Consultation Paper

CP11/9***

Financial Services Authority

Strengthening Capital Standards 3

further consultation on CRD3

May 2011

FSA®

Financial Services Authority

Contents

	Acronyms used in this paper	3
1	Overview	5
2	Trading book	13
3	Securitisation	28
4	Other CRD3 changes	42
5	CEBS guidelines on managing operational risks in market-related activities	47
6	Cost benefit analysis	51

Annex 1: Compatibility with our objectives and the principles of good regulation

Annex 2: Areas of super-equivalence

Annex 3: List of national discretions

Annex 4: List of questions in this Consultation Paper

Appendix 1: Draft Handbook text

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The Financial Services Authority (the FSA) invites comments on this Consultation Paper (CP). Comments on Chapters 2 – 4 should reach us by 11 July 2011, and on Chapter 5 by 11 June 2011.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_09_response.shtml

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Acronyms used in this paper

ABCP	Asset Backed Commercial Paper
ABS	Asset Backed Securities
AMA	Advanced Measurement Approach
APR	All Price Risk
BCBS	Basel Committee on Banking Supervision
BCD	Banking Consolidation Directive
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
CBA	Cost Benefit Analysis
CDO	Collateralised Debt Obligation
CDS	Credit Default Swaps
CEBS	Committee of European Banking Supervisors
COREP	Common Reporting Framework
CP	Consultation Paper
CRD	Capital Requirements Directive
CRM	Comprehensive Risk Measure
EBA	European Banking Authority
ECAI	External Credit Assessment Institution
EU	European Union
FSA	The Financial Services Authority
FSMA	Financial Services and Markets Act 2000

GENPRU	General Prudential sourcebook
IRB	Internal Ratings Based approach to credit risk
IRC	Incremental Risk Charge
LGD	Losses Given Default
PD	Probability of Default
PS	Policy Statement
PWCE	Programme Wide Credit Enhancements
QIS	Quantitative Impact Study
Re-Remics	Re-securitisations of real estate mortgage investment conduits
RMBS	Residential Mortgage-Backed Securities
RWEA	Risk Weighted Exposure Amounts
TP	Transitional Provision
TSA	The Standardised Approach
VaR	Value-at-Risk

1 Overview

Introduction

1.1 This Consultation Paper (CP) is an update to CP09/29[1], which set out our proposals for implementing changes to the Capital Requirements Directive (CRD) from the European Commission's CRD2[2] and CRD3[3] packages of amendments.

1.2 The purpose of this CP is to:

- set out implementation proposals for the areas of CRD3 that we have not previously consulted on;
- re-consult where, since CP09/29, our proposals for CRD3 implementation have changed;
- provide feedback where we have not already done so, and additional clarification where appropriate, to responses we received on the CRD3 proposals in CP09/29; and
- consult on Committee of European Banking Supervisors (CEBS) guidance in relation to CRD2 implementation, which was released late in 2010.

1 www.fsa.gov.uk/pubs/cp/cp09_29.pdf

2 'Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management'. In addition, technical changes to Directive 2006/49/ EC were implemented by 'Directive 2009/27/EC amending certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management', and to Directive 2006/48/EC by 'Directive 2009/83/EC amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management'.

3 'Directive amending Directives 2006/48/EC and 2009/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies'.

Background

1.3 The aim of the CRD is to ensure the financial soundness of credit institutions – essentially banks and building societies and certain investment firms (collectively referred to as 'firms' unless stated otherwise). It stipulates the financial resources such firms must hold to cover their risks. This legal framework is being regularly updated and refined by a series of packages which the European Commission (the 'Commission') has now numbered to avoid confusion and for ease of reference.

1.4 In CP09/29 we consulted on changes to CRD2 and most of CRD3. The national legislation for the CRD2 changes was required to be put in place by 31 October 2010, and we made the necessary changes to our rules in CP10/17[4] and Handbook Notice 103.[5] CRD2 also made changes to liquidity rules, but these were the subject of a separate consultation.

1.5 In December 2009, when CP09/29 was published, the final CRD3 directive text had not been published (and was not until December 2010). We considered it right to consult on the CRD3 package, even though the European Parliament had yet to vote on the final text and the amendments and timing were subject to change. We believed that, despite areas of uncertainty, consulting on CRD3 amendments was the most efficient course of action and would prove useful in highlighting potential changes to industry, while recognising that we would need to consult further. As we expected, changes were made to the Directive text and we now consult on those changes and other parts of CRD3 where we did not consult in CP09/29.

CRD3

1.6 The CRD3 package was the subject of consultation by the Commission during spring 2009 and it was published in the Official Journal of the European Union (EU) on 14 December 2010.[6] Under the original timetable of CRD3 (and as reflected in CP09/29), the relevant national laws, regulations and administrative provisions were to come into force by 1 January 2011. However, as a result of changes during final negotiations of the Directive text, most of the CRD3 amendments are now required to be implemented by 31 December 2011 at the latest.

1.7 Some parts of CRD3, such as those concerning remuneration and minor amendments related to covered bonds and capital floors, were required to be implemented by 31 December 2010. We made the CRD3 changes to our remuneration rules in PS10/21[7] and the other changes in Handbook Notice 105.[8]

4 www.fsa.gov.uk/pubs/cp/cp09_29.pdf
5 www.fsa.gov.uk/pubs/Handbook/hb_notice103.pdf
6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0001:0002:EN:PDF
7 www.fsa.gov.uk/pubs/policy/ps10_21.pdf
8 www.fsa.gov.uk/pubs/Handbook/hb_notice105.pdf

1.8 The CRD3 changes that are the subject of this CP are:

- strengthening capital requirements in the trading book;
- higher capital requirements for re-securitisations;
- extending the prudent valuation framework;
- requiring enhanced public disclosures under Pillar 3 of the capital framework;
- amending our rules for various technical amendments to the CRD; and
- changes to our reporting rules to require from firms the information necessary to supervise the trading book and securitisation changes.

Summary of the contents of this CP

1.9 We consulted on most CRD3 changes in CP09/29 and gave some feedback in CP10/17, but now that the final CRD3 text has been published we can finalise those proposals and present our overall approach for implementing CRD3. The following is a summary of the contents of each chapter in this CP.

Trading book

1.10 The financial crisis demonstrated that the current market risk framework fails to adequately capture some important risks in firms' trading books. In response, the Basel Committee on Banking Supervision (BCBS) decided it was necessary to increase the risk capture and level of: capital requirements in the trading book focusing on arbitrage between the non-trading book and the trading book; and credit risk and illiquidity in the trading book. The CRD changes implement these requirements in Europe and will result in higher market risk capital under both the internal models methods and standardised rules.

1.11 We have previously consulted on implementing the majority of the CRD3 trading book amendments, therefore in this CP we intend to consult only on:

- the calibration of the floor to the correlation trading portfolio all price risk (APR) model as 8% of the standardised charge for such products;
- providing guidance on stress testing the correlation trading portfolio;
- removing our super-equivalent standard rules for securitisation credit derivatives;
- a transitional provision (TP) allowing firms to take the higher of the capital charges for net long securitisation positions and net short securitisation positions;

- allowing firms to cap the capital charge for individual debt positions at the maximum possible loss for that position; and
- allowing firms that hold positions in credit derivatives as protection sellers to have a choice of exposure value.

1.12 We also summarise the feedback we provided in CP10/17 to our previous consultation exercise (CP09/29) and provide further guidance that we consider helpful.

Securitisation

1.13 Although there are no material changes to securitisation in the non-trading book from the European Council CRD3 text we consulted on in CP09/29, we are re-consulting in this CP for the purpose of clarity. The proposals that we present are in relation to:

- our approach to implementing the new CRD3 requirements that relate to securitisation in the non-trading book, namely re-securitisation and own unfunded support;
- adopting CEBS Article 122a guidelines (CRD2), published on 31 December 2010[9]; and
- minor changes to existing BIPRU 9 (Prudential sourcebook for Banks, Building Societies and Investment Firms) provisions that implement Article 122a, to ensure our rules are consistent with the interpretation of the Directive that is set out in the guidelines.

1.14 In CP10/17 (the response to CP09/29) we did not think it appropriate to give detailed feedback for areas potentially subject to change before the final CRD3 text was published. We now provide this for:

- the scope of re-securitisations and securitisations;
- highly complex re-securitisations (Article 122b); and
- re-securitisation risk weights.

1.15 We also update our proposals for changes to the reporting of securitisation positions in Data Item FSA046. This will now include data elements for re-securitisation positions.

Other CRD3 changes

1.16 CRD3 made changes to the prudent valuation framework, Pillar 3 requirements, and some technical amendments to the CRD.

9 www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

1.17 There were no differences in the final CRD3 text to the changes originally proposed in relation to prudent valuation, Pillar 3 or technical amendments. Therefore, our proposals in these areas have not changed. However, we did not provide a response in CP10/17 to the feedback we received in relation to Pillar 3, and we now set this out in Chapter 4. We also summarise the changes for prudent valuation and technical amendments.

CEBS guidelines

1.18 We are also consulting on CEBS guidelines on the management of operational risks in market-related activities.[10] We propose to implement these guidelines by inserting references to the CEBS material in the Handbook. More information is provided in Chapter 5.

Cost benefit analysis

1.19 Chapter 6 provides a cost benefit analysis for the proposals in the Trading Book (Chapter 2) and Securitisation (Chapter 3) chapters. It also gives an assessment of the macroeconomic impact of the proposed changes in these sections.

1.20 The CBA for the other proposals in this CP, where relevant, are contained within the relevant chapters.

Reporting

1.21 As a result of the CRD3 changes, we are making adjustments to FSA data items (reporting forms) FSA005 (market risk), FSA046 (securitisation: non-trading book), and FSA058 (securitisation: trading book).

1.22 FSA058 captures information on firms' trading book securitisation positions that fall under BIPRU 7.2, where they are acting as originator, sponsor or investor. FSA005 also captures trading book securitisation information, and has been amended to include trading book related changes. We set out our proposed changes to these two data items in Chapter 2.

1.23 FSA046 data item captures information on a firm's non-trading book securitisation positions which fall under BIPRU 9, where they are acting as originator, sponsor or investor. We set our proposed changes in Chapter 3.

10 Guidelines on the management of operational risks in market-related activities, CEBS, 12 October 2010 – www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx.

1.24 We consulted on changes to these Data Items in CP09/29, where some respondents questioned the need for new reporting requirements in respect of securitisations held in the trading book to be included in a separate form (i.e. the new FSA058 report). Our response in CP10/17 was that to remain consistent with the Pillar 3 approach, two separate reports are required. It was also considered inappropriate, where there was only one report covering both trading book and non-trading book, to include a significant amount of information in FSA046 that may not be relevant to a large proportion of firms.

1.25 We recognise that the changes will only be effective until superseded by the Common Reporting Framework (COREP) templates, which are being prepared by the European Banking Authority (EBA) and are expected at the end of 2012. However, the changes are necessary to enable us to comply with our obligations under CRD3.

Our approach to implementation

1.26 Many of the responses to CP09/29 suggested that the timing of CRD3 implementation should be aligned with the European timetable. At the time CP09/29 was published, CRD3 was to come into force by 1 January 2011. Due to changes in the CRD3 text, most of the elements of the text are now due for implementation no later than 31 December 2011, which is when we intend to implement. The rules that needed to be put in place for 1 January 2011 were implemented by PS10/19[11] and PS10/21.

1.27 This CP consults on the parts of CRD3 on which we have not previously consulted, as well as any changes to the Directive from the version we consulted on in CP09/29. We are not consulting on areas where there has been no change since CP09/29.

1.28 Following review of the responses to this CP, we intend to make the final rules in Q3 this year.

Who should read this paper?

1.29 The contents of this paper apply principally to banks, building societies and certain investment firms within the scope of the CRD (see Chapter 2 of CP09/29, scope of application), and will be of particular interest to such firms and their advisers.

Smaller firms

1.30 This CRD3 changes that are the subject of this paper are not of particular relevance to smaller businesses.

11 www.fsa.gov.uk/pubs/policy/ps10_19.pdf

Consumers

1.31 This paper primarily focuses on meeting our market confidence objective by reducing the risks that banks and other financial market firms face, and improving stability in the financial sector in general. This improved stability is expected, in turn, to enhance consumer protection.

Next steps

1.32 The consultation for the CRD3 changes in this paper will close on 11 July 2011, two months after publication. Given that most of the CRD3 amendments are unchanged from what was set out in CP09/29, and the need to make final rules in time for firms to implement before 31 December 2011, we feel two months is an appropriate consultation period. We plan to issue feedback to this consultation, together with our Policy Statement (PS) confirming the final rules, in Q3 2011.

1.33 The consultation period for the implementation of the CEBS Operational Risk guidelines will close on 11 June 2011. We plan to issue feedback to this consultation in the July Handbook Notice.

1.34 The rule changes required to transpose CRD3 need to be made by 31 December 2011, and the draft version of the new Handbook text is set out in Appendix 1 to this CP.

Ongoing EU developments

1.35 Negotiations are ongoing for the introduction of CRD4, which will implement Basel III amendments. CRD4 will include:

- liquidity standards;
- definition of capital;
- leverage ratio;
- capital buffers;
- counterparty credit risk; and
- single rule book for banking.

1.36 The European Commission's (the Commission's) legislative proposal is expected to be tabled in summer 2011.

1.37 Negotiations under the EU co-decision legislative process are likely to take place in the second half of 2011, with any FSA public material to follow into 2012, to meet the BCBS timetable of 1 January 2013 for some of the new requirements to be in place.

2

Trading book

Introduction

2.1 This chapter outlines our proposed approach to the UK implementation of the CRD3 amendments[12] for market risk capital requirements.[13] These amendments have been driven by the July 2009 BCBS trading book amendments to strengthen the Basel II framework for market risk.[14]

2.2 The changes in CRD3 set out to:

- increase the level of capital held against trading book risks;
- reduce the relative cyclicality of the market risk capital requirements;
- reduce the opportunity for arbitrage between the non-trading book and the trading book; and
- improve the capture of credit risk and illiquidity in the trading book.

2.3 These changes are separate from the fundamental review of the capital regime for trading activities called for in *The Turner Review* that is currently being conducted by the BCBS.

2.4 At the time CP09/29 was published, the European parliament had yet to vote on the final CRD3 package and thus the amendments and implementation date were subject to change. The final CRD3 directive was published in the Official Journal on 14 December 2010.

12 The market risk amendments are part of the CRD3 package or the 'Directive amending Directives 2006/48/EC and 2009/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies'.

13 A firm is required to calculate market risk capital requirements for its interest rate and equity positions in the trading book, plus all commodity and foreign exchange positions.

14 *Revisions to the Basel II market risk framework* www.bis.org/publ/bcbs193.htm and *Guidelines for computing capital for incremental risk in the trading book* www.bis.org/publ/bcbs159.htm.

2.5 We have previously consulted on implementing the majority of the CRD3 trading book amendments, therefore in this CP we intend to consult only on:

- the amendments to CRD3 since CP09/29; and
- those areas identified in CP09/29 where we deemed it necessary to defer consultation (for example, our super-equivalent standard rules for securitisation credit derivatives).

2.6 For the benefit of readers, this chapter is structured to provide a complete picture of the CRD3 package in one location, and highlighting those amendments that we have not consulted on previously.

2.7 This chapter is structured as follows:

1) An overview of the whole CRD3 package.
2) The amendments to the CRD3 directive since we first consulted in CP09/29.
3) A summary of the feedback (reproduced from CP10/17) to our previous consultation exercise, along with further clarification where we think this is appropriate.
4) Consultation on the new CRD3 material and those areas in CP09/29 where we stated that we will consult at a later date.

2.8 The final draft Handbook text is attached in Appendix 1.

Overview of changes

2.9 The CRD3 market risk requirements will take effect from 31 December 2011 and predominantly affect those firms with a Value at Risk (VaR) model permission. However, there are also some changes to the standard rules for securitisation positions, nth-to-default credit derivatives and equities. Our approach to implementing CRD3 has been one of 'intelligent copy-out' from the Directive.

2.10 Following implementation of these requirements, all firms with a VaR model permission will be required to:

- calculate an additional capital charge based on a stressed calibration of the VaR model;
- apply the new standardised securitisation charges to all securitisation positions in the trading book (other than where the correlation trading carve-out applies); and
- improve the modelling standards being applied to VaR models.

2.11 The following requirements will apply to firms with a VaR model permission covering specific interest rate risk:

- Calculate an incremental risk charge (IRC), which will capture the default and migration risk for credit risk positions in the trading book. This charge will apply to all trading book positions (subject to specific interest rate risk) that are not securitisations and replace the incremental default risk charge (IDRC).
- Calculate an All Price Risk (APR) measure for correlation trading positions, subject to a capital floor that is based on the standardised securitisation charges.

2.12 Firms using the standard rules will be subject to:

- revised standardised charges for securitisation positions;
- an increase in the equity specific risk requirement from 4% to 8%; and
- amended standardised charges for nth-to-default credit derivatives.

Changes since CP09/29

2.13 The final CRD3 Directive text was published after CP09/29. The key 'copy out' changes to CRD3 since CP09/29 are as follows:

- The floor on the APR model has been calibrated as 8% of the standard rules charge for such products.
- A transitional has been provided allowing firms to take the higher of the capital charges for net long securitisation positions and net short securitisation positions in their trading books.
- Firms will be allowed to cap the capital charge for individual debt positions, (including securitisation and correlation trading positions) at the maximum possible loss for that position.
- Firms that hold positions in credit derivatives as protection sellers will have options for calculating their exposure value.

2.14 In CP09/29 we stated that as the CRD minimum capital requirements for securitisation positions are changing, we will reassess whether it is appropriate to continue with our super-equivalent standard rules for securitisation credit derivatives. We stated that we will defer consultation on this until the CRD3 text had been finalised. We have now completed the Cost Benefit Analysis (CBA) and believe that we should remove our standard rules for securitisation credit derivatives and single-name credit derivatives in BIPRU 7.11.

2.15 These issues are covered in greater detail either in the 'Summary of responses and feedback in CP10/17' section or, where we feel it is necessary to consult on the amendments, in the 'Further consultation' section.

2.16 The CBA presented in Chapter 6 incorporates the impact of these Handbook amendments.

Summary of responses and feedback in CP10/17

2.17 This section summarises the responses to CP09/29 and our feedback to those responses. Furthermore, this section provides, where relevant, any updates to our feedback in light of the final directive text and the development of our implementation plan.

2.18 The majority of the trading book proposals we consulted on in CP09/29 related to CRD3. The key amendments proposed were:

- introducing a stressed VaR measure;
- introducing an IRC for modelled debt instruments;
- applying the standardised banking book risk weights to trading book securitisations; and
- introducing an APR measure with a capital floor for the correlation trading portfolio.

2.19 Other CRD3 amendments proposed were:

- improving VaR modelling standards;
- adjusting the equity position risk requirements; and
- technical amendments relating to nth-to-default credit derivatives.

Stressed VaR

2.20 The stressed VaR measure is a one-tailed 99% confidence interval 10-day VaR measure of the firm's current portfolio with the VaR model inputs calibrated to historical data from a continuous 12-month period of financial stress. CP09/29 discussed the key areas where firms may need guidance to calculate the stressed VaR measure.

2.21 Most respondents indicated that no detailed guidance was required to define the approach for selecting a stressed historical period or to implement stressed VaR. One respondent stated that reducing the cost of implementing stressed VaR could be achieved if we published a set of clear guidelines on how firms should select stress data periods. Another respondent said that a regulatory one-year stressed historical period should be defined. Some respondents requested specific guidance on how to address instances where firms have positions in products that did not exist in the stressed historical period.

Some respondents also indicated that further direction would be beneficial in:

- clarifying expectations around the 'Use Test for stressed VaR';
- confirming the relationship between a firm's stressed VaR multiplier and its VaR multiplier; and
- how to appropriately apply the stressed VaR methodology across subsidiaries and parent entities.

2.22 A small number of respondents indicated that we should engage with firms to understand the various stressed VaR methodologies being considered, so we can steer ongoing implementation by UK firms.

2.23 Our response in CP10/17 noted that we have identified some common areas where we believe that firms would benefit from some general guidance to help them understand what is expected at a high level when implementing stressed VaR. In CP10/17 we also provided some initial thoughts on areas that we had identified and we stated that we continue to engage with firms to understand the various methodological approaches being considered by firms and the issues that arise in implementing them. This information-gathering exercise intended to guide the scope and nature of any guidance and the most appropriate channels through which to disseminate it.

2.24 The European Banking Authority (EBA)[15] is mandated to produce guidelines on some parts of stressed VaR implementation. We are active participants in this process and the key issues that the EBA will provide comment on considerable overlap with those issues that we have previously identified. The EBA guidelines are expected to be released for consultation in the second quarter of 2011 and we intend to reference the final guidelines in our Handbook.

2.25 Firms can obtain additional information on stressed VaR requirements from the recently published BCBS interpretative issues document.[16] The document provides a BCBS consensus view on interpretative challenges posed by the introduction of stressed VaR, IRC, the modelling of the correlation trading portfolio and the amendments to the standardised approach (TSA) for trading book securitisations. The FSA is represented in this group. The BCBS intend to publish updated versions of this document on the committee's website when necessary. Firms are reminded that the BCBS interpretative issues document references the Basel market risk framework, which is not identical to market risk rules in the EU directive. Firms will therefore need to be mindful of areas that are divergent.

15 Formerly CEBS

16 Basel Committee on Banking Supervision, *Interpretative issues with respect to the revisions to the market risk framework*, February 2011. Available at: www.bis.org/publ/bcbs193a.pdf

The Incremental Risk Charge (IRC)

2.26 The IRC aims to improve the risk capture of the market risk framework by requiring firms to hold capital for the default and migration risk of traded debt instruments that is incremental to that captured by their VaR model.

2.27 Respondents said our proposed rules text was sufficiently clear on the model parameters and validation techniques necessary to introduce an appropriate IRC model. Some additional guidance was sought on how to determine appropriate liquidity horizons, how to treat maturity mismatches between a product and its hedge, and reconciling these mismatches with the constant level of risk assumption.

2.28 A small number of respondents had specific views on some aspects of the new requirements. These included questions on the likelihood that an IRC capital charge would lead to double counting with charges already calculated under stressed VaR and VaR, and on the CBA of attempting to model product basis risk in the IRC given the likely materiality of such risks compared to default risk.

2.29 Our response in CP10/17 concluded that firms would benefit from general guidance in implementing certain aspects of the IRC, this included:

- the product scope of the IRC;
- the use of data sources;
- the copula assumptions; and
- the use of single period vs multi-period models.

2.30 CRD3 mandates the EBA to produce guidelines on non-standard approaches to the IRC implementation criteria, which are located in BIPRU 7.10.55AR to BIPRU 7.10.55RR (see Appendix 1 of this CP). We understand that to produce guidelines on non-standard approaches the guidelines will have to present examples of standard approaches. We are active participants in this process and the key issues that the EBA will provide comment on overlap considerably with those issues that we have previously identified. The EBA guidelines are expected to be released for consultation in the third quarter of 2011 and we intend to reference the final guidelines in our Handbook.

2.31 Firms can obtain additional information on implementing IRC requirements through the BCBS interpretative issues document. The document provides a BCBS consensus view on interpretative challenges posed by introducing the IRC model. A number of the issues covered in the interpretative issues document overlap with those areas where we felt that firms would benefit from additional guidance, for instance the interpretative issues document clearly states that all sovereign bonds should be included in the IRC model. However, as noted above, firms are reminded that the BCBS interpretative issues document references the Basel market risk framework, which is not identical to market risk rules in the EU directive. Firms will therefore need to be mindful of areas that are divergent.

Applying the standardised measure to securitisations

2.32 The CRD amendments in CP09/29 seek to address the possibility for arbitrage between the non-trading book and the trading book for securitisation positions by aligning the capital charges for securitisations in the trading book under the standardised method.

2.33 Some respondents questioned how to identify trades that are subject to implicit support, and requested guidance on applying the due diligence requirements. We said in CP10/17 that we will use the outcome of the CEBS guidelines on Article 122a to inform our thinking on the nature and form of guidance on the amendments to CRD2 relating to securitisations. This guidance has now been finalised and is discussed in Chapter 3.

2.34 We asked what other guidance respondents would find useful in helping to apply the non-trading book securitisation requirements to securitisation positions in the trading book, and respondents raised the following concerns:

- The potential for ambiguities in how banking book and trading book securitisations are treated as trading book securitisations span two chapters of the BIPRU Handbook. Concerns were also raised that the BIPRU 7 sections on trading book securitisations do not fully encapsulate the relevant sections in BIPRU 9, nor wholly reflect the draft CRD language.
- How to apply the supervisory formula approach to securitisations in the trading book.
- Continuing uncertainty about the construction of the final securitisation rules, especially as the capital charges are likely to be significant.
- Whether a maximum loss principle could apply, i.e. could the capital charge calculated on an individual securitisation position be limited to the maximum possible loss on the position?

Differences between trading book and non-trading book sections of BIPRU

2.35 In this CP we present our proposed final consolidated rules, which should be clearer.

Application of the supervisory formula method

2.36 Our policy concerning the use of the supervisory formula method was first outlined in CP09/29. In response to feedback from CP09/29, we have clarified our intended approach below.

2.37 Firms with an internal ratings based (IRB) permission are able – subject to meeting a number of requirements and gaining supervisory approval – to apply the supervisory formula method to unrated securitisation positions that they hold as an investor through modifying their IRB waiver.[17] Where firms already meet the requirements for using the supervisory formula method as an investor for particular exposure classes in the non-trading book, they will be able to use this approach for similar exposure classes in the trading book as an investor, but will first require an additional supervisory approval through a modification of their IRB waiver.

2.38 Firms may also, subject to supervisory approval, use estimates of probability of default (PD) and loss given default (LGD) based on estimates that are derived from their IRC approach, provided that these estimates are in line with the quantitative standards for the IRB approach. We plan to make such supervisory approval part of the VaR model approval process. Therefore, firms will be required to apply for a modification to their waiver if they wish to use estimates of PD and LGD in the supervisory formula that are based on estimates derived from their IRC approach.

2.39 We encourage firms to contact us as soon as possible if they wish to apply for a modification to their waiver to use the supervisory formula method, under either of the approaches outlined above. We intend to undertake the necessary review of firms' practices in this area in line with our timeline for wider CRD3 model approval.

Maximum loss principle/final securitisation rules

2.40 The final CRD3 text clarifies a number of outstanding issues raised by firms in our consultation process concerning the scope and application of TSA to trading book securitisations. We are implementing each of these directive points via 'intelligent copy out'.

2.41 Our final proposed rules specify what positions qualify for inclusion in the correlation trading portfolio (see BIPRU 7.2.42AR to 7.2.42CR in Appendix 1 of this CP) and which may, therefore, be included in an APR model if the firm has approval to apply such a model. The capital charge for all other securitisation positions must be calculated by applying the risk weights used in the banking book (see BIPRU 7.2.48AR and BIPRU 7.2.48CR to BIPRU 7.2.48GR in Appendix 1) to the net risk position.

2.42 Our rules also explain that the maximum loss principle will apply to all debt positions, including to securitisation positions and correlation trading portfolio positions (see BIPRU 7.2.43R (3), BIPRU 7.2.48AR (2) and BIPRU 7.2.48LR (3) in Appendix 1).

2.43 The directive includes a TP, ending on 31 December 2013, allowing firms to calculate their capital charge as the higher of the capital charges for net long securitisation positions and net short securitisation positions, as opposed to the sum of the capital charges for net long and net short positions (see BIPRU 7.2.48AR (3) in Appendix 1 for our implementation).

17 This only applies in circumstances where a firm is acting as an investor. Where a firm acts as an originator or sponsor to a securitisation, they do not require a modification to their waiver to apply the Supervisory Formula Method.

2.44 Firms that hold positions in credit derivatives as protection sellers will have the choice of using either the notional value as the exposure value or the notional value, minus any market value changes in the credit derivative since trade inception.

> **Q1:** Do you require any additional guidance concerning the securitisation rules? If so, what specific aspects do you feel require attention?

Correlation trading portfolio – APR and capital floor to the APR

2.45 Correlation trading is a structured credit trading activity commonly undertaken by investment banks and the investment banking arms of some universal banks. The amendments in CP09/29 incorporate a correlation trading portfolio carve-out for securitisations, and nth-to default credit derivatives that meet specific criteria.

2.46 In CP10/17, respondents were generally concerned that it was premature to formalise an approach to the APR measure while there were ongoing discussions regarding the scope and calibration of the correlation trading portfolio at an international level.

2.47 Most respondents were focused on concerns in introducing an APR measure, such as:

- the likelihood that there will be multiple-counting of capital charges across a number of risk capital calculations;
- the complexity and computational challenges in creating such a model; and
- the imposition, methodology and calibration of a capital floor to the APR measure.

2.48 We responded in CP10/17 that we considered the APR measure requirements to be challenging and that firms would benefit from some general guidance to help them implement these requirements.

2.49 We believe that firms can obtain additional guidance on interpreting the APR measure[18], through the recently published BCBS interpretative issues document.[19] The document provides international consensus on interpretative challenges posed by introducing the APR model. The BCBS intend to publish updated versions of this document on the Committee's website if and when additional interpretive issues arise. We ask firms to bring to our attention queries that they may have in implementing the APR measure, which may be appropriate to feed into future versions of the interpretative issues document. However, as noted above, firms are reminded that the BCBS interpretative issues document references the Basel market risk framework, which is not identical to market risk rules in the EU directive. Firms will therefore need to be mindful of areas that are divergent.

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18 The Basel Committee uses the equivalent term Comprehensive Risk Measure (CRM).

19 Basel Committee on Banking Supervision, *Interpretative issues with respect to the revisions to the market risk framework*, February 2011. Available at: www.bis.org/publ/bcbs193a.pdf.

2.50 Recognising the challenges posed by the cumulative impact of introducing three new models in one directive, we have recently sent a letter to all relevant firms, which outlines our application process and documentary requirements for model approval of stressed VaR, IRC and the APR measure.

2.51 Since our previous consultation, the final CRD3 text specifies what positions qualify for inclusion in the correlation trading portfolio (see BIPRU 7.2.42AR to 7.2.42CR in Appendix 1 of this CP) and which may, therefore, be included in an APR model if the firm has approval to apply such a model.

2.52 In CP10/17 we responded to firms' concerns about introducing a floor capital charge to the APR measure. We explained that we continue to support imposing a capital floor, as in our view, methodological and computational complexities in creating an APR model demand, in our view, a simple capital floor backstop. We recognised, however, the need for international agreement on the methodology and calibration of such a floor. At the time of our original CP, discussions on the composition of a capital floor were ongoing at BCBS, and so we did not consult on its introduction. We explained our intention to consult on the final capital floor methodology and calibration in this CP. This is covered in greater detail in the subsequent section titled 'further consultation'.

Improvements to VaR modelling standards

2.53 The CRD amendments include several modifications to the VaR modelling standards. Respondents' comments on these centred on the implications of introducing an actual ten-day holding period to calculate regulatory VaR, as opposed to a ten-day equivalent holding period.

2.54 The final CRD3 text has reverted to the status quo, thereby allowing firms to continue applying a 10-day equivalent holding period. We reiterate what we stated in CP10/17, which is that we expect firms to implement best practice as industry standards evolve.

Equity position risk adjustment

2.55 The CRD amendments will require firms that use a standard rules method to calculate their specific risk on equity positions to do so by multiplying the sum of their net short and net long positions by 8%. The reduced specific risk requirements for qualifying equities have been removed. The general equity risk charge remains at 8% of the overall net position.

2.56 Generally there were few responses to this amendment following CP09/29. One response noted that it is unclear what this amendment attempts to resolve.

Nth-to-default credit derivatives

2.57 The changes to the CRD require the seller of protection on nth-to-default credit derivatives that are externally rated to calculate the capital charge using the rating of the derivative and apply the relevant securitisation framework risk weighting. Related changes in the technical amendments section are found in Chapter 4.

2.58 Responses were in favour of the proposed change but noted the insignificant impact of the amendment.

Further consultation

2.59 This section sets out our proposals to implement the following CRD3 trading book changes not included in our original consultation:

- correlation trading portfolio – capital floor;
- correlation trading portfolio – stress testing guidance; and
- BIPRU 7.11 – securitisation credit derivatives.

Correlation trading portfolio – capital floor to the APR measure

2.60 Since our previous consultation, the BCBS has undertaken a quantitative impact study (QIS) to calibrate the floor to the APR measure. As a result of this process, international consensus was reached and BCBS had agreed to set the floor at 8% of the standardised charges for such positions.

2.61 The final CRD3 text confirms the BCBS decision, which is that firms using the APR measure will be subject to a capital charge floor of not less than 8% of the capital charge that would be calculated in accordance with the standardised securitisation approach for all positions included in the APR model.

2.62 In calculating TSA capital charge for the correlation trading portfolio, firms may take the larger of:

- the capital charges that would apply just to the net long positions of the correlation trading portfolio; and
- the capital charges that would apply just to the net short positions of the correlation trading portfolio.

2.63 Therefore, we propose to set the APR measure capital floor as 8% of the higher of the net long positions included in the APR measure and the net short positions included in the APR measure.

> **Q2:** Would additional guidance be helpful in applying the capital floor to the APR measure? If so, what specific aspects do you feel require attention?

Correlation trading portfolio – stress testing guidance

2.64 CRD3 requires firms to regularly apply a set of predetermined stress scenarios to their APR model. The stress scenarios must consider the effect of stress to default rates, recovery rates, credit spreads and correlations on the profit and loss of the correlation trading desk. Firms are required to conduct these stress scenarios at least weekly and must report, on at least a quarterly basis, the results of the stress tests to the FSA. When CP09/29 was published, the BCBS was working on internationally-agreed guidance regarding what it considers to be appropriate stress scenarios that firms should undertake to satisfy this requirement. In CP09/29 we stated our intention to include additional guidance in this area once the BCBS has published its work.

2.65 The BCBS has now published its guidance as an annex to the document *Revisions to the Basel II Market Risk Framework*.[20] We would expect firms to use the Basel Guidance document as the basis for their stress scenarios and internal stress testing and we intend to reference the Basel guidance document in our Handbook. We will expect firms to satisfy the FSA that their stress scenarios are sufficiently robust and reflective of their portfolio make-up (for example, that four jump-to-default scenarios are sufficiently adequate). Over time, and as firms develop a greater understanding of the drivers affecting their APR model capital calculations, we may make revisions to our stress scenario guidance requirements to reflect new developments.

20 Basel Committee on Banking Supervision, *Revisions to the Basel II market risk framework: updated as at 31 December 2010*, February 2011. Available at: http://www.bis.org/publ/bcbs193.htm.

Q3: Do you believe we should provide any further stress testing guidance for the correlation trading portfolio over and above that supplied by the BCBS? If so, what specific aspects do you feel require attention?

BIPRU 7.11 – Securitisation credit derivatives and single-name credit derivatives

2.66 When implementing the CRD in 2007, we introduced a set of rules for calculating the capital requirements for securitisation and single-name credit derivatives in the trading book (see BIPRU 7.11). These rules are super-equivalent to the CRD, which would otherwise require credit derivatives to be treated under BIPRU 7.2 (interest rate risk in the trading book). In BIPRU 7.11, we introduced separate treatments for single-name and securitisation credit derivatives.

2.67 In CP09/29 we stated that, because the directive minimum capital requirements for securitisation credit derivatives are changing, it was appropriate to investigate whether we should continue with our super-equivalent rules. We agreed to undertake an assessment of the costs and benefits of retaining our super-equivalent rules for securitisation credit derivatives compared to the new directive minimum, and use this to inform our policy decision.

2.68 The super-equivalent rules affect the trading book in two areas:

- the capital charge for non-correlation trading securitisation positions; and
- the calculation of the floor for correlation trading positions.

2.69 We requested information from firms to assess the impact of our securitisation credit derivative rules compared to the new directive minimum of banking book risk weights in both areas. We found that the super-equivalent rules are not binding for non-correlation trading securitisation positions, whereas for the calculation of the correlation trading floor the BIPRU 7.11 rules may be binding depending on the portfolio mix and the size of the firms' APR charge. However, the additional capital requirement imposed by BIPRU 7.11 was not considerable and we felt that the incremental capital benefit did not justify the computational burden placed on firms. For the cost-benefit analysis of the trading book changes see Chapter 6.

2.70 After due consideration we have, therefore, decided to remove our BIPRU 7.11 super-equivalent securitisation credit derivative rules.

2.71 We also received some information from firms on our single-name credit derivatives rules, because these rules can have an impact on the calculation of the floor for correlation trading positions. Our analysis found that the additional capital requirement imposed by BIPRU 7.11 rules was not considerable. We have, therefore, also decided to remove our BIPRU 7.11 super-equivalent single-name credit derivative rules.

2.72 Those aspects of BIPRU 7.11 that are not super-equivalent to the CRD remain in that section of the Handbook.

> **Q4:** Do you believe that the FSA should retain or remove the BIPRU 7.11 rules for securitisation and single-name credit derivatives? Please provide arguments to support your response.

Reporting

2.73 In CP09/29 we proposed to reflect the CRD2 and CRD3 amendments on reporting requirements through changes to the main market risk reporting form (FSA005), to incorporate the introduction of new models, and creating a new reporting form (FSA058) for securitisations that are originated or are held in the trading book. This new form reflects the alignment of the capital treatments for securitisations in the trading book and non-trading book and, therefore, is founded on the existing non-trading book securitisation reporting form (FSA046).

2.74 We received one response to our reporting proposals, which questioned why a new reporting form FSA058 had been introduced when they believed that FSA046 can cater for this requirement.

2.75 In response, we explained that we believe there will be materially fewer firms required to complete FSA058 than FSA046 and so we do not consider it appropriate to include a significant number of cells in FSA046 that may not be relevant to a large proportion of firms were there only one report covering both trading book and non-trading book.

2.76 In response to the additions and amendments to the final CRD3 text, we have made some further changes to the forms FSA005 and FSA058 to what we consulted on in CP09/29. These can be summarised as:

- FSA005: inserting additional data rows to accommodate the transitional provisions for non-correlation trading securitisations.
- FSA005: inserting additional rows to accommodate the standardised approach for the correlation trading portfolio.
- FSA005: inserting additional rows to accommodate the calculation of the all price risks measure capital floor.
- FSA005: removing the equity risk data row on qualifying equities.

- FSA058: inserting a table requiring firms to report the total capital requirement (sum of net long and net short capital positions) for non-correlation trading portfolio securitisations.
- FSA058: creating a separate correlation trading portfolio section for firms that are using the standardised approach to calculate the Correlation Trading Portfolio charge. This section does not need to be completed by firms that solely use the models-based approach to calculate the correlation trading portfolio capital charge, nor does this section need to be completed to report the APR measure capital floor. We have introduced this additional section at this juncture, because we are mindful that in the move to COREP it is extremely likely that firms will have to report the risk positions for non-correlation trading securitisations and the correlation trading portfolio separately.

Q5: Are the proposed changes to FSA005 and FSA058 clear?

Cost benefit analysis

2.77 As the Trading Book and Securitisation chapters are related, we have combined the CBA for both in Chapter 6.

3 Securitisation

Introduction

3.1 In CP09/29 we consulted on CRD2 and CRD3 changes relating to securitisation in the non-trading book. We provided feedback, and final rules for the CRD2 changes in CP10/17.

3.2 We consulted on the European Council draft of CRD3 in CP09/29, despite the European Parliament not yet having voted on the final text. We felt that including the CRD3 proposals in CP09/29 would prove useful in highlighting the potential CRD3 changes, and our proposed implementation approach, to industry. The final CRD3 text has now been agreed.

3.3 In this chapter we refresh the feedback we gave in CP10/17, and re-consult where we think appropriate on the following areas:

- re-securitisation;
- the use of external credit assessment institution (ECAI) credit assessments based on unfunded support; and
- CEBS guidelines in relation to CRD Article 122a.

3.4 There were no material amendments to the draft CRD3 text we consulted on in CP09/29 regarding securitisation in the non-trading book.

Re-securitisation

3.5 In CP09/29 we consulted on the draft CRD3 changes for re-securitisations. We received a number of responses in relation to this area, and provided some initial feedback in CP10/17, but did not feel it was appropriate to provide a detailed response until we reviewed the final CRD3 text. In this chapter we provide feedback to the responses, as well as present our proposals for implementation.

Definition of re-securitisation

3.6 The CRD3 amendments relating to re-securitisation adopt the approach developed by the BCBS to apply higher capital requirements to re-securitisation positions to reflect the higher risk of 'unexpected impairment losses'.

3.7 The CRD defines a 're-securitisation' as 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. A 're-securitisation position' is an exposure to a re-securitisation.

3.8 Respondents to CP09/29 expressed concern regarding the scope of the CRD definitions of securitisation and re-securitisation but we can confirm that the FSA intends to adopt the new CRD definition of re-securitisation (see 3.13 for further details). The aforementioned definition of a re-securitisation position captures collateralised debt obligations (CDOs) of asset-backed securities (ABS) including, for example, a CDO backed by residential mortgage-backed securities (RMBS). As previously stated in CP09/29, there is no materiality threshold provided by the amendments; therefore, even if only one of the underlying exposures is a securitisation exposure, any tranched exposure to that pool is considered a re-securitisation position. Furthermore, when an instrument's performance is linked to one or more re-securitisation positions, generally that instrument is a re-securitisation position. So a credit derivative providing credit protection for a CDO tranche that is itself a re-securitisation position will also be a re-securitisation position.

3.9 Some respondents to CP09/29 sought clarification on our proposed treatment of internally restructured transactions, including re-securitisations of real estate mortgage investment conduits (re-remics), in the context of the new re-securitisation provisions. As stated in CP10/17, we consider that such transactions are captured within the definition of re-securitisation, as they are securitisations of existing securitisation positions.

3.10 Respondents to CP09/29 indicated that the guidance in Recital 24 of CRD3 is useful in providing examples of exposures to Asset Backed Commercial Paper (ABCP) programmes that would fall within the definition of re-securitisation, and requested that this be included within the BIPRU text. We do not consider it appropriate to be prescriptive in BIPRU on the structures we consider to fall within scope of the re-securitisation definition and those that do not. Given that securitisation transactions can be structured in many different ways, we would expect firms to consider whether any given transaction is a securitisation or re-securitisation based on its economic substance. Despite the need for firms to assess the economic substance of transactions, firms may have regard to Recital 24 when determining whether an exposure is a re-securitisation position.

Highly complex re-securitisations (Article 122b)

3.11 The European Commission draft of CRD3 included requirements for highly complex re-securitisations in the proposed Article 122b. Although these requirements were not included in the European Council draft of CRD3, and consequently we did not consult on them in CP09/29, concerns were raised in feedback to CP09/29 that Article 122b was disproportionate. Market participants argued that the issues it was designed to address were already addressed by the due diligence and associated investor penalties in Article 122a of CRD2. They argued that the potential for an automatic capital deduction in respect of highly complex re-securitisations would be an unnecessary drag on the potential recovery of the securitisation market.

3.12 The CRD3 text in the Official Journal does not include provisions for highly complex re-securitisations and we do not intend to introduce any specific provisions in this area. However, we would expect that firms comply with Article 122a for re-securitisations, and only invest in such positions after they have conducted comprehensive due diligence, including only becoming exposed to the credit risk of a position if the originator, sponsor or original lender has retained at least 5% of the net economic interest.

Definition of securitisation

3.13 Respondents expressed concerns that, in our implementation of a new definition of re-securitisation, we would look to reassess our views on the scope of exposures captured by the CRD definition of securitisation. Commercial Real Estate AB loan structures were highlighted in this regard. It is not our intention to classify exposures in a manner that is inconsistent with the CRD definition of securitisation, and we are not amending the definition of securitisation in the Glossary. But firms should consider the economic substance, not just the legal form, of each exposure to determine whether it is a securitisation or a re-securitisation position. We are also of the view that firms should apply a consistent approach when classifying exposures, and that potential regulatory capital requirements should not be a key consideration in determining whether an exposure is a securitisation position or not.

3.14 The provisions in BIPRU 9 that are applicable to securitisation positions will also apply to re-securitisation positions unless BIPRU 9 explicitly requires a different approach. Therefore, except in relation to calculating risk-weighted exposure amounts (RWEAs), firms should treat re-securitisation positions as securitisation positions for the purposes of applying BIPRU 9.

Re-securitisation risk weights

3.15 The CRD3 amendments apply increased risk weights to re-securitisation positions compared to straight securitisations due to their complexity and sensitivity to correlated losses. There have been no changes in this respect between the draft CRD3 text we previously consulted on in CP09/29 and the final CRD3 text. We therefore propose to implement these provisions in the manner identified in CP09/29. These provisions state that increased risk weights for re-securitisation positions apply both under the Standardised Approach (TSA) and the Internal Ratings Based (IRB) approach.

3.16 Under the IRB approach, CRD3 introduces two additional categories of risk weights that can be applied to re-securitisation positions, depending on whether or not the re-securitisation position is in the most senior tranche of the re-securitisation, and whether any of the underlying exposures are themselves re-securitisation exposures. Consequently, there are now five categories (A to E) of risk weights for IRB firms:

- Firms must apply the weightings in column C where a 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 must be applied, unless the position is in the most senior tranche of a securitisation, in which case the weightings in column A apply.
- For re-securitisation positions, the weightings in column E must be applied unless the re-securitisation position is in the most senior tranche of the re-securitisation and none of the underlying exposures are themselves re-securitisation exposures, in which case column D may be applied.

3.17 In determining whether a tranche is the most senior, firms are not required to take into consideration amounts due under interest rate or currency derivative contracts, fees due, or other similar payments.

3.18 Some respondents to CP09/29 were of the view that re-securitisation risk weights should not be applied retrospectively to existing positions, on the basis that the new risk weights are intended to influence behaviours going forward. We accept that the higher re-securitisation risk weights are intended to influence behaviours, but they are also intended to ensure firms hold appropriate levels of capital against the credit risk to which they are exposed. We believe this applies equally to legacy and new securitisation positions, and we are not therefore proposing any grandfathering of existing positions. We believe that differentiating between existing and new exposures would result in the undercapitalisation of certain legacy exposures that the crisis demonstrated to be more risky than their current regulatory risk weights indicate.

> **Q6:** Do you agree with our proposed approach to implementing the CRD3 re-securitisation changes?

Unfunded support

Background

3.19 CRD3 contains an amendment that limits the use of a credit assessment of an eligible ECAI where the credit assessment is based, or partly based, on unfunded support provided by the credit institution itself. In such a case, the position would need to be treated as unrated.

3.20 We acknowledged in CP10/17 that some respondents to CP09/29 had raised concerns in respect of the unfunded support amendment. These respondents were of the view that while the amendment may be appropriate where the unfunded support was a key determinant of the credit assessment, it would also capture support such as interest rate and currency derivatives. They argued that, while such support could influence a credit assessment, it would typically not be a material determinant of the assessment, meaning a potential capital deduction or 1,250% risk weight would be disproportionate to the risk being addressed.

3.21 As discussed in the CBA to this section, participants in the Basel QIS undertaken in Q2 2010 provided a wide range of estimates of the impact of the new amendments. Our expectation is that this variance results mainly from different interpretations of the scope of the unfunded support provisions. In light of this, and to promote convergence of practices with regard to the unfunded support provisions, we set out below some considerations, which firms should have regard to when assessing their compliance with the provisions.

Purpose

3.22 The CRD3 unfunded support provisions are derived from changes to the Basel framework for 'ratings resulting from self guarantees', which were set out by the BCBS in July 2009.[21] The context provided for the Basel change was evidence from the financial crisis that several banks that provided liquidity facilities (LFs) to ABCP programmes chose to purchase commercial paper (the Paper) issued by the ABCP conduit instead of having the conduit draw on its LF. The LF provider then risk weighted its exposure to the ABCP based on the Paper's external rating. As a result, the LF provider benefited from the external rating of the Paper when assigning a risk weight to it, even though the rating was due in large part to the bank's own support of the conduit in the form of the LF.

21 Basel Committee on Banking Supervision, *Enhancements to the Basel II framework*, July 2009. Available at: www.bis.org/publ/bcbs157.htm.

3.23 The behaviour the BCBS was seeking to address arose in circumstances where the Basel II framework provided a firm with different means of holding regulatory capital against its credit risk exposure to a securitisation. This enabled firms to arbitrage the regulatory capital requirements by taking the course of action that resulted in the lowest capital requirement. For example, if the LF had been drawn on by the conduit, the LF provider would have been required to hold regulatory capital against the drawn amount. By buying Paper, the LF provider removed the need for the conduit to draw on the LF. This resulted in lower capital requirements, as the credit assessment of the Paper did not fully reflect the circularity of the creditworthiness of the securitisation.

Scope

3.24 Although unfunded support provided to ABCP programmes was the only example provided in the BCBS paper, we do not consider that the example should be read as an exhaustive list of circumstances that the new requirements are intended to capture. Furthermore, the CRD3 unfunded support provisions do not include examples of the circumstances covered. Therefore, and consistent with our view that the Basel provisions were intended to apply more widely than just to ABCP programmes, we believe the CRD3 provisions potentially apply to all securitisation structures where unfunded support has been provided by the investing institution itself.

3.25 There are three elements of the amendment to Banking Consolidation Directive (BCD) Annex IX, Part 3, Point 3 that are relevant to determining the potential impact of the requirement:

- the meaning of 'based or partly based';
- the meaning of 'unfunded support'; and
- the meaning of 'the relevant position'.

3.26 The CRD3 text does not explicitly set out how to determine what constitutes 'based or partly based', although Recital 31 is relevant to making such a determination. We are not proposing to define 'based or partly based' in our implementation of the Directive.

3.27 The term 'unfunded support' is not defined in the CRD. To determine what is meant to be captured by the term, it is useful to break it down into its components to assess:

- the meaning of 'unfunded'; and
- the meaning of 'support'.

3.28 'Unfunded' is not a defined term in the BCD. Where there is an element of funding to the support (e.g. some level of initial payment available to settle obligations following a specified event), it is arguable that the support in question is no longer unfunded, but at least partially funded, and therefore not subject to the unfunded support provisions. However, we expect firms to consider the economic substance of any support provided and not to structure support with minimal collateralisation to avoid the unfunded support provisions. We do not expect firms to structure support in a way that is non-market standard to avoid the unfunded support provisions.

3.29 'Support' is also an undefined term in the BCD. Although structured finance ECAI credit assessments are primarily concerned with the credit risk of the positions being assessed, they also consider other risks associated with the securitisation, including market and liquidity risks. Therefore, any mechanisms provided to the securitisation via which credit, market or liquidity risk is reduced, and the credit assessment improved as a result, could potentially be considered unfunded support.

3.30 However, Recital 31 of CRD3 states that 'Where an external credit assessment for a securitisation position incorporates the effect of credit protection provided by the investing institution itself, the institution should not be able to benefit from the lower risk weight resulting from that protection'. The explanatory text for the Basel framework paragraphs also states that 'The Basel Committee has added language to the Basel II framework so that a bank cannot recognise ratings – either in the SA or IRB Approach – that are based on guarantees or similar support provided by the bank itself'.

3.31 The CRD3 reference to 'credit protection', and the Basel reference to 'guarantees or similar support', can be read as narrowing the scope of unfunded support to only that which provides credit protection to a securitisation. We therefore propose to limit the scope of the unfunded support provisions to support that provides credit protection to a securitisation position.

3.32 However, given that it is possible to structure support to mitigate more than one type of risk (for example, credit and liquidity risk), a firm must be able to justify any determination that provision of unfunded support has not resulted in credit protection to securitisation positions it holds, based on the economic substance of the support provided. When determining whether unfunded support provides credit protection to a securitisation position, it is not sufficient to base the determination solely on the seniority of the unfunded support in the securitisation structure.

3.33 We interpret 'relevant position' to include any securitisation position held in the securitisation by the provider of unfunded support. For example, if a firm had provided an LF providing credit protection to a securitisation that covered all positions in the securitisation, and if that firm had also invested in the senior and mezzanine positions of the securitisation, the firm would need to treat the senior and the mezzanine positions as unrated. If, however, the LF only covered the senior position, the firm would only need to treat the senior position as unrated. The mezzanine position would not need to be treated as unrated, as the support being provided to the transaction would be unlikely to affect the credit assessment of this position.

Treatment of unrated positions

3.34 CRD3 provides a specific treatment for positions in commercial paper where unfunded support has been provided. For such positions, the credit institution may – subject to FSA approval – use the risk-weight assigned to an LF to calculate the risk-weighted exposure amount for the ABCP if:

- the LF ranks *pari passu* with the ABCP so that they form overlapping positions; and
- 100 % of the ABCP issued by the programme is covered by LFs.

3.35 As stated in CP09/29, we propose that our approval process be carried out via a waiver.

3.36 For non-ABCP paper securitisation positions that must be treated as unrated in accordance with the unfunded support provisions, Recital 31 of CRD3 indicates that this need not result in the position being deducted from capital or 1250% risk weighted if there are other ways to determine a risk weight that reflects the actual risk of the position, not taking into account the impact of the unfunded support. For example, a firm that has provided unfunded support to a position in which it has invested may not have to deduct that position from capital or 1,250% risk weight in the following circumstances:

- A firm subject to the standardised approach to securitisation may be able to use the 'treatment of unrated securitisation positions' approach set out in BIPRU 9.11.6R – BIPRU 9.11.7G to calculate the RWEA for the position.
- A firm subject to the IRB approach to securitisation may be able to infer a rating for the unrated position under BIPRU 9.12.7R, provided the criteria set out in BIPRU 9.12.7R are satisfied.
- A firm subject to the IRB approach to securitisation may, in certain circumstances and provided certain criteria are met, be able to use the 'supervisory formula method' set out in BIPRU 9.12.21R – BIPRU 9.12.24G to calculate the RWEA for the position.

3.37 Where a firm has provided unfunded support to a securitisation position and subsequently calculates RWEA for that position under BIPRU 9.11.6R – 9.11.7G or BIPRU 9.12.21.R – 9.12.24G, we would not expect the firm to apply a lower risk weight to the position under such an approach than originally required before the position was treated as unrated. We consider that such an approach would be inconsistent with the purpose and spirit of the unfunded support provisions. Therefore, the original risk weight applied to a securitisation position should act as the risk weight floor for the relevant position.

Q7: Do you agree with our proposed approach to implementing the unfunded support amendments?

CRD2 Article 122a guidelines

3.38 Article 122a of the CRD provides new requirements to be fulfilled by credit institutions when acting in a particular capacity, such as originator or sponsor, and also when investing in securitisations. These include retention, on an ongoing basis, of a material net economic interest of not less than 5%, performance of effective due diligence before investing, and for originators and sponsors to make certain disclosures and apply appropriate underwriting standards.

3.39 In CP09/29, we acknowledged that certain provisions within Article 122a would potentially benefit from clarification, but that we would wait until the final CEBS guidelines on that Article had been published before deciding whether to provide additional guidance on the new provisions. In CP10/17, we summarised the CP09/29 feedback received for Article 122a. We also reconfirmed our stance that we would wait for the final CEBS guidelines to be published before determining whether it would be appropriate for us to publish additional guidance. The guidelines to Article 122a of the CRD were published on 31 December 2010 and we are now able to set out our implementation approach.

Approach to adopting the CEBS guidelines

3.40 CEBS guidelines have been issued to enhance the convergence of supervisory practices on the application of Article 122a. This is seen as an important part of restoring confidence in securitisation markets. We consider that the guidelines are comprehensive in nature and should facilitate the convergence of practices with regard to Article 122a. They have been drafted with the intention of being sufficiently flexible to be applied by market participants to a range of potential structures, without the need for additional prescriptive guidance from supervisors.

3.41 We have added a provision in BIPRU 9 to clarify that firms should have regard to the Guidelines when considering compliance with their obligations under Article 122a. The FSA will also have regard to the guidelines when reviewing firms' compliance with Article 122a and when determining whether a firm has failed to meet any of the requirements of the Directive because of negligence or omission.

3.42 The Directive requires competent authorities to impose additional risk weights on credit institutions for non-compliance with Article 122a. When calculating any additional risk weights to apply to a firm for material non-compliance with the Directive because of negligence or omission, we will follow the methodology for calculating additional risk weights as set out in the CEBS guidelines. Our supervisory review of firms' compliance with Article 122a will take into account the extent to which firms monitor their compliance with Article 122a on an ongoing basis and the extent to which they have taken timely and effective remedial measures where breaches have been identified.

3.43 The imposition of additional risk weights does not prevent us from taking formal enforcement action against a firm for non-compliance under section 45 of FSMA, should the grounds for such action be met.

Scope of application

3.44 The CEBS guidelines state that a credit institution will become exposed to the credit risk of a securitisation position by virtue of the relevant activities of any related entity (authorised or unauthorised) that falls within the same scope of a group where consolidated supervision applies. They also explain that the economic substance of the requirements (e.g. no hedging) should be respected at consolidated as well as solo level. Despite this, we understand that there remains some uncertainty in the market about how Article 122a applies to groups in practice.

3.45 We support the application of Article 122a at a group level to reduce the potential for firms to invest in, or become exposed to, securitisation positions where the protections of Article 122a are not in place and also because otherwise a potential avoidance mechanism is available. This is because an EU banking group could invest in securitised positions via an unregulated entity, a regulated non-credit institution or a regulated subsidiary in a non-EU country without the need to comply with the new due diligence requirements and the requirement to ensure that the originator or sponsor has retained an economic interest in the securitisation. Also, where a credit institution acts as originator or sponsor, its retained economic interest could be hedged away at consolidated level by another entity within the group. Therefore, the intent and rationale behind Article 122a (to ensure greater confidence in the securitisation activities of EU banking groups and in turn help re-start the market on a sounder basis) could be undermined.

3.46 Given that the guidelines do not apply directly to firms, and to provide additional clarity on our approach, we propose to add new provisions in BIPRU 9 that set out our application of Article 122a at group level. Our proposed Handbook text requires the following:

- A credit institution must ensure that any undertaking, in relation to which the credit institution is a parent undertaking, meets the due diligence requirements of Article 122a (as set out in BIPRU 9.15). To comply with this requirement, a credit institution should be able to demonstrate that it has in place adequate group policies and procedures that its subsidiaries must follow to materially meet the requirements of BIPRU 9.15.
- When assessing group risk in accordance with GENPRU 1.2.30R, the credit institution should have regard to the potential risks arising from securitisation investments and exposures held by other, non-subsidiary, undertakings within its group, such as affiliated companies and participated entities.

3.47 The requirement that subsidiary undertakings of a credit institution comply with Article 122a does not apply to insurance undertakings, UK UCITS management companies or alternative investment fund managers on the basis that, going forward, such firms will be subject to similar requirements to Article 122a under other EU legislation. We are also not applying Article 122a requirements to the third party agency business of investment firms, provided such business does not result in the investment firm itself becoming exposed to the credit risk of securitisation positions.

3.48 For group entities supervised by non-EEA authorities that would fall under the scope of the proposed BIPRU requirements, applying Article 122a on a group basis could require compliance, even where different retention requirements are required by the home supervisor. For example, several UK credit institutions have US broker-dealer subsidiaries who may invest in US securitisation transactions. Through provisions to be implemented under the US Dodd Frank legislation, differing EU and US retention requirements may apply for such US transactions, leading to increased operational costs. Potentially, in some cases, it may not be possible for non-EEA subsidiaries within a credit institution's group to invest in securitisation positions in a way that is compliant with both Article 122a and the local requirement.

3.49 To mitigate these potential conflicts, we propose to allow firms to apply for a waiver of the new BIPRU requirements in certain cases, specifically for their non-EEA subsidiaries. We would expect firms to be able to satisfy the waiver statutory tests in FSMA s148 in circumstances where non-EEA group entities were themselves subject to requirements under local law, which were substantially similar to Article 122a and delivered equivalent outcomes, but where the detailed local rules would conflict with the specific Article 122a requirements and make compliance with both requirements unduly burdensome or impossible. A waiver approach would enable non-EEA group entities to maintain a strictly limited ability to invest in, or become exposed to, securities that are non-compliant or partially compliant with Article 122a requirements. We would assess firms' compliance at a group level and their use of any flexibility provided by a waiver as part of our ongoing supervision.

3.50 We believe that our approach should deliver the intended outcomes of Article 122a requirements while also addressing some of the industry's concerns regarding competitiveness and potentially conflicting future legislation in non-EEA states.

Other Article 122a issues

3.51 Paragraph 57 of the CEBS guidelines clarifies that a firm may seek to retain a material net economic interest in a securitisation under option d) of the guidelines via a letter of credit, a guarantee or other form of credit support, as long as certain conditions are satisfied, e.g. it is provided by the sponsor, originator or original lender (and not by any other entity). We would expect investors in securitisations where retention is held on such a basis to consider (in their due diligence) the ability of the provider of credit support that fulfils the retention to pay their obligations when due. For example, we would not expect credit institutions to invest in securitisations where retention is achieved via a credit derivative where there is a likelihood that the protection seller would not be able to make payments under the derivative when due, given that this would undermine the effectiveness of retention.

3.52 We are also proposing minor changes to certain existing BIPRU 9 provisions that implement Article 122a. This is to ensure that our rules are consistent with the interpretation of the Directive that is set out in the CEBS guidelines and to promote convergence of supervisory practices with regard to Article 122a. The changes are as follows:

- BIPRU 9.3.15R – we propose to amend the rule to clarify that the criteria for granting credit to be applied by credit institutions acting as originator or sponsor must be sound and well defined. The meaning of 'sound and well defined' is explained in the CEBS guidelines.
- BIPRU 9.15.6R – we propose to amend the rule to clarify that the requirement in Paragraph 1 of Article 122a that 'there shall be no multiple applications of the retention requirements for any given securitisation' does not mean that there is a prohibition on multiple applications of retention. Rather, it is sufficient for only one of the originator, sponsor or original lender to retain a net economic interest of at least 5% and multiple application is not required by the Directive.

Q8: Do you agree with our proposed approach to adopting the CEBS guidelines?

Handbook amendments

3.53 Our approach to adopting the Article 122a guidelines at group level is, we believe, superequivalent to the CRD. However, we consider that our approach is consistent with the original intent and objectives of the CRD text, and has support from the European Commission and EBA.

3.54 We have adopted an intelligent copy-out approach to CRD3 implementation. Draft rules and guidance are set out in Appendix 1.

> **Q9:** Is the draft Handbook text clear? Would you find additional guidance useful? Please detail the specific areas and suggested text in your response.

> **Q10:** Do you agree with our interpretation of the final CRD3 text for securitisation?

Reporting

3.55 In CP09/29, we proposed changes to FSA046 to capture data on the following:

- CRD2 amendments, including the requirement to hold additional capital for material non-compliance with Article 122a and the retention of a material net economic interest by originators and sponsors;
- the proposed CRD3 requirement to apply higher risk-weights to re-securitisation positions; and
- additional information on the capital held by firms against securitisation positions in the role of originator or sponsor.

3.56 The amendments to FSA046 confirmed in CP10/17 did not include the new elements capturing data on re-securitisation positions because CRD3 had not been published in the Official Journal of the EU at the time the CP was published. Now that CRD3 has been finalised, we propose to amend FSA046 to include data elements for re-securitisation positions. We are also proposing to make the following additional changes:

- An amendment to the positioning of the section title 'Transaction level information – where the firm is an originator or sponsor' to clarify that data element 3 of the report applies to originators and sponsors only, and at a transaction level, whilst data elements 1, 2, 21 and 22 apply to originators, sponsors and investors, and on an aggregate basis.

- Adding the additional data elements G to H in the 'Risk positions – standardised exposures' section of the report to capture information on standardised firms' use of the provisions in BIPRU 9.11.6R to calculate RWEA for unrated positions.

Q11: Are the proposed changes to FSA046 clear?

Cost benefit analysis

3.57 As the Trading Book and Securitisation chapters are related, we have combined the CBA for both in Chapter 6.

4

Other CRD3 changes

4.1 CP09/29 consulted on several assorted changes to CRD3, which we have grouped together in this chapter:

- Pillar 3;
- Prudent Valuation; and
- Technical Amendments.

Pillar 3

4.2 In CP09/29 we consulted on implementing amendments to the Pillar 3 disclosure requirements introduced by the CRD2 and CRD3 amendment packages.

4.3 The CRD2 changes were put into our rules in CP10/17, and with the final CRD3 text published[22], we can now respond to the feedback we received from CRD3 consultation and set out our final proposals for implementing those changes.

CRD3 requirements

4.4 The new requirements introduce limited changes to disclosures on market risk and operational risk, and significant amendments to the securitisation disclosures as summarised below.

22 The Official Journal published CRD3 on 14 December 2010 and required Member States to transpose the new rules into national regulation by 31 December 2011.

Extending public disclosure requirements beyond information specifically required to compute minimum capital requirements under Pillar 1

4.5 This information will, however, enable market participants to better understand a firm's overall risk profile. In particular, firms will be required to ensure that their disclosures convey their risk profile comprehensively to market participants, with disclosures beyond the Pillar 3 requirements where necessary. This should support users' assessments of a firm's capital strength as markets evolve over time. We propose to update BIPRU 11.3.3 to reflect this change.

Increasing disclosures for firms that calculate their market risk capital requirements using a VaR model

4.6 Firms will be required to provide more information on the daily VaR measures during the period. We propose to update BIPRU 11.5.12.

Increasing disclosures for firms using the Advanced Measurement Approach (AMA)

4.7 Firms using the AMA to calculate their operational risk capital requirement will have to provide more information, in particular on risk mitigation. We intend to make this change in BIPRU 11.5.14.

Increasing disclosures on securitisation

4.8 These disclosures have been significantly enhanced in several areas, including securitisation positions in the trading book and sponsorship of off-balance-sheet vehicles. Disclosures for securitisation positions in the trading book are now broadly in line with those relating to positions in the banking book positions. Re-securitisation positions, and their associated capital requirements, must be disclosed separately, with sufficient granularity on risk-weight bands and credit-risk mitigation. BIPRU 11.5.17 will be amended.

Feedback on CP09/29

4.9 CP09/29 asked two questions in relation to Pillar 3 changes. In CP10/17 we responded to the comments made in relation to the CRD2 related changes, and do so now for the CRD3 changes.

4.10 In Q46 we asked: 'Do you believe that our approach to implementing Pillar 3 remains appropriate?' Respondents indicated that they continue to support the current implementation approach to Pillar 3, which uses straight copy-out with no additional guidance.

4.11 In Q47 we asked: 'Do you have any comments on our approach to implementing the changes to public disclosure requirements?' Most responded in favour of our approach, supporting the use of copy-out and agreeing that it is in the spirit of the Pillar 3 intentions, i.e. promoting market discipline and transparency. One respondent also noted that there was a minor referencing error in the consulted text.

Another respondent noted that in the transposition text some technicalities seem to introduce requirements over and above those contained in the directive.

Our response

We have consistently taken a straight copy-out approach to implementing the Pillar 3 requirements, and we believe that this avoids being super equivalent.

We support the decision of Basel to expand public disclosure requirements beyond information specifically required to compute minimum capital requirements under Pillar 1. We see merits in giving market participants a comprehensive understanding of how a firm manages its risk profile. We believe that those new disclosures are a supportive addition to market discipline.

The referencing error noted by one respondent has been rectified in the draft text.

4.12 In addition to responses to the formal questions in CP09/29, we also received a general comment on the Pillar 3 changes.

4.13 One respondent was concerned that, although acknowledging that risk disclosures provide useful information about firms risk profiles and are a useful adjunct to the financial statements in a firm' annual report and accounts, there was an increasing potential for overlap.

Our response

We are aware of an overlapping of information between Pillar 3 and the Annual Report. Our view is supportive of firms' approach to cross reference elements of Pillar 3 to the Annual Report as long as both documents are publicly available for market consultation at any given time.

Cost benefit analysis

4.14 There were no significant changes from the European Council text council CRD3 text we consulted on in CP09/29 to the Official Journal text. Therefore we feel there is no need to revisit our CBA, which concluded that the costs of implementing these changes will be insignificant.

Our implementation approach

4.15 We have adopted a copy-out approach to implementing the CRD3 Pillar 3 changes. There were only minor changes in the Official Journal CRD3 text from the European Council text and, apart for the correction mentioned above, our proposed Handbook Text (see Appendix 1) is unchanged from that presented in CP09/29.

Prudent valuation

4.16 CRD3 made several changes to the prudent valuation framework, including more specific requirements around policies and procedures for valuation, applying the prudent valuation requirements to all fair-valued positions, and an explicit requirement to consider the need for valuation adjustments arising from model risk. We consulted on these changes, as well as a change to the terminology used in GENPRU 1.3 to remove a reference to valuation 'reserves' in CP09/29, and provided feedback to responses in CP10/17.

4.17 In general, respondents presented mixed views towards the proposed changes, although they were supportive of the current approach where the prudent valuation framework is applied to all fair value positions in the trading book and banking book. A number of respondents also noted that the changes did not represent a substantive change in policy and were not expected to generate significant additional costs for firms, provided that they are not accompanied by other changes to the framework arising from our work examining current prudent valuation practices (such as through a need for major systems development or unintended regulatory consequences).

4.18 The final CRD3 text has now been published, with no changes from the EC text in this area, and so we propose to make the changes as proposed in CP09/29, which are included in Appendix 1.

Technical amendments

4.19 In CP09/29 we consulted on technical amendments to the CRD from both the CRD2 and CRD3 packages. The CRD2 changes were made into our rules in CP10/17.

4.20 The technical amendments for CRD3 included:

- clarifying the treatment of exposures to regional and local governments;
- limits on potential future exposure (PFE) for written credit default swaps;
- changing references to settlement risk in Pillar 1; and
- changing references to treatment of expected loss amounts regarding value adjustments.

4.21 We received no comments from respondents to the CRD3 technical amendments changes proposed in CP09/29 and there were no changes to the technical amendment provisions between the European Council and Official Journal versions of the CRD3 text.

4.22 For the first three amendments above, we propose to make the changes as outlined in CP09/29. Regarding changing references to treatment of expected loss amounts regarding value adjustments, we are undertaking further work before finalising our proposals.

Treatment of expected loss amounts regarding value adjustments

4.23 We consulted on implementing a change to the Handbook text to correct a reference to the double default calculation in the treatment of expected loss amounts for IRB firms.

4.24 This amendment serves only to reconcile the Handbook text with the Directive's original intention, and was therefore not explicitly considered as part of the previous CBA exercise. It was clear at the time, however, that due to the typographical error, the treatment of credit valuation adjustments in the regulatory capital calculation varied considerably across the industry. In CP09/29 we made it clear that we would undertake further work to investigate practices among regulated firms to better understand the extent of any non compliance.

4.25 This work is still is ongoing and also forms part of a wider exercise to consider whether the existing treatment of incurred CVA and a CVA volatility charge could coexist under the forthcoming CRD4 proposals. At this stage, participants should be aware that the treatment detailed in CP09/29 may be subject to change as part of CRD4-led revisions to the counterparty credit risk framework.

Cost benefit analysis

4.26 These changes are intended to clarify existing rules and make corrections to inconsistencies in the existing CRD. Most of the changes proposed involve minor changes that will not incur significant, if any, costs to firms. Therefore, we do not see a need to update the CBA from CP09/29. We will provide more information in due course on our further analysis regarding the treatment of expected loss amounts for value adjustments.

5

CEBS guidelines on managing operational risks in market-related activities

Overview

5.1 In October 2010, CEBS published guidelines on the management of operational risks in market-related activities[23] (the guidelines). The guidelines provide specific principles and implementation measures for identifying, assessing, controlling and monitoring operational risk in market-related activities.

5.2 The guidelines complement the framework set out in CEBS' 'Guidelines on the Application of a Supervisory Review and Evaluation Process under Pillar 2'[24], the 'High-level principles for Risk Management'[25] and the 'High- level principles for Remuneration Policy'.[26]

5.3 We welcome the guidelines and propose to adopt them in the supervision of all BIPRU firms that perform market-related activities. Firms should demonstrate that in meeting the risk management standards required of them they have considered the guidelines.

5.4 We propose to give effect to the guidelines by inserting references to them in BIPRU 6.3, 6.4 and 6.5.

23 Guidelines on the management of operational risks in market-related activities, CEBS, 12 October 2010, www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx
24 Guidelines on the Application of the Supervisory Review and Evaluation Process - Section 2 (25 January, 2006)
25 High level principles on risk management (16 February, 2010)
26 High level principles on remuneration policies (20 April 2009)

Key features of the guidelines

5.5 In relation to governance mechanisms, the guidelines set out five principles that should facilitate the management body's awareness of:

- operational risks affecting market-related activities;
- a culture of the front office designed to mitigate operational risks; and
- control functions with the appropriate skill, authority and incentive to challenge the traders' activities and the prevention of fraudulent and suspicious activities.

5.6 In relation to internal controls, the guidelines set out ten principles related to the initiation and conclusion of the transactions (including places and timing), documentation requirements, relationships between traders and their eligible counterparts, as well as confirmation, settlement, reconciliation and margining processes. Specific attention is provided to potential sources of operational risks in market-related activities[27] and to the level of quality of the information systems designed in trading areas.

5.7 Finally, the guidelines set out two principles on internal reporting, highlighting the importance of reports that have levels of quality and consistency appropriate for the recipients they are intended for and that generate appropriate warnings and alerts for management when suspicious operations or material incidents are detected.

5.8 The rationale of the guidelines is consistent with the 'Scope of operational risk and operational risk loss' paper (included into the 'Compendium of supplementary guidelines on implementation issues on operational risk')[28], as both these documents are directed to all credit institutions and investment firms (according to a proportionality principle) and fills gaps in the current regulatory framework on operational risk, which left many elements necessary for its implementation unregulated.

Proposed amendments to BIPRU

5.9 The guidelines set out a series of specific principles and implementation measures for identifying, assessing, controlling and monitoring operational risk in market-related activities.

27 For instance, gross notional amounts, unusual and remarkable transactions, anomalies in confirmation and reconciliation processes, errors in recording, processing and settling transactions, along with cancellations, amendments, late trades and off-market rates.

28 The "Scope" paper and other two papers directed to AMA firms ("The use test" and "The allocation mechanisms") are included into the Compendium www.c-ebs.org/getdoc/0448297d-3f85-4f7d-9fa6-c6ba5f80895a/CEBS-2009_161_rev1_Compendium.aspx

5.10 While these guidelines are relevant to all firms that engage in market-related activity, the principle of proportionality should be taken into account in their implementation and application. Accordingly, the level of sophistication of governance mechanisms, internal controls, and reporting systems for the management of operational risk in market-related activities should be commensurate with the complexity and size of these activities within the individual institution. The structure of the guidelines i.e. a number of principles, do not lend themselves to inclusion in the Handbook. Therefore, we propose a specific reference to the guidelines in BIPRU 6.3, 6.4 and 6.5.

5.11 The proposed references highlight that firms should be able to demonstrate that they have taken into account the guidelines when considering operational risk in their market-related activities.

5.12 The text of the proposed amendments is set out in the draft Handbook Text (see Appendix 1).

> **Q12:** Are the references to the CEBS guidelines clear?

Consultation period

5.13 During the preparation of the guidelines, CEBS undertook two consultations.

5.14 The first consultation period ended on 31 March 2010 and a public hearing was held in March 2010.[29] Substantial changes were made to address a number of significant issues that had been raised by respondents to the first consultation (e.g. requirements on reconciliation and audit trail). A second consultation period of one month was granted.

5.15 The second consultation period ended on 23 July 2010. CEBS received eight responses. Many of the responses acknowledged that CEBS had considered the comments made during the first consultation. The comments received during the second consultation aimed mostly to further clarify the guidelines, in particular regarding 'anti fraud management' (Principle 5) and the reconciliation process (contained in Principle 11).

5.16 Following on from this consultation process, CEBS has approved and published the guidelines and has mandated that these must be given effect by supervisors by 30 June, 2011. We consider a one-month consultation period is justified. In view of this, and that we do not expect the proposed amendments to be contentious, we invite comments by 11 June 2011. However, the references to the guidelines will not appear in our Handbook until July.

29 The results of the first consultation period can be accessed under the following link: www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP31-CP40/CP35.aspx

Cost benefit analysis

5.17 Section 155 of the Financial Services and Markets Act (FSMA) requires the FSA to publish a cost benefit analysis (CBA) of the implications of proposed amendments. The requirement under section 155 of FSMA does not apply if there will be no increase in costs or if any increase in costs will be of minimal significance.

5.18 It is in firms' interests to have good governance and effective processes to manage market-related operational risk, because operational risk failures in market-related activities can contribute to significant losses.

5.19 Firms should already comply with the FSA Handbook. We do not expect the guidelines to lead to any significant increase in costs.

5.20 We do not envisage that the guidelines will alter firms' behaviour, so the wider effect on managing operational risk in market-related activities will be minimal. Similarly, increases in compliance costs relating merely to consequential changes to Handbook and related FSA costs will be minimal.

Q13: Do you agree with our assessment that the requirement for a CBA does not apply as the increase in costs due to these guidelines is negligible or of minimal significance?

6

Cost benefit analysis

Introduction

6.1 In this section we consider the costs and benefits for the trading book and securitisation proposals in this CP. For each proposal, we describe expected capital and non-capital compliance costs to firms, and indirect market impacts. All these impacts are summarised in the table below.

Table 1: Estimated annual cost of CRD3 implementation

	Trading book	Securitisation
Capital compliance costs	£630m per annum	£170m per annum
Non-capital compliance costs	£0.4 – 0.6m per annum	N/A

6.2 In addition, we provide an analysis of the estimated macroeconomic costs and benefits of the proposals. This analysis is based on the methodology described in our forthcoming Occasional Paper.

Trading book

Summary of proposals

6.3 The CRD3 trading book proposals set out to:

- increase the level of capital held against trading book risks;
- reduce the relative cyclicality of the market risk capital requirements;
- reduce the opportunity for arbitrage between the non-trading book and the trading book; and
- improve the capture of credit and illiquidity risks for trading book exposures.

6.4 The key amendments proposed, which will affect the trading book in several ways, are:

- to introduce a stressed value-at-risk (VaR) measure;
- to introduce an incremental risk charge model for debt instruments;
- to apply the standardised banking book risk-weights to trading book securitisations; and
- to introduce an all price risk (APR) measure and capital floor for the correlation trading portfolio.

6.5 We already consulted on the majority of the trading book in CP09/29. However, since CP09/29 was published, some proposals have been amended and new proposals have been introduced. These new and amended proposals include:

- the introduction of the maximum loss principle and market value principle for calculating capital charges on securitisation exposures;
- the calibration and methodology for the correlation trading floor;
- transitional provisions for standardised rules for securitisation (introduction of the higher of net longs and net shorts methodology); and
- correlation trading stress tests.

6.6 These proposals are described in details in the main text.

Scope and markets affected

6.7 As we outlined in CP09/29, the trading book proposals will apply to all BIPRU firms that maintain a trading book. However, large banking groups with significant investment banking businesses are likely to be the most appreciably affected by the changes. This is because they tend to have a significant proportion of their assets held in the trading book and calculate regulatory capital requirements for a large proportion of these assets using regulator-approved internal models. Smaller firms and building societies generally do not maintain a trading book and therefore are generally not subject to the market risk capital requirements.

6.8 Various markets will be directly or indirectly affected by the proposals. Implementing the stressed VaR calculation will increase the capital requirements held against all products that are included in a firm's VaR model. Therefore it could have an impact on all markets where positions are held in the trading book. Applying standardised charges for securitisation positions and the APR measure for correlation trading will affect markets for all securitised assets and, in turn, could have an indirect impact on prices and volumes in other credit markets (such as mortgages, corporate loans and credit default swaps). The incremental risk charge (IRC) could also affect credit markets.

Costs

6.9 At the firm level, the expected costs of CRD3 trading book include:

- the cost of holding additional regulatory capital, based on Quantitative Impact Study (QIS) results as of 31 December 2009[30]; and
- the other costs of complying with the rules, including systems, compliance and legal costs, as estimated in CP09/29.

6.10 The wider market section discusses potential impacts on financial markets.

Costs to firms – capital compliance costs, static estimates

6.11 The following section details the steps taken to arrive at the £630m annual Trading Book capital compliance cost presented in Table 1.

6.12 In estimating the capital impact of the proposals, we have used detailed quantitative information from a sample of major banks[31], which were provided as part of the Basel Comprehensive Quantitative Impact Study conducted in 2010. We have calculated expected incremental increase in capital requirements for each of the sample firms as of 31 December 2009. Setting our reference point shortly after publishing the first CRD3 draft allows us to present the total impact of the CRD3 trading book package.

6.13 Overall, our estimates are based on:

- QIS data for a sample of four UK major banks. The increase in capital requirements will predominantly affect those firms that have large trading books and use regulatory approved internal models to calculate their market risk capital requirements. The majority of these firms are indeed large banks with significant investment banking businesses.
- FSA internal data (including regulatory returns for 2010, 2009 and 2008).
- The cost-benefit analysis prepared for CP09/29 and the feedback received.
- Research published by the FSA in Occasional Paper (OP) 36.[32]
- Discussions with FSA supervisors.

6.14 The QIS numbers, which do not consider the adjustments that banks are likely to make to their balance sheets as a result of the proposals, suggest that implementing the CRD market risk amendments will increase regulatory capital requirements of the major UK banks in the sample by £16.1bn.[33] This represents an average increase of 109% in market risk capital and 8% of core capital for these sample firms.

30 In practice firms may react to the change in capital requirements by altering the composition of their trading book, thus the estimated increase in regulatory capital may not fully materialise.

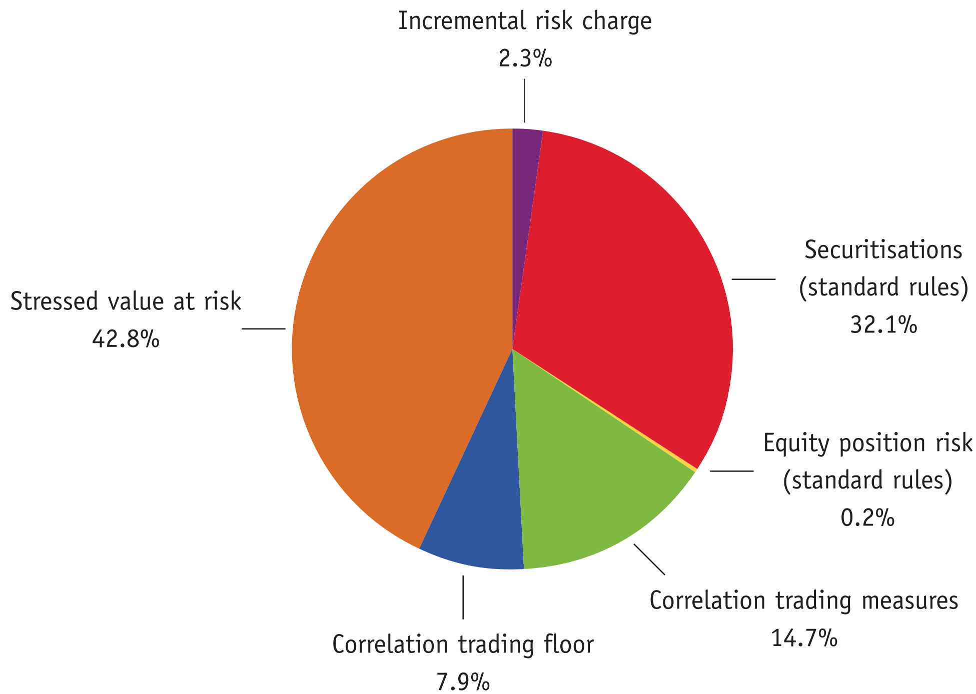
31 The sample of firms is very similar to the sample used for CP09/29, though not exactly the same.

32 www.fsa.gov.uk/pubs/occpapers/op36.pdf

33 We estimate that the 'static' increase in capital across the UK prudentially-regulated sector would be around £28bn.

6.15 The chart below shows the distribution of this £16.1bn of extra capital increase across the main trading book proposals. The stressed VaR and securitisation amendments have the largest impact.

Figure 1: Split of the estimated capital impact of the CRD3 trading book package for sample firms



Costs to firms – capital compliance costs, dynamic estimates

6.16 The £16.1bn impact presented above is static and measured before banks adjust their balance sheets as a result of the proposals.

6.17 However, recent research published by the FSA[34] shows that banks faced with higher capital requirements: i) reduce the size and adjust the composition of their assets; and ii) raise new capital to maintain a buffer above the minimum requirement. This suggests the actual increase in capital is therefore likely to be lower than £16.1bn. We use the analysis presented in OP36 to estimate the impact of higher capital requirements on banks' actual capital and balance sheet size.[35] We calculate how the additional capital required under the trading book changes is likely to affect the capital ratio of large UK banking entities holding a large majority of the banking assets in the country.

6.18 The trading book policy initiatives form part of the broader Basel initiatives that will be copied out into non-discretionary capital directives. There are still uncertainties about the overall package and discussions continue to develop among international supervisory bodies. Below we present estimates of both the incremental impact of a central calibration of the Basel package[36] and the individual contribution of the trading book proposals as part of this package. Calculations were made using historical data from banks' balance sheets and behavioural parameters to simulate these impacts. The analysis conservatively assumes that banks' increase in capital ratio is permanent.

6.19 Our model suggests that the central calibration of the Basel package would lead major banks to increase capital by £58bn. We estimate that banks would comply with the rest of the increase in capital requirements by reducing their risk-weighted assets in the ten-year period considered until December 2019.[37] Banks' risk-weighted assets are estimated to be 23% less than they would have been without the Basel package. We estimate that out of this £58bn increase in capital, the trading book proposals are responsible for an increase in capital of £7.4bn. This is equivalent to an increase of 3.8% of their core capital. The decrease in risk-weighted assets as a result of the trading book proposals is estimated at 2.3%.

34 FSA Occasional Paper 36, 'Bank regulation, capital and credit supply: Measuring the impact of Prudential Standards'.

35 As explained in CP09/29, our research has predominantly focussed on changes in banking book regulatory requirements. Increases in trading book capital requirements may not lead to the same behaviour as previously observed. In the long run, firms may rebalance their assets and significantly reduce the size of their trading book. This could further reduce the amount of capital they need to raise. Historical relationships were estimated in a pre-Basel II world, so there may be differences in the way firms react now. The simulations assume that firms behave in the future as they did in the past and there is always a possibility that banks do other things which will not affect lending in the same way.

36 The central calibration includes the following elements: Basel III minima, buffers and definition of capital; changes to trading book and re-securitisation requirements in the CRD2; increases in counterparty credit risk in the calculation of RWAs; the introduction of a systemic surcharge; and the introduction of liquidity coverage ratio.

37 The model assumes that banks began to adjust to the new standards from the initial CRD3 policy announcement date (Q4 2009). The model also assumes a progressive adjustment towards their targeted capital.

Table 2: Estimated capital impact of the CRD3 trading book proposals for sample firms

	Estimated increase in capital and reduction in risk-weighted assets	
	i) Static QIS estimate	ii) Dynamic estimate taking banks' balance sheet adjustment into consideration
Increase in core capital	8.4% (£16.1bn)	3.8% (£7.4bn)
Reduction in risk weighted assets	0% (£0bn)	2.3% (£52bn)

6.20 The estimate of £7.4bn does not reflect the whole industry. Applying the same dynamic transformation to static non-QIS estimates suggests an additional capital increase of £5.5bn for the other affected firms. We therefore estimate that the corresponding impact on the prudentially-regulated sector would be around £13bn.

6.21 To calculate the ongoing cost of funding this extra £13bn in capital, we use the same methodology as in CP09/29, with updated data. We also provide further details on this methodology at the end of this annex.

6.22 We calculate the cost of incremental capital to be 4.9% per annum.[38] Funding an extra £13bn of capital would therefore cost these firms approximately £630m p.a.

6.23 As discussed above, since the publication of CP09/29, some trading book proposals have been amended and new proposals have been introduced. The impact of these changes is included in the estimates given above. However, we also describe below the impact of these changes from what we consulted on in CP09/29:

6.24 Maximum loss principle and market value principle: We do not have separate data on the application of maximum loss principle and market value principle for securitisations. Firms have generally completed the QIS on a market value principle but have not taken the maximum loss principle into account. For some exposures (such as short positions on credit-default swaps), this means that the QIS estimates could slightly underestimate the capital impact. A small survey of banks showed that this small impact could be around £50m in capital.

6.25 Correlation trading floor: The calibration and methodology of the correlation trading floor is expected to have a capital impact of around £1.3bn across our sample of major banks.

38 As we explained in CP10/17, we acknowledge that our methodology to estimate the cost of incremental capital is based on historical relationships and does not reflect potential market pressure which could affect the return on equity required by investors. However, in CP10/17 we noted that when firms raise this capital, this incremental cost will not only be affected by the number of firms raising capital in a short period of time, but also by other demand factors (such as investors' appetite for banking exposure) and wider economic conditions. Providing a cost estimate which would take these dynamics into account is an inherently complex task that was not deemed a proportionate use of our resources. As explained in CP09/29, our estimate is conservative in many respects and we still believe that our methodology provides an appropriate estimate of the incremental ongoing cost of funding additional capital. Furthermore, banks now have a relatively long time frame to adjust to the new regime, meaning that 1) they could also increase capital by retaining profits and 2) all banks would not necessarily have to raise capital at the same time.

6.26 Transitional provisions: On the transitional provision of the further changes to standardised rules for securitisation, the higher of net longs and net shorts methodology until 31 December 2013 would reduce the capital impact by around £1.7bn. The capital impact until 31 December 2013 is therefore expected to be £14.5bn.

6.27 Correlation trading stress tests: The CRD text also requires firms to send authorities the results of their correlation trading models stress tests on a weekly basis. After reviewing these stress tests, supervisors could require a capital add-on. The impact of this potential charge cannot be quantified at this stage given that banks' models are still being developed and have not yet been reviewed. Nevertheless, firms are required to model conservatively and this should be reflected in the capital impact given by the QIS numbers. Thus, if firms comply with regulation, no material capital add-on on top of what is estimated above should be required. We expect firms to perform these stress tests for their own purpose too, so that the non-capital compliance cost of performing the stress test would not be incremental.

Costs to firms – non-capital compliance costs estimates

6.28 We now turn to the compliance, legal and systems costs of implementing new modelling requirements. These costs were estimated in CP09/29. The implementation guidance we are consulting on does not change the requirements. They are meant to facilitate firms' compliance. We therefore do not expect the guidance to materially change the costs we estimated last year – these costs are presented in Table 3.

6.29 Firms in our CP09/29 sample population presented a wide range of estimated incremental compliance costs as a result of these proposals. We would expect a large complex bank to incur costs closer to the upper end of the estimates.

Table 3: Estimated system costs per firm

Proposal	One-off costs	Ongoing costs p.a.
Incremental risk charge	£0.5m – £1m	£0.1m – £0.7m
Stressed VaR	£0m – £2.3m	£0m – £1.9m
Applying standard rules to securitisation positions	£0.2m – £1.1m	£0.2m – £0.7m
Development and implementation of the all price risk measure	£0.5m – £2m	£0.1m – £2m
Application of standard rules to nth-to-default credit derivatives	Minimal	Minimal
Implementing required improvements to VaR	£0 – £0.4m	£0 – £0.7m
Increase in Equity Specific Risk under standard rules	Minimal	Minimal
Total	£1.2m – £6.8m	£0.4m – £0.6m

6.30 Reporting systems costs for the new internal model charges (stressed VaR, the IRC and the APR measure) are included in the relevant non-capital compliance costs in Table 3.

Indirect market impacts

6.31 Finally, we re-iterate some indirect market impacts that the proposals may have. As we described in CP09/29, some markets will directly or indirectly be affected by the proposals. In particular, the implementation of the stressed VaR will increase the capital requirements held against all products that are included in a firm's VaR model. The cost of that extra capital will make trading more expensive for a wide range of products for which modelling is permitted. Instead of increasing their capital, firms could reduce their trading book or alter their composition; particularly in the most volatile assets attracting higher capital charge. If most firms act in this way, liquidity in affected markets could diminish, increasing the cost of trading for all participants whether or not they are directly affected by the proposals.

6.32 The modelling limitation and application of standardised charges to securitisation positions could have a similar effect in all securitisation markets. Capital requirements against most securitisation exposures will increase, but the effect will be particularly significant for non-investment grade positions. Standardised charges substantially increase for positions rated BB+/Ba1 and below, non-rated positions and re-securitisations. Therefore, some firms indicated that the proposals would make them reconsider the risk-reward trade-offs of these assets. If banks stopped trading some of these products, reduced activity and smaller markets could, particularly in the case of securitisation, indirectly make banks' funding diversification and risk sharing more expensive, thereby increasing the cost of credit to businesses and consumers. It could also negatively affect any recovery in the securitisation markets and affect the availability of credit during the recovery from the last crisis.

6.33 Some amendments to the CP09/29 securitisation proposals, such as implementing the maximum loss principle and market value principle and the transitional provisions will mitigate these effects.

6.34 Restricting the modelling of securitisation positions for the purposes of calculating regulatory capital requirements could also affect firms' incentives to hedge such positions. Firms commonly hedge securitisation exposures with credit derivative indices. Index hedging can be cheaper and easier to execute than a single-name hedge, although it carries more basis risk. Under VaR modelling approaches, index credit default swap (CDS) contracts are included in the model along with the positions they are intended to hedge. While firms need to consider the risk of potential mismatch between the position and the hedge, to the extent historical prices moved in opposite directions, some offset was implicitly recognised by the model. Under the new proposals, modelling securitisation positions is not permitted and standardised charges will be applied. The benefit of hedges will be recognised for regulatory capital purposes, only if they meet stringent netting criteria. An institution hedging its positions with indices may therefore be required to hold capital against the position and against the hedge. The overall cost this imposes reduces the firm's incentive to hedge or to hold the position in the first place. The correlation trading carve-out recognises the particular case of the correlation trading business, and firms can include eligible positions in the all-price risk measure. Firms will be allowed to include some positions in the all-price risk measure that do not meet the definition of the correlation trading portfolio, but that hedge correlation trading positions. The degree to which firms will be able to do this and the level of regulatory capital benefit they will gain is currently unclear.

6.35 Relative to the baseline (i.e. without policy change), the comprehensive risk measure (CRM) will increase capital requirements for correlation trading positions even for those meeting the correlation trading carve-out criteria. Demand for correlation trading products has declined since the height of 2006/07 and firms have indicated that the market is evolving towards more standardised uniform (index tranche) products. Higher capital charges are likely to further reduce activity in these products. Theoretically, such an outcome could reduce liquidity of simpler credit derivatives and make some banks' credit risk management more expensive, which eventually could increase the cost of borrowing for consumers and businesses. However, the strength of this transmission channel from credit derivatives markets to the real economy is unclear. We are currently visiting firms that wish to use the all-price risk measure. As part of our review of firms' models, we will obtain data on the extent to which firms wish to include hedging positions in their all-price risk models.

6.36 Finally, the fixed costs involved in developing new risk models (stressed VaR, CRM) could increase the barriers to entry and make it more difficult for new players to enter businesses for which those models are necessary. This could have an adverse impact on competition in the market.

Benefits

6.37 As we explained in CP09/29, the recent financial crisis has revealed shortcomings in the way capital requirements for trading book positions are currently calculated. The framework did not appropriately capture certain risks and resulted in capital requirements against market risk being small relative to the size of trading activities for some markets.[39] By mitigating the shortcomings of the current framework and increasing capital requirements against trading book positions, the proposals will make firms with significant trading activities more robust to severe market downturns and reduce the expected cost of their individual failure and of systemic crisis.

6.38 Standard VaR models failed to capture the danger of low probability high-impact tail events. Pre crisis, capital against future losses was estimated using data from the recent past, and could suggest to individual banks that the risks facing them were low at the very point when, at the total system level, they were most extreme. Adding a calculation based on a period of extreme stress will mitigate procyclicality, as well as increasing the level of capital requirements. While other widely recognised problems to VaR models are already being addressed by firms, a risk remains that the misleading methodology will still be applied to reduce capital requirements. The improvement in modelling standards detailed earlier in this chapter will mitigate this risk.

39 See Turner Review: *A regulatory response to the global crisis*, March 2009

6.39 The introduction of the IRC will improve market risk frameworks' capture of credit risk and of default on traded debt products. The IRC should capture risks that VaR models, by design, struggle to capture. This is particularly important given the dramatic rise in the trading of credit products since the majority of the market risk framework was designed.[40]

6.40 Most models were not able to accurately capture the risks of complex securitised products. Standardised capital requirements for securitisation exposures will ensure these positions attract higher capital charges on their underlying credit quality. While it is acknowledged that capitalising trading book exposures on the basis of their credit risk is not ideal, the harmonisation of trading book and banking book charges will limit the scope for arbitrage between trading and banking book treatments of such positions.

6.41 The correlation trading carve-out will allow firms to continue modelling these products, but will subject them to a more comprehensive modelling approach than is currently the case. This should lead to a more comprehensive framework for correlation trading products.

6.42 At the market-wide level, by increasing capital requirements against market risk, the proposals will make firms with significant trading activities more robust to severe market downturns and systemic shocks. More capital will reduce firms' leverage, provide them with more 'cushion' against future losses and reduce the probability and expected cost of individual banks failures and systemic crises.

6.43 At a firm level, a reduction in the probability of firms with trading activities failing reduces the expected costs of such events. Apart from the costs of failure to firms' owners and employees, failures may also be costly to other stakeholders. Recent events have shown that the resolution of a failed bank can be costly to taxpayers. Costs are also borne by FSCS levy payers if the cost of resolving a distress situation falls on the FSCS. Further costs of bank failure may arise to borrowers from the distressed bank and its creditors, including depositors.

6.44 At the aggregate level, the new regime will reduce the frequency of systemic financial crises, and the expected cost of such crises. Recent events have shown that the costs of systemic crises can be widely distributed among shareholders, taxpayers and the wider population and can induce a slowdown or actual decline in aggregate real output. Systemic crises arise when the failure (or fear of failure) of a large financial firm causes distress and defaults across the financial system. Since negative shocks in asset markets can stress institutions' balance sheets, increasing capital requirements against trading-book positions should make individual banks less likely to fail and counterparties more confident in each other's solvency. The trading book proposals will therefore reduce the scope for crisis propagation and make the financial system more resilient to shocks in asset markets. In the 'macroeconomic impact' section, we give estimates of this benefit for a realistic calibration of the Basel package.

40 The majority of the current market risk framework was introduced in the 1996 market risk amendment.

BIPRU 7.11

Summary

6.45 The additional capital requirement imposed by the BIPRU 7.11 rules was not considerable and we felt that the incremental capital benefit did not justify the computational burden placed on firms.

Background

6.46 When we implemented the CRD, we introduced a set of rules for calculating the capital requirements for credit derivatives in the trading book. These rules are set out in BIPRU Chapter 7.11. These rules are super-equivalent to the CRD, which would otherwise require credit derivatives to be treated under BIPRU 7.2 (interest rate risk in the trading book). In BIPRU 7.11, we introduced separate treatments for single-name and securitisation credit derivatives.

6.47 In CP09/29, we agreed that, because the amount of capital required by the directive minimum for securitisation credit derivatives is changing, it was appropriate to investigate whether we should continue to have super-equivalent rules. We agreed to undertake a quantitative impact study on the costs and benefits of retaining our super-equivalent rules compared to the new directive minimum, and use this to inform our policy decision. This section provides some background on the costs and benefits of our quantitative impact study.

Capital costs, scope and markets affected

6.48 With the introduction of CRD3, the BIPRU 7.11 rules would affect the trading book in two areas:

- the capital charge for non-correlation trading securitisation positions; and
- the calculation of the floor for correlation trading positions.

6.49 We found that the super-equivalent rules are not binding for non-correlation trading securitisation positions. In calculating the correlation trading portfolio floor, however, our findings are inconclusive. We found situations where BIPRU 7.11 rules bind, i.e. the capital required under those rules is higher than the directive minimum and vice versa.[41]

6.50 Due to the limited set of firms where the BIPRU 7.11 rules apply in the correlation trading portfolio, it is challenging for us to provide numerical data to support our findings without revealing firm sensitive information. We estimate that the cost of holding the additional capital required by the BIPRU 7.11 credit derivative rules may be in the region of £5m to £10m per firm per annum, based on a cost of capital of 4.9%.

41 The less conclusive findings, compared to non-correlation trading securitisation positions, reflect differences in the directive minimum rules for correlation trading portfolios and non-correlation trading securitisations. For example, the standardised capital charge for the correlation trading portfolio is the higher of the net long positions capital charge and the net short positions capital charge regardless of whether the BIPRU 7.11 rules or the directive minimum risk weights apply.

Non-capital compliance costs

6.51 There are a number of firms that will be forced to calculate the BIPRU 7.11 capital charge, but do not find it binding since the securitisation risk weights are already relatively conservative. For these firms and others, there are compliance costs associated with developing and maintaining systems for calculating the BIPRU 7.11 charges, which we recognise, due to the complexity of the BIPRU 7.11 rules, are not insignificant.

Benefits

6.52 The BIPRU 7.11 rules provide an additional risk-based approach, because they capture both credit and market risk, whereas the directive minimum approach only captures credit risk. Under Pillar II we have the discretion to adjust capital levels to reflect these risks if required.

Q14: Do you agree with the Trading Book CBA?

Securitisation

Introduction

6.53 This CBA updates the analysis presented in CP09/29 for the costs and benefits of the CRD2 Article 122a and CRD3 policy changes.

6.54 Here we discuss the areas where we expect the guidelines to change our original assessment of the costs and benefits of Article 122a. Using the results of the BCBS Comprehensive QIS, we evaluate the costs that will fall on firms as a result of implementing the new CRD3 rules on re-securitisation and own unfunded support. We also look at the indirect market impact of these provisions. We then examine the benefits to the industry and the wider economy of the new requirements.

6.55 Our analysis of the CRD3 changes is based on:

- the results of the BCBS QIS;
- discussions with firms and other market participants;
- the examination of our previous CPs and the data behind them; and
- input from policy, supervisory and other experts within the FSA.

6.56 We are grateful to firms and other parties that have provided input to this CBA.

CRD2 Article 122a guidelines

6.57 In CP09/29, we set out our CBA for the new requirements of Article 122a. Our CBA was based on a range of sources, including a literature review, regulatory returns and responses to a survey. The survey was completed by a sample of 21 firms, including large banking institutions, as well as some smaller firms and was completed on the basis of the Article 122a Directive text alone.

6.58 Further to the publication of the CEBS Article 122a guidelines, there is now greater clarity about how the Directive requirements should be complied with in practice. In the paragraphs below, we consider the expected impact of the guidelines on our original assessment in CP09/29 of the costs and benefits of Article 122a.

Areas of Article 122a where we expect the CEBS guidelines to potentially increase the costs estimated in CP09/29

Applying Article 122a at group level

6.59 The Article 122a guidelines clarify that a credit institution will become exposed to the credit risk of securitisation positions by virtue of the activities of any related entity that falls within the same scope where consolidated supervision is applied. In addition, the economic substance of the requirements (e.g. no hedging) should be respected at consolidated level as well as solo level.

6.60 The guidelines, and our adoption of them via proposed BIPRU requirements, are likely to increase costs to firms in circumstances where they had previously interpreted the Directive requirements as applying exclusively to EU credit institutions at a solo level, as opposed to at a group level in circumstances where there is an EU credit institution within the group. Furthermore, the application of Article 122a to entities supervised by non-EEA authorities that are within the relevant scope of group application may require compliance in circumstances where different retention requirements are required by the home supervisor. For example, several UK credit institutions have US broker-dealer subsidiaries who may invest in US securitisation transactions, and who may be captured within group application of Article 122a. By virtue of provisions to be implemented under US legislation, differing retention requirements may apply for the same US transactions, potentially leading to increased operational costs. Potentially, in some cases, it may not be possible for non-EEA subsidiaries within a credit institution's group to invest in securitisation positions that comply with both Article 122a and the local requirement. This may reduce the liquidity of the global market for securitisation.

6.61 Where conflicting requirements apply, we propose to allow credit institutions to apply for a waiver of the new BIPRU requirements in certain circumstances, specifically for their non-EEA subsidiaries. Should a firm be granted a waiver (following satisfaction of the waiver statutory tests in FSMA s148), we would expect the potential costs of conflicting Article 122a and non-EEA requirements to be mitigated to a significant degree.

6.62 In respect of non-EEA entities, to the extent local authorities have introduced similar requirements to those in Article 122a that do not conflict with Article 122a, the incremental impact of the Article 122a provisions should be reduced as costs would be incurred in complying with the local requirements, even in the absence of Article 122a.

6.63 To determine the cost to firms of applying Article 122a on a group basis, we considered the FSA046 securitisation data submitted by firms that also responded to our CP09/29 survey. We used these regulatory returns to calculate the percentage difference between the total securitisation exposure value at solo versus group level for each firm. We extrapolated this result to responses provided by firms in our CP09/29 survey to estimate the costs to firms of applying Article 122a requirements on a consolidated basis. Our analysis indicates that applying Article 122a at group level could increase major firms' average due diligence costs estimated at the solo level (circa £210,000 one-off and circa £180,000 per annum ongoing) by around £100,000 for one-off costs and £90,000 for ongoing costs.

Credit analysis and risk assessment (Paragraph 4 of Article 122a)

6.64 The guidelines supplement the Directive text with further detail on the nature of credit analysis and risk assessment that firms would be expected to undertake to ensure they had a comprehensive and thorough understanding of the risk profile of their investments in securitised positions.

6.65 For those firms that intended to apply lower due diligence standards than those prescribed by the guidelines, ongoing due diligence compliance costs could be higher than the cost estimates reported in CP09/29 (these estimates were around £300,000 per annum for an individual firm with over £500 billion of assets and around £5,000 to £10,000 per annum for an individual firm with less than £500 billion of assets).

Disclosure on loan level data (Paragraph 7)

6.66 The guidelines clarify that providing information on 'individual underlying exposures' would typically require loan level data to be disclosed, unless this may be inappropriate, for example, when the granularity of the pool of exposures being securitised was very high and provided loan level disclosure was not a material necessity for due diligence. For the market participants who had interpreted the Directive text as not requiring this level of disclosure, the guidelines may generate additional costs to originator and sponsor credit institutions relating to the collection and distribution of such data.

Areas of Article 122a where we expect the CEBS guidelines to potentially reduce the costs estimated in CP09/29

Use of the retained interest for secured funding purposes (Paragraph 1)

6.67 In clarifying that it is possible for the party retaining the net economic interest to use the retained interest for secured funding purposes (provided that the credit risk of the retained exposures is retained), the guidelines may reduce costs to certain firms. Firms may be able to obtain additional funding at a lower cost than via unsecured funding and, as a result, reduce their cost of capital by diversifying their sources of funding.

Correlation trading portfolios (Paragraph 3)

6.68 The guidelines clarify that 'transactions based on a clear, transparent and accessible index' would typically have an equivalent scope to the securitisation positions eligible to be included in a 'correlation trading portfolio', as defined in the CRD. This clarification may reduce any uncertainty around the scope of the exemption from the retention requirement. This may benefit investors with correlation trading portfolios as it may increase the certainty that they are investing in Article 122a compliant transactions.

Correlation trading portfolios (Paragraph 4)

6.69 The guidelines provide scope for firms to potentially satisfy their Article 122a obligations for correlation trading portfolios by meeting their obligations under CRD3, provided this results in the firm ensuring that it has a comprehensive and thorough understanding of the risk profile of its investments in the securitised positions. The elimination of any potential duplication of due diligence in this area has the potential to reduce costs.

Credit granting standards (Paragraph 6)

6.70 The guidelines elaborate what is meant by applying 'sound and well defined' criteria. The guidelines clarify that Paragraph 6 does not require firms to fully homogenise credit granting standards but rather to ensure that exposures to be securitised are not subject to a sub-standard level of credit granting relative to exposures to be held on balance sheet. For those firms that did not interpret the Directive as providing such flexibility in the credit-granting process, the clarification in the guidelines could reduce the costs of compliance with the Directive.

6.71 More generally, the guidelines set out the key issues that EU competent authorities will take into consideration when assessing firms' compliance with the Directive. To the extent that this better enables firms to demonstrate to competent authorities that they have satisfied their Directive obligations, this should reduce the likelihood of additional risk weights being imposed on firms for non-compliance with the Directive.

Areas of Article 122a where we expect the CEBS guidelines to potentially increase the benefit estimated in CP09/29

6.72 Generally speaking, we would expect the guidelines to generate benefits by facilitating the convergence of supervisory practices across the EU with regard to Article 122a. This should result in more consistent application of Article 122a across the EU which should reduce the barriers to cross-border securitisation activity in the EU and contribute to the deepening of the EU single market in financial services.

Applying Article 122a at a group level

6.73 Applying Article 122a at a group level, rather than on a solo basis, should produce benefits by reducing the potential for regulatory arbitrage. If the requirements of Article 122a only applied when the credit institution itself acts as originator, sponsor or investor (i.e. on a solo basis), then a clear avoidance mechanism is available (as set out in paragraph 3.45). This represents an undermining of the intent and rationale behind Article 122a – to increase confidence in the securitisation activities of EU banking groups and in turn help revive the market on a sounder basis. Applying Article 122a on a group basis is therefore beneficial as it serves to remove this potential arbitrage opportunity.

Applying the retention requirements (Paragraph 1)

6.74 The guidelines provide additional clarification on applying the retention requirement to securitisation structures where it is difficult to identify the entity that is best placed to retain the net economic interest to both align incentives and comply with the Directive. The additional flexibility provided by the guidelines should have benefits in circumstances where firms would have found it difficult to structure transactions to comply with Article 122a under a strict reading of the Directive only. The benefits should result from greater liquidity in the market for these types of securitised products as a result of EU credit institutions having greater confidence that they will potentially be able to invest in such transactions in compliance with the Directive.

Improved due diligence practices (Paragraph 4)

6.75 Should the guidelines result in a higher standard of due diligence practices being performed, this should benefit firms by reducing the likelihood of them becoming exposed to risk which they do not understand and are unable to effectively manage. This should benefit society more widely by reducing the risk of firm failure and the consequential impact on deposit guarantee schemes and government funds.

Clarification on the computation of additional risk weights for material non-compliance (Paragraph 5)

6.76 The guidelines clarify the methodology for calculating additional risk weights to be imposed for material non-compliance with Article 122a. The additional risk-weight formula should generate benefits by increasing the likelihood that additional risk weights will be imposed in a consistent manner across different member states.

Disclosure on individual underlying exposures (Paragraph 7)

6.77 By clarifying that the disclosures by originators and sponsors of materially relevant information on 'individual underlying exposures' should typically be at a granular level, the guidelines might further reduce information asymmetries between originators/ sponsors and investors. This would in turn increase the effectiveness of market discipline exerted by investors and should reduce the scope for moral hazard in the activities of originators and sponsors.

Clarifying the scope of securitisations covered by Article 122a (Paragraph 8)

6.78 The guidelines make clear the scope of securitisations that will be subject to Article 122a. Given our understanding that there was uncertainty among market participants with regard to the scope of positions covered by Article 122a, this additional clarification should result in benefits as potential investors will have greater certainty about whether the provisions of Article 122a apply to their proposed investments, which should potentially increase the liquidity of securitised products.

CRD3 changes

Costs to firms from increased capital requirements

6.79 In CP09/29 we set out estimates of the costs of increased capital requirements for different securitisation proposals, namely:

- increased risk weights for re-securitisations (CRD3);
- underwriting (CRD2);
- removal of the 6% risk weight for most senior positions (CRD2); and
- increased conversion factors for liquidity facilities (CRD2).

6.80 These estimates were compiled from the responses to a survey undertaken in September 2009 and sent to a sample of 21 UK firms, which included large UK banking groups, as well as smaller institutions. The impact of the own unfunded support provisions was not estimated in CP09/29. However, data received from firms in the Basel QIS indicated that these provisions may have a material impact. We have therefore considered the potential impact in this CBA.

6.81 The QIS assessed the impact of the changes to the BCBS securitisation framework set out in the 'Enhancements to the Basel II Framework' document published in July 2009. These changes are intended to strengthen the securitisation framework and respond to lessons learned from the financial crisis, and can be summarised as follows:

- increased risk weights for re-securitisations;
- own unfunded support;
- due diligence; and
- liquidity facilities.

6.82 This CBA analyses the QIS data for the two Basel amendments introduced in CRD3: the higher risk weights for re-securitisations and own unfunded support.

Increased re-securitisation risk weights

Direct costs

6.83 The responses to the survey conducted in CP09/29 indicate an additional capital requirement for the industry of approximately £3.6 billion, which would result in an upper-bound cost to firms of around £170m per year. The CP09/29 CBA indicated that none of the £3.6 billion cost was attributable to underwriting requirements (as sampled firms stated that they had already met this condition) or increased conversion factors for liquidity facilities. Only £6.7m could be attributed to the removal of the 6% risk weight. Therefore, a very high proportion of the £3.6 billion cost identified in CP09/29 could be attributed to the impact of the higher re-securitisation risk weights.

6.84 We have considered the data submitted by 11 UK banks and building societies who reported holdings of securitisation positions in their QIS submission. We have used this data to update our CP09/29 estimates of the capital impact of the re-securitisation risk weights. This data indicated that 24% of the exposure value of the sample firms' securitisation positions will be classified as re-securitisation positions under the CRD3 definition of re-securitisation. At a firm-specific level this figure varied between 0% and 51.6%. The QIS data indicates that the additional capital requirement resulting from the new re-securitisation risk weights will be approximately £1.35 billion for the 11 firms in the sample. The sample firms held 83% of the total exposure value of securitisation positions held by UK banks and building societies at the time of the QIS submission. Like in CP09/29, these estimations are an upper-bound and do not take into account the fact that, in practice, firms may alter the composition of their asset holdings, which could give rise to a smaller increase in capital requirements.

6.85 The latest estimations based on the QIS are £2.25 billion lower than our initial estimates for CP09/29. This can potentially be explained by the following two factors:

- The difference in the sample of firms who participated in the Basel QIS compared to the CP09/29 CBA with the QIS involving a narrower sample of 11 firms compared to the 21 firms surveyed for CP09/29 (albeit the firms who participated in CP09/29 and not in the QIS did not report a material increase in capital requirements as a result of the increased re-securitisation risk weights).
- As stated in footnote 76 in CP09/29, firms' CP09/29 estimates of the capital cost of increased risk weights for re-securitisation positions were based on 'best efforts using conservative estimates due to the uncertainty around exactly what exposures will meet the definition of re-securitisation'. We believe that firms may have more accurately categorised their existing securitisation positions into securitisation and re-securitisation positions for the purposes of the QIS compared to the CP09/29 CBA.

Indirect market impact

6.86 As stated in the CBA in CP09/29, higher capital requirements may lead some firms to exit the re-securitisation market and sell their positions. Assuming other regulated firms took the same action, this could lead to illiquidity and a downward price spiral in certain assets, stressing further some banks' balance sheets. However, given the contribution of re-securitisation products to the recent crisis, even if it can be argued that some products were creating liquidity in underlying ABS, it is not clear that a reduction in the size of this market would bring net economic costs, particularly in circumstances where it was previously economically rational for firms to invest in such positions only because of their low capital requirements, which did not accurately reflect their risk of losses.

Unfunded support

6.87 Data was not collected on the impact of unfunded support in CP09/29. Analysis of the data submitted by the 11 UK firms under the Basel QIS exercise indicates that the own unfunded support provisions should account for a non-material amount of the estimated CRD3 capital increase.

6.88 This assessment is based on our understanding that the majority of firms sampled in the QIS adopted a narrow interpretation of the own unfunded support provisions, under which they only apply to liquidity facilities providing credit enhancement to ABCP conduits. We have chosen to include only these firms[42] in our estimation because while we consider that the potential scope of the requirements is not limited to only liquidity facilities provided to ABCP conduits, we do consider that only support that provides credit protection to a position would be within scope, as we set out in paragraphs 3.19 to 3.37 and our proposed BIPRU guidance.

6.89 We also note that, where the unfunded support provisions do apply, the requirement to treat the relevant securitisation positions as unrated does not necessarily mean the position will need to be 1,250% risk weighted or deducted from capital resources. This is likely to mitigate the impact of the unfunded support provisions.

FSA046 reporting

6.90 We set out the expected incremental costs of changes to FSA046 in paragraph 5.76 of CP09/29. The draft FSA046 report on which our CBA was based included the new data elements required to capture information on re-securitisation positions. We do not therefore expect any incremental cost above that identified in CP09/29 for reporting re-securitisation positions.

6.91 The amendment to the positioning of the section title 'Transaction level information – Where the firm is an originator or sponsor' clarifies the existing scope of the FSA046 data elements and should not result in any incremental costs.

6.92 We expect there will be some incremental costs to standardised firms resulting from systems changes and providing information on their use of the 'concentration ratio' (BIPRU 9.11.6R) to calculate their capital requirements for unrated securitisation positions. However, we expect that the use of BIPRU 9.11.6R is limited to a relatively narrow set of circumstances, which will limit the cost of providing the information. We would also expect firms to already have this information as part of their ongoing risk monitoring and to calculate their regulatory capital requirements. We will benefit from receiving this information as it will improve the quality of our data on, and understanding of, the treatment of unrated securitisation positions by standardised firms.

42 We have excluded any firm that may have employed a much wider interpretation covering all unfunded support that impacts the credit assessment, regardless of whether the support provides credit protection.

Benefits

6.93 The CRD3 policy changes for re-securitisation and own unfunded support will bring benefits to firms and society by mitigating market or regulatory failures. Specifically, by increasing capital requirements against more complex and leveraged products, such as re-securitisation, the provisions should make the firms holding these positions more robust to losses on these exposures. More capital will provide firms with more of a 'cushion' against future losses. At a firm level, a reduction in the probability of firms failing as a result of inadequate capital held against credit risk reduces the expected costs of such events. At the aggregate level, the new regime should contribute to reducing the frequency of systemic financial crises and the expected costs of such crises.

Costs to the FSA

6.94 In CP10/17, we set out our expected costs from monitoring firms' compliance with Article 122a. We estimated that our review costs were unlikely to exceed £125,000 per annum, but that the exact figure would be dependent on the nature of the supervisory review methodologies adopted in CEBS. We note that discussions around Article 122a supervisory review are ongoing at an EBA level, but we continue to believe that £125,000 per annum will represent an upper bound to our likely costs of review.

6.95 The clarification in the guidelines that Article 122a applies at a group level should not impact on our costs estimate as our original figure was based on our reviewing compliance with the requirements at group level. The formula in the guidelines for calculating additional risk weights for material non-compliance with the Directive should reduce our costs as it will reduce the time required to address non-compliance.

6.96 We do not expect any change to the costs to the FSA set out in CP09/29 from the CRD3 provisions.

> **Q15:** Do you agree with the Securitisation CBA?

Macroeconomic impacts

6.97 In this section, we consider the macroeconomic impacts of the proposals.

Banks' behaviour

6.98 The trading book and securitisation policy initiatives described above will have a significant impact on capital requirements and the total value and the balance of risk weighted assets held by banks. Our OP36 analysis indicates that banks adjust approximately 50% of their new capital requirements by reducing their risk-weighted assets, while the remaining shortfall is matched by increasing the level of total capital. Our approach considers changes in bank behaviour and adjustments to balance sheets other than dividends.

Capital increase and benefits

6.99 We estimate that the measures included in this package (trading book and securitisation) translate into an increase of UK bank capital by 1.54%, contributing to the stability of the UK banking system. This increase will happen over a period of time between the trading book measures announcement and the final implementation date. Recent data indicates that banks are adjusting ahead of the measures holding sizable buffers above current capital target levels. These adjustments are related to several factors: the current overall supervisory requirements; expectations of future higher prudential standards; and the currently poor economic environment. We are unable to say how much of this adjustment is attributable to each factor.

6.100 Since the trading book and securitisation policy initiatives form part of larger CRD and Basel initiatives it is not possible to separate capital buffer increases due to the trading book package from provisions made due to non-trading-book initiatives. This also implies that it is not possible to disentangle the economic benefits of the trading book from other prudential measures part of the overall package. In addition, there are still uncertainties about the overall package and discussions continue to develop among international supervisory bodies. Our current calibration includes: Basel III minima, buffers and definition of capital; changes to trading book and re-securitisation requirements in the CRD2; increases in counterparty credit risk in the calculation of RWAs; the introduction of a systemic surcharge; and the introduction of liquidity coverage ratio. The assessment of the overall package indicates that the economic benefits correspond to a perpetual annualised increase of GDP of £17.2 billion. Further refinements to the estimates presented in this section on macroeconomic impacts, and the details of the methodology used, are described in our forthcoming Occasional Paper.

Economic costs

6.101 Our model assumes that banks recover the additional cost of capital by increasing borrowing charges to consumers relative to deposit rates. This and the adjustment of banks' assets towards lower risk will result in economic costs through lower investment. We estimate the economic costs of the trading book and securitisation proposals amount to a perpetual annualised loss of GDP £1.2 billion.

6.102 We also estimate the cost of the overall Basel package will be equivalent to a perpetual annualised loss of GDP £6.4 billion. This cost arises from banks adjusting assets, capital levels, lending mix and charges in response to all the measures in the package and include the trading book costs. We estimate the benefits of the overall Basel package will be equivalent to a perpetual annualised gain of GDP £17.2 billion. We therefore estimate that the net benefits of the overall package correspond to a perpetual annualised increase of GDP £10.8 billion.

Further details on the cost of incremental capital

6.103 In this section, we detail our approach to calculate the cost of the incremental capital we expect firms to raise (4.9%). We use this to estimate the capital compliance costs of certain policy proposals described in this CP. The approach is similar to the one we also used in CP09/29.

6.104 The methodology assumes that, to increase their capital ratio, banks substitute some of existing debt funding, with more expensive equity funding. Multiplied by the amount of equity to raise, the difference between the cost of these alternative funding sources gives an estimate of the incremental capital compliance costs of the relevant policy. We therefore call this difference between the cost of equity and the cost of debt, the cost of incremental capital.

6.105 As we explained in CP09/29, the cost of incremental capital calculated this way should be seen as an upper bound. Indeed, the analysis conservatively assumes that firms' cost of debt will not adjust downwards to reflect their lower leverage. In fact, when firms are required to hold a greater proportion of their liabilities as equity, the Modigliani-Miller Theorem would suggest that the cost of increasing the proportion of equity funding would be exactly offset by a reduction in the cost of debt (since debt holders are now more secured). However, as we explained in DP09/04, *Turner Review Conference Discussion Paper*, empirical evidence often finds that firms' average cost of funding does increase when regulatory capital requirements increase. Reasons for this may include the different tax treatment of debt versus equity or the fact that the cost of debt funding for banks is insensitive to capital levels because of the existence of explicit deposit insurance guarantees and implicit assumed guarantees arising from observing past government rescues of troubled institutions. The actual extent of the increase in firms' cost of capital is difficult to assess.

6.106 We estimate bank's cost of equity and cost of debt by considering widely used banks indices. The cost of equity is estimated with the Capital Asset Pricing Model (CAPM). We use the FTSE 350 Banks index to obtain an estimate of banks' beta. The cost of debt is based on the redemption yield of the iBOXX Corporate Banks index.

6.107 With CAPM, the cost of equity (KE) is given by:

$K_E = R_f + \beta * ERP$ where

- R_f is the return on risk-free asset. It is measured using ten-year nominal spot rate from Bank of England yield curve data. A maturity of ten-years was chosen because:

- it matches the average life of bonds in the IBOXX index reasonably well, providing a reasonably consistent comparator for the cost of debt measure used in the model; and
- it was assumed that equities investors into banks would have a relatively long investment horizon – this assumed long-term investment horizon is also consistent with the use of a long period to historically estimate the equity market risk premium.

- R_m is the market return estimated by the monthly total returns on the FTSE All share index.
- ERP is the equity market risk premium calculated as the average of the monthly difference between R_m and R_f over the period from January 1970 to December 2010. Considering a long-term average for the ERP reduces the impact of its volatility.
- β is the beta estimate measuring the relative risk of returns on a UK bank portfolio (FTSE 350 Banks index) to market returns (FTSE All Share index). It is derived by taking the average over the period from August 2004 to December 2006 of the slope coefficient obtained when regressing (linearly) banks return (FTSE 350 Banks index) on market returns (FTSE All Share).[43] The betas have been measured using monthly returns over the previous five-year period.

Table 4: Cost of equity – variables summary

	Definition	Data	Period	Source	Value
R_f	Risk free rate	UK nominal ten year spot rate	Jan 70 – Dec 10	Bank of England (BoE)	Average for the period (1998-2007): 4.63%
R_m	Market return	FTSE all share total returns	Jan 70 – Dec 10	Datastream	n/a
ERP	Equity risk premium	Geometric average of the monthly (R_m - R_f)	Jan 70 – Dec 10	BoE/Datastream	5.68%
β	Beta	Average of monthly rolling beta (estimated on the previous 5 years of returns.	Aug 04 – Dec 06	Datastream	1.21
K_E	Cost of equity				11.50%

6.108 The cost of debt (KD) is estimated by calculating the average of the daily IBOXX Banks Sterling Bond index redemption yields, adjusted to a ten-year term using data for a period from January 1998 to December 2010.

43 Specifically, we used the following:

$R_{bt} = \alpha_b + \beta_{bt} (R_{mt})$, where

R_{bt} = return on stock of bank b (or bank portfolio) in month t;

R_{mt} = return on the market portfolio in period t;

α_b = regression intercept for bank stock b; and

β_{bt} = beta for bank stock b (or bank portfolio).

6.109 The IBOXX Banks Sterling bond index represents a portfolio of bonds issued in sterling by international banks.[44] The inclusion of bonds issued from non-UK banks in the index, may include bonds with lower credit ratings than those issued by UK banks, which may make the IBOXX banks bond index an overestimate of the cost of debt to UK banks. This is consistent with the fact that during the 'pre-crisis' period the IBOXX banks yield is higher (by about 30bp) than that of an index of AA-rated bond indices.

Table 5: Cost of debt – variable summary

	Definition	Data	Period	Source	Value
K_D	Cost of debt	iBoxx Banks Bond	Jan 98 – Dec 10	Datastream	6.60%

6.110 Finally, the cost of incremental capital is estimated by taking the difference of the above estimates of banks' cost of equity and banks' cost of debt. We obtain a value of 4.9%.

$$K_I = K_E - K_D$$

Table 6: Cost of incremental capital – summary variable

	Definition	Value
K_I	Cost of incremental capital	4.89%

6.111 Our final estimate considers indices rather than individual banks. It does not make adjustments for bank's capital structure. The index approach assumes that all banks have a similar capital structure. Typically, changes in banks' capital structure can influence the volatility of their stock returns. All else being equal, a bank with higher equity faces less risk than an otherwise identical bank with lower equity. So increasing equity should lower a bank's beta and as a result its cost of equity. This would reduce the difference between the cost of equity and the cost of debt. In ignoring this potential impact on cost, the model further overstates the cost of incremental capital for banks.

44 The FTSE financials bond index was also considered, but IBOXX was preferred because it focused specifically on banks.

Annex 1

Compatibility with our objectives and the principles of good regulation

Introduction and statement of purpose

1. This annex sets out how the implementation proposals within this CP, for CRD3 and CEBS guidance in relation to operational risk, are compatible with our objectives and the principles of good regulation.

Compatibility with our statutory objectives

2. Our planned implementation of the changes proposed in this CP and the set of draft Handbook text that accompanies it, meet our statutory objectives of:

- market confidence;
- consumer protection; and
- financial stability.

3. The draft Handbook text is not aimed particularly at promoting public awareness or at reducing financial crime.

Market confidence

4. This objective requires us to maintain confidence in the UK financial system. Our draft Handbook rules and guidance in the areas covered by this CP seek to reduce the risk of market disruption arising from financial failure of an authorised firm or group of firms. This is achieved by:

- Making the relevant parts of the prudential framework more risk sensitive by strengthening capital requirements in the trading book and for securitisations and re-securitisations in the non-trading book.
- Upgrading disclosure standards for securitisation exposures and requiring enhanced public disclosures under Pillar 3 of the capital framework.
- Providing our implementation approach to the CEBS guidelines, to foster a common understanding among the competent authorities across the EEA on the implementation and application of Article 122a. This will create more transparency for market participants to assist compliance by credit institutions with the relevant requirements of the Directive.

Consumer protection

5. The proposed (CRD) changes seek to align the capital held by firms within the scope of the CRD more closely to the risks arising from their business profile and the strength of their systems and controls. We expect that the enhancements made to the prudential framework for these firms as a result of the changes the CRD requires will make it less likely that they fail, and the guidelines elaborated in this CP will help. This should have positive outcomes for consumer protection.

Financial stability

6. The CRD aims to ensure the financial soundness of credit institutions by stipulating how much of their own financial resources such firms must have to cover their risks and protect their depositors. This legal framework needs to be regularly updated and refined to respond to the needs of the financial system as a whole. The proposals therefore address some of the lessons learned from the credit market turmoil, follow up on aspects of our Turner Review publications, focus on meeting our market confidence objective by reducing the risks that financial market firms face and, overall, improve stability in the financial sector as a whole by contributing to the protection and enhancement of the UK financial system.

Compatibility with the need to have due regard to the principles of good regulation

7. Under section 2 (3) of FSMA, we must consider the specific matters set out below, when carrying out our general functions.

Efficiency and economy

8. Publishing this CP allows the industry time to consider and implement the relevant changes to the CRD. Furthermore, the timing enables us to publish, in due course, a Policy Statement (PS) in response to comments from industry and other stakeholders on our implementation proposals and still have the final rules in place by the required date.

9. Our approach to implementation includes the following important elements designed to ensure that we use resources efficiently:

- using 'copy-out' wherever appropriate; and
- taking into account, where appropriate, the decisions and/or work of other regulators and international forums, including preparing guidelines by CEBS, to which we contribute and which has its own consultation process.

Role of management

10. We are required to take account of the responsibilities of those who manage the affairs of firms. The proposed guidelines emphasise the importance of strengthening the principles of sound internal governance, with more specific principles and implementation measures for the identification, assessment, control and monitoring of operational risks in market-related activities.

Principle that a burden or restriction should be proportionate to the benefits, considered in general terms, expected to result from imposing that burden or restriction

11. We have undertaken a cost benefit analysis (CBA) of the material changes to help with this CP. Given the diverse nature of the different policy topics covered in the package of changes as a whole, the results are set out in Chapter 6.

12. The results of the CBA suggest that the costs arising from implementing the Directive changes, even as part of a broader Basel package, are proportionate to the benefits. Furthermore, Annex 2 identifies areas of super-equivalence, ensuring that we pay due regard to this principle in areas where it has discretion.

13. We may have overlooked some of the significant effects of the CBA. Differences of opinion may also rise over the nature and extent of these effects. We therefore welcome the input of respondents in helping us identify such areas.

Desirability of facilitating innovation in connection with regulated activities

14. The changes seek to update, strengthen and align more closely various prudential requirements with the risks that firms face, so the CRD can continue promoting the development of strong risk management techniques, which should improve the efficiency of capital allocation. This should also facilitate innovation for risk management and product development.

International character of financial services and markets and the desirability of maintaining the competitive position of the UK

15. Our intention is to adopt a predominantly 'copy-out' approach to implementing changes to the CRD in the UK. In areas where we propose to be super-equivalent, as listed in Annex 2, we have taken account of the competitive implications between firms based in the UK and in other countries. We also continue to work in CEBS to achieve effective implementation, including through its guidelines where appropriate. Annex 3 sets out how we propose to exercise national directions permitted by the CRD.

Need to minimise the adverse effects of competition that may arise from anything done in the discharge of the FSA's functions

16. The CBA indicates that the overall package of proposed changes should not have material adverse effects on competition. However, we remain open-minded and would welcome responses from readers on this matter.

Desirability of facilitating competition between those who are subject to regulation by us

17. The overall effects of the changes should lead to more risk-sensitive capital requirements and promote good risk management. This, in turn, should facilitate more effective competition.

Most appropriate way for us to meet our regulatory objectives

18. We are required to set out why we think our standards are the most appropriate way to meet our obligations. We are required under EU law to comply with CEBS guidance or explain our reasons for not doing so. This CP considers the choices available to us and our reasons for making our proposals in those areas which contain any discretion.

Equality and diversity issues

19. We have assessed that our proposals, which are designed for all credit institutions, do not give rise to discrimination and the proposals are of low relevance to the equality agenda. We would nevertheless welcome any comments respondents may have on any equality issues they believe arise.

Annex 2

Areas of super-equivalence

1. We have identified the following area of super-equivalence, which is set out in more detail in the relevant chapter:

   - Adopting the Article 122a guidelines – Chapter 3.

Annex 3

List of national discretions

1. The changes we are making in this CP implement proposals for the areas of CRD3 for which we have not previously consulted, and consult on CEBS guidance in relation to CRD2 implementation. There are no national discretions applicable.

Annex 4

List of questions in this Consultation Paper

Chapter 2: Trading book

Q1: Do you require any additional guidance concerning the securitisation rules? If so, what specific aspects do you feel require attention?

Q2: Would additional guidance be helpful in applying the capital floor to the APR measure? If so, what specific aspects do you feel require attention?

Q3: Do you believe that we should provide any further stress testing guidance for the correlation trading portfolio over and above that supplied by the BCBS? If so, what specific aspects do you feel require attention?

Q4: Do you believe that the FSA should retain or remove the BIPRU 7.11 rules for securitisation and single-name credit derivatives? Please provide arguments to support your response

Q5: Are the proposed changes to FSA005 and FSA058 clear?

Chapter 3: Securitisation

Q6: Do you agree with our proposed approach to implementing the CRD3 re-securitisation changes?

Q7: Do you agree with our proposed approach to implementing the unfunded support amendments?

Q8: Do you agree with our proposed approach to adopting the CEBS guidelines?

Q9: Is the draft Handbook text clear? Would you find additional guidance useful? Please detail the specific areas and suggested text in your response.

Q10: Do you agree with our interpretation of the final CRD3 text for securitisation?

Q11: Are the proposed changes to FSA046 clear?

Chapter 4: Other CRD3 changes

No questions

Chapter 5: CEBS Guidelines on the management of operational risks in market-related activities

Q12: Are the references to the CEBS guidelines clear?

Q13: Do you agree with our assessment that the requirement for a CBA does not apply as the increase in cost estimates because of these guidelines is negligible or of minimal significance?

Chapter 6: Cost benefit analysis

Q14: Do you agree with the Trading Book CBA?

Q15: Do you agree with the Securitisation CBA?

Appendix 1

Draft Handbook text

CAPITAL REQUIREMENTS DIRECTIVE (HANDBOOK AMENDMENTS NO 3) INSTRUMENT 2011

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 150(2) (Actions for damages);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 31 December 2011.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
General Prudential sourcebook (GENPRU)	Annex B
Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)	Annex C
Supervision manual (SUP)	Annex D

Notes

E. In this instrument, the "notes" (indicated by "**Note:**") are included for the convenience of readers but do not form part of the legislative text

Citation

F. This instrument may be cited as the Capital Requirements Directive (Handbook Amendments No 3) Instrument 2011.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

all price risk measure	(in *BIPRU* 7.10 (Use of a Value at Risk Model)) has the meaning in *BIPRU* 7.10.116AR (Capital calculations for VaR models), which is, in relation to a *business day*, the *all price risk measure* required under the provisions in *BIPRU* 7.10 about *specific risk* for the *correlation trading portfolio*.
correlation trading portfolio	(in *BIPRU* 7) a portfolio consisting of *securitisation positions* and nth-to-default credit derivatives that meet the criteria set out at *BIPRU* 7.2.42AR, or other *positions* which may be included in accordance with *BIPRU* 7.2.42BR.
resecuritisation position	in *BIPRU* 7 and 9, an *exposure* to a *resecuritisation*. [**Note:** *BCD*, Article 4(40b)]
stressed VaR	The stressed VaR measure in respect of *positions* coming within the scope of the *VaR model permission*, calculated in accordance with the *VaR model*, *BIPRU* 7.10 (Use of a Value at Risk Model) and any methodology set out in the *VaR model permission* based on a stressed historical period.

Amend the following as shown.

~~*credit default swap PRR method*~~	~~the *ordinary credit default swap PRR method* or the *securitisation credit default swap PRR method*.~~
~~*clean*~~ *hypothetical profit and loss figure*	(in *BIPRU* 7.10 (Use of a value at risk model) and in relation to a *business day*) the ~~*clean*~~ *profit and loss figure* that would have occurred for that *business day* if the portfolio on which the *VaR number* for that *business day* is based remained unchanged, as more fully defined in *BIPRU* 7.10.111R (Backtesting: Hypothetical profit and loss).
incremental ~~*default*~~ *risk charge*	(in *BIPRU* 7.10 (Use of a value at risk model)) has the meaning in *BIPRU* 7.10.116R (Capital calculations for ~~*VaR models*~~ VaR models), which is in summary, in relation to a ~~business day~~ *business day*, the incremental ~~default~~ risk charge required under the provisions in

	BIPRU 7.10 about *specific risk*, in respect of the previous *business day's* close-of-business *positions* with respect to which those provisions apply.
~~*ordinary credit default swap PRR method*~~	~~the method for calculating the *specific risk* portion of the *interest rate PRR* for credit default swaps that are not *securitisation positions* set out in *BIPRU* 7.11.24R to *BIPRU* 7.11.37R.~~
~~*clean*~~ *profit and loss figure*	(in *BIPRU* 7.10 (Use of a value at risk model) and in relation to a *business day*) a *firm's* actual profit or loss for that day in respect of the trading activities within the scope of the *firm's VaR model permission*, adjusted by stripping out specified items, as more fully defined in *BIPRU* 7.10.100R (Backtesting: Calculating the ~~clean~~ profit and loss).
~~*qualifying equity*~~	~~a *share* that satisfies the conditions in BIPRU 7.3.35R (Definition of a qualifying equity).~~
resecuritisation	~~(in accordance with point 49 of Part 4 of Annex IX of the *Banking Consolidation Directive* (Ratings based method)) *securitisation* of *securitisation exposure* (securitisation having the meaning in paragraph (2) of the definition of securitisation for these purposes)~~ in *BIPRU* 7 and 9, 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*. [**Note:** *BCD*, Article 4(40a)]
~~*securitisation credit default swap PRR method*~~	~~the method for calculating the *specific risk* portion of the *interest rate PRR* for credit default swaps that are *securitisation positions* set out in *BIPRU* 7.11.39R to *BIPRU* 7.11.53R.~~

Annex B

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex underlining indicates new text and striking through indicates deleted text.

1.3.3 G (1) In the case of a *BIPRU firm*, this section implements Article 74 of the *Banking Consolidation Directive*, ~~Article~~ Articles 64(4) and 64(5) of the *Banking Consolidation Directive* (Own funds) and Article 33 and Part B of Annex VII of the *Capital Adequacy Directive*.

…

…

1.3.13 R (1) Except to the extent that *GENPRU*, *BIPRU* or *INSPRU* provide for another method of valuation, *GENPRU* 1.3.14R to *GENPRU* 1.3.34R (Marking to market, Marking to model, Independent price verification, ~~Adjustments~~ Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves) apply:

…

…

(3) Systems and controls under (2) must 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, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month-end and ad-hoc verification procedures, and, in the case of a *BIPRU firm*, guidelines for the use of unobservable inputs reflecting the *firm*'s assumptions of what market participants would use in pricing the *position*; and

…

…

1.3.16 R (1) …

(2) When calculating the current *exposure* value of a credit risk *exposure* for *counterparty credit risk* purposes:

…

(b) where the difference between the more prudent side of bid/offer and the mid-market price is material, the *firm* must consider making adjustments or, in the case of an *insurer* or a *UK ISPV*, making adjustments or establishing reserves.

General requirements: Marking to model

1.3.17 R Where marking to market is not possible, a *firm* must (in the case of a *BIPRU firm*, conservatively) use mark to model in order to measure the value of the investments and positions to which this *rule* applies under *GENPRU* 1.3.13R and *GENPRU* 1.3.38R to *GENPRU* 1.3.41R. Marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. *GENPRU* 1.3.18R to *GENPRU* 1.3.25R apply when marking to model.

…

General requirements: Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves

1.3.29 R The recognition of any gains or losses arising from valuations subject to *GENPRU* 1.3.13R and *GENPRU* 1.3.38R to *GENPRU* 1.3.41R must be recognised for the purpose of calculating *capital resources* in accordance with *GENPRU* 1.3.14R to *GENPRU* 1.3.34R (Marking to market, Marking to model, Independent price verification, ~~Adjustments~~ Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves). However, if *GENPRU*, *BIPRU* or *INSPRU* provide for another treatment of such gains or losses, that other treatment must be applied.

1.3.30 R A *firm* must establish and maintain procedures for considering valuation adjustments or, in the case of an *insurer* or a *UK ISPV*, valuation adjustments or reserves. These procedures must be compliant with the requirements set out in *GENPRU* 1.3.33R.

…

1.3.32 R A *firm* must consider the need for making adjustments or, in the case of an *insurer* or a *UK ISPV*, establishing reserves for less liquid positions and, on an ongoing basis, review their continued appropriateness in accordance with the requirements set out in *GENPRU* 1.3.33R. Less liquid positions could arise from both markets events and institution-related situations e.g. concentration positions and/or stale positions.

1.3.33 R (1) …

(2) A *firm* must consider the following adjustments or, in the case of an *insurer* or a *UK ISPV*, adjustments or reserves: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where appropriate, model risk.

(3) (a) In the case of a *BIPRU firm*, a *firm* must establish and maintain procedures for calculating adjustments to the current valuation of less liquid positions. Those adjustments must, where necessary, be in addition to any changes to the value of the position required for financial reporting purposes and must be designed to reflect the illiquidity of the position.

(b) A *firm* must consider several factors when determining whether a valuation adjustment or, in the case of an *insurer* or a *UK ISPV*, valuation adjustment or reserve is necessary for less liquid positions. These factors include the amount of time it would take to hedge out the position/risks within the position; the average and volatility of bid/offer spreads; the availability of market quotes (number and identity of market makers); the average and volatility of trading volumes; market concentrations; the ageing of positions; the extent to which valuation relies on marking to model and the impact of other model risks.

(4) With regard to complex products including, but not limited to, *securitisation exposures* and nth-to-default credit derivatives, a *BIPRU firm* must explicitly consider the need for valuation adjustments for model risk arising from using a valuation which may be incorrect or the risk from using unobservable calibration parameters in the valuation model.

1.3.34 R If the result of ~~establishing~~ making adjustments or, in the case of an *insurer* or a *UK ISPV*, making adjustments or establishing reserves under *GENPRU* 1.3.29R to *GENPRU* 1.3.33R is a valuation which differs from the fair value determined in accordance with *GENPRU* 1.3.4R, a *firm* must reconcile the two valuations.

…

Trading book and other fair-valued positions, and revaluations.

…

1.3.39 R ~~*Trading*~~ Both *trading book* positions and other fair-valued positions are subject to prudent valuation rules as specified in *GENPRU* 1.3.14R to *GENPRU* 1.3.34R (Marking to market, Marking to model, Independent price verification, ~~Adjustments~~ Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves). In accordance with those *rules*, a *firm* must ensure that the value applied to each of its *trading book* positions and other fair-valued positions appropriately reflects the current market value. This value must 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 and other fair-

valued positions.

…

1.3.41 R (1) For the purposes of *GENPRU* and *INSPRU*, an *insurer* or a *UK ISPV* must apply *GENPRU* 1.3.14R to *GENPRU* 1.3.34R (Marking to market, Marking to model, Independent price verification, ~~Adjustments~~ Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves) to account for:

…

…

…

2.2.237 R A *BIPRU firm* calculating *risk weighted exposure amounts* under the *IRB approach* or the *standardised approach* to credit risk must deduct from its *capital resources* the ~~exposure amount of *securitisation positions* which receive a *risk weight* of 1250% under BIPRU 9 (Securitisation), unless the *firm* includes the *securitisation positions* in its calculation of *risk weighted exposure amounts* (see *BIPRU* 9.10 (Reduction in risk-weighted exposure amounts)).~~ following:

(1) the exposure amount of *securitisation positions* which receive a *risk weight* of 1250% under *BIPRU* 9 (Securitisation), unless the *firm* includes the *securitisation positions* in its calculation of *risk weighted exposure* amounts (see *BIPRU* 9.10 (Reduction in risk-weighted exposure amounts)); and

(2) the *exposure* amounts of *securitisation positions* in the *trading book* that would receive a *risk weight* of 1250% if they were in the *firm's non-trading book*.

Annex C

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Exposures to regional governments or local authorities: General

3.4.10 R Without prejudice to *BIPRU* 3.4.15R to *BIPRU* 3.4.19R:

(1) a *firm* must *risk weight exposures* to regional governments and local authorities in accordance with *BIPRU* 3.4.11R to *BIPRU* 3.4.14R and *BIPRU* 3.4.19AR; and

…

…

3.4.19A R Without prejudice to *BIPRU* 3.4.17R to *BIPRU* 3.4.19R, an *exposure* to a regional government or local authority of an *EEA State* denominated and funded in the domestic currency of that regional government or local authority must be assigned a risk weight of 20%.

[**Note:** *BCD* Annex VI Part 2(b)]

…

General risk management standards

6.3.16 G (1) In common with all *BIPRU firms*, a *firm* calculating its *ORCR* using the *basic indicator approach* is required to meet the general risk management standards set out in SYSC 4.1.1 R to SYSC 4.1.2 R and [2]SYSC 7.1.16 R.

(2) In meeting those general risk management standards, a *firm* that undertakes market-related activities should be able to demonstrate to the *FSA* that it has considered the Committee of European Banking Supervisors' Guidelines on the management of *operational risk* in market-related activities published in October 2010. These can be found at http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx.

…

Eligibility

…

6.4.1A G In meeting the general risk management standards referred to in *BIPRU* 6.4.1R(1), a *firm* that undertakes market-related activities should be able to demonstrate to the *FSA* that it has considered the Committee of European Banking Supervisors' Guidelines on the management of *operational risk* in market-related activities published in October 2010. These can be found at http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx.

…

Minimum standards

…

6.5.5A G In meeting the general risk management standards referred to in *BIPRU* 6.5.5R(1), a *firm* that undertakes market-related activities should be able to demonstrate compliance with the Committee of European Banking Supervisors' Guidelines on the management of *operational risk* in market-related activities published in October 2010. These can be found at http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Management-of-op-risk/CEBS-2010-216-(Guidelines-on-the-management-of-op-.aspx.

…

Deriving the net position in the correlation trading portfolio

7.2.42A R A *correlation trading portfolio* may only consist of *securitisation positions* and nth-to-default credit derivatives that meet the following criteria:

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

(2) 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 reference entities which meet this criterion;

(3) the *positions* do not fall under the exposure classes outlined in *BIPRU* 3.2.9R(8) (retail claims or contingent retail claims) and *BIPRU* 3.2.9R(9) (claims or contingent claims secured on real estate property); and

(4) the *positions* do not represent a claim on a *special purpose vehicle*.

7.2.42B R *Positions* which are not *securitisation positions* or nth-to-default credit derivatives may be included in the *correlation trading portfolio* only if they hedge other such *positions* in this portfolio and a liquid two-way market exists for the relevant *position* or its reference entities.

7.2.42C R For the purposes of *BIPRU* 7.2.42AR(2) and *BIPRU* 7.2.42BR, a two-way market may be deemed to exist only 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 one *business day* and settled at that price within a relatively short time conforming to trade custom.

7.2.42D R A *firm* must calculate both the net long and the net short *positions* in the *correlation trading portfolio* by applying *BIPRU* 7.2.36R and *BIPRU* 7.2.37R.

Specific risk calculation

7.2.43 R (1) A *firm* must calculate the *specific risk* portion of the *interest rate PRR* for each debt *security* by multiplying the market value of the individual net *position* (ignoring the sign) by the *appropriate PRA* from the table in *BIPRU* 7.2.44R or as specified by *BIPRU* 7.2.45R – *BIPRU* ~~7.2.47R~~ 7.2.48LR.

…

(3) For the purpose of (1), a *firm* may cap the product of multiplying the individual net *position* by the *appropriate PRA* at the maximum possible default-risk-related loss. For a short *position* in a credit derivative, a *firm* may calculate the maximum possible default-risk-related loss as a change in value due to the underlying names immediately becoming default-risk-free.

…

7.2.46A G *BIPRU* 7.2.43R includes both actual and notional *positions*. However, notional *positions* in a *zero-specific-risk security* do not attract *specific risk*. For example:

(1) Interest-rate *swaps*, *foreign currency swaps*, *FRAs*, interest-rate *futures*, *foreign-currency forwards*, *foreign-currency futures*, and the cash leg of *repurchase agreements* and *reverse repurchase agreements* create notional *positions* which will not attract *specific risk*; while

(2) *futures*, *forwards* and *swaps* which are based on the price (or yield) of one or more debt *securities* will create at least one notional *position* that attracts *specific risk*.

Specific risk: securitisations and resecuritisations

7.2.47 R ~~A *securitisation exposures* that would be subject to a deduction treatment under the treatment set out in *GENPRU* 2.2. (Capital resources) or *risk weighted* at 1250% as set out in *BIPRU* 9 (Securitisation) is subject to a capital charge that is no less than that set out under those treatments. Unrated liquidity facilities are subject to a capital charge that is no less than that set out in *BIPRU* 9.~~ [deleted]

7.2.47A G ~~*Originators*, investors and *sponsors* of *securitisations* in the *trading book* will have to meet the requirements of *BIPRU* 9.3.1AR, *BIPRU* 9.3.15R to *BIPRU* 9.3.20R and *BIPRU* 9.15.~~ [deleted]

7.2.47B G ~~Subject to *BIPRU* 7.2.47CG, *BIPRU* 9.15.9R and *BIPRU* 9.15.10R, where the investor, *originator* or *sponsor* of a *securitisation* fails to meet any of the requirements in *BIPRU* 9.3.18R to *BIPRU* 9.3.20R (Disclosure requirements) and *BIPRU* 9.15.11R to *BIPRU* 9.15.16R (investor due diligence requirements) in any material respect by reason of its negligence or omission, the *FSA* will use its powers under section 45 (Variation etc. on the Authority's own initiative) of the *Act* to impose an additional capital charge of no less that 250% (capped at 1250%) of the *PRR* that would otherwise apply to the relevant *securitisation positions* under the *rules* in *BIPRU* 7.2. The additional capital charge imposed will be progressively increased with each relevant, subsequent infringement of the requirements in *BIPRU* 9.3.18R to *BIPRU* 9.3.20R and *BIPRU* 9.15.11R to *BIPRU* 9.15.16R.~~ [deleted]

7.2.47C G ~~When calculating the additional capital charge it will impose under *BIPRU* 7.2.47BG, the *FSA* will take into account the exemption of certain *securitisations* from the scope of *BIPRU* 9.15.3R under *BIPRU* 9.15.9R and *BIPRU* 9.15.10R and, if those exemptions are relevant, reduce the capital charge it would otherwise impose.~~ [deleted]

7.2.48 G ~~*BIPRU* 7.2.43R includes both actual and notional *positions*. However, notional *positions* in *zero-specific-risk security* do not attract *specific risk*. For example:~~

~~(1) interest rate *swaps*, *foreign currency swaps*, *FRAs*, interest rate *futures*, *foreign currency forwards*, *foreign currency futures*, and the cash leg of *repurchase agreements* and *reverse repurchase agreements* create notional *positions* which will not attract *specific risk*; whilst~~

~~(2) *futures*, *forwards* and *swaps* which are based on the price (or yield) of one ore more debt *securities* will create at least one notional *position* that attracts *specific risk*.~~ [deleted]

7.2.48A R (1) Subject to (3), a *firm* must calculate the *specific risk* portion of the *interest rate PRR* for each *securitisation* and *resecuritisation position* by multiplying the market value of the individual net *position*

(ignoring the sign) by the *appropriate PRA* from the table in *BIPRU* 7.2.48DR or BIPRU 7.2.48ER, or in accordance with *BIPRU* 7.2.48FR, as applicable.

(2) In calculating the *specific risk* capital charge of an individual net *securitisation* or *resecuritisation position*, a *firm* may cap the product of the weight and the individual net position at the maximum possible default-risk-related loss. For a short position, that limit may be calculated as a change in value due to the underlying names immediately becoming default-risk-free.

(3) For a transitional period ending on 31 December 2013, where a *firm* holds *securitisation* and *resecuritisation positions*, other than *positions* included in the *correlation trading portfolio*, it must calculate:

(a) the total *specific risk* capital charges that would apply just to the net long *positions*; and

(b) the total *specific risk* capital charges that would apply just to the net short *positions.*

The total *specific risk* capital charge for *securitisation* and *resecuritisation positions* will be the higher of (3)(a) and (3)(b).

7.2.48B R The *firm* must report to the *FSA* the total sum of its weighted net long and net short *securitisation* and *resecuritisation positions*, broken down by types of underlying assets.

7.2.48C R When calculating the *PRR* of a *protection seller* in *securitisation* and *resecuritisation* credit derivatives, a *firm* must apply *BIPRU* 7.11.3R.

7.2.48D R Table: specific risk PRAs – standardised approach

Credit quality step	**1**	**2**	**3**	**4 (only for credit assessments other than short-term credit assessments)**	**All other credit quality steps**
Securitisations	1.6%	4%	8%	28%	100%
Resecuritisations	3.2%	8%	18%	52%	100%

A *firm* may only apply the *risk weights* in this table where it must calculate a *risk weighted exposure amount* in accordance with the *standardised approach* to *securitisation* and *resecuritisation positions* in its *non-trading book* under *BIPRU* 9. The *appropriate PRA* is calculated as 8% of the *risk weight* that would apply to the *position* under the *standardised approach* in *BIPRU* 9.11.2R, subject to the requirements of *BIPRU* 9.9 to *BIPRU* 9.11, where appropriate.

7.2.48E R Table: specific risk PRAs – IRB approach

Credit Quality Step		**Securitisation positions**			**Resecuritisation positions**	
Credit assessments other than short term	**Short-term credit assess-ments**	**A**	**B**	**C**	**D**	**E**
1	1	0.56%	0.96%	1.6%	1.6%	2.4%
2		0.64%	1.20%	2%	2%	3.2%
3		0.8%	1.44%		2.8%	4%
4	2	0.96%	1.6%		3.2%	5.2%
5		1.60%	2.8%	2.8%	4.8%	8%
6		2.8%	4%		8%	12%
7	3	4.8%	6%		12%	18%
8		8%			16%	28%
9		20%			24%	40%

10	34%	40%	52%
11	52%	60%	68%
all other unrated	100%		

A *firm* may only apply the *risk weights* in this table where it must calculate a *risk weighted exposure amount* in accordance with the *IRB approach* to *securitisation* and *resecuritisation positions* in its *non-trading book* under *BIPRU* 9. The *appropriate PRA* is calculated as 8% of the *risk weight* that would apply to the *position* under the *IRB approach* in *BIPRU* 9.12.11R, subject to the requirements in *BIPRU* 9.12 where appropriate.

7.2.48F R (1) A *firm* may use the *supervisory formula method* to calculate the *appropriate PRA* for *specific risk* where:

(a) the *firm* is permitted to apply the *supervisory formula method* to the same *position* if it was held in its *non-trading book* in accordance with *BIPRU* 9.12; or

(b) otherwise, the *firm* is expressly permitted by its *VaR model permission* to apply the *supervisory formula method* to calculate the *appropriate PRA* for *specific risk*.

(2) The *appropriate PRA* under the *supervisory formula method* must be calculated by multiplying the *risk weight* calculated according to *BIPRU* 9.12.21R by 8%.

(3) Where relevant, estimates of *PDs* and *LGDs* as inputs to the *supervisory formula method* must be determined in accordance with *BIPRU* 4.

(4) Where expressly permitted by its *VaR model permission*, a *firm* may use the approach outlined in *BIPRU* 7.10.55AR to *BIPRU* 7.10.55SR (Incremental Risk Charge) to determine *PDs* and *LGDs* as inputs to the *supervisory formula method*.

7.2.48G R Where a *securitisation position* in the *trading book* is subject to an increased *risk weight* in accordance with *BIPRU* 9.15, the *appropriate PRA* must be calculated as 8% of the *risk weight* that would apply to the *position* in accordance with *BIPRU* 9.15.

7.2.48H G *Originators*, investors and *sponsors* of *securitisations* in the *trading book* will have to meet the requirements of *BIPRU* 9.3.1AR, *BIPRU* 9.3.15R to *BIPRU* 9.3.20R and *BIPRU* 9.15.

7.2.48I G (1) Subject to *BIPRU* 7.2.48JG, *BIPRU* 9.15.9R and *BIPRU* 9.15.10R, where the investor, *originator* or *sponsor* of a *securitisation* fails to meet any of the requirements in *BIPRU* 9.3.18R to *BIPRU* 9.3.20R (Disclosure requirements) and *BIPRU* 9.15.11R to *BIPRU* 9.15.16R (investor due diligence requirements) in any material respect by reason of its negligence or omission, the *FSA* will use its powers under section 45 (Variation etc. on the Authority's own initiative) of the *Act* to impose an additional capital charge in accordance with *BIPRU* 7.2.48GR. The additional capital charge imposed will be progressively increased with each relevant, subsequent infringement of the requirements in *BIPRU* 9.3.18R to *BIPRU* 9.3.20R and *BIPRU* 9.15.11R to *BIPRU* 9.15.16AR, up to a maximum of 1250% *risk weight*.

(2) Subject to *BIPRU* 9.3.22G, *BIPRU* 9.15.9R and *BIPRU* 9.15.10R, where a *credit institution* fails to meet in any material respect the requirements in *BIPRU* 9.15.16AR (Group level requirements), the *FSA* may consider using its powers under section 45 (Variation etc on the Authority's own initiative) of the *Act* in the manner described in (1). In order to calculate the *risk weights* that would apply to the *credit institution*, the *FSA* may treat the *securitisation* investments of the *subsidiary undertaking* as if they were *securitisation positions* held directly by the *credit institution*.

7.2.48J G When calculating the additional capital charge it will impose under *BIPRU* 7.2.48GR, the *FSA* will take into account the exemption of certain *securitisations* from the scope of *BIPRU* 9.15.3R under *BIPRU* 9.15.9R and *BIPRU* 9.15.10R and, if those exemptions are relevant, it will reduce the capital charge it would otherwise impose.

7.2.48K R A *securitisation exposure* in the *trading book* that would be subject to deduction in accordance with *GENPRU* 2.2. (Capital resources) or to a 1250% *risk weight* in accordance with *BIPRU* 9 (Securitisation) is subject to a capital charge that is no less than that set out under those provisions. Unrated liquidity facilities are subject to a capital charge that is no less than that set out in *BIPRU* 9.

Specific risk: *correlation trading portfolio*

7.2.48L R (1) Where a *firm* holds a *position* in the *correlation trading portfolio*, it must calculate:

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

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

(2) The higher of (1)(a) and (1)(b) will be the *specific risk* capital

charge for the *correlation trading portfolio*.

(3) In calculating the *specific risk* capital charge of an individual net *position* in the *correlation trading portfolio*, a *firm* may cap the product of multiplying the individual net *position* by the appropriate *PRA* at the maximum possible default-risk-related loss. For a short *position*, a *firm* may calculate the maximum possible default-risk-related loss as a change in value due to the underlying names immediately becoming default-risk-free.

…

7.3.30 R Table: simplified equity method PRAs

This table belongs to *BIPRU* 7.3.29R

Instrument	*PRA*
Single *equities*	~~12%~~16%
Qualifying equity ~~indices~~ *indices* (see *BIPRU* 7.3.38R)	8%
All other *equity* indices or baskets	~~12%~~16%

If it is necessary to distinguish between the *specific risk PRA* and the *general market risk PRA*, the *specific risk PRA* for the first and third rows is ~~4~~ 8% and that for the second row is 0%. The rest of the *PRA* in the second column is the *general market risk PRA*.

…

7.3.34 R Table: PRAs for specific risk under the standard equity method

This table belongs to *BIPRU* 7.3.33R

Instrument	*PRA*
~~*Qualifying equities*~~	~~2%~~
Qualifying equity ~~indices~~ *indices* (see *BIPRU* 7.3.38R)	0%
All ~~other~~ *equities*, and other *equity* indices or ~~*equities*~~ *equity* baskets.	~~4%~~ 8%

Definition of a qualifying equity

7.3.35 R ~~A *qualifying equity* is one that satisfies the following conditions:~~

~~(1) it belongs to a country portfolio that satisfies the following conditions:~~

~~(a) no individual *position* exceeds 10% of the portfolio's gross value; and~~

~~(b) the sum of *positions* (ignoring the sign) which individually represent between 5% and 10% of the portfolio's gross value, does not exceed 50% of the portfolio's gross value;~~

~~(2) it is not of an issuer that has issued only traded debt *securities* that currently attracts an 8% or 12% *PRA* in the table in *BIPRU* 7.2.44R (Specific risk PRA) or that attracts a lower requirement only because they are guaranteed or secured; and~~

~~(3) it is a constituent of an index in the table in *BIPRU* 7.3.39R.~~ [deleted]

7.3.36 G ~~(1) The following example illustrates *BIPRU* 7.3.35R(1).~~ [deleted]

~~(2) A country portfolio has a gross value of £100 and is made up of *positions* in 29 different *equities* (some are long *positions*, others are short *positions*). Not all the *equities* are constituents of an index used to create the FT All-World Index (this criterion only becomes relevant once a *firm* has determined whether the country portfolio meets the test in *BIPRU* 7.3.35R(1)).~~ [deleted]

~~(3) Six *positions* exceed the 5% threshold. The following diagram shows the composition of the portfolio.~~ [deleted]

[Diagram deleted]

~~(4) Part (a): the portfolio meets the first part of the test because no individual *position* is worth more than 10% of the portfolio's value.~~ [deleted]

~~(5) Part (b): the portfolio fails the second part of the test because the sum (ignoring the sign) of the six relevant *positions* is £52; this exceeds 50% of the portfolio's value.~~ [deleted]

7.3.37 G ~~(1) A country portfolio can be split into two sub-portfolios if this enables one sub-portfolio to meet the requirements in *BIPRU* 7.3.35R(1). Individual *positions* may be sub-divided between sub-portfolios.~~ [deleted]

~~(2) Continuing the example above, one of the largest *positions* is taken out of the portfolio and put into a new portfolio. The new portfolio fails the two tests, but the amended portfolio meets both tests:~~

~~(a) Part (a): no single remaining *position* exceeds £9.10.~~

~~(b) Part (b): the sum of the five relevant *positions* is £43, this is less that 50% of the new portfolio's value of £91.~~ [deleted]

[Diagram deleted]

…

7.10.27A R *Stressed VaR* must be calculated at least weekly, using a 99% one-tailed confidence limit.

…

7.10.30A R The *stressed VaR* measure must be based on inputs calibrated to historical data from a continuous twelve-month period of significant financial stress relevant to the *firm*'s portfolio. The choice of that historical period will be subject to the *FSA's* approval and will form part of a *firm's VaR model permission.*

7.10.30B R A *firm* must review the selection of the *stressed VaR* historical observation period at least annually.

…

7.10.35 G The minimum updating frequency for the current *VaR measure* that can be specified in a *VaR model permission* is ~~quarterly~~ monthly.

…

7.10.39A R A *firm* must incorporate risk factors that are included in its pricing model in its *VaR model*. A *firm's VaR model* must capture nonlinearities for *options* and other products, as well as correlation risk and *basis risk*. Where proxies for risk factors are used they must show a good track record for the actual *position* held. In addition, *BIPRU* 7.10.40R to *BIPRU* 7.10.44R apply for individual risk types.

7.10.39B R A *firm* with a *VaR model permission* must justify to the *FSA* any omissions of risk factors from its *VaR model*, if they are included in its pricing model.

…

7.10.46 R …

(7) In addition to the other requirements in *BIPRU* 7.10, a *firm* must have an approach in place to capture, in the calculation of its capital requirements, the ~~default risk~~ *incremental risk charge* of its *trading book positions* that is incremental to the default and migration risk captured by the *VaR measures*, as specified in ~~this *rule*, *BIPRU* 7.10.48R, BIPRU 7.10.49R~~ *BIPRU* 7.10.55AR to *BIPRU* 7.10.55SR and *BIPRU* 7.10.107R (Backtesting: *Specific risk* backtesting).

(8) ~~A *firm* must be able to demonstrate that the approach referred to in (7) meets soundness standards comparable to the approach set out in *BIPRU* 4 (The IRB approach), under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of~~

liquidity, concentrations, hedging and optionality. [deleted]

…

7.10.48 R (1) Where a *firm* is subject to event risk that is not reached in its *VaR measure*, because it is beyond the 10-day holding period and 99 percent confidence interval (low probability and high severity events), the *firm* must ensure that the impact of such events is factored into its internal capital assessment. [deleted]

(2) …

7.10.50 R To avoid double counting capital requirements under *BIPRU* 7.10.46R(7) a *firm* may, when calculating its incremental default charge, take into account the extent to which default risk has already been incorporated into the *VaR* calculation, especially for risk *positions* that could and would be closed within 10 *business days* in the event of adverse market conditions or other indications of deterioration in the credit environment. Where a *firm* captures its incremental default risk through a surcharge, it must have in place methodologies for validating the measure. [deleted]

7.10.51 R A *firm* that does not capture the incremental default risk through an internally developed approach must calculate the surcharge through an approach consistent with either the *standardised approach* to credit risk or the *IRB approach*. [deleted]

7.10.52 R With respect to *securitisation exposures* that would be subject to a deduction treatment in the calculation of its *capital resources* or *risk weighted* at 1250% as set out in *BIPRU* 9, these *positions* (cash or synthetic) are subject to a capital charge that is no less than set forth under that treatment. A *firm* that is a dealer in these *exposures* may apply a different treatment where it could demonstrate to the *FSA*, in addition to trading intent, that a liquid two-way market exists for the *securitisation exposures* or, in the case of *synthetic securitisation* that rely solely on credit derivatives, for the *securitisation exposures* themselves or all their constituent risk components. For the purposes of this *rule* a two-way market is deemed to exist where there are independent good faith offers to buy and sell so that a price reasonably related to the last sales price or current good faith competitive bid and offer quotations can be determined within one day and settled at such a price within a relatively short time conforming to trade custom. For a *firm* to apply a different treatment, it must have sufficient market data to ensure that it fully captures the concentrated default risk of these *exposures* in its internal approach for measuring the incremental default risk in accordance with the *VaR specific risk minimum requirements*. [deleted]

…

Incremental risk charge: Scope and parameters

7.10.55A R A *firm* must demonstrate that its *incremental risk charge* meets soundness standards comparable to those under the *IRB approach*, assuming a constant level of risk and adjusted, where appropriate, to reflect the impact of liquidity, concentrations, hedging and optionality.

7.10.55B R The *incremental risk charge* must cover all *positions* subject to a capital charge for interest-rate *specific risk*, except *securitisation positions* and nth-to-default credit derivatives. Where permitted by the *firm's VaR model permission*, a *firm* may choose consistently to include all listed *equity positions* and *derivatives positions* based on listed *equities* for which that inclusion is consistent with how the *firm* internally measures and manages risk, but the approach must reflect the impact of correlations between default and migration events, and it must not reflect the impact of diversification between default and migration events and other market risk factors.

7.10.55C R The *firm's* approach to capture the *incremental risk charge* must measure losses due to default and internal or external ratings migration at the 99.9% confidence interval over a capital horizon of one year.

7.10.55D R The *firm's* correlation assumptions must be supported by the analysis of objective data in a conceptually sound framework. The approach to capture the *incremental risk charge* must appropriately reflect *issuer* concentrations. Concentrations that can arise within and across product classes under stressed conditions must also be reflected.

7.10.55E R The *firm's* approach must 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, a *firm* may choose consistently to use a one-year constant *position* assumption.

Incremental risk charge: Liquidity horizons

7.10.55F R (1) The *firm's* liquidity horizons for calculating *incremental risk charge* must be set according to the time required to sell the *position* or to hedge all material and relevant price risks in a stressed market, having particular regard to the size of the *position*.

(2) Liquidity horizons must reflect actual practice and experience during periods of both systematic and idiosyncratic stresses. The liquidity horizon must be measured under conservative assumptions and must 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.

7.10.55G R The determination of the appropriate liquidity horizon for a *position* or set of *positions* is subject to a floor of three months. The determination of the appropriate liquidity horizon for a position or set of *positions* must take into

account a *firm*'s internal policies relating to valuation adjustments and the management of stale positions.

7.10.55H R When a *firm* determines liquidity horizons for sets of *positions* rather than for individual *positions*, the criteria for defining sets of *positions* must be defined in a way that meaningfully reflects differences in liquidity. The liquidity horizons must be greater for positions that are concentrated, reflecting the longer period needed to liquidate those *positions.*

7.10.55I R The liquidity horizon for a *securitisation* warehouse must reflect the time to build, sell and securitise the assets, or to hedge the material risk factors, under stressed market conditions.

Incremental risk charge: Hedges

7.10.55J R

(1) Hedges may be incorporated into the calculation of a *firm*'s *incremental risk charge*. *Positions* may be netted only when long and short *positions* refer to the same financial instrument.

(2) 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.

(3) A *firm* must 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. A *firm* must reflect a hedge only to the extent that it can be maintained even as the obligor approaches a credit or other event.

7.10.55K R 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 only if the *firm*:

(1) chooses to model rebalancing of the hedge consistently over the relevant set of *trading book positions*;

(2) demonstrates that the inclusion of rebalancing results in a better risk measurement;

(3) demonstrates that the markets for the instruments serving as hedges are liquid enough to allow for this rebalancing even during periods of stress; and

(4) reflects in the capital charge any residual risks resulting from dynamic hedging strategies.

Incremental risk charge: Nonlinear positions and model risk

7.10.55L R (1) The *incremental risk charge* must reflect the nonlinear impact of *options*, structured credit derivatives and other *positions* with material nonlinear behaviour with respect to price changes.

(2) The *firm* must also consider the amount of model risk inherent in the valuation and estimation of price risks associated with those products.

7.10.55M R The *incremental risk charge* must be based on objective and up-to-date data.

Incremental risk charge: Validation

7.10.55N R A *firm* must validate its approach to *incremental risk charge*. In particular, a *firm* must:

(1) 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;

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

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

7.10.55O R A *firm's* approach for *incremental risk charge* must be consistent with the *firm*'s internal risk management methodologies for identifying, measuring, and managing trading risks.

Incremental risk charge: Documentation and frequency of calculation

7.10.55P R A *firm* must document its approach for the *incremental risk charge* clearly, setting out its correlation and other modelling assumptions.

7.10.55Q R A *firm* must calculate its *incremental risk charge* at least weekly.

Incremental risk charge: Internal approaches based on different parameters

7.10.55R R A *firm* may use an approach for *incremental risk charge* that does not comply with all the requirements in *BIPRU* 7.10.55AR to *BIPRU* 7.10.55PR, only if:

(1) such an approach is consistent with the *firm's* internal methodologies for identifying, measuring, and managing risks; and

(2) the *firm* can demonstrate that its approach results in a capital

requirement that is at least as high as it would be if based on an approach in full compliance with the requirements in *BIPRU* 7.10.55AR to *BIPRU* 7.10.55PR.

7.10.55S G The *FSA* will review at least annually any approach taken by the *firm* under *BIPRU* 7.10.55RR.

All price risk measure: General requirements

7.10.55T R As part of its *VaR model permission*, the *FSA* may authorise a *firm* to use the *all price risk measure* to calculate an additional capital charge in relation to *positions* in its *correlation trading portfolio* if it meets the following minimum standards:

(1) it adequately captures all price risks at a 99.9% confidence interval over a capital horizon of one year under the assumption of a constant level of risk, and adjusted, where appropriate, to reflect the impact of liquidity, concentrations, hedging and optionality;

(2) it adequately captures the following risks:

(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 that the *all price risk measure* incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing those hedges.

7.10.55U R The amount of the capital charge for the *correlation trading portfolio* calculated in accordance with the *all price risk measure* must not be less than 8% of the capital charge that would result from applying *BIPRU* 7.2.48LR to all *positions* in the *correlation trading portfolio* subject to the *all price risk measure*.

7.10.55V R A *firm* may include in its *all price risk measure positions* that are jointly managed with *positions* in the *correlation trading portfolio* and would otherwise be included in the *incremental risk charge*. In that case, the *firm* must exclude these *positions* from the calculation of its *incremental risk charge*.

7.10.55W R A *firm* must have sufficient market data to ensure that it fully captures the salient risks of the *positions* in its *all price risk measure* in accordance with the standards set out in *BIPRU* 7.10.55TR.

7.10.55X R A *firm* must demonstrate through backtesting or other appropriate means that its *all price risk measure* can appropriately explain the historical price variation of these *positions*. A *firm* must be able to demonstrate to the *FSA* that it can identify the *positions* within its *correlation trading portfolio*, in relation to which it is authorised to use the *all price risk measure*, separately from those other *positions* in relation to which it is not authorised to do so.

7.10.55Y R A *firm* must calculate the capital charge under the *all price risk measure* at least weekly.

All price risk measure: Stress testing

7.10.55Z R (1) For *positions* within its *correlation trading portfolio* in relation to which a firm may use the *all price risk measure*, a *firm* must regularly apply a set of specific, predetermined stress scenarios. These stress scenarios must examine the effects of stress to default rates, recovery rates, credit spreads, and correlations on the profit and loss of the *correlation trading portfolio*.

(2) A *firm* must apply the stress scenarios in (1) at least weekly and report the results to the *FSA* in accordance with *BIPRU* 7.10.129R.

7.10.55ZA R If the results of the stress tests carried out in accordance with *BIPRU* 7.10.55ZR indicate a material shortfall in the amount of capital required under the *all price risk measure*, a *firm* must notify the *FSA* of this circumstance by no later than two *business days* after the *business day* on which the material shortfall occurred.

7.10.55ZB G The *FSA* may use its powers under section 45 (Variation etc. on the Authority's own initiative) of the *Act* to impose on the *firm* a capital add-on to cover the material shortfall reported under *BIPRU* 7.10.55ZAR.

7.10.55ZC G The *all price risk measure* is based on the *incremental risk charge*. Therefore, when applying the *all price risk* measure, a *firm* should have regard to the requirements in *BIPRU* 7.10.55AR to *BIPRU* 7.10.55SR.

…

7.10.90A R A *firm* must also carry out reverse stress tests.

…

7.10.93 G Backtesting conducted only at a whole portfolio level using a single measure of profit and loss has limited power to distinguish an accurate *VaR model* from an inaccurate one. Backtesting should therefore be regarded as an additional safeguard rather than a primary validation tool. Such testing does however form the basis of the *FSA's plus factor* system. The test has been chosen as the basis of the backtesting regime because of its simplicity. A *firm* will therefore be expected to complement this backtesting with more granular backtesting analysis and involving more than one measure of profit and loss (i.e. both a ~~*clean*~~ *profit and loss figure* and a ~~*clean*~~ *hypothetical profit and loss figure*).

7.10.94 R A *firm* must have the capacity to analyse and compare its ~~*clean*~~ *profit and loss figures* and ~~*clean*~~ *hypothetical profit and loss figures* to the *VaR measure*, both at the level of the whole portfolio covered by the *VaR model permission* and at the level of individual books that contain material amounts of risk.

7.10.94A R At a minimum, backtesting of *hypothetical profit and loss figures* must be used for regulatory backtesting and also to calculate *plus factors*.

7.10.95 G ~~Clean profit and loss backtesting should be used for regulatory backtesting and used to calculate *plus factors*. Hypothetical profit and loss backtesting~~ Backtesting of *hypothetical profit and loss figures* is also used for model validation and for reporting to the *FSA*.

Backtesting: Basic testing requirements

7.10.96 R ~~A~~ At a minimum, a *firm* must, on each *business day*, compare each of its 250 most recent *business days*' ~~*clean profit and loss figures*~~ *hypothetical profit and loss figures* (ending with the *business day* preceding the *business day* in question) with the corresponding one-day *VaR measures*.

…

Backtesting: Calculating the ~~clean~~ profit and loss

7.10.99 G The ultimate purpose of backtesting is to assess whether capital is sufficient to absorb actual losses. ~~Therefore backtesting should be performed using a measure of actual daily profit and loss.~~ Actual daily profit and loss means the day's profit and loss arising from trading activities within the scope of the *VaR model permission*. This measure should, however, be 'cleaned' using *BIPRU* 7.10.100R inclusion in profit and loss of non-modelled factors.

7.10.100 R The ~~*clean*~~ p*rofit and loss figure* for a particular business day is the *firm's* actual profit or loss for that day in respect of the trading activities within the scope of the *firm's VaR model permission*, adjusted by stripping out:

(1) fees and commissions;

(2) brokerage;

(3) additions to and releases from reserves which are not directly related to *market risk* (e.g. administration reserves); and

(4) any inception profit exceeding an amount specified for this purpose in the *firm's VaR model permission* (where inception profit is defined as any profit arising immediately on entering into a new transaction).

7.10.101 G The definition of ~~*clean*~~ *profit and loss figure* may be amended or replaced in an individual *VaR model permission* if the *firm* can demonstrate to the *FSA* that the alternative method meets the spirit and purpose of the provisions in *BIPRU* 7.10 about the ~~*clean*~~ *profit and loss figure*.

7.10.102 G The *FSA* will review as part of a *firm's VaR model permission* application the processes and documentation relating to the derivation of profit and loss used for backtesting. A *firm's* documentation should clearly set out the basis for cleaning profit and loss. To the extent that certain profit and loss elements are not updated every day (for example certain reserve calculations) the documentation should clearly set out how such elements are included in the ~~clean~~ profit and loss series.

Backtesting: Definition of backtesting exception

7.10.103 R A *backtesting exception* is deemed to have occurred for any *business day* if the ~~*clean profit and loss figure*~~ *hypothetical profit and loss figure* for that *business day* shows a loss, which in absolute magnitude exceeds the *one-day VaR measure* for that *business day*. The only exception is if that *business day* is identified in the *firm's VaR model permission* as giving rise to an excluded *backtesting exception*.

…

Backtesting: Hypothetical profit and loss

7.10.111 R A *firm* must ~~also~~ perform backtesting against a ~~*clean*~~ *hypothetical profit and loss figure* with respect to each *business day*. A ~~*clean*~~ *hypothetical profit and loss figure* for a *business day* means the ~~*clean profit and loss figure*~~ *hypothetical profit and loss figure* that would have occurred for that *business day* if the portfolio on which the *VaR number* for that *business day* is based remained unchanged.

7.10.112 G (1) A ~~*clean hypothetical profit and loss figure*~~ *hypothetical profit and loss figure* is based on the day's change in the value of the same portfolio that was used to generate the value-at-risk forecast.

(2) ~~Backtesting under *BIPRU* 7.10.111R, although carried out with respect to each *business day*, need not be carried out each day. A~~

~~*firm* need only carry it out sufficiently frequently to comply with its reporting requirements under *BIPRU* 7.10.129R. An exception arising out of such backtesting need not be reported to the *FSA* under *BIPRU* 7.10.104R.~~ [deleted]

(3) The *firm* may also need to calculate a ~~*clean hypothetical profit and loss figure*~~ *hypothetical profit and loss figure* in order to produce profit attribution reports and to analyse the cause of *backtesting exceptions*.

7.10.112A G The definition of *hypothetical profit and loss figure* may be amended or replaced in an individual *VaR model permission* if the *firm* can demonstrate to the *FSA* that the alternative method meets the spirit and purpose of the provisions in *BIPRU* 7.10 about the *hypothetical profit and loss figure*.

Capital calculations: General

7.10.113 R The *model PRR* is, for any *business day* (the "relevant" *business day*), calculated in accordance with the following formula:

(1) …

(2) (in the case of a *VaR model permission* that covers *specific risk*) the ~~*incremental default risk charge* for the relevant *business day*~~ higher of:

(a) the *incremental risk charge* for the relevant *business day*; and

(b) the average of the twelve-week *incremental risk charge*; and

(3) the higher of:

(a) the latest *stressed VaR number*; and

(b) the average of the *firm's* daily *stressed VaR numbers* for the 60 *business days* ending with the relevant *business day*, multiplied by the *multiplication factor* applied to the *stressed VaR* measure for the relevant *business day*; and

(4) (in the case of a *VaR model permission* that covers *all price risk measure*) the higher of:

(a) the *all price risk measure* for the relevant *business day*; and

(b) the average of the twelve-week *all price risk measure*.

…

7.10.116 R The *incremental* ~~*default*~~ *risk charge* for any *business day* means the ~~incremental default risk charge~~ *incremental risk charge* required under the provisions in *BIPRU* 7.10 about *specific risk*, in respect of the previous *business day's* close-of-business *positions* with respect to which those

provisions apply.

7.10.116A R The *all price risk measure* for any *business day* means the *all price risk measure* required under the provisions in *BIPRU* 7.10 about *specific risk* for the *correlation trading portfolio*.

7.10.117 G The following equation expresses *BIPRU* 7.10.113R mathematically:

[Editor's Note: The existing formula is deleted and is replaced by the following, which is not shown underlined.]

$$PRR_{VaR} = \text{Max}\left\{\text{VaR}_t, \text{f}x\frac{1}{60}\sum_{i=0}^{59}\text{VaR}_{t-i}\right\} + \text{Max}\left\{\text{SVaR}_t, \text{s}x\frac{1}{y}\sum_{i=0}^{y-1}\text{SVaR}_{t-i}\right\} + \text{Max}\left\{\text{IRC}_t, \frac{1}{z}\sum_{i=0}^{z-1}\text{IRC}_{t-i}\right\} + \text{Max}\left\{\text{APR}_t, \frac{1}{w}\sum_{i=0}^{w-1}\text{APR}_{t-i}\right\}$$

(1) …

…

(4) *f* is the *multiplication factor* for *VaR*; ~~and~~

(5) ~~*IDRC* is the *incremental default risk charge* (if applicable)~~ *SVARt* represents the latest *stressed VaR* figure;

(6) *SVARt-i* represents the *stressed VaR* calculated for *i business days* earlier;

(7) *s* is the *multiplication factor* for *stressed VaR*;

(8) *y* is the number of times the *stressed VaR* was calculated in the last 60 *business days*;

(9) *IRCt* represents the latest *incremental risk charge*;

(10) *IRCt-i* represents the *incremental risk charge* calculated for *i business days* earlier;

(11) *z* is the number of times the *incremental risk charge* was calculated in the last 12 weeks;

(12) *APRt* represents the latest *all price risk measure*;

(13) *APRt-i* represents the *all price risk measure* calculated for *i business days* earlier; and

(14) *w* is the number of times the *all price risk measure* was calculated in the last 12 weeks.

Capital calculations: Multiplication factors

7.10.118 R The *multiplication factor*, for *VaR* and *stressed VaR*, for any *business day* is the sum of the *minimum multiplication factor* and the *plus factor* for that day.

7.10.119 R The *minimum multiplication factor*, for *VaR* and *stressed VaR*, is three or any higher amount the *VaR model permission* defines it as.

7.10.120 G The *minimum multiplication factor*, for *VaR* and *stressed VaR*, will never be less than three. If the *FSA* does set the *minimum multiplication factor*, for *VaR* and *stressed VaR*, above three the *VaR model permission* will have a table that sets ~~outs~~ out the reasons for that add on and specify how much of the add on is attributable to each reason (see *BIPRU* 7.10.121R). If there are weaknesses in the *VaR model* that may otherwise be considered a breach of the minimum standards referred to in *BIPRU* 7.10.42R the *FSA* may apply such an add on to act as a mitigant for those weaknesses.

7.10.121 R Something that would otherwise be a breach of the minimum standards in *BIPRU* 7.10.26R – *BIPRU* 7.10.53R is not a breach to the extent that that thing is identified in the *firm's VaR permission* as a reason for an increase in the *minimum multiplication factor*, for *VaR* and *stressed VaR*, above 3.

…

7.10.124 R The table in *BIPRU* 7.10.125R sets out the *plus factors* to be added to the *minimum multiplication factor*, for *VaR* and *stressed VaR*, for any *business day*. It is based on the number of *backtesting exceptions* that occurred during the backtesting period as referred to in *BIPRU* 7.10.96R (Backtesting: Basic Backtesting requirements) ending three *business days* preceding the *business day* for which the *model PRR* is being calculated.

…

7.10.129 R A *firm* must, no later than the number of *business days* after the end of each quarter specified in the *VaR model permission* for this purpose, submit, in respect of that quarter, a report to the *FSA* about the operation of the *VaR model*, the systems and controls relating to it and any changes to the *VaR model* and those systems and controls. Each report must outline as a minimum the following information in respect of that quarter:

…

(3) a summary of backtesting performance against ~~*clean*~~ *profit and loss figures* (if calculated) and ~~*clean*~~ *hypothetical profit and loss figures*, which must be provided in electronic format as stipulated by the *VaR model permission*;

…

(9) an up-to-date list of products covered by the *VaR model permission* showing all changes made since the *VaR model permission* was granted; ~~and~~

(10) where applicable (nil returns are not required), details of:

…

(f) the *VaR model* not accurately capturing risks (as referred to in *BIPRU* 7.10.53R) and any steps taken under *BIPRU* 7.10.53R; and

(11) the results of the stress tests on the *firm's correlation trading portfolio* under *BIPRU* 7.10.55ZR, including a comparison to the current capital charge.

7.10.130 R A *firm* must provide to, and discuss with, the *FSA* details of any significant planned changes to the *VaR model* before those changes are implemented. These details must include information about the nature of the change and an estimate of the impact on *VaR numbers* and the *incremental* ~~*default*~~ *risk charge*.

…

7.10.136 R (1) …

(2) ~~If~~ Subject to *BIPRU* 7.10.136AR, if , where the *standard market risk PRR rules* apply, a *position* is subject to a *PRR charge* and the *firm's VaR model permission* says that it covers the risks to which that *PRR charge* relates, the *firm* must, for those risks, calculate the *PRR* for that *position* under the *VaR model approach* rather than under the *standard market risk PRR rules*.

…

7.10.136A R A *firm* must calculate the *market risk capital requirement* for *securitisation positions* and *positions* in the *correlation trading portfolio* in accordance with the *standard market risk PRR rules*, with the exception of those *positions* subject to the *all price risk measure*.

…

7.11.3 R (1) When calculating the *PRR* of the *protection seller*, unless specified differently by other *rules* and subject to (2), the notional amount of the credit derivative contract must be used. For the purpose of calculating the *specific risk PRR charge*, other than for total return swaps, the maturity of the credit derivative contract is applicable instead of the maturity of the obligation.

(2) When calculating the *PRR* of the *protection seller*, a *firm* may choose to replace the notional value of the credit derivative by the notional value adjusted for changes in the *market value* of the credit derivative since trade inception.

…

7.11.11 R If ~~a first or second-asset to default~~ an nth-to-default derivative is externally rated and meets the conditions for a *qualifying debt security*, then the *protection seller* need only calculate one *specific risk* charge reflecting the rating of the derivative. The *specific risk* charge must be based on the *securitisation PRAs* in *BIPRU* 7.2 as applicable.

…

Deriving the net position in each debt security: Credit derivatives

7.11.12C R A *firm* must calculate both the net long and the net short positions in credit derivatives by applying *BIPRU* 7.2.36R and *BIPRU* 7.2.37R and, where applicable, *BIPRU* 7.2.42AR to *BIPRU* 7.2.42CR.

Recognition of hedging provided by credit derivatives ~~against cash positions~~

7.11.13 R

(1) …

(2) …

(3) ~~*BIPRU* 7.11.13 R – *BIPRU* 7.11.17 R are subject to the requirements of the *credit default swap PRR methods*.~~ [deleted]

…

~~Special treatment of credit default swaps: Provisions applicable to all methods~~
Specific risk calculation

…

7.11.18 R ~~*BIPRU* 7.11.18R - *BIPRU* 7.11.58R set out the calculation of the *specific risk* portion of the *interest rate PRR* for credit default swaps.~~ [deleted]

7.11.19 R ~~The *specific risk* portion of the *interest rate PRR* is calculated separately for:~~

~~(1) credit default swaps (other than those in (2));~~

~~(2) credit default swaps that are also *securitisation positions*;~~

~~(3) other *positions*;~~

~~that are subject to the *interest rate PRR*.~~ [deleted]

7.11.20 R The *specific risk* portion of the *interest rate PRR* for ~~positions falling into *BIPRU* 7.11.19 R (1) and *BIPRU* 7.11.19 R (2)~~ credit derivatives in the *trading book* must be calculated in accordance with ~~the *credit default swap PRR methods* rather than in accordance with *BIPRU* 7.2 (Interest rate PRR)~~ *BIPRU* 7.2.43R to *BIPRU* 7.2.46AG (Specific risk calculation), *BIPRU* 7.2.48AR to *BIPRU* 7.2.48KR (Specific risk: securitisations and re-securitisations), *BIPRU* 7.2.48LR (Specific risk: Correlation trading

portfolio), *BIPRU* 7.2.49R to *BIPRU* 7.2.51G (Definition of a qualifying debt security) and the other provisions of *BIPRU* 7.11, as applicable. ~~However a firm may apply *BIPRU* 7.11.13R- *BIPRU* 7.11.17R before applying the credit default swap PRR methods. If it does so the firm must apply the credit default swap PRR methods to the remaining position in credit default swaps.~~

Delete 7.11.21R to 7.11.58R. The deleted text is not shown.

Amend the following as shown.

7.11.61 G *BIPRU* 7.11.62G - *BIPRU* ~~7.11.64 GG~~ 7.11.63G cover risks relating to credit derivatives that may not be captured in this section. This *guidance* is of particular relevance to the *overall financial adequacy rule*, the *overall Pillar 2 rule* and the *general stress and scenario testing rule*.

…

7.11.64 G ~~If a *firm* uses models in its valuation process, it should consider whether the default capital requirements under the *credit default swap PRR methods* adequately cover the default losses that the *firm's* model estimates it will be exposed to.~~ [deleted]

…

9.1.9 G *BIPRU* 9 deals with:

(1) ...;

…

(3) the requirements that investors, *originators* and *sponsors* of *securitisations* in the *trading book* will have to meet (*BIPRU* 9.3.1AR, *BIPRU* 9.3.15R to *BIPRU* 9.3.20R, *BIPRU* 9.6.1AR and *BIPRU* 9.15).

9.3.2 G ~~[deleted]~~ A *credit institution* should have regard to the Committee of European Banking Supervisors' Guidelines to Article 122a of the *Banking Consolidation Directive* when considering its obligations under *BIPRU* 9.3.15R to *BIPRU* 9.3.20R and *BIPRU* 9.15. The Guidelines can be found at http://www.eba.europa.eu/Publications/Standards-Guidelines.aspx.

…

Origination criteria

9.3.15 R A *credit institution*, whether acting as *sponsor* or *originator*, must apply the same sound and well-defined criteria used for credit-granting in respect of exposures held on their *trading* and *non-trading book* under *SYSC* 7.1.9R to

exposures to be securitised. The criteria applied must include the processes for approving and, where relevant, amending, renewing and re-financing credits.

…

…

9.6.1 R An *originator* which, in respect of a securitisation in the *non-trading book*, has made use of *BIPRU* 9.3.1R in the calculation of *risk weighted exposure amounts*, or a *sponsor*, must not, with a view to reducing potential or actual losses to investors, provide support to the *securitisation* beyond its contractual obligations.

[**Note:** *BCD* Article 101(1)]

9.6.1A R An *originator* which has sold instruments in its *trading book* to an *SSPE* and no longer holds *market risk capital requirements* for these instruments, or a *sponsor*, must not, with a view to reducing potential or actual losses to investors, provide support to the *securitisation* beyond its contractual obligations.

[**Note:** *BCD* Article 101(1)]

9.6.2 R If an *originator* or *sponsor* fails to comply with *BIPRU* 9.6.1R or *BIPRU* 9.6.1AR in respect of a *securitisation*, it must:

(1) hold capital against all of the *securitised exposures* associated with the *securitisation* transaction as if they had not been *securitised*; and

(2) disclose publicly:

(a) that it has provided non-contractual support~~,~~; and

(b) the regulatory capital impact of doing so.

…

…

9.7.2 R (1) A *firm* ~~may~~ must not use the credit assessment of an *eligible ECAI* to determine the *risk weight* of a *securitisation position* in accordance with *BIPRU* 9.9 unless it complies with the principles of credibility and transparency as elaborated in (2) to (~~4~~6).

…

(5) The credit assessment must not be based, or partly based, on unfunded support provided by the *firm* itself.

(6) In the case of a credit assessment referred to in (5), the *firm* must consider the relevant position as if it were not rated and must apply

the relevant treatment of unrated positions as set out in *BIPRU* 9.11 and *BIPRU* 9.12.

[**Note:** *BCD*, Article 97(5) and Annex IX, Part 3, Point 1]

9.7.2A G The requirements in *BIPRU* 9.7.2R(5) and *BIPRU* 9.7.2R(6) apply to situations where a *firm* holds *securitisation positions* which receive a lower *risk weight* by virtue of unfunded credit protection provided by the *firm* itself acting in a different capacity in the *securitisation* transaction. The assessment of whether a *firm* is providing unfunded support to its *securitisation positions* should take into account the economic substance of such support in the context of the overall transaction and any circumstances in which the *firm* could become exposed to a higher credit risk in the absence of such support.

…

9.7.4 G Where *BIPRU* 9.7.2R(5) applies to *securitisation positions* in an *ABCP programme*, the *firm* may be granted a *waiver* which allows it to use the *risk weight* assigned to a *liquidity facility* in order to calculate the *risk weighted exposure amount* for the positions in the *ABCP programme,* provided that the *liquidity facility* ranks pari passu with the positions in the *ABCP programme* so that they form overlapping positions and 100% of the commercial paper issued by the *ABCP programme* is covered by *liquidity facilities*.

[**Note:** *BCD*, Annex IX, Part 4, Point 5]

…

9.9.8 R (1) Where a *firm* has two or more overlapping positions in a *securitisation* the *firm* must, to the extent the positions overlap, 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 *firm* may also recognise such an overlap between capital charges for *specific risk* in relation to *positions* in the *trading book* and capital charges for positions in the *non-trading book*, provided that the *firm* is able to calculate and compare the capital charges for the relevant positions.

…

9.9.10 G Where *BIPRU* 9.7.2R(5) applies to *securitisation positions* in an *ABCP programme*, the *firm* may be granted a *waiver* in the terms described in *BIPRU* 9.7.4G.

[**Note:** *BCD*, Annex IX, Part 4, Point 5]

…

9.11 Calculation of risk-weighted exposure amounts under the standardised approach to securitisations

9.11.1 R Subject to *BIPRU* 9.11.5R, the *risk weighted exposure amount* of a ~~*rated*~~ rated *securitisation position* or *resecuritisation position* must 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, as prescribed in *BIPRU* 9.11.2R ~~or *BIPRU* 9.11.3R~~.

[**Note:** *BCD*, Annex IX, Part 4, point 6]

9.11.2 R Table ~~Positions other than ones with short-term credit assessments~~

This table belongs to *BIPRU* 9.11.1R

Credit Quality step	1	2	3	4 (only for credit assessments other than short-term credit assessments)	~~5 and below~~ All other credit quality steps
~~*Risk weight*~~ *Securitisation positions*	20%	50%	100%	350%	1250%
Resecuritisation positions	40%	100%	225%	650%	1250%

…

[**Note**: For mapping of the *credit quality step* to the credit assessments of *eligible ECAIs*, refer to: www.fsa.gov.uk/pubs/international/ecais_securitisation.pdf]

[**Note:** *BCD*, Annex IX, Part 4, point 6, Table 1]

9.11.3 R ~~Table: Positions with short-term credit assessments~~

~~This table belongs to *BIPRU* 9.11.1R~~

~~*Credit quality step*~~	~~1~~	~~2~~	~~3~~	~~All other credit assessments~~
~~*Risk weight*~~	~~20%~~	~~50%~~	~~100%~~	~~1250%~~

~~[**Note:** For mapping of the *credit quality step* to the credit assessments of eligible *ECAIs*, refer to:~~

~~http://ww.fsa.gov.uk/pubs/international/ecais_securitsation.pdf]~~ [deleted]

…

9.12 Calculation of risk-weighted exposure amounts under the IRB approach

…

Ratings based method

…

9.12.10 R Under the *ratings based method*, the *risk weighted exposure amount* of a ~~*rated*~~ rated *securitisation position* or *resecuritisation position* must be calculated by applying to the *exposure* value the *risk weight* associated with the *credit quality step* with which the credit assessment is associated as prescribed in *BIPRU* 9.12.11R ~~and *BIPRU* 9.12.12R~~ multiplied by 1.06.

[**Note:** *BCD*, Annex IX, Part 4, point 46]

9.12.11 R Table: ~~Positions other than ones with short-term credit assessments~~

This table belongs to *BIPRU* 9.12.10R

Credit Quality Step ~~(CQS)~~		~~Risk weight~~ Securitisation positions			Resecuritisation positions	
Credit assess-ments other than short term	Short-term credit assessments	A	B	C	D	E
~~CQS~~1	1	7%	12%	20%	20%	30%
~~CQS~~ 2		8%	15%	25%	25%	40%
~~CQS~~ 3		10%	18%	35%	35%	50%
~~CQS~~ 4	2	12%	20%		40%	65%
~~CQS~~ 5		20%	35%		60%	100%
~~CQS~~ 6		35%	50%		100%	150%
~~CQS~~ 7	3	60%	75%		150%	225%
~~CQS~~ 8		100%			200%	350%

~~CQS~~ 9		250%	300%	500%
~~CQS~~ 10		425%	500%	650%
~~CQS~~ 11		650%	750%	850%
~~Below CQS 11~~ all other, unrated		1250%		

[**Note**: For mapping of the *credit quality step* to the credit assessments of eligible *ECAIs*, refer to: www.fsa.gov.uk/pubs/international/ecais_securitisation.pdf]

[**Note:** *BCD*, Annex IX, Part 4, point 46]

9.12.12 R ~~Table: Positions with short-term credit assessments~~

~~This table belongs to *BIPRU* 9.12.10R~~

~~Credit Quality Step (CQS)~~	~~Risk weight~~		
	~~A~~	~~B~~	~~C~~
~~CQS 1~~	~~7%~~	~~12%~~	~~20%~~
~~CQS 2~~	~~12%~~	~~20%~~	~~35%~~
~~CQS 3~~	~~60%~~	~~75%~~	~~75%~~
~~All other credit assessments~~	~~1250%~~	~~1250%~~	~~1250%~~

~~[**Note:** For mapping of the *credit quality step* to the credit assessments of eligible *ECAIs*, refer to: http://ww.fsa.gov.uk/pubs/international/ecais_securitsation.pdf]~~ [deleted]

9.12.13 R ~~Subject to *BIPRU* 9.12.16R and *BIPRU* 9.12.17R, the *risk weights* in column A of each table in *BIPRU* 9.12.11R and *BIPRU* 9.12.12R must be applied where the position is in the most senior *tranche* of a *securitisation*.~~ For the purposes of *BIPRU* 9.12.10R:

(1) the weightings in column C of *BIPRU* 9.12.11R must be applied where the *securitisation position* is not a *resecuritisation position* and where the effective number of *exposures* securitised is less than six;

(2) for the remainder of the *securitisation positions* that are not *resecuritisation positions*, the weightings in column B must be applied unless the position is in the most senior *tranche* of a *securitisation*, in which case the weightings in column A must be applied; and

(3) for *resecuritisation positions*, the weightings in column E must be applied unless the *resecuritisation position* is in the most senior *tranche* of the *resecuritisation* and none of the underlying *exposures* were themselves *resecuritisation exposures*, in which case column D must be applied.

[**Note:** *BCD*, Annex IX, Part 4, point 47(part)]

…

9.12.17 R ~~The *risk weights* in column C of each table in *BIPRU* 9.12.11R and *BIPRU* 9.12.12R must be applied where the position is in a *securitisation* where the effective number of *exposures securitised* is less than six.~~ 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*, C1, is available, the *firm* may compute N as 1/C1.

[**Note:** *BCD*, Annex IX, Part 4, point 49~~(part)~~]

9.12.18 R ~~In the case of *resecuritisation*, the *firm* must 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. If the portfolio share associated with the largest exposure, C1, is available, the *firm* may compute N as $1/C_1$.~~

~~[**Note:** *BCD* Annex IX Part 4 point 49 (part)]~~ [deleted]

9.12.19 R ~~The *risk weight* in Column B in the tables *BIPRU* 9.12.11R and *BIPRU* 9.12.12R must be applied to all other positions.~~

~~[**Note:** *BCD* Annex IX Part 4 point 50]~~ [deleted]

…

Supervisory formula method

9.12.21 R Subject to any *permission* of the type described in *BIPRU* 9.12.28G, under the *supervisory formula method*, the *risk weight* for a *securitisation position* must be ~~the greater of 7% or~~ the *risk weight* to be applied in accordance with *BIPRU* 9.12.22R. However, the *risk weight* must be no less than 20% for *resecuritisation positions* and no less than 7% for all other *securitisation positions*.

[**Note:** *BCD*, Annex IX, Part 4, point 52]

9.12.22 R (1) Subject to any *permission* of the type described in *BIPRU* 9.12.28G,

the *risk weight* to be applied to the *exposure* amount must be:

…

…

(19) N is the effective number of *exposures* calculated in accordance with *BIPRU* 9.12.17R – *BIPRU* 9.12.18R. In the case of *resecuritisations*, the *firm* must look at the number of *securitisation exposures* in the pool and not the number of underlying *exposures* in original pools from which the underlying *securitisation exposures* stem.

…

[**Note:** *BCD*, Annex IX, Part 4, point 53 (part)]

…

Application

9.15.1 R Subject to *BIPRU* 9.15.1AR, *BIPRU* 9.15 applies to:

(1) new *securitisations* issued on or after 1 January 2011; and

(2) from 31 December 2014, to existing *securitisations* where new underlying ~~exposures~~ *exposures* are added or substituted after that date.

[**Note:** *BCD*, Article 122a, paragraph 8]

9.15.1A R *BIPRU* 9.15.16AR and *BIPRU* 9.15.16BR only apply to:

(1) new *securitisations* issued on or after 31 December 2011; and

(2) from 31 December 2014, to existing *securitisations* where new underlying *exposures* are added or substituted after that date.

9.15.1B G A *credit institution* should have regard to the Committee of European Banking Supervisors' Guidelines to Article 122a of the *Banking Consolidation Directive* when considering its obligations under *BIPRU* 9.3.15R to *BIPRU* 9.3.20R and *BIPRU* 9.15. The Guidelines can be found at http://www.eba.europa.eu/Publications/Standards-Guidelines.aspx.

…

9.15.6 R Multiple applications of the retention of net economic interest requirements for any given *securitisation* are ~~prohibited~~ not required.

…

Group level requirements

9.15.16A R Subject to *BIPRU* 9.15.16BR, a *credit institution* must ensure that any *undertaking* in relation to which the *credit institution* is a *parent undertaking*:

(1) becomes exposed to the credit risk of a *securitisation* only where the *originator*, *sponsor* or *original lender* in the *securitisation* has explicitly disclosed to the *undertaking* that it will retain, on an *ongoing basis*, a material net economic interest which, in any event, must not be less than 5%, as set out in *BIPRU* 9.15.3R to *BIPRU* 9.15.10R;

(2) complies before investing in a *securitisation*, and continues to comply thereafter, with the investor due diligence requirements set out in *BIPRU* 9.15.11R to *BIPRU* 9.15.13R; and

(3) complies in relation to its investments in *securitisations* with the monitoring requirements set out in *BIPRU* 9.15.14R to *BIPRU* 9.15.16R.

9.15.16B R The requirements in *BIPRU* 9.15.16AR do not apply in respect of *subsidiaries* of a *credit institution* which are *insurance undertakings*, *UK UCITs management companies* or alternative investment fund managers.

9.15.16C G The purpose of *BIPRU* 9.15.16AR is to ensure that a *credit institution* meets the requirements in *BIPRU* 9.15 at *group* level in relation to its *subsidiary undertakings*. In order to comply with this *rule*, a *credit institution* should be able to demonstrate to the *FSA* that it has put in place adequate *group* policies and procedures which its *subsidiary undertakings* must follow in order to materially meet the requirements for investors set out in *BIPRU* 9.15, and that it regularly monitors compliance with those policies.

9.15.16D G Where a *credit institution* applies to the *FSA* for a *waiver* of *BIPRU* 9.15.16AR in relation to its non-*EEA subsidiary undertakings*, the *FSA* will have regard to whether those *undertakings* are themselves subject to requirements in their jurisdiction similar to those set out in *BIPRU* 9.15 and to any potential conflicts that may arise as a result of the *credit institution* having to apply *BIPRU* 9.15.16AR in relation to those *undertakings*.

9.15.16E G Without prejudice to *BIPRU* 9.15.16AR, when assessing *group risk* in accordance with *GENPRU* 1.2.30R a *credit institution* should have regard to the potential risks arising from *securitisation* investment activities carried out by other *undertakings* within its *group,* such as *affiliated companies* and *undertakings* in which the *credit institution* has a participating interest. Where these *undertakings* are not subject to similar requirements as those set out in *BIPRU* 9.15, the *FSA* may seek to address the potential risks arising from this situation for example by imposing a specific capital add-on in the *credit institution*'s *ICG*.

Consequences of failure to meet requirements

9.15.17 G (1) Subject to BIPRU 9.3.22G, BIPRU 9.15.9R to BIPRU 9.15.10R and BIPRU 9.15.18G, where a *credit institution* fails to meet any of the requirements in BIPRU 9.3.18G to BIPRU 9.3.20R (disclosure requirements), and BIPRU 9.15.11R to BIPRU 9.15.16R (investor due diligence requirements) in any material respect by reason of its negligence or omission, the *FSA* will use its powers under section 45 (Variation etc on the Authority's own initiative) of the *Act* to impose an additional *risk weight* of no less than 250% (capped at 1250%) of the risk weight that would otherwise apply to the relevant *securitisation positions* under BIPRU 9.11 to BIPRU 9.14. The additional *risk weight* imposed will be progressively increased with each relevant, subsequent infringement of the requirements in BIPRU 9.3.18 R to BIPRU 9.3.20R and BIPRU 9.15.11R to BIPRU 9.15.16R.

[**Note:** *BCD*, Article 122a, paragraph 5]

(2) Subject to *BIPRU* 9.3.22G, *BIPRU* 9.15.9R to *BIPRU* 9.15.10R and *BIPRU* 9.15.18G, where a *credit institution* fails to meet in any material respect the requirements in *BIPRU* 9.15.16AR (Group level requirements), the *FSA* may consider using its powers under section 45 (Variation etc on the Authority's own initiative) of the *Act* in the manner described in (1). In order to calculate the *risk weights* that would apply to the *credit institution*, the *FSA* may treat the *securitisation* investments of the *subsidiary undertaking* as if they were *securitisation positions* held directly by the *credit institution*.

...

Disclosure policy

11.3.3 R (1) A *firm* must adopt a formal policy to comply with the disclosure requirements laid down in *BIPRU* 11.3.1R and *BIPRU* 11.3.2R and have policies for assessing the appropriateness of its disclosures, including their verification and frequency.

(2) A *firm* must also have policies for assessing whether its disclosures convey its risk profile comprehensively to market participants. Where those disclosures do not convey its risk profile comprehensively to market participants, a *firm* must publicly disclose the information necessary in addition to that required according to *BIPRU* 11.3.3R(1). However, a *firm* may omit one or more items of information if those items are not, in the light of the criterion specified in *BIPRU* 11.4.1R, regarded as material, or if those items are, in the light of the criteria specified in *BIPRU* 11.4.2R and *BIPRU* 11.4.3R, regarded as proprietary or confidential.

[**Note:** *BCD* Article 145(3)]

…

Disclosure: Market risk

11.5.12 R A *firm* must disclose its *capital resources requirements* separately for each risk referred to in (1), ~~and~~ (2) and (3)~~.~~:

(1) in respect of its *trading-book* business, its:

(a) *interest rate PRR*;

(b) *equity PRR*;

(c) *option PRR*;

(d) *collective investment schemes PRR*;

(e) *counterparty risk capital component*; and

(f) *concentration risk capital component*; and

(2) in respect of all its business activities, its:

(a) *commodity PRR*; and

(b) *foreign currency PRR*; and

(3) its specific interest-rate risk of *securitisation positions*.

[**Note:** *BCD* Annex XII Part 2 point 9]

…

Disclosure: Use of VaR model for calculation of market risk capital requirement

11.5.13 R The following information must be disclosed by a *firm* which calculates its *market risk capital requirement* using a *VaR model*:

(1) for each sub-portfolio covered:

(a) the characteristics of the models used;

(b) a description of stress testing applied to the sub-portfolio;

(c) a description of the approaches used for backtesting and validating the accuracy and consistency of the internal models and modelling process;

(d) ~~the highest, the lowest and the mean of the daily *value-at-risk* measures over the reporting period and the *value-at-risk* measure as per the end of the period;~~ for the capital charges calculated according to the *incremental risk charge* and the *all*

price risk measure separately, the methodologies used and the risks measured through the use of an internal model, including a description of the approach used by the 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;

(e) 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;

(2) the scope of the *firm's VaR model permission*; and

(3) a description of the extent and methodologies for compliance with the requirements set out in *GENPRU* 1.3.13R(2) and *GENPRU* 1.3.13R(3) and *GENPRU* 1.3.14R to *GENPRU* 1.3.34R.;

(4) the highest, the lowest and the mean of the following:

(a) the daily *VaR measures* over the reporting period and the *VaR measure* as per the period end;

(b) the *stressed VaR* measures over the reporting period and the *stressed VaR* measure as per the period end;

(c) the capital charge according to the *incremental risk charge* over the reporting period and as per the period end;

(d) the capital charge according to the *all price risk measure* over the reporting period and as per the period end;

(5) the amount of capital according to the *incremental risk charge* and the amount of capital according to the *all price risk measure* shown separately, together with the weighted average liquidity horizon for each sub-portfolio covered; and

(6) a comparison of the daily end-of-day *VaR 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.

[**Note:** *BCD* Annex XII Part 2 point 10]

…

Disclosures: Securitisation

11.5.17 R A *firm* calculating *risk weighted exposure amounts* in accordance with *BIPRU* 9 or *capital resource requirements* according to *BIPRU* 7.2.48AR to

BIPRU 7.2.48KR must disclose the following information, where relevant separately for its *trading book* and *non-trading book*:

(1) a description of the *firm*'s objectives in relation to *securitisation* activity;

(1A) the nature of other risks, including *liquidity risk* inherent in securitised assets;

(1B) the type of risks in terms of seniority of underlying *securitisation positions* and in terms of assets underlying these latter *securitisation positions* assumed and retained with *resecuritisation* activity;

(2) the different roles played by the *firm* in the *securitisation* process;

(3) an indication of the extent of the *firm's* involvement in each of them;

(3A) 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 positions* and a description of how those processes differ for *resecuritisation positions*;

(3B) a description of the *firm's* policy governing the use of hedging and unfunded protection to mitigate the risks of retained *securitisation* and *resecuritisation positions*, including identification of material hedge counterparties by relevant type of risk exposure;

(4) the approaches to calculating *risk weighted exposure amounts* that the *firm* follows for its *securitisation* activities, including the types of *securitisation exposures* to which each approach applies;

(4A) the types of *SSPEs* that the *firm*, as *sponsor*, uses to securitise third-party *exposures*, including whether, and in what form, and to what extent, the *firm* has *exposures* to these *SSPEs*, separately for on and off-balance sheet *exposures*, as well as a list of the entities that the *firm* manages, or advises, and that invest in either the *securitisation positions* that the *firm* has securitised or in *SSPEs* that the *firm* sponsors;

(5) a summary of the *firm's* accounting policies for *securitisation* activities, including:

(a) whether the transactions are treated as sales or financings;

(b) the recognition of gains on sales;

(c) the methods, key assumptions, inputs and the changes from the previous period for valuing *securitisation positions* ~~retained interests~~; ~~and~~

(d) the treatment of *synthetic securitisations* if this is not covered by other accounting policies;

(e) how assets awaiting *securitisation* are valued and whether they are recorded in the *firm's non-trading book* or *trading book*; and

(f) policies for recognising liabilities on the balance sheet for arrangements that could require the *firm* to provide financial support for securitised assets;

(6) the names of the *ECAIs* used for *securitisations* and the types of *exposure* for which each agency is used;

(6A) where applicable, a description of the *ABCP internal assessment approach* as set out in *BIPRU* 9.12.20R, including the structure of the internal assessment process and relation between internal assessment and external ratings, the use of internal assessment other than for *ABCP internal assessment approach* 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;

(6B) an explanation of significant changes to any of the quantitative disclosures in *BIPRU* 11.5.17R(13) to *BIPRU* 11.5.17R(15) since the last reporting period;

(7) ~~the total outstanding amount of *exposures securitised* by the *firm* and subject to the *securitisation* framework (broken down into *traditional* and *synthetic*), by *exposure* type;~~ [deleted]

(8) for the *non-trading book* and for *exposures securitised* by the *firm* ~~and subject to the *securitisation* framework, a breakdown by *exposure* type of~~, the amount of impaired and past due *exposures securitised*, and the losses recognised by the *firm* during the current period, broken down by *exposure* type;

(9) ~~the aggregate amount of *securitisation positions* retained or purchased, broken down by *exposure* type;~~ [deleted]

(10) ~~the aggregate amount of *securitisation positions* retained or purchased:~~

~~(a) broken down into a meaningful number of *risk weight* bands; and~~

~~(b) with separate disclosure of *positions* that have been *risk weighted* at 1250% or deducted;~~ [deleted]

(11) ~~the aggregate outstanding amount of *securitised revolving exposures* segregated by the *originator's* interest and the investors' interest; and~~ [deleted]

(12) ~~a summary of the *securitisation* activity in the period, including the amount of *exposures securitised* (by *exposure* type), and recognised gain or loss on sale by *exposure* type.~~ [deleted]

(13) separately for the *trading book* and the *non-trading book*, the following information broken down by *exposure* type:

(a) the total outstanding amount of *exposures securitised* by the *firm*, separately for *traditional securitisations* and *synthetic securitisations*, and *securitisations* for which the *firm* acts only as *sponsor*;

(b) the aggregate amount of on-balance sheet *securitisation positions* retained or purchased, and off-balance sheet *securitisation exposures*;

(c) the aggregate amount of assets awaiting *securitisation*;

(d) for securitised facilities subject to an *early amortisation provision*, the aggregate drawn-down *exposures* attributed to the *originator's* and investors' interests respectively, the aggregate *capital resources requirement* incurred by the *firm* against the *originator's* interest and the aggregate *capital resources requirement* incurred by the *firm* against the investors' shares of drawn balances and undrawn lines;

(e) the amount of *securitisation positions* that have been *risk weighted* at 1250% or deducted; and

(f) a summary of the *securitisation* activity of the current period, including the amount of *exposures securitised* and recognised gain or loss on sale;

(14) separately for the *trading book* and the *non-trading book*, the following information:

(a) the aggregate amount of *securitisation positions* retained or purchased and the associated *capital resources requirements*, broken down by *securitisation* and *resecuritisation exposures*, and further broken down into a meaningful number of *risk weight* or *capital resources requirement* bands, for each *capital resources requirement* approach used; and

(b) the aggregate amount of *resecuritisation exposures* retained or purchased, broken down according to the *exposure* before and after hedging or insurance, and the *exposure* to financial

guarantors, broken down according to guarantor credit worthiness categories or guarantor name; and

(15) for the *trading book*, the total outstanding *exposures securitised* by the *firm* and subject to a *market risk capital requirement*, broken down into *traditional* and *synthetic,* and by *exposure* type.

[**Note:** *BCD* Annex XII Part 2 point 14]

…

14.2.6 R In the case of a credit default swap, a *firm* the *exposure* of which arising from the swap represents a long position in the underlying may 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 potential for future credit *exposure* of the *firm* must be limited to the amount of premia which are not yet paid by the entity to the *firm*.

[**Note:** *CAD* Annex II point 7]

…

Treatment of expected loss amounts under the IRB approach

14.2.18 R Where a *firm* calculates *risk weighted exposure amounts* for the purposes of *BIPRU* 14 in accordance with the *IRB approach*, then for the purposes of the calculation provided for in *BIPRU* 4.4.79R (Double default) 4.3.8R, the following will apply:

…

…

TP 4 Pre CRD capital requirements applying on a solo basis during 2007: Banks

…

4.36 G Any reference to a *qualifying debt security* or *qualifying equity* in a part of *BIPRU* that applies during 2007 should be interpreted in accordance with *IPRU(BANK)*. However BIPRU 7.2.50 R (Must not apply *qualifying debt security* treatment to risky assets) also applies.

…

4.43 G The definitions definition of *qualifying debt security* and *qualifying equity* in the *Glossary* apply applies if the security or obligor in question comes within the scope of a *firm's IRB permission*.

…

TP 6 Pre CRD capital requirements applying on a solo basis during 2007: Investment management firms

…

6.24 R Any reference to a *qualifying debt security* in a part of *BIPRU* that applies during 2007 must be interpreted in accordance with the meaning it has when used in section A of Table 5.2.3(5)(b) of chapter 5 of *IPRU(INV)* (Position risk requirement for qualifying debt securities). However BIPRU 7.2.50 R (Must not apply *qualifying debt security* treatment to risky assets) also applies. ~~Any reference to a *qualifying equity* in a part of *BIPRU* that applies during 2007 must be interpreted in accordance with the definition in the Glossary to chapter 10 of *IPRU(INV)*.~~

6.25 G The reason for *BIPRU* TP 6.23R and *BIPRU* TP 6.24R is that the calculation of the *specific risk* portion of the *interest rate PRR* under BIPRU 7 (Market risk) involves the use of the *standardised approach* to credit risk. The *specific risk rules* therefore need to be adjusted for a *firm* that is not using the *standardised approach* to credit risk in 2007 so as to apply the pre-2007 method of calculating *specific risk*. However chapter 5 does not use the concept of *specific risk*. The nearest equivalent is in chapter 10 of *IPRU(INV)* (*Securities and futures firms*). ~~The definition of *qualifying equity* also depends in part on the *standardised approach* to credit risk.~~

…

6.34 R The definition of *qualifying debt security* ~~and *qualifying equity*~~ in the *Glossary* ~~apply~~ applies if the security or obligor in question comes within the scope of a *firm's IRB permission*.

…

TP 8 Pre CRD capital requirements applying on a solo basis during 2007: Securities and futures firms

…

8.30 R Any reference to a *qualifying debt security* ~~or *qualifying equity*~~ in a part of *BIPRU* that applies during 2007 must be interpreted in accordance with the definition in the Glossary to chapter 10 of *IPRU(INV)*. However BIPRU 7.2.50 R (Must not apply *qualifying debt security* treatment to risky assets) also applies.

8.31 G The effect of *BIPRU* TP 8.29R and *BIPRU* TP 8.30R is that a *firm* should apply *rules* 43R to 47R of Appendix 4 of Chapter 10 of *IPRU(INV)* (Specific risk portion of interest rate PRR) instead of BIPRU 7.2.43 R to BIPRU 7.2.49 R (*Specific risk* portion of *interest rate PRR*). The reason for this is that the calculation of the *specific risk* portion of the *interest rate PRR* under BIPRU 7 (Market risk) involves the use of the *standardised approach* to credit risk. The *specific risk rules* therefore need to be adjusted

for a *firm* that is not using the *standardised approach* to credit risk in 2007 so as to apply the pre-2007 method of calculating *specific risk*. ~~The definition of *qualifying equity* also depends in part on the *standardised approach* to credit risk.~~

…

8.38	R	The ~~definitions~~ <u>definition</u> of *qualifying debt security* ~~and *qualifying equity*~~ in the *Glossary* ~~apply~~ <u>applies</u> if the security or obligor in question comes within the scope of a *firm's IRB permission*.

TP 9 Pre CRD capital requirements applying on a solo basis during 2007 and capital floors: Personal investment firms

…

9.36	R	Any reference to a *qualifying debt security* in a part of *BIPRU* that applies during 2007 must be interpreted in accordance with the definition in the Glossary to chapter 13 of *IPRU(INV)*. However BIPRU 7.2.50 R (Must not apply *qualifying debt security* treatment to risky assets) also applies. ~~Any reference to a *qualifying equity* in a part of *BIPRU* that applies during 2007 must be interpreted in accordance with the definition in the Glossary to chapter 10 of *IPRU(INV)*.~~
9.37	R	The reason for *BIPRU* TP 9.35R and *BIPRU* TP 9.36R is that the calculation of the *specific risk* portion of the *interest rate PRR* under BIPRU 7 (Market risk) involves the use of the *standardised approach* to credit risk. The *specific risk rules* therefore need to be adjusted for a *firm* that is not using the *standardised approach* to credit risk in 2007 so as to apply the pre-2007 method of calculating *specific risk*. However chapter 13 does not distinguish between *specific risk* and *general market risk*. The nearest equivalent is in chapter 10 of *IPRU(INV)* (*Securities and futures firms*). ~~The definition of *qualifying equity* also depends in part on the *standardised approach* to credit risk.~~

…

9.44	R	The definition of *qualifying debt security* ~~and *qualifying equity*~~ in the *Glossary* ~~apply~~ <u>applies</u> if the security or obligor in question comes within the scope of a *firm's IRB permission*.

…

TP 14 Market risk: VaR models

…

14.4 R A *firm* may treat:

(1) …: and

(2) the *incremental* ~~*default*~~ *risk charge* as being replaced by the provisions of that written concession relating to the calculation of capital requirements for *specific risk*.

…

Sch 2 Notification and reporting requirements

…

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
…				
BIPRU 7.2.48B	Total sum of a *firm*'s weighted net long and net short *securitisation* and *resecuritisation positions*, broken down by types of underlying assets	Total sum of a *firm*'s weighted net long and net short *securitisation* and *resecuritisation positions*, broken down by types of underlying assets	Periodically as set out in *SUP* 16.12.	In accordance with *SUP* 16.12.
…				
BIPRU 7.10.55G ZA	Material shortfall in the amount of capital required under the *all price risk measure* identified as a result of performing the stress tests under BIPRU 7.10.55RZ	Information about the stress tests and the material shortfall in capital	Existence of a material shortfall in capital	No later than two *business days* after the *business day* on which the material shortfall occurred
…				
BIPRU 7.10.130R	Details of significant planned changes to the *VaR model*	Information about the nature of the change and an estimate of the impact on *VaR numbers* and the *incremental* ~~*default*~~ *risk charge*	Intention to change	Prior to any changes being implemented

…

Annex D

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise indicated.

16.12 Integrated Regulatory Reporting

…

Regulated Activity Group 1

16.12.5 R The applicable *data items* and forms or reports referred to in *SUP* 16.12.4 R are set out according to *firm* type in the table below:

…

Note 23 Only applicable to *firms* that hold *securitisation positions* in the *trading book* and/or are the *originator* or *sponsor* of *securitisations* ~~of *trading book exposures*~~ held in the *trading book*.

…

Regulated Activity Group 3

…

16.12.11 R The applicable *data items* referred to in *SUP* 16.12.4R are set out according to *firm* type in the table below:

…

Note 32 Only applicable to *firms* that hold *securitisation positions* in the *trading book* and/or are the *originator* or *sponsor* of *securitisations* ~~of *trading book exposures*~~ held in the *trading book*.

…

Regulated Activity Group 4

…

16.12.15 R The applicable *data items* referred to in *SUP* 16.12.4R according to type of *firm* are set out in the table below:

…

Note 29 Only applicable to *firms* that hold *securitisation positions* in the *trading book* and/or are the *originator* or *sponsor* of *securitisations* ~~of *trading book exposures*~~ held in the *trading book*.

…

Regulated Activity Group 7

…

16.12.22A R The applicable *data items* referred to in *SUP* 16.12.4R are set out according to type of *firm* in the table below:

…

Note 22 Only applicable to *firms* that hold *securitisation positions* in the *trading book* and/or are the *originator* or *sponsor* of *securitisations* ~~of *trading book exposures*~~ held in the *trading book*.

…

Regulated Activity Group 8

…

16.12.25A R The applicable *data items* referred to in *SUP* 16.12.4R are set out according to type of *firm* in the table below:

…

Note 27 Only applicable to *firms* that hold *securitisation positions* in the *trading book* and/or are the *originator* or *sponsor* of *securitisations* ~~of *trading book exposures*~~ held in the *trading book*.

SUP 16 Annex 24 Data items for SUP 16.12

FSA005
Market risk
Note: In this table numerical references correspond with those shown on the online submission form and are not presented here in strict numerical order.

		A	B	C	D	E	F	G
	Interest rate risk							
	General interest rate risk	**USD**	**GBP**	**EUR**	**CHF**	**YEN**	**Other**	**Total**
1	Valuations of longs							
2	Valuation of shorts							
3	PRR (as per handbook)							
	Specific interest rate risk							
	Amount by risk bucket							**Total**
4	0.00%							
5	0.25%							
6	1.00%							
7	1.60%							
8	8.00%							
9	12.00%							
10	PRR							
~~11~~	~~Securitisation exposures/unrated liquidity facilities PRR~~							
66	Net long securitisation (excl. re-securitisation) exposures/unrated liquidity facilities PRR							
67	Net short securitisation (excl. re-securitisation) exposures/unrated liquidity facilities PRR							
68	Net long re-securitisation exposures/unrated liquidity facilities PRR							
69	Net short re-securitisation exposures/unrated liquidity facilities PRR							
12	Ordinary CDS (outside correlation trading portfolio) PRR							
13	Securitisation CDS (outside correlation trading portfolio) PRR							
14	Basic interest rate PRR calculation for equity instruments							
15	Option PRR for interest rate positions							
16	CAD1 PRR for interest rate positions							
17	Other PRR							
70	Correlation trading portfolio - Net long positions PRR							
71	Correlation trading portfolio - Net short positions PRR							
18	Total interest rate PRR							
	Equity risk							
	General equity risk (or simplified)	**USD**	**GBP**	**EUR**	**CHF**	**YEN**	**Other**	**Total**
19	Valuations of longs							
20	Valuation of shorts							
21	PRR							

FSA005 continued

		A USD	B GBP	C EUR	D CHF	E YEN	F Other	G Total
	Specific equity risk by risk bucket							
~~22~~	~~Qualifying equities~~							
23	Qualifying equity indices							
~~24~~	~~Other equities, indices or equity baskets~~							
82	All equities, and other equity indices or equity baskets							
~~63~~ 65	Convertibles adjustment							
25	PRR							
26	Option PRR for equity positions							
27	CAD 1 PRR for equity positions							
28	Other PRR							
29	Total Equity PRR							

Commodity Risk

		Precious metals	Base metals	softs	energy	other	Total
30	Valuation of longs						
31	Valuation of shorts						
32	Outright PRR						
33	Spread PRR						
34	Carry PRR						
35	Simplified PRR						
36	Total PRR						
37	Option PRR for commodity positions						
38	CAD 1 PRR for commodity positions						
39	Other PRR						
40	Total Commodity PRR						

Foreign currency risk

	General foreign currency risk	USD	GBP	EUR	CHF	YEN	Other	Total
41	Total net long positions							
42	Total net short positions							
43	Net gold position							
44	PRR							

FSA005 continued

		A USD	B GBP	C EUR	D CHF	E YEN	F Other	G Total
45	Option PRR for foreign currency							
46	CAD 1 PRR for foreign currency							
47	Other							
48	Total foreign currency PRR							

Collective investment undertaking risk

		USD	GBP	EUR	CHF	YEN	Other	Total
	General CIU risk							
49	Total net long positions							
50	Total net short positions							
51	PRR							
52	Option PRR for CIU							
53	CAD 1 PRR for CIU							
54	Other PRR							
55	Total CIU PRR							

Other PRR

		Total
56	Any other PRR	

Internal models-based charges

		Total
57	Multiplier	
58	Previous day's VaR PRR	
59	Average of previous 60 days VaR	
~~60~~	~~Incremental Default Risk Surcharge~~	
72	SVaR Multiplier	
73	Latest SVaR	
74	Average of previous 60 days SVaR	
75	Latest Incremental Risk Charge	
76	Average of previous 12 weeks Incremental Risk Charge	
77	Latest All Price Risk Measure	
78	Average of previous 12 weeks All Price Risk Measure	
79	Standard Rules charge for net long correlation trading portfolio products in APR model	
80	Standard Rules charge for net short correlation trading portfolio products in APR model	
81	All Price Risk Floor Charge	

FSA005 continued

Add-ons

		A Description	**B** **Value**
63	1		
	2		
	3		
	…		
	n		

64	Total Add-ons	
61	Internal models-based PRR	
62	**GRAND TOTAL PRR**	

• • •

FSA046
Securitisation: Non-Trading Book

General ~~Transaction level information - Where the firm is an originator or sponsor~~

		A
1	Location of the most recent Pillar 3 disclosures for securitisation (BIPRU 11.5.17R)	
2	Additional capital requirements for significant risk transfer (BIPRU 9.3.1R)	
21	Additional capital requirements (BIPRU 9.3.21G and BIPRU 9.15.17G)	
22	Reduction in RWAs according to BIPRU 9.10.4R and BIPRU 9.10.6R	

Transaction level information - Where the firm is an originator or sponsor

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P
3	Programme Name	Asset class	Originator's Interest	Investors' Interest	Location of Investor Reports	Assets appear on FSA001?	BIPRU 9.3.1R Applied?	Conversion Factor applied?	Exposure value before securitisation	Capital requirement before securitisation	Exposure value after securitisation	Exposure value deducted from capital resources	Capital requirement after securitisation before cap	Capital requirement after securitisation after cap	Retention of net economic interest (% to 2dp)	Method of retention of net economic interest
1																
…																
n																

Risk positions - standardised exposures

		~~A~~	~~B~~	~~C~~	~~D~~	~~E~~	~~F~~
		~~CQS1~~	~~CQS2~~	~~CQS3~~	~~CQS4 (only for credit assessments other than short-term credit assessments)~~	~~All other credit assessments~~	~~Deductions from capital~~
~~4~~	~~Originator~~						
~~5~~	~~Sponsor~~						
~~6~~	~~Counterparty credit risk~~						
~~7~~	~~All other exposures~~						

			A	B	C	D	E	F	G	H
			CQS1	CQS2	CQS3	CQS4 (only for credit assessments other than short-term credit assessments)	All other credit assessments	Deductions from capital	Concentration ratio (Exposure value)	Concentration ratio (Capital requirement)
31	Originator	Securitisation								
32		Resecuritisation								
33	Sponsor	Securitisation								
34		Resecuritisation								
35	Counterparty credit risk	Securitisation								
36		Resecuritisation								
37	All other exposures	Securitisation								
38		Resecuritisation								

FSA046 (cont)
Securitisation: Non-Trading Book

Risk positions - IRB exposures

			B	C	D	E	F	G	H	I	J	K	L	M	N	P	O
			CQS1 / ST CQS1	CQS2	CQS3	CQS4 / ST CQS2	CQS5	CQS6	CQS7 / ST CQS3	CQS8	CQS9	CQS10	CQS11	Below CQS11 / All other credit assessments	Supervisory formula (Exposure Value)	Supervisory formula (Capital Requirement)	Deductions from capital
8	Originator	A															
9		B															
10		C															
23		D															
24		E															
11	Sponsor	A															
12		B															
13		C															
25		D															
26		E															
14	Counterparty credit risk	A															
15		B															
16		C															
27		D															
28		E															
17	All other exposures	A															
18		B															
19		C															
29		D															
30		E															

...

FSA058
Securitisation: Trading Book

General ~~Transaction level information - Where the firm is an originator or sponsor~~

		A
1	Location of the most recent Pillar 3 disclosures for securitisation (BIPRU 11.5.17R)	
21	Additional capital requirements (BIPRU 7.2.47HG)	

Non-correlation trading portfolio securitisations

Transaction level information - Where the firm is an originator or sponsor

	A	B	C	D	E	F	O	P
3	Programme Name	Asset class	Originator's Interest	Investors' Interest	Location of Investor Reports	Assets appear on FSA001?	Retention of net economic interest (% to 2dp)	Method of retention of net economic interest
1								
…								
n								

[Insert the following tables as new Data Elements for Data Item FSA058. The text is not underlined.]

Risk positions - standardised exposures

			A	B	C	D	E	F
			CQS1	CQS2	CQS3	CQS4 (only for credit assessments other than short-term credit assessments)	All other credit assessments	Deductions from capital
31	Originator	Securitisation						
32		Resecuritisation						
33	Sponsor	Securitisation						
34		Resecuritisation						
35	Counterparty credit risk	Securitisation						
36		Resecuritisation						
37	All other exposures	Securitisation						
38		Resecuritisation						

Risk positions - IRB exposures

			B	C	D	E	F	G	H	I	J	K	L	M	N	P	O
			CQS1	CQS2	CQS3	CQS4	CQS5	CQS6	CQS7	CQS8	CQS9	CQS10	CQS11	Below CQS11	Supervisory formula (Exposure Value)	Supervisory formula (Capital Requirement)	Deductions from capital
			ST CQS1			ST CQS2			ST CQS3					All other credit assessments			
8	Originator	A															
9		B															
10		C															
23		D															
24		E															
11	Sponsor	A															
12		B															
13		C															
25		D															
26		E															
14	Counterparty credit risk	A															
15		B															
16		C															
27		D															
28		E															
17	All other exposures	A															
18		B															
19		C															
29		D															
30		E															

FSA058 (cont)
Securitisation: Trading Book
Total capital requirement (net long positions plus net short positions) broken down by underlying assets

		A
		Capital requirement
39	Residential mortgages	
40	Commercial mortgages	
41	Credit cards	
42	Leasing	
43	Loans to corporates	
44	Consumer loans	
45	Trade receivables	
46	Securitisations	
47	Other	

Correlation trading portfolio positions

Risk positions - standardised exposures

		A	B	C	D	E	F
		CQS1	CQS2	CQS3	CQS4 (only for credit assessments other than short-term credit assessments)	All other credit assessments	Deductions from capital
48	Originator						
49	Sponsor						
50	Counterparty credit risk						
51	All other exposures						

Risk positions - IRB exposures

			B	C	D	E	F	G	H	I	J	K	L	M	N	P	O
			CQS1			CQS4			CQS7					Below CQS11			
			ST CQS1	CQS2	CQS3	ST CQS2	CQS5	CQS6	ST CQS3	CQS8	CQS9	CQS10	CQS11	All other credit assessments	Supervisory formula (Exposure Value)	Supervisory formula (Capital Requirement)	Deductions from capital
52	Originator	A															
53		B															
54		C															
55	Sponsor	A															
56		B															
57		C															
58	Counterparty credit risk	A															
59		B															
60		C															
61	All other exposures	A															
62		B															
63		C															

…

16 Annex 25G Guidance notes for data items in SUP 16 Annex 24R

…

FSA005 – Market risk

....

~~**11 Securitisation exposures/unrated liquidity facilities PRR**~~

~~See *BIPRU* 7.2.47R.~~

~~[*CEBS' MKR SA TDI item 3.5, column 9*]~~

66 Net long securitisation (excl. resecuritisation) exposures/unrated liquidity facilities PRR

See *BIPRU* 7.2.48AR to *BIPRU* 7.2.48KR.

67 Net short securitisation (excl. re-securitisation) exposures/unrated liquidity facilities PRR

See *BIPRU* 7.2.48AR to *BIPRU* 7.2.48KR.

68 Net long resecuritisation exposures/unrated liquidity facilities PRR

See *BIPRU* 7.2.48AR to *BIPRU* 7.2.48KR.

69 Net short resecuritisation exposures/unrated liquidity facilities PRR

See *BIPRU* 7.2.48AR to *BIPRU* 7.2.48KR.

12 Ordinary CDS (outside correlation trading portfolio) PRR

See *BIPRU* 7.11.24R

[*Part of CEBS' MKR SA TDI item 3, columns 6 and 7*]

13 Securitisation CDS (outside correlation trading portfolio) PRR

See *BIPRU* 7.11.35R

[*Part of CEBS' MKR SA TDI item 3, columns 6 and 7*]

...

17 Other PRR for interest-rate risk

Where a 'prudent' uplift is required under *BIPRU* 7.2.46R or PRR arising from other non-standard transactions as required by *BIPRU* ~~7.1.7 R~~ 7.1.9R to *BIPRU* ~~7.1.13E~~ 7.1.16E and that is attributable to interest rate risk.

70 Correlation trading portfolio - Net long positions PRR

See *BIPRU* 7.2.42AR to *BIPRU* 7.2.42DR and *BIPRU* 7.2.48LR.

71 Correlation trading portfolio - Net short positions PRR

See *BIPRU* 7.2.42AR to *BIPRU* 7.2.42DR and *BIPRU* 7.2.48LR.

18 Total interest rate PRR

This is the sum of the general interest rate, specific interest rate, *securitisation* exposures/unrated liquidity facilities, *resecuritisation positions* / unrated liquidity facilities,

ordinary CDS, *securitisation* CDS, basic interest rate, options, CAD1, ~~and~~ other PRRs, and *correlation trading portfolio positions*.

This will have the same value as data element 96A in FSA003.

[*CEBS' MKR SA TDI column 9 total less item 4 column 9*]

Equity risk

...

~~**22 Qualifying equities**~~
~~Enter the valuation of the instruments. See *BIPRU* 7.3.35R to *BIPRU* 7.3.37G.~~
~~[*CEBS' MKR SA EQU item 2.1, column 6*]~~

23 Qualifying equity indices
Enter the valuation of the instruments. See *BIPRU* 7.3.38R to *BIPRU* 7.3.39R.

~~**24 Other equities**~~
~~Enter the valuation of all other equities, equity indices or equities baskets.~~

~~[*CEBS' MKR SA EQU item 2.2, column 6*]~~

82 All equities, and other equity indices or equity baskets

Enter the valuation of all equities, other equity indices or equities baskets. See *BIPRU* 7.3.31G to *BIPRU* 7.3.34R.

…

Internal models-based charges

See *BIPRU* 7.10.

...

59 Average of previous 60 days VaR

This equates to item (3) in *BIPRU* 7.10.117G.

[*CEBS' MKR IM total positions column 1 divided by total positions column 7*]

~~**60 Incremental default risk charge**~~

~~This is the incremental default risk charge under *BIPRU* 7.10.116R. It also includes the specific risk surcharge under *BIPRU* 7.10.127G.~~

~~[*CEBS' MKR IM total positions columns 3 and 4*]~~

72 SVaR Multiplier

See *BIPRU* 7.10.118R *to BIPRU* 7.10.126G.

73 Latest SVaR

See *BIPRU* 7.10.27AR

74 Average of previous 60 days SVaR

See *BIPRU* 7.10.27AR and *BIPRU* 7.10.117G (6) and (8).

75 Latest Incremental Risk Charge

See *BIPRU* 7.10.116R.

76 Average of previous 12 weeks Incremental Risk Charge

See *BIPRU* 7.10.116 R and *BIPRU* 7.10.117 G (10) and (11).

77 Latest All Price Risk Measure

See *BIPRU* 7.10.55TR to *BIPRU* 7.10.55YR and *BIPRU* 7.10.116AR.

78 Average of previous 12 weeks All Price Risk Measure

See *BIPRU* 7.10.55T R *to BIPRU* 7.10.55Y R, *BIPRU* 7.10.116A R and *BIPRU* 7.10.117G (13) & (14).

79 Standard Rules charge for net long correlation trading portfolio products in APR model

Firms should report the total standard rules capital charge before multiplying the charge by the *APR* floor charge (8%). The *APR* floor charge is reported in data element 81.

See *BIPRU* 7.10.55UR.

80 Standard Rules charge for net short correlation trading portfolio products in APR model

Firms should report the total standard rules capital charge before multiplying the charge by the *APR* floor charge (8%). The *APR* floor charge is reported in data element 81.

See *BIPRU* 7.10.55UR

81 All Price Risk Floor Charge

See *BIPRU* 7.10.55UR.

…

61 Internal models-based PRR

~~See BIPRU 7.10.113R to BIPRU 7.10.117G.~~

~~This will have the same value as data element 102A on FSA003.~~

~~[CEBS' MKR IM total positions column 5]~~

This is the sum of the *VaR* capital charge, *stressed VaR* (SVaR) capital charge, *incremental risk charge*, *all price risks measure* and any internal models add-ons. See *BIPRU* 7.10.113 R to *BIPRU* 7.10.117G.

This will have the same value as data element 102A in FSA003.

FSA005 – Market risk validations

Internal validations

Data elements are referenced by row then column.

Validation number	Data element		
…			
7			[deleted – replaced by validation 56]
…			
52			[deleted – replaced by validation 57]
…			
54	81G	=	Higher of (79G * 8%, 80G * 8%)
55	61G	=	Higher of (58G, 59G * 57G) + higher of (73G, 74G * 72G) + higher of (75G, 76G) + higher of (77G, 78G, 81G) + 64G
56	25G	=	(82G * 8%) + (23G*0%) + 65G
57	18G	=	3G + 10G + 12G + 13G + 14G + 15G + 16G + 17G +higher of (66G + 68G, 67G + 69G) + higher of (70G, 71G)
58	57G	>=	3.00 (if element 57G is reported)
59	72G	>=	3.00 (if element 72G is reported)

…

FSA046 – Securitisation – non-trading book

...

Risk positions – standardised exposures

All *exposures* that are treated under *BIPRU* 9.11 should be shown in this section, broken down by credit quality, ~~and~~ how the *exposure* arose, and whether the position is a *securitisation* or *resecuritisation*.

~~Row 4~~ Rows 31 & 32 : Originator

This is for *exposures* where the *firm* originated the underlying assets.

~~Row 5~~ Rows 33 & 34: Sponsor

This is for *exposures* to *Asset backed commercial paper programmes*.

~~Row 6~~ Rows 35 & 36: Counterparty credit risk

This is the *exposure* values generated under *BIPRU* 13.

~~Row 7~~ Rows 37 & 38: All other exposures

This is for any standardised *exposures* not included in *data elements* ~~4-6~~ 31 – 38 above.

…

Column F

This is for positions deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R as appropriate.

Column G

Firms should state the exposure value of *securitisation positions* for which *risk weighted exposure amounts* are calculated under *BIPRU* 9.11.6R to *BIPRU* 9.11.7G.

Column H

Firms should state the capital requirement for *securitisation positions* for which *risk weighted exposure amounts* are calculated under *BIPRU* 9.11.6R to *BIPRU* 9.11.7G.

Risk positions – IRB exposures

All *exposures* that are treated under *BIPRU* 9.12 should be shown in this section, broken down by credit quality, granularity and how the *exposure* arose.

Rows 8 – 10 & 23 -24: Originator

This is for *exposures* where the *firm* originated the underlying *exposures*.

Rows 11 – 13 & 25 - 26: Sponsor

This is for *exposures* to *Asset backed commercial paper programmes*.

Rows 14 – 16 & 27 - 28: Counterparty credit risk

This is for exposure values generated under *BIPRU* 13 where the *exposure* is also a *securitisation* position.

Rows 17 – 19 & 29 - 30: All other exposures

This covers any IRB *exposures* not included above.

Columns B – M

This should be split by credit rating according to *BIPRU* 9.12.11R and *BIPRU* 9.12.12R.

Column N

Firms should state the *exposure* value calculated under *BIPRU* 9.12.21R to *BIPRU* 9.12.23R.

Column O

This is for positions deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R as appropriate.

Column P

Firms should state the capital requirement calculated under *BIPRU* 9.12.21R to *BIPRU* 9.12.23R.

…

FSA058 – Securitisation – trading book

This data item allows a greater understanding of the prudential risk profile of the *firm*. It also enables the *FSA* to lead debate on credit risk transfer in international discussions.

This data item captures information on the *firm's trading book securitisation positions* which fall under *BIPRU* 7.2 where they are acting as *originator*, *sponsor* or investor. *Non-trading book securitisations* are captured in FSA046.

The data item has been separated into three sections:

- general *trading book securitisation* information;
- information on non-*correlation trading portfolio securitisations*; and
- *correlation trading portfolio securitisations*.

…

Non-correlation trading portfolio securitisations

Transaction level information - Where the firm is an originator or sponsor

All *securitisations* where you have acted as an *originator* or *sponsor* where the assets are held in the *trading book* should be shown in this section, irrespective of whether you meet *BIPRU* 9.3.1R.

...

[Insert the following new text at the end of FSA058. The text is not underlined]

Risk positions – standardised exposures

All non-*correlation trading portfolio securitisation positions* that are treated under *BIPRU* 7.2.48DR should be shown in this section, broken down by credit quality, how the *exposure* arose, and whether the position is a *securitisation* or *resecuritisation*.

Rows 31 & 32: Originator

This is for *exposures* where the *firm* originated the underlying assets.

Rows 33 & 34: Sponsor

This is for *exposures* where the firm acts as a *sponsor*.

Rows 35 & 36: Counterparty credit risk

This is the *exposure* values generated under *BIPRU* 13.

Rows 37 & 38: All other exposures

This is for any standardised *exposures* not included in *data elements* 31 – 38 above. For example, a firm that is an investor in *trading book securitisations*.

Columns A – E

Positions should be split by credit rating according to *BIPRU* 7.2.48DR.

Column F

This is for *positions* deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R as appropriate.

Risk positions – IRB exposures

All *exposures* that are treated under *BIPRU* 7.2.48ER should be shown in this section, broken down by credit quality, granularity and how the *exposure* arose.

Rows 8 – 10 & 23 – 24: Originator

This is for *exposures* where the *firm* originated the underlying *exposures*.

Rows 11 – 13 & 25 – 26: Sponsor

This is for *exposures* where the firm acts as a *sponsor*.

Rows 14 – 16 & 27 – 28: Counterparty credit risk

This is for exposure values generated under *BIPRU* 13 where the *exposure* is also a *securitisation position*.

Rows 17 – 19 & 29 – 30: All other exposures

This covers any *IRB exposures* not included above. For example, a *firm* that is an investor in *trading book securitisations*.

Columns B – M

This should be split by credit rating according to *BIPRU* 7.2.48ER.

Column N

Firms should state the exposure value calculated under *BIPRU* 7.2.48AR to *BIPRU* 7.2.48CR.

Column P

Firms should state the capital requirement calculated under *BIPRU* 7.2.48FR.

Column O

This is for *positions* deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R as appropriate.

Total capital requirement (net long positions plus net short positions) broken down by underlying assets

Rows 39 – 47

Enter the total capital requirement (net long positions and net short positions) broken down by underlying assets as shown.

Correlation trading portfolio positions

Risk positions: standardised exposures

All *correlation trading portfolio positions* that are treated under *BIPRU* 7.2.48DR should be shown in this section, broken down by credit quality and how the *exposure* arose.

Row 48: Originator

This is for *exposures* where the *firm* originated the underlying assets.

Row 49: Sponsor

This is for *exposures* where the firm acts as a sponsor.

Row 50: Counterparty credit risk

This is the exposure values generated under *BIPRU* 13.

Row 51: All other exposures

This is for any standardised *exposures* not included in *data elements* 48 - 50 above. For example, a firm that is an investor in *correlation trading portfolio positions*.

Columns A – E

Positions should be split by credit rating according to *BIPRU* 7.2.48DR.

Column F

This is for *positions* deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R as appropriate.

Risk positions: IRB exposures

All *exposures* that are treated under *BIPRU* 7.2.47ER should be shown in this section, broken down by credit quality, granularity and how the *exposure* arose.

Rows 52 – 54: Originator

This is for *exposures* where the *firm* originated the underlying *exposures*.

Rows 55 – 57: Sponsor

This is for *exposures* where the *firm* acts as a sponsor.

Rows 58 – 60: Counterparty credit risk

This is for exposure values generated under *BIPRU* 13 where the *exposure* is also a *securitisation position*.

Rows 61 – 63: All other exposures

This covers any *IRB exposures* not included above. For example, a *firm* that is an investor in *correlation trading portfolio positions.*

Columns B – M

This should be split by credit rating according to *BIPRU* 7.2.48ER.

Column N

Firms should state the exposure value calculated under *BIPRU* 7.2.48A R to *BIPRU* 7.2.48CR.

Column P

Firms should state the capital requirement calculated under *BIPRU* 7.2.48FR.

Column O

This is for positions deducted from capital at part 1 of stage M of the capital calculations in *GENPRU* 2, Annexes 2R, 3R, 4R, 5R or 6R, as appropriate.

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