

Chapter 4

Own funds requirements

4.14 K-TCD requirement

- 4.14.1** **R** (1) The *K-TCD requirement* of a MIFIDPRU investment firm is an amount equal to the sum of the *TCD own funds requirement* for all transactions specified in (2).
- (2) This *rule* applies to the transactions in ■ MIFIDPRU 4.14.3R where the transactions:
- (a) are recorded in the *trading book* of a *firm dealing on own account* (whether for itself or on behalf of a *client*); or
 - (b) in the case of the transactions specified in ■ MIFIDPRU 4.14.3R(2)-(7), are carried out by a *firm* that has the necessary *permissions* to *deal on own account*.

- 4.14.2** **G** (1) The effect of ■ MIFIDPRU 4.14.1R(2)(b) is that where a *firm* is authorised to *deal on own account*, it must include in the calculation of its *K-TCD requirement* any transactions specified in ■ MIFIDPRU 4.14.3R(2)-(7). This applies even if the *firm's* involvement in the transaction does not constitute *dealing on own account* and the transaction may not be recorded in its *trading book*.
- (2) A *firm* that is not authorised to *deal on own account* is not subject to the *K-TCD requirement* under ■ MIFIDPRU 4.14.1R, even if it is involved in a transaction that would otherwise fall within ■ MIFIDPRU 4.14.3R(2)-(7).

Transactions to which K-TCD applies

- 4.14.3** **R** Subject to ■ MIFIDPRU 4.14.5R, the transactions to which ■ MIFIDPRU 4.14.1R applies are as follows:
- (1) derivative contracts listed in Annex II to the *UK CRR*, with the exception of the following:
 - (a) derivative contracts directly or indirectly cleared through a *CCP*, where all of the following conditions are met:
 - the positions and assets of the *firm* related to the contracts are distinguished and segregated, at the level of both the *clearing member* and the *CCP*, from the position and assets of the *clearing member* and the other clients of that *clearing member* and, as a result of that distinction and segregation, those positions and assets are bankruptcy remote under applicable law in the event of default or insolvency of the *clearing member* or one or more of its other clients;

		<ul style="list-style-type: none"> (ii) the legal requirements applicable to or binding the <i>clearing member</i> facilitate the transfer of the client's positions relating to the contracts and of the corresponding collateral to another <i>clearing member</i> within the applicable margin period of risk in the event of default or insolvency of the original <i>clearing member</i>; and (iii) the <i>firm</i> has obtained an independent, written and reasoned legal opinion that concludes that, in the event of a legal challenge, the <i>firm</i> would bear no losses on account of the insolvency of its <i>clearing member</i> or of any of its <i>clearing member's</i> clients; <ul style="list-style-type: none"> (b) exchange-traded derivative contracts; and (c) derivative contracts held for hedging a position of the <i>firm</i> resulting from an activity outside the <i>trading book</i>; <ul style="list-style-type: none"> (2) <i>long settlement transactions</i>; (3) <i>repurchase transactions</i>; (4) <i>securities or commodities lending or borrowing transactions</i>; (5) <i>margin lending transactions</i>; (6) any other types of <i>securities financing transactions</i>; and (7) credits and loans referred to in the activity in point 2 of paragraph 1 of Part 3A of Schedule 2 to the <i>Regulated Activities Order</i>, if the <i>firm</i> is: <ul style="list-style-type: none"> (a) executing the trade in the name of the <i>client</i>; or (b) receiving and transmitting the order without executing it.
4.14.4	R	<p>A derivative contract that is directly or indirectly cleared through an <i>authorised central counterparty</i> is deemed to meet the conditions in ■ MIFIDPRU 4.14.3R(1)(a).</p>
4.14.5	R	<p>The <i>K-TCD requirement</i> does not apply to transactions with the following counterparties:</p> <ul style="list-style-type: none"> (1) central governments and central banks, where the underlying exposures would receive a 0% risk weight under article 114 of the <i>UK CRR</i>; (2) multilateral development banks listed in article 117(2) of the <i>UK CRR</i>; or (3) international organisations listed in article 118 of the <i>UK CRR</i>.
4.14.6	R	<ul style="list-style-type: none"> (1) With the prior consent of the <i>FCA</i>, a <i>firm</i> may exclude transactions with the following counterparties from the calculation of its <i>K-TCD requirement</i> under ■ MIFIDPRU 4.14.1R: <ul style="list-style-type: none"> (a) its <i>parent undertaking</i>;

- (b) its *subsidiary*;
 - (c) a *subsidiary* of its *parent undertaking*; or
 - (d) an *undertaking* with which the *firm* is linked by *majority common management*.
- (2) To obtain the *FCA* consent in (1), the *firm* must demonstrate all of the following to the satisfaction of the *FCA*:
- (a) the counterparty is subject to appropriate prudential requirements and is one of the following:
 - (i) a *credit institution*;
 - (ii) an *investment firm*; or
 - (iii) a *financial institution*;
 - (b) the counterparty is:
 - (i) included in the same prudential consolidation group as the *firm* on a full basis in accordance with the *UK CRR* or the consolidation provisions in ■ MIFIDPRU 2.5; or
 - (ii) supervised along with the *firm* for compliance with the group capital test in ■ MIFIDPRU 2.6;
 - (c) the counterparty is subject to the same risk evaluation, measurement and control procedures as the *firm*;
 - (d) the counterparty is established in the *UK*; and
 - (e) there is no current or foreseen material practical or legal impediment to the prompt transfer of *own funds* or repayment of liabilities from the counterparty to the *firm*.
- (3) To apply for *FCA* consent under (1), a *firm* must complete the form in ■ MIFIDPRU 4 Annex 10R and submit it using the *online notification and application system*.

Calculation of TCD own funds requirement

4.14.7



The *TCD own funds requirement* for each transaction or *netting set* must be calculated using the following formula:

$$TCD \text{ own funds requirement} = \alpha * EV * RF * CVA$$

where:

- (1) $\alpha = 1.2$
- (2) EV = the exposure value calculated in accordance with ■ MIFIDPRU 4.14.8R
- (3) RF = the risk factor applicable to the counterparty type as set out in the table in ■ MIFIDPRU 4.14.29R
- (4) CVA = the credit valuation adjustment calculated in accordance with ■ MIFIDPRU 4.14.30R

Exposure value

4.14.8

R

The exposure value must be calculated using the following formula:

Exposure value = Max (0; RC + PFE – C)

where:

- (1) RC = the replacement cost calculated in accordance with [■ MIFIDPRU 4.14.9R](#) (which may be a positive value, thereby increasing the exposure value, or a negative value, thereby decreasing the exposure value)
- (2) PFE = potential future exposure calculated in accordance with [■ MIFIDPRU 4.14.10R](#)
- (3) C = collateral as determined in accordance with [■ MIFIDPRU 4.14.24R](#) and [■ MIFIDPRU 4.14.25R](#) (which may be a positive value, thereby decreasing the exposure value, or a negative value, thereby increasing the exposure value)

Replacement cost

4.14.9

R

- (1) A *firm* must calculate the replacement cost for all transactions referred to in [■ MIFIDPRU 4.14.3R](#).
- (2) The replacement cost must be determined as follows:
 - (a) for derivative contracts, the replacement cost is the *CMV*;
 - (b) for *long settlement transactions*, the replacement cost is the settlement amount of cash to be paid or to be received by the *firm* upon settlement, with a receivable being treated as a positive amount and a payment being treated as a negative amount;
 - (c) unless (d) applies, for *repurchase transactions* and *securities or commodities lending or borrowing transactions*, the replacement cost is the amount of cash lent or borrowed, with cash lent by the *firm* being treated as a positive amount and cash borrowed by the *firm* being treated as a negative amount;
 - (d) for *securities financing transactions*, where both legs of the transaction are securities, the replacement cost is the *CMV* of the security lent by the *firm*, increased by the corresponding volatility adjustment in [■ MIFIDPRU 4.14.25R](#); and
 - (e) for *margin lending transactions* and the credits and loans referred to in [■ MIFIDPRU 4.14.3R\(7\)](#), the replacement cost is the book value of the asset in accordance with the applicable accounting framework.

Potential future exposure

4.14.10

R

- (1) A *firm* is required to calculate potential future exposure (PFE) only for derivative contracts.
- (2) A *firm* must calculate the potential future exposure for derivative contracts in a *netting set* using one of the following approaches:

- (a) the hedging approach in ■ MIFIDPRU 4.14.14R; or
- (b) the derivative netting ratio approach in ■ MIFIDPRU 4.14.18R.
- 4.14.11** **R** Where a single derivative contract cannot be allocated to a *netting set* with other derivative contracts, it must be treated as a separate *netting set* for the purposes of ■ MIFIDPRU 4.14.10R.
- 4.14.12** **R** A *firm* must apply its chosen approach under ■ MIFIDPRU 4.14.10R:
- (1) continuously for at least 24 *months*; and
 - (2) consistently across all its *netting sets*.
- Potential future exposure: hedging approach**
- 4.14.13** **G**
- (1) If a derivative contract has a negative replacement cost, a *firm* should still calculate a PFE in relation to that contract if it is possible for the replacement cost to become positive before the maturity date.
 - (2) As the replacement cost of an individual written option can never be a positive amount, written options are exempt from the requirement to calculate a PFE, unless they are subject to netting with contracts other than written options for the purposes of calculating PFE in accordance with ■ MIFIDPRU 4.14.14R and ■ MIFIDPRU 4.14.16R.
 - (3) If a written option is subject to netting for the purposes of calculating PFE, a *firm* may cap the PFE in relation to that option at an amount that would result in a replacement cost of zero.
- 4.14.14** **R**
- (1) For the purposes of calculating the PFE of derivative contracts included within a *netting set* under ■ MIFIDPRU 4.14.16R, a *firm* must:
 - (a) calculate the effective notional amount of each contract (EN) in accordance with ■ MIFIDPRU 4.14.20R;
 - (b) allocate each derivative contract to an asset class in accordance with (2) and (3); and
 - (c) calculate a separate net notional amount for each asset class in (b) by netting the EN of all derivative contracts allocated to that asset class, with long positions to be treated as positive amounts and short positions to be treated as negative amounts.
 - (2) Subject to (3), a *firm* must assign derivative contracts to separate asset classes as follows:
 - (a) except as specified in (b) to (d), a derivative contract must be allocated to the relevant asset class specified in the table in ■ MIFIDPRU 4.14.22R;
 - (b) interest rate derivatives must be allocated to separate asset classes according to their currency;
 - (c) foreign exchange derivatives must be allocated to separate asset classes according to each currency pair; and

- (d) derivative contracts falling within the “other” class in ■ MIFIDPRU 4.14.22R may be allocated to the same class if their primary risk driver is identical, but otherwise must each be treated as a separate class.
- (3) Derivative contracts that would fall within a specific asset class under (2) must be allocated to a separate asset class if:
 - (a) they reference the basis between two risk factors and are denominated in a single currency (i.e. they are basis transactions), in which case all basis transactions referencing that same pair of risk factors must be allocated to a separate asset class; or
 - (b) they reference the volatility of a risk factor (i.e. they are volatility transactions), in which case all volatility transactions referencing that same risk factor must be allocated to a separate asset class.

4.14.15

G

- (1) ■ MIFIDPRU 4.14.14R(2) defines the main asset classes to which derivative contracts should be assigned to calculate the potential future exposure of a *netting set*. For example, a single name equity derivative would be allocated to the equity single name asset class in ■ MIFIDPRU 4.14.22R, while a credit derivative would be allocated to the credit asset class in that *rule*.
- (2) ■ MIFIDPRU 4.14.14R(3) requires basis transactions or volatility swaps that would otherwise fall within one of the main asset classes in ■ MIFIDPRU 4.14.14R(2) to be allocated to separate asset classes. The separate asset classes are defined according to the relevant risk factor or pair of risk factors.
- (3) For example, an equity index future on Equity Index A and another equity index future on Equity Index B would be allocated to the same asset class under ■ MIFIDPRU 4.14.14R(2)(a), as they both fall within the asset class (i.e. equity indices) in ■ MIFIDPRU 4.14.22R. However, a volatility swap that references Equity Index A must be allocated to a separate class under ■ MIFIDPRU 4.14.14R(3)(b), but can be grouped with another volatility swap that also references Equity Index A (i.e. the same risk factor).
- (4) For derivative contracts relating to foreign exchange, a *firm* may net contracts relating to a currency pair (for example, USD/EUR) against contracts relating to the inverse pair (i.e. in this example, EUR/USD) by treating one pair as a long position and the inverse pair as a short position.
- (5) For interest rate derivative contracts that have multiple legs, the *firm* should add together the notional amounts of the positive (receive) and negative (pay) legs, after adjusting for the duration and the supervisory delta in accordance with the calculation of the effective notional amount in ■ MIFIDPRU 4.14.20R. The net amount should then be included in the calculation of PFE.

4.14.16

R

For the purposes of ■ MIFIDPRU 4.14.10R(2)(a), a *firm* must calculate the potential future exposure of derivative contracts included within a *netting set* by:

- (1) multiplying the absolute value of the net notional amount under ■ MIFIDPRU 4.14.14R(1)(c) for each asset class within the *netting set* by the supervisory factor for that asset class specified in ■ MIFIDPRU 4.14.22R;
- (2) adding together the product of the calculation in (1) for all asset classes within the *netting set*; and
- (3) multiplying the sum under (2) by:
 - (a) 0.42, for *netting sets* of transactions with financial or non-financial counterparties for which, if required, collateral is exchanged bilaterally with the counterparty in accordance with the conditions laid down in article 11 of *EMIR*; or
 - (b) 1, for other *netting sets*.

Potential future exposure: derivative netting ratio approach

4.14.17

G

- (1) If a derivative contract has a negative replacement cost, a *firm* should still calculate a potential future exposure (PFE) in relation to that contract if it is possible for the replacement cost to become positive before the maturity date.
- (2) As the replacement cost of an individual written option can never be a positive amount, written options are exempt from the requirement to calculate a PFE, unless they are subject to netting with contracts other than written options for the purposes of calculating PFE in accordance with ■ MIFIDPRU 4.14.18R.

4.14.18

R

A *firm* must calculate a net potential future exposure for each *netting set* using the following formula:

$$\text{PFE}_{\text{net}} = \frac{\text{RC}_{\text{net}}}{\text{RC}_{\text{gross}}} \cdot \text{PFE}_{\text{gross}}$$

where:

- (1) PFE_{net} = the net potential future exposure for the *netting set*;
- (2) $\text{PFE}_{\text{gross}}$ = the sum of the potential future exposure of all derivative contracts included in the *netting set*, calculated by multiplying the absolute value of the effective notional amount of each derivative contract (as calculated in accordance with ■ MIFIDPRU 4.14.20R) by the relevant supervisory factor for the corresponding asset class specified in ■ MIFIDPRU 4.14.22R;
- (3) RC_{net} = the sum of the replacement cost (as determined in accordance with ■ MIFIDPRU 4.14.9R) of all transactions included in the *netting set*, unless that sum is a negative amount, in which case RC_{net} is zero;
- (4) RC_{gross} = the sum of the replacement cost (as determined in accordance with ■ MIFIDPRU 4.14.9R) of all transactions included in the *netting set* that have a positive *CMV*, and

- (5) where the value of RCgross is zero, then the result of RCnet divided by RCgross is deemed to be:
 - (a) a value of '1' when a *netting set* consists of a single derivative contract; or
 - (b) a value of zero when a *netting set* consists of more than one derivative contract.

4.14.18A **G**

For the purposes of ■ MIFIDPRU 4.14.18R(5), a *firm* should:

- (1) still consider any residual risk of potential harm that may arise in connection with using the derivative netting ratio approach as part of the *ICARA process* under ■ MIFIDPRU 7; and
- (2) be consistent in its approach to allocating transactions to *netting sets*.

4.14.19 **R**

For the purposes of ■ MIFIDPRU 4.14.10R(2)(b), the potential future exposure for the derivative contracts included within a *netting set* is the product of multiplying PFEnet (as determined in accordance with ■ MIFIDPRU 4.14.18R) by:

- (1) 0.42, for *netting sets* of transactions with financial or non-financial counterparties for which, if required, collateral is exchanged bilaterally with the counterparty in accordance with the conditions laid down in article 11 of *EMIR*; or
- (2) 1, for other *netting sets*.

Effective notional amount

4.14.20 **R**

- (1) The effective notional amount is calculated as follows:

Effective notional amount = $N * D * SD$

- (a) N = the notional amount, determined in accordance with (2);
 - (b) D = the duration, calculated in accordance with (3); and
 - (c) SD = the supervisory delta, calculated in accordance with (5).
- (2) The notional amount, unless clearly stated and fixed until maturity, is determined as follows:
 - (a) for foreign exchange derivative contracts:
 - (i) if one leg of the contract is in the domestic currency, the notional amount is the notional amount of the foreign currency leg of the contract, converted into the domestic currency;
 - (ii) if both legs of the contract are denominated in currencies other than the domestic currency, the notional amount of each leg must be converted into the domestic currency and the leg with the larger value in the domestic currency is the notional amount; and
 - (iii) the term "domestic currency", when used in this *rule*, refers to the currency in which the *firm* reports to the *FCA*;
 - (b) for equity and commodity derivatives contracts and emissions allowances and derivatives thereof, the notional amount is the

- product of the market price of one unit of the underlying instrument and the number of units referenced by the trade;
- (c) for transactions with multiple pay-offs that are state contingent including digital options or target redemption forwards, a *firm* must calculate the notional amount for each state and use the largest resulting calculation;
 - (d) where the notional is a formula of market values, the *firm* must use the *CMVs* to determine the trade notional amount;
 - (e) for variable notional swaps such as amortising and accreting swaps, a *firm* must use the average notional over the remaining life of the swap as the trade notional amount;
 - (f) leveraged swaps must be converted to the notional amount of the equivalent unleveraged swap so that where all of the rates in a swap are multiplied by a factor, the stated notional amount is multiplied by the factor on the interest rates to determine the notional amount; and
 - (g) for a derivative contract with multiple exchanges of principal, the stated notional amount must be multiplied by the number of exchanges of principal in the derivative contract to determine the notional amount.
- (3) The duration must be determined in accordance with the following:
- (a) for all derivative contracts other than interest rate contracts and credit derivative contracts, the duration is 1;
 - (b) for interest rate contracts and credit derivative contracts, the duration is determined in accordance with the following formula in which the time to maturity is specified in years:

$$\text{Duration} = (1 - \exp(-0.05 * \text{time to maturity})) / 0.05$$
- (4) The maturity of a contract must be determined as follows:
- (a) for an option, the maturity is the latest contractual exercise date as specified by the contract;
 - (b) for a derivative contract that is structured such that on specified dates, any outstanding exposure is settled and the terms are reset so that the fair value of the contract is zero, the remaining maturity is the time until the next reset date;
 - (c) for any other derivative contract, the maturity is the latest date on which the contract may still be executed; and
 - (d) in each case, if the derivative contract references the value of another interest rate or credit instrument, the time period must be determined on the basis of that underlying instrument.
- (5) The supervisory delta must be determined as follows:
- (a) for options and swaptions, the *firm* may calculate the supervisory delta itself by using an appropriate model if:
 - (i) the model the *firm* uses meets the minimum standards set out in ■ MIFIDPRU 4.12.12G to ■ MIFIDPRU 4.12.18G (Minimum standards for own estimates of delta), as modified by ■ MIFIDPRU 4.14.21R, for each type of option or swaption for which it calculates delta;

- (ii) the *firm* has notified the *FCA* that the minimum standards in (i) are met before the *firm* begins to use its own estimates for the relevant supervisory delta; and
- (iii) the notification in (ii) is made using the form in ■ MIFIDPRU 4 Annex 5R and submitted using the *online notification and application system*;
- (b) for transactions other than options and swaptions, or transactions in respect of which a *firm* is unable to use an appropriate model in accordance with (a), the supervisory delta is 1 or -1; and
- (c) in each case, the supervisory delta must reflect the relationship between the contract and the underlying, whereby a contract that increases exposure (by increasing RC) as the underlying increases shall have a positive supervisory delta, and a contract that decreases exposure (by decreasing RC) as the underlying increases shall have a negative supervisory delta.

4.14.21 R

- (1) When applying the minimum standards in ■ MIFIDPRU 4.12.12G to ■ MIFIDPRU 4.12.18G for the purposes of ■ MIFIDPRU 4.14.20R(5)(a), the standards apply with the following modifications:
 - (a) a reference to the “standardised approach” is a reference to the *rules* in this section relating to the calculation of the *K-TCD requirement*; and
 - (b) a reference to the *K-NPR requirement* is a reference to the *K-TCD requirement*.
- (2) In addition to the minimum standards in ■ MIFIDPRU 4.12.12G to ■ MIFIDPRU 4.12.18G a *firm* must also confirm to the *FCA* that the relevant model estimates the rate of change of the value of the option for small changes in the market value of the underlying.

4.14.22 R

The supervisory factor for each asset class is set out in the following table:

Asset class	Supervisory factor
Interest rate	0.5%
Foreign exchange	4%
Credit	1%
Equity single name	32%
Equity index	20%
Commodity and emission allowance	18%
Other	32%

4.14.23 R

Transactions relating to gold or gold derivatives must be allocated to the foreign exchange asset class in ■ MIFIDPRU 4.14.22R.

Value of collateral.....

4.14.24 R

- (1) This *rule* applies for the purposes of determining the value of C under ■ MIFIDPRU 4.14.8R.

- (2) For the transactions specified in ■ MIFIDPRU 4.14.3R(1), ■ (5) and ■ (7), the value of the C is the notional amount of collateral received by the *firm*, decreased in accordance with the relevant volatility adjustment specified in ■ MIFIDPRU 4.14.25R.
- (3) Unless (4) applies, for the transactions specified in ■ MIFIDPRU 4.14.3R(2), ■ (3), ■ (4) and ■ (6), the value of the C is the sum of:

(a) the *CMV* of the *security* leg; and

(b) the net amount of collateral posted or received by the *firm*.
- (4) For *securities financing transactions* where both legs of the transaction are *securities*, the value of the C is the *CMV* of the *security* borrowed by the *firm*.
- (5) Where the *firm* is purchasing or has lent the *security*, the *CMV* of the *security* shall be treated as a negative amount and shall be decreased to a larger negative amount, using the volatility adjustment specified in ■ MIFIDPRU 4.14.25R.
- (6) Where the *firm* is selling or has borrowed the *security*, the *CMV* of the *security* shall be treated as a positive amount and be decreased by the volatility adjustment specified in ■ MIFIDPRU 4.14.25R.
- (7) Where different types of transactions are covered by a contractual netting agreement that meets the requirements in ■ MIFIDPRU 4.14.28R(3), the applicable volatility adjustments in column C (volatility adjustment other transactions) of the table in ■ MIFIDPRU 4.14.25R must be applied to the respective amounts calculated under (3)(a) and (b) on an issuer basis within each asset class.
- (8) Where there is a currency mismatch between the transaction and the collateral received or posted, an additional currency mismatch volatility adjustment of 8% shall apply.

4.14.25

R

- (1) A *firm* must apply the volatility adjustments in (2) to all transactions referred to in ■ MIFIDPRU 4.14.3R.
- (2) Collateral for bilateral and cleared transactions shall be subject to volatility adjustments in accordance with the following table:

(A)		(B)	(C)
		Volatility ad- justment: re- purchase trans- actions and se- curities lending and borrowing transactions	Volatility ad- justment: other transactions
Asset class			
Debt securities issued by central governments or central banks	≤ 1 year	0.707%	1%
	> 1 year ≤ 5 year	2.121%	3%
	> 5 years	4.243%	6%

(A)		(B)	(C)
Asset class		Volatility adjustment: re-purchase transactions and securities lending and borrowing transactions	Volatility adjustment: other transactions
Debt securities issued by other entities	≤ 1 year	1.414%	2%
	> 1 year ≤ 5 years	4.243%	6%
	> 5 years	8.485%	12%
Securitisation positions (excluding re-securitisation positions)	≤ 1 year	2.828%	4%
	> 1 year ≤ 5 years	8.485%	12%
	> 5 years	16.970%	24%
Listed equities and convertibles		14.143%	20%
Other financial instruments (including re-securitisation positions) and commodities		17.678%	25%
Gold		10.607%	15%
Cash		0%	0%

4.14.26 **G** The references to years in column A of the table in ■ MIFIDPRU 4.14.25R are references to the remaining maturity of the relevant security or position.

4.14.27 **G** The following is an example of how the volatility adjustment under ■ MIFIDPRU 4.14.24R and ■ MIFIDPRU 4.14.25R applies. A *firm* enters into an OTC derivative contract and receives collateral in the form of a debt security issued by a central bank with a maturity of 6 years. The notional value of the debt security is 100. ■ MIFIDPRU 4.14.24R(2) requires the notional value of the collateral to be decreased by the applicable volatility adjustment. In accordance with the table in ■ MIFIDPRU 4.14.25R, the relevant volatility adjustment is 6%. The resulting value of the collateral after the volatility adjustment has been applied is therefore 94.

Netting

4.14.28 **R** For the purposes of calculating its *K-TCD requirement*, a *firm* may, in the following order:

- (1) first, treat perfectly matching contracts included in a netting agreement as if they were a single contract with a notional principal equivalent to the net receipts;
- (2) second, net other transactions subject to novation under which all obligations between the *firm* and its counterparty are automatically amalgamated in such a way that the novation legally substitutes one set single net amount for the previous gross obligations; and
- (3) third, net other transactions where the *firm* ensures that the following conditions have been met:

- (a) the transactions are covered by a netting contract with the counterparty, or by another agreement that creates a single legal obligation, such that the *firm* would have either a claim to receive, or obligation to pay, only the net sum of the positive and negative mark-to-market values of the individual transactions if a counterparty fails to perform due to any of the following:
 - (i) default;
 - (ii) bankruptcy;
 - (iii) liquidation; or
 - (iv) similar circumstances;
- (b) in the event of default of a counterparty, the netting contract does not contain any clause that permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulting party even if the defaulting party is a net creditor;
- (c) the *firm* has obtained an independent, written and reasoned legal opinion that, in the event of a legal challenge to the netting agreement, the *firm's* claims and obligations would be equivalent to those referred to in (a) under each of the following legal regimes:
 - (i) the law of the jurisdiction in which the counterparty is incorporated;
 - (ii) if a foreign branch of a counterparty is involved, the law of the jurisdiction in which the branch is located;
 - (iii) the law that governs the individual transactions included in the netting agreement; or
 - (iv) the law that governs any contract or agreement necessary to effect the netting.

Risk factor

4.14.29 R

The risk factor for a counterparty is set out in the following table:

Counterparty type	Risk factor
Central governments, central banks and public sector entities	1.6%
Credit institutions and investment firms	1.6%
Other counterparties	8%

Credit valuation adjustment

4.14.30 R

- (1) For the purposes of this *rule*, the "credit valuation adjustment" (CVA) means an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty that reflects the *CMV* of the credit risk of the counterparty to the *firm*, but does not reflect the *CMV* of the credit risk of the *firm* to the counterparty.
- (2) The CVA for all transactions is 1.5, except for the transactions in (3).
- (3) The CVA for the following transactions is 1:

- (a) the following transactions, if they do not exceed the clearing threshold specified in article 10(3) and (4) of *EMIR*:
 - (i) transactions with non-financial counterparties (as defined in point (9) of article 2 of *EMIR*); or
 - (ii) transactions with non-financial counterparties established in a *third country*;
- (b) intra-group transactions as provided for in article 3 of *EMIR*;
- (c) *long settlement transactions*;
- (d) *securities financing transactions* unless the *FCA* has notified the *firm* that the *firm's* CVA risk exposures arising from those transactions are material; and
- (e) credits and loans referred to in ■ MIFIDPRU 4.14.3R(7).