failure to remargin and the liquidation of the collateral is no more than four business days.
- D.2.6 The transaction is settled across a settlement system proven for that type of transaction.
- D.2.7 Standard market documentation in the securities concerned is used for the agreement covering the repo-style transactions.
- D.2.8 The documentation of the transaction should specify that the transaction is immediately terminable if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults.
- D.2.9 Upon any event of default, regardless of whether the counterparty is insolvent or bankrupt, the institution should have an unfettered and legally enforceable right to immediately seize and liquidate the collateral for its benefit.

APPENDIX E: **REQUIREMENTS FOR RECOGNITION OF COLLATERAL**

E.1 **Introduction**

E.1.1 Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised by first priority claims, in whole or in part with cash or securities, a loan exposure may be guaranteed by a third party, or a bank may buy a credit derivative to offset various forms of credit risk. Additionally, banks may agree to set-off loans owed to them against deposits from the same counterparty.

E.1.2 Where these techniques meet the requirements for legal certainty as described in paragraph E.3 below, the revised approach to CRM allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than is permitted under the 1988 Accord (Basel I).

E.2 **General remarks**

E.2.1 No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

E.2.2 The effects of CRM should not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.

E.2.3 While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including:

- Strategy;
- Consideration of the underlying credit;
- Valuation;
- Policies and procedures;
- Systems;
- Control of roll-off risks; and
- Management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.

E.2.4 Where these risks are not adequately controlled, the Commission may impose additional capital charges or take other supervisory actions, as outlined in Pillar 2 of Basel II.

E.3 **Legal certainty**

E.3.1 In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met:

- All documentation used in collateralised transactions, and for documenting balance sheet netting, guarantees and credit derivatives, must be binding on all parties and legally enforceable in all relevant jurisdictions; and
 - Banks must have conducted sufficient legal review to verify this, have a well-founded legal basis to reach this conclusion and undertake such further review as necessary to ensure continuing enforceability.
- E.3.2 In addition to the general requirements for legal certainty set out above, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, banks must take all steps necessary to fulfil those requirements under the law applicable to the bank's interest in the collateral to obtain and maintain an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set-off.
- E.3.3 In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty - or by any related group entity - would provide little protection and so would be ineligible.
- E.3.4 Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.
- E.3.5 Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

APPENDIX F: **ILLUSTRATIONS ON REPORTING OF CREDIT RISK MITIGATION TECHNIQUES**

F.1 **Balance sheet example: Collateralised loan**

F.1.1 The bank provides a 5-year term loan of £5,000,000 to an unrated corporate. The loan is secured by debt securities issued by a bank and denominated in Euro. The bank is incorporated in a country with a consensus ECA country score of “1” and the debt securities have a remaining maturity of 7 years. They are subject to daily revaluation and presently have a market value in GBP equivalent amount of £5,200,000.

F.1.2 Considerations:

- A loan to an unrated corporate is subject to a risk weight of 100%.
- A bank incorporated in a country with a consensus ECA country score of “1” is mapped to a risk weight of 20%.
- As the market value of the collateral debt securities is £5,200,000, the loan is fully secured.
- RWA of the loan: 5,000,000 x 20% = £1,000,000.

F.1.1 Reporting illustration: balance sheet example:

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
...
C	Claims on Corporates				
C.1	Risk Weight 20%	0	0	20	0
C.2	Risk Weight 50%	0	0	50	0
C.3	Risk Weight 100%	5,000	0	100	0
C.4	Risk Weight 150%	0	0	150	0
	SUBTOTAL	5,000	0		0

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
D	Claims on Banks				
D.1	Claims on Banks, except guarantees				
D.1.1	Maturity more than 3 Months				
D.1.1.1	Risk Weight 20%	0	5,000	20	1,000
D.1.1.2	Risk Weight 50%	0	0	50	0
D.1.1.3	Risk Weight 100%	0	0	100	0
D.1.1.4	Risk Weight 150%	0	0	150	0
...
	SUBTOTAL	0	5,000		1,000

F.2 **Off-balance sheet example: Collateralised loan commitment**

F.2.1 If it were the case that the corporate borrower in the above example had not yet drawn down the loan facility, the transaction would be recorded as a commitment

in the book of the bank. Assuming that the rest of the deal was unaltered – same collateral etc – and that the commitment cannot be cancelled unconditionally, the capital requirement of the transaction under the two approaches would be calculated as follows:

F.2.2 Considerations:

- The commitment for a 5-year term loan attracts a CCF of 50% as it cannot be cancelled unconditionally. The credit equivalent amount of this secured commitment is therefore calculated as: £5,000,000 x 50% = £2,500,000.
- As the amount committed is £5,000,000 and the market value of the collateral debt securities is £5,200,000 the commitment is considered fully secured.
- A 20% risk weight for the collateral debt securities is applied to calculate the RWA of this secured transaction: £2,500,000 x 20% = £500,000.

F.2.3 Reporting illustration: off-balance sheet:

Item	M.6	M.7	M.8	M.9a	M.9b
Nature of Item	Partly paid up shares and securities	Forward deposits placed	Note Issuance and revolving Underwriting Facilities	Other commitments with original maturity of less than 1 year	Other commitments with original maturity of 1 year and over
Amount	0	0	0	0	5,000
Credit Conversion Factor	100	100	50	20	50
Credit Equivalent Amount	0	0	0	0	2,500
After CRM:					
Risk Weight 0%	0	0	0	0	0
Risk Weight 20%	0	0	0	0	2,500
Risk Weight 35%	0	0	0	0	0
Risk Weight 50%	0	0	0	0	0
Risk Weight 75%	0	0	0	0	0
Risk Weight 100%	0	0	0	0	0
Risk Weight 150%	0	0	0	0	0
Risk Weighted Amount	0	0	0	0	500
Items requiring Capital Deduction	0	0	0	0	0

F.3 OTC derivative transaction example

F.3.1 The bank has a £100,000,000 interest rate contract with a four-year residual maturity. The other counterparty to the contract is an unrated corporate. Pledged as collateral for the contract is an £800,000 bond issued by a bank incorporated in a country with a consensus ECA country score of “2”, which has more than five years to go to maturity. This is a capital market transaction subject to daily remargining and there are no foreign exchange mismatches between the interest rate contract and the collateral. The mark-to-market value of the interest rate contract is £1,000,000 and the add-on is 0.5%, giving an “Add-on amount” of £500,000.

F.3.2 Considerations:

- Credit equivalent amount of the interest rate contract is the sum of the positive

mark-to-market and the “Add-on amount” (i.e. £1,000,000 + £500,000 = £1,500,000).

- The unrated corporate attracts a 100% risk weight.
- The £800,000 bank bond attracts a 50% risk weight.
- RWA of secured portion: £800k x 50% = £400k.
- RWA of unsecured portion: £700k x 100% = £700k.
- Total RWA (secured + unsecured): £400k + £700k = £1,100k.

Reporting illustration: OTC schedule:

N.1 Interest rate contracts

	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-on Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
	100,000	1,000			500	1,500	1,500		1,100

N.1 Schedule

No.	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-on Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
...
6	0	0	1 - 5 years	0.50%	0	0	0	0%	0
7	0	0	1 - 5 years	0.50%	0	0	0	20%	0
8	0	0	1 - 5 years	0.50%	0	0	800	50%	400
9	100,000	1,000	1 - 5 years	0.50%	500	1,500	700	100%	700
10	0	0	1 - 5 years	0.50%	0	0	0	150%	0
...

F.3.3 Reporting illustration: OTC summary page (assuming no other OTC contracts – automatically populated with summary information from the Schedules):

N Off-Balance Sheet - OTCs					
Item	N.1	N.2	N.3	N.4	N.5
Nature of Item	Interest rate contracts	Foreign exchange and gold contracts	Equity contracts	Other precious metal contracts	Other commodity contracts
Amount	100,000	0	0	0	0
Positive Mark-to-Market	1,000	0	0	0	0
Add-on Amount	500	0	0	0	0
Credit Equivalent Amount	1,500	0	0	0	0
After CRM:					
Risk Weight 0%	0	0	0	0	0
Risk Weight 20%	0	0	0	0	0
Risk Weight 50%	800	0	0	0	0
Risk Weight 100%	700	0	0	0	0
Risk Weight 150%	0	0	0	0	0
Risk Weighted Amount	1,100	0	0	0	0

APPENDIX G: **CRITERIA FOR CLASSIFICATION AS A RETAIL EXPOSURE AND / OR AS A RESIDENTIAL MORTGAGE**

G.1 **Retail Exposures**

G.1.1 To be included in the “Regulatory Retail Portfolio”, claims must meet the following four criteria:

- Orientation criterion: The exposure is to an individual person or persons or to a small business (less than £2m turnover and balance sheet footings);
- Product criterion: The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g. instalment loans, auto loans and leases, student and educational loans, personal finance) and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property (see G.2).
- Granularity criterion: The Commission must be satisfied that the “Regulatory Retail Portfolio” is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. Accordingly, in defining what constitutes a significant number of retail exposures (for diversification) a bank need only satisfy itself that the number of retail exposures is sufficiently large to diversify away idiosyncratic risk¹. This assessment will be subject to supervisory review and part of a bank’s Supervisory Review and Evaluation Process (SREP). The Commission requires each bank to set out its criteria and may, where necessary, require changes to be made if the bank is to be allowed to utilise the 75% risk weight.
- Low value of individual exposures. The maximum aggregated retail exposure to one counterparty cannot exceed an absolute threshold of £750,000.

G.2 **Residential mortgages**

G.2.1 The Commission has set the following criteria:

- The security may be indirect – an example of this would be where the security held comprised shares where the share ownership conferred ownership of a property e.g. share transfer ownership;
- The lending may either be directly to an individual or to a corporate structure.
- If the lending is to a corporate structure, the bank must have recourse to the beneficial owner in the event of default.
- The properties must be either occupied by the borrower or rented to individuals. In the case of the latter, a property (or property portfolio) should

¹ Also known as unsystematic risk this is the risk of price change due to the unique and uncorrelated circumstances of an asset or firm as opposed to a market movement.

not comprise more than 10 rental units / properties.

- For claims secured by residential properties with loan-to-value ratios of up to 80% a risk weight of 35% will apply. For higher LTVs a risk weight of 75% will apply on that portion above 80% LTV.
- If a bank does not hold information regarding LTVs for individual exposures, a risk weighting of 50% will apply to the whole of those exposures.
- LTVs should be assessed on a regular basis, making use of relevant indices and market information where appropriate.