Calculation

3-63(1) R

A firm must calculate its eligible capital substitutes in accordance with table 361, subject to (2) to (9) below.

Approved eligible capital substitutes

3-63(2) R

A firm may treat a subordinated loan, approved bank bond or approved undertaking as an eligible capital substitute only if it is:

(a) drawn up in accordance with the relevant standard form obtained from the FCA; and
(b) signed by authorised signatories of all the parties.

3-63(2) G

If a firm wishes to use a form which differs from the standard form it will need to seek a modification to, or modification or waiver of, this rule.

A firm may, under the provisions of IPRU(INV) 1.2.5R continue to treat a subordinated loan, bank bond or approved undertaking as an eligible capital substitute if it was entitled to do so immediately prior to the specified day, and the other conditions set out in IPRU(INV) 1.2.5R are met.

Approved lenders

3-63(3) R

A firm may treat a subordinated loan as an eligible capital substitute only if the lender is:

(a) the firm's controller;
(b) a regulated banking institution;
(c) an approved person; or
(d) a regulated financial institution.

3-63(3) G

If the firm wishes to include as an eligible capital substitute a subordinated loan from a lender not within the above list, it will need to apply for a modification or modification or waiver of 3-63.

Notice of repayment and termination

3-63(4) R

A firm must provide the FCA with five business days written notice of any repayment, prepayment or termination of a subordinated loan, approved bank bond or approved undertaking, except when the firm's financial resources after payment of interest or principal etc would be less than or equal to 120% of its financial resources requirement, in which case the firm must not repay, prepay or terminate any subordinated loan, ap-

(b) the firm has a material proportion of its expenditure incurred on its behalf by third parties and such expenditure is not fully recharged to the firm.

3-73(4) G

FCA would for example consider an application to vary a firm's permitted activity as a significant change.

FCA would consider 10% of a firm's expenditure incurred on its behalf by third parties to be material.

If a firm is in any doubt, it should always seek guidance from the FCA.

Recent Authorisation

3-73(5) R

If a firm has not been authorised long enough to have prepared annual financial statements after authorisation, it must base its relevant annual expenditure on budgeted or other accounts which it submitted to the FCA as part of its application.

Application

3-74(1) R

The volume of business requirement applies only to a firm which settles margined transactions for counterparties.

Margined transactions

3-74(2) R

A firm's volume of business requirement is 3.5% of the aggregate gross amounts of any initial margin (as calculated in (3) below) of the firm's counterparties at the relevant time.

Initial margin

3-74(3) R

A counterparty's initial margin for the purposes of (2) above is the sum of the following amounts:

(a) in respect of exchange traded transactions, the counterparty's initial margin requirement; and
(b) in respect of OTC transactions, the amount of margin that the counterparty is required by the firm to deposit.

3-75 LIQUIDITY ADJUSTMENT

General rule

3-75(1) R

(c) raw materials which will be combined with physical commodities to produce a finished processed commodity, in which case there is no liquidity adjustment (but see PRR rules).

Investments in connected companies

3-75(7) R

The liquidity adjustment for an investment in a connected company is the balance sheet value of the investment, except where the investment is a marketable investment which is not in a subsidiary, in which case there is no liquidity adjustment but such investment must be subject to the PRR rules.

Other investments

3-75(8) R

Other investments have no liquidity adjustment but instead are subject to the PRR rules.

Prepayments

3-75(9) R

The liquidity adjustment for a prepayment is the balance sheet value of that prepayment, except that there is no liquidity adjustment to the extent that it relates to goods and services to be received or performed in the next three months (or six weeks in the case of an investment manager; an introducing broker who is not responsible for its counterparties' performance; a venture capital firm which is an arranger; or a model A clearing firm).

Debtors arising from investment business or dealing activities

3-75(10) R

Debtors arising from investment business or dealing activities have no liquidity adjustment but instead are subject to the CRR rules.

Other debtors

3-75(11) R

The liquidity adjustment for debtors other than debtors arising from investment business or dealing activities is the balance sheet value of the debtor, except that there is no liquidity adjustment in the following circumstances:

(a) amounts due from connected companies which are adequately secured and are repayable within 90 days;
(b) unsecured amounts due at the request of the firm from a connected company which is a regulated banking institution within 90 days;
(c) unsecured amounts due at the request of the firm from a connected company which is a regulated financial institution within seven days;
(d) having given prior written notice to the FCA, unsecured amounts receivable at the request of the firm from a connected company within seven days under an approved treasury arrangement, up to a maximum of the firm's excess of financial resources over

its financial resources requirement before taking into account the approved treasury arrangement;

(e) amounts receivable in respect of cash dividends declared by either exchange traded companies or authorised persons which have been outstanding for 30 days or less from the date the dividends were due to be paid;

(f) amounts accrued or receivable in respect of interest on marketable investments which have been outstanding for 30 days or less from the date the interest was due to be paid;

(g) amounts receivable on U.K. value added tax which have been outstanding for 30 days or less from the date that the value added tax return was due to be received by HM Customs & Excise; and

(h) amounts receivable on taxation other than U.K. value added tax which have been agreed with the appropriate tax authorities and have been outstanding for 30 days or less from the date that the amounts were due to be received.

Cash deposits

3-75(12) R

The liquidity adjustment for a cash deposit is the balance sheet value of the deposit, except for qualifying deposits and those other deposits which are subject to rule 3-180.

Other assets

3-75(13) R

The liquidity adjustment for assets other than those specifically stated above is the balance sheet value of the asset concerned. Other assets do not include a defined benefit asset or a deferred acquisition cost asset.

Charged assets - General rule

3-76 R

A firm must calculate the primary requirement for charged assets as the aggregate balance sheet value of each asset of the firm over which a third party has the right of sale or retention on default by the firm except:

(a) to the extent of any liability of the firm plus a reasonable margin in respect of the charged asset; or

(b) where the asset is collateral for a transaction which is subject to the CRR rules.

Contingent liabilities - General rule

3-77 R

A firm must calculate a primary requirement for each of its contingent liabilities.

Deficiencies in subsidiaries - General rule

3-78 R

A firm must calculate the primary requirement for deficiencies in subsidiaries as an amount equal to any deficiency in shareholders' funds at any time of a subsidiary of the firm except to the extent that:

(a) provision has already been made by the firm; or

(b) the firm has already calculated a liquidity adjustment or CRR because the deficiency arises or partially arises out of a liability of the subsidiary to the firm.

SECONDARY REQUIREMENT

Risk Profile

3-79(1) R

A firm must include in its secondary requirement any amount specified in any requirement to cover an unusual risk profile

Operational risks

3-79(2) R

A firm must include in its secondary requirement any amount specified in any requirement to cover the inadequate management of operational risk to which a firm is exposed.

3-79(2) G

In assessing whether to impose a requirement on a firm to cover an unusual risk profile or operational risks, the FCA will consider various criteria. In addition, the FCA will take into account material group risks to a firm, where these have not been captured in a group financial resources test. Secondary requirements may be applied, for example, where there has been a major failure on the part of a firm to maintain adequate controls, as a means of providing an additional capital buffer whilst these problems are addressed.

POSITION RISK REQUIREMENT

3-80 GENERAL PRINCIPLES OF PRR

Application

3-80(1) R

Rules 3-80 to 3-169B apply to any arranger or broad scope firm, except a venture capital firm or a corporate finance advisory firm.

Obligation to calculate PRR*

3-80(2) R

A firm must calculate a minimum PRR in respect of any position according to one of the methods available to it under the rules below, as appropriate, but may calculate a higher PRR in any other way at its option.

3-80(2) G

Notwithstanding the methods available for calculating the PRR, a firm may, in respect of any individual position, calculate a PRR which is more conservative than that calculated under the appropriate rule. However, in that case, the firm will need to be able to demonstrate that, in all circumstances, the calculation being employed does give rise to a higher PRR for the position.

* For guidance notes as to which methods to apply, see **Appendix 20**

Frequency of calculation

3-80(3) R

A firm must be able to monitor its total PRR on an intra-day basis and must re-calculate it in a full and detailed manner before executing any trade which is likely to increase it to such a level that the firm's financial resources requirement might exceed the firm's financial resources.

Marking to market

3-80(4) R

A firm must mark to market its positions, whether or not on the balance sheet, in accordance with the valuation rule 3-41(9) at least once every business day and more frequently as appropriate.

3-80(4A) R

A firm must calculate the PRR for any position which is a marketable investment as 8% of the mark to market value of the position, other than in respect of a derivative (whatever the nature of the underlying instrument) or off balance sheet contract, when the PRR is 8% of the value of the notional position underlying the contract.

Non marketable investments

3-80(5) R

A firm must calculate the PRR for any position which is not a marketable investment as 100% of the mark to market value of the position, other than in respect of a derivative (whatever the nature of the underlying instrument) or off balance sheet contract, when the PRR is 100% of the value of the notional position underlying the contract.

Instruments for which no percentage risk addition has been specified

3-80(6) R

A firm must calculate the PRR for any on or off balance sheet position in a marketable investment for which no percentage risk addition is specified under the PRR rules as an appropriate percentage of the current mark to market value of any position or notional position underlying the contract and must notify the FCA of the terms of the instrument and the proposed PRR treatment.

3-80(6A) E

(1) In 3-80(6) "an appropriate percentage" is:

(a) 100%; or
(b) A percentage which takes account of the characteristics of the instrument concerned and of discussions with the FCA or a predecessor regulator;

(2) Compliance with (1) may be relied on as tending to establish compliance with 3-80(6).
(3) Contravention of (1) may be relied on as tending to establish contravention of 3-80(6).

Group hedging arrangements

3-80(7) R

A firm may amend its PRR to take account of a group hedging arrangement to which the firm is party, provided the group hedging arrangement is recorded by an agreement in writing between all the relevant parties and the firm first notifies the FCA in writing of the terms of the arrangement and of the proposed amendment to the PRR.

Alternative treatments

3-80(8) R

Where a firm has the alternative of treating a position under two or more different methods or treatments within methods, it must treat the position under one of those methods.

Simpler approach to PRR calculation

3-80(9) R

As a simpler approach to calculating PRR, a firm may calculate the total PRR by multiplying all positions in marketable investments by the relevant percentage stated in the table below and summing the results.

TABLE 3-80(9)

Position risk requirement - simpler approach

C: Stock positions in physical commodities

Stock positions in physical commodities associated with a firm's investment business	30% of realisable value

D: Certain derivatives and foreign exchange

Exchange traded futures and written options	4 x initial margin requirement
OTC futures and written options	Apply the percentage shown in C above to the mark to market value of the underlying position
Purchased options	Apply the percentage shown in C above to the mark to market value of the underlying position but the result may be limited to the mark to market value of the option

(b) where the price of an instrument is quoted in more than one currency, a position in that instrument must be treated as an asset or liability in the currency in which the firm accounts for the instrument; and

(c) notwithstanding (a) and (b) above, a position in an American depository receipt or similar form of instrument must be treated as a position, translated at current spot rate, in the currency of the underlying instrument.

3-152 APPLICATION OF FOREIGN CURRENCY EXPOSURES AND DERIVATIVES METHODS TO FOREIGN CURRENCY DERIVATIVES

Risk assessment models

3-152(1) G

A firm may seek a modification or waiver from the FCA to use a risk assessment model in respect of its currency options to calculate notional positions which may be included in the foreign currency exposures method, provided the model forms part of the day to day management supervision of the firm's options business and meets other criteria (further guidance on the criteria for the approval of such models can be obtained from the FCA).

Obligatory use of foreign currency derivatives method

3-152(2) R

A firm must apply the foreign currency derivatives method to any currency option which is less than 5% "in the money".

Optional use of foreign currency derivatives method

3-152(3) R

Subject to (2) above, a firm may apply the foreign currency derivatives method to any exchange traded currency option or future instead of applying the foreign currency exposures method.

Obligatory use of foreign currency exposures method

3-152(4) R

A firm must apply the foreign currency exposures method to any OTC currency future.

Calculation of "in the money"

3-152(5) R

For the purposes of this rule, a firm must determine the extent to which the option contract is "in the money" by reference to the difference between the exercise price and the current forward rate for the final date on which the option may be exercised as a percentage of that forward rate.

(a) A firm must calculate a net open position for all currencies including the currency of the firm's books of account by netting all foreign currency exposures to which the method applies.

(b) The net open position for the currency of the firm's books of account may be calculated as the difference between the aggregate net open long positions and aggregate net open short positions of all other currencies.

COMMODITIES METHOD

Types of positions to be included in the commodities method

3-166 GENERAL RULE

3-166(1) R

A firm must calculate PRR on all positions in commodities in accordance with one of the four approaches set out in rules 3-167 to 3-169A. All spot, physical trading, derivative and other off balance sheet items whose price is affected by changes in commodities prices must be included in the calculation.

3-166(1) G

In general, a commodity is a physical product which is or can be traded on the secondary market. Commodities include precious metals (except gold, which is to be treated as a foreign currency), agricultural products, minerals and base metals, oil and other energy products.

3-166(2) R

A firm must calculate the PRR for each commodity separately, except that:

(a) different subcategories of the same commodity that are deliverable against each other may be treated together; and

(b) commodities which are close substitutes for each other, and whose price movements over a minimum period of one year can be shown by the firm to exhibit a stable and reliable correlation of at least 0.9, may be treated together.

3-166(2) G

The onus is on the firm to show that the correlation referred to in (b) above exists on a continuing basis.

3-166(3) R

(a) Positions which are purely stock financing may be omitted from the calculation of PRR on commodities positions under rule 3-166 and a firm may net notional long and short government securities arising from swaps, FRAs, futures and options on interest rates

3-168 MATURITY LADDER APPROACH

3-168(1) R

All positions in each commodity or commodity derivatives must be expressed in terms of the standard unit of measurement for that commodity (such as tonnes, barrels or kilos) or in terms of value. A firm must allocate net positions on any given day to the appropriate maturity band in the table below. Physical stock must be assigned to the first band.

Table 3-168

Maturity Bands for Maturity Ladder Approach	
0-1 month	1-2 years
1-3 months	2-3 years
3-6 months	over 3 years
6-12 months	

3-168(2) R

A firm may then offset long and short positions within and between maturity bands in accordance with the following:

(a) For markets which have daily delivery dates, a firm may offset contracts in the same commodity against each other provided that the expiry dates are within 10 business days of each other.

(b) For each maturity band, the firm must sum all the open long positions, and sum all the open short positions. The firm may then subtract the shorts from the longs to form the overall net position. The amount subtracted is the "matched amount". The firm must multiply twice the matched amount by the spread rate of 1.5%, and then by the spot price for the commodity to arrive at the spread risk charge.

3-168(2) G

If the total of all longs in a maturity band is 100, and the total of all shorts is 75, the "matched amount" is 75 and the overall net position 25. Algebraically, if the total of all longs is A, and the total of all shorts is B, the "matched amount" is min{A,B}, and the overall net position is A-B.

(c) The firm may then carry backwards or forwards all or part of the overall net position within a band to an adjacent maturity band for further netting allowances. Where this is the case, the firm must calculate:

(i) a carry charge by multiplying the amount carried by the carry rate of 0.6%, and
(ii) a spread charge, in accordance with (b) above, where the carried position is matched against a position in an adjacent maturity band.

The firm may repeat the procedure for carrying positions through to other maturity bands as appropriate. An additional carry charge and spread charge must be calculated at each stage of the process.

3-169B(1) G

A firm may propose any methodology that it believes will capture spread, carry and outright risks and that reflects its own day-to-day risk management. A firm is strongly advised to contact the FCA at the earliest point if it is considering introducing a model or adapting an existing one.

No models

3-169B(2) R

A firm may only include an option in the maturity ladder approach, the extended maturity ladder approach or the simplified approach if it is in the money by more than the appropriate outright rate. Such options must be included as a position in the underlying commodity, of an amount equal to the "tonnage" underlying the option (long or short as appropriate), and with a maturity equal to the expiry date of the spot, forward or futures contract underlying the option.

3-169B(3) R

An option which does not satisfy the condition in rule 3-169B(2) attracts a PRR in accordance with the following:

(a) In the case of a purchased option, the PRR must be the mark to market value of the full position underlying the option multiplied by the appropriate outright rate, but the result may be limited to the mark to market value of the option.

(b) In the case of a written option, the PRR must be the mark to market value of the full position underlying the option multiplied by the appropriate outright rate, reduced by the outof- the-money amount. The PRR must be limited to zero if the calculation results in a negative number.

3-169B(3) G

The out-of-the-money amount is any excess of the exercise value over the mark to market value of the underlying commodity in the case of a call option, or vice versa for a put option.

COUNTERPARTY RISK REQUIREMENT

3-170 GENERAL PRINCIPLES OF CRR

Application

3-170(1) R

(a) Rules 3-170 to 3-182 apply to a broad scope firm, except a venture capital firm which is subject only to rules 3-180 to 3- 182.

(b) Rules 3-180 to 3-182 apply to an arranger, except a corporate finance advisory firm.

%N applicable to interest rate derivatives may be utilised to calculate the credit equivalent amount.
For a derivative referenced on a 'non-qualifying' bond, the credit equivalent amount must be calculated with reference to the %N applicable to equity derivatives.
For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be equal to the time until the next reset date. In the case of interest-rate contracts that meet these criteria and have a remaining maturity of over one year, the percentage is no lower than 0.5%.

Netting

3-173A R

A firm may offset counterparty exposures arising on derivative transactions calculated in accordance with (2) above before it

(3) multiplies the residual exposure by the appropriate CRR percentage as follows:

(a) variation margin payable to a counterparty against an initial margin requirement or variation margin requirement receivable from a counterparty;
(b) variation margin payable to a counterparty against a positive "A" as calculated in accordance with Table 3- 173A(2A);
(c) a negative "A" as calculated in accordance with Table 3- 173A(2A) against an initial margin requirement or variation margin requirement receivable from a counterparty;
(d) a negative "A" against a positive "A" in each case as calculated in accordance with Table 3-173A(2A);
(e) losses on a closed out derivative transaction which has not been settled against variation margin payable to a counterparty; or
(f) losses on a closed out derivative transaction which has not been settled against negative "A" calculated in accordance with Table 3173A(2A),
(g) profit on a closed out derivative transaction which has not been settled against an initial margin requirement or variation margin requirement receivable from a counterparty;
(h) profit on a closed out derivative transaction which has not been settled against a loss on a closed out derivative transaction;
(i) profit on a closed out derivative transaction which has not been settled against a positive "A" as calculated in accordance with Table 3-173A(2A);
(j) premium receivable in respect of written options against variation margin payable, initial margin payable or a closed out profit payable to the counterparty or a negative "A" as calculated in accordance with Table 3-173A(2A);
(k) positive "A" on purchased options calculated in accordance with Table 3-173A(2A) against negative "A" on written options; or
(l) in the case of perfectly matched contracts these may be treated as a single contract with a notional principal equivalent to the net receipts; or
(m) where transactions are subject to (3)(c) above, the potential future credit exposures (PFCE) on transactions with the same counterparty (i.e. % on N) may be netted in accordance with Table 3-173A(3) below,

provided that:

(i) the exposures arise on transactions with the same counterparty; and
(ii) the firm has a written agreement, supported by a legal opinion obtained in accordance with rule 3-170(11).

Table 3-173A(3)

The netted PFCE is the sum of:	
step one	40% of gross PFCE
step two	60% of gross PFCE multiplied by the net-to-gross ratio (NGR)
Notes:	
NGR = (gross replacement cost) / (net replacement cost)	
The NGR must be calculated on all contracts included in a legally valid bilateral netting agreement with a given counterparty.	

CRR percentages

3-173A (4) R

(a) Where a firm does not offset counterparty exposures arising on derivative transactions in accordance with (3) above, it must multiply the counterparty exposure by the appropriate percentage from:

(i) Table 3-173A(4)A if the counterparty exposure arises on a transaction in a derivative listed on an exchange or approved exchange; or
(ii) Table 3-173A(4)B if the counterparty exposure arises on a transaction in a derivative not listed on an exchange or approved exchange,

but may opt to calculate CRR using the highest available credit percentage in Tables 3-173A(4)A or B below in order to avoid undue complication.

(b) Where a firm does offset counterparty exposures on derivative exposures in accordance with (3) above, it must multiply the residual net counterparty exposure by the appropriate percentage from Table 3-173A(4)A or B.
(c) A firm may opt to calculate the CRR using the highest available CRR percentage in the tables below in order to avoid undue complication.

Table 3-173A(4)A - CRR percentages for transactions in derivatives listed on an exchange or approved exchange

Counterparty		Business days since exposure occurred	
		0 - 3	over 3
1	Firm has an ACMP and counterparty is not a market counterparty	10%	10%
2	Firm has an ACMP and counterparty is a market counterparty	5%	5%
3	Firm does not have an ACMP	10%	100%

Table 3-173A(4)B - CRR percentages for transactions in derivatives not listed on an exchange or approved exchange

	Status of the counterparty	%
1	A firm, a supranational organisation, a United Kingdom discount house, a gilt edged market maker, a stock exchange money broker, a regulated banking institution, a building society under the Building Societies Act 1986, a United Kingdom local authority, a regulated financial institution.	2%

2	Any other counterparty	5%

Exposures to local firms

3-173A (5) R

A firm must calculate a 100% CRR for amounts of initial and variation margin not met with acceptable collateral or a positive equity balance owed to a firm by a local firm in respect of transactions in derivatives listed on an exchange or approved exchange from the date of any shortfall. However, a firm may use an alternative treatment if it:

(a) participates in the profits or losses of the local firm for 25% or more when the firm may include the local firm position in its own position which will then be subject to PRR; or
(b) calculates PRR for local firms in which case its requirement will be the sum of the following:

(i) 10% of the PRR result for each local firm; and
(ii) the excess over the "net liquidating balance" of the PRR applied to the positions of each local firm; and

(c) for the purposes of (b) above, "net liquidating balance" means the cash amount which would remain in a local firm account if all positions were liquidated and there were added (1) cash balances (2) the value of marketable investments, and (3) letters of credit and guarantees issued by a regulated banking institution which is not the counterparty or an associate of the counterparty in the control of the firm; and there were deducted all loans and overdrafts from, and other liabilities to the firm; and to the extent that a firm includes an exposure in the net liquidating balance calculation, it does not also need to apply the liquidity adjustment in rule 3-75 or the CRR to those exposures.

Sums due for payment or owed on closed out derivative transactions

3-173A (6) R

When a counterparty has not fully met amounts owed to a firm arising out of losses on closed out derivative transactions by depositing, acceptable collateral or, has not fully settled amounts owed in respect of periodic or final settlement of transactions, a firm must calculate a CRR equal to the amount outstanding after three days, unless:

(a) the firm has offset the amount owed against variation margin payable in accordance with (3)(e) above; or
(b) the firm has offset the amount owed against a negative "A" in accordance with (3)(f) above,

in which case the firm must calculate a CRR equal to the residual amount outstanding after three days.

Equivalent contracts

3-173A (7) R

Rule 3-173A (2)(b) also applies to contracts which, although they are listed on an exchange or approved exchange, are fully dependent upon the issuer for performance (e.g. covered warrants).

(c) a firm must calculate the counterparty exposure arising from a derivative transaction other than a written or sold option or a derivative transaction listed on an exchange or cleared through a clearing house, as the credit equivalent amount calculated in accordance with Table 3-173B(3A), not covered by the deposit of acceptable collateral not otherwise used.

Table 3-173B(3A) - Method of calculating credit equivalent amount

Type of derivative transaction	**Credit equivalent amount**	
	If A is positive	**If A is negative**
Interest rate swaps: single currency (a) floating rate swapped against floating rate A nil	A	nil
(b) fixed rate swapped against floating rate: - under one year to maturity - over one year to five years - over five years	 A A + 0.5% of N A + 1.5% of N	 nil 0.5% of N 1.5% of N
Cross-currency interest rate swaps - under one year to maturity - over one year to five years - over five years	 A + 1% of N A + 5% of N A + 7.5% of N	 1% of N 5% of N 7.5% of N
Other interest rate contracts* - under one year to maturity - over one year to five years - over five years	 A A + 0.5% of N A + 1.5% of N	 nil 0.5% of N 1.5% of N
Foreign exchange and gold contracts* - exchange rate contracts with an original maturity of 14 days or less	nil A + 1% of N A + 5% of N A + 7.5% of N	nil 1% of N 5% of N 7.5% of N
- under one year to maturity - over one year to five years - over five years		
Equity contracts* - under one year to maturity - over one year to five years - over five years	 A + 6% of N A + 8% of N A + 10% of N	 6% of N 8% of N 10% of N
Precious metal (not gold) contracts* - under one year to maturity - over one year to five years - over five years Commodity contracts* - under one year to maturity - over one year to five years - over five years	 A + 7% of N A + 7% of N A + 8% of N A + 10% of N A + 12% of N A + 15% of N	 7% of N 7% of N 8% of N 10% of N 12% of N 15% of N
Notes * FRAs, swaps, futures, purchased options, and other contracts for differences A = the replacement cost of the contract N = the notional or actual principal amount or value underlying the contract For contracts with multiple exchanges of principal, the % of N has to be multiplied by the remaining number of payments still to be made according to the contract. In the case of a derivative referenced on a bond which satisfies the criteria for a qualifying debt security, the %N applicable to interest rate derivatives may be utilised to calculate the credit equivalent amount. For a derivative referenced on a 'non-qualifying' bond, the credit equivalent amount must be calculated with reference to the %N applicable to equity derivatives.		

(f) loss on a closed out derivative transaction which has not been settled against negative "A" calculated in accordance with Table 3-173B(3A);

(g) profit on a closed out derivative transaction which has not been settled against an initial margin requirement or variation margin requirement receivable from a counterparty;

(h) profit on a closed out derivative transaction which has not been settled against a loss on a closed out derivative transaction;

(i) profit on a closed out derivative transaction which has not been settled against a positive "A" as calculated in accordance with Table 3-173B(3A);

(j) premium receivable in respect of written options against variation margin payable, initial margin payable or a closed out profit payable to the counterparty or a negative "A" as calculated in accordance with Table 3-173B(3A);

(k) where the firm has received the premium due for a written option, a negative "A" (the replacement cost) for the written option against a positive "A" in each case as calculated in accordance with Table 3-173B(3A); or

(l) in the case of perfectly matched contracts these may be treated as a single contract with a notional principal equivalent to the net receipts; or

(m) where transactions are subject to (3)(c) above, the potential future credit exposures (PFCE) on transactions with the same counterparty (i.e. % o N) may be netted in accordance with Table 3-173B(6) below,

provided that:

(i) the exposures arise on transactions with the same counterparty; and

(ii) the firm has a written agreement, supported by a legal opinion obtained in accordance with rule 3-170(11).

Table 3-173B(6)

The netted PFCE is the sum of:	
step one	40% of gross PFCE
step two	60% of gross PFCE multiplied by the net-to-gross ratio (NGR)
Notes:	
NGR =	(net replacement cost)
	(gross replacement cost)
The NGR must be calculated on all contracts included in a legally valid bilateral netting agreement with a given counterparty.	

Equivalent contracts

3-173B (7) R

Rule 3-173B(3)(c) also applies to contracts, which, although they are listed on an exchange are fully dependent upon the issuer for performance (e.g. covered warrants).

Sub-total

3-173B (8) R

The sum of the amounts calculated in accordance with this rule is the firm's CRR for derivative transactions.

Where a firm has entered into any repurchase, securities or physical commodities lending or sale and buy back agreement in respect of securities or physical commodities, it must calculate, subject to (3) below, a CRR for each such agreement in accordance with the table below.

Table 3-176(1) - Repurchase, securities lending and sale and buy back agreements

Type of security sold or lent	**CRR**
Qualifying debt securities	The "mark to market value" of the securities less 105% of the acceptable collateral under the agreement, if the net figure is positive.
Other securities or physical commodities	The "mark to market value" of the securities or physical commodities less 110% of the acceptable collateral under the agreement, if the net figure is positive.

Reverse repurchase, securities borrowing and buy and sale back agreements

3-176(2) R

Where a firm has entered into any reverse repurchase, securities or physical commodities borrowing or buy and sale back agreement in respect of securities or physical commodities, it must calculate, subject to (3) below, a CRR for each such agreement in accordance with the table below.

Table 3-176(2) - Reverse repurchase, securities borrowing and buy and sale back agreements

Type of security purchased or borrowed			**CRR**
1	For all transactions where the firm has in its possession a "written agreement" evidencing the transaction, in accordance with rule 3-176(5)		
	a)	qualifying debt securities	The amount paid or collateral given for the securities less 105% of the current "mark to market value" of the securities received (see note), if the net figure is positive
	b)	other securities or physical	The amount paid or collateral given for the securities or physical commodities less 110% of the current "mark to market value" of the securities or physical commodities commodities received (see note), if the net figure is positive
2	Where a firm does not have in its possession a "written agreement" evidencing the transaction, in accordance with rule 3-176(5)		The appropriate requirements from 1 plus the market value of the securities or physical commodities multiplied by the appropriate percentage risk addition.
Note: the securities or physical commodities received can be included only where they are held under the control of the firm or where they were delivered into the control of the firm upon initiation of the agreement.			

Netting

3-176(3) R

A firm may reduce the CRR by netting where it has more than one exposure to an individual counterparty provided that it has a written agreement supported by a legal opinion obtained in accordance with rule 3-170(11) as follows:

Application

3-177(1) R

This rule applies to money brokers.

Lending money

3-177(2) R

When a money broker is lending money it must calculate a 100% CRR except to the extent that it holds acceptable collateral; except where the broker does not have a "written agreement" in accordance with rule 3-176(5) between the firm and counterparty specifying, inter alia, the interest rate on the loan and stating that the loan is repayable on demand or for a term no longer than 30 days, when the CRR is 100% of the amount outstanding.

Lending and borrowing securities etc

3-177(3) R

For all reverse repurchase and repurchase agreements, securities borrowing and lending agreements and buy and sale back and sale and buy back agreements other than where securities are lent or sold or borrowed or purchased through an approved payments system, a money broker must calculate an additional CRR of 0.5% applied to the value of all securities transferred.

Sub-total

3-177(5) R

The sum of the amounts calculated in accordance with (2) and (3) above is the firm's total CRR for money brokers.

3-178 OPTIONS PURCHASED FOR A COUNTERPARTY

Single premium options

3-178(1) R

Where a firm has purchased a single premium option on behalf of a counterparty and the counterparty has not paid the full option premium cost by three business days after trade date, a firm must calculate a CRR as the amount by which the option premium owed to the firm exceeds the market value of the option or acceptable collateral.

Traditional options

3-178(2) R

Where a firm has purchased a traditional option for its own account or a counterparty and paid the option premium, it must calculate a CRR equal to the value of the option premium.

Sub-total

3-178(3) R

The sum of the amounts calculated in accordance with (1) and (2) above is the firm's CRR in respect of purchased options.

3-180 QUALIFYING AND OTHER DEPOSITS

General rule

3-180(1) R

Subject to (2) below, a firm must calculate a CRR for a deposit referred to in the table below by multiplying the value of the deposit by the appropriate percentage contained in the table below.

Table 3-180(1) Qualifying and other deposit risk percentages

Type of deposit	**%**
Qualifying deposits	nil
Other deposits with an approved bank related to a transaction creating an offsetting liability for the firm or subject to an agreement with the bank allowing its use as collateral for a loan that may be withdrawn within -	
- three months to one year - over one year	2.5% 4.0%
Note: All other deposits are subject to a liquidity adjustment (see rule 3-75(12))	

Timing

3-180(2) R

Qualifying deposits and other deposits outstanding three days after a repayment request has been made or more than three days past maturity date are subject to a full CRR.

Netting

3-180(2A) R

A firm may reduce the value of the deposit by an amount owed by the firm to a counterparty before it multiplies the residual exposure by the appropriate percentage in Table 3-180(1) provided that:

(a) the exposures arise with the same counterparty; and
(b) the firm has a written agreement supported by a legal opinion obtained in accordance with rules 3-170(11).

Sub-total

3-180(3) R

The sum of the amounts calculated in accordance with Table 3- 180(1) is the firm's CRR for Qualifying deposits and other deposits.

3-181 LOANS TO COUNTERPARTIES

General rule

3-181(1) R

A firm must calculate a 100% CRR on the amount by which a loan to a counterparty is not:

(a) secured by acceptable collateral; or
(b) offset against amounts owed by the firm to the counterparty where the firm has a written agreement supported by a legal opinion obtained in accordance with rule 3-170(11).

Sub-total

3-181(2) R

The sum of the amounts calculated in accordance with this rule is the firm's CRR for loans to counterparties.

3-182 OTHER AMOUNTS OWED TO A FIRM ARISING OUT OF INVESTMENT BUSINESS OR INVESTMENT DEALING ACTIVITIES

Nil CRR items

3-182(1) R

The following receivables arising out of investment business or investment dealing activities do not require a CRR at any time:

(a) any debt not covered elsewhere in the CRR rules to the extent that it is adequately secured;
(b) amounts in respect of 30 day items specified in (3) below which have been outstanding for less than 30 days from the date on which they were first recorded on the firm's balance sheet; and

(c) accrued income for interest on marketable investments, except where it has been outstanding for more than 30 days after the date that the interest was due to be received.

CRR on amounts owed to a firm in respect of international underwriting and stabilisation activities

3-182(2) R

(a) Where management or other fees are owed to a firm in respect of international underwriting or stabilisation activities, the firm must calculate full CRR on any amounts remaining unpaid 30 days after they first appeared on the firm's balance sheet.
(b) A firm acting as stabilising manager must also calculate a CRR equal to 100% of any income accrued as a result of net profit on stabilising activities while the stabilising account remains open.

CRR on 30 day items

3-182(3) R

A firm must calculate a 100% CRR in respect of the following receivables due to the firm if they have been outstanding for more than 30 days from the date on which they were first recorded on the firm's balance sheet:

(a) commissions and fees earned in connection with the firm's investment business;
(b) commissions and fees earned which are due and payable from client bank accounts;
(c) repayments of marketable investments at maturity or call;
(d) the value of scrip issues and rights issues;
(e) proceeds arising from takeovers and mergers;
(f) domestic underwriting or stabilisation fees; and
(g) accrued income and work in progress.

100% CRR items

3-182(4) R

A firm must calculate a 100% CRR in respect of other receivables arising from investment business and investment dealing activities not covered elsewhere in this rule from the time that the receivable is recorded on the balance sheet.

Netting

3- 182(4A) R

A firm may reduce the value of the amounts owed to the firm by an amount owed by the firm to a counterparty before it multiplies this by 100% provided that:

(a) the exposures arise with the same counterparty; and
(b) the firm has a written agreement supported by a legal opinion obtained in accordance with rule 3-170(11).

Sub-total

3-182(5) R

open positions at that time,

on the assumption that those transactions were the only transactions undertaken on the exchange or clearing house by the firm or intermediate broker at that time;

margined transaction means a transaction effected by a firm with or for a customer relating to an investment of any description referred to in articles 83, 84 and 85 of the Regulated Activities Order (or any right or any interest in such an investment) under the terms of which the customer will or may be liable to make a deposit in cash or collateral to secure performance of obligations which he may have to perform when the transaction falls to be completed or upon the earlier closing out of his position;

mark to market means to value an investment at its current market value in accordance with rule 3-41(9);

marketable investment means -

(a) an investment which is traded on or under the rules of an exchange or an approved exchange;
(b) a debt instrument which may be transferred without the consent of the issuer or any other person (including a collateralised mortgage obligation);
(c) a physical commodity;
(d) a warrant, option, future or other instrument which entitles the holder to subscribe for or acquire -
    (i) an investment or physical commodity which falls under (a) to (c) above;
    (ii) any currency; or
    (iii) any combination of (i) and (ii) above;
(e) a contract for differences (including interest rate and currency swaps) relating to fluctuations in -
    (i) the value or price of an investment or physical commodity in (a) to (d) above;
    (ii) any currency;
    (iii) the rate of interest in any currency or any index of such rates;
    (iv) the level of any index which is derived from the prices of an investment or physical commodity in (a) to (c) above; or
    (v) any combination of (i) to (iv) above;
(f) warrants, options, futures or other instruments entitling the holder to obtain the rights of those contracts in (d) or (e) above; and
(g) a unit in a regulated collective investment scheme;

model A clearing firm means a regulated clearing firm which uses its own money for settlement but is reimbursed on a daily basis by the non-clearing firms it settles for;

money broker means a firm for which the total value of repurchase, securities lending and sale and buy back agreements is or has been at any time during the previous year, at least 25% of its total assets;[ii]

new securities means, in relation to a particular offering, securities which are issued pursuant or with a view to an offering;

new to the market means, in relation to an offering, securities which are not already exchange traded;

non clearing floor member means a firm which:

(a) is authorised to trade on the floor of a recognised investment exchange which permits this category;
(b) is not prohibited by the rules of that exchange from dealing with customers;
(c) has entered in to an agreement with a clearing firm which accepts full responsibility for every deal entered into by the non clearing floor member; and
(d) is not authorised to handle client money;

non recourse loan means a loan to a firm secured on specific land or buildings, under the terms of which the lender has no claim on the other assets of the firm nor on assets for which the firm is accountable in any circumstances (including a winding up);

note issuance facility means an arrangement under the terms of which a borrower is able to issue short

	term notes in its own name with a guarantor, or consortium of guarantors ensuring the availability of funds to the borrower by agreeing to purchase any unsold notes, and which includes for example revolving underwriting facilities, note purchase facilities, euronote facilities and similar arrangements;
offering	means an offering of securities which are - (a) issued for the purpose of the offering; (b) new to the market; or (c) existing securities which are exchange traded subject to the purchase of those securities having the same characteristics as an offering of new securities, or securities which are new to the market;
open-priced deal	means an international offering which is not a bought deal or pre-priced deal;
option	(for the purposes of rule 3-173B) means a contract which confers the right to buy or sell a security, contractually based investment, currency, gold or commodity at a given price on or before a given date. (NB: the definition of an option used for this purposes deliberately differs from that in the main Handbook Glossary);
out of the money	means those options and warrants which are not in the money;
pari passu security	means a security which is the same as another security, except only in respect of payment, entitlement to initial dividend and the nature of documents of title; passported institution means an incoming EEA firm;
percentage risk addition	means a percentage to be applied to the value of positions in investments held by the firm to determine its PRR;
perfectly matching contracts	mean certain OTC derivatives contracts which are included in a legally binding netting agreement that are equal and exact opposites and perfectly matching in all material respects;
physical commodities method	means the method of calculating PRR under rules 3-166 to 3- 169B;
physical commodity	means the actual commodity, documents of title to actual commodities or shipping documents conveying title to actual commodities;
preference security	means a share with rights, in respect of capital or dividends, superior to those of ordinary equity;
pre-priced deal	means an international offering other than a bought deal all the pricing terms of which have been fixed;
pricing terms	means, in relation to an offering, the amount of currency, maturity, offering price, rate of or means of calculating interest and any prices at which securities may be redeemed or converted or exchanged into other securities;
primary requirement	is the primary requirement calculated in accordance with Table 3-61;
profit share	means an appropriation of profit before tax on a predetermined basis for the benefit of management or employees;
property fund	means a scheme dedicated to permitted immovables and property related assets, whether with or without other transferable securities;
PRR	means the position risk requirement of a firm as calculated in accordance with rules 3-80 to 3-169B;
put option	means an option to sell an investment, other instrument, foreign currency or physical commodity at a given price on or before a given date;
qualifying debt security	means a debt security which: (1) (other than for the purposes of rule 3-173B): (a) represents or evidences indebtedness; (b) is a marketable investment; (c) if it or "equivalent debt" is rated by a "relevant agency" (and there has been no announcement that the rating will be cancelled) - (i) the security or the "equivalent debt" is so rated at or higher than the level indicated in the table in **Appendix 34**; (ii) there has been no announcement that the rating will be down-graded below the level so indicated; and (iii) the firm has no reasonable cause to believe that another

"relevant agency" has rated the security or "equivalent debt" below the level so indicated; and

(d) if neither it nor any "equivalent debt" is rated by a "relevant agency" (or there has been an announcement that such a rating will be cancelled), it satisfies one or more of the following -

(i) it is issued or guaranteed by or is subject to the full faith and credit of a sovereign government or province or state thereof (or a corporation over 75% owned by such sovereign government, or province or state), which is a member of the OECD and the government, province, state or corporation has not defaulted, or entered into any rescheduling or similar arrangement, or announced the intention of so doing, in respect of itself or its agency's debt within the last five years;

(ii) it is issued or guaranteed by a supranational organisation;

(iii) it is issued or guaranteed by a corporation (not being a bank, for which see (iv) below) the ordinary shares of which are included within the following categories -

(aa) UK : constituents of the FT All Share Index;

(bb) Japan : constituents of the First Section of the Tokyo Stock Exchange;

(cc) USA: constituents of the NYSE, AMEX or NASDAQ NMS; or

(dd) countries listed below: the constituents of the FTThe
Actuaries World Indices in respect thereof;
Australia
Belgium
Canada
Denmark
France
Germany
Hong Kong
Italy
Netherlands
Norway
Singapore
Spain
Sweden
Switzerland

(iv) it is issued or guaranteed by a bank which is supervised by an authority in a state such as is referred to above and has capital and reserves (including subordinated loans which are not repayable within five years) of not less than £100,000,000 or the equivalent as shown by its latest published audited consolidated accounts (or, in the absence of consolidated accounts, unconsolidated accounts); or

(iv) is it issued or guaranteed by a local authority or building society in the United Kingdom;

provided that the issuer or guarantor of the security is not in default as to any payment on any other security issued or guaranteed by it; and

(2) for the purposes of (1) above -

(a) in respect of any security of, or guaranteed by, any issuer or

guarantor, "equivalent debt" means any debt which ranks pari passu with, or subordinate to, the security or (as the case may be) the guarantee; and

(b) in relation to any issuer or guarantor, a "relevant agency" means one of the agencies named in **Appendix 34** by reference to the category of issuer or guarantor;

(3) (for the purposes of rule 3-173B) meets the following conditions:

(a) it attracts zero specific risk under Table 2 in **Appendix 47**; or

(b) it is issued by, or fully guaranteed by:

(i) a Zone B central government or central bank and the security is denominated in the local currency of the issuer;

(ii) a multilateral development bank;

(iii) a Zone A public sector entity;

(iv) a company whose share is a constituent of one of the indices making up the FTSE All-World Index; or

(v) an issue of, or fully guaranteed by an investment firm or recognised third-country investment firm; or

(c) it is issued by, fully guaranteed by, endorsed or accepted by:

(i) a credit institution incorporated in a Zone A country; or

(ii) a credit institution incorporated in a Zone B country and the debt security has a residual maturity of one year or less; or

(d) it is a mortgage backed security relating to residential real estate of the type referred to in BIPRU 3.4.94R(1)(d)(i) which meets the requirements about legal certainty referred to in BIPRU 3.4.62R; or

(e) it is rated by at least one of the agencies shown in Table 3 Appendix 47, and every such rating equals or exceeds the corresponding minimum shown in that table;

qualifying deposit — means a deposit which is one of the following -

(a) balance on current account with an approved bank;

(b) money on deposit with an approved bank, United Kingdom local authority, member of the Finance Houses Association, stock exchange moneybroker, regulated clearing firm, the National Savings Bank, exchange, approved exchange or approved depository which may be withdrawn within three months;

(c) money on deposit with an approved bank directly related to a transaction creating an offsetting liability for the firm or subject to an agreement with the bank allowing its use as collateral for a loan that may be withdrawn within three months, which relates to a liability of the same maturity and arises out of a transaction;

(d) amount evidenced by a certificate of tax deposit;

(e) amount evidenced by a certificate of deposit issued by a regulated banking institution which matures within three months; or

(f) deposit of cash by way of margin with an exchange, approved exchange, clearing house or intermediate broker;

regulated banking institution — means any banking institution which has paid up share capital and reserves of over £5,000,000 as shown by its latest published audited accounts, and which is authorised under the Act or supervised by the central bank or other regulatory authority of a member state of the OECD in which the bank is incorporated;

regulated business — means investment business which is

(a) business carried on from a permanent place of business maintained by a firm (or its appointed representative) in the United Kingdom; and

(b) other business carried on with or for customers in the United Kingdom, unless that business is -

(i) business carried on from an office of a firm outside the United Kingdom which, if that office were a separate person, would fall

within the overseas persons exclusions set out in article 72 of the Regulated Activities Order; or

(ii) business of an appointed representative of the firm which is not carried on in the United Kingdom;

regulated clearing firm	means a clearing firm which is an authorised person;
regulated financial institution	means a firm, or an institution which is authorised to conduct investment business involving the execution of transactions on exchanges or on securities or derivatives exchanges by one or more of the following regulators - (a) any regulator of investment business in any member state of the EU (other than the United Kingdom) established by law in that state; or (b) a body referred to in Part 1 of **Appendix 35**; provided, in the case of any such institution that the firm has no reason to suppose that the institution is in breach, in any material respect, of the rules enforceable by the relevant regulator;
relevant annual expenditure	means the relevant annual expenditure of a firm calculated in accordance with rule 3-73;
reporting statement	means any one or more of the following types of report as required by the Supervision manual: (a) audited annual financial statements; (b) annual reporting statement; (c) [deleted]; (d) internal control letter; (e) quarterly reporting statement; (f) position risk reporting statement; (g) counterparty risk reporting statement; (h) annual reconciliation; (i) monthly reporting statement; and (j) the audited accounts of a subsidiary of the firm;
repurchase agreement	(and sale and buy back agreement) means an agreement for the sale of securities or physical commodities subject to a commitment to repurchase from the same person the same or similar securities or physical commodities;
reverse repurchase agreement	(and "buy and sale back agreement") means an agreement for the purchase of securities or physical commodities subject to a commitment to resell to the same person the same or similar securities or physical commodities;
Sale	includes any disposal for valuable consideration;
sale and buy back agreement	see repurchase agreement;
scheme management activity	[deleted]
settlement day	means the day on which under the recognised practice of an exchange or approved exchange, bargains are contracted for settlement; and in the case of bargains not transacted on an exchange or approved exchange, or entered into for forward settlement, 20 days from the date of the transaction, or, if earlier, the contractual due date;
stock exchange moneybroker	is a moneybroker which is an authorised person and acts as an intermediary in the gilt market;
supranational organisation	means any organisation referred to in Part 2 of **Appendix 35**;
swap	means a transaction in which two counterparties agree to exchange streams of payments over time according to a predetermined basis;
takeover or related operation	means: (a) any offer to which the Takeover Code applies and any transaction or arrangement which is of such a nature that the Takeover Code would have applied to it had it concerned a company whose shares are listed under Part VI of the Act and whose head office and place of central management are in

the United Kingdom;

(b) any offer, transaction or arrangement relating to the purchase of securities with a view to establishing or increasing a strategic holding of a person, or of a person together with his associates in the securities concerned;

(c) any transaction or arrangement entered into in contemplation or furtherance of any offer, transaction or arrangement falling within (a) or (b) above; and

(d) any transaction or arrangement entered into by way of defence or protection against any offer, transaction or arrangement falling within (a), (b) or (c) above which has taken place or which is contemplated;

tangible net worth	is the tangible net worth of a firm calculated in accordance with rule 3-62;
total PRR	means the sum of all the amounts calculated as a PRR under rules 3-80 to 3- 169B;
traditional option	means any option arranged but not traded under the rules of the London Stock Exchange;
trust beneficiary	means a beneficiary under a trust (not being the settlor) who benefits from the performance by a firm as trustee of investment services relating to the management of the trust assets;
underwriting	means a commitment to take up securities where others do not acquire or retain them;
underwriting price	means the price at which the firm is committed to take up the securities or the price at which it is committed to do so if required under the underwriting commitment less any commissions or discounts paid or allowed in connection with the transaction, except to the extent that the firm has taken credit for them in its accounts;
variable rate note	means a debt security with the characteristics of an FRN except that the margin with respect to the index rate of interest is subject to variation depending on periodic negotiations;
variation margin requirement	means in relation to a counterparty the value of any amounts which the firm or intermediate broker would be required to pay under the rules of an exchange, approved exchange or clearing house to meet any marked to market losses occurring on contracts undertaken for that counterparty at that time on the assumption that those transactions were the only transactions undertaken on the exchange, approved exchange or clearing house by the firm or intermediate broker at that time;
venture capital schemes	means a scheme for providing capital to a body corporate whose equity is not traded or listed on an exchange;
walkaway clause	means a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of the defaulter, even if the defaulter is a net creditor;
warrant fund	means a scheme which is dedicated to transferable securities except that it is permitted to invest entirely in warrants;
zone A	see definition of Zone A country in the Glossary; and
zone B	means any country not in Zone A.

[i] These are the same activities as are included in the definition of "designated investment business" used in the Main Handbook Glossary.

[ii] For guidance notes on money brokers, see **Appendix 37**.

APPENDIX 20: GUIDANCE NOTES ON RECONCILIATION OF FIRM'S BALANCES WITH A COUNTERPARTY WHICH IS A MEMBER OF AN EXCHANGE (RULE 3-11(1)(D)) AND IPRU(INV) 9.6.1R (FOR AN EXEMPT CAD FIRM))

INTRODUCTION

1

The purpose of this guidance is to state how under rule 3-11(1)(d) and IPRU(INV) 9.6.1.R (for an exempt CAD firm) the reconciliation process with counterparties which are also members of exchanges should be performed.

SCOPE

2

The reconciliation to be performed with counterparties should cover all outstanding balances and securities positions with such counterparties from all sources except to the extent that the components of such balances and securities positions have been agreed by other means. Agreement by other means shall include (but is not to be limited to) those which have been-

(a) matched or cleared through an exchange, clearing house or clearing system; or
(b) verified by dispatch to or receipt from the counterparty of a confirmation or statement. Such verification should have been evidenced in writing or by electronic media.

3

The reconciliation should cover all remaining outstanding items including, for example, feebased items, dividends where these are on the firm's balance sheet, coupons, amounts arising under OTC contracts, repurchase and reverse repurchase agreements and securities lending and borrowing.

4

The items to be included should be all those past trade date which is consistent with trade date accounting.

5

Where necessary a firm should initially circularise a list of all relevant open items as set out above rather than a net balance. A firm should identify the assumptions made by them in ascertaining which balances (or types of balances) have been included in the reconciliation. A firm should also identify where the balances or securities positions with a counterparty arise from different accounts operated by them with that counterparty.

6

The scope of the rule is intended to cover nil balances although these may be covered on a sample basis only. They are included because discrepancies in such balances may only come to light as being incorrectly stated on the performance of a circularisation. However, reconciliations of nil balances do not need to be performed where-

(a) the counterparty is also a firm; or
(b) there has been no outstanding balance with the counterparty at any point during the year.

TIMING

7

It is considered preferable for a firm to be aware in advance at which periods of the year they will receive reconciliations requests. This may be of use to a firm in enabling it to plan in advance the allocation of staff for the performance of the reconciliations. Thus, it is suggested that a firm submits such circularisations, where possible, at calendar quarter end dates. It is considered that, in any case, the majority of firms would be likely to circularise such statements at these dates. However, a firm will be eligible to circularise at other dates as, for example, when its own annual or quarterly accounting reference dates do not coincide with the calendar quarter end.

8

A firm may perform the reconciliation in conjunction with the work undertaken by its auditors for the purposes of the annual audit.

THE OBLIGATION ON FIRMS

9

It is considered preferable for a firm to be aware in advance at which periods of the year they will receive reconciliations requests. This may be of use to a firm in enabling it to plan in advance the allocation of staff for the performance of the reconciliations. Thus, it is suggested that a firm submits such circularisations, where possible, at calendar quarter end dates. It is considered that, in any case, the majority of firms would be likely to circularise such statements at these dates. However, a firm will be eligible to circularise at other dates as, for example, when its own annual or quarterly accounting reference dates do not coincide with the calendar quarter end.

10

A recipient of a circularisation request from another firm must use its best endeavours to respond. Notwithstanding paragraphs 7 and 8 above, this obligation will apply even if this request is received more frequently than once a year from the same counterparty or is wider in scope than required by paragraphs 2 to 6 above (for example, by also covering balances which have already been agreed by other means). Rule 3-11 (or IPRU(INV) 9.6.1R for an exempt CAD firm) only requires that specific balances be covered. This is intended as a minimum requirement and not necessarily as the norm. If a firm need not reply to a request more than once a year or which covered balances of a wider scope, firms would be discouraged from requesting such reconciliations.

11

Rule 3-11(3) (or IPRU(INV) 9.6.1(1)R(4) for an exempt CAD firm) requires a firm to respond, within one month of receipt, to a circularisation request received from another firm. The one month response period should also

be observed in relation to circularisation requests received under rule 3-11(1)(d) (or IPRU(INV) 9.6.1(1)R for an exempt CAD firm).

12

It is not considered necessary to issue detailed guidance for the procedure to be adopted in cases where the recipient does not reply to a circularisation request sent by a firm. It is intended that a firm need only take reasonable steps to obtain any such reply. However, before a firm has taken such steps, it should not assume that the circularisation is agreed merely due to the absence of a reply from the counterparts.

APPENDIX 21: GUIDANCE NOTES ON THE VALUATION OF POSITIONS (RULE 3-41(9))

INTRODUCTION

1

Rule 3-41(9) states that a position must be valued at its close out price, where close out price means that a long position should be valued at current bid price and a short position at current offer price. In addition, rule 3-41(9) states that a firm must value a position on a prudent and consistent basis, and have regard to the liquidity of the instrument concerned and any special factors that may adversely affect the closure of the position.

2

The following paragraphs give general indications to firms on the appropriate valuation methodology. However, it is emphasised that prudence should be the overriding influence in the valuation exercise and that, where uncertainty exists as to the most appropriate price, the firm should use that price which gives the most conservative valuation.

GENERAL PRINCIPLES

3

Firms should value positions by reference to market prices, but where necessary should add a prudent and appropriate buffer to the bid or offer price to account for factors which would adversely affect the firm's ability to realise the close-out value, such as -

- (a) the liquidity of the security in question;
- (b) the size of the position held in that security relative to the sizes at which prices are quoted;
- (c) the direction of the position (long or short) relative to the current direction of the market;
- (d) the exposure of the firm to the relevant market as a whole;
- (e) any conversion or foreign exchange costs that would be incurred if the position were closed out;
- (f) any other factors which may affect the close-out price.

4

Where a mid-market or single price only is available for the security in question, firms must adjust this price by a prudent and appropriate buffer as outlined in paragraph 3 above.

5

With respect to paragraphs 3 and 4 above, firms should be able to demonstrate at all times how they determined the final price applied to any position in a security.

APPENDIX 26 (RULES 3-81 TO 3-165): SUMMARY TABLES OF WHICH METHOD OF PRR TO APPLY TO AN INSTRUMENT

INSTRUMENT		CIRCUMSTANCES	METHOD	RULES
1	note issuance facilities	all circumstances	note issuance facilities	3-80
2	foreign currency asset or capital or liability	all circumstances	foreign currency exposures	3-150 to 3-154
3	currency option and future	see rule 3-152	foreign currency exposures or foreign currency derivatives	3-150 to 3-154
4	physical commodity, actual and forward	all circumstances	commodities	3-166 to 3-169B
5	physical commodity, option and future	all circumstances	commodities	3-166 to 3-169B
6	concentrated position	all circumstances	method relevant to position + concentrated position	As above
7	forward	equity foreign currency physical commodities	equity foreign currency exposures	3-80 3-150 to 3-154
			commodities	3-166 to 3-169B
8	regulated collective investment scheme	all circumstances	equity derivatives	3-80
9	non marketable investments and others	all circumstances	100% PRR	3-80

APPENDIX 33 (EXCHANGES): LIST OF APPROVED EXCHANGES

The following exchanges are approved for the purposes of the definition of "approved exchange" -

Athens Stock Exchange (ASE)
Barcelona Stock Exchange (Bolsa de Valores de Barcelona)
Belgian Futures & Options Exchange (BELFOX)

Berlin Stock Exchange (Berliner Börse)
Bilbao Stock Exchange (Bolsa de Valores de Bilbao)
BVLP (Bolsa de Valori de Lisbao e Porto
Bolsa de Mercadorios & Futures (BM&F)
Boston Stock Exchange
Bovespa (The São Paulo Stock Exchange)
Bremen Stock Exchange (Bremer Wertpapierbörse)
BVRJ (The Rio de Janeiro Stock Exchange)
Cincinnati Stock Exchange
Copenhagen Stock Exchange (Kobenhavns Fondsbors)
Dusseldorf Stock Exchange (Rheinisch-Westfälische Börse zu Düsseldorf)
Frankfurt Stock Exchange (Frankfurter Wertpapierbörse)
Hannover (Niedersächsische Börse zu Hannover)
Italian Exchange
Kuala Lumpur Stock Exchange
Luxembourg Stock Exchange (Société de la Bourse de Luxembourg SA)
Madrid Stock Exchange (Bolsa de Valores de Madrid)
Mercato Italiano Futures (MIF)
Munich Stock Exchange (Bayerische Börse in München)
Nagoya Stock Exchange
New Zealand Stock Exchange
Oslo Stock Exchange (Oslo Bors)
Stuttgart Stock Exchange (Baden-Würtembergische Wertpapierbörse zu Stuttgart)
Swiss Exchange (SWX)
Taiwan Stock Exchange
Tel Aviv Stock Exchange
The Stock Exchange of Thailand
Valencia Stock Exchange (Bolsa de Valores de Valencia)

APPENDIX 34 ("QUALIFYING DEBT SECURITY"): RELEVANT AGENCY

The agencies in the table below are "relevant agencies" for the purposes of the definitions of "qualifying debt security".

		Securities minimum category	**Money market obligations minimum category**
1	**For all issuers** Moody's Investors Service Standard and Poor's Corporation Fitch Ratings Ltd	 Baa3 BBB BBB	 P3 A3 A3
2	**For all banks, Building Societies and parent companies and subsidiaries of banks** Thomson BankWatch	 BBB-	 TBW-3
3	**For Canadian issuers and issues in Canadian dollars** Canadian Bond Rating Service Dominion Bond Rating Service	 B++low BBB low	 A-3 R-2
4	**For Japanese issuers and issues in Japanese yen**		

	Fitch Ratings Ltd Japan Credit Rating Agency, Ltd Japan Rating and Investment Information, Inc Mikuni & Co Ltd	BBB- BBB- BBB- BBB	F-3 J-2 a-2 M-3
5	**For United States issuers and issues in US dollars** Fitch Ratings Ltd	 BBB-	 F-3

APPENDIX 35 ("REGULATED FINANCIAL INSTITUTION" AND "SUPRANATIONAL ORGANISATION"): LIST OF REGULATED FINANCIAL INSTITUTIONS AND SUPRANATIONAL ORGANISATIONS

PART 1LIST OF REGULATORS FOR THE PURPOSES OF THE DEFINITION OF REGULATED FINANCIAL INSTITUTION

Australian Stock Exchange Limited;
The Hong Kong Monetary Authority;
The Hong Kong Securities and Futures Commission;
Investment Dealers Association of Canada;
Japanese Ministry of Finance;
Sydney Futures Exchange;
Toronto Stock Exchange;
United States Commodity and Futures Trading Commission;
United States Securities and Exchange Commission;
Vancouver Stock Exchange.

PART 2 LIST OF SUPRANATIONAL ORGANISATIONS

a multilateral development bank;
The Bank for International Settlements;
The Council of Europe;
Euratom (The European Atomic Energy Community);
Eurofima (The European Company for Financing of Railroad Rolling Stock);
The EU;
The International Monetary Fund;

APPENDIX 37 (RULE3-177): GUIDANCE NOTES FOR MONEY BROKERS APPLICATION OF THE COUNTERPARTY RISK REQUIREMENT

INTRODUCTION

1

This Appendix offers guidance to money brokers on the application of rule 3-177 relating to the counterparty risk requirement.

CALCULATION OF 0.5% ADDITIONAL CRR

2

A money broker should calculate the additional CRR requirement as follows -

(a) if a money broker is satisfied that it has a legal right to net off exposures with an individual counterparty, valid and enforceable in the United Kingdom or any other relevant country, it may do so in accordance with the rule 3-176(3). The obligation rests with the broker to demonstrate that the method it uses is reasonable and justifiable. It is stressed that this right to net is at the option of the firm and is not mandatory;

(b) a money broker should then aggregate its total level of securities subject to a repurchase or reverse repurchase agreement, securities lending or borrowing agreement and sale and buy back or buy and sale back agreement (either net or gross) to or from individual counterparties outside an approved payments system and money lent against Talisman short-term certificates. A capital requirement of 0.5% of this sum should then be calculated.

APPROVED PAYMENTS SYSTEMS

3

The following are approved payment systems when the systems concerned provide for settlement on a delivery versus payment basis -

- Austraclear New Zealand
- Banca D'Italia's Giornaliera
- Banque Nationale de Belgique
- Bank of Spain Interbank Bond Settlements System
- Banque de France's SATURNE
- BOJ-NET DVP
- Central Gilts Office
- Clearstream
- Depository Trust Company
- Euroclear
- Fedwire - see The Federal Reserve System
- Kassenverein
- Necigef
- SICOVAM (Relit settlement only)
- Sociedad de Compensacion y Liquidacion de Valores
- The Canadian Depository for Securities Ltd
- The Federal Reserve System (Fedwire), and
- Vardepapperscentralen VPC AB

COLLATERAL

4

It is recognised that letters of credit may be used as collateral and may have a value in excess of the amount of the securities transferred. Provided it is clearly established that claims cannot be made on the letter of credit in excess of the value of the securities borrowed, no CRR will be imposed on the amount by which the letter of credit exceeds the value of the securities borrowed. Firms are reminded that the definition of acceptable collateral includes marketable investments which may take the form of money market instruments.

APPENDIX 43: GUIDANCE NOTES ON THE FINANCIAL RESOURCES AND ACCOUNTING TREATMENT OF SOFT COMMISSION AGREEMENTS (RULES 3-73 AND 3-182(3))

INTRODUCTION

1

This Appendix contains detailed guidance to the following rules-

Rules	
3-73	Expenditure requirement
3-182(3)	CRR requirement on other amounts owed to a firm arising out of investment business or investment dealing activity

2

The FCA is of the view that it is not responsible for setting accounting policies in relation to a firm's audited annual financial statements. However, the FCA considers that it is preferable for all firms participating in "soft commission agreements" to have consistent accounting policies. Without such consistency, certain firms would have a competitive advantage in terms of their financial resources. Therefore, for the purposes of completing financial reporting statement submitted to the FCA, appropriate accounting policies should be used. The guidance and interpretations made in this Appendix should be considered in this context.

3

The guidance applies to all firms which participate in "soft commission agreements" whether or not this is the sole investment business of the firm.

DEFINITION

4

A soft commission agreement means-

> "any agreement, whether oral or written, under which a firm which deals in securities on an advisory basis, or in the exercise of discretion, receives goods or services in return for an assurance that not less than a certain amount of such business will be put through or in the way of another person;"

DESCRIPTION

5

A "soft commission agreement" is understood as being one in which a fund manager agrees, either formally or informally, to provide a broker with a certain amount of commission in any one period in return for the provision of services "free". Those services may be provided in-house or by third parties and may take the form of specific research provided by analysts, portfolio valuation systems, or information packages, plus the associated computer hardware and software.

6

Under traditional broking arrangements, the full service broker normally receives commission in return for the total servicing of a fund manager's account, a package which includes execution, perhaps custodianship and, almost certainly, research, also "free". The services provided under traditional broking arrangements are in-house i.e. within a broking group, and mostly are not conditional upon receipt by the broker of a certain level of commission, although there is usually an understanding which may never be articulated, that a certain volume of business will be generated.

EXISTING DIFFERENCE IN ACCOUNTING POLICIES

7

The accounting policies used can in general be divided into those which are "profit & loss" based and those which are "balance sheet" based. Under the former, the firm will write-off such expenditure to its profit & loss account but will usually not accrue a liability in its financial reporting statements for commissions received in advance. Consequently, the "normal" profit & loss based accounting systems for expenses incurred and commissions received will be used. It should be noted that such firms, as they are fundamentally participating in traditional broking arrangements, may not have legally enforceable "soft commission agreements" with their counterparties, such that there may be no absolute contractual liability on the firm or counterparty to provide expenditure or commission.

8

Firms using the "balance sheet" approach will accrue for liabilities but will also tend to capitalise their expenditure under "soft commission agreements". This may be the policy used by firms which specialise in legally enforceable "soft commission agreements" and reflects the legal status of such agreements. These may contract the counterparty to pay a level of commission related to the level of expenditure incurred by the firm (and vice versa if the counterparty has paid advance commission in excess of the expenditure paid by the firm).

EXPENDITURE AND BALANCES RECEIVABLE

9

Once expenditure is incurred for a counterparty, the soft commission broker may claim that contractually the counterparty is bound to pay him a certain multiple of that expenditure in the form of commission within a certain period of time from the date the expenditure was incurred. Consequently, certain firms have previously capitalised their expenditure and shown it as an asset for the purposes of calculating their financial resources.

REQUIRED TREATMENT

10

Where a firm incurs expenditure on behalf of a counterparty or counterparties in respect of "soft commission agreements" (whether or not it is incurred in relation to a written contract), the firm should immediately write off such expenditure to its profit & loss account.

11

Notwithstanding the above, expenditure may be capitalised (as an asset) in the balance sheet of the company which incurred the expenditure, only where this amount is recoverable under a legally enforceable contract (see paragraph 18 below). Where such expenditure is capitalised it will be subject to rule 3-182(3).

INCOME AND BALANCES PAYABLE

12

Once commission income is received from a counterparty, the firm may recognise that contractually it is bound to pay the counterparty a certain proportion of that income, in the form of the counterparty's expenses, within a certain period. Although certain firms are including this amount as a liability on their balance sheet (and thus reducing their financial resources), other firms are making no such provision.

REQUIRED TREATMENT

13

Where a firm has a contractual liability to, or on behalf of, a counterparty or counterparties which arises from a legally enforceable "soft commission agreement", the firm should accrue in its financial reporting statements a liability for the relevant proportion of any advanced commission income received from the counterparty that will have to be subsequently incurred as an expense by the firm in the form of a payment on behalf of the counterparty for allowable goods and services.

EXPENDITURE REQUIREMENT

14

Once expenditure is incurred for a counterparty, the soft commission broker may claim that contractually the counterparty is bound to pay him a certain multiple of that expenditure in the form of commission within a certain period and thus such expenditure should not be included in the firm's expenditure requirement.

REQUIRED TREATMENT

15

Expenditure incurred by soft commission brokers should be included in a firm's expenditure requirement, unless it is incurred under a legally enforceable "soft commission agreement" when it may be excluded from the expenditure requirement calculation.

16

The reasoning behind this treatment is that the expenditure of a firm participating in soft commission arrangements is similar to shared commissions and can, therefore, be treated as though it were shared commissions under rule 3-73(2)(f), except to the extent that such expenses are irrecoverable, i.e. except where there is no enforceable legal agreement.

17

It is considered that certain firms may have been under the misapprehension that there was a concession for all expenditure related to "soft commission agreements" regardless of whether the agreement was legally enforceable. Where a firm undertakes a mixture of business between legally enforceable contracts and informal arrangements (all of which the firm would classify as "soft commission agreements"), it must take great care in allocating expenditure between legally enforceable contracts and others. Alternatively, it may decide to include all expenditure in the expenditure requirement regardless of source.

LEGALLY ENFORCEABLE CONTRACTS

18

For the purposes of this guidance, for a "soft commission agreement" to be legally enforceable there should be a specific written legal contract governing the arrangements. The contract should be legally enforceable by the firm involved, both in the UK and in any other relevant country.

APPENDIX 46 (TABLE 3-173(2)B): COUNTRIES/TERRITORIES IN WHICH CRR ON ISSUING MARKET FREE DELIVERIES MAY BE RELAXED

INTRODUCTION

This Appendix lists the countries/territories in which free deliveries made in the issuing market are subject to a reduced CRR of 15% of the free delivery value, and the time limit on this reduced CRR.

Country/Territory	Business days since delivery
Hong Kong SAR	20
Indonesia	30
Malaysia	30
Philippines	75
Singapore	21
Thailand	45

Appendix 47: Tables applicable to CRR for derivative transactions under the rule 3-173B

TABLE 1

Counterparty Weights to be Applied in Calculating Liquidity Adjustment and CRR (rule 3- 173B(5)(b))

Type of counterparty	Counterparty weight
claims on, or explicitly guaranteed by, or collateralised with securities issued by: - the central government or central bank of a Zone A country; - the EU or Euratom (the European Atomic Energy Community); or - any other government or central bank, provided the exposure is denominated in that country's national currency.	NIL
claims on discount houses, gilt-edged market makers, institutions with a money market dealing relationship with the Bank of England and those Stock Exchange money brokers which operate in the gilt-edged market, where the claims are secured on gilts, UK Treasury bills, eligible local authority and eligible bank bills, or London CDs	10%
claims on, or explicitly guaranteed by: - a multilateral development bank; - the regional government or local authority of a Zone A country; - a Zone A credit institution; - a recognised clearing house or recognised exchange; - a recognised third country or EEA investment firm; - a Zone B credit institution, provided the exposure has a maturity of one year or less.	20%
any other counterparty	100%

Guidance

The guarantee should be explicit and be legally enforceable by the firm and should prevent a firm's capital from becoming deficient as a result of experiencing a loss on such an exposure. The exposure must be retained on the firm's balance sheet.

TABLE 2

Specific risk percentage risk additions

Issuer	Residual maturity	Percentage risk addition
An issue of, or fully guaranteed by, or fully collateralised by a Zone A central government or central bank or the EU or Euratom (the European Atomic Energy Community)	Any	0%
An issue of, or fully guaranteed by, a Zone B central government or central bank denominated in the local currency	Zero to 12 months	0%

TABLE 3

Minimum ratings for qualifying debt securities

Issuer	Rating agency	Minimum rating	
		Securities	**Money Market Obligations**
Any	Moody's Investors Service Baa3 Standard & Poor's Corporation BBB FITCH Ratings Ltd	P3 A3 BBB	 F-3
Canadian	Canadian Bond Rating Service Dominion Bond Rating Service	B++low BBB low	A-3 R-2
Japanese	Japan Credit Rating Agency, Ltd Mikuno & Co Japan Rating & Investment Information Inc	BBB- BBB BBB-	J-2 M-3 a-2

APPENDIX 56: GUIDE TO ADEQUATE CREDIT MANAGEMENT POLICY (ACMP) (RULES 3-73 TO 3-175, 3-300 AND "ACMP")

INTRODUCTION

1

This appendix contains general guidance on the standards which the FCA expects a firm's ACMP to meet.

OBJECTIVE

2

The FCA's objective is to ensure that adequate procedures and controls are in place to manage effectively the granting of credit and the monitoring and controlling of credit risk.

SCOPE

3

The guidance applies to any firm which wishes to take advantage of the lower CRR percentages (by which counterparty exposures must be multiplied).

4

Before a firm may use the lower percentages in calculating CRR and in preparing its financial reporting statements, it must meet the requirements set by 3-300. The ACMP and its operation will be reviewed periodically by the FCA and, where it is no longer operating effectively, the firm may be in breach of those requirements.

BACKGROUND

5

The FCA is aware that firms grant credit to counterparties in many different ways, including for example, loans to cover actual margin calls as a result of delays between trade date and final settlement or of late settlement etc. This guidance is designed to cover all instances where a firm becomes exposed to credit risk although, depending on the way in which credit risk arises, the procedures for managing it may differ.

6

In considering the credit management policies of a firm, the FCA will expect the firm to operate a robust control structure which is appropriate to the size, scale and nature of its business and the diversity and complexity of its exposures. The FCA recognises that different approaches to and styles of credit management can create an effective operational control environment. Therefore, it is not appropriate for the FCA to lay down prescriptive standards which it would expect a firm to meet, but rather to suggest a broad framework which is flexible, allows for individualised solutions and can accommodate and encourage evolutionary developments.

7

The prime components of a sound credit risk management process are:

- the definition by a firm of what constitutes a credit exposure/risk and is therefore covered by the firm's ACMP;
- a comprehensive credit risk measurement approach;
- the existence of guidelines and other parameters used to determine credit limits and govern the level and types of risk taken; together with
- a strong management information system for controlling, monitoring and reporting exposures.

Thus, when the FCA reviews a firm's credit management process, it will seek comfort that credit exposures are managed and controlled in a highly disciplined manner and that the relevant staff are well versed in the firm's credit procedures.

8

Where a firm's credit risk management is controlled or overseen by its parent or an affiliate in the same group, provided that the firm can identify reasonable grounds for believing that the level of control is suitable, this should not impede use of the firm's ACMP.

GENERAL PRINCIPLES

9

In forming its view as to the adequacy of a firm's credit risk management process, the general characteristics which the FCA may take into account include the following:

Role of senior management

(a) whether the framework of credit risk management, i.e. a firm's policies and procedures, is overseen by the board of directors or an equivalent management body;

Procedures

(b) whether there are clearly established lines of responsibility and levels of authority for:

- the granting of credit to a counterparty;
- extending its permitted use to cover risk arising on a product new to the counterparty;
- increasing existing credit facilities; and
- the monitoring and controlling of all credit risk;

(c) the extent to which the functions of granting, measuring, monitoring and controlling credit risk are managed independently of the front office with a direct reporting line to the senior management ultimately responsible for credit risk management;

(d) whether good channels of communication exist which ensure that the firm's credit management procedures are well understood and followed by all relevant personnel;

(e) whether procedures exist for identifying unintentional credit exposures and dealing with counterparty which has failed to settle its obligations to the firm,(whether merely due to a delay or actual default), or which is expected not to settle its obligations on the due date; including arrangements for closing out transactions. In addition, the FCA may consider whether a firm has the ability to identify and attempt to predict, as well as quantify, any shortfall as it arises and on an aged basis;

(f) whether mechanisms exist for a daily comparison of exposures with credit limits, including the production of exception reports, and the procedures to be followed to deal with the results of those exception reports;

Documentation

(g) whether a firm's credit management policies and procedures are properly documented and reviewed by the firm on a regular and thorough basis to ensure that they continue to remain appropriate and sound;

(h) whether records are kept in respect of each counterparty (identified on an individual legal entity basis) indicating in sufficient detail, the level of credit risk to a counterparty to which the firm is willing to expose itself. Where a firm grants a credit facility similar to a loan to cover, for example, margin calls, such records might give details of the credit facility extended to a counterparty together with any information gathered in support of the decision to grant that credit facility, the types of transaction which the firm may enter into with the counterparty and to which the credit facility may be allocated. Credit information relating to counterparties should be regularly updated and reviewed by the firm to ensure that any credit facility granted remains appropriate;

Collateral and margin

(i) whether the firm has written policies relating to the margining and collateral arrangements with its counterparties. Terms of business or customer agreements would normally detail the circumstances when margin might be called, and the type and level of collateral which would be acceptable to the firm on the basis of its liquidity, volatility and ability to be realised. In addition, it may be relevant to consider the degree to which a firm's collateral records are kept up to date and include detail of the practical procedures for the realisation of such collateral.

Measurement and monitoring of exposures

(j) whether a firm has mechanisms for identifying the level of concentration of credit risk exposures to each individual counterparty, and each group of connected counterparties, etc on a regular and timely basis;

(k) where a firm uses risk reduction techniques (such as master agreements, netting agreements, collateralisation arrangements or the taking of third party credit enhancements, including letters of credit and guarantees), whether the firm has procedures for scrutinising documents and assessing their impact on the credit risk of the firm and assessing the quality of any guarantees or letters of credit;

(l) depending on the nature of the credit exposures to which a firm is subject, whether the firm's mechanisms for measuring such exposures are appropriate to cover the type or level of risk to which they give rise.

ADDITIONAL GUIDANCE ON THE FCA'S ASSESSMENT OF ACMPS

PREAMBLE

This document is intended as a guide to those areas of Credit Management Policies which the FCA will address when considering their adequacy.

A DEFINITION OF CREDIT AND THE MEASUREMENT OF CREDIT RISK

The FCA expects that firms have a clear definition of what is considered to be "credit risk" (by whatever name it is known) within the firm.

The FCA expects firms to consider in depth the measurement of the extent of Credit Risk which is incurred vis a vis any given counterparty. Firms should be aware that the extent of credit risk incurred will not necessarily be the same as the nominal value of contracts entered into ("value at risk" concept).

The FCA will expect that firms measure and monitor the extent of Credit Risk incurred vis a vis any given counterparty by reference to a system of limits showing the maximum Credit Risk which the firm considers it prudent to incur vis a vis that counterparty having regard for the financial strength of the counterparty.

The FCA expects there to be adequate procedures within the firm for the recognition of where credit risk may be incurred, for the approval of incurring such risk, and, once incurred, for the monitoring of that risk to ensure the satisfactory recovery of all amounts owed to the firm by a counterparty.

THE DECISION TO GRANT CREDIT

If there is a formal decision making body (e.g. a "Credit Committee") which reviews applications for credit:

- How does it derive its authority?
- What is the extent of any Credit Committee's authority as regards:
  - amount of credit granted
  - tenor of credit granted
  - products for which credit lines may be approved
  - industry sectors for which credit lines may be approved?
- How is any Credit Committee constituted?
- What are the qualifications of any Credit Committee's members to make the decisions required of them?
- Independence of Committee from profit centres
- Recording of Approvals

If there is no formal committee, what procedures exist to ensure adequate collective responsibility for credit decisions giving regard for the duality ("four eyes") principle and independence of decisions made from profit centres likely to benefit from income? e.g.

- "round robin" circulation of papers to Directors/Credit Management
- individual sign off on each transaction/deal

Many of the comments noted above concerning a "Credit Committee" will be relevant also where no formal Committee meets, as will the following remarks concerning the documentation provided to those making credit decisions.

What documentation is provided to those charged with reaching decision to grant credit?

Cover sheet detailing proposed credit.

- Name of proposed counterparty (identify correct legal entity)
- Address of proposed counterparty
- Amount of credit
- Currency of credit
- Tenor of credit
- Collateral/Security proposed (where applicable)
- Remuneration for credit granted
- Products
- Existing exposure to counterparty (in case of increase/review)
- Previous payment performance of counterparty (in case of increase/review)

Financial information on proposed counterparty.

In order to ascertain the financial strengths and weaknesses of a proposed counterparty the FCA expects firms to revert to financial information, some examples of which are given below.

- Annual report and accounts
- Analysis of annual reports and accounts
- Credit reference agency reports e.g. Dun and Bradstreet
- Rating agency reports e.g. Standard and Poors, Moody's
- Brokers reports
- Bank status reports
- Statements of net worth

"Credit memorandum" or other internally produced paper outlining the reason for proposing the granting of credit to the counterparty.

Some areas which might be covered by such a memorandum are as follows:

- Background information on relationship with proposed counterparty
- Commentary/analysis of financial information
- Future prospects (for profitability, growth etc.)
- Reason for present proposal
- What benefit will it bring to a firm's relationship with company?
- Perceived risks in providing the credit proposed
- What measures have been taken to mitigate these risks?
- Provision of management accounts
- imposition of financial covenants
- Taking of security
- Comments on the collateral or security to be taken
- Comments on legal documentation to be employed

- Industry exposure
- Country exposure
- Spread of counterparties - large exposures

THE MONITORING OF CREDIT EXPOSURES

Once a proposal to grant credit has been approved the FCA will expect that there are adequate procedures in place to ensure the proper monitoring of all credit exposures entered into.

The FCA expects the monitoring function to be separate from and managed independently of those profit centres which may benefit from the incurring of credit risk.

In order to ensure adequate monitoring of credit exposure it will be necessary for firms to ensure that decisions concerning credit matters are communicated promptly and efficiently to those who are responsible for their utilisation and monitoring. firms may wish to consider how such matters are communicated to:

- Those entitled to commit the firm
- Credit Control Officers
- Senior Management
- Documentation Staff

The FCA will consider the methods by which this information is communicated e.g. memorandum, manual lists, credit procedures manuals etc.

COMPUTER SYSTEMS

Where use is made of computer systems the FCA will consider the various methods by which the integrity of databases is ensured. These could include

- Password protection/access rights
- Accuracy/key verification
- Duality principle
- Physical security of systems
- Back up

Where information is transferred between computer systems e.g. for reporting purposes or to PC based systems the FCA will consider any reconciliations which are performed.

REPORTING

The FCA expects there to be an adequate reporting system for the monitoring of credit exposure. Many firms make use of a series of reports, analysing their credit exposure based on a number of different criteria. Examples of the kinds of reports which may be found useful by firms are given below.

- Excess reports/Exception reports
- Exposure reports
    - by customer/group/connected customers
    - by industry
    - by country
- Overdue payments reports

- Facilities due for review
- Facilities by collateral/security type
- Collateral/security held
- Large Exposures

The FCA will give consideration to the frequency of production of reports used in monitoring credit risk.

CREDIT RISK MANAGEMENT/CONTROL

The FCA will expect to be given details of the action taken where monitoring shows that any aspect of credit exposure is not in line with previously agreed parameters.

For example where exposure is in excess of approved limits the FCA will expect to be informed about what action is taken, where payments are not received, how this is followed up. If a counterparty's financial standing deteriorates, what action is taken to attempt to mitigate possible credit loss?

DOCUMENTATION

The FCA expects firms to have adequate procedures in place to be certain that all transactions which require documentation are documented and that this occurs within an acceptable time frame, and that any transactions which fail to be documented are identified and reported to Senior Management for appropriate action to be taken.

The FCA expects any staff responsible for documentation to be separate from front office/profit centres and have an independent reporting structure. This will ensure that the commercial wish to trade and do business does not cloud the negotiation of effective and binding legal documentation.

- Suitability of documentation to be used
- Preparation of documentation
- Qualification of staff (or choice of solicitors to be instructed)
- Training of documentation staff
- Tenacity of documentation staff

Basic documentation to be obtained from all counterparties might include

- Certificate of incorporation
- Memorandum and articles of association (M&AA)
- Board Resolution

Other documents which a firm may wish to call for prior to entering into transactions would include:

- a statement of officers authorised to act for the counterparty and to commit
- it to transactions
- a list of authorised signatories where one exists
- an audited annual report or interim figures
- credit reference report or bank status report

Other areas for consideration could include:

- Prompt execution of documentation
- Monitoring response to documents sent out
- Chasing where no response

- Reporting missing documentation to senior management
- Proper execution
- Secure storage of documentation
- Regular review of documentation held

ONGOING REVIEW OF CREDIT RISK

The FCA expects firms to have in place adequate procedures for the annual (or more frequent) review of credit risk.

- Scope of the review
- Financial information
- Action where concern is raised
- Possible need for more frequent review
- Monitoring of counterparties' performance
- Defaults and delinquent and bad debts
- Provisioning policy

The FCA will expect a firm to be able to explain what action may be taken as the result of review e.g. reduction of credit limit, calling for further collateral etc. Where the review indicates cause for concern.

DOCUMENTATION OF CREDIT POLICIES AND PROCEDURES AND CUSTOMER FILES

The FCA will expect firms to consider the manner in which their Credit Policies are documented. Areas for comment could include:

- Credit Procedures manuals and the context in which they are used
- Internal Board Minutes showing delegated authority
- Credit Committee Minutes
- Operations manuals
- Training material for staff
- Internal memorandum detailing credit policy
- Customer Credit files, to contain
  - credit analysis information
  - copies of decisions to grant credit
  - copies of relevant documentation
  - press cuttings
  - copies of data input documents

APPENDIX 62: NETTING

SIMILAR TYPES OF TRANSACTIONS

The rules set out the requirements to be met by firms before offsetting exposures in 'similar types of transactions ' with a counterparty (i.e.being those transactions falling under a particular counterparty risk rule).The netting of exposures within a particular rule is to be applied on a first in first out basis.

DERIVATIVE TRANSACTIONS

Firms may offset the negative replacement cost on written OTC options against the positive replacement cost of OTC purchased options with the same counterparty.

GUIDANCE ON THE NETTING OF COUNTERPARTY EXPOSURES

INTRODUCTION

1.

This appendix contains guidance on the requirements to be attained in order for firms to net counterparty exposures assessed under the following areas.

Subject
Cash against documents transactions
Free deliveries of securities
Repurchase and reverse repurchase, securities lending and borrowing and sale and buy
back agreements
Derivative transactions
Other amounts owed to a firm arising out of trading book business

SCOPE

2.

The guidance applies to any firm subject to the CRR rules and which takes advantage of the netting provisions contained therein.

BACKGROUND

3.

Agreements which can effect set-off of counterparty exposures exist in two forms:

(a) novation agreements (referred as netting by novation) which replace existing contracts with one new contract and therefore can only be used to cover similar transactions with payments in the same currency for the same value dates;and

(b) netting agreements which can be used to cover transactions of very different types.

The guidance below applies to both novation agreements and netting agreements.

PRINCIPLES OF OFFSET

4.

Before offsetting exposures in similar types of transactions with a counterparty a firm must have a contractual netting agreement with that counterparty which:

(a) covers the transactions which the firm is seeking to net;
(b) creates a single obligation in each currency or a single obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances;
(c) does not include a walkaway clause; and
(d) is supported by written and reasoned independent legal opinions to the effect that, in the event of a legal challenge, the relevant courts would find the firm 's exposure to be the single net amount mentioned in (b) above.

PRINCIPLES OF OFFSET

5.

The prerequisite of holding a netting agreement supported by an independent legal opinion in order to offset exposures is not required where the Financial Law Panel 's (November 1993) Statement of Law on netting applies. This Statement of Law indicates that under English law rule 4-90 of the Insolvency Rules 1986 imposes a requirement for complete setoff of transactions between parties incorporated in England and Wales, provided the transactions are mutual (i.e. credits, debts or claims arise from dealings between the same parties and that the parties are acting in the same capacity). Furthermore, it indicates that set-off is mandatory ,applies whether or not there is any contractual entitlement to set-off and cannot be excluded by agreement between the parties.

6.

As mentioned above mutuality is required in order for there to be complete set-off of transactions. Accordingly, firms are expected to have procedures in place to identify the counterparty and the capacity in which the counterparty is acting. Firms proposing to rely on the Statement of Law on netting must satisfy themselves of the appropriateness of such reliance and,where in doubt, obtain legal advice. It is important to note that Insolvency Rule 4.90 does not apply to building societies, statutory organisations generally, mutual societies, partnerships and individuals.

LEGAL REQUIREMENTS

7.

Legal opinions will be needed for the:

- law of the jurisdiction in which the counterparty is organised;
- law of the jurisdiction in which any branch involved is located;
- law that governs the agreement and, if different, the law that governs individual transactions pursuant to it; and
- law that governs the legal status of the counterparty who is entering into transactions of the type which the firm is seeking to net.

8.

Where a firm uses an industry standard agreement which contains netting/setoff clauses the firm may rely only on a legal opinion relating to the netting/setoff clauses in that standard agreement where no amendment has been made to the agreement which would materially affect these clauses and where the legal opinion addresses the capacity of counterparties of the type with which the firm wishes to contract, the contract type and the relevant jurisdictions.

9.

Where a netting agreement provides that one or both parties may enter into transactions with each other under the agreement through any of its (or certain designated) branches, then all such branches included in the agreement will be considered to be located in relevant jurisdictions for the purpose of this guidance.

10.

Where a netting agreement involves more than one jurisdiction, a legal opinion is required for each to the effect that the agreement creates a single obligation in each currency or a single obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances.

11.

As mentioned above legal opinions should relate to the law of the jurisdiction in which the counterparty is organised (i.e.incorporated or resident). However,certain circumstances may arise where this requirement could be considered not to be applicable; for example where:

- a firm has no assets or exposure in that jurisdiction;
- any judgement obtained in that jurisdiction against a firm would not be enforceable under any of the rules in the UK relating to the enforcement of foreign judgements; or
- there are no other factors relating to that jurisdiction which would affect the ability of a firm to make net payments as contemplated by the netting agreement.

12.

Where a firm believes that the law of the jurisdiction in which a counterparty is organised is not relevant, that point must be addressed in the legal opinion supporting the netting agreement. The ability to exclude the law of the jurisdiction in which a counterparty is organised does not extend to the netting of those off balance sheet exposures listed in the Solvency Ratio Directive: the amendment to this directive (to permit netting)specifically requires this matter to be addressed in the legal opinion.

13.

It is recognised that, with certain aspects of the agreement, it may not be possible to obtain a definite opinion or that a positive opinion regarding enforceability of the netting agreement can only be obtained subject to certain assumptions and/or qualifications. Where qualifications are made, they should be specific and their effect adequately explained. In the same way, assumptions should be specific, of a factual nature (except in relation to matters subject to the law of a jurisdiction other than that covered by the opinion)and should be explained in the opinion.

14.

Legal opinions on netting agreements must be obtained from independent legal advisers with sufficient expertise and experience in this area of law. Opinions from in-house counsel will not be acceptable. Where the regulator in the jurisdiction of the counterparty is satisfied that the netting agreement is not enforceable under the laws of that jurisdiction, the netting agreement cannot be relied upon regardless of the opinions obtained by a firm.

COMPLIANCE WITH THE LEGAL REQUIREMENTS

15.

It is the responsibility of firms to ensure that the legal requirements set out above are met (firms are to calculate CRR on the gross value of exposures to counterparties where this is not the case).Firms do not need to apply to the FCA in order to net exposures. Similarly, legal opinions on netting agreements and the agreements themselves are not required to be submitted to the FCA for approval. The FCA will establish the existence of legal opinions and netting agreements when compliance with the above requirements is being monitored by its staff.

16.

Firms are expected to put procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in light of possible changes in the relevant law.

17.

Firms are expected to maintain records demonstrating that, in relation to the legal requirements, the following considerations have been addressed:

- the applicability of the netting agreement to the counterparties, jurisdictions and transactions involved;
- the applicability of the opinions to the counterparties, jurisdictions and transactions involved;
- where more than one jurisdiction is involved, the potential for conflicts in law;
- all documentation is complete and still valid and that the agreement has been properly executed (i.e. that the acceptance of terms have been evidenced);
- the nature and effect of any qualifications in the legal opinions and assessment that these do not impair the obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances; and
- where an industry standard agreement is used upon which a generic legal opinion has been obtained, identification of those clauses which if altered during the course of negotiating the agreement would affect the right to offset. Internal legal counsel is to evidence review of these agreements to ensure that the effectiveness of the set off clauses has not been altered directly or indirectly by virtue of other clauses being added or deleted.

18.

Firms are expected to hold a copy of the legal opinion and the agreement to which it relates.

19.

Firms are to net exposures within a particular rule on a FIFO basis. Firms may net only current exposures and cannot net potential future exposures.

CROSS-PRODUCT NETTING

Introduction

The FCA will consider granting rule waivers in order to permit firms to take account of cross-product netting in the calculation of their Counterparty Risk Requirement (CRR) in instances where the FCA regards it appropriate.

The current drafting of the FCA's Financial Rules for securities and futures firms allows 'similar ' types of transactions to be netted (where those transactions are covered by a valid netting agreement, with a supporting legal opinion). In practice, 'similar ' has been defined as all transactions which fall within a particular CRR Rule treatment. Thus, currently, for the calculation of CRR in relation to exposures to a counterparty which are covered by valid netting arrangements, a firm would be required to assess, for example, a net exposure for all derivative transactions with that counterparty and a separate net exposure for all repo type transactions with that counterparty.

The FCA will consider granting waivers in accordance with SUP 8, though in general it will expect the following conditions to be met:

1. For the types of transaction which the firm is seeking to net, the firm must have the capability to monitor, and must in practice manage, the resultant exposures on a net basis.
2. All transactions which the firm is seeking to net must be covered by valid netting agreements and supported by legal opinions, in accordance with the requirements of the FCA's Financial Rules; and
3. Where underlying netting agreements are linked by a master netting agreement, the legal opinion must address the enforceability of the netting arrangements in their entirety;

One factor that the FCA will consider in assessing whether a particular applicant meets these requirements is whether the firm has had the use of its ACMP sanctioned for the purposes of calculating CRR.