Prudential sourcebook for Banks, Building Societies and Investment Firms
Prudential sourcebook for Banks, Building Societies and Investment Firms

<table>
<thead>
<tr>
<th>BIPRU 1</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>Application</td>
</tr>
<tr>
<td>1.2</td>
<td>Definition of the trading book</td>
</tr>
<tr>
<td>1.3</td>
<td>Applications for advanced approaches and waivers</td>
</tr>
<tr>
<td>1.4</td>
<td>Actions for damages</td>
</tr>
<tr>
<td>1 Annex 1D</td>
<td>Application form to apply the advanced measurement approach</td>
</tr>
<tr>
<td>1 Annex 2D</td>
<td>Application form to apply the IRB approach</td>
</tr>
<tr>
<td>1 Annex 3D</td>
<td>Application form to apply the CCR internal model method approach</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BIPRU 2</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Solo consolidation</td>
</tr>
<tr>
<td>2.2</td>
<td>Internal capital adequacy standards</td>
</tr>
<tr>
<td>2.3</td>
<td>Interest rate risk in the non-trading book</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BIPRU 3</th>
<th>Standardised credit risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Application and purpose</td>
</tr>
<tr>
<td>3.2</td>
<td>The central principles of the standardised approach to credit risk</td>
</tr>
<tr>
<td>3.3</td>
<td>The use of the credit assessments of ratings agencies</td>
</tr>
<tr>
<td>3.4</td>
<td>Risk weights under the standardised approach to credit risk</td>
</tr>
<tr>
<td>3.5</td>
<td>Simplified method of calculating risk weights</td>
</tr>
<tr>
<td>3.6</td>
<td>Use of rating agencies’ credit assessments for the determination of risk weights under the standardised approach to credit risk</td>
</tr>
<tr>
<td>3.7</td>
<td>Classification of off-balance-sheet items</td>
</tr>
<tr>
<td>3 Annex 1</td>
<td>Guidance on the standardised approach zero risk weighting for intra-group exposures</td>
</tr>
<tr>
<td>3 Annex 2</td>
<td>Regional governments and local authorities eligible for the treatment in BIPRU 3.4.15R</td>
</tr>
<tr>
<td>3 Annex 3</td>
<td>High risk exposures</td>
</tr>
<tr>
<td>3 Annex 4</td>
<td>Exposures to institutions: Interaction with short-term credit assessments in BIPRU 3.4.40R</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BIPRU 4</th>
<th>The IRB approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>The IRB approach: Application, purpose and overview</td>
</tr>
<tr>
<td>4.2</td>
<td>The IRB approach: High level material</td>
</tr>
<tr>
<td>4.3</td>
<td>The IRB approach: Provisions common to different exposure classes</td>
</tr>
<tr>
<td>4.4</td>
<td>The IRB approach: Exposures to corporates, institutions and sovereigns</td>
</tr>
<tr>
<td>4.5</td>
<td>The IRB approach: Specialised lending exposures</td>
</tr>
<tr>
<td>4.6</td>
<td>The IRB approach: Retail exposures</td>
</tr>
<tr>
<td>4.7</td>
<td>The IRB approach: Equity exposures</td>
</tr>
</tbody>
</table>
BIPRU Contents

9.3 Requirements for originators and sponsors
9.4 Traditional securitisation
9.5 Synthetic securitisation
9.6 Implicit support
9.7 Recognition of credit assessments of ECAIs
9.8 Use of ECAI credit assessments for the determination of applicable risk weights
9.9 Calculation of risk-weighted exposure amounts for securitisation positions
9.10 Reduction in risk-weighted exposure amounts
9.11 Calculation of risk weighted exposure amounts under the standardised approach to securitisations
9.12 Calculation of risk-weighted exposure amounts under the IRB approach
9.13 Securitisations of revolving exposures with early amortisation provisions
9.14 Recognition of credit risk mitigation on securitisation positions under the IRB approach
9.15 Requirements for investors

BIPRU 11 Disclosure (Pillar 3)

11.1 Application and purpose
11.2 Basis of disclosures
11.3 Disclosures: Information to be disclosed; Frequency, media and location of disclosures; Verification
11.4 Technical criteria on disclosure: General criteria
11.5 Technical criteria on disclosure: General requirements
11.6 Qualifying requirements for the use of particular instruments or methodologies

BIPRU 12 Liquidity standards

12.1 Application
12.2 Adequacy of liquidity resources
12.3 Liquidity risk management
12.4 Stress testing and contingency funding
12.5 Individual Liquidity Adequacy Standards
12.6 Simplified ILAS
12.7 Liquid assets buffer
12.8 Cross-border and intra-group management of liquidity
12.9 Individual liquidity guidance and regulatory intervention points
12 Annex 1 Mapping of credit assessments of ECAIs to credit quality steps

BIPRU 13 The calculation of counterparty risk exposure values for financial derivatives, securities financing transactions and long settlement transactions

13.1 Application and Purpose
13.2 Unusual Transactions
13.3 Calculation of exposure values for financial derivatives and long settlement transactions: General provisions
13.4 CCR mark to market method
13.5 CCR standardised method
BIPRU Contents

13.6 CCR internal model method
13.7 Contractual netting
13.8 Securities financing transactions
13 Annex 1

BIPRU 14 Capital requirements for settlement and counterparty risk

14.1 Application and purpose
14.2 Calculation of the capital requirement for CCR
14.3 Unsettled transactions
14.4 Free deliveries

Transitional provisions and Schedules

TP 2 Capital floors for a firm using the IRB approach
TP 15 Commodities firm transitionals: Exemption from capital requirements
TP 21 Close substitutes for commodities
TP 29 Liquid assets buffer scalar: simplified ILAS BIPRU firms
Sch 3 Fees and other requirement payments
Sch 4 Powers exercised
Sch 5 Rights of action for damages
Sch 6 Rules than can be waived
Chapter 1

Application
1.1 Application

1.1.1 **G** There is no overall application statement for BIPRU. Each chapter or section has its own application statement. Broadly speaking however, BIPRU applies in the following manner:

(1) [deleted]

(2) [deleted]

(3) to a BIPRU firm;

(3A) to an IFPRU investment firm, only BIPRU 12 (Liquidity standards); and

(4) in relation to groups containing such firms:

(a) only BIPRU 12 (Liquidity standards) applies to the group containing any of the firms in (3) and (3A); and

(b) BIPRU as a whole applies to the group containing only the firms in (3).

1.1.2 **R** BIPRU applies to a firm in relation to the whole of its business, except where a particular provision provides for a narrower scope.

1.1.2A **G** BIPRU applies to a collective portfolio management investment firm that is a BIPRU firm in parallel with IPRUINV link 11 (see IPRUINV link 11.6).

1.1.3 **G** In the main BIPRU only applies to a collective portfolio management investment firm in respect of designated investment business (excluding managing an AIF and managing a UCITS). However BIPRU 2.2 (Internal capital adequacy standards), BIPRU 2.3 (Interest rate risk in the non-trading book), BIPRU 8 (Group risk - consolidation) and BIPRU 11 (Disclosure) apply to the whole of its business.

Purpose

1.1.4 **G** BIPRU 1.1 implements in part the third paragraph of article 95(2) of the EU CRR that permits the FCA to apply the Banking Consolidation Directive and the Capital Adequacy Directive.
The definition of a BIPRU firm

1.1.7
None of the following is a BIPRU firm:

1. incoming EEA firm;
2. incoming Treaty firm;
3. any other overseas firm;
4. an ELMI;
5. an insurer; and
6. an ICVC.

In summary, a BIPRU firm:

1. does not provide the ancillary service of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management, and is not authorised to do so;
2. is not authorised to provide the following investment services:
   a. to deal in any financial instruments for its own account;
   b. to underwrite issues of financial instruments on a firm commitment basis;
   c. to place financial instruments without a firm commitment basis; and
   d. to operate a multilateral trading facility;
3. is authorised to provide one or more of the following investment services:
   a. the execution of investors' orders for financial instruments; or
   b. the management of individual portfolios of investments in financial instruments;
4. may be authorised to provide one or more of the following investment services:
   a. reception and transmission of investors' orders for financial instruments; or
   b. investment advice; and
5. does not hold clients' money and/or securities and is not authorised to do so (it should have a limitation or requirement prohibiting the holding of client money and its permission should not include safeguarding and administering investments).

1.1.10
(1) This paragraph applies to an undertaking that would be a third country BIPRU firm if it were authorised under the Act.
(2) Except in exceptional circumstances, it is the appropriate regulator's policy that it will not give an overseas applicant a Part 4A permission unless the appropriate regulator is satisfied that the applicant will be subject to prudential regulation by its home state regulatory body that is broadly equivalent to that provided for in the Handbook and the applicable EEA prudential sectoral legislation. The appropriate regulator will take into account not only the requirements to which the firm is subject but how they are enforced. The appropriate regulator will also take into account the laws, regulations and administrative provisions to which it is subject in its home state. The reasons for that policy include:

(a) it is unlikely that a firm that is not subject to equivalent supervision will be able to satisfy the threshold conditions (and in particular threshold condition 5 (Suitability)) and it is unlikely that it will be possible to establish that the firm does satisfy them; and

(b) such a firm is likely to pose a threat to the interests of consumers and potential consumers, particularly as effective supervision of an overseas firm depends on cooperation between the appropriate regulator and the regulatory body that authorises the firm in its home country and on the appropriate regulator being able to place appropriate reliance on the supervision carried out by such regulatory body.

(c) [deleted]

(3) If an undertaking is not subject to equivalent supervision in its home state and it wishes to carry on in the United Kingdom regulated activities coming within the scope of the activities that define a BIPRU firm it should establish a subsidiary undertaking in the United Kingdom. Such a subsidiary undertaking should be able to show, amongst other things, how it would comply with the threshold conditions (and in particular threshold conditions 3 (Close links) and 5 (Suitability)).

(4) If in exceptional circumstances the appropriate regulator does grant a Part 4A permission to an undertaking that is not subject to equivalent prudential regulation the appropriate regulator is likely to take measures under the regulatory system to compensate for the lack of equivalent supervision. These may include applying the prudential requirements for BIPRU firms to the firm.

(5) An overseas firm that is subject to equivalent supervision is subject to the threshold conditions and the Principles. BIPRU and GENPRU do not generally apply. BIPRU 12 applies to a credit institution with respect to liquidity risk in relation to its United Kingdom branch.

Meaning of dealing on own account

(1) Dealing on own account means (for the purpose of GENPRU and BIPRU) the service of dealing in any financial instruments for own account as referred to in point 3 of Section A of Annex I to MiFID, subject to (2) and (3).

(2) In accordance with article 5(2) of the Capital Adequacy Directive (Definition of dealing on own account), a CAD investment firm that executes investors' orders for financial instruments and holds such
financial instruments for its own account does not deal on own account if all of the following conditions are met:

(a) such position only arises as a result of the CAD investment firm’s failure to match investors’ order precisely;
(b) the total market value of all such positions is no higher than 15% of the CAD investment firm’s initial capital;
(c) (in the case of a BIPRU firm) it complies with the main BIPRU firm Pillar 1 rules;
(d) (in the case of a CAD investment firm that is an EEA firm) it complies with the CRD implementation measures of its Home State for Articles 18 and 20 (Minimum capital requirements) of the Capital Adequacy Directive;
(e) (in the case of any other CAD investment firm) it would comply with the rules in (2)(c) if it had been a BIPRU firm on the basis of the following assumptions:
   (i) its head office had been in an EEA State; and
   (ii) it had carried on all its business in the EEA and had obtained whatever authorisations for doing so as are required under MiFID; and
(f) such positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

(3) In accordance with article 5(2) of the Capital Adequacy Directive, the holding of non-trading book positions in financial instruments in order to invest capital resources is not dealing on own account for the purposes referred to in article 4(1)(2)(c) of the EU CRR (see BIPRU 1.1.7A G).
1.2 Definition of the trading book

Application

1.2.1 This section applies to a BIPRU firm.

Purpose

1.2.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, the section implements certain provisions of the Capital Adequacy Directive and the Banking Consolidation Directive relating to the trading book. The precise provisions being implemented are listed as a note after each rule.

Definition of the trading book: General

1.2.3 The trading book of a firm consists of all position in CRD financial instrument and commodities held either with trading intent or in order to hedge other elements of the trading book and which are either free of any restrictive covenants on their tradability or able to be hedged.

[Note: CAD Article 11(1)]

Definition of the trading book: Positions

1.2.4 The term position includes proprietary positions and positions arising from client servicing and market making.

[Note: CAD Article 11(2) second sentence]

1.2.5 Positions arising from client servicing include those arising out of contracts where a firm acts as principal (even in the context of activity described as ‘broking’ or ‘customer business’). Such positions should be allocated to a firm’s trading book if the intent is trading (see BIPRU 1.2.10 R). This applies even if the nature of the business means that generally the only risks incurred by the firm are counterparty risks (i.e. no market risk charges apply). If the nature of the business means that generally the only risks incurred by the firm are counterparty risks, the position will generally still meet the trading intent requirement in BIPRU 1.2.10 R if the position would meet the trading intent requirement if position risk did arise. The appropriate regulator understands that business carried out under International Uniform Brokerage Execution (“Give-Up”) Agreements involve back to back trades as principal. Thus positions arising out of business carried out under such agreements should be allocated to a firm’s trading book.
Definition of the trading book: Repos

1.2.6 [R] Term trading-related repo-style transactions that a firm accounts for in its non-trading book may be included in the trading book for capital requirement purposes so long as all such repo-style transactions are included. For this purpose, trading-related repo-style transactions are defined as those that meet the requirements of ■ BIPRU 1.2.4 R, ■ BIPRU 1.2.10 R and ■ BIPRU 1.2.12 R, and both legs are in the form of either cash or securities includable in the trading book. Regardless of where they are booked, all repo-style transactions are subject to a non-trading book counterparty credit risk charge.

[Note: CAD Annex VII Part D point 4]

1.2.6A [G] Capital requirements for term trading-related repo-style transactions are the same whether the risks arise in the trading book as counterparty credit risk or in the non-trading book as credit risk.

CRD financial instruments

1.2.7 [R] A CRD financial instrument means any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party.

[Note: CAD Article 3(1)(e)]

1.2.8 [R] CRD financial instruments include both primary CRD financial instrument or cash instruments, and derivative CRD financial instruments the value of which is derived from the price of an underlying CRD financial instrument, a rate, an index or the price of another underlying item and include as a minimum the instruments specified in Section C of Annex I to the MIFID.

[Note: CAD Article 3(1) last paragraph]

1.2.9 [G] Generally, for the purpose of the definition of CRD financial instrument:

(1) a financial asset means cash, the right to receive cash or another financial asset, the contractual right to exchange financial assets on potentially favourable terms or an equity instrument; and

(2) a financial liability means the contractual obligation to deliver cash or another financial asset or to exchange financial liabilities under conditions that are potentially unfavourable.

Trading intent

1.2.10 [R] Positions held with trading intent for the purpose of the definition of the trading book are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices, or from other price or interest rate variations.

[Note: CAD Article 11(2) first sentence]
Trading intent must be evidenced on the basis of the strategies, policies and procedures set up by the firm to manage the position or portfolio in accordance with BIPRU 1.2.12 R.

[Note: CAD 11(3)]

Positions/portfolios held with trading intent must comply with the following requirements:

1. there must be a clearly documented trading strategy for the position/instrument or portfolios, approved by senior management, which must include the expected holding horizon;

2. there must be clearly defined policies and procedures to monitor the position against the firm’s trading strategy including the monitoring of turnover and stale position in the firm’s trading book; and

3. there must be clearly defined policies and procedures for the active management of the position, which must include the following:
   (a) position entered into on a trading desk;
   (b) position limits are set and monitored for appropriateness;
   (c) dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;
   (d) positions are reported to senior management as an integral part of the firm’s risk management process; and
   (e) positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge-ability of the position or its component risks, including the assessment of, the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market.

[Note: CAD Annex VII Part A]

Internal hedges

Internal hedges may be included in the trading book, in which case BIPRU 1.2.14 R to BIPRU 1.2.16 R apply.

[Note: CAD Article 11(5)]

(1) An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of position. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in BIPRU 1.2.12 R and the trading book systems and controls rules. In particular:

(a) internal hedges must not be primarily intended to avoid or reduce capital requirements;

(b) internal hedges must be properly documented and subject to particular internal approval and audit procedures;

(c) the internal transaction must be dealt with at market conditions;
(d) the bulk of the market risk that is generated by the internal hedge must be dynamically managed in the \textit{trading book} within the authorised limits; and

(e) internal transactions must be carefully monitored.

(2) Monitoring must be ensured by adequate procedures.

\textbf{Note: CAD Annex VII Part C point 1}

\textbf{1.2.15 R} The treatment referred to in \textbf{BIPRU 1.2.14 R} applies without prejudice to the capital requirements applicable to the "\textit{non-trading book} leg" of the internal hedge.

\textbf{Note: CAD Annex VII Part C point 2}

\textbf{1.2.16 R} By way of derogation from \textbf{BIPRU 1.2.14 R} to \textbf{BIPRU 1.2.15 R}, when a \textit{firm} hedges a \textit{non-trading book} credit risk exposure using a credit derivative booked in its \textit{trading book} (using an internal hedge), the \textit{non-trading book} exposure is not deemed to be hedged for the purposes of calculating capital requirements unless the \textit{firm} purchases from an eligible third party protection provider a credit derivative meeting the requirements set out in \textbf{BIPRU 5.7.13 R} (Additional requirements for credit derivatives) with regard to the \textit{non-trading book} exposure. Without prejudice to the second sentence of \textbf{BIPRU 14.2.10 R}, where such third party protection is purchased and is recognised as a hedge of a \textit{non-trading book} exposure for the purposes of calculating capital requirements, neither the internal nor external credit derivative hedge must be included in the \textit{trading book} for the purposes of calculating capital requirements.

\textbf{Note: CAD Annex VII Part C point 3}

\textbf{Size thresholds}

\textbf{1.2.17 R} (1) Subject to (3), a \textit{firm} may calculate its capital requirements for its \textit{trading book} business in accordance with the \textit{standardised approach} to credit risk (or, if it has an \textit{IRB permission}, the \textit{IRB approach}) as it applies to the \textit{non-trading book} where the size of the \textit{trading book} business meets the following requirements:

(a) the \textit{trading book} business of the \textit{firm} does not normally exceed 5\% of its total business;

(b) its total \textit{trading book position} do not normally exceed €15 million; and

(c) the \textit{trading book} business of the \textit{firm} never exceeds 6\% of its total business and its total \textit{trading book positions} never exceed €20 million.

(2) Subject to (3), if (1) applies, the following are disapplied:

(a) the \textit{rules} relating to the \textit{interest rate PRR}, the \textit{equity PRR}, the \textit{CIU PRR} and the \textit{PRR} calculated under \textbf{BIPRU 7.11} (Credit derivatives in the trading book);

(b) the \textit{rules} relating to the \textit{option PRR} (but only in relation to \textit{positions} which under \textbf{BIPRU 7.6.5 R} (Table: Appropriate calculation for an option or warrant) may be subject to one of the other \textit{PRR charges} listed in (2)(a) or which would be subject
to such a PRR charge if BIPRU 7.6.5 R did not require an option PRR to be calculated;

(c) BIPRU 7.10 (Use of a Value at Risk Model) so far as BIPRU 7.10 relates to the risks covered by the requirements in (a) and (b); and

(d) BIPRU 14 (Capital requirements for settlement and counterparty risk).

(3) If (1) applies, the following continue to apply:

(a) the rules relating to the commodity PRR and the foreign currency PRR;

(b) the rules relating to the option PRR (so far as not disapproved under (2)(b);

(c) BIPRU 7.10 (so far as not disapproved under (2)(c);

(d) BIPRU 14.2.3 R to BIPRU 14.2.8 R (Credit derivatives); and

(e) BIPRU 14.2.15 R to BIPRU 14.2.16 R (Collateral for repurchase transactions and other products).

[Note: CAD Article 18(2)]

1.2.18 R

In order to calculate the proportion that trading book business bears to total business for the purpose of BIPRU 1.2.17 R (1)(a) to BIPRU 1.2.17R (1)(c) the firm must refer to the size of the combined on- and off-balance-sheet business. For this purpose, debt instruments must be valued at their market prices or their principal values, equities at their market prices and derivatives according to the nominal or market values of the instruments underlying them. Long positions and short positions must be summed regardless of their signs.

[Note: CAD Article 18(3)]

1.2.19 R

If a firm should happen for more than a short period to exceed either or both of the limits imposed in BIPRU 1.2.17 R (1)(a) and BIPRU 1.2.17R (1)(b) or either or both of the limits imposed in BIPRU 1.2.17 R (1)(c):

(1) BIPRU 1.2.17 R ceases to apply; and

(2) the firm must notify the appropriate regulator.

[Note: CAD Article 18(4)]

1.2.20 G

As required by BIPRU 8.7.21 R (Special rules for the consolidated market risk requirement), a firm should consider whether it meets the threshold conditions in BIPRU 1.2.17 R on both an unconsolidated (or solo) basis and a consolidated basis. If a firm's trading activities on both an unconsolidated (or solo) basis and a consolidated basis are below the threshold size, it may be appropriate for the firm not to adopt the trading book treatment. However, even if the firm does not apply the trading book treatment it should still adopt a trading book policy statement. That statement may be restricted to identifying the activities the firm normally considers to be trading and that would constitute part of its trading book. The firm should use this policy statement to help it to decide whether or not adopting the trading book treatment is appropriate.
1.2.21 **R** A firm must implement policies and processes for the measurement and management of all material sources and effects of market risks.

[Note: BCD Annex V, Part 7 point 10]

1.2.22 **R** A firm must establish and maintain systems and controls to manage its trading book, in accordance with the trading book systems and controls rules, ■ BIPRU 1.2.6 R (Definition of the trading book: Repos) and the overall financial adequacy rule to ■ BIPRU 1.2.27 R (Trading book policy statements).

[Note: CAD Article 11(4)]

1.2.23 **R** A firm must establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.

[Note: CAD Annex VII Part B point 1]

1.2.24 **R** Systems and controls must include at least the following elements:

(1) documented policies and procedures for the process of valuation (including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures); and

(2) reporting lines for the department accountable for the valuation process that are clear and independent of the front office.

[Note: CAD Annex VII Part B point 2]

1.2.25 **R** The reporting line in relation to the matters covered by ■ BIPRU 1.2.21 R to ■ BIPRU 1.2.24 R must ultimately be to an executive director on the firm’s governing body.

[Note: CAD Annex VII Part B point 2 (last sentence)]

**Trading book policy statements**

1.2.26 **R** A firm must have clearly defined policies and procedures for determining which positions to include in the trading book for the purposes of calculating its capital requirements, consistent with the criteria set out in ■ BIPRU 1.2.3 R to ■ BIPRU 1.2.4 R, ■ BIPRU 1.2.10 R to ■ BIPRU 1.2.11 R, ■ BIPRU 1.1.13 R and ■ BIPRU 1.2.22 R and taking into account the firm’s risk management capabilities and practices. Compliance with these policies and procedures must be fully documented and subject to periodic internal audit.

[Note: CAD Annex VII Part D point 1]

1.2.27 **R** A firm must have clearly defined policies and procedures for overall management of the trading book. At a minimum these policies and procedures must address:
(1) the activities the firm considers to be trading and as constituting part of the trading book for capital requirement purposes;

(2) the extent to which a position can be marked-to-market daily by reference to an active, liquid two-way market;

(3) for positions that are marked-to-model, the extent to which the firm can:
   (a) identify all material risks of the position;
   (b) hedge all material risks of the position with instruments for which an active, liquid two-way market exists; and
   (c) derive reliable estimates for the key assumptions and parameters used in the model;

(4) the extent to which the firm can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;

(5) the extent to which legal restrictions or other operational requirements would impede the firm’s ability to effect a liquidation or hedge of the position in the short term;

(6) the extent to which the firm can, and is required to, actively risk manage the position within its trading operation; and

(7) the extent to which the firm may transfer risk or positions between the non-trading book and trading book and the criteria for such transfers.

[Note: CAD Annex VII Part D point 2]

The policies and procedures referred to in ■BIPRU 1.2.27 R (1) should cover:

(1) the CRD financial instrument and commodities that the firm proposes to trade in, including the currencies, maturities, issuers and quality of issues; and

(2) any instruments to be excluded from its trading book.

(1) The policies and procedures referred to in the overall financial adequacy rule and ■BIPRU 1.2.27 R must be recorded in a single written document. A firm may record those policies and procedures in more than one written document if the firm has a single written document that identifies:
   (a) all those other documents; and
   (b) the parts of those documents that record those policies and procedures.

(2) A trading book policy statement means the single document referred to in this rule.

(1) A firm must notify the appropriate regulator as soon as is reasonably practicable when it adopts a trading book policy statement.
(2) A firm must notify the appropriate regulator as soon as is reasonably practicable if the trading book policy statement is subject to significant changes.

1.2.31 G A significant change for the purpose of the overall Pillar 2 rule includes new types of customers or business requiring different funding or provisioning.

1.2.32 G There is likely to be an overlap between what the trading book policy statement should contain and other documents such as dealing or treasury manuals. A cross reference to the latter in the trading book policy statement is adequate and material in other documents need not be set out again in the trading book policy statement. However where this is the case the matters required to be included in the trading book policy statement should be readily identifiable.

1.2.33 G The trading book policy statement may be prepared on either a consolidated or a solo (or solo-consolidated) basis. It should be prepared on a consolidated basis when a group either manages its trading risk centrally or employs the same risk management techniques in each group member. A trading book policy statement prepared on a consolidated basis should set out how it applies to each firm in the group and should be approved by each such firm’s governing body.

Treatments common to the trading book and the non-trading book

1.2.34 G Capital requirements for foreign currency risk and commodity position risk are the same whether the risk arises in the trading book or the non-trading book. The calculation of capital requirements for foreign currency risk is set out in BIPRU 7.5. The calculation of capital requirements for commodity position risk is set out in BIPRU 7.4.

Trading book treatments

1.2.35 G All positions that are in a firm’s trading book require capital to cover position risk and may require capital to cover counterparty credit risk. Counterparty credit risk in the trading book is dealt with by BIPRU 14.

Non-trading book treatments

1.2.36 G All positions that are not in a firm’s trading book are included in its non-trading book and subject capital requirements for the non-trading book unless they are deducted from capital resources under GENPRU 2.2 (Capital resources).
1.3 Applications for advanced approaches and waivers

Application

This section of the Handbook applies to every BIPRU firm that wishes to apply for a permission to use any of the approaches set out in BIPRU 1.3.2 G.

Purpose

(1) A firm may apply for an Article 129 permission or a waiver in respect of:
   (a) the IRB approach;
   (b) [deleted]
   (c) the CCR internal model method; and
   (d) the VaR model approach.

(2) A firm should apply for a waiver if it wants to:
   (a) apply the CAD 1 model approach; or
   (b) apply the master netting agreement internal models approach; or
   (c) disapply consolidated supervision under BIPRU 8 for its UK consolidation group or non-EEA sub-group; or
   (d) apply the treatment in BIPRU 2.1 (Solo-consolidation waiver); or
   (da) apply the treatment for a core UK group in BIPRU 3.2.25 R (Zero risk-weighting for intra-group exposures).
   (e) [deleted]
   (f) [deleted]

Article 129

An EEA parent institution and its subsidiary undertakings or the subsidiary undertakings of its EEA parent financial holding company or the subsidiary undertakings of its EEA parent mixed financial holding company that wish to use any of the approaches listed in BIPRU 1.3.2 G(1) in respect of its group, including members of its group that are BIPRU firms, may apply for an Article 129 permission.

1.3.4

The Article 129 procedure allows an EEA parent institution and its subsidiary undertakings or the subsidiary undertakings of its EEA parent financial holding company or the subsidiary undertakings of its EEA parent mixed
financial holding company to apply for permission to use the approaches in BIPRU 1.3.2 G (1) without making separate applications to the competent authority of each EEA State where members of a firm's group are authorised.

1.3.5  G The Capital Requirements Regulations 2006 set out the Article 129 procedure.

1.3.6  G Where a firm or its group has been granted an Article 129 permission, each competent authority, including the lead competent authority, will need to take action to apply that Article 129 permission to the institutions that they authorise. Part 3 of the Capital Requirements Regulations 2006 governs how the appropriate regulator will take that action, whether or not the appropriate regulator is the lead competent authority.

Article 129 permissions and waivers - specific conditions

1.3.7  D [deleted]

1.3.8  D [deleted]

1.3.9  D [deleted]

Waiver - general

1.3.10 G As explained in SUP 8, under section 138A of the Act, the appropriate regulator may not grant a waiver to a firm unless it is satisfied that:

(1) compliance by the firm with the rules, or with the rules as modified, would be unduly burdensome or would not achieve the purpose for which the rules were made; and

(2) the waiver would not adversely affect the advancement of any of the appropriate regulator’s objectives.

1.3.11 G The conditions relating to the use of an approach listed in BIPRU 1.3.2 G referred to in the relevant chapter of BIPRU are minimum standards. Satisfaction of those conditions does not automatically mean the appropriate regulator will grant a waiver referred to in those paragraphs. The appropriate regulator will in addition also apply the tests in section 138A of the Act.

1.3.12 G In the appropriate regulator’s view, if the minimum standards referred to in BIPRU 1.3.11 G are satisfied, the conditions referred to in BIPRU 1.3.10 G (1) will generally be met.

Forms and method of application

1.3.13 D Subject to BIPRU 1.3.14 D to BIPRU 1.3.20 D, if a firm wishes to apply for a waiver to apply an approach set out in BIPRU 1.3.2 G, it must comply with SUP 8.3.3 D.
1.3.14 [deleted]

1.3.15 D If a firm wishes to apply for a waiver or an Article 129 permission to use the IRB approach, it must complete and submit the form in BIPRU 1 Annex 2D D.

1.3.16 D If a firm wishes to apply for a waiver or an Article 129 permission to use the CCR internal model method, it must complete and submit the form in BIPRU 1 Annex 3D D.

1.3.17 D Where a firm makes an application in accordance with BIPRU 1.3.14 D, BIPRU 1.3.15 D or BIPRU 1.3.16 D, the firm must state on the application whether it is making an application for a waiver or an Article 129 permission.

1.3.18 D Where a firm applies for a VaR model permission, the firm must state whether it is making an application for a waiver or an Article 129 permission.

1.3.19 G In respect of the application for waivers to apply the approaches set out in BIPRU 1.3.2 G (1), the appropriate regulator will aim to give decisions on applications as soon as practicable. However, the appropriate regulator expects that it will take a significant period to determine and give a decision due to the complexity of the issues raised by the applications. Details of timelines for applications for waivers to use advanced approaches and under the Article 129 procedure are set out on the appropriate regulator website.

1.3.20 D Where a firm applies for a solo consolidation waiver, it must demonstrate how each of the conditions set out in BIPRU 2.1.20 R to BIPRU 2.1.24 R are met and address the criteria set out in the guidance in BIPRU 2.1.25 G as part of its application in accordance with BIPRU 1.3.13 D.

1.3.21 G Before sending in an application for a waiver or Article 129 permission, a firm may find it helpful to discuss the application with its usual supervisory
contact at the *appropriate regulator*. However, the *firm* should still ensure that all relevant information is included in the application.
1.4 Actions for damages

1.4.1 A contravention of the rules in BIPRU does not give rise to a right of action by a private person under section 138D of the Act (and each of those rules is specified under section 138D(3) of the Act as a provision giving rise to no such right of action).
Application form to apply the advanced measurement approach

[deleted]
Application form to apply the IRB approach
Application form to apply the CCR internal model method approach
Chapter 2

Capital
2.1 Solo consolidation

Application

2.1.1 This section applies to a BIPRU firm that has a solo consolidation waiver.

Purpose

2.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, the purpose of this section is to implement Articles 70 and 118 of the Banking Consolidation Directives so far as they apply under Articles 2 and 28 of the Capital Adequacy Directive to CAD investment firms that are subject to the requirements imposed by MiFID (or which would have been subject to that Directive if its head office were in an EEA State), but excluding a bank, building society, a credit institution, a local and an exempt CAD firm.

2.1.3 The rules in GENPRU and BIPRU do not allow a firm that is a parent undertaking to incorporate the capital and requirements of a subsidiary undertaking in the calculation of that firm’s capital resources and capital resources requirement. A firm that wishes to incorporate a subsidiary undertaking for this purpose should therefore apply for a solo consolidation waiver.

Applying for a solo consolidation waiver

2.1.4 BIPRU 1.3 (Applications for advanced approaches) explains how to apply for a solo consolidation waiver.

General

2.1.5 The appropriate regulator will not grant a firm a solo consolidation waiver with respect to a subsidiary undertaking unless the firm and the subsidiary undertaking meet the standards in BIPRU 2.1.19 R to BIPRU 2.1.24 R.

2.1.6 A solo consolidation waiver will modify the relevant parts of GENPRU, BIPRU and SYSC referred to in BIPRU 2.1.7 R to BIPRU 2.1.8 R to apply BIPRU 2.1 to a firm.

The basic rules for solo consolidation

2.1.7 A firm that has a solo consolidation waiver must incorporate in the calculation of its requirements under the main BIPRU firm Pillar 1 rules each
subsidiary undertaking to which the solo consolidation waiver applies. This does not apply to the base capital resources requirement.

2.1.8 R (1) A firm that has a solo consolidation waiver must meet the obligations in SYSC 12.1.13 R (Application of certain systems and controls rules on a consolidated basis) on a consolidated basis with respect to the firm and each subsidiary undertaking to which the firm’s solo consolidation waiver applies.

(2) If (1) applies, SYSC 12.1.13 R applies to the group made up of the firm and its subsidiary undertakings referred to in (1) in the same way as it applies to a UK consolidation group or non-EEA sub-group.

(3) If (1) applies, the provisions of SYSC and BIPRU listed in SYSC 12.1.13 R do not apply to the firm on a solo basis.

Solo consolidation and capital and concentration risk requirements

2.1.9 R BIPRU 2.1.10 R to BIPRU 2.1.18 R apply for the purposes of BIPRU 2.1.7 R.

2.1.10 R A firm must treat itself and each subsidiary undertaking referred to in BIPRU 2.1.7 R as a single undertaking and must apply, on that basis, BIPRU 8 (Group risk - consolidation) to the group made up of the firm and such subsidiary undertakings in the same way as BIPRU 8 applies to a UK consolidation group or non-EEA sub-group.

2.1.11 R Subject to BIPRU 2.1.13 R, a firm must calculate its capital resources in accordance with BIPRU 8.6 (Consolidated capital resources).

2.1.12 R A firm must calculate its capital resources requirement in accordance with BIPRU 8.7.13 R (3) (Treating group members as a single undertaking for consolidation purposes).

2.1.13 R Where GENPRU applies a different method of calculating capital resources or capital resources requirements depending on the category into which the firm in question falls, the method that applies is the one that would apply to the firm on a solo basis.

2.1.14 G For example, the effect of BIPRU 2.1.13 R is that if a firm that is applying BIPRU 2.1 is a limited licence firm it should continue to apply the capital resources and capital resources requirement applicable to a limited licence firm.

2.1.15 R A firm must continue to calculate its base capital resources requirement and the requirement in GENPRU 2.1.42 R (Calculation of capital resources requirement on authorisation) on a solo basis.

2.1.16 R [deleted]
A firm must include in full any subsidiary undertaking in respect of which the firm applies BIPRU 2.1 in the calculations under BIPRU 2.1.7 R.

Minimum standards

A firm must not apply BIPRU 2.1 to a subsidiary undertaking to which the firm's solo consolidation waiver applies BIPRU 2.1 unless in addition it meets the conditions in BIPRU 2.1.20 R to BIPRU 2.1.24 R.

The risk evaluation, measurement and control procedures of the firm must cover the subsidiary undertaking referred to in BIPRU 2.1.19 R.

The firm must hold more than 75% of the voting rights attaching to the shares in the capital of the subsidiary undertaking referred to in BIPRU 2.1.19 R and must have the right to appoint or remove a majority of the members of the governing body of the subsidiary undertaking.

The material exposures or material liabilities of the subsidiary undertaking referred to in BIPRU 2.1.19 R must be to the firm.

Where the firm is a parent institution in a Member State, it must have measures in place that ensure the satisfactory allocation of risks within the group consisting of the firm and each subsidiary undertaking to which BIPRU 2.1 is applied.

A firm must be able to demonstrate fully to the appropriate regulator the circumstances and arrangements, including legal arrangements, by virtue of which there are no material practical or legal impediments, and none are foreseen, to the prompt transfer of the capital resources of the subsidiary undertaking referred to in BIPRU 2.1.19 R or repayment of liabilities when due by the subsidiary undertaking to the firm.

The following are the criteria that the appropriate regulator will take into account when considering whether the condition in BIPRU 2.1.24 R is going to be met:

1. the speed with which funds can be transferred or liabilities repaid to the firm and the simplicity of the method for the transfer or repayment;

2. whether there are any interests other than those of the firm in the subsidiary undertaking and what impact those other interests may have on the firm's control over the subsidiary undertaking and on the ability of the firm to require a transfer of funds or repayment of liabilities;
(3) whether the prompt transfer of funds or repayment of liabilities to the **firm** might harm the reputation of the **firm** or its **subsidiary undertakings**;

(4) whether there are any tax disadvantages for the **firm** or the **subsidiary undertaking** as a result of the transfer of funds or repayment of liabilities;

(5) whether there are any exchange controls that may have an impact on the transfer of funds or repayment of liabilities;

(6) whether there are assets in the **subsidiary undertaking** available either to be transferred or liquidated for the purposes of the transfer of funds or repayment of liabilities;

(7) whether any regulatory requirements impact on the ability of the **subsidiary undertaking** to transfer funds or repay liabilities promptly;

(8) whether the purpose of the **subsidiary undertaking** prejudices the prompt transfer of funds or repayment of liabilities;

(9) whether the legal structure of the **subsidiary undertaking** prejudices the prompt transfer of funds or repayment of liabilities;

(10) whether the contractual relationships of the **subsidiary undertaking** with the **firm** and other third parties prejudices the prompt transfer of funds or repayment of liabilities;

(11) whether past and proposed flows of funds between the **subsidiary undertaking** and the **firm** demonstrate the ability to make prompt transfer of funds or repayment of liabilities; and

(12) whether the degree of solo consolidation by the **firm** undermines the **appropriate regulator’s** ability to assess the soundness of the **firm** as a legal entity (taking into account any other **subsidiary undertakings** to which BIPRU 2.1 is being applied).

**2.1.26** The effect of BIPRU 2.1.19 R is that even though a **firm’s solo consolidation waiver** applies BIPRU 2.1 with respect to a **subsidiary undertaking**, the **firm** should not apply BIPRU 2.1 with respect to that **subsidiary undertaking** unless in addition it meets the conditions in BIPRU 2.1.20 R to BIPRU 2.1.24 R.

**2.1.27** A **firm** should not apply BIPRU 2.1 to a **subsidiary undertaking** to which the **firm’s solo consolidation waiver** applies if it ceases to be a **subsidiary undertaking** of the **firm** even if the **solo consolidation waiver** is not varied by removing the **subsidiary undertaking**.

**2.1.28** If a **subsidiary undertaking** referred to in BIPRU 2.1.27 G later becomes a **subsidiary undertaking** again the **firm** should not apply BIPRU 2.1 to it unless the **solo consolidation waiver** is varied to re-apply it with respect to the **subsidiary undertaking**.
2.2 Internal capital adequacy standards

Application

2.2.1 BIPRU 2.2 applies to a BIPRU firm.

Purpose

2.2.2 (1) BIPRU 2.2 sets out guidance on GENPRU 1.2 (Adequacy of financial resources) so far as it applies to a BIPRU firm. In particular it sets out guidance on how a firm should carry out its ICAAP, as well as some factors the appropriate regulator will take into consideration when undertaking a SREP. The terms ICAAP and SREP are explained in BIPRU 2.2.4 G. BIPRU 2.2.41 R BIPRU 2.2.43 R are rules that apply to a firm with an IRB permission.

(2) BIPRU 2.2 is for the most part written on the basis that GENPRU 1.2 (Adequacy of financial resources) applies to a firm on a solo basis. However it is still relevant when GENPRU 1.2 applies on a consolidated basis. When GENPRU 1.2 applies on a consolidated basis, BIPRU 2.2 should be read with appropriate adjustments.

Meaning of capital

2.2.3 For the purpose of BIPRU 2.2, "capital" refers to a firm’s financial resources, capital resources and internal capital, all as referred to in the overall Pillar 2 rule.

The ICAAP and the SREP: Introduction

2.2.4 The adequacy of a firm’s capital needs to be assessed both by a firm and the appropriate regulator. This process involves:

(1) an internal capital adequacy assessment process (ICAAP), which a firm is obliged to carry out in accordance with the ICAAP rules; and

(2) a supervisory review and evaluation process (SREP), which is conducted by the appropriate regulator.

The ICAAP and the SREP: The ICAAP

2.2.5 The obligation to conduct an ICAAP, includes requirements on a firm to:

(1) carry out regularly assessments of the amounts, types and distribution of financial resources, capital resources and internal capital that it
considers adequate to cover the nature and level of the risks to which it is or might be exposed (GENPRU 1.2.30 R to GENPRU 1.2.41 G (the overall Pillar 2 rule and related rules));

(2) identify the major sources of risk to its ability to meet its liabilities as they fall due (the overall Pillar 2 rule);

(3) conduct stress and scenario tests (the general stress and scenario testing rule), taking into account, in the case of a firm with an IRB permission, the stress test required by BIPRU 4.3.39 R to BIPRU 4.3.40 R (Stress tests used in assessment of capital adequacy for a firm with an IRB permission);

(4) ensure that the processes, strategies and systems required by the overall Pillar 2 rule and used in its ICAAP, are both comprehensive and proportionate to the nature, scale and complexity of that firm’s activities (GENPRU 1.2.35 R); and

(5) document its ICAAP (GENPRU 1.2.60 R).

2.2.6 Where a firm is a member of a group, it should base its ICAAP on the consolidated financial position of the group. The group assessment should include information on diversification benefits and transferability of resources between members of the group and an apportionment of the capital required by the group as a whole to the firm (GENPRU 1.2.44 G to GENPRU 1.2.56 G (Application of GENPRU 1 on a solo and consolidated basis: Processes and tests)). A firm may, instead of preparing the ICAAP itself, adopt as its ICAAP an assessment prepared by other group members.

2.2.7 A firm should ensure that its ICAAP is:

(1) the responsibility of the firm’s governing body;

(2) reported to the firm’s governing body; and

(3) forms an integral part of the firm’s management process and decision-making culture.

The ICAAP and the SREP: The SREP

2.2.8 The appropriate regulator will review a firm’s ICAAP, including the results of the firm’s stress tests carried out under GENPRU and BIPRU, as part of its SREP. Provided that the appropriate regulator is satisfied with the appropriateness of a firm’s capital assessment, the appropriate regulator will take into account that firm’s ICAAP and stress tests in its SREP. More material on stress tests for a firm with an IRB permission can be found in BIPRU 2.2.41 R to BIPRU 2.2.45 G.

2.2.9 The SREP is a process under which the appropriate regulator:

(1) reviews the arrangements, strategies, processes and mechanisms implemented by a firm to comply with GENPRU, BIPRU and SYSC and with requirements imposed by or under the regulatory system and evaluates the risks to which the firm is or might be exposed;
(2) determines whether the arrangements, strategies, processes and mechanisms implemented by the firm and the capital held by the firm ensures a sound management and coverage of the risks in (1); and

(3) (if necessary) requires the firm to take the necessary actions or steps at an early stage to address any failure to meet the requirements referred to in (1).

2.2.10 As part of its SREP, the appropriate regulator may ask a firm to provide it with the results of that firm’s ICAAP, together with an explanation of the process used. Where appropriate, the appropriate regulator will ask for additional information on the ICAAP.

2.2.11 As part of its SREP, the appropriate regulator will consider whether the amount and quality of capital which a firm should hold to meet its CRR in GENPRU 2.1 (Calculation of capital resources requirements) is sufficient for that firm to comply with the overall financial adequacy rule.

2.2.12 After completing a review as part of the SREP, the appropriate regulator will normally give that firm individual guidance (individual capital guidance), advising it of the amount and quality of capital which it should hold to meet the overall financial adequacy rule.

2.2.12A As part of its SREP, the appropriate regulator will also consider whether a firm should hold a capital planning buffer and, in that case, the amount and quality of such capital planning buffer. In making these assessments, the appropriate regulator will have regard to the nature, scale and complexity of a firm’s business and of the major sources of risks relevant to such business as referred to in the general stress and scenario testing rule. Accordingly, a firm’s capital planning buffer should be of sufficient amount and adequate quality to allow the firm to continue to meet the overall financial adequacy rule in the face of adverse circumstances, after allowing for realistic management actions.

2.2.12B After completing a review as part of the SREP, the appropriate regulator may notify the firm of the amount and quality of capital which it should hold as a capital planning buffer over and above the level of capital recommended as its ICG. The appropriate regulator may set a firm’s capital planning buffer either as an amount and quality of capital which it should hold now (that is, at the time of the appropriate regulator’s notification following the firm’s SREP) or, in exceptional cases, as a forward looking target that the firm should build up over time.

2.2.12C Where the amount or quality of capital which the appropriate regulator considers a firm should hold to meet the overall financial adequacy rule or as a capital planning buffer is not the same as that which results from a firm’s ICAAP, the appropriate regulator usually expects to discuss any such difference with the firm. Where necessary, the appropriate regulator may consider the use of its powers under section 166 of the Act (Reports by skilled persons) to assist in such circumstances.
2.2.13 If a firm considers that the *individual capital guidance* given to it is inappropriate to its circumstances it should, consistent with Principle 11 (Relations with regulators), inform the *appropriate regulator* that it disagrees with that guidance. The *appropriate regulator* may reissue *individual capital guidance* if, after discussion with the firm, the *appropriate regulator* concludes that the amount or quality of capital that the firm should hold to meet the *overall financial adequacy rule* is different from the amount or quality initially suggested by the *appropriate regulator*.

2.2.13A If a firm disagrees with the *appropriate regulator’s* assessment as to the amount or quality of capital planning buffer that it should hold, it should, consistent with Principle 11 (Relations with regulators), notify the *appropriate regulator* of its disagreement. The *appropriate regulator* may reconsider its initial assessment if, after discussion with the firm, the *appropriate regulator* concludes that the amount or quality of capital that the firm should hold as capital planning buffer is different from the amount or quality initially suggested.

2.2.14 The *appropriate regulator* will not give *individual capital guidance* to the effect that the amount of capital advised in that guidance is lower than the amount of capital which a firm should hold to meet its *CRR*.

2.2.15 If, after discussion, the *appropriate regulator* and a firm still do not agree on an adequate level of capital, the *appropriate regulator* may consider using its powers under section 55J of the Act to vary on its own initiative a firm’s *Part 4A permission* so as to require it to hold capital in accordance with the *appropriate regulator’s* view of the capital necessary to comply with the *overall financial adequacy rule*. In deciding whether it should use its powers under section 55J, the *appropriate regulator* will take into account the amount and quality of the capital planning buffer which the firm should hold as referred to in 2BIPRU 2.2.12A G and 2BIPRU 2.2.12B G. 2SUP 7 provides further information about the *appropriate regulator’s* powers under section 45.

The drafting of individual capital guidance and capital planning buffer

2.2.16 If the *appropriate regulator* gives *individual capital guidance* to a firm, the *appropriate regulator* will state what amount and quality of capital the *appropriate regulator* considers the firm needs to hold in order to comply with the *overall financial adequacy rule*. It will generally do so by saying that the firm should hold capital resources of an amount which is at least equal to a specified percentage of that firm’s capital resources requirement plus one or more static add-ons in relation to specific risks in accordance with the *overall Pillar 2 rule*.

2.2.17 (1) *Individual capital guidance* may refer to two types of capital resources.

(2) The first type is referred to as general capital. It refers to total *tier one capital resources* and *tier two capital resources* after deductions.
(3) The second type is referred to as total capital. It refers to total tier one capital resources, tier two capital resources and tier three capital resources after deductions.

2.2.18 G

(1) In both of the cases in BIPRU 2.2.17 G capital resources should be calculated in the same way as they are in GENPRU 2.2 (Capital resources). This includes the rules limiting the amount of capital that can be included in the various tiers of capital when capital resources are being calculated.

(2) GENPRU 2.2.42 R does not allow innovative tier one capital to count as tier one capital resources for certain purposes. This restriction does not apply for the purposes in BIPRU 2.2.17 G.

2.2.19 G

(1) Individual capital guidance may also be given with respect to group capital resources. This paragraph explains how such guidance should be interpreted unless the individual capital guidance specifies another interpretation.

(2) If BIPRU 8.2.1 R (General consolidation rule for a UK consolidation group) applies to the firm the guidance relates to its UK consolidation group. If BIPRU 8.3.1 R (General consolidation rule for a non-EEA sub-group) applies to the firm the guidance relates to its non-EEA sub-group. If both apply to the firm the guidance relates to its UK consolidation group and to its non-EEA sub-group.

(3) The guidance will be on the overall financial adequacy rule as it applies on a consolidated basis under GENPRU 1.2.59 R (Application of GENPRU 1.2 on a solo and consolidated basis: Adequacy of resources) and insofar as it refers to capital resources.

(4) BIPRU 2.2.16 G to BIPRU 2.2.18 G apply for the purpose of this paragraph as they apply to guidance given on a solo basis. References to capital resources should be read as being to consolidated capital resources.

2.2.19A G

Where the appropriate regulator notifies a firm that it should hold a capital planning buffer, the notification will state what amount and quality of capital the appropriate regulator considers that is adequate for the firm to hold as such. This will normally be notified to the firm together with its individual capital guidance and expressed as a separate amount of capital resources that the firm should hold in excess of the amount of capital resources indicated as its individual capital guidance.

2.2.19B G

For the purposes of BIPRU 2.2.19A G, BIPRU 2.2.17 G to BIPRU 2.2.19 G apply as they apply to individual capital guidance. References in those provisions to individual capital guidance or guidance should be read as if they were references to capital planning buffer. In relation to BIPRU 2.2.19G (3) and GENPRU 1.2.59 R, where the general stress and scenario testing rule, as part of the ICAAP rules, applies to a firm on a consolidated basis, the appropriate regulator may notify the firm that it should hold a group capital planning buffer. In these cases, the firm should ensure that the group holds a capital planning buffer of sufficient amount and adequate quality to allow it to
continue to meet the overall financial adequacy rule in the face of adverse circumstances, after allowing for realistic management actions.

Failure to meet individual capital guidance and monitoring and reporting on the capital planning buffer

2.2.20 A firm’s continuing to hold capital in accordance with its individual capital guidance and its ability to carry on doing so is a fundamental part of the appropriate regulator’s supervision of that firm. Therefore if a firm’s capital resources have fallen, or are expected to fall, below the level advised in individual capital guidance, then, consistent with Principle 11 (Relations with regulators), a firm should inform the appropriate regulator of this fact as soon as practicable, explaining why this has happened or is expected to happen and:

(1) what action the firm intends to take to increase its capital resources or to reduce its risks and hence its capital requirements; or

(2) what modification the firm considers should be made to the individual capital guidance which it has been given.

2.2.21 In the circumstance set out in BIPRU 2.2.20 G, the appropriate regulator may ask a firm for alternative or more detailed proposals and plans or further assessments and analyses of capital adequacy and risks faced by the firm. The appropriate regulator will seek to agree with the firm appropriate timescales and scope for any such additional work, in light of the circumstances which have arisen.

2.2.22 If a firm has not accepted individual capital guidance given by the appropriate regulator it should, nevertheless, inform the appropriate regulator as soon as practicable if its capital resources have fallen, or are expected to fall, below the level suggested by that individual capital guidance.

2.2.23 Monitoring the use of a firm’s capital planning buffer is also a fundamental part of the appropriate regulator supervision of that firm. A firm should only use its capital planning buffer to absorb losses or meet increased capital requirements if certain adverse circumstances materialise. These should be circumstances beyond the firm’s normal and direct control, whether relating to a deteriorating external environment or periods of stress such as macroeconomic downturns or financial/market shocks, or firm-specific circumstances.

2.2.23A Consistent with Principle 11 (Relations with regulators), a firm should notify the appropriate regulator as early as possible in advance where it has identified that it would need to use its capital planning buffer. The firm’s notification should at least state:

(1) what adverse circumstances are likely to force the firm to draw down its capital planning buffer;

(2) how the capital planning buffer will be used up in line with the firm’s capital planning projections; and
(3) what plan is in place for the eventual restoration of the capital planning buffer.

2.2.23B

Following discussions with the firm on the items listed in BIPRU 2.2.23AG (1) to BIPRU 2.2.23AG (3), the appropriate regulator may put in place additional reporting arrangements to monitor the firm’s use of its capital planning buffer in accordance with the plan referred to in BIPRU 2.2.23AG (3). The appropriate regulator may also identify specific trigger points as the capital planning buffer is being used up by the firm, which could lead to additional supervisory actions.

2.2.23C

Where a firm’s capital planning buffer is being drawn down due to circumstances other than those referred to in BIPRU 2.23 G, such as poor planning or mismanagement, the appropriate regulator may ask the firm for more detailed plans for it to restore its capital planning buffer. In the light of the relevant circumstances, the appropriate regulator may consider taking other remedial actions, which may include using its powers under section 55L (in the case of the FCA) or section 55M (in the case of the PRA) of the Act to impose on its own initiative such requirements on a firm as it considers appropriate.

2.2.23D

A firm should inform the appropriate regulator where its capital planning buffer is likely to start being drawn down even if it has not accepted the appropriate regulator’s assessment as to the amount or quality of its capital planning buffer.

2.2.23E

Where a firm has started to use its capital planning buffer in circumstances where it was not possible to notify in advance, it should notify the appropriate regulator and provide the information referred to in BIPRU 2.2.23AG as soon as practicable afterwards.

2.2.23F

BIPRU 2.2.20 G to BIPRU 2.2.23E G also apply to individual capital guidance and to capital planning buffer on a consolidated basis as referred to in BIPRU 2.2.19 G.

Proportionality of an ICAAP

BIPRU 2.2.25 G to BIPRU 2.2.27 G set out what the appropriate regulator considers to be a proportional approach to preparing an ICAAP as referred to in GENPRU 1.2.35 R (The processes, strategies and systems required by the overall Pillar 2 rule should be comprehensive and proportionate), according to the relative degree of complexity of a firm’s activities. If a firm adopts the appropriate approach, it may enable the appropriate regulator more easily to review a firm’s ICAAP when the appropriate regulator undertakes its SREP. The appropriate regulator is also likely to place more reliance on an ICAAP which takes the appropriate form described in BIPRU 2.2.25 G to BIPRU 2.2.27 G than would otherwise be the case although there may also be circumstances in which the appropriate regulator will be able to rely on an ICAAP that is not drawn up in that form.
(1) This paragraph applies to a small firm whose activities are simple and primarily not credit-related.

(2) In carrying out its ICAAP it could:
   
   (a) identify and consider that firm’s largest losses over the last 3 to 5 years and whether those losses are likely to recur;
   
   (b) prepare a short list of the most significant risks to which that firm is exposed;
   
   (c) consider how that firm would act, and the amount of capital that would be absorbed, in the event that each of the risks identified were to materialise;
   
   (d) consider how that firm’s CRR might alter under the scenarios in (c) and how its CRR might alter in line with its business plans for the next 3 to 5 years;
   
   (e) consider whether any of the risks in the overall Pillar 2 rule is applicable to the firm (it is unlikely that any of those risks not already identified in (a) or (b) will apply to a firm whose activities are simple);
   
   (f) document the ranges of capital required in the scenarios identified and form an overall view on the amount and quality of capital which that firm should hold, ensuring that its senior management is involved in arriving at that view; and
   
   (g) (in order to determine the amount of capital that would be absorbed in the circumstances detailed in (c)) carry out simple sensitivity tests where the firm analyses the impact of a shift in the key risk parameters identified in (b) on the earnings of the firm.

(3) A firm is also expected to form a view on the consolidated amount of capital it should hold as well as the capital required to be held in respect of each of the individual risks identified under the overall Pillar 2 rule. For that purpose, it may conservatively sum the results of the individual tests performed in (2)(c). If the firm chooses however to reduce that sum on the understanding that not all risks will materialise at the same time, then the firm should perform scenario tests that demonstrate that a reduction in capital is legitimate.

(4) A firm should conduct stress tests and scenario analyses in accordance with GENPRU 1.2.42 R to assess how that firm’s capital and CRR would alter and what that firm’s reaction might be to a range of adverse scenarios, including operational and market events. Where relevant, a firm should also consider the impact of a severe economic or industry downturn on its future earnings, capital resources and capital resources requirement, taking into account its business plans. The downturn scenario should be based on forward looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.
(1) having consulted the management in each major business line, prepare a comprehensive list of the major risks to which the business is exposed;

(2) estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using shock stress tests to provide risk estimates;

(3) consider the extent to which that firm's CRR adequately captures the risks identified in (1) and (2);

(4) for areas in which the CRR is either inadequate or does not address a risk, estimate the additional capital (if any) needed to protect that firm and its customers, in addition to any other risk mitigation action that firm plans to take;

(5) consider the risk that that firm's own analyses of capital adequacy may be inaccurate and that it may suffer from management weaknesses, which affect the effectiveness of its risk management and mitigation;

(6) project that firm's business activities forward in detail for one year and in less detail for the next 3 to 5 years and estimate how that firm's capital and CRR would alter, assuming that business develops as expected;

(7) assume that business does not develop as expected and consider how that firm's capital and CRR would alter and what that firm's reaction to a range of adverse economic scenarios might be (see GENPRU 1.2.30 R to GENPRU 1.2.43 G (the overall Pillar 2 rule and related rules and guidance)). Where appropriate, the adverse scenarios should consider the impact of market events that are instantaneous or occur over an extended period of time but which are nevertheless still co-dependent on movements in economic conditions;

(8) document the results obtained from the analyses in (2), (4), (6), and (7) in a detailed report for that firm's senior management, and, where relevant, its governing body; and

(9) ensure that systems and processes are in place to review against performance the accuracy of the estimates made in (2), (4), (6) and (7).

2.2.27 G

(1) This paragraph applies to a proportional ICAAP in the case of a firm whose activities are complex.

(2) A proportional approach to that firm's ICAAP should cover the matters identified in BIPRU 2.2.26 G, but is likely also to involve the use of models, most of which will be integrated into its day-to-day management and operation.

(3) Models of the sort referred to in (2) may be linked so as to generate an overall estimate of the amount of capital that a firm considers appropriate to hold for its business needs. For example, a firm is likely to use value at risk models for market risk (see BIPRU 7.10), advanced
modelling approaches for credit risk (see BIPRU 4) and, possibly, advanced measurement approaches for operational risk (see BIPRU 6.5). A firm might also use economic scenario generators to model stochastically its business forecasts and risks. A firm may also link such models to generate information on the economic capital desirable for that firm. A model which a firm uses to generate its target amount of economic capital is known as an economic capital model (ECM). Economic capital is the target amount of capital which maximises the return for a firm’s stakeholders for a desired level of risk.

(4) A firm is also likely to be part of a group and to be operating internationally. There is likely to be centralised control over the models used throughout the group, the assumptions made and their overall calibration.

(5) The more a firm integrates into its business such economic capital modelling, the more it is likely to focus on managing risks for the benefit of its stakeholders. Consequently, ECMs may produce capital estimates that differ from the amount of capital needed for regulatory purposes. For the appropriate regulator to rely on the results of a firm’s models, including ECMs, a firm should be able to explain the basis and results of its models and how the amount of capital produced by its models reflects the amount of capital needed for regulatory purposes. It may be that those amounts are not equal. Where they are not equal, the appropriate regulator will expect a firm to discuss any differences with the appropriate regulator. However, it may prove difficult to reconcile the outcome of a firm’s modelling with the appropriate regulator’s own assessment of the adequacy of that firm’s capital. This may be the case when, for instance, matters of judgment are involved in arriving at a firm’s capital assessment, or the appropriate regulator relies on information which cannot be fully disclosed to the firm (for example comparisons with the firm’s peers). Nevertheless, a firm whose ECM produces a different amount of capital to that required for regulatory purposes is still obliged to comply with the overall Pillar 2 rule. A firm should therefore be able to explain to the appropriate regulator how the outcome of its ECM is adjusted so that it complies with the overall financial adequacy rule and the overall Pillar 2 rule.

(6) Stress testing should provide senior management with a consolidated view of the amount of risk the firm is or might be exposed to under the chosen stress events. Senior management should therefore be presented with information that considers the possibility of the risks materialising simultaneously in various proportions. For instance, it would be misrepresentative to simulate market risk stressed events without considering that, in those circumstances, market counterparties may be more likely to default. Accordingly, a firm could:

(a) carry out combined stress tests where assets and liabilities are individually subjected to simultaneous changes in two or more risk drivers; for instance, the change in value of each loan made by a firm may be estimated using simultaneous changes to both interest rates and stock market or property values;

(b) integrate the results of market and credit risk models rather than aggregating the results of each model separately; and
(c) consider scenarios which include systemic effects on the firm of wider failures in the firm's market or systems upon which the firm depends and also any possible systemic effects caused by the firm itself suffering losses which affect other market participants which in turn exacerbate the firm's position.

(7) Furthermore, if a complex firm uses an ECM it should validate the assumptions of the model through a comprehensive stress testing programme. In particular this validation should:

(a) test correlation assumptions (where risks are aggregated in this way) using combined stresses and scenario analyses;
(b) use stress tests to identify the extent to which the firm's risk models omit non-linear effects, for instance the behaviour of derivatives in market risk models; and
(c) consider not just the effect of parallel shifts in interest rate curves, but also the effect of curves becoming steeper or flatter.

Guidance on risks to be covered in an ICAAP

2.2.28  
\[\text{[BIPRU 2.2.30 G to BIPRU 2.2.40 G set out guidance on some of the sources of risk identified in the overall Pillar 2 rule. BIPRU 2.2.41 R to BIPRU 2.2.45 G have material relating to a firm with an IRB permission.]}\]

2.2.29  
(1) A firm may take into account factors other than those identified in the overall Pillar 2 rule when it assesses the level of capital it wishes to hold. These factors might include external rating goals, market reputation and its strategic goals. However, a firm should be able to distinguish, for the purpose of its dialogue with the appropriate regulator, between capital it holds in order to comply with the overall financial adequacy rule, capital that it holds as a capital planning buffer and capital held for other purposes.

(2) The calibration of the CRR assumes that a firm's business is well-diversified, well-managed with assets matching its liabilities and good controls, and stable with no large, unusual or high risk transactions. A firm may find it helpful to assess the extent to which its business in fact differs from these assumptions and therefore what adjustments it might be reasonable for it to make to the CRR to arrive at an adequate level of capital resources.

Interest rate risk arising from non-trading book activities

2.2.30  
A firm should assess its exposure to changes in interest rates, in particular risks arising from the effect of interest rate changes on non-trading book activities that are not captured by the CRR. In doing so, a firm may wish to use stress tests to determine the impact on its balance sheet of a change in market conditions.

Securitisation risk

2.2.31  
A firm should assess its exposure to risks transferred through the securitisation of assets should those transfers fail for whatever reason. A firm should consider the effect on its financial position of a securitisation
arrangement failing to operate as anticipated or of the values and risks transferred not emerging as expected.

**Residual risk**

2.2.32 A firm should assess its exposure to residual risks that may result from the partial performance or failure of credit risk mitigation techniques for reasons that are unconnected with their intrinsic value. This could result from, for instance, ineffective documentation, a delay in payment or the inability to realise payment from a guarantor in a timely manner. Given that residual risks can always be present, a firm should assess the appropriateness of its CRR against its assumptions which underlie any risk mitigation measures it may have in place.

**Concentration risk**

2.2.33 A firm should assess, and monitor, in detail its exposure to sectoral, geographic, liability and asset concentrations. The appropriate regulator considers that concentrations in these areas increase a firm’s exposure to credit risk. Where a firm identifies such concentrations it should consider the adequacy of its CRR.

**Liquidity risk**

2.2.34 In accordance with the overall Pillar 2 rule a firm should consider its exposure to liquidity risk and assess its response should that risk materialise.

2.2.35 When assessing liquidity risk, a firm should consider the extent to which there is a mismatch between assets and liabilities.

2.2.36 A firm should also, when assessing liquidity risk, consider the amount of assets it holds in highly liquid, marketable forms that are available should unexpected cash flows lead to a liquidity problem. The price concession of liquidating assets is of prime concern when assessing such liquidity risk and should therefore be built into a firm’s ICAAP.

2.2.37 Some further areas to consider in developing the liquidity risk scenario might include:

1. any mismatching between expected asset and liability cash flows;
2. the inability to sell assets quickly;
3. the extent to which a firm’s assets have been pledged; and
4. the possible need to reduce large asset positions at different levels of market liquidity and the related potential costs and timing constraints.

**Business risk: General**

2.2.38 A firm’s CRR, being risk-sensitive, may vary as business cycles and economic conditions fluctuate over time. A deterioration in business or economic
conditions could require a firm to raise capital or, alternatively, to contract its businesses, at a time when market conditions are most unfavourable to raising capital. Such an effect is known as procyclicality.

2.2.39 G To reduce the impact of cyclical effects, a firm should aim to maintain an adequate capital planning buffer during an upturn in business and economic cycles such that it has sufficient capital available to protect itself in unfavourable market conditions.

2.2.40 G To assess its expected capital requirements over the economic and business cycles, a firm may wish to project forward its financial position taking account of its business strategy and expected growth according to a range of assumptions as to the state of the economic or business environment which it faces. For example, an ICAAP should include an analysis of the impact that the actions of a firm's competitors might have on its performance, in order to see what changes in its environment the firm could sustain. Projections over a three to five year period would be appropriate in most circumstances. A firm may then calculate its projected CRR and assess whether it could be met from expected financial resources. Additional guidance on capital planning over an economic and business cycle can be found in GENPRU 1.2.73A G (Capital planning).

2.2.41 R A firm with an IRB permission must ensure that there is no significant risk that it will not be able to meet its capital resource requirements for credit risk under GENPRU 2.1 (Calculation of capital resources requirements) at all times throughout an economic cycle, including the capital resource requirements for credit risk indicated by any stress test carried out under BIPRU 4.3.39 R to BIPRU 4.3.40 R (Stress tests used in assessment of capital adequacy for a firm with an IRB permission) as being likely to apply in the scenario tested. For the purpose of deciding what capital resources are or will be available to meet those credit risk requirements from time to time a firm must exclude capital resources that are likely to be required to meet its other capital requirements under GENPRU 2.1 at the relevant time. A firm must also be able to demonstrate to the appropriate regulator at any time that it is complying with this rule.

2.2.42 R BIPRU 2.2.41 R applies to a firm on a solo basis if BIPRU 4 (IRB approach) applies to it on a solo basis and applies on a consolidated basis if BIPRU 4 does.

2.2.43 R If BIPRU 2.2.41 R applies to a firm on a consolidated basis the following adjustments are made to BIPRU 2.2.41 R in accordance with the general principles of BIPRU 8 (Group risk - consolidation):

(1) references to capital resources are to the consolidated capital resources of the firm's UK consolidation group or, as the case may be, its non-EEA sub-group; and

(2) references to the capital requirements in GENPRU 2.1 (Calculation of capital resources requirements) are to the consolidated capital requirements with respect to the firm's UK consolidation group or, as
the case may be, its non-EEA sub-group under BIPRU 8 (Group risk - consolidation).

2.2.44 If a firm's current available capital resources are less than the capital resources requirement indicated by the stress test that need not be a breach of BIPRU 2.2.41. The firm may wish to set out any countervailing effects and off-setting actions that can be demonstrated to the satisfaction of the appropriate regulator as being likely to reduce the difference referred to in the first sentence. The appropriate regulator is only likely to consider a demonstration of such actions as credible if those actions are set out in a capital management plan based on the procedures in GENPRU 1.2.73A (Capital planning) and including a plan of the type referred to in GENPRU 1.2.73A (5) that has been approved by the firm’s senior management or governing body.

2.2.45 The countervailing factors and off-setting actions that a firm may rely on as referred to in BIPRU 2.2.44 include, but are not limited to, projected balance sheet shrinkage, growth in capital resources resulting from retained profits between the date of the stress test and the projected start of the economic downturn, the possibility of raising new capital in a downturn, the ability to reduce dividend payments or other distributions, and the ability to allocate capital from other risks which can be shown to be negatively correlated with the firm’s credit risk profile.

Systems and controls

2.2.46 A firm may decide to hold additional capital to mitigate any weaknesses in its overall control environment. These weaknesses might be indicated by the following:

(1) a failure by a firm to complete an assessment of its systems and controls to establish whether they comply with SYSC; or

(2) a failure by a firm’s senior management to approve its financial results; or

(3) a failure by a firm to consider an analysis of relevant internal and external information on its business and control environment.

2.2.47 In considering if there are any systems and control weaknesses and their effect on the adequacy of the CRR, a firm should be able to demonstrate to the appropriate regulator that all the issues identified in SYSC have been considered and that appropriate plans and procedures exist to deal adequately with adverse scenarios.

Risks which may be considered according to the nature of the activities of a firm

2.2.48 (1) BIPRU 2.2.61 to BIPRU 2.2.70 set out guidance for:

(a) [deleted]

(b) an asset management firm; and

(c) a securities firm;
whose activities are either simple or moderately complex.

(2) BIPRU 2.2.49 G to BIPRU 2.2.70 G provide examples of the sorts of risks which such a firm might typically face and of stress tests or scenario analyses which it might carry out as part of its ICAAP.

(3) The material on securities firms is also relevant to a commodities firm.

### Banks and building societies

- **2.2.49**
- **2.2.50**
- **2.2.51**
- **2.2.52**
- **2.2.53**
- **2.2.54**
- **2.2.55**
- **2.2.56**
- **2.2.57**
- **2.2.58**
- **2.2.59**
- **2.2.60**

### An asset management firm

- **2.2.61** An asset manager is primarily exposed to operational risk and reputational risk.
When assessing reputational risk an asset manager should consider issues such as:

1. how poor performance can affect its ability to generate profits;
2. the effect on its financial position should one or more of its key fund managers leave that firm;
3. the effect on its financial position should it lose some of its largest customers; and
4. how poor customer services can affect its financial position; for example, a firm which has outsourced the management of customer accounts may want to consider the impact on its own reputation of the service provider failing to deliver the service.

As an asset manager’s mandates become more complex, the risk of it failing to comply fully with the terms of its contracts increases. In the event of such failure, a firm can be exposed to substantial losses resulting from customers’ claims and legal actions. Although the appropriate regulator would expect an asset manager to have in place adequate controls to mitigate that risk, it may also like to consider the potential cost to it should customers claim that it has not adhered to mandates. Past claims and compensation may provide a useful benchmark for an asset manager to assess its sensitivity to future legal action. In assessing the adequacy of its capital, an asset manager may therefore consider whether it could absorb the highest operational loss it has suffered over the last 3 to 5 years.

In relation to the issues identified in BIPRU 2.2.63, an asset manager should consider, for example:

1. the direct cost to it resulting from fraud or theft;
2. the direct cost arising from customers’ claims and legal action in the future; an asset manager could consider the impact on its financial position if a legal precedent were to encourage its customers to take legal action against that firm for failing to advise correctly on a certain type of product; the relevance of such scenarios is likely to depend on whether the asset manager is acting on a discretionary basis or solely as advisor; and
3. where it has obtained professional indemnity insurance, the deductibles and individual or aggregate limits on the sums insured.

The appropriate regulator expects an asset manager to consider the impact of economic factors on its ability to meet its liabilities as they fall due. An asset manager should therefore develop scenarios which relate to its strategic and business plan. An asset manager might therefore consider:

1. the effect of a market downturn affecting both transaction volumes and the market values of assets in its funds; in assessing the impact of such a scenario, an asset manager may consider the extent to which it can remain profitable (for example, by rapidly scaling down its activities and reducing its costs);
(2) the impact on current levels of capital if it plans to undertake a significant restructuring; and

(3) the impact on current levels of capital if it plans to enter a new market or launch a new product; it should assess the amount of capital it needs to hold, when operating for the first time in a market in which it lacks expertise.

A securities firm

2.2.66

(1) A securities firm may consider the impact of the situations listed in (a) to (c) on its capital levels when assessing its exposure to concentration risk:

(a) the potential loss that could arise from large exposures to a single counterparty;

(b) the potential loss that could arise from exposures to large transactions or to a product type; and

(c) the potential loss resulting from a combination of events such as a sudden increase in volatility leaving a hitherto fully-margined client unable to meet the margin calls due to the large size of the underlying position and the subsequent difficulties involved in liquidating its position.

(2) An example of the analysis in (1)(b) relates to a securities firm which relies on the income generated by a large, one-off corporate finance transaction. It may want to consider the possibility of legal action arising from that transaction which prevents the payment of its fees. Additionally, an underwriting firm may, as a matter of routine, commit to place a large amount of securities. It may therefore like to assess the impact of losses arising from a failure to place the securities successfully.

2.2.67

Where a securities firm deals in illiquid securities (for example, unlisted securities or securities listed on illiquid markets), or holds illiquid assets, potentially large losses can arise from trades that have failed to settle or because of large unrealised market losses. A securities firm may therefore consider the impact of liquidity risk on its exposure to:

(1) credit risk; and

(2) market risk.

2.2.68

Counterparty risk rules only partially capture the risk of settlement failure as the quantification of risk is only based on mark-to-market values and does not take account of the volatility of the securities over the settlement period. A securities firm’s assessment of its exposure to counterparty risk should take into account:

(1) whether it acts as arranger only or whether it also executes trades;

(2) the types of execution venues which it uses; for example, the London Stock Exchange or a retail service provider (RSP) have more depth than multilateral trading facilities; and
(3) whether it offers extended settlements and free delivery compared to
delivery versus payment business.

(1) A securities firm should also consider the impact of external factors
on the levels of capital it needs to hold. Scenarios covering such
external factors should relate to its strategy and business plan. A
securities firm might wish to consider the questions in (2) to (7).

(2) Whether it plans to participate in a one-off transaction that might
strain temporarily or permanently its capital.

(3) Whether the unevenness of its revenue suggests that it should hold a
capital buffer. Such an assessment could be based, for instance, on an
analysis of past revenue and the volatility of its capital.

(4) How its income might alter as interest rates fluctuate where it is
obliged to pay interest to its clients in excess of interest it earns on
client money deposits.

(5) How its capital would be affected by a market downturn. For
instance, how sensitive that firm is to a sharp reduction of trading
volumes.

(6) How political and economic factors will affect that firm’s business. For
instance, a commodity firm may wish to consider the impact of a
sharp increase in prices on initial margins and, consequently, on its
liquidity.

(7) Whether it anticipates expanding its activities (for example, by
offering clearing services), and if so, the impact on its capital.

A securities firm may also want to assess the impact of its internal credit
limits on its levels of capital. For instance, a firm whose internal procedures
authorise dealing without cash in the account or without pre-set dealings
limits might consider more capital is required than if it operated stricter
internal credit limits.

Capital models

A firm may approach its assessment of adequate capital by developing a
model, including an ECM (see BIPRU 2.2.27 G), for some or all of its business
risks. The assumptions required to aggregate risks modelled and the
confidence levels adopted should be considered by a firm’s senior
management. A firm should also consider whether any relevant risks,
including systems and control risks, are not captured by the model.

A firm should not expect the appropriate regulator to accept as adequate
any particular model that it develops or automatically to reflect the results
from the model in any individual capital guidance or capital planning buffer.
However, the appropriate regulator will take into account the results of a
sound and prudent model when giving individual capital guidance or when
dealing with the firm in relation to its capital planning buffer (see
GENPRU 1.2.19 G (Outline of provisions related to GENPRU 2.1 (Adequacy of
financial resources))).
There is no prescribed approach as to how a firm should develop its internal capital model. However, a firm should be able to demonstrate:

1. the confidence levels set and whether these are linked to its corporate strategy;
2. the time horizons set for the different types of business that it undertakes;
3. the extent of historic data used and back-testing carried out;
4. that it has in place a process to verify the correctness of the model's outputs; and
5. that it has the skills and resources to operate, maintain and develop the model.

In relation to the use of an ECM (see BIPRU 2.2.27 G), the appropriate regulator is likely to place more reliance on a firm's ICAAP if the firm provides the following information:

1. a comparison of the amount of capital that the ECM generates in respect of each of the risks captured in the CRR before aggregation with the corresponding components of the CRR calculation; and
2. evidence that the guidance in BIPRU 2.2.71 G to BIPRU 2.2.78 G has been followed.

If a firm adopts a top-down approach to developing its internal model, it should be able to allocate the outcome of the internal model to risks it has previously identified in relation to each separate legal entity, business unit or business activity, as appropriate. In relation to a firm which is a member of a group, GENPRU 1.2.53 R (Application of GENPRU 1.2 on a solo and consolidated basis: Processes and tests) sets out how internal capital identified as necessary by that firm's ICAAP should be allocated.

If a firm's internal model makes explicit or implicit assumptions in relation to correlations within or between risk types, or in relation to diversification benefits between business types, the firm should be able to explain to the appropriate regulator, with the support of empirical evidence, the basis of those assumptions.

A firm's model should also reflect the past experience of both the firm and the sectors in which it operates.

The values assigned to inputs into a firm's model should be derived either stochastically, by assuming the value of an item can follow an appropriate probability distribution and by selecting appropriate values at the tail of the distribution, or deterministically, using appropriate prudent assumptions. For options or guarantees which change in value significantly in certain economic or demographic circumstances, a stochastic approach would normally be appropriate.
2.3 Interest rate risk in the non-trading book

Application

2.3.1 This section of the Handbook applies to a BIPRU firm.

2.3.2 (1) [deleted]
(2) [deleted]
(3) [deleted]
(4) [deleted]

2.3.3 Interest rate risk in the non-trading book may arise from a number of sources for example:

(1) risks related to the mismatch of repricing of assets and liabilities and off balance sheet short and long-term positions;

(2) risks arising from hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions;

(3) risk related to the uncertainties of occurrence of transactions e.g. when expected future transactions do not equal the actual transactions; and

(4) risks arising from consumers redeeming fixed rate products when market rates change.

Purpose

2.3.4 BIPRU 2.3 sets out more detail on how the systems and controls requirements in SYSC and GENPRU 1.2.30 R (Processes, strategies and systems for risks) and the requirements about stress and scenario testing in GENPRU 1.2.36 R apply to interest rate risk in the non-trading book.

2.3.5 BIPRU 2.3 implements Article 124(5) of the Banking Consolidation Directive.

Proportionality

2.3.6 The guidance on proportionality in BIPRU 2.2 applies to BIPRU 2.3.
Stress testing for interest rate risk: General requirement

2.3.7 R

(1) As part of its obligations under GENPRU 1.2.30 R (Processes, strategies and systems for risks) and GENPRU 1.2.36 R (Stress and scenario tests) a firm must carry out an evaluation of its exposure to the interest rate risk arising from its non-trading activities.

(2) The evaluation under (1) must cover the effect of a sudden and unexpected parallel change in interest rates of 200 basis points in both directions.

(3) A firm must immediately notify the appropriate regulator if any evaluation under this rule suggests that, as a result of the change in interest rates described in (2), the economic value of the firm would decline by more than 20% of its capital resources.

2.3.8 G

A firm should, under BIPRU 2.3.7 R (2), apply a 200 basis point shock to each major currency exposure.

2.3.9 G

For a larger and/or more complex firm, appropriate systems to evaluate and manage interest rate risk in the non-trading book should include:

(1) the ability to measure the exposure and sensitivity of the firm's activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (for example, pipeline risk, prepayment risk) as well as changes in assumptions (for example those about customer behaviour);

(2) consideration as to whether a purely static analysis of the impact on their current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach; and

(3) scenarios in which different interest rate paths are computed and in which some of the assumptions (e.g. about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate level.

2.3.10 G

Under GENPRU 1.2.60 R, a firm is required to make a written record of its assessments made under GENPRU 1.2. A firm's record of its approach to evaluating and managing interest rate risk as it affects the firm's non-trading activities should cover the following issues:

(1) the internal definition of and boundary between "banking book" and "trading activities" (see BIPRU 1.2);

(2) the definition of economic value and its consistency with the method used to value assets and liabilities (e.g. discounted cashflows);

(3) the size and the form of the different shocks to be used for internal calculations;

(4) the use of a dynamic and/or static approach in the application of interest rate shocks;
(5) the treatment of commonly called "pipeline transactions" (including any related hedging);

(6) the aggregation of multicurrency interest rate exposures;

(7) the inclusion (or not) of non-interest bearing assets and liabilities (including capital and reserves);

(8) the treatment of current and savings accounts (i.e. the maturity attached to exposures without a contractual maturity);

(9) the treatment of fixed rate assets (liabilities) where customers still have a right to repay (withdraw) early;

(10) the extent to which sensitivities to small shocks can be scaled up on a linear basis without material loss of accuracy (i.e. covering both convexity generally and the non-linearity of pay-off associated with explicit option products);

(11) the degree of granularity employed (for example offsets within a time bucket); and

(12) whether all future cash flows or only principal balances are included.

The appropriate regulator will periodically review whether the level of the shock referred to in BIPRU 2.3.7 R (2) is appropriate in the light of changing circumstances, in particular the general level of interest rates (for instance periods of very low interest rates) and their volatility. A firm's internal systems should therefore be flexible enough to compute its sensitivity to any standardised shock that is prescribed. If a 200 basis point shock would imply negative interest rates or if such a shock would otherwise be considered inappropriate, the appropriate regulator will consider adjusting the requirements accordingly.

Stress testing for interest rate risk: Frequency

(1) A firm must carry out the evaluations required by BIPRU 2.3.7 R as frequently as necessary for it to be reasonably satisfied that it has at all times a sufficient understanding of the degree to which it is exposed to the risks referred to in that rule and the nature of that exposure. In any case it must carry out those evaluations no less frequently than required by (2) or (3).

(2) The minimum frequency of the evaluation in BIPRU 2.3.7 R (1) is once each year.

(3) The minimum frequency of the evaluation in BIPRU 2.3.7 R (2) is once each quarter.

Consolidation

GENPRU 1.2.45 R to GENPRU 1.2.59 R (Application of GENPRU 1.2 on a solo and consolidated basis) apply to BIPRU 2.3 as they apply to GENPRU 1.2.30 R and GENPRU 1.2.36 R.
Chapter 3

Standardised credit risk
3.1 Application and purpose

Application

3.1.1 ■ BIPRU 3 applies to a BIPRU firm.

Purpose

3.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, ■ BIPRU 3 implements:

(1) Articles 78 to 80, paragraph (1) of Article 81, Article 83, Annex II and Parts 1 and 3 of Annex VI of the Banking Consolidation Directive;

(2) Article 18 of the Capital Adequacy Directive so far as it applies Articles 78 to 80, paragraph (1) of Article 81, Article 83 and Parts 1 and 3 of Annex VI of the Banking Consolidation Directive to investment firms; and

(3) Article 40 of the Capital Adequacy Directive for the purposes of the calculation of credit risk under the Banking Consolidation Directive.

3.1.3 ■ BIPRU 3.1 sets out how a firm should calculate the credit risk capital component, which is one of the elements that make up the credit risk capital requirement under ■ GENPRU 2.1.51 R. Part of that calculation involves calculating risk weighted exposure amounts for exposures in the firm’s non-trading book. The rest of ■ BIPRU 3 sets out how the firm should carry out that calculation.

3.1.4 ■ BIPRU 5 deals with the effect of credit risk mitigation on the calculation of risk weighted exposure amounts. ■ BIPRU 13 deals with the calculation of exposure values for certain kinds of products. ■ BIPRU 14.3 deals with the calculation of the counterparty risk capital component for unsettled transactions in the trading book and non-trading book. ■ BIPRU 14.4 deals with capital resources with respect to free deliveries.

Calculation of the credit risk capital component

3.1.5 The credit risk capital component of a firm is 8% of the total of its risk weighted exposure amounts for exposures falling into ■ BIPRU 3.1.6 R, calculated in accordance with ■ BIPRU 3.
3.1.6 An exposure falls into this rule if:

(1) it is in a firm’s non-trading book; and

(2) it has not been deducted from the firm’s capital resources under GENPRU 2.2.
3.2  The central principles of the standardised approach to credit risk

3.2.1  Subject to BIPRU 13:
(1) the exposure value of an asset item must be its balance-sheet value, subject to any value adjustments required by GENPRU 1.3; and
(2) the exposure value of an off-balance sheet item listed in the table in BIPRU 3.7.2 R must be the percentage of its value set out in that table.

[Note: BCD Article 78(1) part]

3.2.2  The off-balance sheet items listed in the table in BIPRU 3.7.2 R must be assigned to the risk categories as indicated in that table.

[Note: BCD Article 78(1) part]

3.2.3  Where an exposure is subject to funded credit protection, a firm may modify the exposure value applicable to that item in accordance with BIPRU 5.

[Note: BCD Article 78(3)]

3.2.4  BIPRU 13 sets out the method for determination of the exposure value of a financial derivative instrument, with the effects of contracts of novation and other netting agreements taken into account for the purposes of that method in accordance with BIPRU 13.7.

[Note: reference to BCD Article 78(2) first sentence. Implementation in BIPRU 13]

3.2.5  BIPRU 13.3 and BIPRU 13.8 set out the provisions applying to the treatment and determination of the exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions (SFTs).

[Note: reference to BCD Article 78(2) second sentence. Implementation in BIPRU 13]

3.2.6  BIPRU 13 also sets out the methods for the determination of exposure values for long settlement transactions.
3.2.7 G BIPRU 13.8 provides that, in the case of a firm using the financial collateral comprehensive method under BIPRU 5, where an exposure takes the form of an SFT, the exposure value should be increased by the volatility adjustment appropriate to such securities or commodities set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R (Supervisory volatility adjustments approach and the own estimates of volatility adjustments approach).

[Note: reference to BCD Article 78(1), part. Implementation in BIPRU 13]

3.2.8 G BIPRU 13.3.13 R and BIPRU 13.8.8 R set out the provisions relating to determination of the exposure value of certain credit risk exposures outstanding with a central counterparty, where the central counterparty credit risk exposures with all participants in its arrangements are fully collateralised on a daily basis.

[Note: reference to BCD Article 78(4). Implementation in BIPRU 13]

Exposure Classes

3.2.9 R A firm must assign each exposure to one of the following exposure classes:

1. claims or contingent claims on central governments or central banks;
2. claims or contingent claims on regional governments or local authorities;
3. claims or contingent claims on administrative bodies and non-commercial undertakings;
4. claims or contingent claims on multilateral development banks;
5. claims or contingent claims on international organisation;
6. claims or contingent claims on institutions;
7. claims or contingent claims on corporates;
8. retail claims or contingent retail claims;
9. claims or contingent claims secured on real estate property;
10. past due items;
11. items belonging to regulatory high-risk categories;
12. claims in the form of covered bonds;
13. securitisation positions;
14. short-term claims on institutions and corporates;
15. claims in the form of CIUs; or
16. other items.

[Note: BCD Article 79(1)]
3.2.10 R  To be eligible for the retail exposure class, an exposure must meet the following conditions:

(1) the exposure must be either to an individual person or persons, or to a small or medium sized entity;

(2) the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced; and

(3) the total amount owed to the firm, its parent undertakings and its subsidiary undertakings, including any past due exposure, by the obligor client or group of connected clients, but excluding claims or contingent claims secured on residential real estate collateral, must not, to the knowledge of the firm, exceed €1 million.

[Note: BCD Article 79(2)]

3.2.11 R  A firm must take reasonable steps to acquire the knowledge referred to in BIPRU 3.2.10 R (3).

[Note: BCD Article 79(2)(c) last sentence]

3.2.12 R  Securities are not eligible for the retail exposure class.

[Note: BCD Article 79(2) last sentence]

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

[Note: BCD Article 79(3)]

Retail exposures: Significance

A key driver of the preferential risk weight afforded retail exposures is the lower correlation and systematic risk associated with such exposures. This aspect is unrelated to the absolute number of retail exposures. Accordingly in defining what constitutes a significant number of retail exposures for the purpose of BIPRU 3.2.10 R (2), a firm need only satisfy itself that the number of retail exposures is sufficiently large to diversify away idiosyncratic risk. This assessment will be subject to supervisory review and part of a firm’s SREP. It will be looked at as one of the issues relating to overall diversification.

Retail exposures: Aggregation: Reasonable steps

In deciding what steps are reasonable for the purposes of BIPRU 3.2.11 R, a firm may take into account complexity and cost, as well as the materiality of the impact upon its capital calculation. A firm should be able to demonstrate to the appropriate regulator that it has complied with the obligation to take reasonable steps under BIPRU 3.2.11 R in the way it takes these factors into account.
### Retail exposures: Aggregation: Single risk

3.2.16

(1) The definition of *group of connected clients* is set out in the *Glossary*. Paragraph (2) of that definition is "two or more persons ... who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties".

(2) Say that a *firm* has *exposures* to A and B. When deciding whether A and B come within paragraph (2) of the definition two conditions should be satisfied. Firstly the connections between A and B should mean that if A experiences financial problems, B should be likely to encounter repayment difficulties. Secondly, the connections between A and B should mean that if B experiences financial problems, A should be likely to encounter repayment difficulties.

(3) The guidance in ■BIPRU 3.2.16 G is provided for the purpose of ■BIPRU 3.2.10 R only and not for the purposes of any other provision in the Handbook that uses the defined term *group of connected clients*.

### Retail exposures: Aggregation: Personal and business exposures

3.2.17

If a *firm* has *exposures* to an owner of a *retail SME* in his personal capacity and *exposures* to the *retail SME* the *firm* should aggregate the two types of *exposure* for the purpose of ■BIPRU 3.2.10 R (3), although it should not include claims secured on residential real estate collateral. In deciding what steps are reasonable for the purposes of ■BIPRU 3.2.11 R in aggregating these two types of *exposure*, a *firm* may take into account the materiality of those personal *exposures*. A *firm* should be able to demonstrate to the *appropriate regulator* that it has complied with the obligation to take reasonable steps under ■BIPRU 3.2.11 R when taking into account materiality in this way.

### Retail exposures: Exchange rate

3.2.18

Where an exposure is denominated in a currency other than the euro, a *firm* may calculate the euro equivalent for purposes of ■BIPRU 3.2.10 R using any appropriate set of exchange rates provided its choice has no obvious bias and that the *firm* is consistent in its approach to choosing rates.

### Retail exposures: Frequency of monitoring

3.2.19

A *firm* may monitor compliance with the €1m threshold in ■BIPRU 3.2.10 R on the basis of approved limits provided it has internal control procedures that are sufficient to ensure that amounts owed cannot diverge from approved limits to such an extent as to give rise to a material breach of the €1m threshold.

3.2.20

(1) To calculate *risk weighted exposure amounts*, *risk weights* must be applied to all *exposures*, unless deducted from *capital resources*, in accordance with the provisions of ■BIPRU 3.4.
(2) The application of risk weights must be based on the standardised credit risk exposure class to which the exposure is assigned and, to the extent specified in BIPRU 3.4, its credit quality.

(3) Credit quality may be determined by reference to:

(a) the credit assessments of eligible ECAIs in accordance with the provisions of BIPRU 3; or

(b) the credit assessments of export credit agencies as described in BIPRU 3.4.

[Note: BCD Article 80(1)]

3.2.21 For the purposes of applying a risk weight, as referred to in BIPRU 3.2.20 R, the exposure value must be multiplied by the risk weight specified or determined in accordance with the standardised approach.

[Note: BCD Article 80(2)]

3.2.22 Notwithstanding BIPRU 3.2.20 R, where an exposure is subject to credit protection the risk weight applicable to that item may be modified in accordance with BIPRU 5.

[Note: BCD Article 80(4)]

3.2.23 Risk weighted exposure amounts for securitised exposures must be calculated in accordance with BIPRU 9.

[Note: BCD Article 80(5)]

3.2.24 Exposures the calculation of risk weighted exposure amounts for which is not otherwise provided for under the standardised approach must be assigned a risk weight of 100%.

[Note: BCD Article 80(6)]

Zero risk-weighting for intra-group exposures: core UK group

3.2.25 Subject to BIPRU 3.2.35 R, and with the exception of exposures giving rise to liabilities in the form of the items referred to in BIPRU 3.2.26 R, a firm is not required to comply with BIPRU 3.2.20 R (Calculation of risk weighted exposures amounts under the standardised approach) in the case of the exposures of the firm to a counterparty which is its parent undertaking, its subsidiary undertaking or a subsidiary undertaking of its parent undertaking provided that the following conditions are met:

(a) the counterparty is

   (i) a core concentration risk group counterparty; and

   (ii) an institution, financial holding company, mixed financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements;

(b) [deleted]
(ba) (in relation to a subsidiary undertaking) 100% of the voting rights attaching to the shares in the counterparty’s capital is held by the firm or a financial holding company (or a subsidiary undertaking of the financial holding company), whether individually or jointly, and that the firm or financial holding company (or its subsidiary undertaking) must have the right to appoint or remove a majority of the members of the board of directors, committee of management or other governing body of the counterparty;

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

(d) the counterparty is incorporated in the United Kingdom; and

(e) there is no current or foreseen material practical or legal impediment to the prompt transfer of capital resources or repayment of liabilities from the counterparty to the firm.

(2) Where a firm chooses under (1) not to apply BIPRU 3.2.20 R, it must assign a risk weight of 0% to the exposure.

(3) A firm need not apply the treatment in (1) and (2) to every exposure that is eligible for that treatment.

[Note: BCD Article 80(7)]

3.2.25A G

(1) [deleted]

(2) [deleted]

3.2.26 R

A firm must not apply the treatment in BIPRU 3.2.25 R to exposures giving rise to liabilities in the form of any of the following items:

(1) in the case of a BIPRU firm, any tier one capital or tier two capital; and

(2) in the case of any other undertaking, any item that would be tier one capital or tier two capital if the undertaking were a BIPRU firm.

[Note: BCD Article 80(7), part]

3.2.27 R

(1) [deleted]

(a) [deleted]

(b) [deleted]

(c) [deleted]

(2) [deleted]

3.2.27A R

(1) For the purpose of BIPRU 3.2.25R (1)(e), a firm must be able on an ongoing basis to demonstrate fully to the appropriate regulator the circumstances and arrangements, including legal arrangements, by virtue of which there are no material practical or legal impediments, and none are foreseen, to the prompt transfer of capital resources or repayment of liabilities from the counterparty to the firm.
(2) In relation to a counterparty that is not a firm, the arrangements referred to in (1) must include a legally binding agreement with each firm that is a member of the core UK group that it will promptly on demand by the firm increase the firm's capital resources by an amount required to ensure that the firm complies with GENPRU 2.1 (Calculation of capital resources requirements) and any other requirements relating to capital resources or concentration risk imposed on a firm by or under the regulatory system.

(3) For the purpose of (2), the obligation to increase the firm's capital resources may be limited to capital resources available to the counterparty and may reasonably exclude such amount of capital resources that, if transferred to the firm, would cause the counterparty to become balance sheet insolvent in the manner contemplated in Section 123(2) of the Insolvency Act 1986.

3.2.28 For the purpose of BIPRU 3.2.25 R (1)(c) it is the risk management functions of the group that should be integrated, rather than the group's operational management. A firm should ensure that if risk management functions are integrated in this way it should be possible for the appropriate regulator to undertake qualitative supervision of the management of the integrated risk management function.

3.2.29 In relation to a core concentration risk group counterparty, an undertaking is included within the scope of consolidation of a group on a full basis if it is at the head of the group or if its assets and liabilities are taken into account in full as referred to in BIPRU 8.5.2 G (Basis of inclusion of undertakings in consolidation).

3.2.29A (1) In relation to BIPRU 3.2.25 R (1)(ba), a subsidiary undertaking should generally be 100% owned and controlled by a single shareholder. However, if a subsidiary undertaking has more than one shareholder, that undertaking may be a member of the core UK group if all its shareholders are also members of the same core UK group.

(2) For the purpose of BIPRU 3.2.25R (1)(d) (Incorporation in the UK), if a counterparty is of a type that falls within the scope of the Council Regulation of 29 May 2000 on insolvency proceedings (Regulation 1346/2000/EC) and it is established in the United Kingdom other than by incorporation, a firm wishing to include that counterparty in its core UK group may apply to the appropriate regulator for a waiver of this condition if it can demonstrate fully to the appropriate regulator that the counterparty's centre of main interests is situated in the United Kingdom within the meaning of that Regulation.

3.2.30 For the purpose of BIPRU 3.2.25R (1)(e) (Prompt transfer of capital resources):

(1) in the case of an undertaking that is a firm the requirement in BIPRU 3.2.25R (1)(e) for the prompt transfer of capital resources refers to capital resources in excess of the capital and financial resources requirements to which it is subject under the regulatory system; and

(2) [deleted]
(3) the FCA will consider the following criteria:

(a) the speed with which funds can be transferred or liabilities repaid to the firm and the simplicity of the method for the transfer or repayment;

(b) whether there are any interests other than those of the firm in the core concentration risk group counterparty and what impact those other interests may have on the firm’s control over the core group concentration risk group counterparty and the ability of the firm to require a transfer of funds or repayment of liabilities;

(c) whether there are any tax disadvantages for the firm or the core concentration risk group counterparty as a result of the transfer of funds or repayment of liabilities;

(d) whether the purpose of the core concentration risk group counterparty prejudices the prompt transfer of funds or repayment of liabilities;

(e) whether the legal structure of the core concentration risk group counterparty prejudices the prompt transfer of funds or repayment of liabilities;

(f) whether the contractual relationships of the core concentration risk group counterparty with the firm and other third parties prejudices the prompt transfer of funds or repayment of liabilities; and

(g) whether past and proposed flows of funds between the core concentration risk group counterparty and the firm demonstrate the ability to make prompt transfer of funds or repayment of liabilities.

3.2.31 The requirement in BIPRU 3.2.25 R (1)(e) for the prompt repayment of liabilities refers to the prompt repayment of liabilities when due.

3.2.32 The guidance in BIPRU 3.2.30 G - BIPRU 3.2.31 G does not apply to BIPRU 2.1 (Solo consolidation) even though the provisions have similar wording. This is because the purpose of the provisions in BIPRU 2.1 is to define the conditions under which two undertakings should be treated as a single undertaking. The purpose of BIPRU 3.2.25 R (1) is to define the circumstances in which it is appropriate to apply a zero risk weight.

3.2.33 A firm that has chosen to apply the treatment in BIPRU 3.2.25 R should monitor the exposures to which a 0% risk weight is applied under that treatment and report these to the appropriate regulator as required.

3.2.34 If a firm has an IRB permission and exposures are exempted from the IRB approach under BIPRU 4.2.26 R (6) the firm may apply a 0% risk weight to them under BIPRU 3.2.25 R (2) (Zero risk weighting for intra-group exposures) if the conditions in BIPRU 3.2.25 R (1) are satisfied.

3.2.35 (1) A firm may not apply BIPRU 3.2.25 R unless it has a core UK group waiver.
(2) [deleted]

(3) A firm may stop applying BIPRU 3.2.25 R or may stop applying it to some exposures.

(4) [deleted]

(5) A firm must notify the appropriate regulator if it becomes aware that any exposure that it has treated as exempt under BIPRU 3.2.25 R has ceased to meet the conditions for exemption or if the firm ceases to treat an exposure under that rule.

3.2.36 G [deleted]

3.2.37 G BIPRU 3 Annex 1 G is a flow chart guide to assessing whether an intra-group exposure can be zero risk weighted using the standardised approach subject to the conditions set out in BIPRU 3.2.25 R - BIPRU 3.2.35 R.

Exposures to recognized third-country investment firms, clearing houses and investment exchanges

3.2.38 R For the purposes of the standardised approach (including as it applies for the purposes of BIPRU 14) and without prejudice to BIPRU 13.3.13 R and BIPRU 13.8.8 R (Exposure to a central counterparty), exposures to recognised third country investment firms and exposures to recognised clearing houses, designated clearing houses, recognised investment exchanges and designated investment exchanges must be treated as exposures to institutions.

[Note: CAD Article 40]
3.3 The use of the credit assessments of ratings agencies

### 3.3.1 An external credit assessment may be used to determine the risk weight of an exposure in accordance with [3.2.20 R to 3.2.26 R] only if the ECAI which provides it is recognised by the appropriate regulator as an eligible ECAI for the purposes of the standardised approach to credit risk.

[Note: BCD Article 81(1)]

### Recognition of ratings agencies

3.3.2 The appropriate regulator will recognise an ECAI as an eligible ECAI for the purposes of [3.3] or will refuse to recognise an ECAI or will revoke its recognition of an ECAI as an eligible ECAI in accordance with the Capital Requirements Regulations 2006.

3.3.3 Regulation 22 of the Capital Requirements Regulations 2006 deals with recognition by the appropriate regulator of eligible ECAIs for exposure risk weight purposes. Regulation 25 deals with revoking recognition.

3.3.4 The criteria which the appropriate regulator must apply when assessing ECAIs for recognition for exposure risk weighting purposes are set out in Regulation 22 and Schedule 1 to the Capital Requirements Regulations 2006. In making an assessment against those criteria and in carrying out the mapping process described in [3.3.7 G to 3.3.9 G] the appropriate regulator will have regard to the approach set out in the Committee of European Banking Supervisors’ “Guidelines on the recognition of External Credit Assessment Institutions” dated 20 January 2006. The appropriate regulator does not expect to recognise an ECAI unless the information set out in those guidelines has been submitted to it.

3.3.5 The list of eligible ECAIs is published on the appropriate regulator website. When the appropriate regulator recognises an ECAI as an eligible ECAI, it publishes that decision by amending the list of eligible ECAIs on the appropriate regulator website to include the name of the eligible ECAI. When the appropriate regulator determines that the recognition of an ECAI should be revoked, it publishes that decision by deleting the name of the ECAI from the list on the appropriate regulator website.

3.3.6 The list of eligible ECAIs includes those who have been recognised as eligible for exposure risk weighting purposes by a competent authority of another EEA State and are subsequently recognised as eligible ECAIs by the...
appropriate regulator without carrying out its own evaluation process under Regulation 22(2) of the Capital Requirements Regulations 2006.

3.3.7 G Mapping of credit assessments

Under Regulation 22(3) of the Capital Requirements Regulations 2006 the appropriate regulator is obliged to determine, taking into account the requirements set out in Schedule 2 to the Capital Requirements Regulations 2006, with which of the credit quality steps set out in Part 1 of Annex VI of the Banking Consolidation Directive the relevant credit assessments of an eligible ECAI are to be associated. Those determinations should be objective and consistent.

3.3.8 R The credit quality step with which a relevant credit assessment of an eligible ECAI is to be associated is that in the table mapping the credit assessments of eligible ECAIs to credit quality steps published by the appropriate regulator under Regulation 22(3) of the Capital Requirements Regulations 2006.

3.3.9 G The table mapping the credit assessments of eligible ECAIs to credit quality steps is published on the appropriate regulator’s website and amended from time to time in line with additions to and deletions from the list of eligible ECAIs. The table includes mappings made by a competent authority of another EEA State which are subsequently recognised by the appropriate regulator without carrying out its own determination process under Regulation 22(5) of the Capital Requirements Regulations 2006.

[Note: For the most recent version of the table, refer to: http://www.fca.org.uk/your-fca/documents/fsa-ecais-standardised for the FCA and http://www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/ecaissstandardised.pdf for the PRA]
Risk weights under the standardised approach to credit risk

3.4 Risk weights under the standardised approach to credit risk

Risk weights: Exposures to central governments or central banks: Treatment

3.4.1 Without prejudice to BIPRU 3.4.2 R to BIPRU 3.4.9 R, exposures to central governments and central banks must be assigned a 100% risk weight.

[Note: BCD Annex VI Part 1 point 1]

3.4.2 Subject to BIPRU 3.4.4 R, exposures to central governments and central banks for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in BIPRU 3.4.3 R in accordance with the assignment by the appropriate regulator in accordance with the Capital Requirements Regulations 2006 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

[Note: BCD Annex VI Part 1 point 2]

Table: Exposures to central governments and central banks for which a credit assessment by a nominated ECAI is available

3.4.3 This table belongs to BIPRU 3.4.2 R.

Exposures to the European Central Bank must be assigned a 0% risk weight.

[Note: BCD Annex VI Part 1 point 3]

Exposures in the national currency of the borrower

3.4.4 Exposures to EEA States’ central governments and central banks denominated and funded in the domestic currency of that central government and central bank must be assigned a risk weight of 0%.

[Note: BCD Annex VI Part 1 point 4]

3.4.6 When the competent authorities of a third country which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA
assign a *risk weight* which is lower than that indicated in BIPRU 3.4.1 R to BIPRU 3.4.3 R to exposures to their central government and *central bank* denominated and funded in the domestic currency, a *firm* may *risk weight* such exposures in the same manner.

[Note: *BCD Annex VI Part 1 point 5*]

### Use of credit assessments by export credit agencies

An export credit agency credit assessment may be recognised by a *firm* for the purpose of determining the *risk weight* to be applied to an *exposure* under the *standardised approach* if either of the following conditions is met:

1. the credit assessment is a consensus risk score from export credit agencies participating in the OECD "Arrangement on Guidelines for Officially Supported Export Credits"; or
2. the export credit agency publishes its credit assessments, and the export credit agency subscribes to the OECD agreed methodology, and the credit assessment is associated with one of the eight minimum export insurance premiums (MEIP) that the OECD agreed methodology establishes.

[Note: *BCD Annex VI Part 1 point 6*]

### Exposures for which a credit assessment by an export credit agency is recognised

Exposures for which a credit assessment by an export credit agency is recognised for *risk weighting* purposes must be assigned a *risk weight* according to the table in BIPRU 3.4.9 R.

[Note: *BCD Annex VI Part 1 point 7*]

#### Table: Exposure for which a credit assessment by an export credit agency is recognised

This table belongs to BIPRU 3.4.8 R.

<table>
<thead>
<tr>
<th>MEIP</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>0%</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>

### Exposures to regional governments or local authorities: General

Without prejudice to BIPRU 3.4.15 R to BIPRU 3.4.19 R:

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

2. the preferential treatment for short-term exposures specified in BIPRU 3.4.37 R, BIPRU 3.4.39 R and BIPRU 3.4.44 R must not be applied.

[Note: *BCD Annex VI Part 1 point 8*]
Exposures to regional governments or local authorities: 
Central government risk weight based method

3.4.11 R

(1) Exposures to regional governments and local authorities must be assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the regional government or local authority is established are assigned in accordance with the table in BIPRU 3.4.12 R.

(2) Exposures to an unrated regional government or local authority must not be assigned a risk weight lower than that applied to exposures to its central government.

[Note: BCD Annex VI Part 1 points 25 and 26]

Table: Central government risk weight based method

3.4.12 R

This table belongs to BIPRU 3.4.11 R.

<table>
<thead>
<tr>
<th>Credit quality step to which central government is assigned</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight of exposure</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>

3.4.13 R

For exposures to regional governments and local authorities established in countries where the central government is unrated, the risk weight must be not more than 100%.

[Note: BCD Annex VI Part 1 point 27]

3.4.14 R

For exposures to regional governments and local authorities with an original effective maturity of three months or less, the risk weight must be 20%.

[Note: BCD Annex VI Part 1 point 28]

3.4.15 R

A firm must treat an exposure to a regional government or local authority of the United Kingdom listed in BIPRU 3 Annex 2 R as an exposure to the central government of the United Kingdom.

[Note: BCD Annex VI Part 1 point 9]

3.4.16 G

The appropriate regulator will include a regional government or local authority in the list in BIPRU 3 Annex 2 R where there is no difference in risk between exposures to that body and exposures to the central government of the United Kingdom because of the specific revenue-raising powers of the regional government or local authority, and the existence of specific institutional arrangements the effect of which is to reduce the risk of default.

[Note: BCD Annex VI Part 1 point 9]
3.4.17 R A firm must treat an exposure to a regional government or local authority of an EEA State other than the United Kingdom as an exposure to the central government in whose jurisdiction that regional government or local authority is established if that regional government or local authority is included on the list of regional governments and local authorities drawn up by the competent authority in that EEA State under a CRD implementation measure with respect to point 9 of Part 1 of Annex VI of the Banking Consolidation Directive.

[Note: BCD Annex VI Part 1 point 9]

3.4.18 R Exposures to churches or religious communities constituted in the form of a legal person under public law must, in so far as they raise taxes in accordance with legislation conferring on them the right to do so, be treated as exposures to regional governments and local authorities, except that BIPRU 3.4.15 R and BIPRU 3.4.17 R do not apply.

[Note: BCD Annex VI Part 1 point 10]

3.4.19 R When competent authorities of a third country jurisdiction which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA treat exposures to regional governments and local authorities as exposures to their central government, a firm may risk weight exposures to such regional governments and local authorities in the same manner.

[Note: BCD Annex VI Part 1 point 11]

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

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

Exposures to administrative bodies and non-commercial undertakings

3.4.20 R BIPRU 3.4.21 R to BIPRU 3.4.26 R set out the provisions applying to exposures to administrative bodies and non-commercial undertakings.

Treatment

3.4.21 R Without prejudice to BIPRU 3.4.22 R to BIPRU 3.4.26 R, exposures to administrative bodies and non-commercial undertakings must be assigned a 100% risk weight.

[Note: BCD Annex VI Part 1 point 12]

Public sector entities

3.4.22 R Without prejudice to BIPRU 3.4.23 R to BIPRU 3.4.26 R, exposures to public sector entities must be assigned a 100% risk weight.

[Note: BCD Annex VI Part 1 point 13]
A firm may treat an exposure to a public sector entity as an exposure to a regional government or local authority in accordance with BIPRU 3.4.11 R to BIPRU 3.4.14 R.

[Note: BCD Annex VI Part 1 point 14]

In exceptional circumstances a firm may treat an exposure to a public sector entity established in the United Kingdom as an exposure to the central government of the United Kingdom if there is no difference in risk between exposures to that body and exposures to the central government of the United Kingdom because of the existence of an appropriate guarantee by the central government.

[Note: BCD Annex VI Part 1 point 15]

Where a competent authority of another EEA State implements points 14 or 15 of Part 1 of Annex VI of the Banking Consolidation Directive by exercising the discretion to treat exposures to public sector entities as exposures to institutions or as exposures to the central government of the EEA State concerned, a firm may risk weight exposures to the relevant public sector entities in the same manner.

[Note: BCD Annex VI Part 1 point 16]

When competent authorities of a third country jurisdiction, which apply supervisory and regulatory arrangements at least equivalent to those applied in the EEA, treat exposures to public sector entities as exposures to institutions, a firm may risk weight exposures to the relevant public sector entities in the same manner.

[Note: BCD Annex VI Part 1 point 17]

Exposures to multilateral development banks: Treatment

(1) A firm must treat exposures to multilateral development banks in the same manner as exposures to institutions in accordance with BIPRU 3.4.34 R to BIPRU 3.4.39 R (Exposures to institutions: credit assessment based method); and

(2) the preferential treatment for short-term exposures specified in BIPRU 3.4.37 R, BIPRU 3.4.39 R and BIPRU 3.4.44 R must not be applied.

[Note: BCD Annex VI Part 1 point 19]

An exposure to a multilateral development bank listed in point (a) of the definition in the Glossary must be assigned a 0% risk weight.

[Note: BCD Annex VI Part 1 point 20]

A risk weight of 20% must be assigned to the portion of unpaid capital subscribed to the European Investment Fund.

[Note: BCD Annex VI Part 1 point 21]
Exposures to international organisations

3.4.30 Exposures to the following international organisations must be assigned a 0% risk weight:

(1) the EU;

(2) the International Monetary Fund; and

(3) the Bank for International Settlements.

[Note: BCD Annex VI Part 1 point 22]

Exposures to institutions: General

3.4.31 [BIPRU 3.4.32 R to BIPRU 3.4.48 R set out the treatment to be accorded to exposures to institutions.]

Exposures to institutions: Treatment

3.4.32 Without prejudice to [BIPRU 3.4.33 R to BIPRU 3.4.47 R, exposures to financial institutions authorised and supervised by the competent authorities responsible for the authorisation and supervision of credit institutions and subject to prudential requirements equivalent to those applied to credit institutions must be risk weighted as exposures to institutions.

[Note: BCD Annex VI Part 1 point 24]

Exposures to institutions: Risk weight floor on exposures to unrated institutions

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

[Note: BCD Annex VI Part 1 point 25]

Exposures to institutions: Credit assessment based method

3.4.34 Exposures to institutions with a residual maturity of more than three months for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in [BIPRU 3.4.35 R in accordance with the assignment by the appropriate regulator in accordance with the Capital Requirements Regulations 2006 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

[Note: BCD Annex VI Part 1 point 29]

Table: Exposures to institutions with a residual maturity of more than three months for which a credit assessment by a nominated ECAI is available

3.4.35 This table belongs to [BIPRU 3.4.34 R.]

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>
3.4.36 R Without prejudice to BIPRU 3.4.33 R, exposures to unrated institutions must be assigned a risk weight of 50%.

[Note: BCD Annex VI Part 1 point 30]

3.4.37 R Exposures to an institution with a residual maturity of three months or less for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in BIPRU 3.4.38 R in accordance with the assignment by the appropriate regulator in accordance with the Capital Requirements Regulations 2006 of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

[Note: BCD Annex VI Part 1 point 31]

Table: Exposures to an institution with a residual maturity of three months or less for which a credit assessment by a nominated ECAI is available

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>150%</td>
</tr>
</tbody>
</table>

3.4.38 R This table belongs to BIPRU 3.4.37 R.

3.4.39 R Without prejudice to BIPRU 3.4.33 R, exposures to unrated institutions having an original effective maturity of three months or less must be assigned a 20% risk weight

[Note: BCD Annex VI Part 1 point 32]

Exposures to institutions: Interaction with short-term credit assessments

3.4.40 R If there is no short-term credit assessment as set out in BIPRU 3.4.112 R, the general preferential treatment for short-term exposures as specified in BIPRU 3.4.37 R applies to all exposures to institutions of up to three months residual maturity.

[Note: BCD Annex VI Part 1 point 34]

3.4.41 R If there is a short-term credit assessment as set out in BIPRU 3.4.112 R and such an assessment determines the application of a more favourable or identical risk weight than the use of the general preferential treatment for short-term exposures, as specified in BIPRU 3.4.37 R, then the short-term assessment and risk weighting specified in BIPRU 3.4.112 R must be used for that specific exposure only. Other short-term exposures must follow the general preferential treatment for short-term exposures, as specified in BIPRU 3.4.37 R.

[Note: BCD Annex VI Part 1 point 35]

3.4.42 R If there is a short-term credit assessment as set out in BIPRU 3.4.112 R and such an assessment determines a less favourable risk weight than the use of the general preferential treatment for short-term exposures, as specified in BIPRU 3.4.37 R, then the general preferential treatment for short-term
exposures must not be used and all unrated short-term claims must be assigned the same risk weight as that applied by the specific short-term assessment.

[Note: BCD Annex VI Part 1 point 36]

3.4.43 BIPRU 3 Annex 4 G contains a flow diagram guide to determining the risk weight to be applied to short-term exposures to institutions according to whether a short-term credit assessment is available.

Exposures to institutions: Short-term exposures in the national currency of the borrower

3.4.44 A firm may assign to an exposure to an institution formed under the law of the United Kingdom of a residual maturity of 3 months or less denominated and funded in pounds sterling a risk weight that is one category less favourable than the preferential risk weight, as described in BIPRU 3.4.5 R (Exposures in the national currency of the borrower), assigned to exposures to the central government of the United Kingdom.

[Note: BCD Annex VI Part 1 point 37]

3.4.45 (1) Where a competent authority of another EEA State implements point 37 of Part 1 of Annex VI of the Banking Consolidation Directive by exercising the discretion to allow the treatment in that point, a firm may assign to the relevant national currency exposures the risk weight permitted by that CRD implementation measure.

(2) When the competent authority of a third country which applies supervisory and regulatory arrangements at least equivalent to those applied in the EEA assigns to an exposure to an institution formed under the law of that third country of a residual maturity of 3 months or less denominated and funded in the national currency a risk weight that is one category less favourable than the preferential risk weight, as described in BIPRU 3.4.6 R (Exposures in the national currency of the borrower), assigned to exposures to the central government of that third country, a firm may risk weight such exposures in the same manner.

[Note: BCD Annex VI Part 1 point 37]

3.4.46 No exposures of a residual maturity of 3 months or less denominated and funded in the national currency of the borrower may be assigned a risk weight less than 20%.

[Note: BCD Annex VI Part 1 point 38]

Exposures to institutions: Investments in regulatory capital instruments

Investments in equity or regulatory capital instruments issued by institutions must be risk weighted at 100%, unless deducted from capital resources.

[Note: BCD Annex VI Part 1 point 39]
Exposures to institutions: Minimum reserves required by the ECB

3.4.48 R

Where an exposure to an institution is in the form of minimum reserves required by the European Central Bank or by the central bank of an EEA State to be held by the firm, a firm may assign the risk weight that would be assigned to exposures to the central bank of the EEA State in question provided:

(1) the reserves are held in accordance with Regulation (EC) No. 1745/2003 of the European Central Bank of 12 September 2003 or a subsequent replacement regulation or in accordance with national requirements in all material respects equivalent to that Regulation; and

(2) in the event of the bankruptcy or insolvency of the institution where the reserves are held, the reserves will be fully repaid to the firm in a timely manner and will not be available to meet other liabilities of the institution.

[Note: BCD Annex VI Part 1 point 40]

Exposures to corporates: General

3.4.49 G

■ BIPRU 3.4.50 R to ■ BIPRU 3.4.52 R set out the treatment to be accorded to exposures to corporates.

Exposures to corporates: Treatment

3.4.50 R

Exposures for which a credit assessment by a nominated ECAI is available must be assigned a risk weight according to the table in ■ BIPRU 3.4.51 R in accordance with the assignment by the appropriate regulator in accordance with the Capital Requirements Regulations 2006 of the credit assessments of eligible ECAs to six steps in a credit quality assessment scale.

[Note: BCD Annex VI Part 1 point 41]

Table: Exposures for which a credit assessment by a nominated ECAI is available

3.4.51 R

This table belongs to ■ BIPRU 3.4.50 R.

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
<td>150%</td>
</tr>
</tbody>
</table>

3.4.52 R

Unrated exposures must be assigned a 100% risk weight or the risk weight of its central government, whichever is the higher.

[Note: BCD Annex VI Part 1 point 42]
Retail exposures

3.4.53  
**Exposures** that comply with the criteria listed in BIPRU 3.2.10 R must be assigned a risk weight of 75%. However a **firm** may treat such an exposure under BIPRU 3.2.24 R (100% risk weight).

[Note: BCD Annex VI Part 1 point 43]

Exposures secured by real estate property

3.4.54  
BIPRU 3.4.55 R to BIPRU 3.4.94 R set out the treatment to be accorded to exposures secured by real estate property.

3.4.55  
Without prejudice to BIPRU 3.4.56 R to BIPRU 3.4.94 R, exposures fully secured by real estate property must be assigned a risk weight of 100%.

[Note: BCD Annex VI Part 1 point 44]

Exposures secured by mortgages on residential property

3.4.56  
Without prejudice to BIPRU 3.4.85 R, an exposure or any part of an exposure fully and completely secured, to the satisfaction of the **firm**, by mortgages on residential property which is or shall be occupied or let by the owner or the beneficial owner in the case of personal investment companies must be assigned a risk weight of 35%.

[Note: BCD Annex VI Part 1 point 45]

3.4.56A  
(1) A **firm** must not treat a lifetime mortgage as an exposure fully and completely secured on residential property for the purposes of BIPRU 3.4.56 R unless the amount of the exposure is calculated according to the following formula:

\[
\text{exposure amount} = \frac{P(1+i)^T}{(1+d)^T}
\]

where:

(a) \( P \) is the current outstanding balance on the lifetime mortgage;

(b) \( i \) is the interest rate charged on the lifetime mortgage, which for the purposes of this calculation must not be lower than the discount rate referred to in (c);

(c) \( d \) is the discount rate which is the risk-free rate as represented by the yield on 10-year UK government bonds; and

(d) \( T \) is the projected number of years to maturity of the exposure.

(2) Notwithstanding (1)(c), a **firm** may calculate an annual average discount rate provided there is no obvious bias in its calculation and it is consistent in its approach.
(1) This paragraph provides guidance on BIPRU 3.4.56A R.

(2) For the purposes of BIPRU 3.4.56A R (2), a firm may use the FTSE UK gilt 10-year yield index which the Council of Mortgage Lenders makes available to its members.

(3) If a firm offers a variable interest rate on a lifetime mortgage, it should calculate an average interest rate in a way which is consistent with the calculation of the discount rate.

(4) To determine the projected number of years to maturity of the exposure, a firm may use the standard mortality tables published by the Institute of Actuaries or the Faculty of Actuaries. For internal risk management purposes, the firm should use factual data or seek actuarial advice to determine how the information in these tables may be adjusted to take account of regional and other relevant variations.

Exposures fully and completely secured, to the satisfaction of the firm, by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of residential property which is or shall be occupied or let by the owner must be assigned a risk weight of 35%.

[Note: BCD Annex VI Part 1 point 46]

Without prejudice to BIPRU 3.4.85 R, an exposure or any part of an exposure to a tenant under a property leasing transaction concerning residential property under which the firm is the lessor and the tenant has an option to purchase, must be assigned a risk weight of 35% provided that the firm is satisfied that the exposure of the firm is fully and completely secured by its ownership of the property.

[Note: BCD Annex VI Part 1 point 47]

An Ijara mortgage is an example of an exposure described in BIPRU 3.4.58 R.

(1) In the exercise of its judgement for the purposes of BIPRU 3.4.56 R to BIPRU 3.4.58 R, a firm may be satisfied only if the conditions in (2) to (6) are met.

(2) The value of the property does not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macroeconomic factors affect both the value of the property and the performance of the borrower.

(3) The risk of the borrower does not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral.

(4) The minimum requirements about:
(a) legal certainty in BIPRU 3.4.64 R;
(b) monitoring of property values in BIPRU 3.4.66 R;
(c) documentation in BIPRU 3.4.72 R; and
(d) insurance in BIPRU 3.4.73 R;
are met.

(5) The valuation rules set out in BIPRU 3.4.77 R to BIPRU 3.4.80 R are met.

(6) The value of the property exceeds the exposures by a substantial margin as set out in BIPRU 3.4.81 R, BIPRU 3.4.83 R, BIPRU 3.4.84 R or BIPRU 3.4.85 R (as applicable).

[Note: BCD Annex VI Part 1 point 48]

3.4.61 R BIPRU 3.4.60 R (3) does not apply to exposures fully and completely secured by mortgages on residential property which is situated within the United Kingdom.

[Note: BCD Annex VI Part 1 point 49]

3.4.62 G The Banking Consolidation Directive permits a competent authority to disapply the condition in BIPRU 3.4.60 R (3), if it has evidence that a well-developed and long-established residential real estate market is present in its territory with loss rates which are sufficiently low to justify such treatment. BIPRU 3.4.61 R implements that option. However, if the evidence changes so that these conditions are no longer satisfied, the appropriate regulator may be obliged to revoke BIPRU 3.4.61 R.

3.4.63 R If a CRD implementation measure of another EEA State exercises the discretion in point 49 of Part 1 of Annex VI of the Banking Consolidation Directive to dispense with the condition corresponding to BIPRU 3.4.60 R (3) (The risk of the borrower should not materially depend upon the performance of the underlying property or project), a firm may apply a risk weight of 35% to such exposures fully and completely secured by mortgages on residential property situated in that EEA State.

[Note: BCD Annex VI Part 1 point 50]

3.4.64 R The requirements about legal certainty referred to in BIPRU 3.4.60 R (4)(a) are as follows:

(1) the mortgage or charge must be enforceable in all relevant jurisdictions which are relevant at the time of conclusion of the credit agreement, and the mortgage or charge must be properly filed on a timely basis;

(2) the arrangements must reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled); and
(3) the protection agreement and the legal process underpinning it must enable the firm to realise the value of the protection within a reasonable timeframe.

[Note: BCD Annex VIII Part 2 point 8(a)]

3.4.65 G The term protection agreement in BIPRU 3.4.64 R (3) refers to the contract or deed by which the mortgage or charge is established.

3.4.66 R (1) The requirements about monitoring of property values referred to in BIPRU 3.4.60 R (4)(b) are as follows:

(a) the value of the property must be monitored on a frequent basis and at a minimum once every three years for residential real estate;

(b) more frequent monitoring must be carried out where the market is subject to significant changes in conditions;

(c) statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;

(d) the property valuation must be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and

(e) for loans exceeding €3 million or 5% of the capital resources of the firm, the property valuation must be reviewed by an independent valuer at least every three years.

(2) For the purposes of (1), ‘independent valuer’ means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

[Note: BCD Annex VIII Part 2 point 8(b)]

3.4.67 G A property will need to be revalued over time to ensure that the original purchase price does not overstate the degree of security provided by the property. Ijara providers should undertake revaluations in the same way as providers of conventional mortgages.

3.4.68 G For the purposes of BIPRU 3.4.66 R (1)(a), the monitoring of property values should be an inherent part of risk managing and tracking the portfolio. The requirement to monitor property values does not include the physical assessment of each property in the portfolio.

3.4.69 G For the purposes of BIPRU 3.4.66 R (1)(d) and (e), the review of a property valuation is more in-depth than the normal monitoring process required by BIPRU 3.4.66 R (1)(a). This requirement is likely to include a review of the property value on an individual exposure basis. Where an exposure is secured by multiple properties, the review can be undertaken at the level of the exposure, rather than at the level of each individual property.
The review of property values required by BIPRU 3.4.66 R (1)(e) may lead to an amendment of the value assigned to the property under by BIPRU 3.4.80 R.

For the purposes of BIPRU 3.4.66 R (2), necessary qualifications need not be professional qualifications but the firm should be able to demonstrate that he or she has the necessary ability and experience to undertake the review.

The requirements about documentation referred to in BIPRU 3.4.60 R (4)(c) are that the types of residential real estate accepted by the firm and its lending policies in this regard must be clearly documented.

[Note: BCD Annex VIII Part 2 point 8(c)]

The requirements about insurance referred to in BIPRU 3.4.60 R (4)(d) are that the firm must have procedures to monitor that the property taken as protection is adequately insured against damage.

[Note: BCD Annex VIII Part 2 point 8(d)]

For the purposes of BIPRU 3.4.73 R a firm should, as a minimum, ensure that it is a requirement of each loan that the property taken as collateral must have adequate buildings insurance at all times, which should be reviewed when any new loan is extended against the property.

A firm may deal with the risk that insurance on properties taken as protection may be inadequate by taking out insurance at the level of the portfolio.

The valuation rules referred to in BIPRU 3.4.60 R (5) are set out in BIPRU 3.4.77 R to BIPRU 3.4.80 R.

The property must be valued by an independent valuer at or less than the market value. In those EEA States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value.

[Note: BCD Annex VIII Part 3 point 62]

Market value means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value must be documented in a transparent and clear manner.

[Note: BCD Annex VIII Part 3 point 63]

Mortgage lending value means the value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local
market conditions, the current use and alternative appropriate uses of the property. Speculative elements must not be taken into account in the assessment of the mortgage lending value. The mortgage lending value must be documented in a transparent and clear manner.

[Note: BCD Annex VIII Part 3 point 64]

3.4.80 R

The value of the collateral must be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under ■ BIPRU 3.4.60 R (4)(b) and ■ BIPRU 3.4.66 R and to take account of any prior claims on the property.

[Note: BCD Annex VIII Part 3 point 65]

3.4.81 R

A firm may not treat an exposure as fully and completely secured by residential property located in the United Kingdom for the purpose of ■ BIPRU 3.4.56 R or ■ BIPRU 3.4.58 R unless the amount of the exposure or of the secured part of the exposure referred to in ■ BIPRU 3.4.56 R or ■ BIPRU 3.4.58 R, as the case may be, is 80% or less of the value of the residential property on which it is secured.

3.4.82 G

(1) The application of ■ BIPRU 3.4.81 R may be illustrated by an example. If a firm has a mortgage exposure of £100,000 secured on residential property in the United Kingdom that satisfies the criteria listed in ■ BIPRU 3.4.56 R to ■ BIPRU 3.4.80 R and the value of that property is £100,000, then £80,000 of that exposure may be treated as fully and completely secured and risk weighted at 35%. The remaining £20,000 may be risk weighted at 75% provided the exposure meets the criteria in ■ BIPRU 3.2.10 R. The portion risk weighted at 75% should be treated as a retail exposure for the purposes of the aggregation calculations specified in ■ BIPRU 3.2.10 R (3). A diagrammatic illustration of this example is in (2).

(2) EXAMPLE

- £100,000 loan secured on property valued at £100,000
- First £80,000 (80% of £100,000) risk weighted at 35%
- Remaining £20,000 risk weighted at 75%
- The loan belongs to retail criteria counts to retail aggregation calculation
- Overall risk weight = 43%

(3) The same approach applies to exposures described in ■ BIPRU 3.4.58 R. On initiation a 35% risk weight should be applied to the first 80% of the principal/purchase price outstanding, with a 75% risk weight being applied to the remainder of the principal (assuming that the exposure meets the requirements in ■ BIPRU 3.2 to be treated as a retail exposure).

3.4.83 R

A firm may only treat an exposure as fully and completely secured by residential property situated in another EEA State for the purposes of ■ BIPRU 3.4.56 R or ■ BIPRU 3.4.58 R if it would be treated as fully and completely secured by the relevant CRD implementation measures in that
For the purposes of ■ BIPRU 3.4.56 R or ■ BIPRU 3.4.58 R, a firm may only treat an exposure as fully and completely secured by residential property situated in the territory of a third-country competent authority that is listed as equivalent for credit risk in ■ BIPRU 8 Annex 6 R if it would be treated as fully and completely secured under the applicable requirements of that third-country competent authority (including any applicable loan-to-value ceiling).

For the purposes of ■ BIPRU 3.4.56 R or ■ BIPRU 3.4.58 R, where the residential property in question is situated in the territory of a third-country competent authority that is not listed as equivalent for credit risk in ■ BIPRU 8 Annex 3 R:

(1) a firm must not treat an exposure as fully and completely secured by the residential property in question unless the value of the property exceeds the exposures by a substantial margin, which must be at least 20%;

(2) the firm must apply a risk weight of 50% to the exposure.

For the purposes of ■ BIPRU 3.4.85 R (1) and in order to satisfy itself that an exposure is fully and completely secured by the relevant property, a firm should make its own assessment of the appropriate margin in each case, using its knowledge of the market in the relevant country and of its own portfolio.

If a firm has more than one exposure secured on the same property they should be aggregated and treated as if they were a single exposure secured on the property for the purposes of ■ BIPRU 3.4.56 R and ■ BIPRU 3.4.58 R and ■ BIPRU 3.4.81 R, ■ BIPRU 3.4.83 R and ■ BIPRU 3.4.84 R.

If an exposure is secured on property that is used in part for residential purposes in accordance with ■ BIPRU 3.4.56 R and partly for commercial purposes (such as a farm, public house, guest house or shop) it may be treated as secured by residential real estate if the firm can demonstrate that the property's main use is, or will be, residential and that the value of the property is not significantly affected by its commercial use.

Exposures secured by mortgages on commercial real estate

Exposures or any part of an exposure secured by mortgages on offices or other commercial premises which cannot properly be considered to fall within any other standardised credit risk exposure class or to qualify for a lower risk weight under ■ BIPRU 3 must be assigned a risk weight of 100%.

[Note: BCD Annex VI Part 1 point 51]

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

[Note: BCD Annex VI Part 1 point 52]

3.4.91 If a CRD implementation measure in another EEA State implements the discretion in point 51 of Part 1 of Annex VI of the Banking Consolidation Directive, a firm may apply the same treatment as that CRD implementation measure to exposures falling within the scope of that CRD implementation measure which are fully and completely secured by mortgages on offices or other commercial premises situated in that EEA State.

[Note: BCD Annex VI Part 1 points 51 and 57]

3.4.92 If a CRD implementation measure in another EEA State implements the discretion in point 53 of Part 1 of Annex VI of the Banking Consolidation Directive, a firm may apply the same treatment as that CRD implementation measure to exposures related to property leasing transactions concerning offices or other commercial premises situated in that EEA State and governed by statutory provisions whereby the lessor retains full ownership of the rented assets until the tenant exercises his option to purchase, as long as that exposure falls within the scope of that CRD implementation measure.

[Note: BCD Annex VI Part 1 points 53 and 57]

3.4.93 In particular, if a firm applies BIPRU 3.4.91 R or BIPRU 3.4.92 R, it must comply with the corresponding CRD implementation measures in relation to points 54-56 of Part 1 of Annex VI of the Banking Consolidation Directive.

[Note: BCD Annex VI Part 1 points 54 to 56]

3.4.94 (1) If a CRD implementation measure in another EEA State implements the discretion in point 58 of Part 1 of Annex VI of the Banking Consolidation Directive to dispense with the condition in point 54(b) for exposures fully and completely secured by mortgages on commercial property situated in that EEA State, a firm may apply the same treatment as that CRD implementation measure to exposures fully and completely secured by mortgages on commercial property situated in that EEA State falling within the scope of that CRD implementation measure.

(2) However a firm may not apply the treatment in (1) if the eligibility to use that treatment under the CRD implementation measure referred to in (1) ceases as contemplated under point 59 of Annex VI of the Banking Consolidation Directive (condition in point 54(b) must apply where conditions in point 58 are not satisfied).

[Note: BCD Annex VI Part 1 points 58, 59 and 60]

Past due items

BIPRU 3.4.96 R to BIPRU 3.4.101 R set out the treatment to be accorded to past due items.
Without prejudice to the provisions contained in BIPRU 3.4.97 R to BIPRU 3.4.101 R, the unsecured part of any item that is past due for more than 90 days (irrespective of the amount of that item or of the unsecured portion of that item) must be assigned a risk weight of:

1. 150% if value adjustments are less than 20% of the unsecured part of the exposure gross of value adjustments; and
2. 100% if value adjustments are no less than 20% of the unsecured part of the exposure gross of value adjustments.

[Note: BCD Annex VI Part 1 point 61]

For the purpose of defining the secured portion of the past due item, eligible collateral and guarantees must be those eligible for credit risk mitigation purposes under BIPRU 5.

[Note: BCD Annex VI Part 1 point 62]

For the purposes of BIPRU 3.4.97 R, the secured portion of a past due item is dealt with under BIPRU 5 (Credit risk mitigation). A firm may treat the secured portion of an exposure covered by a mortgage indemnity product that meets the relevant CRM eligibility criteria as secured for the purposes of BIPRU 3.4.97 R. The risk weight to be applied to the secured portion is determined under BIPRU 5.7.21 R to BIPRU 5.7.24 R. The risk weight of the unsecured portion is determined in accordance with BIPRU 3.4.96 R.

Exposures indicated in BIPRU 3.4.56 R to BIPRU 3.4.63 R (Exposures secured by mortgages on residential property) must be assigned a risk weight of 100% net of value adjustments if they are past due for more than 90 days. If value adjustments are no less than 20% of the exposure gross of value adjustments, the risk weight to be assigned to the remainder of the exposure is 50%.

[Note: BCD Annex VI Part 1 point 64]

The application of BIPRU 3.4.96 R and BIPRU 3.4.99 R may be illustrated on the basis of a £110,000 loan on a property valued at £100,000, where £80,000 of the loan is secured and £30,000 of the exposure is unsecured and provisions of £20,000 are taken:

1. Option 1 (application of BIPRU 3.4.96 R):
   a. provision of £20,000 taken on £80,000 secured exposure;
   b. provision exceeds 20%, so the firm should risk weight the remaining £60,000 secured exposure at 50%;
   c. the risk weight to be applied to the unsecured exposure of £30,000 is 150%;
   d. the average risk weight to be assigned to the net exposure of £90,000 is 83%.

2. Option 2 (application of BIPRU 3.4.99 R):
   a. provision of £20,000 taken on £30,000 unsecured exposure;
(b) provision exceeds 20%, so the firm should risk weight the remaining £10,000 unsecured exposure at 100%;

(c) the risk weight to be applied to the secured exposure of £80,000 is 100%;

(d) the average risk weight to be assigned to the net exposure of £90,000 is 100%.

Exposures indicated in BIPRU 3.4.89 R to BIPRU 3.4.94 R (Exposures secured by mortgages on commercial real estate) must be assigned a risk weight of 100% if they are past due for more than 90 days.

[Note: BCD Annex VI Part 1 point 65]

Non past due items to be assigned a 150% risk weight under BIPRU 3.4 and for which value adjustments have been established may be assigned a risk weight of:

(1) 100% if value adjustments are no less than 20% of the exposure value gross of value adjustments; and

(2) 50%, if value adjustments are no less than 50% of the exposure value gross of value adjustments.

[Note: BCD Annex VI Part 1 point 67]

Items belonging to regulatory high-risk categories

BIPRU 3.4.104 R sets out the treatment to be accorded to items belonging to regulatory high-risk categories.

Exposures listed in BIPRU 3 Annex 3 R must be assigned a risk weight of 150%.

[Note: BCD Annex VI Part 1 point 66]

For the purposes of point 66 of Part 1 of Annex VI of the Banking Consolidation Directive, the exposures listed in BIPRU 3 Annex 3 R are in the view of the appropriate regulator associated with particularly high risk.

Exposures in the form of covered bonds

BIPRU 3.4.107 R to BIPRU 3.4.110 R set out the treatment to be accorded to exposures in the form of covered bonds.

(1) Covered bonds means covered bonds as defined in paragraph (1) of the definition in the glossary (Definition based on Article 22(4) of the UCITS Directive) and collateralised by any of the following eligible assets:

(a) exposures to or guaranteed by central governments, central bank, public sector entities, regional governments and local authorities in the EEA;
(b) (i) exposures to or guaranteed by non-EEA central governments, non-EEA central banks, multilateral development banks, international organisations that qualify for the credit quality step 1;

(ii) exposures to or guaranteed by non-EEA public sector entities, non-EEA regional governments and non-EEA local authorities that are risk weighted as exposures to institutions or central governments and central banks according to BIPRU 3.4.23 R, BIPRU 3.4.24 R, BIPRU 3.4.10 R or BIPRU 3.4.16 G to BIPRU 3.4.17 R respectively and that qualify for the credit quality step 1; and

(iii) exposures in the sense of this point (b) that qualify as a minimum for the credit quality step 2, provided that they do not exceed 20% of the nominal amount of outstanding covered bonds of issuing institutions;

(c) exposures to institutions that qualify for the credit quality step 1 but so that:

(i) the total exposure of this kind must not exceed 15% of the nominal amount of the outstanding covered bonds of the issuing credit institution;

(ii) exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by real estate to the holders of covered bonds must not be comprised by the 15% limit; and

(iii) exposures to institutions in the EEA with a maturity not exceeding 100 days are not comprised by the step 1 requirement but those institutions must as a minimum qualify for credit quality step 2;

(d) loans secured:

(i) by residential real estate or shares in Finnish residential housing companies as referred to in BIPRU 3.4.57 R up to the lesser of the principal amount of the liens that are combined with any prior liens and 80% of the value of the pledged properties; or

(ii) by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of an EEA State securitising residential real estate exposures provided that the special public supervision to protect bond holders as provided for in Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council ensures that the assets underlying such units must, at any time while they are included in the cover pool, be at least 90% composed of residential mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 80% of the value of the pledged properties, that the units qualify for credit quality step 1 and that such units do not exceed 10% of the nominal amount of the outstanding issue; or

(e) (i) loans secured by commercial real estate or shares in Finnish housing companies as referred to in BIPRU 3.4.57 R up to the
lesser of the principal amount of the liens that are combined with any prior liens and 60% of the value of the pledged properties; or

(ii) loans secured by senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities governed by the laws of an EEA State securitising commercial real estate exposures provided that the special public supervision to protect bond holders as provided for in Article 52(4) of Directive 2009/65/EC of the European Parliament and of the Council ensures that the assets underlying such units must, at any time while they are included in the cover pool, be at least 90% composed of commercial mortgages that are combined with any prior liens up to the lesser of the principal amounts due under the units, the principal amounts of the liens, and 60% of the value of the pledged properties, that the units qualify for credit quality step 1 and that such units do not exceed 10% of the nominal amount of the outstanding issue; or

(iii) a firm may recognise loans secured by commercial real estate as eligible where the loan to value ratio of 60% is exceeded up to a maximum level of 70% if the value of the total assets pledged as collateral for the covered bonds exceed the nominal amount outstanding on the covered bond by at least 10%, and the bondholders' claim meets the legal certainty requirements set out in BIPRU 3 and BIPRU 5; the bondholders' claim must take priority over all other claims on the collateral; or

(f) loans secured by ships where only liens that are combined with any prior liens within 60% of the value of the pledged ship.

(2) For the purposes of BIPRU 3.4.107 R (1)(d)(ii) and BIPRU 3.4.107 R (1)(e)(ii) exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by pledged properties of the senior units or debt securities must not be comprised in calculating the 90% limit.

(3) For the purposes of BIPRU 3.4.107 R to BIPRU 3.4.110 R "collateralised" includes situations where the assets described in subpoints (1)(a) to (1)(f) are exclusively dedicated in law to the protection of the bond-holders against losses.

(4) [deleted]

(4A) Until 31 December 2013, the 10% limit for senior units issued by French Fonds Communs de Créances or by equivalent securitisation entities as specified in (1)(d)(ii) and (1)(e)(ii) does not apply, provided that:

(a) the securitised residential or commercial real estate exposures were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior units are made collateral for covered bonds); and

(b) a member of the same consolidated group of which the issuer of the covered bonds is also a member or an entity affiliated to the
BIPRU 3 : Standardised credit
risk

Section 3.4 : Risk weights under the
standardised approach to credit risk

---

3.4.108  
A firm must for real estate collateralising covered bonds meet the minimum requirements set out in BIPRU 3.4.64 R to BIPRU 3.4.73 R and the valuation rules set out in BIPRU 3.4.77 R to BIPRU 3.4.80 R.

[Note: BCD Annex VI Part 1 point 69]

3.4.109  
Notwithstanding BIPRU 3.4.107 R to BIPRU 3.4.108 R, covered bonds meeting the definition of Article 22(4) of the UCITS Directive and issued before 31 December 2007 are also eligible for the preferential treatment until their maturity.

[Note: BCD Annex VI Part 1 point 70]

3.4.110  
Covered bonds must be assigned a risk weight on the basis of the risk weight assigned to senior unsecured exposures to the credit institution which issues them. The following correspondence between risk weights applies:

(1) if the exposures to the institution are assigned a risk weight of 20%, the covered bond must be assigned a risk weight of 10%;

(2) if the exposures to the institution are assigned a risk weight of 50%, the covered bond must be assigned a risk weight of 20%;

(3) if the exposures to the institution are assigned a risk weight of 100%, the covered bond must be assigned a risk weight of 50%; and

(4) if the exposures to the institution are assigned a risk weight of 150%, the covered bond must be assigned a risk weight of 100%.

[Note: BCD Annex VI Part 1 point 71]

---

Items representing securitisation positions

3.4.111  
Risk weighted exposure amounts for securitisation positions must be determined in accordance with BIPRU 9.

[Note: BCD Annex VI Part 1 point 72]

---

Exposures to institutions and corporates with a short-term credit assessment

3.4.112  
Exposures to institutions where BIPRU 3.4.34 R to BIPRU 3.4.39 R apply, and exposures to corporates for which a short-term credit assessment by a nominated ECAI is available must be assigned a risk weight according to the
Table: Exposures to institutions where BIPRU 3.4.34 R to BIPRU 3.4.39 R apply, and exposures to corporates for which a short-term credit assessment by a nominated ECAI is available

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>150%</td>
<td>150%</td>
</tr>
</tbody>
</table>

Table: Exposures in the form of collective investment undertakings (CIUs)

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
<td>150%</td>
</tr>
</tbody>
</table>

Where a firm considers that a position in a CIU is associated with particularly high risks it must assign that position a risk weight of 150%.

A firm should consider a CIU as being high risk where there is no external credit assessment from an eligible ECAI and where the CIU has specific...
features (such as high levels of leverage or lack of transparency) that prevent it from meeting the eligibility criteria laid out in BIPRU 3.4.121 R.

3.4.120 G

Other examples of high risk CIUs are: one in which a substantial element of the CIU’s property is made up of items that would attract a risk weight of over 100%; or one whose mandate (as referred to in BIPRU 3.4.124 R) would permit it to invest in a substantial amount of such items.

3.4.121 R

Where BIPRU 3.4.116 R does not apply, a firm may determine the risk weight for a CIU as set out in BIPRU 3.4.123 R to BIPRU 3.4.125 R, if the following eligibility criteria are met:

(1) one of the following conditions is satisfied:
   (a) the CIU is managed by a company which is subject to supervision in an EEA State; or
   (b) the following conditions are satisfied:
      (i) the CIU is managed by a company which is subject to supervision that is equivalent to that laid down in EU law; and
      (ii) cooperation between competent authorities is sufficiently ensured; and

(2) the CIU’s prospectus or equivalent document includes:
   (a) the categories of assets in which the CIU is authorised to invest; and
   (b) if investment limits apply, the relative limits and the methodologies to calculate them; and

(3) the business of the CIU is reported on at least an annual basis to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period.

[Note: BCD Annex VI Part 1 point 77]

3.4.122 R

If another EEA competent authority approves a third country CIU as eligible under a CRD implementation measure with respect to point 77(a) of Part 1 of Annex VI of the Banking Consolidation Directive then a firm may make use of this recognition.

[Note: BCD Annex VI Part 1 point 78]

3.4.123 R

Where a firm is aware of the underlying exposures of a CIU, it may look through to those underlying exposures in order to calculate an average risk weight for the CIU in accordance with the standardised approach.

[Note: BCD Annex VI Part 1 point 79]

3.4.124 R

Where a firm is not aware of the underlying exposures of a CIU, it may calculate an average risk weight for the CIU in accordance with the standardised approach subject to the following rules: it will be assumed that the CIU first invests, to the maximum extent allowed under its mandate, in
the standardised credit risk exposure classes attracting the highest capital requirement, and then continues making investments in descending order until the maximum total investment limit is reached.

[Note: BCD Annex VI Part 1 point 80]

3.4.125 A firm may rely on a third party to calculate and report, in accordance with the methods set out in BIPRU 3.4.123 R to BIPRU 3.4.124 R, a risk weight for the CIU provided that the correctness of the calculation and report is adequately ensured.

[Note: BCD Annex VI Part 1 point 81]

Other items

3.4.126 BIPRU 3.4.127 R to BIPRU 3.4.133 R set out the treatment to be accorded to other items as referred to in BIPRU 3.2.9 R (16).

Treatment

3.4.127 Tangible assets within the meaning of Article 4(10) of the Bank Accounts Directive must be assigned a risk weight of 100%.

[Note: BCD Annex VI Part 1 point 82]

3.4.128 Prepayments and accrued income for which a firm is unable to determine the counterparty in accordance with the Bank Accounts Directive, must be assigned a risk weight of 100%.

[Note: BCD Annex VI Part 1 point 83]

3.4.129 Cash items in the process of collection must be assigned a 20% risk weight. Cash in hand and equivalent cash items must be assigned a 0% risk weight.

[Note: BCD Annex VI Part 1 point 84]

3.4.130 Holdings of equity and other participations except where deducted from capital resources must be assigned a risk weight of at least 100%.

[Note: BCD Annex VI Part 1 point 86]

3.4.131 Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities must be assigned a 0% risk weight.

[Note: BCD Annex VI Part 1 point 87]

3.4.132 In the case of asset sale and repurchase agreements and outright forward purchases, the risk weight must be that assigned to the assets in question and not to the counterparties to the transactions.

[Note: BCD Annex VI Part 1 point 88]

3.4.133 Where a firm provides credit protection for a number of exposures under terms that the nth default among the exposures triggers payment and that
this credit event terminates the contract, and where the product has an external credit assessment from an eligible ECAI the risk weights prescribed in BIPRU 9 must be assigned. If the product is not rated by an eligible ECAI, the risk weights of the exposures included in the basket must be aggregated, excluding n-1 exposures, up to a maximum of 1250% and multiplied by the nominal amount of the protection provided by the credit derivative to obtain the risk weighted asset amount. The n-1 exposures to be excluded from the aggregation must be determined on the basis that they include those exposures each of which produces a lower risk weighted exposure amount than the risk weighted exposure amount of any of the exposures included in the aggregation.

[Note: BCD Annex VI Part 1 point 89]

The exposure value for leases must be the discounted minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. an option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in BIPRU 5.7.1 R (Eligibility), regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in BIPRU 5.7.6 R (Minimum requirements: General) to BIPRU 5.7.12 R (Additional requirements for guarantees) must also be included in the minimum lease payments. These exposures must be assigned to the relevant exposure class in accordance with BIPRU 3.2.9 R, BIPRU 3.2.10 R, BIPRU 3.2.11 R, BIPRU 3.2.12 R, BIPRU 3.2.13 R and BIPRU 3.2.14 G. When the exposure is a residual value of leased properties, the risk weighted exposure amounts must be calculated as follows:

\[ \frac{1}{t} \times 100\% \times \text{exposure value}; \]

where \( t \) is the greater of 1 and the nearest number of whole years of the lease term remaining.

[Note: BCD Annex VI Part 1, point 90]
3.5 Simplified method of calculating risk weights

3.5.1 This section (■ BIPRU 3.5) sets out a simplified approach to calculating risk weights. This approach is only relevant to an exposure class for which risk weights are determined by the ratings of a nominated ECAI or an export credit agency. For other exposure classes a firm should use the normal approach under the standardised approach.

3.5.2 The approach in this section is only likely to be relevant for a limited licence firm or a limited activity firm that has only incidental credit exposures and for whom it would be prohibitively costly to establish the systems needed to include the credit assessments of ECAIs and export credit agencies in its regulatory capital calculations. However the approach may be used by other firms if appropriate. A firm should notify the appropriate regulator if it adopts the approach in this section.

3.5.3 Rather than risk weighting exposures individually, a firm eligible to apply the simplified approach should apply a single risk weight to all exposures in each exposure class. The simplified risk weight for exposures in a particular class will be the risk weighting for unrated entities for each exposure class in which the external credit assessments influence risk weights.

3.5.4 The table in ■ BIPRU 3.5.5 G has a summary of the risk weights that a firm should use if it uses the simplified method of calculating risk weights referred to in ■ BIPRU 3.5.1 G.

3.5.5 Table : Simplified method of calculating risk weights

This table belongs to ■ BIPRU 3.5.4 G.

<table>
<thead>
<tr>
<th>Exposure class</th>
<th>Exposure sub-class</th>
<th>Risk weights</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government</td>
<td>Exposures to United Kingdom government or Bank of England in sterling</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>
**Exposure sub-class** | **Risk weights** | **Comments**
--- | --- | ---
Exposures to *United Kingdom* government or Bank of England in the currency of another *EEA State* | 0% | See Note 2.
Exposures to *EEA State*’s central government or *central bank* in currency of that state | 0% | See Notes 2 and 3.
Exposures to *EEA State*’s central government or *central bank* in the currency of another *EEA State* | See next column | The *risk weight* is whatever it is under local law. See BIPRU 3.4.6 R for precise details.
Exposures to central governments or *central banks* of certain countries outside the *EEA* in currency of that country | 0% |  
Exposures to European Central Bank | 0% |  
Other exposures | 100% |  
Exposures to the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly in sterling | 0% | See Note 2.
Exposures to the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly in the currency of another *EEA State* | 0% |  
Exposures to *EEA States*’ equivalent regional/local governments in currency of that state | 0% | See BIPRU 3.4.17 R for details of type of local/regional government covered.

**Exposure class** | **Exposure sub-class** | **Risk weights** | **Comments**
--- | --- | --- | ---
Regional/local governments

*Note:* See **Note 2**.
### Exposure class

<table>
<thead>
<tr>
<th>Exposure sub-class</th>
<th>Risk weights</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exposures to EEA States’ equivalent regional/local governments in the currency of another EEA State</strong></td>
<td>0%</td>
<td>See BIPRU 3.4.17 R for details of type of local/regional government covered. See Notes 2 and 3.</td>
</tr>
<tr>
<td><strong>Exposures to local or regional governments of certain countries outside the EEA in currency of that country</strong></td>
<td>0%</td>
<td>See BIPRU 3.4.19 R for details of type of local/regional government covered. See Note 1.</td>
</tr>
<tr>
<td><strong>Exposures to United Kingdom or EEA States’ local/regional government in currency of that state if the exposure has original effective maturity of 3 months or less</strong></td>
<td>20%</td>
<td>See Note 2. See Note 3 for local/regional government of an EEA State other than the United Kingdom.</td>
</tr>
<tr>
<td><strong>Exposures to United Kingdom or EEA States’ local/regional government in the currency of another EEA State if the exposure has original effective maturity of 3 months or less</strong></td>
<td>20%</td>
<td>See Note 2. See Note 3 for local/regional government of an EEA State other than the United Kingdom.</td>
</tr>
<tr>
<td><strong>Exposures to local or regional governments of countries outside the EEA in currency of that country if the exposure has original effective maturity of 3 months or less</strong></td>
<td>20%</td>
<td>See Note 1.</td>
</tr>
<tr>
<td><strong>Other exposures</strong></td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>
### Exposure class

- **PSE**

#### Exposure subclass

- **Exposures to a PSE of the United Kingdom or of an EEA State if that PSE is guaranteed by its central government and if the exposure is in currency of that PSE's state.**

  **Risk weights:** 0%

  **Comments:** BIPRU 3.4.24 R describes the United Kingdom PSEs covered and BIPRU 3.4.25 R describes the EEA PSEs covered.

- **Exposures to PSE of a country outside the EEA if that PSE is guaranteed by the country's central government and if the exposure is in currency of that country.**

  **Risk weights:** 0%

  **Comments:** See BIPRU 3.4.26 R and Note 1.

- **Exposures to a PSE of the United Kingdom or of an EEA State in currency of that state if the exposure has original effective maturity of 3 months or less**

  **Risk weights:** 20%

- **Exposures to a PSE of the United Kingdom or of an EEA State in the currency of another EEA State if the exposure has original effective maturity of 3 months or less**

  **Risk weights:** 20%

  **Comments:** See Notes 2 and 3.

- **Exposures to PSE of a country outside the EEA in currency of that country if the exposure has original effective maturity of 3 months or less**

  **Risk weights:** 20%

  **Comments:** See Note 1.

- **Other exposures**

  **Risk weights:** 100%
<table>
<thead>
<tr>
<th>Exposure class</th>
<th>Exposure sub-class</th>
<th>Risk weights</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multilateral development banks</td>
<td>Exposures to multilateral development banks listed in paragraph (1) of the Glossary definition</td>
<td>0%</td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td></td>
<td>Other exposures</td>
<td>Various</td>
<td>Treated as an institution</td>
</tr>
<tr>
<td>EU, the International Monetary Fund and the Bank for International Settlements</td>
<td>Exposures to United Kingdom institution in sterling with original effective maturity of three months or less</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Exposures to United Kingdom institution in the currency of another EEA State with original effective maturity of three months or less</td>
<td>20%</td>
<td>See Note 2.</td>
</tr>
<tr>
<td></td>
<td>Exposures to institution whose head office is in another EEA State in the currency of that state with original effective maturity of three months or less</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Exposures to institution whose head office is in another EEA State in the currency of another EEA State with original effective maturity of three months or less</td>
<td>20%</td>
<td>See Notes 2 and 3.</td>
</tr>
</tbody>
</table>
### Exposure class

<table>
<thead>
<tr>
<th>Exposure class</th>
<th>Risk weights</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exposures to institution with a head office in a country outside the EEA in the currency of that country with original effective maturity of three months or less</td>
<td>20%</td>
<td>See Note 1.</td>
</tr>
<tr>
<td>Exposures to United Kingdom institution in sterling with original effective maturity of over three months</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Exposures to United Kingdom institution in the currency of another EEA State with original effective maturity of over three months</td>
<td>50%</td>
<td>See Note 2.</td>
</tr>
<tr>
<td>Exposures to an EEA institution with a head office in another EEA State in the currency of that state with original effective maturity of over three months</td>
<td>50%</td>
<td>See Notes 2 and 3.</td>
</tr>
<tr>
<td>Exposures to an EEA institution with a head office in another EEA State in the currency of another EEA State with original effective maturity of over three months</td>
<td>50%</td>
<td></td>
</tr>
</tbody>
</table>
### BIPRU 3 : Standardised credit risk

#### Section 3.5 : Simplified method of calculating risk weights

<table>
<thead>
<tr>
<th>Exposure class</th>
<th>Exposure subclass</th>
<th>Risk weights</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exposures to institution</strong></td>
<td>with a head office in a country outside the EEA in the currency of that country with original effective maturity of over three months</td>
<td>50%</td>
<td>See Note 1.</td>
</tr>
<tr>
<td><strong>Other exposures</strong></td>
<td></td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td><strong>Corporates</strong></td>
<td></td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td><strong>Retail exposures</strong></td>
<td></td>
<td>75%</td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td><strong>Mortgages on residential or commercial property</strong></td>
<td>Various</td>
<td></td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td><strong>Past due items</strong></td>
<td>Various</td>
<td></td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td><strong>High risk items</strong></td>
<td></td>
<td>150%</td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td><strong>Covered bonds</strong></td>
<td>Various</td>
<td></td>
<td>Risk weights are based on the risk weight of issuer as described in BIPRU 3.4.110 R. The risk weight of the issuer for this purpose should be calculated under the simplified approach.</td>
</tr>
<tr>
<td><strong>Securitisation exposures</strong></td>
<td>Generally 1250%. May look through to underlying exposures if BIPRU 9 allows.</td>
<td></td>
<td>Use the BIPRU 9 rules for unrated exposures under the standardised approach.</td>
</tr>
<tr>
<td><strong>Short term exposures with rating</strong></td>
<td></td>
<td></td>
<td>See BIPRU 3.4.112 R. Not applicable as uses ECAI ratings.</td>
</tr>
<tr>
<td>Exposure class</td>
<td>Exposure subclass</td>
<td>Risk weights</td>
<td>Comments</td>
</tr>
<tr>
<td>----------------</td>
<td>------------------</td>
<td>--------------</td>
<td>----------</td>
</tr>
<tr>
<td>CIUs</td>
<td>May look through to underlying under BIPRU 3.4.123 R</td>
<td>Various</td>
<td>Simplified approach does not apply. Normal rules apply. May use simplified approach to underlying if simplified approach applies to underlying.</td>
</tr>
<tr>
<td></td>
<td>May use average risk weight under BIPRU 3.4.124 R</td>
<td>Various</td>
<td>Simplified approach does not apply. Normal rules apply. May use simplified approach to underlyings if simplified approach applies to underlying.</td>
</tr>
<tr>
<td></td>
<td>High risk under BIPRU 3.4.118 R</td>
<td>150%</td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
<tr>
<td></td>
<td>Other items under BIPRU 3.2.9 R (16)</td>
<td>100%</td>
<td>Simplified approach does not apply. Normal rules apply.</td>
</tr>
</tbody>
</table>

Note 1: The risk weight should not be lower than the risk weight that applies for national currency exposures of the central government of the third country in question under BIPRU 3.5. That means that this risk weight only applies if the third country is one of those to which BIPRU 3.4.6 R (Preference risk weight for exposures of the central government of countries outside the EEA that apply equivalent prudential standards) applies.

Note 2: This is a transitional measure. It lasts until 31 December 2012.

Note 3: The risk weight should not be lower than the risk weight that applies for exposures of the central government of the EEA State in question in the currency of another EEA State under BIPRU 3.5.

3.5.6 G If an exposure is guaranteed and if under BIPRU 5 the firm may treat the exposure as being to the guarantor, the simplified approach may be used for the guarantor. The key provisions are BIPRU 5.7.23 R to BIPRU 5.7.25 R.

3.5.7 G If an exposure is collateralised and if under BIPRU 5 the firm may recognise the collateral, the simplified approach may be used to determine the risk weight to be applied to the collateralised exposure. The key provisions are BIPRU 5.4.18 R to BIPRU 5.4.21 R.

3.5.8 R If a firm does not nominate one or more eligible ECAIs as referred to in BIPRU 3.6.4 R the firm must not use the financial collateral comprehensive method.
3.6 Use of rating agencies’ credit assessments for the determination of risk weights under the standardised approach to credit risk

3.6.1 The use of ECAI credit assessments for the calculation of a firm’s risk weighted exposure amounts must be consistent and in accordance with BIPRU 3.6. Credit assessments must not be used selectively.

[Note: BCD Article 83(1)]

3.6.2 Where the appropriate regulator’s recognition of an ECAI is not limited to its solicited credit assessments, a firm may use an unsolicited credit assessment of an eligible ECAI for the calculation of a firm’s risk weighted exposure amounts.

[Note: BCD Article 83(2)]

3.6.3 The appropriate regulator’s recognition of an ECAI may be limited to its solicited credit assessments. Where this is the case a firm should not use unsolicited assessments. The appropriate regulator may indicate that the unsolicited ratings of an eligible ECAI are not to be used for the purposes of BIPRU 3 if those assessments are considered to be inferior in quality to the general quality of solicited assessments or if it considers that the ECAI’s strategy in relation to the issuing of unsolicited assessments is founded in the placing of undue pressure on the rated entity to pay for a rating.

Treatment

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

[Note: BCD Annex VI Part 3 point 1]

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

[Note: BCD Annex VI Part 3 point 2]
3.6.6 R A firm which decides to use the credit assessments produced by an eligible ECAI must use them in a continuous and consistent way over time.

[Note: BCD Annex VI Part 3 point 3]

3.6.7 R A firm can only use ECAIs' credit assessments that take into account all amounts both in principal and in interest owed to it.

[Note: BCD Annex VI Part 3 point 4]

3.6.8 R If only one credit assessment is available from a nominated ECAI for a rated item, that credit assessment must be used to determine the risk weight for that item.

[Note: BCD Annex VI Part 3 point 5]

3.6.9 R If two credit assessments are available from nominated ECAIs and the two correspond to different risk weights for a rated item, the higher risk weight must be applied.

[Note: BCD Annex VI Part 3 point 6]

3.6.10 R If more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest risk weights must be referred to. If the two lowest risk weights are different, the higher risk weight must be assigned. If the two lowest risk weights are the same, that risk weight must be assigned.

[Note: BCD Annex VI Part 3 point 7]

3.6.11 R (1) If a firm has decided to make use of the credit assessments of export credit agencies, when risk weighting exposures to central governments or central banks, if two or more credit assessments are available to a firm from export credit agencies or if credit assessments are available to a firm from both nominated ECAIs and export credit agencies, the firm must adopt the approach in this rule.

(2) If two credit assessments are available and correspond to different risk weights for a rated item, the higher risk weight must be applied.

(3) If more than two credit assessments are available for a rated item, the assessments generating the two lowest risk weights must be referred to:

(a) if the two lowest risk weights are the same, that risk weight must be applied; or

(b) if the two lowest risk weights are different, the higher of the two must be applied.

(4) If a firm does not for the purposes of BIPRU 3 make any use of the consensus risk scores referred to in BIPRU 3.4.7 R (1) it may treat those scores as not being available to it for the purpose of this rule. Likewise, if a firm does not for the purposes of BIPRU 3 make any use of the credit assessments of a particular export credit agency as
BIPRU 3 : Standardised credit risk

3.6.12 R Where a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure belongs, this credit assessment must be used to determine the risk weight to be assigned to that item.

[Note: BCD Annex VI Part 3 point 8]

3.6.13 R Where no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure does not belong or a general credit assessment exists for the issuer, then that credit assessment must be used if it produces a higher risk weight than would otherwise be the case or if it produces a lower risk weight and the exposure in question ranks pari passu or senior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer as relevant.

[Note: BCD Annex VI Part 3 point 9]

3.6.14 R ■ BIPRU 3.6.12 R and ■ BIPRU 3.6.13 R are not to prevent the application of ■ BIPRU 3.4.107 R to ■ BIPRU 3.4.110 R (Exposures in the form of covered bonds).

[Note: BCD Annex VI Part 3 point 10]

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

[Note: BCD Annex VI Part 3 point 11]

3.6.16 R Short-term credit assessments may only be used for short-term asset and off-balance sheet items constituting exposures to institutions and corporates.

[Note: BCD Annex VI Part 3 point 12]

3.6.17 R Any short-term credit assessment may only apply to the item the short-term credit assessment refers to, and it must not be used to derive risk weights for any other item.

[Note: BCD Annex VI Part 3 point 13]

3.6.18 R Notwithstanding ■ BIPRU 3.6.17 R, if a short-term rated facility is assigned a 150% risk weight, then all unrated unsecured exposures on that obligor whether short-term or long-term must also be assigned a 150% risk weight.

[Note: BCD Annex VI Part 3 point 14]
3.6.19  Notwithstanding BIPRU 3.6.17 R, if a short-term rated facility is assigned a 50% risk weight, no unrated short-term exposure may be assigned a risk weight lower than 100%.

[Note: BCD Annex VI Part 3 point 15]

3.6.20  A credit assessment that refers to an item denominated in the obligor’s domestic currency cannot be used to derive a risk weight for another exposure on that same obligor that is denominated in a foreign currency.

[Note: BCD Annex VI Part 3 point 16]

3.6.21  Notwithstanding BIPRU 3.6.20 R, when an exposure arises through a firm’s participation in a loan that has been extended by a multilateral development bank whose preferred creditor status is recognised in the market, the credit assessment on the obligors’ domestic currency item may be used for risk weighting purposes.

[Note: BCD Annex VI Part 3 point 17]
3.7 Classification of off-balance-sheet items

3.7.1 In accordance with BIPRU 3.2.1 R (2) and BIPRU 3.2.2 R, a firm must:

(1) assign an off-balance sheet item listed in the table in BIPRU 3.7.2 R to the risk category indicated in column 1 of that table; and

(2) determine the exposure value of that item as the percentage of its value for the appropriate risk category as set out in column 3 of the table in BIPRU 3.7.2 R.

Table: Classification of off-balance-sheet items

<table>
<thead>
<tr>
<th>Category</th>
<th>Item</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full risk</td>
<td>Guarantees having the character of credit substitutes</td>
</tr>
<tr>
<td></td>
<td>Credit derivatives</td>
</tr>
<tr>
<td></td>
<td>Acceptances</td>
</tr>
<tr>
<td></td>
<td>Endorsements on bills not bearing the name of another credit institution</td>
</tr>
<tr>
<td></td>
<td>Transactions with recourse</td>
</tr>
<tr>
<td></td>
<td>Irrevocable standby letters of credit having the character of credit substitutes</td>
</tr>
<tr>
<td></td>
<td>Assets purchased under outright forward purchase agreements</td>
</tr>
<tr>
<td></td>
<td>Forward deposits</td>
</tr>
<tr>
<td></td>
<td>The unpaid portion of partly-paid shares and securities</td>
</tr>
<tr>
<td></td>
<td>Asset sale and repurchase agreements as defined in Article 12(3) and (5) of the Bank Accounts Directive</td>
</tr>
<tr>
<td></td>
<td>Other items also carrying full risk</td>
</tr>
<tr>
<td>Medium risk</td>
<td>Documentary credits issued and confirmed (see also medium/low risk).</td>
</tr>
<tr>
<td></td>
<td>Warranties and indemnities (including tender, performance, customs and tax)</td>
</tr>
<tr>
<td>Category</td>
<td>Item</td>
</tr>
<tr>
<td>---------------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>bonds) and guarantees not having the character of credit substitutes.</td>
</tr>
<tr>
<td></td>
<td>Irrevocable standby letters of credit not having the character of credit substitutes.</td>
</tr>
<tr>
<td></td>
<td>Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year.</td>
</tr>
<tr>
<td></td>
<td>Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).</td>
</tr>
<tr>
<td>Medium/low risk</td>
<td>Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions.</td>
</tr>
<tr>
<td></td>
<td>Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year which may not be cancelled unconditionally at any time without notice or that do not effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness.</td>
</tr>
<tr>
<td>Low risk</td>
<td>Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) which may be cancelled unconditionally at any time without notice, or that do effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness. Retail credit lines may be considered as unconditionally cancellable if the terms permit the firm to cancel them to the full extent allowable under consumer protection and related legislation.</td>
</tr>
</tbody>
</table>
Guidance on the standardised approach zero risk weighting for intra-group exposures

This flow chart belongs to BIPRU 3.2.25 R - BIPRU 3.2.35 R.

**Flowchart - zero risk weighting for intra-group exposures**

- **Is the firm a solo consolidated subsidiary?**
  - Yes: The exposure is eliminated on solo consolidation.
  - No: Exposures of the subsidiary, other than to its parent are treated as if they were exposures to the firm.

- **Does the exposure constitute either own funds in the counterparty or is lending of a capital nature?**
  - Yes: The exposure is deducted from the own funds of the firm.
  - No: Further checking required.

- **Has the firm a waiver to adopt the IRB approach?**
  - Yes: Does the IRB waiver include the permanent exemption of exposures from the IRB approach?
    - Yes: The exposures are risk weighted following the IRB methodology (EIPRU 4).
    - No: Further checking required.
  - No: Does the exposure meet the firm’s policy for exempting exposures from the IRB framework (EIPRU 4.2.220A) and (EIPRU 4.2.240)?
    - Yes: The exposures are risk weighted following the IRB methodology (EIPRU 4).
    - No: Further checking required.
Regional governments and local authorities eligible for the treatment in BIPRU 3.4.15R

<table>
<thead>
<tr>
<th></th>
<th>The Scottish Parliament</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td>National Assembly for Wales</td>
</tr>
<tr>
<td>(3)</td>
<td>Northern Ireland Assembly</td>
</tr>
</tbody>
</table>
High risk exposures

(1) Exposures arising out of venture capital business (whether or not the firm itself carries on the venture capital business).

(2) Any exposure of the type referred to in BIPRU 3.4.118 R (High risk position in a CIU) that is illiquid and held with a view to long-term sale or realisation.
Exposures to institutions: Interaction with short-term credit assessments in BIPRU 3.4.40R

<table>
<thead>
<tr>
<th>Unsecured component risk weighed at 75%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secured component risk weighed at 35%</td>
</tr>
</tbody>
</table>

**Example**

- £100,000 loan secured on property valued at £120,000
- First £80,000 (66.6% LTV) risk weighted at 35%
- Remaining £20,000 risk weighted at 75% if meets retail criteria counts to retail aggregation calculation
- Overall risk weight = 43%
Chapter 4

The IRB approach
4.1 The IRB approach: Application, purpose and overview

Application

4.1.1 BIPRU 4 applies to a BIPRU firm with an IRB permission.

Purpose

4.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, BIPRU 4 implements the following provisions of the Banking Consolidation Directive:

1. Articles 84 - 89; and
2. Annex VII.

4.1.3 Pursuant to the third paragraph of article 95(2) of the EU CRR, BIPRU 4 also implements Annex VIII of the Banking Consolidation Directive so far as it applies to the IRB approach. In particular, it implements (in part):

1. from Part 1 of that Annex, points 12-16, 19-22, 26(g)(ii) and 27;
2. from Part 2 of that Annex, points 8-11; and
3. from Part 3 of that Annex, points 1, 11, 20, 23-24, 58(h), 61, 64-79 and 90-93.

4.1.4 Similarly, BIPRU 4 also implements article 40 of the Capital Adequacy Directive as it applies to the IRB approach.

4.1.5 Other material on the IRB approach can be found in BIPRU 8 (Group risk), BIPRU 9 (Securitisation), BIPRU 13 (The calculation of exposure values for financial derivatives, securities financing transactions and long settlement transactions) and BIPRU 14 (Capital requirements for settlement and counterparty risk). BIPRU 5 (Credit risk mitigation) also contains material applicable to the IRB approach.

Overview

4.1.6 The IRB approach is an alternative to the standardised approach for calculating a firm’s credit risk capital requirements. It may be applied to all a firm’s exposures or to some of them, subject to various limitations on partial use as set out in BIPRU 4.2. Under the IRB approach capital requirements are
based on a firm’s own estimates of certain parameters together with other parameters set out in the Banking Consolidation Directive.

4.1.7 Exposures are divided into a number of distinct exposure classes. These are listed in BIPRU 4.3.2 R. There is a special treatment for purchased receivables, although they do not form an exposure class on their own.

4.1.8 For exposures in the sovereign, institution and corporate IRB exposure class, there is a foundation IRB approach under which a firm provides its own estimates of PD and an advanced IRB approach under which a firm additionally provides its own estimates of LGD and conversion factors. The distinction between the foundation IRB approach and the advanced IRB approach only applies to this IRB exposure class.

4.1.9 For retail exposures, a firm provides its own estimates of PD, LGD and conversion factors.

4.1.10 For the corporate exposure class there is a separate sub-class of specialised lending exposure. A firm may calculate risk weights for these exposures, where it is able to do so, in the same way as it does for the rest of its corporate exposure class, i.e. using the foundation IRB approach or the advanced IRB approach. Where a firm is not able to use this approach it may calculate risk weights for specialised lending exposures by slotting them into predetermined risk weights.

4.1.11 For equity exposures there are two approaches based on market based measures and a third under which a firm uses its own estimates of PD only.

IRB permissions: general

4.1.12 The rules in GENPRU and BIPRU do not allow a firm to use the IRB approach. A firm that wishes to use the IRB approach should therefore apply for permission to use the IRB approach using the application procedure explained in BIPRU 1.3. If a firm’s application is granted, its terms will be set out in an IRB permission.

4.1.13 The appropriate regulator recognises that the nature of IRB approaches will vary between firms. The scope of and the requirements and conditions set out in an IRB permission may therefore differ in substance or detail from BIPRU 4 in order to address individual circumstances adequately. However any differences will only be allowed if they are compliant with the Banking Consolidation Directive. An IRB permission will implement any such variation by modifying the relevant provisions of GENPRU and BIPRU. An IRB permission may also include additional conditions to meet the particular circumstances of the firm.

4.1.14 (1) The appropriate regulator will only grant an IRB permission if it is satisfied that the firm’s systems for the management and rating of credit risk exposures are sound and implemented with integrity and,
in particular, that they meet the standards in BIPRU 4.2.2 R in accordance with the minimum IRB standards.

(2) Under BIPRU 4.2.11 R, a firm applying for an IRB permission is required to demonstrate that it has been using for the IRB exposure classes in question rating systems that were broadly in line with the minimum IRB standards for internal risk measurement and management purposes for at least three years prior to the date of its IRB permission.

(3) Under BIPRU 4.2.13 R, a firm applying for the use of own estimates of LGDs and/or conversion factors should demonstrate that it has been estimating and employing own estimates of LGDs and/or conversion factors in a manner that was broadly consistent with the minimum IRB standards for use of own estimates for at least three years prior to the date of its IRB permission or of a variation of its IRB permission that, in either case, entitles the firm to use own estimates of LGDs and/or conversion factors.

Link to standard rules: Incorporation of the IRB output into the capital calculation

4.1.15 G An IRB permission will modify GENPRU 2.1.51 R (Calculation of the credit risk capital requirement) by amending, to the extent set out in the IRB permission, the calculation of the credit risk capital requirement in accordance with BIPRU 4 and the other provisions of the Handbook relating to the IRB approach.

4.1.16 R A firm must calculate its credit risk capital component as the sum of:

(1) (for exposures to which the standardised approach is applied) the credit risk capital component as calculated under BIPRU 3.1.5 R; and

(2) (for exposures to which the IRB approach is applied to which the standardised approach would otherwise apply in accordance with BIPRU 3.1.5 R (Credit risk capital component)), 8% of the total of the firm’s risk weighted exposure amounts calculated in accordance with the IRB approach.

4.1.17 G For exposures covered by an IRB permission, BIPRU 5 (Credit risk mitigation) is modified by BIPRU 4.10.

4.1.18 G Under BIPRU 4.9, a firm is required to deal with securitisation positions under those provisions of BIPRU 9 applicable to a firm using the IRB approach.

4.1.19 G Exposures treated under BIPRU 13 are required to be dealt with in accordance with the IRB approach to the extent set out in BIPRU 13.

4.1.20 G By modifying GENPRU 2.1.51 R to allow the firm to use the IRB approach to calculate all or part of its risk weighted exposure amounts, the appropriate regulator is treating it like an application rule. The modification means that
the provisions of BIPRU relating to the IRB approach supersede the rules relating to the standardised approach for exposures coming within the scope of the IRB permission.

4.1.21 R  A reference in the Handbook to a provision of the IRB approach, in the case of a firm:

(1) excludes any provision of the IRB approach set out in the Handbook that is not applied to that firm by its IRB permission;

(2) includes any additional provision contained in the firm’s IRB permission; and

(3) takes into account any other amendments made to the provisions in the Handbook relating to the IRB approach made by the firm’s IRB permission.

4.1.22 R  To the extent that a firm’s IRB permission does not allow it to use a particular approach in the Handbook relating to the IRB approach the Handbook provision in question does not apply to the firm.

4.1.23 R  If a provision of the Handbook relating to the IRB approach says that a firm may do something if its IRB permission allows it, a firm may do that thing unless its IRB permission expressly says that it may not do so except that:

(1) BIPRU 4.2.18 R - BIPRU 4.2.19 R (Sequential implementation of IRB approach) and BIPRU 4.2.26 R (1)-BIPRU 4.2.26R (5) (Combined use of standardised approach with IRB approach) only apply if expressly permitted by a firm’s IRB permission;

(2) a firm may not use the advanced IRB approach for the sovereign, institution and corporate IRB exposure class except to the extent expressly permitted by the firm’s IRB permission;

(3) if a firm uses its own estimates of LGD and conversion factors it may only take into account unfunded credit protection to reduce LGD in the manner set out in its IRB permission;

(4) if a firm uses its own estimates of LGD and conversion factors it may only recognise the effects of financial collateral in the manner set out in its IRB permission;

(5) a firm must deal with equity exposures in the manner set out in its IRB permission; and

(6) (in the case of collateral that is only eligible for recognition under paragraph 21 of Part 1 of Annex VIII of the Banking Consolidation Directive (Other physical collateral)) a firm may not recognise as eligible collateral an item of a type referred to in BIPRU 4.10.16 R (Other physical collateral) unless that item is of a type specified as permitted in its IRB permission.

4.1.24 G  An IRB permission will set out firm-specific material. This will generally include:
(1) details about the firm’s methodology for carrying out the IRB approach, including the models and rating systems that a firm should use;

(2) reporting requirements; and

(3) requirements about internal control structure.

Compliance

4.1.25 If a firm ceases to comply with the requirements of the IRB approach, it must either present to the appropriate regulator a plan for a timely return to compliance or demonstrate that the effect of non-compliance is immaterial.

[Note: BCD Article 84(5)]

4.1.26 If a firm ceases to comply with the requirements of the IRB approach, the appropriate regulator may revoke the IRB permission or take other appropriate supervisory action.

4.1.27 For the purposes of BIPRU 4.1.25 R, the appropriate regulator will expect a firm to demonstrate that, taking into account all instances where the firm has not complied with the requirements of the IRB approach, the effect of non-compliance is immaterial.
4.2 The IRB approach: High level material

Application

4.2.1 This section applies to all exposures treated under the IRB approach.

General approach to granting an IRB permission

4.2.2 A firm's systems for the management and rating of credit risk exposures must be sound and implemented with integrity and, in particular, they must meet the following standards in accordance with the minimum IRB standards:

1. the firm's rating systems provide for a meaningful assessment of obligor and transaction characteristics, a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk;

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

3. the firm has a credit risk control unit responsible for its rating systems that is appropriately independent and free from undue influence;

4. the firm collects and stores all relevant data to provide effective support to its credit risk measurement and management process; and

5. the firm documents its rating systems, the rationale for their design and validates its rating systems.

[Note: BCD Article 84(2) (part)]

4.2.3 Where an EEA parent institution and its subsidiary undertakings or an EEA parent financial holding company and its subsidiary undertakings or an EEA parent mixed financial holding company and its subsidiary undertakings use the IRB approach on a unified basis, the question whether the minimum IRB standards are met is answered by considering the parent undertaking and its subsidiary undertakings together, unless the firm's IRB permission specifies otherwise.

[Note: BCD Article 84(2) (part)]
Outsourcing

4.2.4 (1) This guidance sets out the basis on which a firm may rely upon a rating system or data provided by another member of its group.

(2) A firm may rely upon a rating system or data provided by another member of its group if the following conditions are satisfied:

(a) the firm only does so to the extent that it is appropriate, given the nature and scale of the firm’s business and portfolios and the firm’s position within the group;

(b) the group is an EEA banking and investment group;

(c) the integrity of the firm’s systems and controls is not adversely affected;

(d) the outsourcing of these functions meets the requirements of SYSC; and

(e) (if the provision of the rating system or data is not carried out in the United Kingdom or in the jurisdiction of the competent authority that is the lead regulator of the group) the firm can demonstrate to the appropriate regulator that the ability of the appropriate regulator and that lead regulator to carry out their responsibilities under the Handbook, the Banking Consolidation Directive and the Capital Adequacy Directive are not adversely affected.

(3) If a firm does use a rating system or data provided by another member of its group, the requirements in BIPRU 4 continue to apply to that firm in respect of that rating system and data. A firm cannot absolve itself of the responsibility for complying with those requirements by claiming that any breach is caused by the actions of a third party to which the firm has delegated tasks. The rating system and data provision are still those of the firm, even though personnel elsewhere in the firm’s group are carrying out these functions on its behalf. So any references in BIPRU to what a firm, its personnel and its management should and should not do still apply.

(4) If a firm does use a rating system or data provided by another group member, the firm’s governing body should formally delegate those functions to the persons or bodies that are to carry them out.

(5) Before delegating the provision of a rating system or data to another group member, the firm’s governing body should have explicitly considered the arrangement and decided that it is appropriate and that it enables the firm to meet the conditions in (2).

Assessment and estimation

4.2.5 (1) This paragraph provides guidance on BIPRU 4.2.2 R and in particular BIPRU 4.2.2 R (1).

(2) The information that a firm produces or uses for the purpose of the IRB approach should be reliable and take proper account of the different users of the information produced (customers, shareholders, regulators and other market participants).
(3) A firm should establish quantified and documented targets and standards, against which it should test the accuracy of data used in its rating systems.

(4) Tests under (3) might include:
   (a) report and accounts reconciliation, including completeness in relation to (b);
   (b) whether every exposure has a PD, LGD and, if applicable, conversion factor for reporting purposes;
   (c) whether the firm’s risk control environment has key risk indicators for the purpose of monitoring and ensuring data accuracy;
   (d) whether the firm has an adequate business and information technology infrastructure with fully documented processes;
   (e) whether the firm has clear and documented standards on ownership of data (including inputs and manipulation) and timeliness of current data (daily, monthly, real time); and
   (f) whether the firm has a comprehensive quantitative audit programme.

(5) The reconciliation referred to in 4(a) should be reasonably fit for purpose. In particular it should meet the standards in (6) and (7).

(6) For data inputs, testing for accuracy of data, including the reconciliation referred to in 4(a), should be sufficiently detailed so that, together with other available evidence, it gives reasonable assurance that data input into the rating system is accurate, complete and appropriate. Input data fails the required standard if it gives rise to a serious risk of material misstatement in the capital requirement either immediately or subsequently.

(7) For data outputs, the firm, as part of the reconciliation referred to in 4(a), should be able to identify and explain material differences between the outputs produced under accounting standards and those produced under the requirements of the IRB approach, including in relation to areas that address similar concepts in different ways (for example expected loss on the one hand and accounting provisions on the other).

(8) A firm should have clear and documented standards and policies about the use of data in practice (including information technology standards) which should in particular cover the firm’s approach to the following:
   (a) data access and security;
   (b) data integrity, including the accuracy, completeness, appropriateness and testing of data; and
   (c) data availability.

Further requirements concerning the use test

If a firm uses separate models for the purpose of the IRB approach and for its internal purposes as referred to in BIPRU 4.2.2 R (2) it must be able to demonstrate the reasonableness of any differences between those models.
4.2.7

(1) This paragraph provides guidance on §BIPRU 4.2.2 R and in particular §BIPRU 4.2.2 R (2).

(2) The IRB approach as applicable to a firm should be an integral part of its business and risk management processes and procedures to the extent that credit risk is relevant to them. It should also have a substantial influence on its decision-making and actions.

(a) particular regard should be had to the use of the IRB approach in:

(i) credit approval;
(ii) individual and portfolio limit setting;
(iii) reporting of credit risk information; and
(iv) provisioning;

(b) other relevant aspects include:

(i) assessment of economic capital;
(ii) internal capital allocation so far as related to credit risk;
(iii) risk appetite;
(iv) strategy and acquisitions;
(v) profitability and performance; and
(vi) performance-related remuneration;

(c) the carrying out of the firm’s obligations under the overall Pillar 2 rule; and

(d) matters relating to the firm’s infrastructure, including information technology, skills and resources and organisational culture.

4.2.8

This paragraph provides further guidance on §BIPRU 4.2.2 R and in particular §BIPRU 4.2.2 R (2). In the appropriate regulator’s view risk management has an essential role in informing risk decisions. However, an essential role does not necessarily mean an exclusive role or even always a primary role. There may be justifiable differences between the IRB approach and the firm’s use of rating systems for its internal purposes as referred to in §BIPRU 4.2.2 R (2).

For example, internal standards and policies may refer to estimates of PD and LGD for the length of the asset rather than to estimates based on a one-year period (in the case of PD estimates) or on an economic downturn (in the case of LGD estimates) required by the IRB approach.

4.2.9

If a firm uses scorecards for its internal credit approval process and the models it uses for the purpose of the IRB approach are fundamentally different from those scorecards, a firm’s demonstration of how this is compatible with §BIPRU 4.2.2 R (2) might include demonstrating that estimates calculated under the IRB approach are used to change sanctioning decisions at an individual or portfolio level. Examples of this might include amending cut-offs, the application of policy rules, the revision of an existing scorecard or the introduction of a new one or taking strategic decisions on which segments of the market to target.
To the extent that a firm uses LGD estimates in its internal risk management processes that differ from the downturn LGDs used in the calculation of risk weighted assets (see BIPRU 4.3.103 R), the reasons for the difference should be documented in accordance with BIPRU 4.3.109 R.

Requirements concerning the experience requirement

A firm must be able to demonstrate that it has been using for the IRB exposure classes in question rating systems that were broadly in line with the minimum IRB standards for internal risk measurement and management purposes for at least three years prior to the date of its IRB permission.

[Note: BCD Article 84(3)]

In meeting the experience requirement under BIPRU 4.2.11 R, the appropriate regulator would expect a firm to be able to demonstrate that it has been:

1. operating an internal rating system with estimates of PD;
2. meeting the standards in BIPRU 4 for senior management knowledge and reporting; and
3. meeting the standards in BIPRU 4 relating to the use of rating systems in its business;

for the required minimum 3 year period.

A firm that has applied for the use of own estimates of LGDs and/or conversion factors must be able to demonstrate to the appropriate regulator that it has been estimating and employing own estimates of LGDs and/or conversion factors in a manner that was broadly consistent with the minimum IRB standards for use of own estimates of those parameters for at least three years prior to the date of its IRB permission or of a variation of its IRB permission that, in either case, entitled the firm to use own estimates of LGDs and/or conversion factors.

[Note: BCD Article 84(4)]

In meeting the experience requirement under BIPRU 4.2.13 R, the appropriate regulator would expect a firm to be able to demonstrate that it has been:

1. operating an internal rating system with estimates of LGD and with conversion factors; and
2. compliant with BIPRU 4.2.11 R as applied to the advanced IRB approach.

for the required minimum 3 year period.

In the appropriate regulator’s view the standard required by BIPRU 4.2.11 R and BIPRU 4.2.13 R is for a rating system to be improved in the light of experience during the three year period so that it meets the minimum
implementation more fully for the last year than for the two prior years, provided that the rating system has not changed so profoundly that experience from the first or second years becomes of marginal relevance in assessing the reliability of the changed rating system.

Implementation of the internal ratings based approach

4.2.16 R A firm must comply with any requirements in its IRB permission relating to the matters described in BIPRU 4.2.17 R - BIPRU 4.2.35 G.

4.2.17 R Without prejudice to BIPRU 4.2.26 R, a firm and any parent undertaking and its subsidiary undertakings must implement the IRB approach for all exposures.

[Note: BCD Article 85(1) (part)]

4.2.18 R To the extent that a firm’s IRB permission permits this, implementation may be carried out sequentially across the different IRB exposure classes within the same business unit, across different business units in the same group or for the use of own estimates of LGDs or conversion factors for the calculation of risk weights for the sovereign, institution and corporate IRB exposure class.

[Note: BCD Article 85(1) (part)]

4.2.19 R In the case of the retail exposures, implementation may (but only to the extent provided for in the firm’s IRB permission) be carried out sequentially across the categories of exposures to which the different correlations in BIPRU 4.6.41 R - BIPRU 4.6.44 R correspond.

[Note: BCD Article 85(1) (part)]

4.2.20 R (1) Implementation of the IRB approach as referred to in BIPRU 4.2.18 R must be carried out within a reasonable period of time as set out in the IRB permission.

(2) The implementation must be carried out subject to strict conditions determined by the appropriate regulator and set out in the IRB permission.

(3) A firm must not use the flexibility under BIPRU 4.2.18 R selectively with the purpose of achieving reduced minimum capital requirements in respect of those IRB exposure classes or business units that are yet to be included in the IRB approach or in the use of own estimates of LGDs and conversion factors.

[Note: BCD Article 85(2)]

4.2.21 G (1) A firm should achieve full roll-out of the IRB approach to all its exposures, subject to the exemptions outlined in BIPRU 4.2.26 R, within the period specified in its IRB permission. A firm should not retain a permanent mix of portfolios on the standardised approach and the IRB approach, on the foundation IRB approach and the
advanced IRB approach or on a mixture of all approaches with the exception of portfolios covered by those exemptions.

(2) This applies to a move:
(a) from the standardised approach to the IRB approach;
(b) from the foundation IRB approach to the advanced IRB approach; and
(c) from the transitional rules and guidance for BIPRU to the IRB approach.

(3) The period referred to in BIPRU 4.2.20 R (1) will generally be not more than three years of starting use of the IRB approach or the advanced IRB approach as applicable.

A firm using the IRB approach for any IRB exposure class must at the same time use the IRB approach for the equity exposure class.

[Note: BCD Article 85(3)]

Subject to BIPRU 4.2.17 R - BIPRU 4.2.20 R, BIPRU 4.2.22 R and BIPRU 4.2.26 R, a firm that has an IRB permission must not use the standardised approach for the calculation of risk weighted exposure amounts for the exposures to which the IRB approach applies under the IRB permission.

[Note: BCD Article 85(4)]

Subject to BIPRU 4.2.17 R - BIPRU 4.2.22 R and BIPRU 4.2.26 R, a firm whose IRB permission provides for the use of the advanced IRB approach for the calculation of LGDs and conversion factors for the sovereign, institution and corporate IRB exposure class must not use the LGD values and conversion factors applicable to the foundation IRB approach for the exposures to which the advanced IRB approach applies under the IRB permission.

[Note: BCD Article 85(5)]

The appropriate regulator will not agree to a firm’s request to revoke or vary its IRB permission so as to permit the firm to revert to the standardised approach except for demonstrated good cause. Likewise, the appropriate regulator will not agree to a firm’s request to revoke or vary its IRB permission so as to permit the firm to revert to the foundation IRB approach if the IRB permission provides for it to use the advanced IRB approach, except for demonstrated good cause.

Combined use of methodologies: Basic provisions

(1) To the extent that its IRB permission permits this, a firm permitted to use the IRB approach in the calculation of risk weighted exposure amounts and expected loss amounts for one or more IRB exposure classes may apply the standardised approach in accordance with this rule.
(2) A firm may apply the standardised approach to the IRB exposure class referred to in BIPRU 4.3.2 R (1) (Sovereigns) where the number of material counterparties is limited and it would be unduly burdensome for the firm to implement a rating system for these counterparties. A firm may include in this treatment an exposure of the type described in BIPRU 3.4.18 R (Exposures to churches or religious communities) that would fall within BIPRU 3.4.15 R or BIPRU 3.4.17 R (Exposure to a regional government or local authority) if those provisions had not been excluded by BIPRU 3.4.18 R.

(3) A firm may apply the standardised approach to the IRB exposure class referred to in BIPRU 4.3.2 R (2) (Institutions), where the number of material counterparties is limited and it would be unduly burdensome for the firm to implement a rating system for these counterparties.

(4) A firm may apply the standardised approach to exposures in non-significant business units as well as IRB exposure classes that are immaterial in terms of size and perceived risk profile.

(5) A firm may apply the standardised approach to exposures to the central governments of EEA States and their regional governments, local authorities and administrative bodies, provided that:
   
   (a) there is no difference in risk between the exposures to the central government and those other exposures because of specific public arrangements; and
   
   (b) exposures to the central government are assigned a 0% risk weight under the standardised approach.

(6) A firm may apply the standardised approach to exposures of a firm to a counterparty which is its parent undertaking, its subsidiary undertaking or a subsidiary undertaking of its parent undertaking provided that the counterparty is an institution, a financial holding company, a mixed financial holding company, a financial institution, an asset management company or an ancillary services undertaking subject to appropriate prudential requirements.

(7) A firm may apply the standardised approach to equity exposures to entities whose credit obligations qualify for a 0% risk weight under the standardised approach (including those publicly sponsored entities where a zero risk weight can be applied).

(8) A firm may apply the standardised approach to equity exposures incurred under legislative programmes to promote specified sectors of the economy that provide significant subsidies for the investment to the firm and involve some form of government oversight and restrictions on the equity investments. This exclusion is limited to an aggregate of 10% of capital resources.

(9) A firm may apply the standardised approach to the exposures identified in BIPRU 3.4.48 R (Exposures in the form of minimum reserves required by the European Central Bank or by the central bank of an EEA State) meeting the conditions specified therein.
(10) A firm may apply the standardised approach to state and state-reinsured guarantees pursuant to BIPRU 5.7.12 R (Conditions for state and state-reinsured guarantees).

[Note: BCD Article 89(1)]

Combined use of methodologies: Documentation

As part of the application for an IRB permission, a firm should have a well documented policy explaining the basis on which exposures are to be selected for permanent exemption from the IRB approach and for treatment under the standardised approach. The firm’s roll out plan should also contain provisions for the continuing application of that policy on a consistent basis over time.

Combined use of methodologies: Sovereign and institutional, exposures

A firm intending to make use of BIPRU 4.2.26 R (2) or BIPRU 4.2.26 R (3) should demonstrate to the appropriate regulator when applying for an IRB permission that it meets the requirements of those provisions with respect to its sovereign or, as the case may be, institutional, exposures.

Combined use of methodologies: Meaning of non-significance and immateriality

For the purposes of BIPRU 4.2.26 R (4), the equity exposure IRB exposure class of a firm must be considered material if its aggregate value, excluding equity exposures incurred under legislative programmes as referred to in BIPRU 4.2.26 R (8) but including exposures in a CIU treated as equity exposures in accordance with BIPRU 4.9.11 R to BIPRU 4.9.15 R, exceeds, on average over the preceding year, 10% of the firm’s capital resources. If the number of those equity exposures is less than 10 individual holdings, that threshold is 5% of the firm’s capital resources.

[Note: BCD Article 89(2)]

(1) This rule sets out what must be treated as being non-significant business or immaterial for the purposes of BIPRU 4.2.26 R (4), for exposures that do not fall within the equity exposure IRB exposure class.

(2) A firm may elect permanently to exclude exposures from the IRB approach and apply the standardised approach. However a firm may only make use of this exemption to the extent that:

(a) the consolidated credit risk requirement (adjusted under (6)) so far as it is attributable to the excluded exposures;

would be no more than 15% of:

(b) the consolidated credit risk requirement (adjusted under (6)) with respect to all exposures (including the ones dealt with under (a)).

(3) Exposures excluded under BIPRU 4.2.29 R or BIPRU 4.2.26 R (2), BIPRU 4.2.26 R (3) and BIPRU 4.2.26 R (5)–BIPRU 4.2.26 R (7) must not be included in (a) or (b).
(4) The calculation in (2)(a) is based on the standardised approach.

(5) The calculation in (2)(b) is based on whichever of the standardised approach and the IRB approach would apply to the exposures referred to in (2)(b) at the time when the calculation is being made.

(6) The consolidated credit risk requirement is adjusted for the purposes of this rule as follows:

(a) only the elements based on the credit risk capital component and the counterparty risk capital component are being taken into account; and

(b) the calculation is carried out with respect to the group of undertakings referred to in BIPRU 4.2.17 R.

(7) If a group with respect to which the calculation in this rule is being carried out is not required to calculate the consolidated credit risk requirement, the calculations in this rule must be carried out as if it were.

4.2.31 R If a firm applies to use the advanced IRB approach for the sovereign, institution and corporate IRB exposure class, BIPRU 4.2.26 R (4) also applies with respect to exposures in that class. For these purposes, to the extent permitted in the firm’s IRB permission, a firm may:

(1) exclude some exposures from the IRB approach and apply the standardised approach to those exposures; and

(2) exclude other exposures from the advanced IRB approach and apply the foundation IRB approach to those exposures.

4.2.32 G Where BIPRU 4.2.31 R applies:

(1) the 15% limit in BIPRU 4.2.30 R (2) is a combined limit for excluded exposures remaining on the standardised approach and excluded exposures remaining on the foundation IRB approach; and

(2) the calculation in BIPRU 4.2.30 R (2)(a) is carried out under whichever method of calculation would be applicable to the exposure in question.

Combined use of methodologies: Territorial aspects

4.2.33 G

(1) [deleted]

(2) [deleted]

(3) [deleted]

(4) [deleted]

(5) [deleted]

(6) [deleted]
Combined use of methodologies: Intra-group exposures

(1) Generally, the appropriate regulator will consider excluding, through a firm’s IRB permission, exposures falling into □ BIPRU 4.2.26 R (6) from the IRB approach. The degree to which this exclusion applies will be set out in the firm’s IRB permission.

(2) Exposures excluded under (1) will be eligible for a 0% risk weight under the standardised approach if they satisfy the conditions in □ BIPRU 3.2.25 R to □ BIPRU 3.2.27A R (Zero risk weight for certain intra-group exposures).

(3) Exposures to or holdings in any non-financial undertakings in a firm’s group are not eligible for permanent exemption from the IRB approach under □ BIPRU 4.2.26 R (6), as they are not subject to consolidated supervision. It is also the appropriate regulator’s policy that exposures to or holdings in any insurance undertaking are ineligible. Such exposures should remain on the IRB approach unless excluded under another part of □ BIPRU 4.2.26 R.

(4) If a firm uses the exemption in (1) it should have a policy that:
   (a) provides for the identification of connected counterparties excluded under (1);
   (b) identifies exposures that would be permanently exempted from the IRB approach under (1); and
   (c) identifies the connected counterparty exposures that are not permitted to be permanently exempted from the IRB approach under (1).

(5) The policy in (4) should be applied consistently to all exposures excluded under (1).

Combined use of methodologies: Purchase of a new businesses

(1) This guidance deals with some possible effects of acquiring a major new business after the grant of an IRB permission.

(2) A firm should if possible ensure that the exposures arising through the acquisition are dealt with in accordance with the firm’s IRB permission.

(3) If the acquisition is made during the currency of a roll out plan under □ BIPRU 4.2.18 R, a firm should ensure that the exposures arising through the acquisition are dealt with in accordance with that plan. For these purposes the existing and the acquired business should be considered together. The whole of the firm’s business, including the newly acquired business, should be included in both the denominator and numerator of the fraction in □ BIPRU 4.2.30 R.

(4) If a firm cannot comply with (2) the appropriate regulator will consider an application to vary the firm’s IRB permission in order to deal with the acquisition. For example the appropriate regulator may agree to extend the time by which the roll out should be completed (see □ BIPRU 4.2.20 R). However any such variation should be consistent with the provisions of □ BIPRU 4.2 that would have applied if the
acquisition had been included in the firm's original application for an IRB permission.

(5) If the acquisition is made after a firm has completed its roll out under BIPRU 4.2.18 R the appropriate regulator will not in general agree to an application to treat an exposure:

(a) under the standardised approach if it would otherwise be treated under the IRB approach under the firm's IRB permission; or

(b) under the foundation IRB approach if it would otherwise be treated under the advanced IRB approach under the firm's IRB permission.

(6) Any application to disapply the policy in (5) will be treated in accordance with the approach set out in BIPRU 4.2.25 G.

(7) The appropriate regulator will also adopt the approach in (5) while a roll out plan is in progress if, in relation to an exposure of a particular type, the period for completion of the roll out for those exposures under that plan has ended.
4.3 The IRB approach: Provisions common to different exposure classes

Application

4.3.1 This section applies to all exposures treated under the IRB approach.

Exposure classes

4.3.2 Each exposure must be assigned to one of the following exposure classes:

1. claims or contingent claims on central governments and central banks;
2. claims or contingent claims on institutions;
3. claims or contingent claims on corporates;
4. retail claims or contingent retail claims;
5. equity claims;
6. securitisation positions; and
7. non credit-obligation assets.

[Note: BCD Article 86(1)]

4.3.3 The methodology used by a firm for assigning exposures to different IRB exposure classes must be appropriate and consistent over time.

[Note: BCD Article 86(9)]

Calculation of risk weighted exposure amounts

4.3.4 The risk weighted exposure amounts for credit risk for exposures belonging to one of the exposure classes referred to in (1) to (4) must, unless deducted from capital resources, be calculated in accordance with the following provisions:

1. for exposures in the sovereign, institution and corporate IRB exposure class, BIPRU 4.4.57 R to BIPRU 4.4.60 R, BIPRU 4.4.79 R, BIPRU 4.5.8 R to BIPRU 4.5.10 R (for specialised lending exposures), BIPRU 4.9.3 R
4.3.5 The calculation of risk weighted exposure amounts for credit risk and dilution risk must be based on the relevant parameters associated with the exposure in question. These include probability of default (PD), loss given default (LGD), maturity (M) and the exposure value of the exposure. PD and LGD may be considered separately or jointly, in accordance with the provisions relating to PD and LGD in BIPRU 4.4, BIPRU 4.6, BIPRU 4.7 and BIPRU 4.8 at:

1. for exposures in the sovereign, institution and corporate IRB exposure class, BIPRU 4.4.34 R to BIPRU 4.4.42 R and (for specialised lending exposures) BIPRU 4.5.13 R to BIPRU 4.5.15 R;

2. for exposures in the retail exposure class, BIPRU 4.6.50 R to BIPRU 4.6.58 R, and, for PD and LGD for dilution risk of purchased retail exposure receivables, BIPRU 4.8.24 R and BIPRU 4.8.27 R; and

3. for exposures in the equity exposure class, BIPRU 4.7.18 R and BIPRU 4.7.20 R to BIPRU 4.7.21 R.

[Note: BCD Article 87(3)]

Calculation of expected loss amounts

The expected loss amounts for exposures belonging to one of the IRB exposure classes referred to in (1) to (3) must be calculated in accordance with the methods set out in the following provisions:

1. for exposures in the sovereign, institution and corporate IRB exposure class, BIPRU 4.4.61 R to BIPRU 4.4.62 R and (for specialised lending exposures) BIPRU 4.5.13 R to BIPRU 4.5.15 R;

2. for exposures in the retail exposure class, BIPRU 4.6.47 R to BIPRU 4.6.48 R;

3. for exposures in the equity exposure class, BIPRU 4.7.12 R, BIPRU 4.7.17 R and BIPRU 4.7.26 R; and
(4) (for purchased receivables falling into one of the IRB exposure classes in (1) to (3)) BIPRU 4.8.30 R.

[Note: BCD Article 88(1)]

4.3.7 R

The calculation of expected loss amounts in accordance with BIPRU 4.3.6 R must be based on the same input figures of PD, LGD and the exposure value for each exposure as being used for the calculation of risk weighted exposure amounts in accordance with BIPRU 4. For defaulted exposures, where a firm uses its own estimate of LGDs, EL must be the firm’s best estimate of expected loss ($EL_{BE}$), for the defaulted exposure in accordance with BIPRU 4.3.122 R.

[Note: BCD Article 88(2)]

Treatment of expected loss amounts

4.3.8 R

The expected loss amounts calculated in accordance with BIPRU 4.3.6 R (1), BIPRU 4.3.6 R (2) and BIPRU 4.3.6 R (4) must be subtracted from the sum of value adjustments and provisions related to these exposures. Discounts on balance sheet exposures purchased when in default according to BIPRU 4.4.71 R must be treated in the same manner as value adjustments. Expected loss amounts for securitised exposures and value adjustments and provisions related to these exposures must not be included in this calculation.

[Note: BCD Annex VII Part 1 point 36]

Corporate governance

4.3.9 R

All material aspects of the rating and estimation processes must be approved by the firm’s governing body or a designated committee thereof and senior management. These parties must possess a general understanding of the firm’s rating systems and detailed comprehension of its associated management reports.

[Note: BCD Annex VII Part 4 point 124]

4.3.10 C

(1) A firm’s governing body or designated committee may choose to approve only material aspects of the firm’s rating systems and material changes to the firm’s rating systems.

(2) Where a firm’s governing body or designated committee chooses to approve only material aspects of the firm’s rating systems and material changes to the firm’s rating systems:

(a) the firm’s governing body or designated committee should define the firm’s overall approach to material aspects of rating and estimation processes for all rating systems, including non-material rating systems and approve a policy statement defining that approach; and

(b) the firm should define and document the process for approval of non-material aspects of the firm’s rating systems.
| 4.3.11  | R  | Senior management must provide notice to the **governing body** or a designated committee thereof of material changes or exceptions from established policies that will materially impact the operations of the **firm's rating systems**.  

**[Note: BCD Annex VII Part 4 point 125]** |

| 4.3.12  | G  | Where the **firm's rating systems** are used on a unified basis for the **parent undertaking** and its **subsidiary undertakings** under **BIPRU 4.2.3 R**, and approval and reporting of the **ratings systems** are carried out at the group level, the governance requirements in **BIPRU 4.3.9 R** and **BIPRU 4.3.11 R** may be met if:  

1. the **subsidiary undertakings** have delegated to the **governing body** or designated committee of the EEA parent institution or EEA parent financial holding company responsibility for approval of the **firm's rating systems**;  

2. the **governing body** or designated committee of the EEA parent institution or EEA parent financial holding company approves either:  

   a. all aspects of the **firm's rating systems**, and material changes; or  

   b. all aspects of the **firm's rating systems** that are material in the context of the group, and material changes to those, and a policy statement defining the overall approach to material aspects of rating and estimation processes for all **rating systems**, including non-material **rating systems**. |

| 4.3.13  | R  | Senior management must have a good understanding of the **rating system's designs** and operations. Senior management must ensure on an ongoing basis that the **rating systems** are operating properly. Senior management must be regularly informed by the credit risk control units about the performance of the rating process, areas needing improvement, and the status of efforts to improve previously identified deficiencies.  

**[Note: BCD Annex VII Part 4 point 126]** |

| 4.3.14  | R  | Internal ratings-based analysis of the **firm's credit risk profile** must be an essential part of the management reporting required under **BIPRU 4.3.9 R**, **BIPRU 4.3.11 R** and **BIPRU 4.3.13 R**. Reporting must include at least risk profile by grade, migration across grades, estimation of the relevant parameters per grade, and comparison of realised **default** rates and, to the extent that own estimates are used, of realised **LGDs** and realised **conversion factors** against expectations and stress-test results. Reporting frequencies must depend on the significance and type of information and the level of the recipient.  

**[Note: BCD Annex VII Part 4 point 127]** |

### Credit risk control

| 4.3.15  | R  | The credit risk control unit must be independent from the personnel and management functions responsible for originating or renewing **exposures** and report directly to senior management. The unit must be responsible for the design or selection, implementation, oversight and performance of the... |
rating systems. It must regularly produce and analyse reports on the output of the rating systems.

[Note: BCD Annex VII Part 4 point 128]

4.3.16 The areas of responsibility for the credit risk control unit(s) must include the following:

(1) testing and monitoring grades and pools;
(2) production and analysis of summary reports from the firm's rating systems;
(3) implementing procedures to verify that grade and pool definitions are consistently applied across departments and geographic areas;
(4) reviewing and documenting any changes to the rating process, including the reasons for the changes;
(5) reviewing the rating criteria to evaluate if they remain predictive of risk (and changes to the rating process, criteria or individual rating parameters must be documented and retained);
(6) active participation in the design or selection, implementation and validation of models used in the rating process;
(7) oversight and supervision of models used in the rating process; and
(8) ongoing review and alterations to models used in the rating process.

[Note: BCD Annex VII Part 4 point 129]

4.3.17 Notwithstanding BIPRU 4.3.16 R, a firm using pooled data according to BIPRU 4.3.92 R - BIPRU 4.3.94 R (Overall requirements for estimation) may outsource the following tasks:

(1) production of information relevant to testing and monitoring grades and pools;
(2) production of summary reports from the firm's rating systems;
(3) production of information relevant to review of the rating criteria to evaluate if they remain predictive of risk;
(4) documentation of changes to the rating process, criteria or individual rating parameters; and
(5) production of information relevant to ongoing review and alterations to models used in the rating process.

[Note: BCD Annex VII Part 4 point 130 (part)]

4.3.18 A firm making use of BIPRU 4.3.17 R must ensure that the appropriate regulator has access to all relevant information from the third party that is necessary for examining compliance with the minimum IRB standards and
the firm’s IRB permission and that the appropriate regulator may perform on-site examinations to the same extent as within the firm.

[Note: BCD Annex VII Part 4 point 130 (part)]

Documentation of rating systems

4.3.19 R A firm must document the design and operational details of its rating systems. The documentation must evidence compliance with the minimum IRB standards and the firm’s IRB permission, and address topics including portfolio differentiation, rating criteria, responsibilities of parties that rate obligors and exposures, frequency of assignment reviews, and management oversight of the rating process.

[Note: BCD Annex VII Part 4 point 31]

4.3.20 R A firm must ensure that all documentation relating to its rating systems or otherwise required by the rules governing the IRB approach are stored, arranged and indexed in such a way that the firm would be able to make them all available to the appropriate regulator, or to make any class or description of them specified by the appropriate regulator available to the appropriate regulator, immediately on demand or within a short time thereafter.

4.3.21 R A firm must document the rationale for and analysis supporting its choice of rating criteria. A firm must document all major changes in the risk rating process, and such documentation must support identification of changes made to the risk rating process subsequent to the last review by the appropriate regulator. The organisation of rating assignment including the rating assignment process and the internal control structure must also be documented.

[Note: BCD Annex VII Part 4 point 32]

4.3.22 R A firm must document the specific definitions of default and loss used internally and demonstrate consistency with the definitions of default and loss set out in the glossary and BIPRU 4.

[Note: BCD Annex VII Part 4 point 33]

4.3.23 G A firm’s documentation relating to data should include clear identification of responsibility for data quality. A firm should set standards for data quality and aim to improve them over time. A firm should measure its performance against those standards. A firm should ensure that its data is of high enough quality to support its risk management processes and the calculation of its capital requirements.

4.3.24 R Where a firm employs statistical models in the rating process, the firm must document its methodologies. This material must:

(1) provide a detailed outline of the theory, assumptions and/or mathematical and empirical basis of the assignment of estimates to grades, individual obligors, exposures, or pools, and the data source(s) used to estimate the model;
(2) establish a rigorous statistical process (including out-of-time and out-of-sample performance tests) for validating the model; and

(3) indicate any circumstances under which the model does not work effectively.

[Note: BCD Annex VII Part 4 point 34]

Rating systems

A rating system comprises all of the methods, processes, controls, data collection and IT systems that support the assessment of credit risk, the assignment of exposures to grades or pools (rating), and the quantification of default and loss estimates for a certain type of exposure.

[Note: BCD Annex VII Part 4 point 1]

If a firm uses multiple rating systems, the rationale for assigning an obligor or a transaction to a rating system must be documented and applied in a manner that appropriately reflects the level of risk.

[Note: BCD Annex VII Part 4 point 2]

Assignment criteria and processes must be periodically reviewed to determine whether they remain appropriate for the current portfolio and external conditions.

[Note: BCD Annex VII Part 4 point 3]

Where a firm uses direct estimates of risk parameters these may be seen as the outputs of grades on a continuous rating scale.

[Note: BCD Annex VII Part 4 point 4]

Validation of internal estimates

A firm must have robust systems in place to validate the accuracy and consistency of rating systems, processes, and the estimation of all relevant risk parameters (PD, LGD, conversion factors and EL). A firm must be able to demonstrate to the appropriate regulator that the internal validation process enables it to assess the performance of internal rating and risk estimation systems consistently and meaningfully.

[Note: BCD Annex VII Part 4 point 110]

(1) A firm must validate its rating systems. Its validation process must include, as a minimum, the elements set out in (2) - (8).

(2) A firm must establish and define standards of objectivity, accuracy, stability and conservatism that it designs its rating systems to meet. It must have processes that establish whether its rating systems meet those standards.

(3) A firm must establish and define standards of accuracy of calibration (i.e. whether outcomes are consistent with estimate) and
discriminative power (i.e. the ability to rank-order risk) that it designs its rating systems to meet. It must have processes that establish whether its rating systems meet those standards.

(4) A firm must have policies and standards that specify the actions to be taken when a rating system fails to meet the standards of accuracy and discriminative power referred to in (2) and (3).

(5) A firm’s validation process must include a mix of developmental evidence, benchmarking and process verification. A firm’s validation process must include policies on how this mixture varies between different rating systems.

(6) A firm's validation process must include the use of both quantitative and qualitative techniques.

(7) A firm's validation process must include policies on how validation procedures are expected to vary over time.

(8) A firm's validation process must include independent input into and review of its rating systems.

(9) The standards set under (2) and (3) must meet the minimum IRB standards.

(10) For the purpose of (5):

(a) developmental evidence means evidence that substantiates whether the logic and quality of a rating system (including the quantification process) adequately discriminates between different levels of, and delivers accurate estimates of PD, EL, LGD and conversion factors (as applicable); and

(b) process verification means the process of establishing whether the methods used in a rating system to discriminate between different levels of risk and to quantify PD, EL, LGD and conversion factors are being used, monitored and updated in the way intended in the design of the rating system.

4.3.31 A firm should have regard to the involvement of management at an appropriately senior level in the validation process.

4.3.32 The approach to validation may vary with the significance of the exposures covered by a rating system.

4.3.33 A firm must regularly compare realised default rates with estimated PDs for each grade and where realised default rates are outside the expected range for that grade a firm must specifically analyse the reasons for the deviation. A firm using its own estimates of LGDs and/or conversion factors must also perform analogous analysis for own estimates of LGDs and conversion factors. Such comparisons must make use of historical data that cover as long a period as possible. A firm must document the methods and data used in such comparisons. This analysis and documentation must be updated at least annually.

[Note: BCD Annex VII Part 4 point 111]
(1) This paragraph sets out guidance on assessing the adequacy of a rating system’s discriminative power (see BIPRU 4.3.30 R (3) on the meaning of discriminative power).

(2) A firm should be able to explain the performance of its rating systems against its chosen measure (or measures) of discriminative power. In making this comparison a firm should rely primarily on actual historic default experience where this is available. In particular, a firm should be able to explain:

(a) the extent of any potential inaccuracy in these measures, caused in particular by small sample size; and

(b) the potential for divergence in the future, whether caused by changing economic conditions or other factors.

(3) The assessment of discriminative power should include appropriate use of external benchmarks where available.

(4) The appropriate regulator will, in assessing the firm’s performance, take into consideration the sophistication of the measure of discrimination chosen.

(5) In the case of a portfolio for which there is insufficient default experience to provide any confidence in statistical measures of discriminative power a firm need not carry out the procedure in (2) and may instead use other methods. For example, it may make use of comparison with an external measurement approach by analysing whether the firm’s rating systems and the external approach rank common obligors in broadly similar ways. A firm should be able to explain the methodology it uses and the rationale for its use.

A firm must also use other appropriate quantitative validation tools and comparisons with relevant external data sources. The analysis must be based on data that is appropriate to the portfolio, is updated regularly, and covers a relevant observation period. A firm’s internal assessments of the performance of its rating systems must be based on as long a period as possible.

[Note: BCD Annex VII Part 4 point 112]

The methods and data used for quantitative validation must be consistent through time. Changes in estimation and validation methods and data (both data sources and periods covered) must be documented.

[Note: BCD Annex VII Part 4 point 113]

A firm must have sound internal standards for situations where deviations in realised PDs, LGDs, conversion factors and, where EL is used, total losses, from expectations become significant enough to call the validity of the estimates into question. These standards must take account of business cycles and similar systematic variability in default and loss experience. Where realised values continue to be higher than expected values, a firm must revise estimates upward to reflect its default and loss experience.

[Note: BCD Annex VII Part 4 point 114]
Internal audit

4.3.38 R Internal audit or another comparable independent auditing unit must review at least annually the firm's rating systems and its operations, including the operations of the firm and the estimation of PDs, LGDs, ELs and conversion factors. Areas of review must include adherence to all applicable minimum requirements.

[Note: BCD Annex VII Part 4 point 131]

Stress tests used in assessment of capital adequacy

4.3.39 R A firm must have in place sound stress testing processes for use in the assessment of its capital adequacy. Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on the firm's credit exposures and assessment of the firm's ability to withstand such changes.

[Note: BCD Annex VII Part 4 point 40]

4.3.39A G The appropriate regulator expects that firms will routinely make use of stress testing and scenario analysis as a tool in the calibration and/or validation of their IRB approach parameters in order to increase the accuracy or, at least, the conservatism of the estimates. Stress testing should include a thorough exploration of various outturns different to the firm's normal expectations in order to give the firm a clear view of the potential for the forward-looking estimate to be different from that indicated by the primary data source(s). Firms should consider this as an integral part of their quantification process, and should have clear standards for how the results of the stress tests affect the final estimates used for the IRB approach parameters.

4.3.40 R (1) A firm must regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed must be one chosen by the firm. The test to be employed must be meaningful and reasonably conservative. Stressed portfolios must contain the vast majority of a firm's total exposures covered by the IRB approach.

(2) The stress test must be designed to assess the firm's ability to meet its capital requirements for credit risk under GENPRU 2.1 during all stages of the economic cycle and during an economic downturn scenario based on forward looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

(3) In particular the stress test must address the impact (including by ratings migration) of changes in the credit quality of its credit risk counterparties including its protection providers. A firm using the treatment set out in BIPRU 4.4.79 R must in particular consider the impact of protection providers falling outside the eligibility criteria.

(4) The stress test must be conducted on the basis of the firm's exposures (on- and off-balance sheet) as they stand at the time of the stress test.

(5) The stress test must be carried out at least annually and also in the event of a significant change in the state of the economy.
(6) A firm need not assume that the recession referred to in (2) will occur in the 12 months immediately following the stress test. Instead, the stress test must incorporate a plausible time horizon for the occurrence of the cyclical deterioration of the severity tested for. A firm need not assume that the downturn will occur for all portfolios in all jurisdictions simultaneously.

[Note: BCD Annex VII Part 4 points 41 and 42]

4.3.41 G To the extent that the economic conditions assumed in the stress tests required under ■ BIPRU 4.3.39 R or ■ BIPRU 4.3.40 R coincide with the conditions assumed in the production of economic downturn LGDs (see ■ BIPRU 4.3.103 R), the LGDs to be used might be expected to be similar.

4.3.42 G The requirement in ■ BIPRU 4.3.40 R (2) is to identify, in a forward-looking manner, severe but plausible downturn conditions relevant to business lines and jurisdictions and to determine the likely impact of those conditions on a firm’s credit risk regulatory capital requirements. The description of the economic recession contained in ■ BIPRU 4.3.40 R (2) should not be taken as stipulating one approach (e.g. statistical) over other approaches (e.g. scenario analysis) in the identification of the relevant recessionary circumstances.

Rating systems: Assignment to grades or pools

4.3.43 R A firm must have specific definitions, processes and criteria for assigning exposures to grades or pools within a rating system.

[Note: BCD Annex VII Part 4 point 17 (part)]

4.3.44 R The grade or pool definitions and criteria must be sufficiently detailed to allow those charged with assigning ratings consistently to assign obligors or facilities posing similar risk to the same grade or pool. This consistency must exist across lines of business, departments and geographic locations within each rating system.

[Note: BCD Annex VII Part 4 point 17 (part)]

4.3.45 G In meeting ■ BIPRU 4.3.44 R a firm should have regard to its application to each rating system.

4.3.46 R The documentation of the rating process must allow third parties to understand the assignments of exposures to grades or pools, to replicate grade and pool assignments and to evaluate the appropriateness of the assignments to a grade or a pool.

[Note: BCD Annex VII Part 4 point 17 (part)]

4.3.47 R The criteria referred to in ■ BIPRU 4.3.43 R must also be consistent with the firm’s internal lending standards and its policies for handling troubled obligors and facilities.

[Note: BCD Annex VII Part 4 point 17 (part)]
A firm must take all relevant information into account in assigning obligors and facilities to grades or pools. Information must be current and must enable the firm to forecast the future performance of the exposure. The less information a firm has, the more conservative must be its assignments of exposures to obligor and facility grades or pools. If a firm uses an external rating as a primary factor determining an internal rating assignment, the firm must ensure that it considers other relevant information.

[Note: BCD Annex VII Part 4 point 18]

Rating systems: General governance

(1) This paragraph contains guidance on BIPRU 4.3.43 R and more general guidance about the governance of rating systems.

(2) In determining the assignment referred to in BIPRU 4.3.43 R, a firm should have regard to the sensitivity of the rating to movements in fundamental risk drivers.

(3) A firm should, for any rating system, be able to demonstrate that it acts appropriately or has an appropriate policy, as applicable, with respect to:

(a) any deficiencies caused by its not being sensitive to movements in fundamental risk drivers or for any other reason;
(b) periodic review and action in the light of such review;
(c) provision of appropriate internal guidance to staff to ensure consistency in the use of the rating system, including the assignment of exposures or facilities to pools or grades;
(d) dealing with potential weaknesses of the rating system;
(e) identifying appropriate and inappropriate uses of the rating system and acting on that identification;
(f) novel or narrow rating approaches; and
(g) ensuring the appropriate level of stability over time of the rating system.

Rating systems: Overrides

For grade and pool assignments a firm must document the situations in which human judgement may override the inputs or outputs of the assignment process and the personnel responsible for approving these overrides. A firm must document these overrides and the personnel responsible. A firm must analyse the performance of the exposures whose assignments have been overridden. This analysis must include assessment of the performance of exposures whose rating has been overridden by a particular person, accounting for all the responsible personnel.

[Note: BCD Annex VII Part 4 point 25]

Rating systems: Use of models

(1) This paragraph applies to the use of statistical models and/or other mechanical methods to assign exposures to obligor grades, obligor pools, facility grades or facility pools.
(2) A firm must be able to demonstrate to the appropriate regulator that the model has good predictive power and that capital requirements are not distorted as a result of its use.

(3) The input variables to the model must form a reasonable and effective basis for the resulting predictions. The model must not have material biases.

(4) A firm must have in place a process for vetting data inputs into the model, which includes an assessment of the accuracy, completeness and appropriateness of the data.

(5) A firm must be able to demonstrate to the appropriate regulator that the data used to build the model is representative of the population of the firm's actual obligors or exposures.

(6) A firm must have a regular cycle of model validation that includes monitoring of model performance and stability, review of model specification and testing of model outputs against outcomes.

(7) A firm must complement the statistical model by human judgement and human oversight to review model-based assignments and to ensure that the models are used appropriately. Review procedures must aim at finding and limiting errors associated with model weaknesses. Human judgements must take into account all relevant information not considered by the model. A firm must document how human judgement and model results are to be combined.

(8) Use of a model obtained from a third-party vendor that claims proprietary technology is not a justification for exemption from documentation or any other of the requirements in BIPRU 4 or a firm's IRB permission for rating systems. A firm must be able to satisfy the appropriate regulator that all those requirements are satisfied if it uses such a model.

[Note: BCD Annex VII Part 4 points 30 and 35 (part)]

4.3.52  (1) This paragraph contains guidance on BIPRU 4.3.51 R (7).

(2) BIPRU 4.3.51 R (7) does not require that each individual assignment of an exposure to a pool or grade should be the subject of an open-ended review by reference to factors not covered by the model if:

(a) that is not necessary in order to meet the requirements of BIPRU 4 about the ability of the rating system to predict and to discriminate (as referred to in BIPRU 4.3.29 R to BIPRU 4.3.30 R (Validation of internal estimates)); and

(b) the outputs of the model are not designed to be supplemented by such a review.

4.3.53  (1) This paragraph contains guidance on BIPRU 4.3.51 R for the use of external models.

(2) BIPRU 4.3.51 R (2) - BIPRU 4.3.51 R (8) also apply to mechanical methods to assign exposures or obligors to facility grades or pools and to a combination of models and mechanical methods.
(3) The standards which a firm applies to an external model should not be lower than those for internal models.

(4) The appropriate regulator will not accredit any individual model or vendor. The burden is on a firm to satisfy itself that external models are fit for purpose and meet the relevant requirements of the IRB approach.

(5) Notwithstanding that commercial confidentiality may limit the willingness of vendors of external models to disclose all details, a firm should ensure that it is able to obtain sufficiently detailed information to be able to satisfy the requirements of the IRB approach.

(6) A firm should have a clear understanding of responsibilities for support and maintenance of external models. This should include how new developments will be brought in and what entitlement the firm has to receive and/or request specific enhancements. A firm should ensure that the requirements of §BIPRU 4.3.51 R and other provisions of the IRB approach are complied with on an ongoing basis.

(7) If a firm uses an external model it should have regard to the following:
   (a) the adequacy of the information it has about the population on which the model is built;
   (b) the comparability of the population referred to in (a) to the exposures with respect to which it is using that model;
   (c) what the drivers of the model are and their relevance to the exposures with respect to which it is using the model; and
   (d) how the firm satisfies itself that the standards required by the IRB approach for an internal model are met by the external model.

**Rating systems: Data maintenance**

**4.3.54** R A firm must collect and store data on aspects of its internal ratings as required under §BIPRU 11 (Disclosure).

[Note: BCD Annex VII Part 4 point 36]

**Rating systems: IT systems**

**4.3.55** G A firm should ensure that IT systems relevant to the operation of its rating systems are sound and robust. A firm’s IT systems should provide rapid availability of databases and appropriate archiving. Adequate controls should be in place to prevent unauthorised changes to data being made. Contingency processes and plans should be in place to deal with events of system failure. A firm should document work-flows and procedures related to data collection and storage.

**Definition of default: Main provisions**

**4.3.56** R A default must be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place:
(1) the *firm* considers that the obligor is unlikely to pay its credit obligations to the *firm*, the *parent undertaking* or any of its *subsidiary undertakings* in full, without recourse by the *firm* to actions such as realising security (if held); and

(2) the obligor is past due more than 90 days on any material credit obligation to the *firm*, the *parent undertaking* or any of its *subsidiary undertakings*.

[Note: BCD Annex VII Part 4 point 44 (part)]

The following provisions also apply with respect to the definition of *default*:

(1) for overdrafts, days past due commence once an obligor has breached an advised limit, has been advised a limit smaller than current outstandings, or has drawn credit without authorisation and the underlying amount is material;

(2) an advised limit means a limit which has been brought to the knowledge of the obligor;

(3) days past due for credit cards commence on the minimum payment due date;

(4) in the case of *retail exposures* and *exposures to public sector entities* the number of days past due is as set out in ■ BIPRU 4.4.22 R and ■ BIPRU 4.6.20 R; and

(5) in all cases for the purposes of the definition of *default*, a credit obligation or, for overdrafts, the underlying amount, is material if, when added to the other *exposures* of the obligor, the total exceeds the amount which the *firm* treats as a material default for its internal risk measurement and management purposes.

[Note: BCD Annex VII Part 4 point 44 (part)]

### Definition of default: Materiality

4.3.58 R Where a *firm* applies the definition of *default* at facility level in accordance with ■ BIPRU 4.6.21 R, it should define materiality for the purposes of ■ BIPRU 4.3.57 R (5) by reference to the facility amount only, disregarding other *exposures* of the obligor.

4.3.59 R A *firm* must have a policy which sets out how it will determine whether a credit obligation or, for overdrafts, the underlying amount, is material for the purposes of the definition of *default* in ■ BIPRU 4.3.56 R (2) and ■ BIPRU 4.3.57 R (5).

### Definition of default: Identification of obligor

4.3.60 G (1) This paragraph contains *guidance* on the definition of *default*.

(2) If:
(a) a firm ordinarily assigns exposures in the sovereign, institution and corporate IRB exposure class to a member of a group substantially on the basis of membership of that group and a common group rating; and

(b) the firm does so in the case of a particular group;

(3) the firm should consider whether members of that group should be treated as a single obligor for the purpose of the definition of default.

(4) The appropriate regulator would not expect a firm to treat an obligor as part of a single obligor under (2) if the firm rates its exposures on a stand alone basis or if its rating is notched. A rating is notched if it takes into account individual risk factors or otherwise reflects risk factors that are not applied on a common group basis.

(5) Accordingly if a group has two members who are separately rated the default of one does not necessarily imply the default of the other.

Definition of default: Days past due

(1) This paragraph contains guidance on the meaning of days past due for the purposes of the definition of default.

(2) If an amount is overdue by the relevant number of days past due because of administrative oversight on the part of the obligor or the firm, a firm with sufficient information may, retrospectively if necessary, treat that as not involving a default if:

(a) that failure is not associated with any increase in the risk referred to in BIPRU 4.3.56 R (1); and

(b) treating it as not being in default is consistent with the way that the firm treated the failure in its relationship with the obligor.

(3) If a firm takes advantage of this provision it should have a policy about the circumstances in which it can apply the treatment in (2). That policy should be documented and consistently applied.

Days past due is only one part of the definition of default and should be treated as a back-stop. A firm should not rely solely on the number of days past due set by BIPRU 4 but should also consider all other indicators of unlikeliness to pay when assessing whether a default has occurred.

Definition of default: Unlikeliness to pay

(1) Elements to be taken as indications of unlikeliness to pay must include the items set out in this rule.

(2) The firm putting the credit obligation on non-accrued status must be taken as an indication of unlikeliness to pay.

(3) The firm making a value adjustment resulting from a significant perceived decline in credit quality subsequent to the firm taking on the exposure must be taken as an indication of unlikeliness to pay.
(4) The firm selling the credit obligation at a material credit-related economic loss must be taken as an indication of unlikeliness to pay.

(5) The firm consenting to a distressed restructuring of the credit obligation must be taken as an indication of unlikeliness to pay where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees. This includes in the case of equity exposures assessed under a PD/LGD approach, distressed restructuring of the equity itself.

(6) The firm having filed for the obligor’s bankruptcy or a similar order in respect of an obligor’s credit obligation to the firm, the parent undertaking or any of its subsidiary undertakings must be taken as an indication of unlikeliness to pay.

(7) The obligor seeking or having been placed in bankruptcy or similar protection where this would avoid or delay repayment of a credit obligation to the firm, the parent undertaking or any of its subsidiary undertakings must be taken as an indication of unlikeliness to pay.

[Note: BCD Annex VII Part 4 point 45]

4.3.64 A firm may use the amount overdue as an additional indication of unlikeliness to pay. If a firm uses this approach, the days past due element of the definition of default continues to apply, including the provisions relating to the fixed number of days past due referred to in BIPRU 4.3.57 R (4). A firm might make the use of a definition of default that takes into account the amount overdue consistent with the days past due element of the definition by setting the amount overdue at such a level that, taking into account:

(1) the order in which payments are applied against overdue payments; and

(2) the number of payment dates, the time between them, the amount of the overdue payments that results in a default under the definition used by the firm and other relevant factors;

it is not possible for any payment to be past due by a number of days exceeding the maximum amount specified in BIPRU for the purposes of the definition of default without there being a default under the part of the definition of default based on the amount overdue.

4.3.65 In the case of a retail exposure, a value adjustment resulting from significant perceived decline in credit quality falling within BIPRU 4.3.63 R (3) need not necessarily be taken as an indication of unlikeliness to pay if a firm employs formulaic portfolio provisioning based on a number of days overdue for its retail exposures. However, if such an exposure reaches the compulsory days past due indicator for the purposes of the definition of default it should automatically be deemed to be in default, regardless of the provisioning situation.

4.3.66 An obligation should be considered a distressed restructuring under BIPRU 4.3.63 R (5) if an independent third party, with expertise in the
relevant area, would not be prepared to provide financing on substantially the same terms and conditions.

4.3.67

(1) The realisation or forfeiture of collateral may be taken as an indication of unlikeliness to pay for the purposes of the definition of default.

(2) However, the realisation or forfeiture of collateral may not indicate unlikeliness to pay:

   (a) in the case of an exposure in a market (such as one that involves retail exposures involving margin lending) in which it is established practice for collateral to be sold if its value falls below a certain percentage of the exposure and the obligor does not restore the margin (but this exception does not apply if the value of the collateral has fallen below the amount outstanding); or

   (b) if the firm is able to demonstrate that for some other reason the realisation or forfeiture of collateral is not a meaningful indication of unlikeliness to pay.

4.3.68

(1) If an obligor approach is being taken with respect to retail exposures (that is, the application of the definition of default at an obligor level rather than at a facility level as set out in BIPRU 4.6.21 R), a firm should ensure that the PD associated with unsecured exposures is not understated as a result of the presence of any collateralised exposures. A firm should be able to explain to the appropriate regulator, if asked, how it has ensured that its estimate of PD is appropriate for both secured and unsecured exposures covered by an obligor rating approach.

(2) In the view of the appropriate regulator, firms typically find that the PD of a residential mortgage is lower than the PD of an unsecured loan to the same borrower.

4.3.69

A firm may, but without prejudice to BIPRU 4.4.22 R and BIPRU 4.6.20 R (Fixed numbers of days past due), use additional, or stricter, indicators of unlikeliness to pay if it uses these indicators for internal purposes in accordance with BIPRU 4.2.2 R (2) (Use tests) and if the disclosures under BIPRU 11 (Disclosure) are on this basis.

Risk quantification: Definition of default: Other provisions

4.3.70

A firm must (if it uses external data that is not itself consistent with the definition of default) be able to demonstrate to the appropriate regulator that appropriate adjustments have been made that achieve broad equivalence with the definition of default.

[Note: BCD Annex VII Part 4 point 46]

4.3.71

If a firm considers that a previously defaulted exposure is such that no trigger of default continues to apply, the firm must rate the obligor or facility as it would for a non-defaulted exposure. Should the definition of
default subsequently be triggered, another default must be deemed to have occurred.

[Note: BCD Annex VII Part 4 point 47]

4.3.72

A firm should have a clear and documented policy for determining whether an exposure that has been in default should subsequently be returned to performing status.

Risk quantification: Overall requirements for estimation:

4.3.73

A firm’s own estimates of the risk parameters PD, LGD, conversion factor and EL must incorporate all relevant data, information and methods. The estimates must be derived using both historical experience and empirical evidence, and must not be based purely on judgemental considerations. The estimates must be plausible and intuitive and must be based on the material drivers of the respective risk parameters. The less data a firm has, the more conservative it must be in its estimation.

[Note: BCD Annex VII Part 4 point 49]

4.3.75

(1) This paragraph provides guidance on BIPRU 4.3.73 R.

(2) Relevant data and information under BIPRU 4.3.73 R includes external data.

(3) Where internal default and loss experience is scarce, a firm should consider using material relevant external information. When using external information such as industry averages when determining LGD or conversion factors, a firm should consider whether this data is appropriate to its own experience and whether adjustments are necessary.

4.3.76

(1) In calculating estimates of PD, LGD and conversion factors a firm must adjust the averages of historical experience referred to in the historical averages rules in order to ensure that those estimates are accurate estimates of the default rate, loss rate or conversion factor over the long-run.


4.3.77

Where a firm is able to demonstrate that the effect is immaterial in accordance with BIPRU 4.1.25 R (Compliance), it may estimate average LGDs and conversion factors under the historical average rules in a way that does
not strictly comply with ■ BIPRU 4.3.94 R (Default weighted average), provided the final estimates of LGD and conversion factors following the adjustments to averages of historical experience are made on the basis of default weighted averages for the facility grade or pool in question.

4.3.78 G A firm may carry out the adjustments under ■ BIPRU 4.3.76 R (Adjustments to averages of historical experience) by adjusting the data from which estimates are made rather than by adjusting the estimates themselves if it can demonstrate that capital requirements are not underestimated as a result.

4.3.79 G While the qualitative requirements in ■ BIPRU 4 are important for all portfolios, they are of even greater importance in those cases where a firm lacks sufficient historical data to calibrate or validate its estimates of PD, LGD or conversion factors on the basis of proven statistical significance, sometimes referred to as low default portfolios.

4.3.80 R (1) A firm must collect data on what it considers to be the main drivers of the risk parameters PD, LGD, conversion factor and EL for each group of obligors or facilities.

(2) A firm must document its identification of the main drivers of risk parameters.

(3) A firm must be able to demonstrate that its process of identification is reasonable and appropriate.

4.3.81 R In its processes for identifying the main drivers of risk parameters, a firm must set out its reasons for concluding that the data sources chosen provide in themselves sufficient discriminative power and accuracy and why additional potential data sources do not provide relevant and reliable information that would be expected materially to improve the discriminative power and accuracy of its estimates of the risk parameter in question. This does not require an intensive analysis of all factors.

4.3.82 G If a firm uses a rating model to assign exposures to the borrower or facility grades, it may reflect the data on main drivers of risk parameters by its inclusion in the model as a risk driver or as part of a subsequent process that adjusts the output of that model to calculate the risk parameters PD, LGD, conversion factor and EL.

4.3.83 R A firm must be able to provide a breakdown of its loss experience in terms of default frequency, LGD, conversion factor, or loss where EL estimates are used, by the factors it sees as the drivers of the respective risk parameters. A firm must be able to demonstrate to the appropriate regulator that its estimates are representative of long-run experience.

[Note: BCD Annex VII Part 4 point 50]

4.3.84 R Any changes in lending practice or the process for pursuing recoveries over the observation periods referred to in ■ BIPRU 4.4.31 R (Observation period for sovereigns, institutions and corporates for PDs), ■ BIPRU 4.6.28 R (Observation
period for retail exposures for PDs), BIPRU 4.4.54 R (Observation period for sovereigns, institutions and corporates for LGDs), BIPRU 4.6.33 R (Observation period for retail exposures for LGDs), BIPRU 4.4.55 R (Observation period for sovereigns, institutions and corporates for conversion factors) and BIPRU 4.6.38 R (Observation period for retail exposures for conversion factors) must be taken into account. A firm’s estimates must reflect the implications of technical advances and new data and other information, as it becomes available. A firm must review its estimates when new information comes to light but at least on an annual basis.

[Note: BCD Annex VII Part 4 point 51]

4.3.85 R The population of exposures represented in the data used for estimation, the lending standards used when the data was generated and other relevant characteristics must be comparable with those of a firm’s exposures and standards. A firm must also be able to demonstrate to the appropriate regulator that the economic or market conditions that underlie the data are relevant to current and foreseeable conditions. The number of exposures in the sample and the data period used for quantification must be sufficient to provide a firm with confidence in the accuracy and robustness of its estimates.

[Note: BCD Annex VII Part 4 point 52]

4.3.86 G It may be reasonable for a firm to treat foreseeable in BIPRU 4.3.85 R as referring to the most distant date to which it carries out detailed capital planning.

4.3.87 G A firm should be able to demonstrate to the appropriate regulator:

(1) how, with respect to each rating system, both assignment of ratings and estimates of PD, LGD and conversion factors are affected by:
   (a) movements in the economic cycle; and
   (b) other cyclical effects which are material to levels of default, loss or the amount of exposures at default for the exposures covered by the rating system; and

(2) the level of conservatism inherent in its ratings, as provided for by BIPRU.

4.3.88 R A firm must add to its estimates a margin of conservatism that is related to the expected range of estimation errors. Where methods and data are less satisfactory and the expected range of errors is larger, the margin of conservatism must be larger.

[Note: BCD Annex VII Part 4 point 54]

4.3.89 G Estimation of PD through the use of a technique set out in BIPRU does not remove the need to make conservative adjustments, where necessary, related to the expected range of estimation errors so that capital requirements produced by the relevant model or other rating system are not understated.
4.3.90 If a firm uses different estimates for the calculation of risk weights and internal purposes it must be documented. The firm must be able to demonstrate to the appropriate regulator the reasonableness of such estimates.

[Note: BCD Annex VII Part 4 point 55]

4.3.91 If a firm can demonstrate to the appropriate regulator that for data that has been collected prior to 31 December 2006, appropriate adjustments have been made to achieve broad equivalence with the definitions of default or loss, the appropriate regulator may in the IRB permission allow the firm some flexibility in the application of the required standards for data.

[Note: BCD Annex VII Part 4 point 56]

Risk quantification: Overall requirements for estimation: Pooled data

4.3.92 If a firm uses data that is pooled across institutions it must be able to demonstrate to the appropriate regulator that:

1. the rating systems and criteria of other firms in the pool are similar to its own;
2. the pool is representative of the portfolio for which the pooled data is used; and
3. the pooled data is used consistently over time by the firm for its permanent estimates.

[Note: BCD Annex VII Part 4 point 57]

4.3.93 BIPRU 4.3.92 R (1) is intended to ensure that data entering a pool is consistent and does not contain distortions as a result of different contributors’ practices. It is not intended to constrain the use of pooled data by one firm that is contributed by a second firm where the differences do not affect the data being contributed.

4.3.94 If a firm uses data that is pooled across institutions it remains responsible for the integrity of its rating systems. If a firm uses such data it must be able to demonstrate to the appropriate regulator that it has sufficient in-house understanding of its rating systems, including effective ability to monitor and audit the rating process.

[Note: BCD Annex VII Part 4 point 58]

Risk quantification: Overall requirements for estimation: Requirements specific to PD estimates

4.3.95 (1) If:

(a) a firm's internal experience of exposures of a type covered by a model or other rating system is 20 defaults or fewer; and
(b) in the firm's view, reliable estimates of PD cannot be derived from external sources of default data, including the use of
market price related data, for all the exposures covered by the rating system;
the firm must estimate PD for exposures covered by that rating system in accordance with this rule.

(2) A firm must use a statistical technique to derive the distribution of defaults implied by the firm’s experience, estimating PDs (the “statistical PD”) from the upper bound of a confidence interval set by the firm in order to produce conservative estimates of PDs in accordance with BIPRU 4.3.88 R.

(3) The techniques chosen for the purposes of (2) must take account, as a minimum, of the following modelling issues:
(a) the number of defaults and number of obligor years in the sample;
(b) the number of years from which the sample was drawn;
(c) the interdependence between default events for individual obligors;
(d) the interdependence between default rates for different years; and
(e) the choice of the statistical estimators and the associated distributions and confidence intervals.

(4) The firm must further adjust the statistical PD to the extent necessary to take account of the following:
(a) any likely differences between the observed default rates over the period covered by the firm’s default experience and the long-run PD for each grade in accordance with BIPRU 4.24 R and BIPRU 4.6.24 R; and
(b) any other information that indicates (taking into account the robustness and cogency of that information) that the statistical PD is likely to be an inaccurate estimate of PD.

(5) This rule is in addition to the other requirements in BIPRU about the calculation of PD.

(6) When a firm calculates whether it has 20 defaults or fewer under the calculation in (1)(a), it must only take into account defaults that occurred during periods that are relevant to the validation under BIPRU 4 of the model or other rating system in question.

A firm may if appropriate also choose to use the approach in BIPRU 4.3.91 G if the internal experience on exposures covered by a rating system is greater than 20 defaults.

If a firm excludes defaulted exposures that have been cured (as referred to in BIPRU 4.3.71 R) or restructured (as referred to in BIPRU 4.3.63 R (5)) from estimates of LGD in accordance with BIPRU 4.3.110 G, it may also exclude cures from estimates of PD for these exposures.
Risk quantification: Overall requirements for estimation: Requirements specific to own-LGD estimates

4.3.98 A firm must estimate LGDs by facility grade or pool on the basis of the average realised LGDs by facility grade or pool using all observed defaults within the data sources (default weighted average).

[Note: BCD Annex VII Part 4 point 73]

4.3.100 A firm must calculate the default weighted average on the basis of the number of defaults included in the calculations made under the historical average rules so far as they relate to the calculation of PDs and must not be weighted by the size of exposures.

4.3.101 (1) A firm’s estimates of LGDs must take into account:

(a) data in respect of relevant incomplete workouts; and

(b) the possibility that the proportion of defaulted exposures which are cured (as referred to in BIPRU 4.3.71 R) or restructured (as referred to in BIPRU 4.3.63 R (5)) or the length of the period over which a firm makes recoveries under a defaulted exposure may be different from the firm’s observed historic experience.

(2) An incomplete workout as referred to in (1)(a) means a defaulted exposure included in the data set on which the firm’s LGD estimates are based, but for which the recovery process is still in progress, with the result that the final realised losses in respect of that exposure are not yet certain.

4.3.102 The changes referred to in BIPRU 4.3.101 R (1)(b) may be caused by external factors, such as the economic environment, as well as factors specific to the obligor, the transaction or the policies of the firm.

4.3.103 A firm must use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver constant realised LGDs by grade or pool over time, a firm must make adjustments to its estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

[Note: BCD Annex VII Part 4 point 74]

4.3.104 (1) A firm must have a rigorous and well documented process for:

(a) assessing the effects, if any, of economic downturn conditions on recovery rates; and

(b) producing LGD estimates consistent with downturn conditions as referred to in BIPRU 4.3.103 R.
(2) That process must include the following, which may be included in an integrated manner:

(a) identification of appropriate downturn conditions for each IRB exposure class within each jurisdiction;

(b) identification of adverse dependencies, if any, between default rates and recovery rates; and

(c) incorporation of adverse dependencies, if identified, between default rates and recovery rates in the firm’s estimates of LGD in a manner that meets the requirements in BIPRU 4.3.103 R relating to an economic downturn.

A firm may derive the LGD in accordance with BIPRU 4.3.104 R (2)(c) either by directly assigning to the facility grade or pool an estimate of LGD appropriate for downturn conditions, or alternatively by estimating a default weighted average LGD in accordance with BIPRU 4.3.99 R and BIPRU 4.3.76 R and converting it into an LGD appropriate for downturn conditions by the use of a formula. It should be able to demonstrate that that formula produces well-founded estimates of LGDs consistent with downturn conditions for the exposures in question.

A firm may combine IRB exposure classes, jurisdictions or both for the purpose of BIPRU 4.3.104 R (2)(a) if it can demonstrate that the downturn conditions to which the portfolios are subject will be similar.

The adverse dependencies referred to in BIPRU 4.3.104 R (2)(b) will not always exist. However, if a firm uses LGDs that do not allow for such adverse dependencies, it should be able to justify its decision.

Data relating to economic downturn conditions is likely to be scarce. Accordingly, a firm should use internal data, external data or a combination of data sources in order to produce appropriate downturn LGD estimates in accordance with BIPRU 4.3.103 R.

A firm must retain sufficient data on both LGDs calculated on an economic downturn basis and calculated on a long-run average basis (as referred to in BIPRU 4.3.103 R) to be able to demonstrate to the appropriate regulator (if asked) that its estimates based on an economic downturn are no less conservative than the long-run average as referred to in that rule.

Where a firm is able to demonstrate that the effect is immaterial in accordance with BIPRU 4.1.25 R (Compliance), it may exclude defaulted exposures that have been cured (as referred to in BIPRU 4.3.67 G (1)) or restructured (as referred to in BIPRU 4.3.63 R (5)) from the data about default and loss experience on which LGDs are calculated provided it can demonstrate that its calculation of capital requirements (including capital requirements resulting from the application of capital floors under the transitional rules and guidance in BIPRU) are not reduced as a result of this approximation.
4.3.111 R Irrespective of whether calculated on an economic downturn or long-run average basis, each LGD estimate must be at least zero.

4.3.112 G In order to support an LGD estimate which is very low or zero, a firm should be able to demonstrate that the estimate adequately reflects the expected experience on a default weighted average basis or in a downturn as appropriate, taking into account the costs and discount rate associated with realisations and the operation of BIPRU 4.3.118 R.

4.3.113 R The methods that a firm uses for discounting cash flows for the purposes of estimating LGDs must take account of the uncertainties associated with the receipt of recoveries with respect to a defaulted exposure. If a firm intends to use a discount rate that does not take full account of the uncertainty in recoveries, it must be able to explain by what other process it has taken into account that uncertainty for the purposes of calculating LGDs.

4.3.114 G The uncertainty referred to in BIPRU 4.3.113 R can be addressed by adjusting cash flows to certainty-equivalents or by using a discount rate that embodies an appropriate risk premium; or by a combination of the two.

4.3.115 G A firm may exclude from its calculation of loss indirect costs that it incurs for the purpose of making recoveries with respect to a defaulted exposure if it would also have incurred those costs if there had not been a default.

4.3.116 R A firm must consider the extent of any dependence between the risk of the obligor with that of the collateral or collateral provider. Cases where there is a significant degree of dependence must be addressed in a conservative manner.

[Note: BCD Annex VII Part 4 point 75]

4.3.117 R Currency mismatches between the underlying obligation and the collateral must be treated conservatively in the firm's assessment of LGD.

[Note: BCD Annex VII Part 4 point 76]

4.3.118 R To the extent that LGD estimates take into account the existence of collateral, these estimates must not solely be based on the collateral's estimated market value. LGD estimates must take into account the effect of the potential inability of the firm expeditiously to gain control of its collateral and liquidate it.

[Note: BCD Annex VII Part 4 point 77]

4.3.119 G (1) A firm may comply with BIPRU 4.3.118 R by reducing the amount of the collateral taken into account for the purposes of calculating LGD (applying a haircut to the collateral), basing that reduction on validated realisation experience and using conservatism to reflect the uncertainties.
(2) If collateral is used to reduce the LGD, a firm should be able to demonstrate how the risk in BIPRU 4.3.118 R has been accounted for. To the extent that it is adequately accounted for in that way it need not be reflected again as part of the residual risk in relation to collateral under the overall Pillar 2 rule.

4.3.120 R
To the extent that LGD estimates take into account the existence of collateral, a firm must establish internal requirements for collateral management, legal certainty and risk management that are generally consistent with those set out in BIPRU 5 (Credit risk mitigation) as modified by BIPRU 4.10.

[Note: BCD Annex VII Part 4 point 78]

4.3.121 R
To the extent that a firm recognises collateral for determining the exposure value for counterparty credit risk according to the CCR standardised method or the CCR internal model method, any amount expected to be recovered from the collateral must not be taken into account in the LGD estimates.

[Note: BCD Annex VII Part 4 point 79]

4.3.122 R
For the specific case of exposures already in default, a firm must use the sum of its best estimate of expected loss for each exposure given current economic circumstances and exposure status and the possibility of additional unexpected losses during the recovery period.

[Note: BCD Annex VII Part 4 point 80]

4.3.123 R
To the extent that unpaid late fees have been capitalised in a firm's income statement, they must be added to the firm's measure of exposure and loss.

[Note: BCD Annex VII Part 4 point 81]

Risk quantification: Overall requirements for estimation:
Requirements specific to own-conversion factor estimates

4.3.124 R
BIPRU 4.3.125 R - BIPRU 4.3.131 R set out requirements specific to own-conversion factor estimates.

4.3.125 R
A firm must estimate conversion factors by facility grade or pool on the basis of the average expected conversion factors by facility grade or pool using all observed defaults within the data sources (default weighted average).

[Note: BCD Annex VII Part 4 point 87]

4.3.126 G
(1) A firm using own estimates of conversion factors should take into account all facility types that may result in an exposure when an obligor defaults, including uncommitted facilities.

(2) A firm should treat a facility as an exposure from the earliest date at which a customer is able to make drawings under it.

(3) To the extent that a firm makes available multiple facilities, it should be able to demonstrate:
(a) how it deals with the fact that exposures on one may become exposures under another on which the losses are ultimately incurred; and
(b) the impact of its approach on its capital requirements.

4.3.127 R A firm must use conversion factor estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. To the extent a rating system is expected to deliver realised conversion factors at a constant level by grade or pool over time, a firm must make adjustments to its estimates of risk parameters by grade or pool to limit the capital impact of an economic downturn.

[Note: BCD Annex VII Part 4 point 88]

4.3.128 R A firm’s estimates of conversion factors must reflect the possibility of additional drawings by the obligor up to and after the time a default event is triggered. The conversion factor estimate must incorporate a larger margin of conservatism where a stronger positive correlation can reasonably be expected between the default frequency and the magnitude of conversion factor.

[Note: BCD Annex VII Part 4 point 89]

4.3.129 R In arriving at estimates of conversion factors a firm must consider its specific policies and strategies adopted in respect of account monitoring and payment processing. A firm must also consider its ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events.

[Note: BCD Annex VII Part 4 point 90]

4.3.130 R A firm must have adequate systems and procedures in place to monitor facility amounts, current outstandings against committed lines and changes in outstandings per obligor and per grade. A firm must be able to monitor outstanding balances on a daily basis.

[Note: BCD Annex VII Part 4 point 91]

4.3.131 R If a firm uses different estimates of conversion factors for the calculation of risk weighted exposure amounts and internal purposes it must be documented. The firm must be able to demonstrate their reasonableness to the appropriate regulator.

[Note: BCD Annex VII Part 4 point 92]

Risk quantification: Overall requirements for estimation: Comparability

4.3.132 G (1) This paragraph contains guidance about the interpretation of the requirements relating to comparability in BIPRU 4.3.85 R. It is also relevant to the requirement for representative data in BIPRU 4.3.51 R (5), to the references to comparability in the additional guidance in BIPRU 4.3.53 G (7)(b) and to the requirements for similarity in BIPRU 4.3.92 R.
(2) In general, comparability should be based on analyses of the population of exposures represented in the data, the lending standards used when the data was generated (where relevant) and other relevant characteristics in relation to the corresponding properties of the firm’s own portfolio. Other relevant characteristics could include the distribution of the obligors across industries, the size distribution of the exposures and similarity with respect to the geographic or demographic distribution of the exposures.
4.4 The IRB approach: Exposures to corporates, institutions and sovereigns

Application

4.4.1 (1) This section applies with respect to the sovereign, institution and corporate IRB exposure class.

(2) The sovereign, institution and corporate IRB exposure class includes specialised lending exposures.

(3) Both ■ BIPRU 4.4 and ■ BIPRU 4.5 (Specialised lending exposures) apply to specialised lending exposures. A firm may calculate risk weighted exposure amounts for a specialised lending exposure either:

(a) (if it is able to do so) in accordance with ■ BIPRU 4.4; or

(b) in accordance with ■ BIPRU 4.4 as modified by ■ BIPRU 4.5.

Definition

4.4.2 The following exposures must be treated as exposures to central governments and central banks:

(1) exposures to regional governments, local authorities or public sector entities which are treated as exposures to central governments under the standardised approach; and

(2) exposures to multilateral development banks and international organisations which attract a risk weight of 0% under the standardised approach.

[Note: BCD Article 86(2)]

4.4.3 The following exposures must be treated as exposures to institutions:

(1) exposures to regional governments and local authorities which are not treated as exposures to central governments under the standardised approach;

(2) exposures to public sector entities which are treated as exposures to institutions under the standardised approach;
(3) exposures to multilateral development banks which do not attract a 0% risk weight under the standardised approach; and

(4) without prejudice to BIPRU 13.3.13 R and BIPRU 13.8.7 R (Exposures to a central counterparty) exposures to recognised third country investment firms and exposures to recognised clearing houses and designated investment exchanges.

[Note: BCD Article 86(3) and CAD Article 40]

4.4.4 Any credit obligation not assigned to the IRB exposure classes referred to in BIPRU 4.3.2 R (1) (Sovereigns), BIPRU 4.3.2 R (2) (Institutions) and BIPRU 4.3.2 R (4) - BIPRU 4.3.2 R (6) (Retail, equity and securitisations) must be assigned to the corporate exposure class.

[Note: BCD Article 86(7)]

Rating system: Structure of rating system

4.4.5 A rating system must take into account obligor and transaction risk characteristics.

[Note: BCD Annex VII Part 4 point 5]

4.4.7 A rating system must have an obligor rating scale which reflects exclusively quantification of the risk of obligor default. The obligor rating scale must have a minimum of seven grades for non-defaulted obligors and one for defaulted obligors.

[Note: BCD Annex VII Part 4 point 6]

4.4.8 An obligor grade means for the purpose of BIPRU 4 as it applies to the sovereign, institution and corporate IRB exposure class a risk category within a rating system’s obligor rating scale, to which obligors are assigned on the basis of a specified and distinct set of rating criteria, from which estimates of PD are derived. A firm must document both the relationship between obligor grades in terms of the level of default risk each grade implies and the criteria used to distinguish that level of default risk.

[Note: BCD Annex VII Part 4 point 7]

4.4.9 A firm with portfolios concentrated in a particular market segment and range of default risk must have enough obligor grades within that range to avoid undue concentrations of obligors in a particular grade. Significant concentrations within a single grade must be supported by convincing empirical evidence that the obligor grade covers a reasonably narrow PD band and that the default risk posed by all obligors in the grade falls within that band.

[Note: BCD Annex VII Part 4 point 8]
Rating system: Assignment to grades or pools

4.4.10 G Material on assignment to grades or pools can be found in BIPRU 4.3.43 R - BIPRU 4.3.48 R.

Rating system: Assignment of exposures

4.4.11 R Each obligor must be assigned to an obligor grade as part of the credit approval process.

[Note: BCD Annex VII Part 4 point 19]

4.4.12 R Each separate legal entity to which a firm is exposed must be separately rated. A firm must be able to demonstrate to the appropriate regulator that it has acceptable policies regarding the treatment of individual obligor clients and groups of connected clients.

[Note: BCD Annex VII Part 4 point 22]

4.4.13 R Separate exposures to the same obligor must be assigned to the same obligor grade, irrespective of any differences in the nature of each specific transaction. Exceptions, where separate exposures are allowed to result in multiple grades for the same obligor are:

1. country transfer risk, this being dependent on whether the exposures are denominated in local or foreign currency;
2. where the treatment of associated guarantees to an exposure may be reflected in an adjusted assignment to an obligor grade; and
3. where consumer protection, bank secrecy or other legislation prohibit the exchange of client data.

[Note: BCD Annex VII Part 4 point 23]

Rating system: Overrides

4.4.14 G Material on overrides can be found in BIPRU 4.3.50 R.

Rating system: Integrity of assignment process

4.4.15 R Assignments and periodic reviews of assignments must be completed or approved by an independent party that does not directly benefit from decisions to extend the credit.

[Note: BCD Annex VII Part 4 point 26]

4.4.16 R A firm must update assignments at least annually. High risk obligors and problem exposures must be subject to more frequent review. A firm must undertake a new assignment if material information on the obligor or exposure becomes available.

[Note: BCD Annex VII Part 4 point 27]
Although it will not usually be the case that facility ratings and conversion factors will have to be updated more frequently than annually, LGDs and exposure values are subject to more frequent recalculation due to their connection to drawn balances, which can vary on a daily basis.

A firm must have an effective process to obtain and update relevant information on obligor characteristics that affect PDs, and on transaction characteristics that affect LGDs and conversion factors.

[Note: BCD Annex VII Part 4 point 28]

Material on the use of models can be found in BIPRU 4.3.51 R - BIPRU 4.3.53 G.

Material on the documentation of rating systems can be found in BIPRU 4.3.19 R - BIPRU 4.3.24 R.

In addition to complying with the material in BIPRU 4.3.54 R (Data maintenance) a firm must collect and store:

1. complete rating histories on obligors and recognised guarantors;
2. the dates the ratings were assigned;
3. the key data and methodology used to derive the rating;
4. the person responsible for the rating assignment;
5. the identity of obligors and exposures that defaulted;
6. the date and circumstances of such defaults;
7. data on the PDs and realised default rates associated with rating grades and ratings migration; and
8. (in the case of a firm not using the advanced IRB approach in the calculation of LGDs and/or conversion factors) data on comparisons of realised LGDs to the values as set out in BIPRU 4.4.34 R and BIPRU 4.8.25 R and realised conversion factors to the values as set out in BIPRU 4.4.37 R, BIPRU 4.4.45 R and BIPRU 4.6.44 R.

[Note: BCD Annex VII Part 4 point 37]

This rule, in accordance with BIPRU 4.3.57 R (4) (Definition of default), sets the exact number of days past due that a firm should abide by in the case of exposures to PSEs.
(2) For counterparts that are PSEs situated within the United Kingdom the number of days past due is 180.

(3) For counterparts that are PSEs situated in another EEA State the number of days past due is the lower of:
   (a) 180; and
   (b) the number of days past due fixed under the CRD implementation measure with respect to point 48 of Part 4 of Annex VII of the Banking Consolidation Directive for that EEA State for such exposures.

(4) For counterparts that are PSEs in a state outside the EEA the number of days past due is the lower of:
   (a) 180; and
   (b) (if a number of days past due for such exposures has been fixed under any law of that state applicable to undertakings in the banking sector or the investment services sector that implements the IRB approach) that number.

[Note: BCD Annex VII Part 4 point 44 (part) and point 48 (part)]

Risk quantification: Overall requirements for estimation: Requirements specific to PD estimation

4.4.23 R ■ BIPRU 4.4.24 R - ■ BIPRU 4.4.31 R apply to both the foundation IRB approach and the advanced IRB approach.

4.4.24 R A firm must estimate PDs by obligor grade from long run averages of one-year default rates.

[Note: BCD Annex VII Part 4 point 59]

4.4.25 R A firm must use PD estimation techniques only with supporting analysis. A firm must recognise the importance of judgmental considerations in combining results of techniques and in making adjustments for limitations of techniques and information.

[Note: BCD Annex VII Part 4 point 62]

4.4.26 G Where rating agency experience or the output of a statistical default model are the primary component of PD estimation, a firm should consider whether it needs to make adjustments for other relevant information, such as internal experience, conservatism and cyclical effects. In making these adjustments, a firm should consider the extent to which it needs to take account of the potential for both under-recording of actual defaults experienced and divergence of actual experience from the true underlying average PD.

4.4.27 R To the extent that a firm uses data on internal default experience for the estimation of PDs it must be able to demonstrate in its analysis that the estimates are reflective of underwriting standards and of any differences in the rating system that generated the data and the current rating system.
Where underwriting standards or rating systems have changed, a firm must add a greater margin of conservatism in its estimate of PD.

[Note: BCD Annex VII Part 4 point 63]

4.4.28 R To the extent that a firm associates or maps its internal grades to the scale used by an ECAI or similar organisations and then attributes the default rate observed for the external organisation’s grades to the firm’s grades, mappings must be based on a comparison of internal rating criteria to the criteria used by the external organisation and on a comparison of the internal and external ratings of any common obligors. Biases or inconsistencies in the mapping approach or underlying data must be avoided. The external organisation’s criteria underlying the data used for quantification must be oriented to default risk only and not reflect transaction characteristics. The firm’s analysis must include a comparison of the default definitions used, subject to the requirements in BIPRU 4.3.56 R to BIPRU 4.3.71 R and BIPRU 4.4.22 R (Definition of default). The firm must document the basis for the mapping.

[Note: BCD Annex VII Part 4 point 64]

4.4.29 G It is unlikely that a firm will be able to convince the appropriate regulator that it had considered all relevant and available information, as required by BIPRU 4.3.74 R, if it used only data from one ECAI or similar organisation, where other relevant information is available.

4.4.30 R To the extent that a firm uses statistical default prediction models it may estimate PDs as the simple average of default-probability estimates for individual obligors in a given grade. The firm’s use of default probability models for this purpose must meet the standards specified in BIPRU 4.3.51 R.

[Note: BCD Annex VII Part 4 point 65]

4.4.31 R Irrespective of whether a firm is using external, internal, or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used must be at least five years for at least one source. If the available observation period spans a longer period for any source, and this data is relevant, this longer period must be used. A firm not permitted to use own estimates of LGDs or conversion factors may have, when it implements the IRB approach, relevant data covering a period of two years. The period to be covered must increase by one year each year until relevant data cover a period of five years.

[Note: BCD Annex VII Part 4 point 66 (part)]

IRB foundation approach: General

4.4.32 R ■ BIPRU 4.4.33 R - ■ BIPRU 4.4.39 R set out requirements specific to the foundation IRB approach.

4.4.33 R Under the foundation IRB approach a firm must apply the LGD values set out in ■ BIPRU 4.4.34 R and ■ BIPRU 4.8.25 R and the conversion factors set out in ■ BIPRU 4.4.37 R.

[Note: BCD Article 87(8)]
IRB foundation approach: LGDs

4.4.34 R

A firm must use the following LGD values:

1. senior exposures without eligible collateral, 45%;
2. subordinated exposures without eligible collateral, 75%;
3. a firm may recognise funded and unfunded credit protection in the LGD in accordance with BIPRU 5 (Credit risk mitigation), as modified by BIPRU 4.10;
4. covered bonds may be assigned an LGD value of 11.25%; and
5. for certain senior corporate exposure purchased receivables, for certain subordinated corporate exposure purchased receivables and for dilution risk of corporate purchased receivables the provisions of BIPRU 4.8.25 R (LGDs for corporate receivables) apply.

[Note: BCD Annex VII Part 2 point 8 (part)]

4.4.35 R

[deleted]

1. [deleted]
2. [deleted]
3. [deleted]
4. [deleted]

Foundation IRB approach: Exposure value and conversion factors

4.4.36 R

BIPRU 4.4.37 R - BIPRU 4.4.39 R apply in addition to BIPRU 4.4.71 R - BIPRU 4.4.78 R.

4.4.37 R

1. The exposure value for the items set out in this rule must be calculated as the committed but undrawn amount multiplied by the applicable conversion factor set out in this rule.

2. For credit lines which are uncommitted, that are unconditionally cancellable at any time by the firm without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower’s credit worthiness, a conversion factor of 0% applies. To apply a conversion factor of 0% a firm must actively monitor the financial condition of the obligor, and its internal control systems must enable it immediately to detect a deterioration in the credit quality of the obligor.

3. For short-term letters of credit arising from the movement of goods, a conversion factor of 20% applies for both the issuing and confirming firms.

4. For other credit lines, note issuance facilities (NIFs), and revolving underwriting facilities (RUFs), a conversion factor of 75% applies.
(5) For undrawn purchase commitments for revolving purchased receivables falling under [BIPRU 4.8.29 R], the conversion factor set out in that rule applies.

[Note: BCD Annex VII Part 3 point 9 (part)]

4.4.38 R

Where a commitment refers to the extension of another commitment, the lower of the two conversion factors associated with the individual commitment must be used.

[Note: BCD Annex VII Part 3 point 10]

4.4.39 R

For all off-balance sheet items other than mentioned in [BIPRU 4.4.37 R, BIPRU 4.4.45 R, BIPRU 4.4.71 R - BIPRU 4.4.78 R, BIPRU 4.6.44 R, BIPRU 4.8.28 R and BIPRU 4.8.29 R], the exposure value must be the following percentage of its value:

1. 100% if it is a full risk item;
2. 50% if it is a medium risk item;
3. 20% if it is a medium/low risk item; and
4. 0% if it is a low risk item.

For the purposes of this rule the off-balance sheet items must be assigned to risk categories as indicated in [BIPRU 3.7 (Classification of off-balance sheet items)].

[Note: BCD Annex VII Part 3 point 11]

Advanced IRB approach: General

4.4.40 R

[BIPRU 4.4.41 R - BIPRU 4.4.55 R] set out requirements specific to the advanced IRB approach.

4.4.41 R

Under the advanced IRB approach a firm must use its own estimates of LGDs and conversion factors in accordance with [BIPRU 4].

[Note: BCD Article 87(9)]

Advanced IRB approach: LGDs and PDs

4.4.42 R

A firm using own LGD estimates under the advanced IRB approach may recognise unfunded credit protection by adjusting PDs subject to [BIPRU 4.4.43 R].

[Note: BCD Annex VII Part 2 point 6]

4.4.43 R

Notwithstanding [BIPRU 4.4.34 R and BIPRU 4.8.25 R], if a firm’s IRB permission permits it to use own LGD estimates under the advanced IRB approach for exposures to which [BIPRU 4] applies and permits it to use the approach in this rule, unfunded credit protection may be recognised by adjusting PD and/ or LGD estimates subject to the minimum IRB standards. A firm must not assign guaranteed exposures an adjusted PD or LGD such that the adjusted...
risk weight would be lower than that of a comparable, direct exposure to
the guarantor.

[Note: BCD Annex VII Part 2 point 10]

A firm using the advanced IRB approach may only recognise unfunded credit
protection in accordance with § BIPRU 4.4.43 R. The other methods for
recognising unfunded credit risk mitigation under the standardised approach
and foundation IRB approach are not available to a firm on the advanced
IRB approach.

Advanced IRB approach: Conversion factors

If a firm uses its own estimates of conversion factors under the advanced IRB
approach it must calculate the exposure value of off-balance sheet exposures
calculated with the use of conversion factors by using its own estimates of
conversion factors across different product types as mentioned in
§ BIPRU 4.4.37 R and § BIPRU 4.4.39 R (2) to § BIPRU 4.4.39 R (4).

[Note: BCD Annex VII Part 3 point 9 (part)]

Under § BIPRU 4.4.45 R, a firm may calculate exposure values by calculating
the amount expected to be claimed, instead of the maximum possible
amount of the potential claim. The figure for the amount expected to be
claimed should not be less than the current outstandings from time to time.

Advanced IRB approach: Structure of the rating system

If a firm's IRB permission provides for it to use the advanced IRB approach
for the calculation of LGDs, its rating system must incorporate a distinct
facility rating scale which exclusively reflects LGD related transaction
characteristics.

[Note: BCD Annex VII Part 4 point 9]

A facility grade means for the purpose of the advanced IRB approach a risk
category within a rating system's facility scale to which exposures are
assigned on the basis of a specified and distinct set of rating criteria from
which own estimates of LGDs are derived. The grade definition must include
both a description of how exposures are assigned to the grade and of the
criteria used to distinguish the level of risk across grades.

[Note: BCD Annex VII Part 4 point 10]

Significant concentrations within a single facility grade must be supported by
convincing empirical evidence that the facility grade covers a reasonably
narrow LGD band, respectively, and that the risk posed by all exposures in
the grade falls within that band.

[Note: BCD Annex VII Part 4 point 11]
Advanced IRB approach: Assignment of exposures

4.4.51 R
For a firm permitted to use own estimates of LGDs or conversion factors under the advanced IRB approach, each exposure must be assigned to a facility grade as part of the credit approval process. This is in addition to the requirements in BIPRU 4.4.11 R - BIPRU 4.4.13 R.

[Note: BCD Annex VII Part 4 point 20]

4.4.52 G
BIPRU 4.4.50 R and BIPRU 4.4.51 R should be read in the light of BIPRU 4.3.28 R.

Advanced IRB approach: Data maintenance

4.4.53 R
As well as complying with BIPRU 4.3.54 R and BIPRU 4.4.21 R (Data maintenance), a firm using own estimates of LGDs and/or conversion factors under the advanced IRB approach must collect and store:

(1) complete histories of data on the facility ratings and LGD and conversion factor estimates associated with each rating scale;

(2) the dates the ratings were assigned and the estimates were done;

(3) the key data and methodology used to derive the facility ratings and LGD and conversion factor estimates;

(4) the person who assigned the facility rating and the person who provided LGD and conversion factor estimates;

(5) data on the estimated and realised LGDs and conversion factors associated with each defaulted exposure;

(6) data on the LGD of the exposure before and after evaluation of the effects of a guarantee or credit derivative, for a firm that reflects the credit risk mitigating effects of guarantees or credit derivatives through LGD; and

(7) data on the components of loss for each defaulted exposure.

[Note: BCD Annex VII Part 4 Point 38]

Advanced IRB approach: Requirements specific to own-LGD estimates

4.4.54 R
In addition to the requirements in BIPRU 4.3.74 R - BIPRU 4.3.94 R (General requirements about risk quantification) and BIPRU 4.3.98 R - BIPRU 4.3.123 R (Requirements for risk quantification specific to own-LGD estimates), estimates of LGD must be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period must be used.

[Note: BCD Annex VII Part 4 point 82]
Advanced IRB approach: Requirements specific to own-conversion factor estimates

4.4.55 R
In addition to the requirements in ■ BIPRU 4.3.124 R - ■ BIPRU 4.3.131 R (Requirements specific to own-conversion factor estimates), estimates of conversion factors must be based on data over a minimum of five years, increasing by one year each year after implementation until a minimum of seven years is reached, for at least one data source. If the available observation period spans a longer period for any source, and the data is relevant, this longer period must be used.

[Note: BCD Annex VII Part 4 point 93]

Calculations: General

4.4.56 R
The remainder of this section applies to both the foundation IRB approach and the advanced IRB approach.

Calculations: Risk-weighted exposure amounts

4.4.57 R
Subject to ■ BIPRU 4.4.59 R to ■ BIPRU 4.4.60 R, ■ BIPRU 4.5.6 R, ■ BIPRU 4.5.8 R - ■ BIPRU 4.5.10 R (Risk weights for specialised lending), ■ BIPRU 4.8.16 R, ■ BIPRU 4.8.17 R (Risk weights for corporate exposure purchased receivables) and ■ BIPRU 4.9.3 R (Securitisation: provision of credit protection), risk weighted exposure amounts must be calculated according to the formulae in the table in ■ BIPRU 4.4.58 R and the adjustment formula in ■ BIPRU 4.4.79 R (Double default).

[Note: BCD Annex VII Part 1 point 3]

Table: Formulae for the calculation of risk weighted exposure amounts

This table belongs to ■ BIPRU 4.4.57 R

<table>
<thead>
<tr>
<th>Correlation (R)</th>
<th>0.12 × (1 - EXP(-50<em>PD))/(1-EXP(-50)) + 0.24</em> [1-(1-EXP(-50*PD))/(1-EXP(-50))]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturity factor (b)</td>
<td>(0.11852-0.05478*1n(PD))^2</td>
</tr>
<tr>
<td>(LGD<em>N[(1-R)^0.5</em>G(PD)+(R/(1-R)^0.5 <em>G(0.999)]-PD</em>LGD)* (1-1.5<em>b)^1</em>(1+(M-2.5)*b)<em>12.5</em>1.06</td>
<td></td>
</tr>
<tr>
<td>N(x)</td>
<td>denotes the cumulative distribution function for a standard normal random variable (i.e. the probability that a normal random variable with mean zero and variance of one is less than or equal to x). G(z) denotes the inverse cumulative distribution function for a standard normal random variable (i.e. the value x such that N(x) = z).</td>
</tr>
<tr>
<td>PD = 0</td>
<td>For PD = 0, RW shall be: 0</td>
</tr>
<tr>
<td>PD = 1</td>
<td>For PD = 1:</td>
</tr>
<tr>
<td>(i)</td>
<td>for defaulted exposures where a firm applies the LGD values set out in BIPRU 4.4.32R and BIPRU 4.8.25R RW shall be: 0;</td>
</tr>
<tr>
<td>(ii)</td>
<td>for defaulted exposures where a firm uses its own estimates of LGDs, RW shall be: Max {0, 12.5 *(LGD-EL_{BE})};</td>
</tr>
</tbody>
</table>

where $EL_{BE}$ must be the firm’s best estimate of expected...
For exposures to companies where the total annual sales for the consolidated group of which the firm is a part is less than EUR 50 million a firm may use the following correlation formula for the calculation of risk weights for corporate exposures. In this formula S is expressed as total annual sales in millions of Euros with EUR 5 million ≤ S ≤ EUR 50 million. Reported sales of less than EUR 5 million must be treated as if they were equivalent to EUR 5 million. In accordance with BIPRU 4.8.21 R, for purchased receivables the total annual sales are the weighted average by individual exposures of the pool. The formula for the calculation of correlation (R) is:

\[
0.12 \times \frac{(1 - \exp(-50*PD))/(1 - \exp(-50)))}{(1 - \exp(-50))} + 0.24 \times \left[ 1 - \frac{(1 - \exp(-50*PD))/(1 - \exp(-50)))}{(1 - \exp(-50))} \right] - 0.04 \times \frac{(S - 5)/45}{(S - 5)/45}
\]

A firm must for the purpose of BIPRU 4.4.59 R substitute total assets of the consolidated group for total annual sales when total annual sales are not a meaningful indicator of firm size and total assets are a more meaningful indicator than total annual sales.

Calculations: Expected loss amounts

Expected loss amounts must be calculated according to the formulae in the table in BIPRU 4.4.62 R.

For defaulted exposures (PD = 1) where a firm uses its own estimates of LGDs, EL must be EL_{BE}, the firm’s best estimate of expected loss for the defaulted exposure according to BIPRU 4.3.122 R.

For exposures subject to the treatment set out in BIPRU 4.4.79 R (Double default) EL must be 0.

A firm must provide its own estimates of PDs in accordance with its IRB permission and the minimum IRB standards.
4.4.64 R The PD of a corporate exposure or an exposure in the IRB exposure class referred to in BIPRU 4.3.2 R (2) (Institutions) must be at least 0.03%.

[Note: BCD Annex VII Part 2 point 2]

4.4.65 R The PD of obligors in default must be 100%.

[Note: BCD Annex VII Part 2 point 4]

4.4.66 R Subject to BIPRU 4.4.42 R (Advanced IRB approach: LGDs and PDs) a firm may recognise unfunded credit protection in the PD in accordance with the provisions of BIPRU 5 (Credit risk mitigation), as modified by BIPRU 4.10. For dilution risk, however, a firm may also recognise unfunded credit protection providers which are specified in its IRB permission in addition to those indicated in the CRM eligibility conditions.

[Note: BCD Annex VII Part 2 point 5]

Calculations: Maturity

4.4.67 R

1. A firm must calculate maturity (M) for each of the exposures referred to in this rule in accordance with this rule and subject to BIPRU 4.4.68 R to BIPRU 4.4.70 R. In all cases, M must be no greater than 5 years.

2. For an instrument subject to a cash flow schedule M must be calculated according to the following formula:

\[ M = \text{MAX}(1, \text{MIN}(\sum t_i \cdot \text{CF}_{i}, \sum t_i \cdot \text{CF}_{i} \cdot 5)) \]

where CF\textsubscript{t} denotes the cash flows (principal, interest payments and fees) contractually payable by the obligor in period t.

3. For derivatives subject to a master netting agreement M must be the weighted average remaining maturity of the exposure, where M must be at least 1 year. The notional amount of each exposure must be used for weighting the maturity.

4. For exposures arising from fully or nearly-fully collateralised financial derivative instruments transactions and fully or nearly-fully collateralised margin lending transactions which are subject to a master netting agreement M must be the weighted average remaining maturity of the transactions where M must be at least 10 days. For repurchase transactions or securities or commodities lending or borrowing transactions which are subject to a master netting agreement, M must be the weighted average remaining maturity of transactions, where M must be at least 5 days. The notional amount of each transaction must be used for weighting the maturity.

5. Where a firm uses the CCR internal model method to calculate the exposure values, M must be calculated for exposures to which a firm applies this method and for which the maturity of the longest-dated contract contained in the netting set is greater than one year according to the following formula:

\[ M = \text{MIN} \left( \left( \sum_{z \in Z} \text{EffectiveBB}\textsubscript{z} \cdot \Delta \alpha \cdot d\alpha \cdot \sum_{t \in T} \text{EffectiveBB}\textsubscript{t} \cdot \Delta \alpha \cdot d\alpha \right) \right) \]
where:

dfk = the risk-free discount factor for future time period tk and the remaining symbols are defined in BIPRU 13.6.

(6) Notwithstanding (7), a firm that uses a CCR internal model method model to calculate a one-sided credit valuation adjustment (CVA) may use the effective credit duration estimated by the model as M if permitted to do so by its CCR internal model method permission.

(7) Subject to BIPRU 4.4.68 R, for netting sets in which all contracts have an original maturity of less than one year the formula in (2) must be applied.

(8) If a firm is permitted under its IRB permission to use own PD estimates for corporate exposure purchased receivables, for drawn amounts M must equal the purchased receivables exposure weighted average maturity, where M must be at least 90 days. This same value of M must also be used for undrawn amounts under a committed purchase facility provided the facility contains effective covenants, early amortisation triggers, or other features that protect the purchasing firm against a significant deterioration in the quality of the future receivables it is required to purchase over the facility’s term. Absent such effective protections, M for undrawn amounts must be calculated as the sum of the longest-dated potential receivable under the purchase agreement and the remaining maturity of the purchase facility, where M must be at least 90 days.

(9) For any other instrument than mentioned in this rule or when a firm is not in a position to calculate M as set out in (2), M must be the maximum remaining time (in years) that the obligor is permitted to take fully to discharge its contractual obligations, where M must be at least 1 year.

(10) Notwithstanding (2) and (9), M must be at least one-day for:

(a) import letters of credit (including standby letters of credit issued for similar purposes) and acceptances under them;

(b) export letters of credit confirmation and negotiation;

(c) pre-shipment and post-shipment acceptances and financing;

(d) export and import loans collateralised by underlying goods, up to a maximum maturity of 180 days; and

(e) performance guarantees, bid bonds and other guarantees (including standby letters of credit issued for similar purposes) relating to the export and import of goods and services;

provided these exposures are not part of the firm’s ongoing financing of the obligor.

[Note: BCD Annex VII Part 2 point 13 (part)]

4.4.68 R

Notwithstanding BIPRU 4.4.67 R (2) - (4) and (8)-(9), M must be at least one-day for:

(1) fully or nearly-full collateralised financial derivative instruments;
(2) fully or nearly-fully collateralised margin lending transactions; and

(3) repurchase transactions, securities or commodities lending or borrowing transactions,

provided the documentation requires daily remargining and daily revaluation and includes provisions that allow for the prompt liquidation or setoff of collateral in the event of default or failure to re-margin.

[Note: BCD Annex VII Part 2 point 14 (part)]

4.4.69 The last paragraph of paragraph 14 of Part 2 of Annex VII of the Banking Consolidation Directive says: "In addition, for other short-term exposures specified by the competent authorities which are not part of the credit institution’s ongoing financing of the obligor, M shall be at least one-day. A careful review of the particular circumstances shall be made in each case." ■ BIPRU 4.4.67R (10) is currently the only instance where the appropriate regulator has specified any such short-term exposures.

[Note: BCD Annex VII Part 2 point 14 (part)]

4.4.70 Maturity mismatches must be treated as specified in ■ BIPRU 4.10 and ■ BIPRU 5 (Credit risk mitigation).

[Note: BCD Annex VII Part 2 point 16]

Calculations: Exposure value

4.4.71 Unless provided otherwise in ■ BIPRU 4 the exposure value of on-balance sheet exposures must be measured gross of value adjustments. This also applies to assets purchased at a price different than the amount owed. For purchased assets, the difference between the amount owed and the net value recorded on the balance-sheet of the firm is denoted discount if the amount owed is larger, and premium if it is smaller.

[Note: BCD Annex VII Part 3 point 1]

4.4.72 A firm must not treat the exposure value of a facility as being less than current drawings under it. Interest accrued to date on an exposure under a facility must be included in current drawings or an allowance for it must be built into the conversion factor.

4.4.73 Where a firm uses master netting agreements in relation to repurchase transactions or securities or commodities lending or borrowing transactions the exposure value must be calculated in accordance with ■ BIPRU 5 (Credit risk mitigation), as modified by ■ BIPRU 4.10, and ■ BIPRU 13.8.

[Note: BCD Annex VII Part 3 point 2]
4.4.74 For on-balance sheet netting of loans and deposits a firm must apply for the calculation of the exposure value the methods set out in BIPRU 5 (Credit risk mitigation), as modified by BIPRU 4.10.

[Note: BCD Annex VII Part 3 point 3]

4.4.75 The exposure value for leases must be the discounted minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make and any bargain option (i.e. option the exercise of which is reasonably certain). Any guaranteed residual value fulfilling the set of conditions in BIPRU 5.7.1 R (Eligibility), as modified by BIPRU 4.10.38 R and BIPRU 4.10.39 R (Unfunded credit protection: Eligibility of providers) regarding the eligibility of protection providers as well as the minimum requirements for recognising other types of guarantees provided in BIPRU 5.7.6 R (Minimum requirements: General) to BIPRU 5.7.12 R (Additional requirements for guarantees) should also be included in the minimum lease payments.

[Note: BCD Annex VII Part 3 point 4]

4.4.76 Where an exposure takes the form of securities or commodities sold, posted or lent under repurchase transactions or securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions, the exposure value must be the value of the securities or commodities determined in accordance with GENPRU 1.3 (Valuation). Where the financial collateral comprehensive method is used, the exposure value must be increased by the volatility adjustment appropriate to such securities or commodities as set out in BIPRU 4.10 and BIPRU 5 (Credit risk mitigation). The exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlements transactions and margin lending transactions must be determined in accordance with BIPRU 13.

[Note: BCD Annex VII Part 3 point 7]

4.4.77 Notwithstanding BIPRU 4.4.76 R, the exposure value of credit risk exposures outstanding, as determined by the firm, with a central counterparty must be determined in accordance with BIPRU 13.3.3 R and BIPRU 13.8.8 R (Exposure to central counterparty), provided that the central counterparty’s CCR exposures with all participants in its arrangements are fully collateralised on a daily basis.

[Note: BCD Annex VII Part 3 point 8]

4.4.78 In the case of any financial derivative instrument, the exposure value must be determined by the methods set out in BIPRU 13.

[Note: BCD Annex VII Part 3 point 5]

Double default

4.4.79 The risk weighted exposure amount for each exposure which meets the requirements set out in BIPRU 5.7.2 R and BIPRU 4.4.83 R (Double default) may be adjusted according to the following formula:
(1) Risk weighted exposure amount = RW * exposure value * (0.15 + 160 * PDpp)

(2) PDpp = PD of the protection provider

(3) RW must be calculated using the relevant risk weight formula set out in BIPRU 4.4.57 R for the exposure, the PD of the obligor and the LGD of a comparable direct exposure to the protection provider. The maturity factor (b) must be calculated using the lower of the PD of the protection provider and the PD of the obligor.

[Note: BCD Annex VII Part 1 point 4]

Notwithstanding BIPRU 4.4.34 R and BIPRU 4.4.43 R, for the purposes of BIPRU 4.4.79 R, the LGD of a comparable direct exposure to the protection provider shall either be the LGD associated with an unhedged facility to the guarantor or the unhedged facility of the obligor, depending upon whether in the event both the guarantor and the obligor default during the life of the hedged transaction available evidence and the structure of the guarantee indicate that the amount recovered would depend on the financial condition of the guarantor or obligor, respectively

[Note: BCD Annex VII Part 2 point 11]

For the purposes of BIPRU 4.4.79 R, M must be the effective maturity of the credit protection but at least 1 year.

[Note: BCD Annex VII Part 2 point 13 (part)]

BIPRU 4.4.83 R applies to the eligibility of protection providers under the IRB approach which qualify for the treatment set out in BIPRU 4.4.79 R.

An institution, an insurance undertaking (including an insurance undertaking that carries out reinsurance) or an export credit agency which fulfils the following conditions may be recognised as an eligible provider of unfunded credit protection which qualifies for the treatment set out in BIPRU 4.4.79 R:

(1) the protection provider has sufficient expertise in providing unfunded credit protection;

(2) the protection provider is regulated in a manner equivalent to the rules laid down in the Banking Consolidation Directive or had, at the time the credit protection was provided, a credit assessment by an eligible ECAI which is associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under the standardised approach;

(3) the protection provider had, at the time the credit protection was provided, or for any period of time thereafter, an internal rating with a PD equivalent to or lower than that associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under the standardised approach;

(4) the protection provider has an internal rating with a PD equivalent to or lower than that associated with credit quality step 3 or above
under the rules for the risk weighting of exposures to corporates under the standardised approach;

For the purpose of this rule, credit protection provided by an export credit agency must not benefit from any explicit central government counter-guarantee.

[Note: BCD Annex VIII Part 1 point 29]

4.4.84 R ■ BIPRU 4.4.85 R applies to the requirements to qualify for the treatment set out in ■ BIPRU 4.4.79 R.

4.4.85 R To be eligible for the treatment set out in ■ BIPRU 4.4.79 R, credit protection deriving from a guarantee or credit derivative must meet the following conditions:

1. the underlying obligation must be to:
   (a) a corporate exposure, excluding an exposure to an insurance undertaking (including an insurance undertaking that carries out reinsurance); or
   (b) an exposure to a regional government, local authority or public sector entity which is not treated as an exposure to a central government or a central bank according to ■ BIPRU 4.4.2 R; or
   (c) an exposure to retail SME, classified as a retail exposure according to ■ BIPRU 4.6.2 R;

2. the underlying obligors must not be members of the same group as the protection provider;

3. the exposure must be hedged by one of the following instruments:
   (a) single name unfunded credit derivatives or single name guarantees;
   (b) first to default basket products, with these the treatment must be applied to the asset within the basket with the lowest risk weighted exposure amount;
   (c) n\textsuperscript{th} to default basket products, with these the protection obtained is only eligible for consideration under this framework if eligible (n-1)\textsuperscript{th} default protection has also been obtained or where (n-1) of the assets within the basket has/have already defaulted and where this is the case the treatment must be applied to the asset within the basket with the lowest risk weighted exposure amount;

4. the credit protection must meet the requirements set out in ■ BIPRU 5.7.6 R - ■ BIPRU 5.7.8 R (Minimum requirements: Operational requirements), ■ BIPRU 5.7.11 R (Additional requirements for guarantees) and ■ BIPRU 5.7.13 R - ■ BIPRU 5.7.14 R (Additional requirements for credit derivatives);

5. the risk weight that is associated with the exposure prior to the application of the treatment in ■ BIPRU 4.4.79 R does not already factor in any aspect of the credit protection;
(6) a firm must have the right and expectation to receive payment from the protection provider without having to take legal action in order to pursue the counterparty for payment;

(7) the purchased credit protection must absorb all credit losses incurred on the hedged portion of an exposure that arise due to the occurrence of credit events outlined in the contract;

(8) if the payout structure provides for physical settlement, then there must be legal certainty with respect to the deliverability of a loan, bond or contingent liability and if a firm intends to deliver an obligation other than the underlying exposure, it must ensure that the deliverable obligation is sufficiently liquid so that the firm would have the ability to purchase it for delivery in accordance with the contract;

(9) the terms and conditions of credit protection arrangements must be legally confirmed in writing by both the protection provider and the firm;

(10) a firm must have a process in place to detect excessive correlation between the creditworthiness of a protection provider and the obligor of the underlying exposure due to their performance being dependent on common factors beyond the systematic risk factor;

(11) in the case of protection against dilution risk, the seller of purchased receivables must not be a member of the same group as the protection provider; and

(12) with reference to (6), to the extent possible, a firm must take steps to satisfy itself that the protection provider is willing to pay promptly should a credit event occur.

[Note: BCD Annex VIII Part 2 point 22]
4.5 The IRB approach: Specialised lending exposures

Application

4.5.1 BIPRU 4.5 applies with respect to the exposures referred to in BIPRU 4.5.3 R.

4.5.2 Except for BIPRU 4.5.1 R and BIPRU 4.5.3 R, BIPRU 4.5 only applies to the extent that a firm applies the method in BIPRU 4.5 (slotting).

Definition of specialised lending

4.5.3 Within the corporate exposure IRB exposure class, a firm must separately identify as specialised lending exposures, exposures which possess the following characteristics:

1. The exposure is to an entity which was created specifically to finance and/or operate physical assets;
2. The contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and
3. The primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.

[Note: BCD Article 86(6)]

Treatment of specialised lending

4.5.4 If a firm is using or is applying to use the advanced IRB approach for some or all of its exposures in the sovereign, institution and corporate IRB exposure class, then specialised lending exposures treated under BIPRU 4.5.8 R (Slotting) must be treated as being dealt with under the advanced IRB approach for the purposes of the calculations in BIPRU 4.2.30 R and BIPRU 4.2.31 R. If a firm is not using or applying to use the advanced IRB approach for any of its exposures in the sovereign, institution and corporate IRB exposure class, in the cases in which it is necessary to distinguish between the advanced IRB approach and the foundation IRB approach, then specialised lending exposures treated under BIPRU 4.5.8 R must be treated as being dealt with under the foundation IRB approach for the purposes of the calculations in BIPRU 4.2.30 R and BIPRU 4.2.31 R.
Section 4.5: The IRB approach: Specialised lending exposures

R4.5.5 A firm using the methods set out in BIPRU 4.5.8 R (Slotting) for assigning risk weights for specialised lending exposures is exempt from the requirement to have an obligor rating scale which reflects exclusively quantification of the risk of obligor default for these exposures. Notwithstanding BIPRU 4.4.7 R (Seven grades for exposures to sovereigns, institutions and corporates), a firm must have for these exposures four grades for non-defaulted obligors and one grade for defaulted obligors.

[Note: BCD Annex VII Part 4 point 12 and point 21]

R4.5.6 (1) A firm using the methods set out in BIPRU 4.5.8 R (Slotting) for assigning risk weights for specialised lending exposures must assign each of these exposures to a grade in accordance with BIPRU 4 Annex 1 R, taking into account the following factors:

(a) financial strength;
(b) political and legal environment;
(c) transaction and/or asset characteristics;
(d) strength of the sponsor and developer including any public private partnership income stream; and
(e) security package.

(2) A firm must slot exposures into the five columns in the tables in BIPRU 4.5.9 R and BIPRU 4.5.13 R as follows:

(a) a firm must slot an exposure categorised as strong under Annex X into column 1;
(b) a firm must slot an exposure categorised as good under the Annex X into column 2;
(c) a firm must slot an exposure categorised as satisfactory under Annex X into column 3;
(d) a firm must slot an exposure categorised as weak under Annex X into column 4;
(e) in accordance with BIPRU 4.5.5 R a firm must slot an exposure in default into column 5.

[Note: BCD Annex VII Part 1 point 6 (part)]

R4.5.7 Notwithstanding BIPRU 4.3.5 R (Use of relevant parameters for calculating risk weighted exposure amounts), the calculation of risk weighted exposure amounts for credit risk for specialised lending exposures may be calculated in accordance with BIPRU 4.5.8 R.

[Note: BCD Article 87(5)]

R4.5.8 For specialised lending exposures in respect of which a firm cannot demonstrate that its PD estimates meet the minimum IRB standards it must
assign *risk weights* to these exposures according to the table in ■BIPRU 4.5.9 R.

[Note: *BCD* Annex VII Part 1 point 6 (part)]

### 4.5.9

**Table: Risk weights for specialised lending**

This table belongs to ■BIPRU 4.5.8 R

<table>
<thead>
<tr>
<th>Remaining maturity</th>
<th>Category 1 (Strong)</th>
<th>Category 2 (Good)</th>
<th>Category 3 (Satisfactory)</th>
<th>Category 4 (Weak)</th>
<th>Category 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2.5 years</td>
<td>50%</td>
<td>70%</td>
<td>115%</td>
<td>250%</td>
<td>0%</td>
</tr>
<tr>
<td>Equal or more than 2.5 years</td>
<td>70%</td>
<td>90%</td>
<td>115%</td>
<td>250%</td>
<td>0%</td>
</tr>
</tbody>
</table>

The coverage of each of the categories is set out in BIPRU 4.5.6 R

[Note: *BCD* Annex VII Part 1 point 6 (part)]

### 4.5.10

A *firm* may generally assign preferential *risk weights* of 50% to exposures in category 1, and a 70% *risk weight* to exposures in category 2 if:

1. its *IRB permission* allows this; and
2. the *firm’s* underwriting characteristics and other risk characteristics are substantially strong for the relevant category.

[Note: *BCD* Annex VII Part 1 point 6 (part)]

### 4.5.11

1. If a *firm* applies for an *IRB permission* or for a variation of an *IRB permission* that permits the treatment in ■BIPRU 4.5.10 R it should demonstrate that its standards exceed those of the slotting criteria provided for in ■BIPRU 4.5 and result in ratings that are stronger than the benchmarks referred to in (3).

2. If a *firm* has an *IRB permission* that permits the treatment in ■BIPRU 4.5.10 R it should continue to be able to demonstrate the matters in (1) to the *appropriate regulator* if asked.

3. Although a *firm* should map its internal ratings to the supervisory categories set out in the table in ■BIPRU 4.5.9 R using the slotting criteria provided in ■BIPRU 4.5.6 R, each supervisory category broadly corresponds to a range of external credit assessments of BBB- or better, BB+ or BB, BB- or B+ and B to C- (or their equivalents). The fifth category covers default.

### Calculation of expected loss amounts

The *EL* values for *specialised lending exposures* where a *firm* uses the methods set out in ■BIPRU 4.5.8 R for assigning *risk weights* must be assigned according to the table in ■BIPRU 4.5.13 R.

[Note: *BCD* Annex VII Part 1 point 31 (part)]
### Table: Expected loss values for specialised lending

This table belongs to BIPRU 4.5.12 R

<table>
<thead>
<tr>
<th>Remaining maturity</th>
<th>Category 1 (Strong)</th>
<th>Category 2 (Good)</th>
<th>Category 3 (Satisfactory)</th>
<th>Category 4 (Weak)</th>
<th>Category 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2.5 years</td>
<td>0%</td>
<td>0.4%</td>
<td>2.8%</td>
<td>8%</td>
<td>50%</td>
</tr>
<tr>
<td>Equal or more than 2.5 years</td>
<td>0.4%</td>
<td>0.8%</td>
<td>2.8%</td>
<td>8%</td>
<td>50%</td>
</tr>
</tbody>
</table>

The coverage of each of the categories is set out in BIPRU 4.5.6 R

[Note: BCD Annex VII Part 1 point 31 (part)]

---

4.5.14 Where a firm's IRB permission authorises it generally to assign preferential risk weights as outlined in BIPRU 4.5.10 R of 50% to exposures in category 1, and 70% to exposures in category 2, the EL value for exposures in category 1 must be 0%, and for exposures in category 2 must be 0.4%.

[Note: BCD Annex VII Part 1 point 31 (part)]
4.6 The IRB approach: Retail exposures

Application

4.6.1 R BIPRU 4.6 applies with respect to the exposures referred to in BIPRU 4.6.2 R.

Definition of retail exposures

4.6.2 R To be eligible to be treated as a retail exposure, exposures must meet the following criteria:

1. they must be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the firm and parent undertaking and its subsidiary undertakings, including any past due exposure, by the obligor client or group of connected clients, but excluding claims or contingent claims secured on residential real estate collateral, must not, to the knowledge of the firm, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;

2. they are treated by the firm in its risk management consistently over time and in a similar manner;

3. they are not managed just as individually as exposures in the corporate exposure IRB exposure class; and

4. they each represent one of a significant number of similarly managed exposures.

[Note: BCD Article 86(4) (part)]

4.6.3 R The present value of retail minimum lease payments is eligible to be treated as a retail exposure.

[Note: BCD Article 86(4) (part)]

4.6.4 G (1) This paragraph sets out guidance on BIPRU 4.6.2 R so far as it relates to the boundary between retail exposures and corporate exposures.

(2) In deciding what steps are reasonable for the purposes of BIPRU 4.6.2 R (1), a firm may take into account complexity and cost, as well as the materiality of the impact upon its capital calculation. A firm should be able to demonstrate to the appropriate regulator that it has complied with the obligation to take reasonable steps under BIPRU 4.6.2 R (1) in the way it takes these factors into account.
(3) If a firm has exposures to an owner of a retail SME in his personal capacity and exposures to the retail SME the firm should aggregate the two types of exposure for the purpose of BIPRU 4.6.2 R (1), although it should not include claims secured on residential real estate collateral. In deciding what steps are reasonable for the purposes of BIPRU 4.6.2 R (1) in aggregating these two types of exposure, a firm may take into account the materiality of those personal exposures. A firm should be able to demonstrate to the appropriate regulator that it has complied with the obligation to take reasonable steps under BIPRU 4.6.2 R (1) when taking into account materiality in this way.

(4) The definition of group of connected clients is set out in the glossary. Paragraph (2) of that definition is "two or more persons ... who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties". Say that a firm has exposures to A and B. When deciding whether A and B come within paragraph (2) of the definition two conditions should be satisfied. Firstly the connections between A and B should mean that if A experiences financial problems, B should be likely to encounter repayment difficulties. Secondly, the connections between A and B should mean that if B experiences financial problems, A should be likely to encounter repayment difficulties.

(5) A firm should have its own documented policy on the types of exposures that, in accordance with BIPRU 4.6, qualify as retail SME exposures. The appropriate regulator would not expect that a definition based on the EUR 1m exposure limit would be adequate on its own.

(6) The purpose of the definition of retail exposure is to separate a non-granular retail and small and medium sized business portfolio from other business so that a separate capital calculation may be applied to that portfolio that takes into account its non-granularity. Where retail exposures are assigned to pools it is the statistical characteristics of these pools which are used to derive the IRB approach estimates. Therefore pools should be reasonably homogenous and subject to consistent risk management practices.

(7) A firm should have sufficient controls to ensure that any inadvertent assignment of non-eligible exposures to the retail exposure IRB exposure class is sufficiently immaterial that it does not result in any significant distortion of the overall statistical characteristics of the sub-sets of that IRB exposure class which arise when the exposures are assigned to grades or pools. Cost considerations do not justify inclusion of non-eligible exposures if the effect would be material. Sample testing could be one method of demonstrating that the impact would be immaterial. BIPRU 4.1.25 R applies to exposures treated in accordance with this sub-paragraph (7).

(8) If an exposure to a small or medium sized business crosses the retail exposure size boundary it should be treated as a corporate, unless, in accordance with BIPRU 4.1.25 R, the excess is immaterial because of its size or because it is temporary.
BIPRU 4 : The IRB approach

Section 4.6 : The IRB approach: Retail exposures

(9) BIPRU 4.6.2 R does not require that exposures to retail SMEs should never be individually managed. In deciding whether the frequency and extent of individual management does or does not make exposures ineligible for the retail exposure IRB exposure class, a firm should consider whether that individual management is:

(a) sufficiently insignificant not to disrupt the homogeneity of the pool;

(b) consistent with the management of other exposures in the same retail exposure pool; and

(c) significantly different in extent from the individual management that occurs for corporate exposures, looked at as a whole.

(10) Where an exposure is denominated in other currencies, a firm may calculate the Euro equivalent for the purposes of BIPRU 4.6.2 R (1) using any appropriate set of exchange rates provided its choice has no obvious bias and that the firm is consistent in its approach to choosing rates.

(11) A firm may monitor compliance with the €1m threshold in BIPRU 4.6.2 R (1) on the basis of approved limits provided that it has internal control procedures that are sufficient to ensure that amounts owed cannot diverge from those approved limits to such an extent as to give rise to a breach of the €1m threshold or, if the firm is relying on provisions relating to reasonable steps in BIPRU 4.6.2 R (1), any material breach of that threshold.

Rating system: Structure of rating system

4.6.5 Further material on the structure of rating systems can be found in BIPRU 4.3.25 R - BIPRU 4.3.28 R.

Rating system: Assignment to grades or pools

4.6.6 Rating systems must reflect both obligor and transaction risk, and must capture all relevant obligor and transaction characteristics.

[Note: BCD Annex VII Part 4 point 13]

4.6.7 The level of risk differentiation must ensure that the number of exposures in a given grade or pool is sufficient to allow for meaningful quantification and validation of the loss characteristics at the grade or pool level. The distribution of exposures and obligors across grades or pools must be such as to avoid excessive concentrations.

[Note: BCD Annex VII Part 4 point 14]

4.6.8 (1) This paragraph contains guidance on the level of differentiation referred to in BIPRU 4.6.7 R.

(2) It is important that a firm achieves adequate segmentation to deliver robust estimates of LGD and conversion factors, as well as PD. Whether the focus should be more on exposure size or collateral type is a question of fact for the particular circumstances in which the
assignment of exposures to grades or pools occurs. Typically the appropriate regulator would expect both to be important.

(3) A firm may allocate retail exposures to pools based on direct estimates of PD, LGD and conversion factors as well as using an approach under which the firm segments first and attributes PD, LGD and conversion factors afterwards. However the result should in either case be that the pools are sufficiently homogenous.

(4) The number and size of pools should be determined in relation to the objective of establishing homogeneous risk. Pools should be of sufficient size to permit the production of robust risk estimates but should not be so large as to obscure variations in quality.

A firm must be able to demonstrate to the appropriate regulator that the process of assigning exposures to grades or pools provides for a meaningful differentiation of risk, provides for a grouping of sufficiently homogenous exposures, and allows for accurate and consistent estimation of loss characteristics at grade or pool level.

[Note: BCD Annex VII Part 4 point 15 (part)]

For purchased receivables, BIPRU 4.8 contains material about assignment to grades or pools.

(1) A firm must consider the following risk drivers when assigning exposures to grades or pools:
   (a) obligor risk characteristics;
   (b) transaction risk characteristics, including product or collateral types or both; and
   (c) delinquency.

(2) In the case of (1)(b) a firm must explicitly address cases where several exposures benefit from the same collateral.

(3) However:
   (a) a firm need not consider delinquency if this is compatible with its IRB permission; and
   (b) (in the case of a firm with an IRB permission that permits the firm not to consider delinquency) it should be able to demonstrate to the appropriate regulator that delinquency is not a material risk driver for the exposures treated in this way.

[Note: BCD Annex VII Part 4 Point 16]

Rating system: Assignment of exposures

Each exposure must be assigned to a grade or a pool as part of the credit approval process.

[Note: BCD Annex VII Part 4 point 24]
Rating system: Overrides

Material on overrides can be found in BIPRU 4.3.50 R.

Rating system: Integrity of assignment process

A firm must at least annually update obligor and facility assignments or review the loss characteristics and delinquency status of each identified risk pool whichever is applicable. A firm must also at least annually review in a representative sample the status of individual exposures within each pool as a means of ensuring that exposures continue to be assigned to the correct pool.

[Note: BCD Annex VII Part 4 point 29]

Rating system: Use of models

Material on the use of models can be found in BIPRU 4.3.51 R - BIPRU 4.3.53 G.

Rating system: Documentation

Material on documentation can be found in BIPRU 4.3.19 R - BIPRU 4.3.24 R.

Rating system: Data maintenance

In addition to complying with BIPRU 4.3.54 R (Data maintenance) a firm must collect and store:

1. data used in the process of allocating exposures to grades or pools;
2. data on the estimated PDs, LGDs and conversion factors associated with grades or pools of exposures;
3. the identity of obligors and exposures that defaulted;
4. for defaulted exposures, data on the grades or pools to which the exposure was assigned over the year prior to default and the realised outcomes on LGD and conversion factor; and
5. data on loss rates for qualifying revolving retail exposures.

[Note: BCD Annex VII Part 4 point 39]

Risk quantification: Definition of default

Material on the definition of default can be found in BIPRU 4.3.56 R - BIPRU 4.3.72 G.
4.6.20  R  (1) This rule, in accordance with BIPRU 4.3.57 R (4) (Definition of default), sets the exact number of days past due that a firm must abide by in the case of retail exposures.

(2) For retail exposures to counterparts situated within the United Kingdom the number of days past due is 180 days with the exception of retail SME exposures. For these exposures the number is 90 days.

(3) For retail exposures to counterparts situated in another EEA State the number of days past due is the lower of:

(a) 180; and

(b) the number of days past due fixed under the CRD implementation measure in that EEA State with respect to paragraph 48 of Part 4 of Annex VII of the Banking Consolidation Directive for such exposures.

(4) For retail exposures to counterparts in a state outside the EEA the number of days past due is the lower of:

(a) 180; and

(b) (if a number of days past due for such exposures has been fixed under any national law of that state applicable to undertakings in the banking sector or the investment services sector that implements the IRB approach) that number.

[Note: BCD Annex VII Part 4 point 44 (part) and point 48 (part)]

4.6.21  R  A firm may apply the definition of default at a facility level.

[Note: BCD Annex VII Part 4 point 44 (part)]

4.6.22  G  Where a firm chooses to apply the definition of default at facility level and a customer has defaulted on a facility, then default on that facility is likely to influence the PD assigned to that customer on other facilities and so should be taken into account.

Risk quantification: Overall requirements for estimation
Material on the overall requirements for estimation can be found in BIPRU 4.3.73 R - BIPRU 4.3.94 R.

Risk quantification: Requirements specific to PD estimation
A firm must estimate PDs by obligor grade or pool from long run averages of one-year default rates.

[Note: BCD Annex VII Part 4 point 67]

4.6.24  R  Notwithstanding BIPRU 4.6.24 R, PD estimates may also be derived from realised losses and appropriate estimates of LGDs.

[Note: BCD Annex VII Part 4 point 68]
A firm must regard internal data for assigning exposures to grades or pools as the primary source of information for estimating loss characteristics. A firm may use external data (including pooled data) or statistical models for quantification provided a strong link can be demonstrated between:

1. the firm's process of assigning exposures to grades or pools and the process used by the external data source; and
2. the firm's internal risk profile and the composition of the external data.

[Note: BCD Annex VII Part 4 point 69]

If a firm derives long run average estimates of PD and LGD for retail exposures from an estimate of total losses, and an appropriate estimate of PD or LGD, the process for estimating total losses must meet the minimum IRB standards for estimation of PD and LGD, and the outcome must be consistent with the concept of LGD as set out in BIPRU 4.3.99 R (Default weighted average).

[Note: BCD Annex VII Part 4 point 70]

Irrespective of whether a firm is using external, internal, pooled data sources or a combination of the three, for its estimation of loss characteristics, the length of the underlying historical observation period used must be at least five years for at least one source. If the available observation spans a longer period for any source, and these data are relevant, this longer period must be used. However:

1. a firm need not give equal importance to historic data if this is compatible with its IRB permission; and
2. (in the case of a firm with an IRB permission that permits this treatment of historic data) the firm must be able to convince the appropriate regulator that more recent data is a better predictor of loss rates.

[Note: BCD Annex VII Part 4 point 71 (part)]

A firm may have, when implementing the IRB approach, relevant data covering a period of two years. The period to be covered must increase by one year each year until relevant data covers a period of five years.

[Note: BCD Annex VII Part 4 point 71 (part)]

A firm must identify and analyse expected changes of risk parameters over the life of credit exposures (seasoning effects).

[Note: BCD Annex VII Part 4 point 72]
Risk quantification: Requirements specific to own-LGD estimation

4.6.31  R  Notwithstanding BIPRU 4.3.99 R (Default weighted average), LGD estimates may be derived from realised losses and appropriate estimates of PDs.

[Note: BCD Annex VII Part 4 point 83]

4.6.32  R  Notwithstanding BIPRU 4.128 R (Additional drawings), a firm may reflect future drawings either in its conversion factor or in its LGD estimates.

[Note: BCD Annex VII Part 4 point 84]

4.6.33  R  Estimates of LGD must be based on data over a minimum of five years. Notwithstanding BIPRU 4.3.99 R (Default weighted average):

(1) a firm need not give equal importance to historic data if this is permitted by its IRB permission; and

(2) (in the case of a firm with an IRB permission that permits this treatment of historic data) the firm must be able to convince the appropriate regulator that more recent data is a better predictor of loss rates.

[Note: BCD Annex VII Part 4 point 86 (part)]

4.6.34  R  A firm may have, when it implements the IRB approach, relevant data covering a period of two years. The period to be covered must increase by one year each year until relevant data covers a period of five years.

[Note: BCD Annex VII Part 4 point 86 (part)]

4.6.35  G  The appropriate regulator does not assume that all portfolios are sensitive to downturns. The appropriate regulator also accepts that for some portfolios, particularly in unsecured lending, the impact of the material drivers on LGD may be weak. However the burden is on the firm to demonstrate that its models are appropriate for the circumstances in which they are applied.

4.6.36  G  Additional material on requirements specific to own-LGD estimation can be found in BIPRU 4.3.98 R - BIPRU 4.3.123 R.

Risk quantification: Requirements specific to own-conversion factor estimates

4.6.37  R  Notwithstanding BIPRU 4.128 R (Additional drawings), a firm may reflect future drawings either in its conversion factors or in its LGD estimates.

[Note: BCD Annex VII Part 4 point 94]

4.6.38  R  Estimates of conversion factors must be based on data over a minimum of five years. Notwithstanding BIPRU 4.3.125 R:

(1) a firm need not give equal importance to historic data if this is permitted by its IRB permission; and
(2) (in the case of a firm with an IRB permission that permits this treatment of historic data) the firm must be able to convince the appropriate regulator if asked that more recent data is a better predictor of loss rates.

[Note: BCD Annex VII Part 4 point 95 (part)]

4.6.39 A firm may have, when it implements the IRB approach, relevant data covering a period of two years. The period to be covered must increase by one year each year until relevant data cover a period of five years.

[Note: BCD Annex VII Part 4 point 95 (part)]

4.6.40 Additional material on requirements specific to own-conversion factor estimation can be found in BIPRU 4.3.124 R - BIPRU 4.3.131 R.

Calculation of risk weighted exposure amounts for retail exposures: General

4.6.41 Subject to BIPRU 4.6.43 R and BIPRU 4.6.44 R, the risk weighted exposure amounts for retail exposures must be calculated according to the formulae in the table in BIPRU 4.6.42 R.

[Note: BCD Annex VII Part 1 point 10 1st sentence]

4.6.42 Table: Risk weighted exposure amounts for retail exposures

This table belongs to BIPRU 4.6.41 R

<table>
<thead>
<tr>
<th>Correlation (R)</th>
<th>0.03 × (1 - EXP(-35<em>PD))/(1-EXP(-35)) + 0.16</em> [1-(1-EXP(-35*PD))/(1-EXP(-35))]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight (RW)</td>
<td>(LGD<em>N[(1-R)-0.5</em>G(PD)+R/(1-R)]0.5 <em>G(0.999)-PD</em>LGD)<em>12.5</em>1.06</td>
</tr>
</tbody>
</table>

N(x) denotes the cumulative distribution function for a standard normal random variable (i.e. the probability that a normal random variable with mean zero and variance of one is less than or equal to x).

G(z) denotes the inverse cumulative distribution function for a standard normal random variable (i.e. the value x such that N(x) = z).

PD = 1 For PD = 1 (defaulted exposure), RW must be:

Max {0, 12.5 *(LGD-EL_{BE})}

where EL_{BE} must be the firm’s best estimate of expected loss for the defaulted exposure according to BIPRU 4.3.122 R.

Risk weighted exposure amount equals RW*exposure value

[Note: BCD Annex VII Part 1 point 10 (part)]
Calculation of risk weighted exposure amounts for retail exposures: Retail mortgages

4.6.43 R

For retail exposures secured by real estate collateral a correlation (R) of 0.15 must replace the correlation formula in the table in §BIPRU 4.6.42 R.

[Note: BCD Annex VII Part 1 point 12]

Calculation of risk weighted exposure amounts for retail exposures: Qualifying revolving retail exposures

4.6.44 R

(1) For qualifying revolving retail exposures a correlation (R) of 0.04 must replace the correlation formula in the table in §BIPRU 4.6.42 R.

(2) Retail exposures qualify as qualifying revolving retail exposures if they meet the following conditions:

(a) the IRB permission of the firm in question does not disapply this paragraph;

(b) the exposures are to individuals;

(c) the exposures are revolving, unsecured, and, to the extent they are not drawn, immediately and unconditionally cancellable by the firm;

(d) the maximum exposure to a single individual in the sub-portfolio is EUR 100,000 or less;

(e) the firm is able to demonstrate to the appropriate regulator that the use of the correlation formula in this paragraph is limited to portfolios that have exhibited low volatility of loss rates, relative to their average level of loss rates, especially within the low PD bands; and

(f) the firm is able to demonstrate to the appropriate regulator that treatment as a qualifying revolving retail exposure is consistent with the underlying risk characteristics of the sub-portfolio.

(3) In the context of this rule revolving exposures are defined as those where customers’ outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to a limit established by the firm in question. Undrawn commitments may be considered as unconditionally cancellable if the terms permit the firm to cancel them to the full extent allowable under consumer protection and related legislation.

[Note: BCD Annex VII Part 1 point 13 (part) and Part 3 point 9(a) (part)]

4.6.45 G

A firm should be able to demonstrate the low volatility of loss rates mentioned in §BIPRU 4.6.44 R (2)(e) at the time of the initial application for an IRB permission and thereafter at any time on request. The benchmark level should be the volatility of loss rates for the qualifying revolving retail exposure portfolio relative to the volatilities of loss rates of other relevant types of retail exposures. A firm should demonstrate low volatility by reference to data on the mean and standard deviation of loss rates over a time period that can be regarded as representative of the long-run performance of the portfolios concerned.
In the appropriate regulator's view a sub-portfolio consisting of credit card or overdraft obligations will usually meet the condition in BIPRU 4.6.44 R (2)(f). In the appropriate regulator's view it is unlikely that any other type of retail exposure will do so. If a firm wishes to apply the treatment in BIPRU 4.6.44 R (1) to product types other than credit card or overdraft obligations it should first discuss this with the appropriate regulator.

### Calculation of expected loss amounts

**Expected loss amounts must be calculated according to the formulae in the table in BIPRU 4.6.48 R.**

[Note: BCD Annex VII Part 1 point 30 (part)]

### Calculation of PDs

A firm must provide its own estimates of PDs in accordance with its IRB permission and the minimum IRB standards.

[Note: BCD Article 87(6) (part)]

The PD of an exposure must be at least 0.03%.

[Note: BCD Annex VII Part 2 point 17]

The PD of obligors in default must be 100%. If a firm is using the facility level approach described in BIPRU 4.6.21 R, the PD of an exposure in default must be 100%.

[Note: BCD Annex VII Part 2 point 18]

Unfunded credit protection may be recognised by adjusting PDs subject to BIPRU 4.6.54 R. For dilution risk, where a firm does not use its own estimates of LGDs, this must be subject to compliance with BIPRU 5 (Credit risk mitigation) modified by BIPRU 4.10 and, for this purpose, a firm may recognise unfunded credit protection providers other than those indicated in the CRM eligibility conditions provided the firm is able to demonstrate that the unfunded protection provider giving the undertaking is sufficiently
BIPRU 4 : The IRB approach

Section 4.6 : The IRB approach: Retail
exposures

4.6.53 R A firm must provide its own estimates of LGDs in accordance with its IRB permission and the minimum IRB standards. [Note: BCD Article 87(7) (part)]

4.6.54 R Unfunded credit protection may be recognised as eligible by adjusting PD or LGD estimates subject to the minimum IRB standards as specified in BIPRU 4.10.43 R - BIPRU 4.10.48 R and in accordance with the IRB permission either in support of an individual exposure or a pool of exposures. A firm must not assign guaranteed exposures an adjusted PD or LGD such that the adjusted risk weight would be lower than that of a comparable, direct exposure to the guarantor. [Note: BCD Annex VII Part 2 point 22]

4.6.55 R Except where otherwise specified, BIPRU 4.4.37 R - BIPRU 4.4.39 R (Exposure value and conversion factors), BIPRU 4.4.45 R (AIRB conversion factors) and BIPRU 4.4.71 R - BIPRU 4.4.78 R (Calculation of exposure values for sovereigns, institutions and corporates) also apply to retail exposures.

4.6.56 R A firm must provide its own estimates of conversion factors in accordance with its IRB permission and the minimum IRB standards. [Note: BCD Article 87(7) (part)]

4.6.57 R The risk weighted exposure amount for each exposure to retail SME as defined in BIPRU 4.6.2 R which meets the requirements set out in BIPRU 4.4.83 R and BIPRU 4.4.85 R may be calculated according to BIPRU 4.4.79 R (Double default). [Note: BCD Annex VII Part 1 point 11]

4.6.58 R Notwithstanding BIPRU 4.6.54 R for the purposes of BIPRU 4.4.80 R the LGD of a comparable direct exposure to the protection provider must either be the LGD associated with an unhedged facility to the guarantor or the unhedged facility of the obligor, depending upon whether in the event both the guarantor and obligor default during the life of the hedged transaction available evidence and the structure of the guarantee indicate that the amount recovered would depend on the financial condition of the guarantor or obligor, respectively. [Note: BCD Annex VII Part 2 point 23]
Application

4.7.1 BIPRU 4.7 applies with respect to the exposures referred to in BIPRU 4.7.2 R.

Definition of equity exposures

4.7.2 The following exposures must be classed as equity exposures:

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

(2) debt exposures the economic substance of which is similar to the exposures specified in (1).

[Note: BCD Article 86(2)]

Calculation of risk-weighted exposure amounts

4.7.3 Notwithstanding BIPRU 4.3.5 R (Relevant parameters), the calculation of risk weighted exposure amounts for credit risk for all exposures belonging to the equity exposure IRB exposure class must be calculated in accordance with one of the following ways:

(1) the simple risk weight approach (see BIPRU 4.7.8 R);

(2) the PD/LGD approach (see BIPRU 4.7.13 R); and

(3) the internal models approach (see BIPRU 4.7.23 R);

in accordance with BIPRU 4.7 and subject to the firm's IRB permission.

[Note: BCD Article 87(4) (part)]

4.7.4 Even if a firm's IRB permission would otherwise permit the use of the internal models approach as referred to in BIPRU 4.7.3 R (3), it may only use that approach if it meets the minimum requirements in BIPRU 4.7.27 R - BIPRU 4.7.35 R.

[Note: BCD Article 87(4) (part)]

4.7.5 A firm may employ different approaches to different portfolios where the firm itself uses different approaches internally. A firm must, if it uses different approaches in accordance with the previous sentence, be able to
demonstrate to the appropriate regulator that the choice is made consistently and is not determined by regulatory arbitrage considerations.

[Note: BCD Annex VII Part 1 point 17]

4.7.6 R

Notwithstanding BIPRU 4.7.5 R a firm may, if its IRB permission permits it to do so, attribute the risk weighted exposure amounts for equity exposures to ancillary services undertakings according to the treatment of non credit-obligation assets.

[Note: BCD Annex VII Part 1 point 18]

Exposure value

4.7.7 R

The exposure value must be the value presented in the financial statements. Admissible equity exposure measures are the following:

(1) for investments held at fair value with changes in value flowing directly through income and into capital resources, the exposure value is the fair value presented in the balance sheet;

(2) for investments held at fair value with changes in value not flowing through income but into a tax-adjusted separate component of equity, the exposure value is the fair value presented in the balance sheet; and

(3) for investments held at cost or at the lower of cost or market value, the exposure value is the cost or market value presented in the balance sheet.

[Note: BCD Annex VII Part 3 point 12]

The calculation of risk-weighted exposure amounts for equity exposures: The simple risk weight approach: Introduction

4.7.8 R

BIPRU 4.7.9 R to BIPRU 4.7.12 R set out the simple risk weight approach for calculating the risk weighted exposure amounts for equity exposures as referred to in BIPRU 4.7.3 R (1).

The calculation of risk-weighted exposure amounts for equity exposures: The simple risk weight approach: Risk weighted exposure amounts

4.7.9 R

The risk weighted exposure amounts must be calculated according to the following formula:

risk-weighted exposure amounts = RW * exposure value;

where:

(1) risk weight (RW) = 190% for private equity exposures in sufficiently diversified portfolios;

(2) risk weight (RW) = 290% for exchange traded equity exposures; and
Section 4.7 : The IRB approach: Equity exposures

(3) risk weight (RW) = 370% for all other equity exposures.

[Note: BCD Annex VII Part 1 point 19]

4.7.10 R

Short cash positions and derivative instruments held in the non-trading book are permitted to offset long positions in the same individual stocks provided that these instruments have been explicitly designated as hedges of specific equity exposures and that they provide a hedge for at least another year. Other short positions must be treated as if they are long positions with the relevant risk weight assigned to the absolute value of each position. In the context of maturity mismatched positions, the method is that for corporate exposures as set out in BIPRU 4.4.70 R.

[Note: BCD Annex VII Part 1 point 20]

4.7.11 R

A firm may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in BIPRU 5 (Credit risk mitigation), as modified by BIPRU 4.10.

[Note: BCD Annex VII Part 1 point 21]

The calculation of risk-weighted exposure amounts for equity exposures: The simple risk weight approach: Expected loss

4.7.12 R

The expected loss amounts for equity exposures must be calculated according to the following formula:

(1) expected loss amount = EL × exposure value; and

(2) the EL values must be the following:

(a) expected loss (EL) = 0.8% for private equity exposures in sufficiently diversified portfolios;

(b) expected loss (EL) = 0.8% for exchange traded equity exposures; and

(c) expected loss (EL) = 2.4% for all other equity exposures.

[Note: BCD Annex VII Part 1 point 32]

The calculation of risk-weighted exposure amounts for equity exposures: The PD/LGD approach: Introduction

4.7.13 R

BIPRU 4.7.14 R to BIPRU 4.7.22 R set out the PD/LGD approach for calculating the risk weighted exposure amounts for equity exposures.

The calculation of risk-weighted exposure amounts for equity exposures: The PD/LGD approach: Risk weighted exposure amounts

4.7.14 R

The risk weighted exposure amounts must be calculated according to the formulas in BIPRU 4.4.58 R (Risk weighted exposure amounts for sovereigns, institutions and corporates). If a firm does not have sufficient information to use the definition of default a scaling factor of 1.5 must be assigned to the risk weights.

[Note: BCD Annex VII Part 1 point 22]
At the individual exposure level the sum of the expected loss amount multiplied by 12.5 and the risk weighted exposure amount must not exceed the exposure value multiplied by 12.5.

[Note: BCD Annex VII Part 1 point 23]

A firm may recognise unfunded credit protection obtained on an equity exposure in accordance with the methods set out in BIPRU 5 (Credit risk mitigation) as modified by BIPRU 4.10. This must be subject to an LGD of 90% on the exposure to the provider of the hedge. For private equity exposures in sufficiently diversified portfolios an LGD of 65% may be used.

[Note: BCD Annex VII Part 1 point 24]

The expected loss amounts for equity exposures must be calculated according to the following formulae:

(1) expected loss (EL) = PD x LGD; and

(2) expected loss amount = EL x exposure value.

[Note: BCD Annex VII Part 1 point 33]

PDs must be determined according to the methods for corporate exposures. The following minimum PDs must be applied:

(1) 0.09% for exchange traded equity exposures where the investment is part of a long-term customer relationship;

(2) 0.09% for non-exchange traded equity exposures where the returns on the investment are based on regular and periodic cash flows not derived from capital gains;

(3) 0.40% for exchange traded equity exposures including other short positions as set out in BIPRU 4.7.10 R; and

(4) 1.25% for all other equity exposures including other short positions as set out in BIPRU 4.7.10 R.

[Note: BCD Annex VII Part 2 point 24]

BIPRU 4.4.29 G (five year observation period) applies to the PD/LGD approach.

[Note: BCD Annex VII Part 4 point 66 (part)]
The calculation of risk-weighted exposure amounts for equity exposures: The PD/LGD approach: LGDs

4.7.20 Private equity exposures in sufficiently diversified portfolios may be assigned an LGD of 65%.
[Note: BCD Annex VII Part 2 point 25]

4.7.21 All other exposures must be assigned an LGD of 90%.
[Note: BCD Annex VII Part 2 point 26]

The calculation of risk-weighted exposure amounts for equity exposures: The PD/LGD approach: Maturity

4.7.22 M (maturity) assigned to all exposures must be 5 years.
[Note: BCD Annex VII Part 2 point 27]

The calculation of risk-weighted exposure amounts for equity exposures: The internal models approach: Introduction

4.7.23 BIPRU 4.7.24 R to BIPRU 4.7.35 R set out the internal models approach for calculating the risk weighted exposure amounts for equity exposures as referred to in BIPRU 4.7.3 R (3).

The calculation of risk-weighted exposure amounts for equity exposures: The internal models approach: Risk weighted exposure amounts

4.7.24 The risk weighted exposure amount is the potential loss on the firm’s equity exposures as derived using internal value-at-risk models subject to the 99th percentile, one-tailed confidence interval of the difference between quarterly returns and an appropriate risk-free rate computed over a long-term sample period, multiplied by 12.5. The risk weighted exposure amounts at the equity exposure portfolio level must not be less than the total of the sums of the minimum risk weighted exposure amounts required under the PD/LGD approach and the corresponding expected loss amounts multiplied by 12.5 and calculated on the basis of the PD values set out in BIPRU 4.7.18 R (1) and the corresponding LGD values set out in BIPRU 4.7.20 R and BIPRU 4.7.21 R.
[Note: BCD Annex VII Part 1 point 25]

4.7.25 A firm may recognise unfunded credit protection obtained on an equity position.
[Note: BCD Annex VII Part 1 point 26]

The calculation of risk weighted exposure amounts for equity exposures: The internal models approach: Expected loss amounts

4.7.26 The expected loss amounts for equity exposures under the internal models approach must be 0%.
[Note: BCD Annex VII Part 1 point 34]
The calculation of risk weighted exposure amounts for equity exposures: The internal models approach: Capital requirements and risk quantification

(1) A firm must meet the standards set out in (2) to (9) for the purpose of calculating capital requirements.

(2) The estimate of potential loss must be robust to adverse market movements relevant to the long-term risk profile of the firm's specific holdings. The data used to represent return distributions must reflect the longest sample period for which data is available and be meaningful in representing the risk profile of the firm's specific equity exposures. The data used must be sufficient to provide conservative, statistically reliable and robust loss estimates that are not based purely on subjective or judgmental considerations. A firm must be able to demonstrate to the appropriate regulator that the shock employed provides a conservative estimate of potential losses over a relevant long-term market or business cycle.

(3) A firm must combine empirical analysis of available data with adjustments based on a variety of factors in order to attain model outputs that achieve appropriate realism and conservatism. In constructing Value at Risk (VaR) models estimating potential quarterly losses, a firm may use quarterly data or convert shorter horizon period data to a quarterly equivalent using an analytically appropriate method supported by empirical evidence and through a well-developed and documented thought process and analysis. Such an approach must be applied conservatively and consistently over time. Where only limited relevant data is available a firm must add appropriate margins of conservatism.

(4) The models used must be able to capture adequately all of the material risks embodied in equity returns including both the general market risk and specific risk exposure of the firm's equity exposure portfolio. The internal models must adequately explain historical price variation, capture both the magnitude and changes in the composition of potential concentrations, and be robust to adverse market environments. The population of risk exposures represented in the data used for estimation must be closely matched to or at least comparable with those of the firm's equity exposures.

(5) The internal model must be appropriate for the risk profile and complexity of a firm's equity exposure portfolio. Where a firm has material holdings with values that are highly non-linear in nature the internal models must be designed to capture appropriately the risks associated with such instruments.

(6) Mapping of individual positions to proxies, market indices, and risk factors must be plausible, intuitive, and conceptually sound.

(7) A firm must be able to demonstrate to the appropriate regulator through empirical analyses the appropriateness of risk factors, including their ability to cover both general market risk and specific risk.

(8) The estimates of the return volatility of equity exposures must incorporate relevant and available data, information, and methods.
Independently reviewed internal data or data from external sources (including pooled data) must be used.

(9) A rigorous and comprehensive stress-testing programme must be in place.

[Note: BCD Annex VII Part 4 point 115]

The calculation of risk-weighted exposure amounts for equity exposures: The internal models approach: Risk management and controls

4.7.28

(1) With regard to the development and use of internal models for capital requirement purposes, a firm must establish policies, procedures, and controls to ensure the integrity of the model and modelling process. These policies, procedures, and controls must include the ones set out in the rest of this paragraph.

(2) There must be full integration of the internal model into the overall management information systems of the firm and in the management of the non-trading book equity exposure portfolio. In particular they must be used in:

(a) measuring and assessing equity exposure portfolio performance (including the risk adjusted performance);

(b) allocating economic capital to equity exposures; and

(c) evaluating overall capital adequacy and the investment management process.

(3) A firm must have established management systems, procedures, and control functions for ensuring the periodic and independent review of all elements of the internal modelling process, including approval of model revisions, vetting of model inputs, and review of model results, such as direct verification of risk computations. These reviews must assess the accuracy, completeness, and appropriateness of model inputs and results and focus on both finding and limiting potential errors associated with known weaknesses and identifying unknown model weaknesses. Such reviews may be conducted by an internal independent unit, or by an independent external third party.

(4) There must be adequate systems and procedures for monitoring investment limits and the risk exposures of equity exposures.

(5) The units responsible for the design and application of the model must be functionally independent from the units responsible for managing individual investments.

(6) Parties responsible for any aspect of the modelling process must be adequately qualified. Management must allocate sufficient skilled and competent resources to the modelling function.

[Note: BCD Annex VII Part 4 point 116]
**The calculation of risk-weighted exposure amounts for equity exposures: The internal models approach: Validation and documentation**

4.7.29 A firm must have a robust system in place to validate the accuracy and consistency of its internal models and modelling processes. All material elements of the internal models and the modelling process and validation must be documented.

[Note: BCD Annex VII Part 4 point 117]

4.7.30 A firm must use the internal validation process to assess the performance of its internal models and processes in a consistent and meaningful way.

[Note: BCD Annex VII Part 4 point 118]

4.7.31 The methods and data used for quantitative validation must be consistent through time. Changes in estimation and validation methods and data (both data sources and periods covered) must be documented.

[Note: BCD Annex VII Part 4 point 119]

4.7.32 A firm must regularly compare actual equity exposure returns (computed using realised and unrealised gains and losses) with modelled estimates. Such comparisons must make use of historical data that cover as long a period as possible. A firm must document the methods and data used in such comparisons. This analysis and documentation must be updated at least annually.

[Note: BCD Annex VII Part 4 point 120]

4.7.33 A firm must make use of other quantitative validation tools and comparisons with external data sources. The analysis must be based on data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period. A firm's internal assessments of the performance of its models must be based on as long a period as possible.

[Note: BCD Annex VII Part 4 point 121]

4.7.34 A firm must have sound internal standards for situations where comparison of actual equity exposure returns with the models' estimates calls the validity of the estimates or of the models as such into question. These standards must take account of business cycles and similar systematic variability in equity exposure returns. All adjustments made to internal models in response to model reviews must be documented and consistent with the firm's model review standards.

[Note: BCD Annex VII Part 4 point 122]

4.7.35 The internal model and the modelling process must be documented, including the responsibilities of parties involved in the modelling, and the model approval and model review processes.

[Note: BCD Annex VII Part 4 point 123]
4.8 The IRB approach: Purchased receivables

Application

4.8.1 R BIPRU 4.8 applies with respect to purchased receivables.

4.8.2 G Purchased receivables do not form an IRB exposure class on their own. For any purchased receivable, the provisions of the sections of BIPRU 4 that deal with the IRB exposure class to which it belongs also apply, as modified by this section.

[Note: BCD Annex VII Part 4 point 15 (part)]

Structure of rating systems

4.8.3 R For retail exposure that are purchased receivables, the grouping referred to in BIPRU 4.6.9 R must reflect the seller’s underwriting practices and the heterogeneity of its customers.

Risk quantification: Overall requirements for estimation:
General

4.8.4 G Further general material about the requirements for estimation can be found in BIPRU 4.3.73 R - BIPRU 4.3.94 R.

4.8.5 R The estimates for determining the risk parameters PD, LGD, conversion factor and EL must reflect all relevant information available to the purchasing firm regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing firm, or by external sources. The purchasing firm must evaluate any data relied upon which is provided by the seller.

[Note: BCD Annex VII Part 4 point 53]

Risk quantification: Overall requirements for estimation:
Requirements specific to PD estimation

4.8.6 R With respect to BIPRU 4.6.26 R (Internal and external data for PD estimation: retail exposures) a firm may use external and internal reference data for PD estimation. A firm must use all relevant data sources as points of comparison.

[Note: BCD Annex VII Part 4 point 69 (part)]
4.8.7 R For corporate exposure purchased receivables a firm may estimate ELs by obligor grade from long run averages of one-year realised default rates.

[Note: BCD Annex VII Part 4 point 60]

4.8.8 R If a firm derives long run average estimates of PDs and LGDs for corporate exposure purchased receivables from an estimate of EL, and an appropriate estimate of PD or LGD, the process for estimating total losses must meet the overall standards for estimation of PD and LGD set out in the minimum IRB standards, and the outcome must be consistent with the concept of LGD as set out in BIPRU 4.3.99 R.

[Note: BCD Annex VII Part 4 point 61]

Risk quantification: Overall requirements for estimation:
Requirements specific to own-LGD estimates

4.8.9 R A firm may use external and internal reference data for its LGD estimates in the case of retail exposures that are purchased receivables.

[Note: BCD Annex VII Part 4 point 85]

Risk quantification: Overall requirements for estimation:
Minimum requirements for purchased receivables: General

4.8.10 R BIPRU 4.8.11 R - BIPRU 4.8.15 R set out minimum requirements specific to the treatment of purchased receivables under the IRB approach.

Risk quantification: Overall requirements for estimation:
Minimum requirements for purchased receivables: Legal certainty

4.8.11 R The structure of the facility must ensure that under all foreseeable circumstances a firm has effective ownership and control of all cash remittances from the receivables. When the obligor makes payments directly to a seller or servicer a firm must verify regularly that payments are forwarded completely and within the contractually agreed terms. Servicer means an entity that manages a pool of purchased receivables or the underlying credit exposures on a day-to-day basis. A firm must have procedures to ensure that ownership over the receivables and cash receipts is protected against bankruptcy stays or legal challenges that could materially delay the lender’s ability to liquidate or assign the receivables or retain control over cash receipts.

[Note: BCD Annex VII Part 4 point 105]

Risk quantification: Overall requirements for estimation:
Minimum requirements for purchased receivables: Effectiveness of monitoring systems

4.8.12 R (1) A firm must monitor both the quality of the purchased receivables and the financial condition of the seller and servicer. In particular a firm must comply with the remaining provisions of this rule.

(2) A firm must assess the correlation among the quality of the purchased receivables and the financial condition of both the seller and servicer, and have in place internal policies and procedures that
provide adequate safeguards to protect against such contingencies, including the assignment of an internal risk rating for each seller and servicer.

(3) A firm must have clear and effective policies and procedures for determining seller and servicer eligibility. A firm or its agent must conduct periodic reviews of sellers and servicers in order to verify the accuracy of reports from the seller or servicer, detect fraud or operational weaknesses, and verify the quality of the seller’s credit policies and servicer’s collection policies and procedures. The findings of these reviews must be documented.

(4) A firm must have effective policies and procedures for monitoring on an aggregate basis single-obligor concentrations both within and across purchased receivables pools.

(5) A firm must ensure that it receives from the servicer timely and sufficiently detailed reports of receivables ageings and dilutions to ensure compliance with the firm’s eligibility criteria and advancing policies governing purchased receivables, and provide an effective means with which to monitor and confirm the seller’s terms of sale and dilution.

[Note: BCD Annex VII Part 4 point 106]

Risk quantification: Overall requirements for estimation:
Minimum requirements for purchased receivables:
Effectiveness of work-out systems

A firm must have systems and procedures for detecting deteriorations in the seller’s financial condition and purchased receivables quality at an early stage, and for addressing emerging problems proactively. In particular a firm must have clear and effective policies, procedures, and information systems to monitor covenant violations, and clear and effective policies and procedures for initiating legal actions and dealing with problem purchased receivables.

[Note: BCD Annex VII Part 4 point 107]

Risk quantification: Overall requirements for estimation:
Minimum requirements for purchased receivables:
Effectiveness of systems for controlling collateral, credit availability and cash

A firm must have clear and effective policies and procedures governing the control of purchased receivables, credit, and cash. In particular, written internal policies must specify all material elements of the receivables
purchase programme, including the advancing rates, eligible collateral, necessary documentation, concentration limits, and the way cash receipts are to be handled. These elements must take appropriate account of all relevant and material factors, including the seller’s and servicer’s financial condition, risk concentrations, and trends in the quality of the purchased receivables and the seller’s customer base, and internal systems must ensure that funds are advanced only against specified supporting collateral and documentation.

[Note: BCD Annex VII Part 4 point 108]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Compliance with the firm’s internal policies and procedures

A firm must have an effective internal process for assessing compliance with all internal policies and procedures. The process must include regular audits of all critical phases of the firm’s receivables purchase programme, verification of the separation of duties between, firstly, the assessment of the seller and servicer and the assessment of the obligor and, secondly, between the assessment of the seller and servicer and the field audit of the seller and servicer and evaluations of back office operations, with particular focus on qualifications, experience, staffing levels, and supporting automation systems.

[Note: BCD Annex VII Part 4 point 109]

Calculation of risk-weighted asset amounts: Eligibility for different treatments: Corporate exposures

For its corporate exposure purchased receivables a firm must comply with the minimum requirements set out in ■ BIPRU 4.8.11 R - ■ BIPRU 4.8.15 R. For corporate exposure purchased receivables that comply in addition with the conditions set out in ■ BIPRU 4.8.18 R, and where it would be unduly burdensome for a firm to use the risk quantification standards for corporate exposures as set out in the minimum IRB standards for these receivables, the risk quantification standards for retail exposures as set out in the minimum IRB standards may be used.

[Note: BCD Annex VII Part 1 point 7]

Calculation of risk-weighted asset amounts: Eligibility for different treatments: Retail exposures

For corporate exposure purchased receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for default losses, dilution losses, or both, may be treated as first-loss positions under the provisions in ■ BIPRU 9 (Securitisation) about the IRB approach.

[Note: BCD Annex VII Part 1 point 8]

To be eligible for the retail exposure treatment purchased receivables must comply with the minimum requirements set out in ■ BIPRU 4.8.11 R - ■ BIPRU 4.8.15 R and the following conditions:
(1) the firm has purchased the receivables from unrelated, third party sellers, and its exposure to the obligor of the receivable does not include any exposures that are directly or indirectly originated by the firm itself;

(2) the purchased receivables must be generated on an arm’s-length basis between the seller and the obligor (and as such, intercompany accounts receivables and receivables subject to contra-accounts between firms that buy and sell to each other are ineligible);

(3) the purchasing firm has a claim on all proceeds from the purchased receivables or a pro-rata interest in the proceeds; and

(4) the portfolio of purchased receivables is sufficiently diversified.

[Note: BCD Annex VII Part 1 point 14]

4.8.19 With respect to retail exposures, for purchased receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for default losses, dilution losses, or both, may be treated as first-loss positions under the provisions in BIPRU 9 (Securitisation) about the IRB approach.

[Note: BCD Annex VII Part 1 point 15]

4.8.20 For hybrid pools of purchased retail exposure receivables where the purchasing firm cannot separate exposures secured by real estate collateral and qualifying revolving retail exposures from other retail exposures, the retail risk weight function producing the highest capital requirements for those exposures must apply.

[Note: BCD Annex VII Part 1 point 16]

Calculation of risk weighted asset amounts for dilution risk

4.8.21 The risk weights for dilution risk for purchased receivables (both corporate exposures and retail exposures) must be calculated according to this rule. The risk weights must be calculated according to the formula in BIPRU 4.4.58 R. However, for the purposes of that formula, the total annual sales referred to in BIPRU 4.4.59 R are the weighted average by individual exposures of the pool. The input parameters PD and LGD and the exposure value must be determined under the applicable provisions of BIPRU 4 as modified by this section. M (maturity) must be 1 year. However:

(1) a firm need not recognise dilution risk if its IRB permission permits this; and

(2) (in the case of a firm with an IRB permission that permits the treatment of dilution risk in (1)) the firm must be able to convince the appropriate regulator that dilution risk is immaterial.

[Note: BCD Article 87(2) (part) and Annex VII Part 1 point 28]
Calculation of risk weighted exposure amounts: PDs

For purchased corporate exposure receivables in respect of which a firm cannot demonstrate that its PD estimates meet the minimum IRB standards, the PDs for these exposures must be determined according to the following methods:

1. for senior claims on purchased corporate exposure receivables PD must be the firm’s estimate of EL divided by LGD for these receivables;

2. for subordinated claims on purchased corporate exposure receivables PD must be the firm’s estimate of EL; and

3. if a firm is under its IRB permission using the advanced IRB approach for LGD estimates for corporate exposures and it can decompose its EL estimates for purchased corporate exposure receivables into PDs and LGDs in a reliable manner, the LGD estimate may be used.

[Note: BCD Annex VII Part 2 point 3]

Calculation of risk weighted asset amounts: LGDs: Corporate exposures

The following LGD values apply for purchased corporate exposure receivables:

1. for senior purchased corporate exposure receivables exposures where a firm cannot demonstrate that its PD estimates meet the minimum IRB standards, the value is 45%;

2. for subordinated purchased corporate exposure receivables exposures where a firm cannot demonstrate that its PD estimates meet the minimum IRB standards, the value is 100%; and

In the case of corporate exposures, for dilution risk of purchased receivables PD must be set equal to EL estimate for dilution risk. If a firm is under its IRB permission using the advanced IRB approach for LGD estimates for corporate exposures and it can decompose its EL estimates for dilution risk of purchased corporate exposure receivables into PDs and LGDs in a reliable manner, the PD estimate may be used. A firm may recognise unfunded credit protection in the PD in accordance with the provisions of BIPRU 9 and BIPRU 5 as modified by BIPRU 4.10. A firm may recognise those unfunded credit protection providers set out in its IRB permission in addition to those indicated in the CRM eligibility conditions. Where a firm’s IRB permission allows it to use its own LGD estimates for dilution risk of purchased corporate receivables, the firm may recognise unfunded credit protection by adjusting PDs subject to the provisions of BIPRU 4.4.43 R.

[Note: BCD Annex VII Part 2 point 7]

In the case of retail exposures, for dilution risk of purchased receivables PD must be set equal to EL estimates for dilution risk. If a firm can decompose its EL estimates for dilution risk of purchased receivables into PDs and LGDs in a reliable manner, the PD estimate may be used.

[Note: BCD Annex VII Part 2 point 19]
(3) for dilution risk of purchased corporate exposure receivables, the value is 75%.

[Note: BCD Annex VII Part 2 point 8(e) to (g)]

4.8.26 R Notwithstanding ■ BIPRU 4.4.34 R and ■ BIPRU 4.8.25 R, for dilution risk and default risk if a firm is under its IRB permission using the advanced IRB approach for LGD estimates for corporate exposures and it can decompose its EL estimates for purchased corporate exposure receivables into PDs and LGDs in a reliable manner, the LGD estimate for purchased corporate exposure receivables may be used.

[Note: BCD Annex VII Part 2 point 9]

Calculation of risk weighted asset amounts: LGDs: Retail exposures

4.8.27 R For dilution risk of purchased retail exposure receivables an LGD value of 75% must be used. If a firm can decompose its EL estimates for dilution risk of purchased receivables into PDs and LGDs in a reliable manner, the LGD estimate may be used.

[Note: BCD Annex VII Part 2 point 21]

Calculation of risk weighted asset amounts: Exposure value

4.8.28 R The exposure value for the calculation of risk weighted exposure amounts of purchased receivables must be the outstanding amount minus the capital requirements for dilution risk prior to credit risk mitigation.

[Note: BCD Annex VII Part 3 point 6]

4.8.29 R (1) The exposure value for the items in (2) must be calculated as the committed but undrawn amount multiplied by a conversion factor.

(2) For undrawn purchase commitments for revolving purchased receivables that are unconditionally cancellable or that effectively provide for automatic cancellation at any time by the firm without prior notice, a conversion factor of 0% applies. To apply a conversion factor of 0%, a firm must actively monitor the financial condition of the obligor, and its internal control systems must enable it immediately to detect a deterioration in the credit quality of the obligor.

[Note: BCD Annex VII Part 3 point 9 (c)]

Calculation of expected loss amounts

4.8.30 R The expected loss amounts for dilution risk of purchased receivables must be calculated according to the following formula:

\[ \text{expected loss (EL)} = \text{PD} \times \text{LGD}; \text{ and} \]

\[ \text{expected loss amount} = \text{EL} \times \text{exposure value}. \]

[Note: BCD Article 88(5) and Annex VII Part 1 point 35]
4.9 The IRB approach: Securitisation, non-credit obligations assets and CIUs

Application

4.9.1 BIPRU 4.9 applies with respect to securitisation exposures, non credit-obligation assets and exposures to CIUs.

Securitisation exposures

4.9.2 The following must be calculated in accordance with BIPRU 9 (Securitisation):

(1) risk-weighted exposure amounts for securitised exposures and for exposures belonging to the IRB exposure class referred to in BIPRU 4.3.2 R (6) (securitisation positions); and

(2) the expected loss amounts for securitised exposures.

[Note: BCD Article 87(10) and Article 88(3)]

Provision of credit protection

4.9.3 Where a firm provides credit protection for a number of exposures under terms that the nth default among the exposures shall trigger payment and that this credit event shall terminate the contract, if the product has an external credit assessment from an eligible ECAI the risk weights set out in BIPRU 9 must be applied. If the product is not rated by an eligible ECAI, the risk weights of the exposures included in the basket must be aggregated, excluding n-1 exposures where the sum of the expected loss amount multiplied by 12.5 and the risk weighted exposure amount must not exceed the nominal amount of the protection provided by the credit derivative multiplied by 12.5. The n-1 exposures to be excluded from the aggregation must be determined on the basis that they must include those exposures each of which produces a lower risk weighted exposure amount than the risk weighted exposure amount of any of the exposures included in the aggregation.

[Note: BCD Annex VII Part 1 point 9]

Non credit obligation assets: Introduction

4.9.4 BIPRU 4.9.5 R - BIPRU 4.9.10 R apply to non credit-obligation assets.
Non credit obligation assets: Inclusion of residual value of leases

4.9.5 The non credit obligation asset IRB exposure class includes the residual value of leased properties, if not included in the lease exposure as defined in BIPRU 4.4.75 R.

[Note: BCD Article 86(8)]

Non credit obligation assets: Risk weighted exposure amount

4.9.6 The risk weighted exposure amounts must be calculated according to the formula:

\[ \text{Risk-weighted exposure amount} = 100\% \times \text{exposure value except for when the exposure is a residual value of leased properties in which case it must be calculated as follows:} \]

\[ \frac{1}{t} \times 100\% \times \text{exposure value}; \text{where } t \text{ is the greater of 1 and the nearest number of whole years of the lease remaining.} \]

[Note: BCD Annex VII Part 1 point 27]

4.9.7 \( t \) should be an integer number reflecting the nearest number of whole years of the lease remaining and should decrease as the lease matures so that the discounted value steps up gradually from a small value to 100% as the end of the lease approaches.

4.9.8 Where a firm has full recourse in respect of purchased receivables for default risk and for dilution risk, to the seller of the purchased receivables, BIPRU 4.8.21 R and BIPRU 4.8.30 R need not be applied. The exposure may instead be treated as a collateralised exposure.

[Note: BCD Article 87(2) (part)]

Non credit obligation assets: Exposure value

4.9.9 The exposure value of non credit-obligation assets must be the value presented in the financial statements.

[Note: BCD Annex VII Part 3 point 13]

Non credit obligation assets: Expected loss amounts

4.9.10 For non credit-obligation assets the expected loss amount must be zero.

[Note: BCD Article 88(4)]

Collective investment undertakings

4.9.11 (1) Where exposures in the form of a CIU meet the criteria set out in BIPRU 3.4.121 R to BIPRU 3.4.122 R (Conditions for look through treatment under the standardised approach) and the firm is aware of all of the underlying exposures of the CIU, the firm must look through to those underlying exposures in order to calculate risk weighted exposure amounts and expected loss amounts in accordance with the methods set out in BIPRU 4. BIPRU 4.9.12 R applies to the part of the underlying exposures of the CIU of which the firm is not
Section 4.9 : The IRB approach: Securitisation, non-credit obligations assets and CIUs

aware or could not reasonably be aware. In particular, BIPRU 4.9.12 R must apply where it would be unduly burdensome for the firm to look through the underlying exposures in order to calculate risk weighted exposure amounts and expected loss amounts in accordance with methods set out in this rule.

(2) Where (1) applies but a firm does not meet the conditions for using the methods set out in BIPRU 4 for all or part of the underlying exposures of the CIU, risk weighted exposure amounts and expected loss amounts must be calculated in accordance with the following approaches.

(3) For equity exposures the approach set out in BIPRU 4.7.9 R - BIPRU 4.7.12 R (Simple risk weights) must be used. If, for those purposes, the firm is unable to differentiate between private equity, exchange-traded and other equity exposures, it must treat the exposures concerned as other equity exposures.

(4) For all other underlying exposures, the standardised approach must be used, subject to the following modifications:

(a) [deleted]

(b) [deleted]

(c) for exposures subject to a specific risk weight for unrated exposures or subject to the credit quality step yielding the highest risk weight for a given exposure class, the risk weight must be multiplied by a factor of two, but cannot be higher than 1250%; and

(d) for all other exposures, the risk weight must be multiplied by a factor of 1.1 and subject to a minimum of 5%.

[Note: BCD Article 87(11)]

4.9.12 R

(1) Where exposures in the form of a CIU do not meet the criteria set out in BIPRU 3.4.121 R to BIPRU 3.4.122 R (Conditions for look through treatment under the standardised approach) or the firm is not aware of all of the underlying exposures of the CIU, a firm must look through to the underlying exposures and calculate risk weighted exposure amounts and expected loss amounts in accordance with the approach set out in BIPRU 4.7.9 R - BIPRU 4.7.12 R (Simple risk weights). If, for those purposes, the firm is unable to differentiate between private equity, exchange-traded and other equity exposures, it must treat the exposures concerned as other equity exposures. For these purposes, non-equity exposures must be assigned to one of the classes (private equity, exchange traded equity or other equity) set out in BIPRU 4.7.9 R (Simple risk weight approach) and unknown exposures must be assigned to the other equity class.

(2) Alternatively to the method described in (1), a firm may calculate itself or rely on a third party to calculate and report the average risk weighted exposure amounts based on the CIU’s underlying exposures and calculated in accordance with the approaches in BIPRU 4.9.11 R (3) to BIPRU 4.9.11 R (4), provided that the correctness of the calculation and the report is adequately ensured.

(3) [deleted]
For the purposes of BIPRU 4.9.12 R (1), in the case of non-equity exposures a firm should look at the risk profile of the underlying exposures and map these to an equivalent equity risk weight. For example, if the underlying exposures are exchange-traded, the risk weight of exchange-traded equity exposures will apply. If the underlying exposures are unknown, the risk weight of the other equity class will apply. Only under exceptional circumstances would supervisors expect to see non-equity exposures mapped to the diversified private equity risk weight.

For the purposes of BIPRU 4.9.12 R (2), a firm should ensure that any third party relied on for the calculations and report possesses the necessary competence and experience to ensure that the calculations and report are correct.

The expected loss amounts for exposures referred to in BIPRU 4.9.11 R - BIPRU 4.9.12 R must be calculated in accordance with the methods set out in BIPRU 4.4.61 R (Calculation of expected loss for sovereigns, institutions and corporates), BIPRU 4.5.12 R - BIPRU 4.5.14 R (Calculation of expected loss for specialised lending), BIPRU 4.6.47 R - BIPRU 4.6.48 R (Calculation of expected loss for retail exposures), BIPRU 4.7.12 R, BIPRU 4.7.17 R and BIPRU 4.7.26 R (Calculation of expected loss for equity exposures) and BIPRU 4.8.30 R (Dilution risk of purchased receivables).

[Note: BCD Article 88(6)]
4.10 The IRB approach: Credit risk mitigation

Application

4.10.1 G BIPRU 4.10 applies to all exposures treated under the IRB approach.

Purpose

4.10.2 G BIPRU 4.10 sets out modifications to BIPRU 5 (Credit risk mitigation) for those exposures for which the IRB approach is being used.

General

4.10.3 R A firm using the IRB approach, but not using its own estimates of LGD and conversion factors, may recognise credit risk mitigation in accordance with BIPRU 5 as modified by BIPRU 4.10 in the calculation of risk weighted exposure amounts for the purposes of the calculation of the credit risk capital component or as relevant expected loss amounts for the purposes of the calculation in GENPRU 2.2.191 R to GENPRU 2.2.193 R or GENPRU 2.2.236 R.

[Note: BCD Article 91 (as it applies to the IRB approach)]

4.10.4 R

(1) Where the requirements of BIPRU 5.2.2 R - BIPRU 5.2.8 R are met the calculation of risk weighted exposure amounts, and, as relevant, expected loss amounts, may be modified in accordance with BIPRU 5 as modified by BIPRU 4.10.

(2) No exposure in respect of which credit risk mitigation is obtained must produce a higher risk weighted exposure amount or expected loss amount than an otherwise identical exposure in respect of which there is no credit risk mitigation.

(3) Where the risk weighted exposure amount already takes account of credit protection under the IRB approach the calculation of the credit protection must not be further recognised under BIPRU 5 or BIPRU 4.10.

(4) Subject to BIPRU 5.2.8 R (Maturity mismatches), BIPRU 5.2.9 R (Combinations of credit risk mitigation in the standardised approach) and BIPRU 5.7.27 R to BIPRU 5.7.28 R (Basket credit risk mitigation techniques), where the CRM eligibility conditions and the CRM minimum requirements are satisfied, the calculation of risk weighted exposure amounts and expected loss amounts under the IRB approach may be modified in accordance with the provisions of BIPRU 5 and
BIPRU 4 : The IRB approach  
Section 4.10 : The IRB approach: Credit risk mitigation

---

**BIPRU 4.10** that deal with calculating the effects of credit risk mitigation.

[Note: BCD Article 93 and Annex VIII Part 3 point 1 (as they apply to the IRB approach)]

---

### Eligibility of funded credit protection: General

#### 4.10.5 R

In addition to the collateral set out in BIPRU 5.3.1 R to BIPRU 5.3.2 R, BIPRU 5.4.1 R to BIPRU 5.4.8 R and BIPRU 5.6.1 R (Eligibility of funded credit protection) the provisions of BIPRU 4.10.6 R - BIPRU 4.10.12 R (Eligibility of real estate collateral), BIPRU 4.10.14 R (Eligibility: receivables), BIPRU 4.10.16 R (Eligibility: other physical collateral), and BIPRU 4.10.19 R (Eligibility: leasing), apply where a firm calculates risk weighted exposure amounts and expected loss amounts under the IRB approach.

[Note: BCD Annex VIII Part 1 point 12]

---

### Real estate collateral: Types of eligible collateral: General

#### 4.10.6 R

(1) Residential real estate property which is or will be occupied or let by the owner or the beneficial owner in the case of personal investment companies and commercial real estate property, that is offices and other commercial premises, may be recognised as eligible collateral where the conditions set out in the remaining provisions of this paragraph are met.

(2) The value of the property must not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower.

(3) The risk of the borrower must not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility must not materially depend on any cash flow generated by the underlying property serving as collateral.

[Note: BCD Annex VIII Part 1 point 13]

---

#### 4.10.7 R

The condition in BIPRU 4.10.6 R (3) does not apply to exposures secured by residential real estate property situated within the United Kingdom.

[Note: BCD Annex VIII Part 1 point 16 (part)]

---

#### 4.10.8 G

(1) Under paragraph 16 of Part 1 of Annex VIII of the Banking Consolidation Directive, a competent authority may only disapply the condition in BIPRU 4.10.6 R (3) if the competent authority has evidence that the relevant market is well-developed and long-established with loss-rates which are sufficiently low to justify such action.

(2) If the evidence were to change so that the action was no longer justified the appropriate regulator would expect to revoke BIPRU 4.10.7 R.
### BIPRU 4 : The IRB approach

#### Section 4.10 : The IRB approach: Credit risk mitigation

**4.10.9**

(1) The condition in **BIPRU 4.10.6 R (3)** does not apply for exposures secured by residential real estate property situated within the territory of another *EEA State*.

(2) However (1) only applies if and to the extent that the *CRD implementation measures* for that *EEA State* in relation to the *IRB approach* implement the option set out in paragraph 16 of Part 1 of Annex VIII of the *Banking Consolidation Directive* (waiver for residential real estate property) with respect to residential real estate property situated within that *EEA State*. Therefore (1) does not apply if the eligibility to use this treatment under those measures ceases as contemplated under paragraph 18 of Part 1 of Annex VIII of the *Banking Consolidation Directive* (suspension of alternative treatment).

[Note: *BCD Annex VIII Part 1 point 16 (part)*]

**4.10.10**

(1) The condition in **BIPRU 4.10.6 R (3)** does not apply for commercial real estate property situated within the territory of another *EEA State*.

(2) However (1) only applies if and to the extent that the *CRD implementation measures* for that *EEA State* in relation to the *IRB approach* implement the option set out in paragraph 17 of Part 1 of Annex VIII of the *Banking Consolidation Directive* (waiver for commercial real estate property) with respect to commercial real estate property situated within that *EEA State*. Therefore (1) does not apply if the eligibility to use this treatment under those measures ceases as contemplated under paragraph 18 of Part 1 of Annex VIII of the *Banking Consolidation Directive* (suspension of alternative treatment).

[Note: *BCD Annex VIII Part 1 point 19*]

### Real estate collateral: Types of eligible collateral: Finnish housing legislation

**4.10.11**

A *firm* may also recognise as eligible collateral shares in Finnish residential housing companies operating in accordance with the Finnish *Housing Company Act of 1991* or subsequent equivalent legislation in respect of residential property which is or will be occupied or let by the owner, as residential real estate collateral, provided that the conditions in **BIPRU 4.10.6 R** are met.

[Note: *BCD Annex VIII Part 1 point 14*]

**4.10.12**

A *firm* may also recognise as eligible collateral shares in Finnish housing companies operating in accordance with the Finnish *Housing Company Act of 1991* or subsequent equivalent legislation as commercial real estate collateral, provided that the conditions in **BIPRU 4.10.6 R** are met.

[Note: *BCD Annex VIII Part 1 point 15*]

### Real estate collateral: Minimum requirements for recognition

**4.10.13**

For the recognition of real estate collateral: the minimum requirements in **BIPRU 3.4.64 R** - **BIPRU 3.4.73 R** must be met with the following adjustments:
those provisions apply to all real estate collateral eligible under BIPRU 4.10; and

(2) the minimum frequency of valuation as referred to in BIPRU 3.4.66 R is once every year for commercial real estate.

[Note: BCD Annex VIII Part 2 point 8 (as it applies to the IRB approach)]

Receivables: Types of eligible collateral

Amounts receivable linked to a commercial transaction or transactions with an original maturity of less than or equal to one year may be recognised as eligible collateral. Eligible receivables do not include those associated with securitisations, sub-participations or credit derivatives or amounts owed by affiliated parties.

[Note: BCD Annex VIII Part 1 point 20]

Receivables: Minimum requirements for recognition

(1) For the recognition of receivables as collateral the requirements in this paragraph must be met.

(2) The legal mechanism by which the collateral is provided must be robust and effective and ensure that the lender has clear rights over the proceeds.

(3) A firm must take all steps necessary to fulfil local requirements in respect of the enforceability of security interests. There must be a framework which allows the lender to have a first priority claim over the collateral subject to any claims of preferential creditors provided for in applicable insolvency law.

(4) A firm must have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions.

(5) The collateral arrangements must be properly documented, with a clear and robust procedure for the timely collection of collateral. A firm's procedures must ensure that any legal conditions required for declaring the default of the borrower and timely collection of collateral are observed. In the event of the obligor’s financial distress or default, a firm must have legal authority to sell or assign the receivables to other parties without consent of the receivables obligors.

(6) A firm must have a sound process for determining the credit risk associated with the receivables. Such a process must include, among other things, analyses of the obligor’s business and industry and the types of customers with whom the obligor does business. Where a firm relies on the obligor to ascertain the credit risk of the customers, the firm must review the obligor’s credit practices to ascertain their soundness and credibility.

(7) The margin between the amount of the exposure and the value of the receivables must reflect all appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an
individual obligor, and potential concentration risk within the firm's total exposures beyond that controlled by the firm's general methodology. A firm must maintain a continuous monitoring process appropriate to the receivables. Additionally, compliance with loan covenants, Environmental restrictions, and other legal requirements must be reviewed on a regular basis.

(8) The receivables pledged by an obligor must be diversified and not be unduly correlated with the obligor. Where there is material positive correlation, the attendant risks must be taken into account in the setting of margins for the collateral pool as a whole.

(9) Receivables from affiliates of the obligor (including subsidiary undertakings and employees) must not be recognised as risk mitigants.

(10) A firm must have a documented process for collecting receivable payments in distressed situations. The requisite facilities for collection must be in place, even when the firm normally looks to the obligor for collections.

[Note: BCD Annex VIII Part 2 point 9]

Other physical collateral: Types of eligible collateral

A firm may recognise as eligible collateral a physical item of a type other than those types indicated in BIPRU 4.10.6 R - BIPRU 4.10.12 R (Eligibility of real estate collateral) if its IRB permission provides that the firm may treat collateral of that type as eligible and if the firm is able to demonstrate the following:

(1) the existence of liquid markets for disposal of the collateral in an expeditious and economically efficient manner;

(2) the existence of well-established, publicly available market prices for the collateral; and

(3) there is no evidence that the net prices it receives when collateral is realised deviates significantly from the market prices referred to in (b).

[Note: BCD Annex VIII Part 1 point 21]

If a firm wishes to recognise other types of collateral in accordance with BIPRU 4.10.16 R (whether as part of its application for an IRB permission or under a variation of its IRB permission) it should demonstrate to the appropriate regulator how the criteria in BIPRU 4.10.16 R (1) - BIPRU 4.10.16 R (3) have been met with respect to that type of collateral.

Other physical collateral: Minimum requirements for recognition

(1) If a type of other physical collateral referred to in BIPRU 4.10.16 R is potentially eligible under a firm's IRB permission a firm must only recognise it as eligible if the minimum requirements in (2) to (10) are met.
(2) The collateral arrangement must be legally effective and enforceable in all relevant jurisdictions and must enable the firm to realise the value of the property within a reasonable timeframe.

(3) With the sole exception of permissible prior claims referred to in BIPRU 4.10.15 R (3), only first liens on, or charges over, collateral must be permissible. As such, the firm must have priority over all other lenders to the realised proceeds of the collateral.

(4) The value of the property must be monitored on a frequent basis and at a minimum once every year. More frequent monitoring must be carried out where the market is subject to significant changes in conditions.

(5) The loan agreement (or other agreement documenting the exposure) must include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation.

(6) The types of physical collateral accepted by the firm and policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount must be clearly documented in internal credit policies and procedures available for examination.

(7) The firm's credit policies with regard to the transaction structure must address appropriate collateral requirements relative to the exposure amount, the ability to liquidate the collateral readily, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility or a proxy of the volatility of the value of the collateral.

(8) Both initial valuation and revaluation must take fully into account any deterioration or obsolescence of the collateral. Particular attention must be paid in valuation and revaluation to the effects of the passage of time on fashion- or date-sensitive collateral.

(9) The firm must have the right to inspect the property physically. It must have policies and procedures addressing its exercise of the right to physical inspection.

(10) The firm must have procedures to monitor that the property taken as protection is adequately insured against damage.

[Note: BCD Annex VIII Part 2 point 10]

Leasing: Types of eligible transactions and conditions of eligibility

(1) Where the requirements set out in this paragraph are met, exposures arising from transactions whereby a firm leases property to a third party must be treated the same as loans collateralised by the type of property leased.

(2) For the exposures arising from leasing transactions to be treated as collateralised by the type of property leased, the following conditions must be met:
(a) the conditions set out or referred to in BIPRU 4.10.13 R or BIPRU 4.10.18 R as appropriate for the recognition as collateral of the type of property leased are met;

(b) there is robust risk management on the part of the lessor with respect to the use to which the leased asset is put, its age, and planned duration of its use, including appropriate monitoring of the value of the security;

(c) there is in place a robust legal framework establishing the lessor's legal ownership of the asset and its ability to exercise its rights as owner in a timely fashion; and

(d) where this has not already been ascertained in calculating the LGD level, the difference between value of the unamortised amount and the market value of the security must not be so large as to overstate the credit risk mitigation attributed to the leased assets.

[Note: BCD Annex VIII Part 1 point 22 and Part 2 point 11]

Calculating risk-weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Introduction

4.10.20 R BIPRU 4.10.21 R - BIPRU 4.10.37 R and BIPRU 4.10.49 R set out how the calculation of risk weighted exposure amounts and expected loss amounts under BIPRU 4.1 - BIPRU 4.9 may be modified to take into account credit risk mitigation that meets the CRM eligibility conditions and the CRM minimum requirements.

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Valuation: Receivables

4.10.21 R The value of receivables for the purpose of calculating the effect of credit risk mitigation must be the amount receivable.

[Note: BCD Annex VIII Part 3 point 66]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Valuation: Other physical collateral

4.10.22 R Physical collateral recognised as eligible as described in BIPRU 4.10.16 R must be valued for the purpose of calculating the effect of credit risk mitigation at its market value. Market value is the estimated amount for which the property would exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction.

[Note: BCD Annex VIII Part 3 point 67]

Calculating risk weighted exposure amounts and expected loss amounts: General treatment

4.10.23 R BIPRU 4.10.24 R - BIPRU 4.10.29 R apply to collateral in the form of real estate collateral, receivables, other physical collateral and leasing permitted by BIPRU 4.10 and exposures secured by such collateral.
4.10.24 R LGD* (the effective loss given default) calculated as set out in
■ BIPRU 4.10.25 R - ■ BIPRU 4.10.28 R must be taken as the LGD.

[Note: BCD Annex VIII Part 3 point 68]

4.10.25 R Where the ratio of the value of the collateral (C) to the exposure value (E) is
below a threshold level of C* (the required minimum collateralisation level
for the exposure) as laid down in ■ BIPRU 4.10.28 R, LGD* must be the LGD
laid down in the other sections of ■ BIPRU 4 for uncollateralised exposures
to the counterparty. For this purpose, the exposure value of items listed in
■ BIPRU 4.4.37 R to ■ BIPRU 4.4.39 R and ■ BIPRU 4.8.29 R must be calculated using
a conversion factor or percentage of 100% rather than the conversion
factors or percentages indicated in those rules.

[Note: BCD Annex VIII Part 3 point 69]

4.10.26 R Where the ratio of the value of the collateral to the exposure value exceeds
a second, higher threshold level of C** (i.e. the required level of
collateralisation to receive full LGD recognition) as laid down in
■ BIPRU 4.10.28 R, LGD* must be that prescribed in that table.

[Note: BCD Annex VIII Part 3 point 70]

4.10.27 R Where the required level of collateralisation C** is not achieved in respect of
the exposure as a whole, the exposure must be considered to be two
exposures - that part in respect of which the required level of
collateralisation C** is achieved and the remainder.

[Note: BCD Annex VIII Part 3 point 71]

4.10.28 R Table: Minimum LGD for secured portion of exposures

This table belongs to ■ BIPRU 4.10.24 R - ■ BIPRU 4.10.27 R

<table>
<thead>
<tr>
<th></th>
<th>LGD* for senior claims or contingent claims</th>
<th>LGD* for subordinated claims or contingent claims</th>
<th>Required minimum collateralisation level of the exposure (C*)</th>
<th>Required minimum collateralisation level of the exposure (C**)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>35%</td>
<td>65%</td>
<td>0%</td>
<td>125%</td>
</tr>
<tr>
<td>Residential real estate/commercial real estate</td>
<td>35%</td>
<td>65%</td>
<td>30%</td>
<td>140%</td>
</tr>
<tr>
<td>Other collateral</td>
<td>40%</td>
<td>70%</td>
<td>30%</td>
<td>140%</td>
</tr>
</tbody>
</table>

[Note: BCD Annex VIII Part 3 point 72 (part)]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Alternative
treatment for real estate collateral

(1) A firm may apply the treatment in paragraph 74 of Part 3 of Annex
VIII of the Banking Consolidation Directive (50% risk weight for
exposures secured by real estate) in respect of exposures collateralised by:
(a) residential real estate property; or
(b) commercial real estate property;
located in the territory of another EEA State.

(2) However (1)(a) or (1)(b) only applies if the CRD implementing measures for that EEA State with respect to the IRB approach have implemented the option set out in the provision of the Banking Consolidation Directive referred to in (1) with respect to the relevant category of real estate property situated within that EEA State.

(3) The use of the treatment in (1) with respect to property in another EEA State must be subject to the same conditions as apply under the relevant CRD implementation measures for that EEA State.

[Note: BCD Annex VIII Part 3 point 75]

Calculating risk weighted exposure amounts and expected loss amounts: Mixed pools of collateral

(1) Where:
(a) risk weighted exposure amounts and expected loss amounts are calculated under the IRB approach; and
(b) an exposure is collateralised by both financial collateral and other eligible collateral;
LGD* to be taken as the LGD for the purposes of the IRB approach must be calculated in accordance with this rule.

(2) A firm must subdivide the volatility-adjusted value of the exposure (i.e. the value after the application of the volatility adjustment as set out in BIPRU 5.4.28 R (Volatility adjustments under the financial collateral comprehensive method) into parts each covered by only one type of collateral. That is, the firm must divide the exposure into the part covered by eligible financial collateral, the part covered by receivables, the parts covered by commercial real estate property collateral and/or residential real estate property collateral, the part covered by other eligible collateral, and the unsecured part, as relevant.

(3) LGD* for each part of exposure must be calculated separately in accordance with the relevant provisions of BIPRU 5 (Credit risk mitigation) and BIPRU 4.10.

[Note: BCD Annex VIII Part 3 points 76 to 78]
Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Financial collateral simple method

4.10.31
The financial collateral simple method must not be used under the IRB approach.

[Note: BCD Annex VIII Part 3 point 24 (part)]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Master netting agreements

4.10.32
(1) This rule sets out how the calculations under BIPRU 5.6.11 R (Using the supervisory volatility adjustments or the own estimates volatility adjustments approaches to master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions) must be modified under the IRB approach.

(2) Where risk weighted exposure amounts and expected loss amounts are calculated under the IRB approach, E is the exposure value for each separate exposure under the agreement referred to in the provisions listed in (1) that would apply in the absence of the credit protection.

[Note: BCD Annex VIII Part 3 point 11 (as it applies to the IRB approach)]

4.10.33
(1) This rule sets out how the calculations under BIPRU 5.6.24 R (Using the internal models approach to master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions) must be modified under the IRB approach.

(2) Where risk weighted exposure amounts and expected loss amounts are calculated under the IRB approach, E is the exposure value for each separate exposure under the agreement referred to in the provisions listed in (1) that would apply in the absence of the credit protection.

[Note: BCD Annex VIII Part 3 point 20 (as it applies to the IRB approach)]

4.10.34
(1) This rule sets out how the calculations under BIPRU 5.6.29 R (Calculating risk-weighted exposure amounts and expected loss amounts for master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions) must be modified under the IRB approach.

(2) $E^*$ must be taken as the exposure value of the exposure to the counterparty arising from the transactions subject to the master
Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Financial collateral comprehensive method

4.10.35

(1) This rule sets out how the calculations under [BIPRU 5.4.28 R (Calculating adjusted values under the financial collateral comprehensive method)] must be modified under the IRB approach.

(2) E as referred to in the provisions listed in (1) is the exposure value as would be determined under the IRB approach if the exposure was not collateralised. For this purpose, where a firm calculates risk weighted exposure amounts under the IRB approach, the exposure value of the items listed in [BIPRU 4.4.37 R to BIPRU 4.4.39 R, BIPRU 4.4.45 R, BIPRU 4.6.44 R (3) and BIPRU 4.8.29 R] must be calculated using a conversion factor of 100% rather than the conversion factors or percentages indicated in those provisions.

4.10.36

(1) This rule sets out the calculation of risk weighted exposure amounts and expected loss amounts under the financial collateral comprehensive method for a firm using the IRB approach.

(2) LGD* (the effective loss given default) calculated as set out in this paragraph must be taken as the LGD for the purposes of [BIPRU 4].

(3) \( \text{LGD}^* = \text{LGD} \times \left( \frac{E^*}{E} \right) \)

   where:

   (a) \( \text{LGD} \) is the loss given default that would apply to the exposure under the IRB approach if the exposure was not collateralised;

   (b) \( E \) is the exposure value as calculated under [BIPRU 4]; and

   (c) \( E^* \) is as calculated under [BIPRU 5.4.28 R (3) (Calculation of adjusted values under the financial collateral comprehensive method)].

[Note: BCD Annex VIII Part 3 point 61]

4.10.37

(1) In the case of a firm using the IRB approach to calculate risk weighted exposure amounts and expected loss amounts, the persons in (2) are added to the list in [BIPRU 5.4.64 R (Definition of core market participant)].

(2) The persons referred to in (1) are other financial companies (including insurance companies) exposures to which do not have a credit assessment by an eligible ECAI and are internally rated as having a probability of default equivalent to that associated with the credit assessments of ECAIs that are associated with credit quality step 2 or above under the rules for the risk weighting of exposures under the standardised approach to credit risk.

[Note: BCD Annex VIII Part 3 point 58(h) (as it applies to the IRB approach)]
4.10.38 R

(1) In the case of a firm using the IRB approach in calculating risk weighted exposure amounts and expected loss amounts, the persons in (2) are added to the list in BIPRU 5.7.1 R (List of eligible providers of unfunded credit protection).

(2) The persons referred to in (1) are other corporate entities, including parent undertakings, subsidiary undertakings and affiliate corporate entities of the firm, that do not have a credit assessment by an eligible ECAI and are internally rated as having a probability of default equivalent to that associated with the credit assessments of ECAs that are associated with credit quality step 2 or above under the rules for the risk weighting of exposures under the standardised approach to credit risk.

[Note: BCD Annex VIII Part 1 point 26(g)(ii)]

4.10.39 R

Where risk weighted exposure amounts and expected loss amounts are calculated under the IRB approach, to be eligible a guarantor must be internally rated by a firm in accordance with the provisions of the minimum IRB standards.

[Note: BCD Annex VIII Part 1 point 27]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Introduction

4.10.40 R

■ BIPRU 4.10.41 R to ■ BIPRU 4.10.48 R set out the minimum requirements:

(1) assessing the effect of guarantees and credit derivatives for:

(a) exposures in the sovereign, institution and corporate IRB exposure class where the advanced IRB approach is being used to calculate LGDs; and

(b) retail exposures; and

(2) additionally, in the case of retail exposure guarantees, to the assignment of exposures to grades or pools, and the estimation of PD.

[Note: BCD Annex VII Part 4 point 97]

4.10.41 R

The requirements in ■ BIPRU 4.10.40 R (2) and ■ BIPRU 4.10.42 R - ■ BIPRU 4.10.48 R do not apply to guarantees provided by institutions, central governments, central banks and other corporate entities which meet the requirements in ■ BIPRU 5.7.1 R (7) if the firm has received approval under ■ BIPRU 4.2 to apply the standardised approach for exposures to such entities. In this case the requirements of ■ BIPRU 5 (credit risk mitigation) apply.

[Note: BCD Annex VII Part 4 point 96]
Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Eligible guarantors and guarantees

4.10.42 A firm must have clearly specified criteria for the types of guarantors it recognises for the calculation of risk weighted exposure amounts.

[Note: Annex VII Part 4 point 98]

4.10.43 For recognised guarantors the same requirements as for obligors as set out in ■ BIPRU 4.3.43 R - ■ BIPRU 4.3.48 R (Assignment to grades and pools), ■ BIPRU 4.4.11 R - ■ BIPRU 4.4.18 R and ■ BIPRU 4.4.51 R (Assignment of exposures and rating systems), ■ BIPRU 4.5.6 R (Assignment of exposures) and ■ BIPRU 4.6.11 R and ■ BIPRU 4.6.14 R (Assignment of exposures and rating systems) apply.

[Note: BCD Annex VII Part 4 point 99]

4.10.44 The guarantee must be evidenced in writing, non-cancellable on the part of the guarantor, in force until the obligation is satisfied in full (to the extent of the amount and tenor of the guarantee) and legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgement. Guarantees prescribing conditions under which the guarantor may not be obliged to perform (conditional guarantees) may be recognised if the IRB permission permits this. A firm must (in the case of a firm with an IRB permission that permits conditional guarantees) be able to demonstrate to the appropriate regulator that the assignment criteria adequately address any potential reduction in the risk mitigation effect.

[Note: BCD Annex VII Part 4 point 100]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Adjustment criteria

4.10.45 A firm must have clearly specified criteria for adjusting grades, pools or LGD estimates, and in the case of retail exposures and eligible purchased receivables, the process of allocating exposures to grades or pools, to reflect the impact of guarantees for the calculation of risk weighted exposure amounts. These criteria must comply with the minimum requirements referred to in ■ BIPRU 4.10.43 R.

[Note: BCD Annex VII Part 4 point 101]

4.10.46 The criteria in ■ BIPRU 4.10.45 R must be plausible and intuitive. They must address the guarantor’s ability and willingness to perform under the guarantee, the likely timing of any payments from the guarantor, the degree to which the guarantor’s ability to perform under the guarantee is correlated with the obligor’s ability to repay, and the extent to which residual risk to the obligor remains.

[Note: BCD Annex VII Part 4 point 102]
Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Credit derivatives

4.10.47 R The minimum requirements for guarantees set out in ■ BIPRU 4.10 also apply for single name credit derivatives. In relation to a mismatch between the underlying obligation and the reference obligation of the credit derivative or the obligation used for determining whether a credit event has occurred the requirements set out under ■ BIPRU 5.7.14 R (Mismatches and credit derivatives) apply. For retail exposures and eligible purchased receivables, this paragraph applies to the process of allocating exposures to grades or pools.

[Note: BCD Annex VII Part 4 point 103]

4.10.48 R The criteria applied by ■ BIPRU 4.10.47 R must address the payout structure of the credit derivative and conservatively assess the impact this has on the level and timing of recoveries. A firm must consider the extent to which other forms of residual risk remain.

[Note: BCD Annex VII Part 4 point 104]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Calculating risk weighted exposure amounts and expected loss amounts

4.10.49 R (1) This rule relates to the calculation of risk-weighted exposure amounts and expected loss amounts in the case of unfunded credit protection.

(2) ■ BIPRU 5.7.21 R (Tranching) applies for the purpose in (1).

(3) The provisions in (4) replace those in ■ BIPRU 5.7.22 R to ■ BIPRU 5.7.25 R (Calculating risk weighted exposure amounts under the standardised approach in the case of unfunded credit protection).

(4) For the covered portion of the exposure value E (based on the adjusted value of the credit protection G_A), the PD for the purposes of ■ BIPRU 4 may be the PD of the protection provider, or a PD between that of the borrower and that of the guarantor if a full substitution is deemed not to be warranted. In the case of subordinated exposures and non-subordinated unfunded protection, the LGD to be applied for the purposes of ■ BIPRU 4 may be that associated with senior claims.

(5) For any uncovered portion of the exposure value E the PD must be that of the borrower and the LGD must be that of the underlying exposure.

(6) G_A is the value of G* as calculated under ■ BIPRU 5.7.17 R (Valuation of unfunded credit protection) further adjusted for any maturity mismatch as laid down in ■ BIPRU 4.10.51 R (Maturity mismatches).

(7) E is the exposure value as related to the following rules: ■ BIPRU 4.4.38 R, ■ BIPRU 4.4.39 R, ■ BIPRU 4.4.71 R to ■ BIPRU 4.4.78 R, ■ BIPRU 4.7.7 R, ■ BIPRU 4.8.28 R, ■ BIPRU 4.8.29 R and ■ BIPRU 4.9.9 R. For this purpose, the exposure value of the items referred to in ■ BIPRU 4.4.37 R to ■ BIPRU 4.4.39 R and ■ BIPRU 4.8.29 R must be
calculated using a conversion factor or percentage of 100% rather than the conversion factors or percentages indicated in those rules.

[Note: BCD Annex VIII Part 3 points 90 to 92]

Maturity mismatches

In addition to BIPRU 5.8.2 R, where there is a maturity mismatch the credit protection must not be recognised where the exposure is a short term exposure specified in the firm’s IRB permission as being subject to a one-day floor rather than a one-year floor in respect of the maturity value (M) under BIPRU 4.4.68 R.

[Note: BCD Annex VIII Part 4 point 2(b)]

G_A as calculated under BIPRU 5.8.11 R is then taken as the value of the protection for the purposes of calculating the effects of unfunded credit protection under the IRB approach.

[Note: BCD Annex VIII Part 4 point 8 (part)]
Supervisory Slotting Criteria for Specialised Lending

This Annex outlines the criteria that must be used to slot a *specialised lending exposure* into the categories in [BIPRU 4.5.6 R](#).

This table belongs to [BIPRU 4.5.6 R](#) and must be used in accordance with that rule only for project finance exposures.

| Table 1 - Supervisory Rating Grades for Project Finance Exposures |
|---------------------------------|-----------------|-----------------|-----------------|-----------------|
| **Financial strength**          | **Strong**      | **Good**        | **Satisfactory**| **Weak**        |
| Market conditions               | Few competing suppliers or substantial and durable advantage in location, cost, or technology. Demand is strong and growing | Few competing suppliers or better than average location, cost, or technology but this situation may not last. Demand is strong and stable | Project has no advantage in location, cost, or technology. Demand is adequate and stable | Project has worse than average location, cost, or technology. Demand is weak and declining |
| Financial ratios (e.g. debt service coverage ratio (DSCR), loan life coverage ratio (LLCR), project life coverage ratio (PLCR), and debt-to-equity ratio) | Strong financial ratios considering the level of project risk; very robust economic assumptions | Strong to acceptable financial ratios considering the level of project risk; robust project economic assumptions | Standard financial ratios considering the level of project risk | Aggressive financial ratios considering the level of project risk |
| Stress analysis                 | The project can meet its financial obligations under sustained, severely stressed economic or sectoral conditions | The project can meet its financial obligations under normal stressed economic or sectoral conditions. The project is only likely to default under severe economic conditions | The project is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn | The project is likely to default unless conditions improve soon |
| **Financial structure**         | **Strong**      | **Good**        | **Satisfactory**| **Weak**        |
| Duration of the credit compared to the duration of the project | Useful life of the project significantly exceeds tenor of the loan | Useful life of the project exceeds tenor of the loan | Useful life of the project may not exceed tenor of the loan | Useful life of the project may not exceed tenor of the loan |
| Amortisation schedule           | Amortising debt | Amortising debt | Amortising debt repayments with limited bullet payment | Bullet repayment or amortising debt repayments with high bullet repayment |
| **Political and legal environment** | **Strong** | **Good** | **Satisfactory** | **Weak** |
| Political risk, incentives      | Very low exposure; | Low exposure; saturation | Moderate exposure | High exposure; no |
### Table 1 - Supervisory Rating Grades for Project Finance Exposures

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Including transfer risk,</strong> considering project type and mitigants</td>
<td>strong mitigation instruments, if needed</td>
<td>isfactory mitigation instruments, if needed</td>
<td>sure; fair mitigation instruments</td>
<td>or weak mitigation instruments</td>
</tr>
<tr>
<td><strong>Force majeure risk</strong> (war, civil unrest, etc)</td>
<td>Low exposure</td>
<td>Acceptable exposure</td>
<td>Standard protection</td>
<td>Significant risks, not fully mitigated</td>
</tr>
<tr>
<td><strong>Government support and project’s importance for the country over the long term</strong></td>
<td>Project of strategic importance for the country (preferably export-oriented). Strong support from Government</td>
<td>Project considered important for the country. Good level of support from Government</td>
<td>Project may not be strategic but brings unquestionable benefits for the country. Support from Government may not be explicit</td>
<td>Project not key to the country. No or weak support from Government</td>
</tr>
<tr>
<td><strong>Stability of legal and regulatory environment (risk of change in law)</strong></td>
<td>Favourable and stable regulatory environment over the long term</td>
<td>Favourable and stable regulatory environment over the medium term</td>
<td>Regulatory changes can be predicted with a fair level of certainty</td>
<td>Current or future regulatory issues may affect the project</td>
</tr>
<tr>
<td><strong>Acquisition of all necessary supports and approvals for such relief from local content laws</strong></td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td><strong>Enforceability of contracts, collateral and security</strong></td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are considered enforceable even if certain non-key issues may exist</td>
<td>There are unresolved key issues in respect if actual enforcement of contracts, collateral and security</td>
</tr>
<tr>
<td><strong>Transaction characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Design and technology risk</strong></td>
<td>Fully proven technology and design</td>
<td>Fully proven technology and design</td>
<td>Proven technology and design - start-up issues are mitigated by a strong completion package</td>
<td>Unproven technology and design; technology issues exist and/or complex design</td>
</tr>
<tr>
<td><strong>Construction risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Permitting and siting</strong></td>
<td>All permits have been obtained</td>
<td>Some permits are still outstanding but their receipt is considered very likely</td>
<td>Some permits are still outstanding but the permitting process is well defined and they are considered routine</td>
<td>Key permits still need to be obtained and are not considered routine. Significant conditions may be attached</td>
</tr>
<tr>
<td><strong>Type of construction contract</strong></td>
<td>Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)</td>
<td>Fixed-price date-certain turnkey construction EPC</td>
<td>Fixed-price date-certain turnkey construction contract with one or several contractors</td>
<td>No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors</td>
</tr>
<tr>
<td>Table 1 - Supervisory Rating Grades for Project Finance Exposures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Strong</strong></td>
<td><strong>Good</strong></td>
<td><strong>Satisfactory</strong></td>
<td><strong>Weak</strong></td>
<td></td>
</tr>
<tr>
<td>Completion guarantees</td>
<td>Substantial liquidated damages supported by financial substance and/or strong completion guarantees from sponsors with excellent financial standing</td>
<td>Significant liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing</td>
<td>Adequate liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing</td>
<td>Inadequate liquidated damages or not supported by financial substance or weak completion guarantees</td>
</tr>
<tr>
<td>Track record and financial strength of contractor in constructing similar projects.</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>Operating risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scope and nature of operations and maintenance (O&amp;M) contracts</td>
<td>Strong long-term O&amp;M contract, preferably with contractual performance incentives, and/or O&amp;M reserve accounts</td>
<td>Long-term O&amp;M contract, and/or O&amp;M reserve accounts</td>
<td>Limited O&amp;M contract or O&amp;M reserve account</td>
<td>No O&amp;M contract: risk of high operational cost over-runs beyond mitigants</td>
</tr>
<tr>
<td>Operator’s expertise, track record, and financial strength</td>
<td>Very strong, or committed technical assistance of the sponsors</td>
<td>Strong</td>
<td>Acceptable</td>
<td>Limited/weak, or local operator dependent on local authorities</td>
</tr>
<tr>
<td>Off-take risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) If there is a take-or-pay or fixed-price off-take contract:</td>
<td>Excellent creditworthiness of off-taker; strong termination clauses; tenor of contract comfortably exceeds the maturity of the debt</td>
<td>Good creditworthiness of off-taker; strong termination clauses; tenor of contract exceeds the maturity of the debt</td>
<td>Acceptable financial standing of off-taker; normal termination clauses; tenor of contract generally matches the maturity of the debt</td>
<td>Weak off-taker; weak termination clauses; tenor of contract does not exceed the maturity of the debt</td>
</tr>
<tr>
<td>(b) If there is no take-or-pay or fixed-price off-take contract:</td>
<td>Project produces essential services or a commodity sold widely on a world market; output can readily be absorbed at projected prices even at lower than historic market growth rates</td>
<td>Project produces essential services or a commodity sold widely on a regional market that will absorb it at projected prices at historical growth rates</td>
<td>Commodity is sold on a limited market that may absorb it only at lower than projected prices</td>
<td>Project output is demanded by only one or a few buyers or is not generally sold on an organised market</td>
</tr>
<tr>
<td>Supply risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price, volume and transportation risk of feed-stocks; supplier’s track record and financial strength</td>
<td>Long-term supply contract with supplier of excellent financial standing</td>
<td>Long-term supply contract with supplier of good financial standing</td>
<td>Long-term supply contract with supplier of good financial standing - a degree of price risk may remain</td>
<td>Short-term supply contract or long-term supply contract with financially weak supplier - a degree of price risk definitely remains</td>
</tr>
<tr>
<td></td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>------------------------</td>
<td>---------------------------------------------</td>
<td>-------------------------------------------</td>
<td>--------------------------------------------</td>
<td>-------------------------------------------</td>
</tr>
<tr>
<td><strong>Reserve risks</strong></td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Proven reserves can supply the project adequately through the maturity of the debt</td>
<td>Project relies to some extent on potential and undeveloped reserves</td>
</tr>
<tr>
<td><strong>Strength of Sponsor</strong></td>
<td>Strong sponsor with excellent track record and high financial standing</td>
<td>Good sponsor with satisfactory track record and good financial standing</td>
<td>Adequate sponsor with adequate track record and good financial standing</td>
<td>Weak sponsor with no or questionable track record and/or financial weaknesses</td>
</tr>
<tr>
<td><strong>Sponsor support</strong></td>
<td>Strong. Project is highly strategic for the sponsor (core business - long-term strategy)</td>
<td>Good. Project is strategic for the sponsor (core business - long-term strategy)</td>
<td>Acceptable. Project is considered important for the sponsor (core business)</td>
<td>Limited. Project is not key to sponsor’s long-term strategy or core business</td>
</tr>
<tr>
<td><strong>Security Package</strong></td>
<td>Fully comprehensive</td>
<td>Comprehensive</td>
<td>Acceptable</td>
<td>Weak</td>
</tr>
<tr>
<td><strong>Pledge of assets</strong></td>
<td>First perfected security interest in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Perfected security interest in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Acceptable security interest in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Little security or collateral for lenders; weak negative pledge clause</td>
</tr>
<tr>
<td><strong>Lender’s control</strong></td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td><strong>over cash flow</strong></td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td></td>
<td>(e.g. cash sweeps, independent escrow accounts)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Strength of the covenant package</strong></td>
<td>Covenant package is strong for this type of project</td>
<td>Covenant package is satisfactory for this type of project</td>
<td>Covenant package is fair for this type of project</td>
<td>Covenant package is insufficient for this type of project</td>
</tr>
<tr>
<td></td>
<td>Project may issue no additional debt</td>
<td>Project may issue extremely limited additional debt</td>
<td>Project may issue limited additional debt</td>
<td>Project may issue unlimited additional debt</td>
</tr>
<tr>
<td><strong>Reserve funds</strong></td>
<td>Longer than average coverage period, all reserve funds fully funded in cash or letters of credit from highly rated bank</td>
<td>Average coverage period, all reserve funds fully funded</td>
<td>Average coverage period, all reserve funds fully funded</td>
<td>Shorter than average coverage period, reserve funds funded from operating cash flows</td>
</tr>
</tbody>
</table>

This table belongs to BIPRU 4.5.6 R and must be used in accordance with that rule only for income-producing real estate exposures.
### Table 2 - Supervisory Rating Grades for Income-Producing Real Estate Exposures

<table>
<thead>
<tr>
<th>Financial strength</th>
<th>Market conditions</th>
<th>Financial ratios and advance rate</th>
<th>Stress analysis</th>
<th>Cash-flow predictability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strong</strong></td>
<td>The supply and demand for the project's type and location are currently in equilibrium. The number of competitive properties coming to market is equal or lower than forecasted demand</td>
<td>The property's debt service coverage ratio (DSCR) is considered strong (DSCR is not relevant for the construction phase) and its loan to value ratio (LTV) is considered low given its property type. Where a secondary market exists, the transaction is underwritten to market standards</td>
<td>The property's resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress (e.g. interest rates, economic growth)</td>
<td>The property's leases are long-term with creditworthy tenants and their maturity dates are scattered. The property has a track record of tenant retention upon lease expiration. Its vacancy rate is</td>
</tr>
<tr>
<td><strong>Good</strong></td>
<td>The supply and demand for the project's type and location are currently in equilibrium. The number of competitive properties coming to market is roughly equal to forecasted demand</td>
<td>The DSCR (not relevant for development real estate) and LTV are satisfactory. Where a secondary market exists, the transaction is underwritten to market standards</td>
<td>The property can meet its financial obligations under a sustained period of financial stress (e.g. interest rates, economic growth). The property is likely to default only under severe economic conditions</td>
<td>Most of the property's leases are long-term, with tenants that range in creditworthiness. The property experiences a normal level of tenant turnover upon lease expiration. Its vacancy rate is</td>
</tr>
<tr>
<td><strong>Satisfactory</strong></td>
<td>Market conditions are roughly in equilibrium. Competitive properties are coming on the market and others are in the planning stages. The project's design and capabilities may not be state of the art compared to new projects</td>
<td>The property's DSCR has deteriorated and its value has fallen, increasing its LTV</td>
<td>During an economic downturn, the property would suffer a decline in revenue that would limit its ability to fund capital expenditures and significantly increase the risk of default</td>
<td>Most of the property's leases are medium rather than long-term with tenants that range in creditworthiness. The property experiences a moderate level of tenant turnover upon lease expiration. Its vacancy rate is</td>
</tr>
<tr>
<td><strong>Weak</strong></td>
<td>Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium. The project is losing tenants at lease expiration. New lease terms are less favourable compared to those expiring</td>
<td>The property's DSCR has deteriorated significantly and its LTV is well above underwriting standards for new loans</td>
<td>The property's financial condition is strained and is likely to default unless conditions improve in the near term</td>
<td>The property's leases are of various terms with tenants that range in creditworthiness. The property experiences a very high level of tenant turnover upon lease expiration. Its vacancy rate is</td>
</tr>
</tbody>
</table>
### Table 2 - Supervisory Rating Grades for Income-Producing Real Estate Exposures

<table>
<thead>
<tr>
<th>Category</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Location</strong></td>
<td>Property is located in highly desirable location that is convenient to services that tenants desire</td>
<td>Property is located in desirable location that is convenient to services that tenants desire</td>
<td>The property location lacks a competitive advantage</td>
<td>The property's location, configuration, design and maintenance have contributed to the property's difficulties</td>
</tr>
<tr>
<td><strong>Design and condition</strong></td>
<td>Property is favoured due to its design, configuration, and maintenance, and is highly competitive with new properties</td>
<td>Property is appropriate in terms of its design, configuration and maintenance. The property's design and capabilities are competitive with new properties</td>
<td>Property is adequate in terms of its configuration, design and maintenance</td>
<td>Weaknesses exist in the property's configuration, design or maintenance</td>
</tr>
<tr>
<td><strong>Property is under construction</strong></td>
<td>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified</td>
<td>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified</td>
<td>Construction budget is adequate and contractors are ordinarily qualified</td>
<td>Project is over budget or unrealistic given its technical hazards. Contractors may be under qualified</td>
</tr>
<tr>
<td><strong>Strength of Sponsor/Developer</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial capacity and willingness to support the property</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>-----------------------------------------------------------</td>
<td>--------</td>
<td>------</td>
<td>--------------</td>
<td>------</td>
</tr>
<tr>
<td>The sponsor/developer made a substantial cash contribution to the construction or purchase of the property. The sponsor/developer has substantial resources and limited direct and contingent liabilities. The sponsor/developer's properties are diversified geographically and by property type</td>
<td>The sponsor/developer made a material cash contribution to the construction or purchase of the property. The sponsor/developer's financial condition allows it to support the property in the event of a cash flow shortfall. The sponsor/developer's properties are located in several geographic regions.</td>
<td>The sponsor/developer's contributions may be immaterial or non-cash. The sponsor/developer is average to below average in financial resources</td>
<td>The sponsor/developer lacks capacity or willingness to support the property</td>
<td></td>
</tr>
</tbody>
</table>

| Reputation and track record with similar properties | Experienced management and high sponsors' quality. Strong reputation and lengthy and successful record with similar properties. | Appropriate management and sponsors' quality. The sponsor or management has a successful record with similar properties | Moderate management and sponsors' quality. Management or sponsor track record does not raise serious concerns | Ineffective management and sub-standard sponsors' quality. Management and sponsor difficulties have contributed to difficulties in managing properties in the past |

| Relationships with relevant real estate actors | Strong relationships with leading actors such as leasing agents | Proven relationships with leading actors such as leasing agents | Adequate relationships with leasing agents and other parties providing important real estate services | Poor relationships with leasing agents and/or other parties providing important real estate services |

<table>
<thead>
<tr>
<th>Security Package</th>
<th>Nature of lien (Note 1)</th>
<th>Nature of lien (Note 1)</th>
<th>Nature of lien (Note 1)</th>
<th>Ability of lender to foreclose is constrained</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perfected first lien</td>
<td>Perfected first lien</td>
<td>Perfected first lien</td>
<td>The lender has not obtained an assignment. The lender maintains the information that would facilitate the provision of notice to the tenant, such as the current rent roll and copies of the tenant's leases</td>
<td>The lender has not obtained an assignment. The lender maintains the information that would facilitate the provision of notice to the tenant, such as the current rent roll and copies of the tenant's leases</td>
</tr>
</tbody>
</table>
### Table 2 - Supervisory Rating Grades for Income-Producing Real Estate Exposures

<table>
<thead>
<tr>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality of the insurance coverage</td>
<td>Appropriate</td>
<td>Appropriate</td>
<td>Appropriate</td>
</tr>
</tbody>
</table>

**Note 1:** Lenders in some markets extensively use loan structures that include junior liens. Junior liens may be indicative of this level of risk if the total LTV inclusive of all senior positions does not exceed a typical first loan LTV.

This table belongs to BIPRU 4.5.6 R and must be used in accordance with that rule only for object finance exposures.

### Table 3 - Supervisory Rating Grades for Object Finance Exposures

<table>
<thead>
<tr>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial strength</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market conditions</td>
<td>Demand is strong and growing, strong entry barriers, low sensitivity to changes in technology and economic outlook</td>
<td>Demand is strong and stable. Some entry barriers, some sensitivity to changes in technology and economic outlook</td>
<td>Demand is adequate and stable, limited entry barriers, significant sensitivity to changes in technology and economic outlook</td>
</tr>
<tr>
<td>Financial ratios (debt service coverage ratio and loan-to-value ratio)</td>
<td>Strong financial ratios considering the type of asset. Very robust economic assumptions</td>
<td>Strong / acceptable financial ratios considering the type of asset. Robust project economic assumptions</td>
<td>Standard financial ratios for the asset type</td>
</tr>
<tr>
<td>Stress analysis</td>
<td>Stable long-term revenues, capable of withstanding severely stressed conditions through an economic cycle</td>
<td>Satisfactory short-term revenues. Loan can withstand some financial adversity. Default is only likely under severe economic conditions</td>
<td>Uncertain short-term revenues. Cash flows are vulnerable to stresses that are not uncommon through an economic cycle. The loan may default in a normal downturn</td>
</tr>
<tr>
<td>Market liquidity</td>
<td>Market is structured on a worldwide basis; assets are highly liquid</td>
<td>Market is worldwide or regional; assets are relatively liquid</td>
<td>Market is regional with limited prospects in the short term, implying lower liquidity</td>
</tr>
<tr>
<td><strong>Political and legal environment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political risk, including transfer risk</td>
<td>Very low; strong mitigation instruments, if needed</td>
<td>Low; satisfactory mitigation instruments, if needed</td>
<td>Moderate; fair mitigation instruments</td>
</tr>
<tr>
<td>Legal and regulatory risks</td>
<td>Jurisdiction is favourable to repossession and enforcement of contracts</td>
<td>Jurisdiction is favourable to repossession and enforcement of contracts</td>
<td>Jurisdiction is generally favourable to repossession and enforcement of contracts, even if repossession might be long and/or difficult</td>
</tr>
</tbody>
</table>
### Table 3 - Supervisory Rating Grades for Object Finance Exposures

<table>
<thead>
<tr>
<th>Transaction characteristics</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing term compared to the economic life of the asset</td>
<td>Full payout profile/minimum balloon. No grace period</td>
<td>Balloon more significant, but still at satisfactory levels</td>
<td>Important balloon with potentially grace periods</td>
<td>Repayment in fine or high balloon</td>
</tr>
<tr>
<td>Operating risk</td>
<td>All permits have been obtained; asset meets current and foreseeable safety regulations</td>
<td>All permits obtained or in the process of being obtained; asset meets current and foreseeable safety regulations</td>
<td>Most permits obtained or in the process of being obtained, outstanding ones considered routine, asset meets current safety regulations</td>
<td>Problems in obtaining all required permits, part of the planned configuration and/or planned operations might need to be revised</td>
</tr>
<tr>
<td>Permits / licensing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scope and nature of O &amp; M contracts</td>
<td>Strong long-term O&amp;M contract, preferably with contractual performance incentives, and/or O&amp;M reserve accounts (if needed)</td>
<td>Long-term O&amp;M contract, and/or O&amp;M reserve accounts (if needed)</td>
<td>Limited O&amp;M contract or O&amp;M reserve account (if needed)</td>
<td>No O&amp;M contract: risk of high operational cost overruns beyond mitigants</td>
</tr>
<tr>
<td>Operator’s financial strength, track record in managing the asset type and capability to re-market asset when it comes off-lease</td>
<td>Excellent track record and strong re-marketing capability</td>
<td>Satisfactory track record and re-marketing capability</td>
<td>Weak or short track record and uncertain re-marketing capability</td>
<td>No or unknown track record and inability to re-market the asset</td>
</tr>
<tr>
<td>Asset characteristics</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Configuration, size, design and maintenance (i.e. age, size for a plane) compared to other assets on the same market</td>
<td>Strong advantage in design and maintenance. Configuration is standard such that the object meets a liquid market</td>
<td>Above average design and maintenance. Standard configuration, maybe with very limited exceptions - such that the object meets a liquid market</td>
<td>Average design and maintenance. Configuration is somewhat specific, and thus might cause a narrower market for the object</td>
<td>Below average design and maintenance. Asset is near the end of its economic life. Configuration is very specific; the market for the object is very narrow</td>
</tr>
<tr>
<td>Resale value</td>
<td>Current resale value is well above debt value</td>
<td>Resale value is moderately above debt value</td>
<td>Resale value is slightly above debt value</td>
<td>Resale value is below debt value</td>
</tr>
<tr>
<td>Sensitivity of the asset value and liquidity to economic cycles</td>
<td>Asset value and liquidity are relatively insensitive to economic cycles</td>
<td>Asset value and liquidity are sensitive to economic cycles</td>
<td>Asset value and liquidity are quite sensitive to economic cycles</td>
<td>Asset value and liquidity are highly sensitive to economic cycles</td>
</tr>
<tr>
<td>Strength of sponsor</td>
<td>Excellent track record</td>
<td>Satisfactory track</td>
<td>Weak or short</td>
<td>No or unknown</td>
</tr>
<tr>
<td>Operator’s financial strength</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Table 3 - Supervisory Rating Grades for Object Finance Exposures

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social strength, track record in managing the asset type and capability to re-market asset when it comes off-lease</td>
<td>Social strength, track record in managing the asset type and capability to re-market asset when it comes off-lease</td>
<td>Track record and inability to re-market the asset</td>
<td>Track record and inability to re-market the asset</td>
<td></td>
</tr>
<tr>
<td>Sponsors' track record and financial strength</td>
<td>Sponsors with excellent track record and high financial standing</td>
<td>Sponsors with good track record and good financial standing</td>
<td>Sponsors with adequate track record and good financial standing</td>
<td>Sponsors with no or questionable track record and/or financial weaknesses</td>
</tr>
<tr>
<td><strong>Security Package</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset control</td>
<td>Legal documentation provides the lender effective control (e.g. a first perfected security interest, or a leasing structure including such security) on the asset, or on the company owning it</td>
<td>Legal documentation provides the lender effective control (e.g. a perfected security interest, or a leasing structure including such security) on the asset, or on the company owning it</td>
<td>Legal documentation provides the lender effective control (e.g. a perfected security interest, or a leasing structure including such security) on the asset, or on the company owning it</td>
<td>The contract provides little security to the lender and leaves room to some risk of losing control on the asset</td>
</tr>
<tr>
<td>Rights and means at the lender’s disposal to monitor the location and condition of the asset</td>
<td>The lender is able to monitor the location and condition of the asset, at any time and place (regular reports, possibility to lead inspections)</td>
<td>The lender is able to monitor the location and condition of the asset, at any time and place</td>
<td>The lender is able to monitor the location and condition of the asset, at any time and place</td>
<td>The lender is able to monitor the location and condition of the asset are limited</td>
</tr>
<tr>
<td>Insurance against damages</td>
<td>Strong insurance coverage including collateral damages with top quality insurance companies</td>
<td>Satisfactory insurance coverage (not including collateral damages) with good quality insurance companies</td>
<td>Fair insurance coverage (not including collateral damages) with acceptable quality insurance companies</td>
<td>Weak insurance coverage (not including collateral damages) or with weak quality insurance companies</td>
</tr>
</tbody>
</table>

This table belongs to BIPRU 4.5.6 R and must be used in accordance with that rule only for commodities finance exposures.

### Table 4 - Supervisory Rating Grades for Commodities Finance Exposures

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial strength</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Degree of over-collateralisation of trade</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>Political and legal Environment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Country risk</td>
<td>No country risk</td>
<td>Limited exposure to country risk (in particular, offshore)</td>
<td>Exposure to country risk (in particular, offshore location)</td>
<td>Strong exposure to country risk (in particular, inland)</td>
</tr>
<tr>
<td><strong>Table 4 - Supervisory Rating Grades for Commodities Finance Exposures</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Strong</strong></td>
<td><strong>Good</strong></td>
<td><strong>Satisfactory</strong></td>
<td><strong>Weak</strong></td>
<td></td>
</tr>
<tr>
<td>Mitigation of country risks</td>
<td>location of reserves in an emerging country</td>
<td>location of reserves in an emerging country</td>
<td>reserves in an emerging country</td>
<td></td>
</tr>
<tr>
<td>Strong mitigation:</td>
<td>Strong mitigation:</td>
<td>Acceptable mitigation:</td>
<td>Only partial mitigation:</td>
<td></td>
</tr>
<tr>
<td>Strong offshore mechanisms</td>
<td>Offshore mechanisms</td>
<td>Offshore mechanisms</td>
<td>No offshore mechanisms</td>
<td></td>
</tr>
<tr>
<td>Strategic commodity</td>
<td>Strategic commodity</td>
<td>Less strategic commodity</td>
<td>Non-strategic commodity</td>
<td></td>
</tr>
<tr>
<td>1st class buyer</td>
<td>Strong buyer</td>
<td>Acceptable buyer</td>
<td>Weak buyer</td>
<td></td>
</tr>
</tbody>
</table>

**Asset characteristics**

| Liquidity and susceptibility to damage | Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage | Commodity is quoted and can be hedged through OTC instruments. Commodity is not susceptible to damage | Commodity is not quoted but is liquid. There is uncertainty about the possibility of hedging. Commodity is not susceptible to damage | Commodity is not quoted. Liquidity is limited given the size and depth of the market. No appropriate hedging instruments. Commodity is susceptible to damage |

<table>
<thead>
<tr>
<th>Strength of sponsor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial strength of trader</td>
</tr>
<tr>
<td>Track record, including ability to manage the logistic process</td>
</tr>
<tr>
<td>Trading controls and hedging policies</td>
</tr>
<tr>
<td>Quality of financial disclosure</td>
</tr>
<tr>
<td>Security package</td>
</tr>
<tr>
<td>Asset control</td>
</tr>
</tbody>
</table>
### Table 4 - Supervisory Rating Grades for Commodities Finance Exposures

<table>
<thead>
<tr>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>the assets at any time if needed</td>
<td>the assets at any time if needed</td>
<td>sets by the lender. The rupture is mitigated by knowledge of the trade process or a third party undertaking as the case may be</td>
<td>sets. Recovery could be jeopardised</td>
</tr>
</tbody>
</table>

**Insurance against damages**

- **Strong insurance coverage** including collateral damages with top quality insurance companies
- **Satisfactory insurance coverage** (not including collateral damages) with good quality insurance companies
- **Fair insurance coverage** (not including collateral damages) with acceptable quality insurance companies
- **Weak insurance coverage** (not including collateral damages) or with weak quality insurance companies
5.1 Application and purpose

Application

5.1.1 BIPRU 5 applies to a BIPRU firm.

Purpose

5.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, BIPRU 5 implements, in part, Articles 78(1) and 91 to 93 and Annex VIII of the Banking Consolidation Directive.

5.1.3 BIPRU 5 sets out the principles for the recognition of credit risk mitigation in the calculation of risk weighted exposure amounts for the purposes of the calculation of the credit risk capital component.

5.1.4 BIPRU 4.10 implements those parts of Articles 91 to 93 and Annex VIII of the Banking Consolidation Directive which are specific to the recognition of credit risk mitigation by firms using the IRB approach, and modifies the application of the provisions in BIPRU 5 to those firms.

5.1.5 In certain cases provisions specific to the IRB approach have been kept in BIPRU 5 in order to reduce duplication. The main examples are certain references to expected loss and references in the IRB approach in the provisions in BIPRU 5.7 about basket CRM techniques.
5.2 The central principles of credit risk mitigation

5.2.1 A firm using the standardised approach may recognise credit risk mitigation in accordance with BIPRU 5 in the calculation of risk weighted exposure amounts for the purposes of the calculation of the credit risk capital component.

[Note: BCD Article 91]

5.2.2 The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by a lending firm must be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.

[Note: BCD Article 92(1)]

5.2.3 (1) A firm must not recognise credit protection as eligible until it has conducted sufficient legal review confirming that the credit protection arrangements are legally effective and enforceable in all relevant jurisdictions in accordance with BIPRU 5.2.2 R.

(2) A firm must re-conduct legal reviews as necessary to ensure continuing enforceability and effectiveness.

5.2.4 A lending firm must take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

[Note: BCD Article 92(2)]

Funded credit protection

5.2.5 In the case of funded credit protection:

(1) to be eligible for recognition the assets relied upon must be sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk weighted exposure amounts and to the degree of recognition allowed; eligibility is limited to the assets set out in the CRM eligibility conditions; and

(2) the lending firm must have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy of the obligor – or other credit

event set out in the transaction documentation – and, where applicable, of the custodian holding the collateral; the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor must not be undue.

[Note: BCD Article 92(3) and (4)]

Treatment of credit linked notes

5.2.6 A credit linked note should be treated, to the extent of its cash funding, as funded credit protection. Therefore the conditions in BIPRU 5 regulating the eligibility of protection providers for unfunded credit protection do not apply. However the other provisions about the requirements for the recognition of unfunded credit protection do apply.

Unfunded credit protection

5.2.7 In the case of unfunded credit protection:

(1) to be eligible for recognition the party giving the undertaking must be sufficiently reliable, and the protection agreement legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk weighted exposure amounts and to the degree of recognition allowed; and

(2) eligibility is limited to the protection providers and types of protection agreement set out in the CRM eligibility conditions.

[Note: BCD Article 92(5)]

Minimum requirements

5.2.8 The minimum requirements set out in BIPRU 5 must be complied with.

[Note: BCD Article 92(6)]

5.2.9 A firm must be able to satisfy the appropriate regulator that it has adequate risk management processes to control the risks to which the firm may be exposed as a result of carrying out credit risk mitigation. Those processes must include appropriate stress tests and scenario analyses relating to those risks, including residual risk and the risks relating to the intrinsic value of the credit risk mitigation.

[Note: BCD Annex VIII Part 2 point 1]

5.2.10 Notwithstanding the presence of credit risk mitigation taken into account for the purposes of calculating risk weighted exposure amounts and as relevant expected loss amounts, a firm must continue to undertake full credit risk assessment of the underlying exposure and must be in a position to demonstrate to the appropriate regulator the fulfilment of this requirement. In the case of repurchase transactions and/or securities or commodities lending or borrowing transactions the underlying exposure must, for the purposes of this rule only, be deemed to be the net amount of the exposure.

[Note: BCD Annex VIII Part 2 point 2]
Calculating the effects of the credit risk mitigation

5.2.11 R Where the requirements of BIPRU 5.2.2 R to BIPRU 5.2.8 R are met the calculation of risk weighted exposure amounts, may be modified in accordance with BIPRU 5.

[Note: BCD Article 93(1)]

5.2.12 R No exposure in respect of which credit risk mitigation is obtained may produce a higher risk weighted exposure amount than an otherwise identical exposure in respect of which there is no credit risk mitigation.

[Note: BCD Article 93(2)]

5.2.13 R Where the risk weighted exposure amount already takes account of credit protection under the standardised approach the calculation of the credit protection must not be further recognised under BIPRU 5.

[Note: BCD Article 93(3)]

5.2.14 R Subject to BIPRU 5.8, BIPRU 5.9 and BIPRU 5.7.27 R to BIPRU 5.7.28 R, where the CRM eligibility conditions and the CRM minimum requirements are satisfied, the calculation of risk weighted exposure amounts under the standardised approach may be modified in accordance with the provisions of BIPRU 5.

[Note: BCD Annex VIII Part 3 point 1]

5.2.15 R Cash, securities or commodities purchased, borrowed or received under a repurchase transaction or securities or commodities lending or borrowing transaction must be treated as collateral.

[Note: BCD Annex VIII Part 3 point 2]
5.3 On balance sheet netting

Eligibility

5.3.1 [R] A firm may recognise as eligible the on-balance sheet netting of mutual claims between the firm and its counterparty.

[Note: BCD Annex VIII Part 1 point 3]

5.3.2 [R] Without prejudice to BIPRU 5.6.1 R, eligibility is limited to reciprocal cash balances between a firm and a counterparty. Only loans and deposits of the lending firm may be subject to a modification of risk weighted exposure amounts and, as relevant, expected loss amounts as a result of an on-balance sheet netting agreement.

[Note: BCD Annex VIII Part 1 point 4]

Minimum requirements

5.3.3 [R] For on-balance sheet netting agreements - other than master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions and/or other capital market-driven transactions – to be recognised for the purposes of BIPRU 5 the following conditions must be satisfied:

(1) they must be legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;

(2) the firm must be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;

(3) the firm must monitor and control the risks associated with the termination of the credit protection; and

(4) the firm must monitor and control the relevant exposures on a net basis.

[Note: BCD Annex VIII Part 2 point 3]

Calculating the effects of credit risk mitigation

5.3.4 [R] Loans and deposits with a lending firm subject to on-balance sheet netting are to be treated as cash collateral.

[Note: BCD Annex VIII Part 3 point 4]
5.4 Financial collateral

Eligibility

5.4.1

(1) Where the credit risk mitigation used relies on the right of a firm to liquidate or retain assets, eligibility depends upon whether risk weighted exposure amounts, and, as relevant, expected loss amounts, are calculated under the standardised approach or the IRB approach.

(2) Eligibility further depends upon whether the financial collateral simple method is used or the financial collateral comprehensive method.

(3) In relation to repurchase transactions and securities or commodities lending or borrowing transactions, eligibility also depends upon whether the transaction is booked in the non-trading book or the trading book.

[Note: BCD Annex VIII Part 1 point 6]

5.4.2

The following financial items may be recognised as eligible collateral under all approaches and methods:

1. cash on deposit with, or cash assimilated instruments held by, the lending firm;

2. debt securities issued by central governments or central banks which securities have a credit assessment by an eligible ECAI or export credit agency recognised as eligible for the purposes of the standardised approach, which is associated with credit quality step 4 or above under the rules for the risk weighting of exposures to central governments and central banks under the standardised approach;

3. debt securities issued by institutions which securities have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of exposures to a credit institution under the standardised approach;

4. debt securities issued by other entities which securities have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of exposures to corporates under the standardised approach;

5. debt securities with a short-term credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weighting of short term exposures under the standardised approach;
(6) equities or convertible bonds that are included in a main index; and
(7) gold.

[Note: BCD Annex VIII Part 1 point 7 (part)]

### 5.4.3 R

For the purposes of BIPRU 5.4.2 R (2), ‘debt securities issued by central governments or central banks’ include –

1. debt securities issued by regional governments or local authorities to which are treated as exposures to the central government in whose jurisdiction they are established under the standardised approach;
2. debt securities issued by public sector entities which are treated as exposures to central governments in accordance with BIPRU 3.4.24 R;
3. debt securities issued by multilateral development banks to which a 0% risk weight is assigned under the standardised approach; and
4. debt securities issued by international organisations which are assigned a 0% risk weight under the standardised approach.

[Note: BCD Annex VIII Part 1 point 7 (part)]

### 5.4.4 R

For the purposes of BIPRU 5.4.2 R (3), ‘debt securities issued by institutions’ include:

1. debt securities issued by regional governments or local authorities other than those to which are treated as exposures to the central government in whose jurisdiction they are established under the standardised approach;
2. debt securities issued by public sector entities, exposures to which are treated as exposures to a credit institution under the standardised approach;
3. debt securities issued by multilateral development banks other than those to which a 0% risk weight is assigned under the standardised approach.

[Note: BCD Annex VIII Part 1 point 7 (part)]

### 5.4.5 R

Debt securities issued by institutions which securities do not have a credit assessment by an eligible ECAI may be recognised as eligible collateral if they fulfil the following criteria:

1. they are listed on a recognised investment exchange or a designated investment exchange;
2. they qualify as senior debt;
3. all other rated issues by the issuing institution of the same seniority have a credit assessment by an eligible ECAI associated with credit quality step 3 or above under the rules for the risk weight of
exposures to institutions or short term exposures under the standardised approach;

(4) the lending firm has no information to suggest that the issue would justify a credit assessment below that indicated in (3); and

(5) the firm can demonstrate to the appropriate regulator that the market liquidity of the instrument is sufficient for these purposes.

[Note: BCD Annex VIII Part 1 point 8]

5.4.6

(1) Units in CIUs may be recognised as eligible collateral if the following conditions are satisfied:

(a) they have a daily public price quote;

(b) the CIU is limited to investing in instruments that are eligible for recognition under BIPRU 5.4.2 R to BIPRU 5.4.5 R; and

(c) if the CIU is not limited to investing in instruments that are eligible for recognition under BIPRU 5.4.2 R to BIPRU 5.4.5 R, units may be recognised with the value of the eligible assets as collateral under the assumption that the CIU has invested to the maximum extent allowed under its mandate in non-eligible assets. In cases where non-eligible assets can have a negative value due to liabilities or contingent liabilities resulting from ownership, the firm must calculate the total value of the non-eligible assets and must reduce the value of the eligible assets by that of the non-eligible assets in case the latter is negative in total.

(2) The use (or potential use) by a CIU of derivative instruments to hedge permitted investments shall not prevent units in that CIU from being eligible.

[Note: BCD Annex VIII Part 1 point 9]

5.4.7

In relation to BIPRU 5.4.2 R (2) to (5):

(1) where a security has two credit assessments by eligible ECAIs, the less favourable assessment must be deemed to apply;

(2) in cases where a security has more than two credit assessments by eligible ECAIs:

(a) the two most favourable assessments must be deemed to apply;

or

(b) if the two most favourable credit assessments are different, the less favourable of the two must be deemed to apply.

[Note: BCD Annex VIII Part 1 point 10]

5.4.8

(1) In addition to the collateral set out in BIPRU 5.4.2 R to BIPRU 5.4.7 R, where a firm uses the financial collateral comprehensive method, the following financial items may be recognised as eligible collateral:
(a) equities or convertible bonds not included in a main index but traded on a recognised investment exchange or a designated investment exchange;

(b) units in CIUs if the following conditions are met:
   (i) they have a daily public price quote; and
   (ii) the CIU is limited to investing in instruments that are eligible for recognition under BIPRU 5.4.2 R to BIPRU 5.4.5 R and the items mentioned in (a); and

(c) if the CIU is not limited to investing in instruments that are eligible for recognition under BIPRU 5.4.2 R to BIPRU 5.4.5 R and the items mentioned in (a) of this rule, units may be recognised with the value of the eligible assets as collateral under the assumption that the CIU has invested to the maximum extent allowed under its mandate in non-eligible assets. In cases where non-eligible assets can have a negative value due to liabilities or contingent liabilities resulting from ownership, the firm must calculate the total value of the non-eligible assets and must reduce the value of the eligible assets by that of the non-eligible assets, in case the latter is negative in total.

(2) The use (or potential use) by a CIU of derivative instruments to hedge permitted investments shall not prevent units in that CIU from being eligible.

[Note: BCD Annex VIII Part 1 point 11]

Minimum requirements

5.4.9 R For the recognition of financial collateral and gold, the following conditions must be met:

(1) the low correlation conditions in BIPRU 5.4.10 R;

(2) the legal certainty conditions in BIPRU 5.4.11 R; and

(3) the operational requirements in BIPRU 5.4.12 R.

[Note: BCD Annex VIII Part 2 point 6]

5.4.10 R The low correlation conditions referred to in BIPRU 5.4.9 R (1) are as follows:

(1) (a) the credit quality of the obligor and the value of the collateral must not have a material positive correlation; and
   (b) securities issued by the obligor, or any related group entity are not eligible.

(2) notwithstanding (1)(b), the obligor’s own issues of covered bonds falling within the terms of BIPRU 3.4.107 R to BIPRU 3.4.109 R may be recognised as collateral for repurchase transactions, provided that (1)(a) is complied with.

[Note: BCD Annex VIII Part 2 point 6(a)]
The legal certainty conditions referred to in [BIPRU 5.4.9 R (2)] are as follows:

1. A firm must fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of the collateral arrangements under the law applicable to its interest in the collateral;

2. In accordance with the general principle in [BIPRU 5.2.2 R], a firm must have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions; and

3. A firm must re-conduct such review as necessary to ensure continuing enforceability.

[Note: BCD Annex VIII Part 2 point 6(b)]

The operational requirements referred to in [BIPRU 5.4.9 R (3)] are as follows:

1. The collateral arrangements must be properly documented, with a clear and robust procedure for the timely liquidation of collateral;

2. A firm must employ robust procedures and processes to control risks arising from the use of collateral – including risks of failed or reduced credit protection, valuation risks, risks associated with the termination of the credit protection, concentration risk arising from the use of collateral and the interaction with the firm's overall risk profile;

3. A firm must have documented policies and practices concerning the types and amounts of collateral accepted;

4. A firm must calculate the market value of the collateral, and revalue it accordingly, with a minimum frequency of once every six months and whenever the firm has reason to believe that there has occurred a significant decrease in its market value; and

5. Where the collateral is held by a third party, a firm must take reasonable steps to ensure that the third party segregates the collateral from its own assets.

[Note: BCD Annex VIII Part 2 point 6(c)]

In addition to the requirements set out in [BIPRU 5.4.9 R], for the recognition of financial collateral under the financial collateral simple method the residual maturity of the protection must be at least as long as the residual maturity of the exposure.

[Note: BCD Annex VIII Part 2 point 7]

The financial collateral simple method: General

[BIPRU 5.4.17 R – BIPRU 5.4.22 R] set out the calculation of the effects of credit risk mitigation under the financial collateral simple method.
5.4.15 R The financial collateral simple method is available only where risk weighted exposure amounts are calculated under the standardised approach to credit risk.

[Note: BCD Annex VIII Part 3 point 24 (part)]

5.4.16 R A firm must not use both the financial collateral simple method and the financial collateral comprehensive method, unless such use is for the purposes of BIPRU 4.2.17 R to BIPRU 4.2.19 R and BIPRU 4.2.26 R, and such use is provided for by the firm’s IRB permission. A firm must demonstrate to the appropriate regulator that this exceptional application of both methods is not used selectively with the purpose of achieving reduced minimum capital requirements and does not lead to regulatory arbitrage.

[Note: BCD Annex VIII Part 3 point 24 (part)]

The financial collateral simple method: Valuation

5.4.17 R Under the financial collateral simple method, recognised financial collateral is assigned a value equal to its market value as determined in accordance with BIPRU 5.4.12 R.

[Note: BCD Annex VIII Part 3 point 25]

The financial collateral simple method: Calculating risk-weighted exposure amounts

5.4.18 R The risk weight that would be assigned under the standardised approach to credit risk if the lending firm had a direct exposure to the collateral instrument must be assigned to those portions of exposure values collateralised by the market value of recognised collateral. For this purpose, the exposure value of an off-balance sheet item listed in BIPRU 3.7.2 R must be 100% of its value rather than the exposure value indicated in BIPRU 3.2.1 R. The risk weight of the collateralised portion must be a minimum of 20% except as specified in BIPRU 5.4.19 R to BIPRU 5.4.21 R. The remainder of the exposure value receives the risk weight that would be applied to an unsecured exposure to the counterparty under the standardised approach.

[Note: BCD Annex VIII Part 3 point 26]

The financial collateral simple method: Repurchase transactions and securities lending or borrowing transactions

5.4.19 R A risk weight of 0% must be assigned to the collateralised portion of the exposure arising from transactions which fulfil the criteria enumerated in BIPRU 5.4.62 R or BIPRU 5.4.65 R. If the counterparty to the transaction is not a core market participant a risk weight of 10% must be assigned.

[Note: BCD Annex VIII Part 3 point 27]

The financial collateral simple method: financial derivative instruments subject to daily mark-to-market

5.4.20 R A risk weight of 0% must, to the extent of the collateralisation, be assigned to the exposure values determined under BIPRU 13 for financial derivative instruments and subject to daily marking-to-market, collateralised by cash or
A 0% risk weight may be assigned where the exposure and the collateral are
denominated in the same currency, and either:

(1) the collateral is cash on deposit or a cash assimilated instrument; or

(2) the collateral is in the form of debt securities issued by central
governments or central banks eligible for a 0% risk weight under the
standardised approach, and its market value has been discounted by
20%.

[Note: BCD Annex VIII Part 3 point 29]
be added to the volatility adjustment appropriate to the collateral as set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[Note: BCD Annex VIII Part 3 point 31]

5.4.26 R

In the case of financial derivative instrument covered by netting agreements recognised under BIPRU 13, a volatility adjustment reflecting currency volatility must be applied when there is a mismatch between the collateral currency and the settlement currency. Even in the case where multiple currencies are involved in the transactions covered by the netting agreement, only a single volatility adjustment may be applied.

[Note: BCD Annex VIII Part 3 point 32]

5.4.27 R

In the case of a firm using the financial collateral comprehensive method, where an exposure takes the form of securities or commodities sold, posted or lent under a repurchase transaction or under a securities or commodities lending or borrowing transaction, and margin lending transactions the exposure value must be increased by the volatility adjustment appropriate to such securities or commodities as prescribed in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[Note: BCD Article 78(1), third sentence]

The financial collateral comprehensive method: Calculating adjusted values

5.4.28 R

(1) The volatility-adjusted value of the collateral to be taken into account is calculated as follows in the case of all transactions except those transactions subject to recognised master netting agreements to which the provisions set out in BIPRU 5.6.5 R to BIPRU 5.6.29 R are to be applied:

\[ C_{VA} = C x (1-H_C-H_{FX}) \]

(2) The volatility-adjusted value of the exposure to be taken into account is calculated as follows:

\[ E_{VA} = E x (1+H_E), \] and in the case of financial derivative instruments \[ E_{VA} = E. \]

(3) The fully adjusted value of the exposure, taking into account both volatility and the risk-mitigating effects of collateral is calculated as follows:

\[ E^* = \max \{0, [E_{VA} - C_{VAM}]\} \]

Where:

(a) E is the exposure value as would be determined under the standardised approach if the exposure was not collateralised.

(b) \( E_{VA} \) is the volatility-adjusted exposure amount.

(c) \( C_{VA} \) is the volatility-adjusted value of the collateral.

(d) \( C_{VAM} \) is \( C_{VA} \) further adjusted for any maturity mismatch in accordance with the provisions of BIPRU 5.8.

(e) \( H_E \) is the volatility adjustment appropriate to the exposure (E), as calculated under BIPRU 5.4.30 R to BIPRU 5.4.65 R.
(f) $H_C$ is the volatility adjustment appropriate for the collateral, as calculated under BIPRU 5.4.30 R to BIPRU 5.4.65 R.

(g) $H_{FM}$ is the volatility adjustment appropriate for currency mismatch, as calculated under BIPRU 5.4.30 R to BIPRU 5.4.65 R.

(h) $E^*$ is the fully adjusted exposure value taking into account volatility and the risk-mitigating effects of the collateral.

(4) For the purpose of (3)(a), for a firm calculating risk weighted exposure amounts under the standardised approach the exposure value of an off-balance sheet items listed in BIPRU 3.7 must be 100% of its value rather than the exposure value indicated in BIPRU 3.2.1 R and BIPRU 3.7.2 R.

[Note: BCD Annex VIII Part 3 point 33]

The financial collateral comprehensive method: Calculation of volatility adjustments to be applied: General

5.4.29 R BIPRU 5.4.30 R – BIPRU 5.4.65 R set out the calculation of volatility adjustments under the financial collateral comprehensive method.

5.4.30 R Volatility adjustments may be calculated in two ways: the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach.

[Note: BCD Annex VIII Part 3 point 34]

5.4.31 R A firm may choose to use the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach independently of the choice it has made between the standardised approach and the IRB approach for the calculation of risk weighted exposure amounts. However, if a firm seeks to use the own estimates of volatility adjustments approach, it must do so for the full range of instrument types, excluding immaterial portfolios where it may use the supervisory volatility adjustments approach.

[Note: BCD Annex VIII Part 3 point 35 (part)]

5.4.32 R Where the collateral consists of a number of recognised items, the volatility adjustment must be

$$H = \sum \alpha_i H_i$$

where:

1. $\alpha_i$ is the proportion of an item to the collateral as a whole; and
2. $H_i$ is the volatility adjustment applicable to that item.

[Note: BCD Annex VIII Part 3 point 35 (part)]

The financial collateral comprehensive method: Supervisory volatility adjustments approach

5.4.33 R BIPRU 5.4.34 R – BIPRU 5.4.43 R set out the calculation of volatility adjustments under the supervisory volatility adjustments approach.
The volatility adjustments to be applied under the supervisory volatility adjustments approach (assuming daily revaluation) are those set out in the tables in BIPRU 5.4.35 R – BIPRU 5.4.38 R.

[Note: BCD Annex VIII Part 3 point 36]

Table: Volatility adjustments for debt securities described in BIPRU 5.4.2R(2) and (3) – (4)

<table>
<thead>
<tr>
<th>Credit quality step with which the credit assessment of the debt security is associated</th>
<th>Residual Maturity</th>
<th>Volatility adjustments for debt securities issued by entities described in BIPRU 5.4.2 R (2)</th>
<th>Volatility adjustments for debt securities issued by entities described in BIPRU 5.4.2 R (3) and (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>20 day liquidation period (%)</td>
<td>10 day liquidation period (%)</td>
</tr>
<tr>
<td>1 ≤ 1 year</td>
<td>0.707</td>
<td>0.5</td>
<td>0.354</td>
</tr>
<tr>
<td>&gt; 1 ≤ 5 years</td>
<td>2.828</td>
<td>2</td>
<td>1.414</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>5.657</td>
<td>4</td>
<td>2.828</td>
</tr>
<tr>
<td>2–3 ≤ 1 year</td>
<td>1.414</td>
<td>1</td>
<td>0.707</td>
</tr>
<tr>
<td>&gt; 1 ≤ 5 years</td>
<td>4.243</td>
<td>3</td>
<td>2.121</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>8.485</td>
<td>6</td>
<td>4.243</td>
</tr>
<tr>
<td>4 ≤ 1 year</td>
<td>21.213</td>
<td>15</td>
<td>10.607</td>
</tr>
<tr>
<td>&gt; 1 ≤ 5 years</td>
<td>21.213</td>
<td>15</td>
<td>10.607</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>21.213</td>
<td>15</td>
<td>10.607</td>
</tr>
</tbody>
</table>

Table: Volatility adjustments for debt securities described in BIPRU 5.4.2R(5)
### Credit quality step with which the credit assessment of a short term debt security is associated

<table>
<thead>
<tr>
<th>Volatility adjustments for debt securities issued by entities described in BIPRU 5.4.2 R (2) with short-term credit assessments</th>
<th>Volatility adjustments for debt securities issued by entities described in BIPRU 5.4.2 R (3) and (4) with short-term credit assessments</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 day liquidation period (%)</td>
<td>10 day liquidation period (%)</td>
</tr>
<tr>
<td>1</td>
<td>0.707</td>
</tr>
<tr>
<td>2–3</td>
<td>1.414</td>
</tr>
</tbody>
</table>

#### Table: Volatility adjustments for other collateral or exposure types

This table belongs to BIPRU 5.4.34 R.

<table>
<thead>
<tr>
<th>Other collateral or exposure types</th>
<th>20 day liquidation period (%)</th>
<th>10 day liquidation period (%)</th>
<th>5 day liquidation period (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main index equities, main index convertible bonds</td>
<td>21.213</td>
<td>15</td>
<td>10.607</td>
</tr>
<tr>
<td>Other equities or convertible bonds listed on a recognised investment exchange or designated investment exchange</td>
<td>35.355</td>
<td>25</td>
<td>17.678</td>
</tr>
<tr>
<td>Cash</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Gold</td>
<td>21.213</td>
<td>15</td>
<td>10.607</td>
</tr>
</tbody>
</table>

#### Table: Volatility adjustments for currency mismatch

This table belongs to BIPRU 5.4.34 R.

<table>
<thead>
<tr>
<th>Volatility adjustment for currency mismatch</th>
<th>20 day liquidation period (%)</th>
<th>10 day liquidation period (%)</th>
<th>5 day liquidation period (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>11.314</td>
<td>8</td>
<td>5.657</td>
</tr>
</tbody>
</table>
5.4.39 For secured lending transactions the liquidation period is 20 business days.

5.4.40 In the tables in BIPRU 5.4.35 R – BIPRU 5.4.38 R and in BIPRU 5.4.41 R to BIPRU 5.4.43 R, the credit quality step with which a credit assessment of the debt security is associated is the credit quality step with which the external credit assessment is associated under the standardised approach. For the purposes of this rule, BIPRU 5.4.7 R also applies.

5.4.41 For non-eligible securities or for commodities lent or sold under repurchase transactions or securities or commodities lending or borrowing transactions, the volatility adjustment is the same as for non-main index equities listed on a recognised investment exchange or a designated investment exchange.

5.4.42 For eligible units in CIUs the volatility adjustment is the weighted average volatility adjustments that would apply, having regard to the liquidation period of the transaction as specified in BIPRU 5.4.39 R, to the assets in which the fund has invested. If the assets in which the fund has invested are not known to the firm, the volatility adjustment is the highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.

5.4.43 For unrated debt securities issued by institutions and satisfying the eligibility criteria in BIPRU 5.4.5 R the volatility adjustments are the same as for securities issued by institutions or corporates with an external credit assessment associated with credit quality steps 2 or 3.

The financial collateral comprehensive method: Own estimates of volatility adjustments approach: General

5.4.44 BIPRU 5.4.45 R – BIPRU 5.4.60 R deal with the calculation of volatility adjustments under the own estimates of volatility adjustments approach.

5.4.45 A firm complying with the requirements set out in BIPRU 5.4.50 R to BIPRU 5.4.60 R may use the own estimates of volatility adjustments approach.
for calculating the volatility adjustments to be applied to collateral and exposures.

[Note: BCD Annex VIII Part 3 point 42]

5.4.46 When debt securities have a credit assessment from an eligible ECAI equivalent to investment grade or better, a firm may calculate a volatility estimate for each category of security.

[Note: BCD Annex VIII Part 3 point 43]

5.4.47 In determining relevant categories, a firm must take into account the type of issuer of the security, the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates must be representative of the securities included in the category by the firm.

[Note: BCD Annex VIII Part 3 point 44]

5.4.48 For debt securities having a credit assessment from an eligible ECAI equivalent to below investment grade and for other eligible collateral the volatility adjustments must be calculated for each individual item.

[Note: BCD Annex VIII Part 3 point 45]

5.4.49 A firm using the own estimates of volatility adjustments approach must estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral and/or exchange rates.

[Note: BCD Annex VIII Part 3 point 46]

The financial collateral comprehensive method: Own estimates of volatility adjustments approach: Quantitative Criteria

5.4.50 In calculating the volatility adjustments, a 99th percentile one-tailed confidence interval must be used.

[Note: BCD Annex VIII Part 3 point 47]

5.4.51 The liquidation period is 20 business days for secured lending transactions; 5 business days for repurchase transactions except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities and securities lending or borrowing transactions; and 10 business days for other capital market-driven transactions.

[Note: BCD Annex VIII Part 3 point 48]

5.4.52 A firm may use volatility adjustment numbers calculated according to shorter or longer liquidation periods, scaled up or down to the liquidation period set out in BIPRU 5.4.51 R for the type of transaction in question, using the square root of time formula:

$HM = HN \times \sqrt{\frac{T_M}{T_N}}$

where:
(1) $T_M$ is the relevant liquidation period;

(2) $H_M$ is the volatility adjustment under $T_M$; and

(3) $H_N$ is the volatility adjustment based on the liquidation period $T_N$.

[Note: BCD Annex VIII Part 3 point 49]

5.4.53 **R** A firm must take into account the illiquidity of lower-quality assets. The liquidation period must be adjusted upwards in cases where there is doubt concerning the liquidity of the collateral. A firm must also identify where historical data may understate potential volatility, e.g. a pegged currency. Such cases must be dealt with by means of stress scenario assessments.

[Note: BCD Annex VIII Part 3 point 50]

5.4.54 **R** The historical observation period (sample period) for calculating volatility adjustments must be a minimum length of one year. For a firm that uses a weighting scheme or other methods for the historical observation period, the effective observation period must be at least one year (that is, the weighted average time lag of the individual observations must not be less than 6 months).

[Note: BCD Annex VIII Part 3 point 51]

5.4.55 **G** The appropriate regulator may also require a firm to calculate its volatility adjustments using a shorter observation period if, in the appropriate regulator's judgement, this is justified by a significant upsurge in price volatility.

5.4.56 **R** A firm must update its data sets at least once every three months and must also reassess them whenever market prices are subject to material changes. This implies that volatility adjustments must be computed at least every three months.

[Note: BCD Annex VIII Part 3 point 52]

The financial collateral comprehensive method: Own estimates of volatility adjustments approach: Qualitative Criteria

5.4.57 **R** The volatility estimates must be used in the day-to-day risk management process of a firm including in relation to its internal exposure limits.

[Note: BCD Annex VIII Part 3 point 53]

5.4.58 **R** If the liquidation period used by a firm in its day-to-day risk management process is longer than that set out in BIPRU 5.4 for the type of transaction in question, the firm's volatility adjustments must be scaled up in accordance with the square root of time formula set out in BIPRU 5.4.52 R.

[Note: BCD Annex VIII Part 3 point 54]

5.4.59 **R** A firm must have established procedures for monitoring and ensuring compliance with a documented set of policies and controls for the operation
An independent review of a firm’s system for the estimation of volatility adjustments must be carried out regularly in the firm’s own internal auditing process. A review of the overall system for the estimation of volatility adjustments and for integration of those adjustments into the firm’s risk management process must take place at least once a year and must specifically address, at a minimum:

1. the integration of estimated volatility adjustments into daily risk management;
2. the validation of any significant change in the process for the estimation of volatility adjustments;
3. the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of volatility adjustments, including the independence of such data sources; and
4. the accuracy and appropriateness of the volatility assumptions.

The financial collateral comprehensive method: Scaling up of volatility adjustments

The volatility adjustments set out in BIPRU 5.4.34 R to BIPRU 5.4.43 R are the volatility adjustments to be applied where there is daily revaluation. Similarly, where a firm uses its own estimates of the volatility adjustments in accordance with BIPRU 5.4.45 R to BIPRU 5.4.60 R, these must be calculated in the first instance on the basis of daily revaluation. If the frequency of revaluation is less than daily, larger volatility adjustments must be applied. These must be calculated by scaling up the daily revaluation volatility adjustments, using the following ‘square root of time’ formula:

\[ H = H_M \sqrt{N_R + (T_M - 1)/(T_M)} \]

where:

1. \( H \) is the volatility adjustment to be applied;
2. \( H_M \) is the volatility adjustment where there is daily revaluation;
3. \( N_R \) is the actual number of business days between revaluations; and
4. \( T_M \) is the liquidation period for the type of transaction in question.

The financial collateral comprehensive method: Conditions for applying a 0% volatility adjustment

In relation to repurchase transaction and securities lending or borrowing transactions, where a firm uses the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach and where
The conditions set out in (1) – (8) are satisfied, a firm may, instead of applying the volatility adjustments calculated under BIPRU 5.4.30 R to BIPRU 5.4.61 R, apply a 0% volatility adjustment:

1. both the exposure and the collateral are cash or debt securities issued by central governments or central banks within the meaning of BIPRU 5.4.2 R (2) and eligible for a 0% risk weight under the standardised approach;

2. both the exposure and the collateral are denominated in the same currency;

3. either the maturity of the transaction is no more than one day or both the exposure and the collateral are subject to daily marking-to-market or daily remargining;

4. it is considered that the time between the last marking-to-market before a failure to remargin by the counterparty and the liquidation of the collateral is no more than four business days;

5. the transaction is settled across a settlement system proven for that type of transaction;

6. the documentation covering the agreement is standard market documentation for repurchase transactions or securities lending or borrowing transactions in the securities concerned;

7. the transaction is governed by documentation specifying that if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction is immediately terminable; and

8. the counterparty is a core market participant.

[Note: BCD Annex VIII Part 3 point 58 (part)]

5.4.63 R The option in BIPRU 5.4.62 R is not available in respect of a firm using the master netting agreement internal models approach.

[Note: BCD Annex VIII Part 3 point 58 (part)]

5.4.64 R Core market participant means the following entities:

1. the entities mentioned in BIPRU 5.4.2 R (2) exposures to which are assigned a 0% risk weight under the standardised approach to credit risk;

2. institutions;

3. other financial companies (including insurance companies) exposures which are assigned a 20% risk weight under the standardised approach;

4. regulated CIUs that are subject to capital or leverage requirements;

5. regulated pension funds; and
(6) a recognised clearing house or designated clearing house.

[Note: BCD Annex VIII Part 3 point 58 (part)]

5.4.65 If under the CRD implementation measure for a particular EEA State with respect to point 58 of Part 3 of Annex VIII of the Banking Consolidation Directive (Conditions for applying the 0% volatility adjustment) the treatment set out in that point is permitted to be applied in the case of repurchase transactions or securities lending or borrowing transactions in securities issued by the domestic government of that EEA State, then a firm may adopt the same approach to the same transactions.

[Note: BCD Annex VIII Part 3 point 59]

Financial collateral comprehensive method: Calculating risk-weighted exposure amounts

5.4.66 Under the standardised approach $E^*$ as calculated under BIPRU 5.4.28 R must be taken as the exposure value for the purposes of BIPRU 3.2.20 R to BIPRU 3.2.26 R. In the case of off-balance sheet items listed in BIPRU 3.7, $E^*$ must be taken as the value to which the percentages indicated in BIPRU 3.2.1 R and BIPRU 3.7.2 R must be applied to arrive at the exposure value.

[Note: BCD Annex VIII Part 3 point 60]
5.5 Other funded credit risk mitigation

5.5.1 Deposits with third parties: Eligibility

Cash on deposit with, or cash assimilated instruments held by, a third party institution in a non-custodial arrangement and pledged to a lending firm may be recognised as eligible credit protection.

[Note: BCD Annex VIII Part 1 point 23]

5.5.2 Deposits with third parties: Minimum requirements

To be eligible for the treatment set out at BIPRU 5.5.3 R, the protection referred to in BIPRU 5.5.1 R must satisfy the following conditions:

1. The borrower's claim against the third party institution is openly pledged or assigned to the lending firm and such pledge or assignment is legally effective and enforceable in all relevant jurisdictions;
2. The third party institution is notified of the pledge or assignment;
3. As a result of the notification, the third party institution is able to make payments solely to the lending firm or to other parties with the lending firm's consent; and
4. The pledge or assignment is unconditional and irrevocable.

[Note: BCD Annex VIII Part 2 point 12]

5.5.3 Deposits with third parties: Calculating the effects of the credit risk mitigation

Where the conditions set out in BIPRU 5.5.2 R are satisfied, credit protection falling within the terms of BIPRU 5.5.1 R may be treated as a guarantee by the third party institution.

[Note: BCD Annex VIII Part 3 point 79]

5.5.4 Life insurance policies: Eligibility

Life insurance policies pledged to a lending firm may be recognised as eligible credit protection.

[Note: BCD Annex VIII Part 1 point 24]
Life insurance policies: Minimum requirements

For life insurance policies pledged to a lending firm to be recognised the following conditions must be met:

1. the party providing the life insurance must be subject to the Solvency II Directive, or is subject to supervision by a competent authority of a third country which applies supervisory and regulatory arrangements at least equivalent to those applied in the Community;
2. the life insurance policy is openly pledged or assigned to the lending firm;
3. the party providing the life insurance is notified of the pledge or assignment and as a result may not pay amounts payable under the contract without the consent of the lending firm;
4. the surrender value is declared by the company providing the life insurance and is non-reducible;
4A. the surrender value must be paid in a timely manner upon request;
4B. the surrender value must not be requested without the consent of the lending firm;
5. the lending firm must have the right to cancel the policy and receive the surrender value in a timely way in the event of the default of the borrower;
6. the lending firm is informed of any non-payments under the policy by the policyholder;
7. the credit protection must be provided for the maturity of the loan. Where this is not possible because the insurance relationship ends before the loan relationship expires, the lending firm must ensure that the amount deriving from the insurance contract serves the lending firm as security until the end of the duration of the credit agreement; and
8. the pledge or assignment must be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

[Note: BCD Annex VIII Part 2 point 13 (part)]

Where it is not possible for a firm to meet the condition set out in BIPRU 5.5.5 R (7), because the insurance relationship ends before the loan relationship expires, the firm must ensure that the amount deriving from the insurance contract serves the firm as security until the end of the duration of the credit agreement.

[Note: BCD Annex VIII Part 2 point 13 (part)]

Life insurance policies: Calculating the effects of the credit risk mitigation

1. Where the conditions set out in BIPRU 5.5.5 R are satisfied, the portion of the exposure collateralised by the current surrender value
of credit protection falling within the terms of BIPRU 5.5.4 R must be either:

(a) subject to the risk weights specified in (3) where the exposure is subject to the standardised approach to credit risk; or

(b) assigned an LGD of 40% where the exposure is subject to the IRB approach but not subject to the firm’s own estimates of LGD.

(2) In case of a currency mismatch, the current surrender value must be reduced according to BIPRU 5.7.17 R and BIPRU 5.7.18R, the value of the credit protection being the current surrender value of the life insurance policy.

(3) For the purpose of (1)(a), the following risk weights must be assigned on the basis of the risk weight assigned to a senior unsecured exposure to the company providing the life insurance:

(a) a risk weight of 20%, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 20%;

(b) a risk weight of 35%, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 50%;

(c) a risk weight of 70%, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 100%; and

(d) a risk weight of 150%, where the senior unsecured exposure to the company providing the life insurance is assigned a risk weight of 150%.

[Note: BCD Annex VIII Part 3 point 80]

Instruments purchased on request: Eligibility

5.5.8 Instruments issued by third party institutions which will be repurchased by that institution on request may be recognised as eligible credit protection.

[Note: BCD Annex VIII Part 1 point 25]

Instruments purchased on request: Calculating the effects of the credit risk mitigation

5.5.9 Instruments eligible under BIPRU 5.5.8 R may be treated as a guarantee by the issuing institution.

[Note: BCD Annex VIII Part 3 point 81]

5.5.10 For the purposes of BIPRU 5.5.9 R, the value of the credit protection recognised is the following:

(1) where the instrument will be repurchased at its face value, the value of the protection is that amount; or
(2) where the instrument will be repurchased at market price, the value of the protection is the value of the instrument valued in the same way as the debt securities specified in [BIPRU 5.4.5 R].

[Note: BCD Annex VIII Part 3 point 82]

Credit linked notes

5.5.11 Investments in credit linked notes issued by a lending firm may be treated as cash collateral.

[Note: BCD Annex VIII Part 3 point 3]
5.6 Master netting agreements

Eligibility

5.6.1

(1) For a firm adopting the financial collateral comprehensive method, the effects of bilateral netting contracts covering repurchase transactions, securities or commodities lending or borrowing transactions, and/or other capital market-driven transactions with a counterparty may be recognised.

(2) Without prejudice to BIPRU 14 to be recognised the collateral taken and securities or commodities borrowed within such agreements must comply with the eligibility requirements for collateral set out at BIPRU 5.4.2 R to BIPRU 5.4.8 R.

[Note: BCD Annex VIII Part 1 point 5]

Minimum requirements

5.6.2

For master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions to be recognised for the purposes of BIPRU 5, they must:

(1) be legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;

(2) give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty; and

(3) provide for the netting of gains and losses on transactions closed out under a master agreement so that a single net amount is owed by one party to the other.

[Note: BCD Annex VIII Part 2 point 4]

5.6.3

In addition the minimum requirements for the recognition of financial collateral under the financial collateral comprehensive method set out in BIPRU 5.4.9 R must be fulfilled.

[Note: BCD Annex VIII Part 2 point 5]
Calculation of the fully adjusted exposure value: the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach

R5.6.4
BIPRU 5.6.5 R to BIPRU 5.6.11 R set out the calculation of the fully adjusted exposure value under the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach.

R5.6.5
In calculating the ‘fully adjusted exposure value’ (E) for the exposures subject to an eligible master netting agreement covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions, a firm must calculate the volatility adjustments to be applied in the manner set out in BIPRU 5.6.6 R to BIPRU 5.6.11 R either using the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach as set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R for the financial collateral comprehensive method. For the use of the own estimates of volatility adjustments approach the same conditions and requirements apply as under the financial collateral comprehensive method.

[Note: BCD Annex VIII Part 3 point 5]

R5.6.6
A firm must calculate the net position in each type of security or commodity by subtracting from the total value of the securities or commodities of that type lent, sold or provided under the master netting agreement, the total value of securities or commodities of that type borrowed, purchased or received under the agreement.

[Note: BCD Annex VIII Part 3 point 6]

R5.6.7
For the purposes of BIPRU 5.6.6 R, type of security means securities which are issued by the same entity, have the same issue date, the same maturity and are subject to the same terms and conditions and are subject to the same liquidation periods as indicated in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[Note: BCD Annex VIII Part 3 point 7]

R5.6.8
A firm must calculate the net position in each currency other than the settlement currency of the master netting agreement by subtracting from the total value of securities denominated in that currency lent, sold or provided under the master netting agreement added to the amount of cash in that currency lent or transferred under the agreement, the total value of securities denominated in that currency borrowed, purchased or received under the agreement added to the amount of cash in that currency borrowed or received under the agreement.

[Note: BCD Annex VIII Part 3 point 8]

R5.6.9
A firm must apply the volatility adjustment appropriate to a given type of security or cash position to the absolute value of the positive or negative net position in the securities of that type.

[Note: BCD Annex VIII Part 3 point 9]
A firm must apply the foreign exchange risk (fx) volatility adjustment to the net positive or negative position in each currency other than the settlement currency of the master netting agreement.

[Note: BCD Annex VIII Part 3 point 10]

$E^* = \max \{0, [(\Sigma(E) - \Sigma(C)) + \Sigma(|\text{net position in each security}| \times H_{\text{sec}}) + (\sum|E_{\text{fx}}| \times H_{\text{fx}})]\}$

where:

1. (where risk weighted exposure amounts are calculated under the standardised approach) $E$ is the exposure value for each separate exposure under the agreement that would apply in the absence of the credit protection;
2. $C$ is the value of the securities or commodities borrowed, purchased or received or the cash borrowed or received in respect of each such exposure;
3. $\Sigma(E)$ is the sum of all Es under the agreement;
4. $\Sigma(C)$ is the sum of all Cs under the agreement;
5. $E_{\text{fx}}$ is the net position (positive or negative) in a given currency other than the settlement currency of the agreement as calculated under BIPRU 5.6.8 R;
6. $H_{\text{sec}}$ is the volatility adjustment appropriate to a particular type of security;
7. $H_{\text{fx}}$ is the foreign exchange volatility adjustment; and
8. $E^*$ is the fully adjusted exposure value.

[Note: BCD Annex VIII Part 3 point 11]

Calculation of the fully adjusted exposure value: the master netting agreement internal models approach

BIPRU 5.6.16 R to BIPRU 5.6.28 G apply to a firm that has a master netting agreement internal models approach permission and set out the calculation of the effects of credit risk mitigation under the master netting agreement internal models approach.

A firm that wishes to use the master netting agreement internal models approach will need to apply to the appropriate regulator for a master netting agreement internal models approach permission. BIPRU 1.3 sets out the requirements and procedures relating to those applications.

A master netting agreement internal models approach permission will amend, to the extent set out in the master netting agreement internal models approach permission, BIPRU 5.6.1 R so as to provide that, with the exceptions provided in BIPRU 5.6, a firm must use the master netting agreement internal models approach permission.
5.6.15 A firm which has been granted a VaR model waiver will still need to make an application to the appropriate regulator for a master netting agreement internal models approach permission. However, the application should generally be straightforward as a firm which is able to satisfy the requirements for a VaR model waiver should usually also be able to satisfy the requirements for a master netting agreement internal models approach permission.

[Note: BCD Annex VIII Part 3 point 14]

5.6.16 The master netting agreement internal models approach is an alternative to using the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach in calculating volatility adjustments for the purpose of calculating the ‘fully adjusted exposure value’ (E*) resulting from the application of an eligible master netting agreement covering repurchase transactions, securities or commodities lending or borrowing transactions and/or other capital market-driven transactions other than derivative transactions. The master netting agreement internal models approach takes into account correlation effects between security positions subject to a master netting agreement as well as the liquidity of the instruments concerned. The internal model used for the master netting agreement internal models approach must provide estimates of the potential change in value of the unsecured exposure amount (ΣE - ΣC).

[Note: BCD Annex VIII Part 3 point 12 (part)]

5.6.17 A firm may also use the internal model used for the master netting agreement internal models approach for margin lending transactions if the transactions are covered under the firm’s master netting agreement internal models approach permission and the transactions are covered by a bilateral master netting agreement that meets the requirements set out in BIPRU 13.7.

[Note: BCD Annex VIII Part 3 point 12 (part)]

5.6.18 A firm may use the master netting agreement internal models approach independently of the choice it has made between the standardised approach and the IRB approach for the calculation of risk weighted exposure amounts. However, if a firm uses the master netting agreement internal models approach, it must do so for all counterparties and securities, excluding immaterial portfolios where it may use the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach as set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[Note: BCD Annex VIII Part 3 point 13]

5.6.19 (1) A firm must be able to satisfy the appropriate regulator that the firm’s risk management system for managing the risks arising on the transactions covered by the master netting agreement is conceptually sound and implemented with integrity and that, in particular, the minimum qualitative standards in (2) – (11) are met.
(2) The internal risk-measurement model used for calculation of potential price volatility for the transactions is closely integrated into the daily risk-management process of the firm and serves as the basis for reporting risk exposures to senior management of the firm.

(3) The firm has a risk control unit that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the firm’s risk-management system. It must produce and analyse daily reports on the output of the risk-measurement model and on the appropriate measures to be taken in terms of position limits.

(4) The daily reports produced by the risk-control unit are reviewed by a level of management with sufficient authority to enforce reductions of positions taken and of overall risk exposure.

(5) The firm has sufficient staff skilled in the use of sophisticated models in the risk control unit.

(6) The firm has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk-measurement system.

(7) The firm’s models have a proven track record of reasonable accuracy in measuring risks demonstrated through the back-testing of its output using at least one year of data.

(8) The firm frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets.

(9) The firm must conduct, as part of its regular internal auditing process, an independent review of its risk-measurement system. This review must include both the activities of the business trading units and of the independent risk-control unit.

(10) At least once a year, the firm must conduct a review of its risk management system.

(11) The internal model used for the master netting agreement internal models approach must meet the requirements set out in BIPRU 13.6.65 R to BIPRU 13.6.67 R.

[Note: BCD Annex VIII Part 3 point 16]

5.6.19A This paragraph provides guidance in relation to BIPRU 5.6.19R (8). In carrying out the stress testing programme, a firm should evaluate the simultaneous impact of individual stress scenarios on its counterparty exposures, its positions and the aggregate amount of margin calls that it would receive. A firm’s stress scenarios should take into account the possibility that the liquidation period may be substantially longer than 5 days for repurchase transactions and securities lending or borrowing transactions, and 10 days for other types of securities financing transactions.

5.6.20 The calculation of the potential change in value must be subject to the following minimum standards:
BIPRU 5 : Credit risk mitigation  Section 5.6 : Master netting agreements

(1) at least daily calculation of the potential change in value;
(2) a 99th percentile, one-tailed confidence interval;
(3) a 5-day equivalent liquidation period, except in the case of transactions other than securities repurchase transaction or securities lending or borrowing transactions where a 10-day equivalent liquidation period should be used;
(4) an effective historical observation period of at least one year except where a shorter observation period is justified by a significant upsurge in price volatility; and
(5) three-monthly data set updates.

[Note: BCD Annex VIII Part 3 point 17]

5.6.21  The internal risk-measurement model must capture a sufficient number of risk factors in order to capture all material price risks.

[Note: BCD Annex VIII Part 3 point 18]

5.6.22  A firm may use empirical correlations within risk categories and across risk categories provided that it is able to satisfy the appropriate regulator that the firm's system for measuring correlations is sound and implemented with integrity.

[Note: BCD Annex VIII Part 3 point 19]

5.6.23  The appropriate regulator will not grant a master netting agreement internal models approach permission if it is not satisfied that the standards in BIPRU 5.6.19 R to BIPRU 5.6.22 R are met.

5.6.24  The fully adjusted exposure value ($E^*$) for a firm using the master netting agreement internal models approach must be calculated according to the following formula:

$$E^* = \max \{0, \left[\Sigma E - \Sigma C\right] + (VaR \text{ output of the internal models})\}$$

where

(1) (where risk weighted exposure amounts are calculated under the standardised approach) $E$ is the exposure value for each separate exposure under the agreement that would apply in the absence of the credit protection;

(2) $C$ is the value of the securities borrowed, purchased or received or the cash borrowed or received in respect of each such exposure;

(3) $\Sigma (E)$ is the sum of all Es under the agreement; and

(4) $\Sigma (C)$ is the sum of all Cs under the agreement.

[Note: BCD Annex VIII Part 3 point 20]
In calculating risk weighted exposure amounts using the master netting agreement internal models approach, a firm must use the previous business day's model output.

[Note: BCD Annex VIII Part 3 point 21]

No changes should be made to the internal model used for the master netting agreement internal models approach unless the change is not material. Material changes to such a model will require a variation of the master netting agreement internal models approach permission. Materiality is measured against the model as it was at the time that the master netting agreement internal models approach permission was originally granted or, any later date set out in the master netting agreement internal models approach permission for this purpose. If a firm is considering making material changes to such a model then it should notify the appropriate regulator at once.

If a firm ceases to meet the requirements of BIPRU 5 in relation to the master netting agreement internal models approach, the firm should notify the appropriate regulator at once.

The appropriate regulator is likely to revoke a master netting agreement internal models approach permission if a firm ceases to meet the requirements of BIPRU 5 in relation to the master netting agreement internal models approach.

Calculation of risk weighted exposure amounts under the standardised approach

(1) A firm must under the standardised approach calculate risk weighted exposure amounts for repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions covered by master netting agreements under this rule.

(2) \( E^* \) as calculated under BIPRU 5.6.5 R to BIPRU 5.6.25 R must be taken as the exposure value of the exposure to the counterparty arising from the transactions subject to the master netting agreement for the purposes of BIPRU 3.2.20 R to BIPRU 3.2.26 R.

[Note: BCD Annex VIII Part 3 point 22]
5.7 Unfunded credit protection

Eligibility

5.7.1 The following parties may be recognised as eligible providers of unfunded credit protection:

(1) central governments and central banks;
(2) regional governments or local authorities;
(3) multilateral development banks;
(4) international organisations exposures which are assigned a 0% risk weight under the standardised approach;
(5) public sector entities, claims on which are treated as claims on institutions or central governments under the standardised approach;
(6) institutions;
(7) other corporate entities, including parent undertakings, subsidiary undertakings and affiliate corporate entities of the firm, that have a credit assessment by an eligible ECAI associated with credit quality step 2 or above under the rules for the risk weighting of exposures to corporates under the standardised approach.

[Note: BCD Annex VIII Part 1 point 26]

Types of credit derivatives

5.7.2 The following types of credit derivatives, and instruments that may be composed of such credit derivatives or that are economically effectively similar, may be recognised as eligible:

(1) credit default swaps;
(2) total return swaps; and
(3) credit linked notes to the extent of their cash funding.

[Note: BCD Annex VIII Part 1 point 30]

5.7.3 Where a firm buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either...
through reductions in fair value or by an addition to reserves), the credit protection must not be recognised as eligible.

[Note: BCD Annex VIII Part 1 point 31]

**Internal hedges**

5.7.4 When a firm conducts an internal hedge using a credit derivative – i.e. hedges the credit risk of an exposure in the non-trading book with a credit derivative booked in the trading book – in order for the protection to be recognised as eligible for the purposes of BIPRU 4.10 or BIPRU 5 the credit risk transferred to the trading book must be transferred out to a third party or parties. In such circumstances, subject to the compliance of such transfer with the requirements for the recognition of credit risk mitigation set out in BIPRU 4.10 or BIPRU 5, the rules for the calculation of risk weighted exposure amounts and expected loss amounts where unfunded credit protection is acquired set out in BIPRU 4.10 or BIPRU 5 must be applied.

[Note: BCD Annex VIII Part 1 point 32]

**Minimum requirements: General**

5.7.5 Subject to BIPRU 5.7.9 R, for the credit protection deriving from a guarantee or credit derivative to be recognised the following conditions must be met:

1. the credit protection must be direct;
2. the extent of the credit protection must be clearly defined and incontrovertible;
3. the credit protection contract must not contain any clause, the fulfilment of which is outside the direct control of the lender, that:
   a. would allow the protection provider unilaterally to cancel the protection;
   b. would increase the effective cost of protection as a result of deteriorating credit quality of the protected exposure;
   c. could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due; or
   d. could allow the maturity of the credit protection to be reduced by the protection provider; and
4. it must be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

[Note: BCD Annex VIII Part 2 point 14]

5.7.7 For the purposes of BIPRU 5.7.6 R (3)(a), payment of premiums and other monies due under the contract is within the control of the lending firm. So a clause that allows the protection provider unilaterally to cancel the contract
after a reasonable period due to non payment of such monies will not mean
that the condition in that rule is not met.

Minimum requirements: Operational requirements

5.7.8

A firm must be able to satisfy the appropriate regulator that it has systems in
place to manage potential concentration of risk arising from the firm’s use of
guarantees and credit derivatives. The firm must be able to demonstrate
how its strategy in respect of its use of credit derivatives and guarantees
interacts with its management of its overall risk profile.

[Note: BCD Annex VIII Part 2 point 15]

Minimum requirements: Sovereign and other public sector
counter-guarantees

5.7.9

Where an exposure is protected by a guarantee which is counter-guaranteed
by a central government or central bank, a regional government or local
authority or a public sector entity claims on which are treated as claims on
the central government in whose jurisdiction they are established under the
standardised approach, a multilateral development bank or an international
organisation, to which a 0% risk weight is assigned under or by virtue of the
standardised approach, or a public sector entity, claims on which are treated
as claims on credit institutions under the standardised approach, the
exposure may be treated as protected by a guarantee provided by the entity
in question provided the following conditions are satisfied:

(1) the counter-guarantee covers all credit risk elements of the claim;

(2) both the original guarantee and the counter-guarantee meet the
requirements for guarantees set out in BIPRU 5.7.6 R, BIPRU 5.7.8 R
and BIPRU 5.7.11 R, except that the counter-guarantee need not be
direct; and

(3) the firm is able to satisfy the appropriate regulator that the cover is
robust and that nothing in the historical evidence suggests that the
coverage of the counter-guarantee is less than effectively equivalent
to that of a direct guarantee by the entity in question.

[Note: BCD Annex VIII Part 2 point 16]

The treatment of BIPRU 5.7.9 R applies, also, to an exposure which is not
counter-guaranteed by an entity listed in that rule if the exposure’s counter-
guarantee is in its turn directly guaranteed by one of the listed entities and
the conditions listed in BIPRU 5.7.9 R are satisfied.

[Note: BCD Annex VIII Part 2 point 17]

Additional requirements for guarantees

5.7.11

For a guarantee to be recognised the following conditions must also be met:

(1) on the qualifying default of and/or non-payment by the counterparty,
the lending firm must have the right to pursue, in a timely manner,
the guarantor for any monies due under the claim in respect of which
the protection is provided;
(2) payment by the guarantor must not be subject to the *lending firm* first having to pursue the obligor;

(3) in the case of *unfunded credit protection* covering residential mortgage loans, the requirements in § BIPRU 5.7.6 R (3)(c) and in this rule have only to be satisfied within 24 months;

(4) the guarantee must be an explicitly documented obligation assumed by the guarantor;

(5) subject to (6), the guarantee must cover all types of payments the obligor is expected to make in respect of the claim; and

(6) where certain types of payment are excluded from the guarantee, the recognised value of the guarantee must be adjusted to reflect the limited coverage.

[Note: BCD Annex VIII Part 2 point 18]

In the case of guarantees provided in the context of mutual guarantee schemes recognised for these purposes by another EEA competent authority under a *CRD implementation measure* with respect to point 19 of Part 2 of Annex VIII of the *Banking Consolidation Directive* or provided by or counter-guaranteed by entities referred to in § BIPRU 5.7.9 R, the requirements in § BIPRU 5.7.11 R (1) – § (3) will be satisfied where either of the following conditions are met:

(1) the *lending firm* has the right to obtain in a timely manner a provisional payment by the guarantor calculated to represent a robust estimate of the amount of the economic loss, including losses resulting from the non-payment of interest and other types of payment which the borrower is obliged to make, likely to be incurred by the *lending firm* proportional to the coverage of the guarantee; or

(2) the *lending firm* is able to demonstrate to the appropriate regulator that the loss-protecting effects of the guarantee, including losses resulting from the non-payment of interest and other types of payments which the borrower is obliged to make, justify such treatment.

[Note: BCD Annex VIII Part 2 point 19]

### Additional requirements for credit derivatives

For a credit derivative to be met the following conditions must also be met.

(1) Subject to (2), the credit events specified under the credit derivative must at a minimum include:

(a) the failure to pay the amounts due under the terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with or shorter than the grace period in the underlying obligation);

(b) the bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and
(c) the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. value adjustment or other similar debit to the profit and loss account).

(2) Where the credit events specified under the credit derivative do not include restructuring of the underlying obligation as described in (1)(c), the credit protection may nonetheless be recognised subject to a reduction in the recognised value as specified in BIPRU 5.7.16 R.

(3) In the case of credit derivatives allowing for cash settlement a robust valuation process must be in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit-event valuations of the underlying obligation.

(4) If the protection purchaser’s right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.

(5) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection provider. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.

[Note: BCD Annex VIII Part 2 point 20]

5.7.14 A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for the purposes of determining cash settlement value or the deliverable obligation) or between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible only if the following conditions are met:

(1) the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be, ranks pari passu with or is junior to the underlying obligation; and

(2) the underlying obligation and the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be, share the same obligor (i.e., the same legal entity) and there are in place legally enforceable cross-default or cross-acceleration clauses.

[Note: BCD Annex VIII Part 2 point 21]

Unfunded credit protection: Valuation

5.7.15 BIPRU 5.7.16 R to BIPRU 5.7.19 R set out the provisions applying to the valuation of unfunded credit protection.

5.7.16 (1) The value of unfunded credit protection (G) is the amount that the protection provider has undertaken to pay in the event of the default
or non-payment of the borrower or on the occurrence of other specified credit events.

(2) In the case of credit derivatives which do not include as a credit event restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that result in a credit loss event (e.g. value adjustment, the making of a value adjustment or other similar debit to the profit and loss account):

(a) where the amount that the protection provider has undertaken to pay is not higher than the exposure value, the value of the credit protection calculated under (1) must be reduced by 40%; or

(b) where the amount that the protection provider has undertaken to pay is higher than the exposure value, the value of the credit protection must be no higher than 60% of the exposure value.

[Note: BCD Annex VIII Part 3 point 83]

5.7.17 Where unfunded credit protection is denominated in a currency different from that in which the exposure is denominated (a currency mismatch) the value of the credit protection must be reduced by the application of a volatility adjustment \( H_{\text{FX}} \) as follows:

\[ G^* = G \times (1-H_{\text{FX}}) \]

where:

(1) \( G \) is the nominal amount of the credit protection;

(2) \( G^* \) is \( G \) adjusted for any foreign currency risk; and

(3) \( H_{\text{FX}} \) is the volatility adjustment for any currency mismatch between the credit protection and the underlying obligation.

[Note: BCD Annex VIII Part 3 point 84 (part)]

5.7.18 Where there is no currency mismatch:

\[ G^* = G \]

[Note: BCD Annex VIII Part 3 point 84 (part)]

5.7.19 The volatility adjustments to be applied for any currency mismatch may be calculated based on the supervisory volatility adjustments approach or the own estimates of volatility adjustments approach as set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[Note: BCD Annex VIII Part 3 point 85]

Calculating risk weighted exposure amounts and expected loss amounts

5.7.20 BIPRU 5.7.21 R to BIPRU 5.7.28 R set out the provisions applying to the calculation of risk weighted exposure amounts.
Calculating risk weighted exposure amounts: Partial protection – tranching

Where a firm transfers a part of the risk of a loan in one or more tranches, BIPRU 9 applies. Materiality thresholds on payments below which no payment shall be made in the event of loss are considered to be equivalent to retained first loss positions and to give rise to a tranching transfer of risk.

[Note: BCD Annex VIII Part 3 point 86]

Calculating risk-weighted exposure amounts : The standardised approach

5.7.22

■ BIPRU 5.7.23 R to ■ BIPRU 5.7.25 R set out the provisions applying to the calculation of risk weighted exposure amounts under the standardised approach in the case of unfunded credit protection.

Calculating risk weighted exposure amounts: standardised approach: Full protection

5.7.23

For the purposes of ■ BIPRU 3.2.20 R to ■ BIPRU 3.2.26 R, g shall be the risk weight to be assigned to an exposure, the exposure value (E) of which is fully protected by unfunded credit protection (G_A), where:

(1) g is the risk weight of exposures to the protection provider as specified under the standardised approach;

(2) G_A is the value of G^* as calculated under ■ BIPRU 5.7.17 R further adjusted for any maturity mismatch as laid down in ■ BIPRU 5.8; and

(3) E is the exposure value according to ■ BIPRU 3.2.1 R to ■ BIPRU 3.2.3 R and ■ BIPRU 13; for this purpose the exposure value of an off-balance sheet item listed in ■ BIPRU 3.7.2 R shall be 100% of its value rather than the exposure value indicated in ■ BIPRU 3.2.1 R.

[Note: BCD Annex VIII Part 3 point 87]

Calculating risk weighted exposure amounts: Standardised approach: Partial protection – equal seniority

5.7.24

Where the protected amount is less than the exposure value and the protected and unprotected portions are of equal seniority – i.e. the firm and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief is afforded. For the purposes of ■ BIPRU 3.2.20 R to ■ BIPRU 3.2.26 R risk weighted exposure amounts must be calculated in accordance with the following formula:

(E-G_A) x r + G_A x g

where:

(1) E is the exposure value; according to ■ BIPRU 3.2.1 R to ■ BIPRU 3.2.3 R and ■ BIPRU 13; for this purpose, the exposure value of an off-balance sheet item listed in ■ BIPRU 3.7.2 R shall be 100% of its value rather than the exposure value indicated in ■ BIPRU 3.2.1 R;

(2) G_A is the value of G^* as calculated under ■ BIPRU 5.7.17 R further adjusted for any maturity mismatch as laid down in ■ BIPRU 5.8;
Calculating risk weighted exposure amounts: standardised approach: Sovereign guarantees

5.7.25  A firm may apply the treatment provided for in BIPRU 3.4.5 R to BIPRU 3.4.7 R to exposures or parts of exposures guaranteed by the central government or central bank, where the guarantee is denominated in the domestic currency of the borrower and the exposure is funded in that currency.

[Note: BCD Annex VIII Part 3 point 89]

Calculating risk-weighted exposure amounts and expected loss amounts: Basket CRM techniques

5.7.26  BIPRU 5.7.27 R to BIPRU 5.7.28 R set out the provisions applying to the calculation of risk weighted exposure amount and expected loss amounts where basket credit risk mitigation techniques are used.

First-to-default credit derivatives

5.7.27  Where a firm obtains credit protection for a number of exposures under terms that the first default among the exposures will trigger payment and that this credit event will terminate the contract, the firm may modify the calculation of the risk weighted exposure amount and, as relevant, the expected loss amount of the exposure which would in the absence of the credit protection produce the lowest risk weighted exposure amount under the standardised approach or the IRB approach as appropriate in accordance with BIPRU 4.10 or BIPRU 5, but only if the exposure value is less than or equal to the value of the credit protection.

[Note: BCD Annex VIII Part 6 point 1]

Nth-to-default credit derivatives

5.7.28  Where the nth default among the exposures triggers payment under the credit protection provided by a credit derivative, a firm purchasing the protection may only recognise the protection for the calculation of risk weighted exposure amounts and, as relevant, expected loss amounts if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases the methodology must follow that set out in BIPRU 5.7.27 R for first-to-default derivatives appropriately modified for nth-to-default products.

[Note: BCD Annex VIII Part 6 point 2]
5.8 Maturity mismatches

5.8.1 For the purposes of calculating risk weighted exposure amounts, a maturity mismatch occurs when the residual maturity of the credit protection is less than that of the protected exposure. Protection of less than three months residual maturity, the maturity of which is less than the maturity of the underlying exposure, must not be recognised.

[Note: BCD Annex VIII Part 4 point 1]

5.8.2 Where there is a maturity mismatch the credit protection must not be recognised where the original maturity of the protection is less than 1 year.

[Note: BCD Annex VIII Part 4 point 2 (part)]

Definition of maturity

5.8.3 Subject to a maximum of 5 years, the effective maturity of the underlying is the longest possible remaining time before the obligor is scheduled to fulfil its obligations. Subject to BIPRU 5.8.4, the maturity of the credit protection is the time to the earliest date at which the protection may terminate or be terminated.

[Note: BCD Annex VIII Part 4 point 3]

5.8.4 Where there is an option to terminate the protection which is at the discretion of the protection seller, the maturity of the protection must be taken to be the time to the earliest date at which that option may be exercised. Where there is an option to terminate the protection which is at the discretion of the protection buyer and the terms of the arrangement at origination of the protection contain a positive incentive for the firm to call the transaction before contractual maturity, the maturity of the protection must be taken to be the time to the earliest date at which that option may be exercised; otherwise such an option may be considered not to affect the maturity of the protection.

[Note: BCD Annex VIII Part 4 point 4]

5.8.5 Where a credit derivative is not prevented from terminating prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay the maturity of the protection must be reduced by the amount of the grace period.

[Note: BCD Annex VIII Part 4 point 5]
### Valuation of protection: Transactions subject to funded credit protection – financial collateral simple method

**5.8.6 R** BIPRU 5.8.7 R sets out the calculation for the valuation of transactions subject to funded credit protection under the financial collateral simple method.

**5.8.7 R** Where there is a mismatch between the maturity of the exposure and the maturity of the protection, the collateral must not be recognised.

[Note: BCD Annex VIII Part 4 point 6]

### Valuation of protection: Transactions subject to funded credit protection – financial collateral comprehensive method

**5.8.8 R** BIPRU 5.8.9 R sets out the calculation for the valuation of transactions subject to funded credit protection under the financial collateral comprehensive method.

**5.8.9 R**

1. The maturity of the credit protection and that of the exposure must be reflected in the adjusted value of the collateral according to the following formula:

   \[ C_{VAM} = C_{VA} \times \frac{(t-t^*)}{(T-t^*)} \]

   where:

   a. \( C_{VA} \) is the volatility adjusted value of the collateral as specified in BIPRU 5.4.28 R or the amount of the exposure, whichever is the lowest;

   b. \( t \) is the number of years remaining to the maturity date of the credit protection calculated in accordance with BIPRU 5.8.3 R to BIPRU 5.8.5 R, or the value of \( T \), whichever is the lower;

   c. \( T \) is the number of years remaining to the maturity date of the exposure calculated in accordance with BIPRU 5.8.3 R to BIPRU 5.8.5 R, or 5 years, whichever is the lower; and

   d. \( t^* \) is 0.25.

2. \( C_{VAM} \) must be taken as \( C_{VA} \) further adjusted for maturity mismatch to be included in the formula for the calculation of the fully adjusted value of the exposure \( (E^*) \) set out at BIPRU 5.4.28 R.

[Note: BCD Annex VIII Part 4 point 7]

### Valuation of protection: Transactions subject to unfunded credit protection

**5.8.10 R** BIPRU 5.8.11 R sets out the calculation for the valuation of transactions subject to unfunded credit protection.

**5.8.11 R**

1. The maturity of the credit protection and that of the exposure must be reflected in the adjusted value of the credit protection according to the following formula:

   \[ G_A = G^* \times \frac{(t-t^*)}{(T-t^*)} \]
where:

(a) $G^*$ is the amount of the protection adjusted for any currency mismatch;

(b) $G_A$ is $G^*$ adjusted for any maturity mismatch;

(c) $t$ is the number of years remaining to the maturity date of the credit protection calculated in accordance with BIPRU 5.8.3 R to BIPRU 5.8.5 R, or the value of $T$, whichever is the lower;

(d) $T$ is the number of years remaining to the maturity date of the exposure calculated in accordance with BIPRU 5.8.3 R to BIPRU 5.8.5 R, or 5 years, whichever is the lower; and

(e) $t^*$ is 0.25.

(2) $G_A$ is then taken as the value of the protection for the purposes of BIPRU 5.7.16 R to BIPRU 5.7.25 R.

[Note: BCD Annex VIII Part 4 point 8]
5.9 Combinations of credit risk mitigation in the standardised approach

5.9.1 In the case where a firm calculating risk weighted exposure amounts under the standardised approach has more than one form of credit risk mitigation covering a single exposure (e.g. a firm has both collateral and a guarantee partially covering an exposure), the firm must subdivide the exposure into parts covered by each type of credit risk mitigation tool (e.g. a part covered by collateral and a portion covered by guarantee) and the risk weighted exposure amount for each portion must be calculated separately in accordance with the provisions of the standardised approach and BIPRU 5.

[Note: BCD Annex VIII Part 5 point 1]

5.9.2 When credit protection provided by a single protection provider has differing maturities, a similar approach to that described in BIPRU 5.9.1 R must be applied.

[Note: BCD Annex VIII Part 5 point 2]
Chapter 7

Market risk
7.1 Application, purpose, general provisions and non-standard transactions

Application

7.1.1 This chapter applies to a BIPRU firm.

Purpose

7.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, the purpose of this chapter is to implement Annexes I, III, IV and V of the Capital Adequacy Directive.

General provisions: Obligation to calculate PRR

7.1.3 A firm must calculate a PRR in respect of:

1. all its trading book positions;
2. all positions falling within BIPRU 7.5.3 R (Scope of the foreign exchange PRR calculation), whether or not in the trading book; and
3. all positions in commodities (including physical commodities) whether or not in the trading book;

even if no treatment is provided for that position in the other sections of this chapter.

A firm must calculate a PRR for any position falling into BIPRU 7.1.3 R using:

1. the PRR calculations contained in BIPRU 7; or
2. another method provided the firm is able to demonstrate that in all circumstances the calculation being employed results in a higher PRR for the position than would be required under (1).

General provisions: Non-trading book items

7.1.5 Positions in instruments which are non-trading book items should be treated under BIPRU 3 (Standardised credit risk), BIPRU 4 (The IRB approach) or BIPRU 13 (Financial derivatives, SFTs and long settlement transactions) unless deducted as an illiquid asset. If they fall into BIPRU 7.1.3R(2) or (3) they also give rise to a PRR charge.
General provisions: Frequency of calculation

7.1.6 A firm must be able to monitor its total PRR on an intra-day basis, and, before executing any trade, must be able to re-calculate PRR to the level of detail necessary to establish whether or not the firm’s capital resources exceed its capital resources requirement.

7.1.7 A firm may rely on intra-day limits for the purposes of BIPRU 7.1.6R.

Purpose of rules for non-standard transactions and instruments for which no PRR treatment has been specified

7.1.8 The methodologies which have been developed for calculating PRR charges have been based on existing instruments and assume instruments with standard characteristics. However, as a result of innovation and because there are instruments which, although based on a standard contract, contain structural features which would make the rules in the rest of this chapter inappropriate, flexible rules are required. The rules in this section about transactions for which no PRR treatment has been specified and non-standard transactions are designed to address this.

Instruments for which no PRR treatment has been specified

7.1.9 Where a firm has a position for which no PRR treatment has been specified, it must calculate the PRR for that position in accordance with BIPRU 7.1.12R- BIPRU 7.1.13R.

7.1.10 If BIPRU 7.1.9 R applies, a firm must document its policies and procedures for calculating the PRR for that position of that type in its trading book policy statement.

7.1.11 Under BIPRU 1.2.30 R (2) a firm should notify the appropriate regulator as soon as is reasonably practicable if its trading book policy statement is subject to significant changes. Therefore if a firm makes a change in accordance with BIPRU 7.1.10R it should consider whether it is necessary to report it to the appropriate regulator.

7.1.12 A firm may calculate the PRR for a position falling into BIPRU 7.1.9R by applying by analogy the rules relating to the calculation of the interest rate PRR, the equity PRR, the commodity PRR, the foreign currency PRR, the option PRR or the collective investment undertaking PRR if doing so is appropriate and if the position and PRR item are sufficiently similar to those that are covered by those rules.

7.1.13 Where a firm has a position for which no PRR treatment has been specified and it is not applying BIPRU 7.1.12R, it must calculate a PRR of an appropriate percentage of the current value of the position calculated under GENPRU 1.3 (Valuation).
Instruments in non-standard form

7.14 R

(1) If a firm has a position:

(a) in a PRR item in non-standard form; or
(b) that is part of a non-standard arrangement; or
(c) that, taken together with other positions (whether or not they are subject to PRR charges under BIPRU 7), gives rise to a non-standard market risk;

the firm must notify the appropriate regulator of that fact and of details about the position, PRR item, arrangements and type of risk concerned.

(2) Except as (1) provides to the contrary, (1) applies to a position that is subject to a PRR under BIPRU 7.1.3R.

(3) The question of what is non-standard for the purposes of (1) must be judged by reference to the standards:

(a) prevailing at the time the rule is being applied; and
(b) of firms generally who carry on business which gives rise to PRRs under BIPRU 7 rather than merely by reference to the firm’s own business.

7.15 R

If a firm has a position or combination of positions falling into BIPRU 7.1.14R and the PRR relating to that position or positions materially underestimates the market risk incurred by the firm to which they give rise, the firm must calculate the PRR for that position or positions under BIPRU 7.1.13R.

Meaning of appropriate percentage for non-standard transactions

7.16 E

(1) In BIPRU 7.1.13R and, to the extent that that rule applies BIPRU 7.1.13R, BIPRU 7.1.15R, an “appropriate percentage” is:

(a) 100%; or
(b) a percentage which takes account of the characteristics of the position concerned and of discussions with the appropriate regulator or a predecessor regulator under the Banking Act 1987 or the Financial Services Act 1986.

(2) Compliance with (1) may be relied on as tending to establish compliance with BIPRU 7.1.13R or, insofar as it incorporates the requirements relating to an appropriate percentage, BIPRU 7.1.15R.

(3) Contravention of (1) may be relied on as tending to establish contravention with BIPRU 7.1.13 R or, insofar as it incorporates the requirements relating to an appropriate percentage, BIPRU 7.1.15 R.

Stress testing and scenario analyses of trading book positions

7.17 R

A firm must conduct a regular programme of stress testing and scenario analysis of its trading book positions, both at the trading desk level and on a firm-wide basis. The results of these tests must be reviewed by senior management and reflected in the policies and limits the firm sets.
The firm’s stress testing programme should be comprehensive in terms of both risk and firm coverage, and appropriate to the size and complexity of trading book positions held.

In carrying out the stress tests and scenario analyses required by BIPRU 7.1.17 R, a firm must incorporate and take into account any other relevant stress tests and scenario analyses that it is required to carry out under any other provision of the Handbook, and in particular under BIPRU 7.10.72 R where the firm has a VaR model permission.

This paragraph gives guidance in relation to the stress testing programme that a firm must carry out in relation to its trading book positions.

1. The frequency of the stress testing of trading book positions should be determined by the nature of the positions.

2. The stress testing should include shocks which reflect the nature of the portfolio and the time it could take to hedge out or manage risks under severe market conditions.

3. The firm should have procedures in place to assess and respond to the results of the stress testing programme. In particular, stress testing should be used to evaluate the firm’s capacity to absorb losses or to identify steps to be taken by the firm to reduce risk.

4. As part of its stress testing programme, the firm should consider how prudent valuation principles (see GENPRU 1.3) will be met in a stressed scenario.

The stress testing and scenario analysis under BIPRU 7.1.17 R should be taken into account under the overall Pillar 2 rule.
7.2 Interest rate PRR

General rule

7.2.1 A firm must calculate its interest rate PRR under BIPRU 7.2 by:

(a) identifying which positions must be included within the interest rate PRR calculation;
(b) deriving the net position in each debt security in accordance with BIPRU 7.2.36R–BIPRU 7.2.41R;
(c) including these net positions in the interest rate PRR calculation for general market risk and the interest rate PRR calculation for specific risk; and
(d) summing all PRRs calculated for general market risk and specific risk.

7.2.2 The interest rate PRR calculation divides the interest rate risk into the risk of loss from a general move in market interest rates, and the risk of loss from an individual debt security's price changing for reasons other than a general move in market interest rates. These are called general market risk and specific risk respectively.

Scope of the interest rate PRR calculation

7.2.3 A firm's interest rate PRR calculation must:

(1) include all trading book positions in debt securities, preference shares and convertibles, except:

(a) positions in convertibles which have been included in the firm's equity PRR calculation;
(b) positions fully deducted as a material holding under the calculations under the capital resources table, in which case the firm may exclude them; or

(c) positions hedging an option which is being treated under BIPRU 7.6.26R (Table: Appropriate treatment for equities, debt securities or currencies hedging options);

(2) include notional positions arising from trading book positions in the instruments listed in the table in BIPRU 7.2.4R; and

(3) (if the firm is the transferor of debt securities or guaranteed rights relating to title to debt securities in a repurchase agreement or the lender of debt securities in a debt securities lending agreement) include such debt securities if those debt securities meet the criteria for inclusion in the trading book.

Table: Instruments which result in notional positions

This table belongs to BIPRU 7.2.3R(2)

<table>
<thead>
<tr>
<th>Instrument</th>
<th>See</th>
</tr>
</thead>
<tbody>
<tr>
<td>Futures, forwards or synthetic futures on debt securities</td>
<td>BIPRU 7.2.13 R</td>
</tr>
<tr>
<td>Futures, forwards or synthetic futures on debt indices or baskets</td>
<td>BIPRU 7.2.14R</td>
</tr>
<tr>
<td>Interest rate futures or forward rate agreements (FRAs)</td>
<td>BIPRU 7.2.18 R</td>
</tr>
<tr>
<td>Interest rate swaps or foreign currency swaps</td>
<td>BIPRU 7.2.21R</td>
</tr>
<tr>
<td>Deferred start interest rate swaps or foreign currency swaps</td>
<td>BIPRU 7.2.24R</td>
</tr>
<tr>
<td>The interest rate leg of an equity swap (unless the firm calculates the interest rate PRR on the instrument using the basic interest rate PRR calculation in BIPRU 7.3 (Equity PRR and basic interest rate PRR for equity derivatives))</td>
<td>BIPRU 7.2.27R</td>
</tr>
<tr>
<td>The cash leg of a repurchase agreement or a reverse repurchase agreement</td>
<td>BIPRU 7.2.30R</td>
</tr>
<tr>
<td>Cash borrowings or deposits</td>
<td>BIPRU 7.2.31 R</td>
</tr>
<tr>
<td>Options on a debt security, a basket of debt securities, a debt security index, an interest rate or an interest rate future or swap (including an option on a future on a debt security) (unless the firm calculates a PRR on the option under BIPRU 7.6 (Option PRR))</td>
<td>BIPRU 7.2.32R</td>
</tr>
<tr>
<td>Dual currency bonds</td>
<td>BIPRU 7.2.33R</td>
</tr>
<tr>
<td>Foreign currency futures or forwards</td>
<td>BIPRU 7.2.34R</td>
</tr>
<tr>
<td>Gold futures or forwards</td>
<td>BIPRU 7.2.34R</td>
</tr>
<tr>
<td>Forwards, futures or options (except cliquets) on an equity, basket of</td>
<td>BIPRU 7.2.34R</td>
</tr>
</tbody>
</table>
Instrument | See
---|---
equities or equity index (unless the firm calculates the interest rate PRR on the instrument using the basic interest rate PRR calculation in BIPRU 7.3) | 
Credit derivatives | BIPRU 7.11
A warrant must be treated in the same way as an option

7.2.5  ■ BIPRU 7.2.3R(1) includes a trading book position in debt security, preference share or convertible that is subsequently repo'd under a repurchase agreement or lent under a stock lending agreement. Clearly, if the security had initially been obtained via a reverse repurchase agreement or stock borrowing agreement, the security would not have been included in the PRR calculation in the first place.

7.2.6  ■ BIPRU 7.2.3R(1) includes net underwriting positions or reduced net underwriting position in debt securities.

7.2.7  ■ Firms are reminded that the table in ■ BIPRU 7.6.5R (Table: Appropriate PRR calculation for an option or warrant) divides options and warrants on interest rates, debt securities and interest rate futures and swaps into:

1) those which must be treated under ■ BIPRU 7.6 (Option PRR); and

2) those which must be treated under either ■ BIPRU 7.2 or ■ BIPRU 7.6, the firm being able to choose whether ■ BIPRU 7.2 or ■ BIPRU 7.6 is used.

7.2.8  ■ Cliquets on equities, baskets of equities or equity indices do not attract an interest rate PRR. The table in ■ BIPRU 7.2.4R excludes them from the scope of the interest rate PRR calculation in ■ BIPRU 7.2 and ■ BIPRU 7.3.45R excludes them from the basic interest rate PRR calculation in ■ BIPRU 7.3 (Equity PRR and basic interest rate PRR for equity derivatives).

7.2.9  ■ The table in ■ BIPRU 7.2.4R shows that equity derivatives are excluded from ■ BIPRU 7.2's PRR calculation if they have been included in the basic interest rate PRR calculation in ■ BIPRU 7.3 (see ■ BIPRU 7.3.45R).

**Derivation of notional positions: General approach**

7.2.10  ■ BIPRU 7.2.11 R - ■ BIPRU 7.2.35R convert the instruments listed in the table in ■ BIPRU 7.2.4R into notional positions in:

1) the underlying debt security, where the instrument depends on the price (or yield) of a specific debt security; or

2) notional debt securities to capture the pure interest rate risk arising from future payments and receipts of cash (including notional payments and receipts) which, because they are designed to represent
pure general market risk (and not specific risk), are called zero-specific-risk securities; or

(3) both (1) and (2).

7.2.11 R

(1) For the purposes of calculating interest rate PRR, unless specified otherwise, a firm must derive the value of notional positions as follows:

(a) notional positions in actual debt securities must be valued as the nominal amount underlying the contract at the current market price of the debt security; and

(b) positions in zero-specific-risk securities must be valued using one of the two methods in (2).

(2) A firm must use one of the following two methods for all positions arising under (1)(b) and must use the same method for all positions denominated in the same currency:

(a) the present value approach, under which the zero-specific-risk security is assigned a value equal to the present value of all the future cash flows that it represents; or

(b) the alternative approach, under which the zero-specific-risk security is assigned a value equal to:

(i) the market value of the underlying notional equity position in the case of an equity derivative;

(ii) the notional principal amount in the case of an interest rate or foreign currency swap; or

(iii) the notional amount of the future cash flow that it represents in the case of any other CRD financial instrument.

7.2.12 R

A firm must use BIPRU 7.2.11R(2)(a) in respect of any positions that it includes in the interest rate duration method.

Derivation of notional positions: Futures, forwards or synthetic futures on a debt security

7.2.13 R

Futures, forwards or synthetic futures on a single debt security must be treated as follows:

(1) a purchased future, synthetic future or forward is treated as:

(a) a notional long position in the underlying debt security (or the cheapest to deliver (taking into account the conversion factor) where the contract can be satisfied by delivery of one from a range of securities); and

(b) a notional short position in a zero coupon zero-specific-risk security with a maturity equal to the expiry date of the future or forward; and

(2) a sold future, synthetic future or forward is treated as:

(a) a notional short position in the underlying security (or the cheapest to deliver (taking into account the conversion factor)
where the contract can be satisfied by delivery of one from a range of securities); and

(b) a notional long position in a zero coupon zero-specific-risk security with a maturity equal to the expiry date of the future, synthetic future or forward.

Derivation of notional positions: Futures, forwards or synthetic futures on a basket or index of debt securities

7.2.14 Futures, forwards or synthetic futures on a basket or index of debt securities must be converted into forwards on single debt securities as follows (and then the resulting positions must be treated under BIPRU 7.2.13R):

(1) futures, synthetic futures or forwards on a single currency basket or index of debt securities must be treated as either:
   (a) a series of forwards, one for each of the constituent debt securities in the basket or index, of an amount which is a proportionate part of the total underlying the contract according to the weighting of the relevant debt security in the basket; or
   (b) a single forward on a notional debt security; and

(2) futures, synthetic futures or forwards on multiple currency baskets or indices of debt securities must be treated as either:
   (a) a series of forwards (using the method described in (1)(a)); or
   (b) a series of forwards, each one on a notional debt security to represent one of the currencies in the basket or index, of an amount which is a proportionate part of the total underlying the contract according to the weighting of the relevant currency in the basket.

7.2.15 Under BIPRU 7.2.14R(2)(b), a forward on basket of three Euro denominated debt securities and two Dollar denominated debt securities would be treated as a forward on a single notional Euro denominated debt security and a forward on a single notional Dollar denominated debt security.

7.2.16 The notional debt securities in BIPRU 7.2.14R are assigned a specific risk position risk adjustment and a general market risk position risk adjustment equal to the highest that would apply to the debt securities in the basket or index.

7.2.17 The debt security with the highest specific risk position risk adjustment within the basket might not be the same as the one with the highest general market risk position risk adjustment. BIPRU 7.2.16R requires a firm to select the highest percentages even where they relate to different debt securities in the basket or index, and regardless of the proportion of those debt securities in the basket or index.
Derivation of notional positions: Interest rate futures and forward rate agreements (FRAs)

7.2.18 R Interest rate futures or FRAs must be treated as the two notional positions (one long, one short) shown in the table in ▫ BIPRU 7.2.19R.

7.2.19 R Table: Interest rate futures and FRAs

This table belongs to ▫ BIPRU 7.2.18R

<table>
<thead>
<tr>
<th>Where the firm buys an interest rate future or sells an FRA</th>
<th>A long position in a zero coupon zero-specific-risk security</th>
<th>A short position in a zero coupon zero-specific-risk security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturity equals the expiry date of the future (or settlement date of the FRA)</td>
<td>Maturity equals the expiry date of the future (or settlement date of the FRA) plus the maturity of the notional borrowing/deposit</td>
<td></td>
</tr>
</tbody>
</table>

(1) The following example illustrates ▫ BIPRU 7.2.18R and ▫ BIPRU 7.2.19R in conjunction with ▫ BIPRU 7.2.11R (the last rule determines the value of notional positions). A firm sells £1mn notional of a 3v6 FRA at 6%. This results in:

(a) a short position in a zero-specific-risk security with a zero coupon, three month maturity, and a nominal amount of £1million; and

(b) a long position in a zero-specific-risk security with a zero coupon, six month maturity, and nominal amount of £1,015,000 (i.e. notional plus interest at 6% over 90 days).

(2) If a firm were to apply the approach in ▫ BIPRU 7.2.11R(2)(a) the two nominal amounts would have to be present valued.

Derivation of notional positions: Interest rate swaps or foreign currency swaps

7.2.21 R Interest rate swaps or foreign currency swaps without deferred starts must be treated as the two notional positions (one long, one short) shown in the table in ▫ BIPRU 7.2.22R.

7.2.22 R Table: Interest rate and foreign currency swaps

This table belongs to ▫ BIPRU 7.2.21R
7.2.23 G For a foreign currency swap, the two notional zero-specific-risk securities would be denominated in different currencies. A foreign currency swap is also included in the foreign currency PRR calculation.

**Derivation of notional positions: Deferred start interest rate swaps or foreign currency swaps**

7.2.24 R Interest rate swaps or foreign currency swaps with a deferred start must be treated as the two notional positions (one long, one short) shown in the table in ▪ BIPRU 7.2.25R.

7.2.25 R Table: Deferred start interest rate and foreign currency swaps

This table belongs to ▪ BIPRU 7.2.24R

<table>
<thead>
<tr>
<th>Receving fixed and pay-</th>
<th>Paying leg (which must be treated as a short position in a zero-specific-risk security)</th>
<th>Receving leg (which must be treated as a long position in a zero-specific-risk security)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receving floating</td>
<td>Coupon equals the floating rate and maturity equals the reset date</td>
<td>Coupon equals the fixed rate of the swap and maturity equals the maturity of the swap</td>
</tr>
<tr>
<td>Paying fixed and receiv-</td>
<td>Coupon equals the fixed rate of the swap and maturity equals the maturity of the swap</td>
<td>Coupon equals the floating rate and maturity equals the reset date</td>
</tr>
<tr>
<td>ing floating</td>
<td>Paying floating and receiv-</td>
<td>Coupon equals the floating rate and maturity equals the reset date</td>
</tr>
<tr>
<td>ing floating</td>
<td>Paying fixed and receiv-</td>
<td>Coupon equals the fixed rate of the swap and maturity equals the reset date</td>
</tr>
<tr>
<td>ing floating</td>
<td>Paying floating and receiv-</td>
<td>Coupon equals the floating rate and maturity equals the reset date</td>
</tr>
</tbody>
</table>

7.2.26 G An example of ▪ BIPRU 7.2.24R is as follows. A firm enters into a five year swap which starts in two year’s time. The firm has contracted to receive 6% and pay six month Libor on a principal amount of £1 million. This results in a long position in a 7 year debt security and a short position in a 2 year debt security. Both have a coupon of 6%. ▪ BIPRU 7.2.24R deals with the capital treatment of the delayed start date; once the swap has started, ▪ BIPRU 7.2.21R applies.
Derivation of notional positions: Swaps where only one leg is an interest rate leg (e.g. equity swaps)

7.2.27 R A firm must treat a swap with only one interest rate leg as a notional position in a zero-specific-risk security:

1. with a coupon equal to that on the interest rate leg;
2. with a maturity equal to the date that the interest rate will be reset; and
3. which is a long position if the firm is receiving interest payments and short if making interest payments.

7.2.28 G BIPRU 7.2.27R includes equity swaps, commodity swaps and any other swap where only one leg is an interest rate leg.

Derivation of notional positions: Cash legs of repurchase agreements and reverse repurchase agreements

7.2.29 G Firms are reminded that for the purposes of BIPRU 7.2.30R, a repurchase agreement includes a sell/buy back or stock lending; and a reverse repurchase agreement includes a buy/sell back or a stock borrowing.

7.2.30 R The forward cash leg of a repurchase agreement or reverse repurchase agreement must be treated as a notional position in a zero-specific-risk security which:

1. is a short notional position in the case of a repurchase agreement; and a long notional position in the case of a reverse repurchase agreement;
2. has a value equal to the market value of the cash leg;
3. has a maturity equal to that of the repurchase agreement or reverse repurchase agreement; and
4. has a coupon equal to:
   (a) zero, if the next interest payment date coincides with the maturity date; or
   (b) the interest rate on the contract, if any interest is due to be paid before the maturity date.

Derivation of notional positions: Cash borrowings and deposits

7.2.31 R A cash borrowing or deposit must be treated as a notional position in a zero coupon zero-specific-risk security which:

1. is a short position in the case of a borrowing and a long position in the case of a deposit;
2. has a value equal to the market value of the borrowing or deposit;
(3) has a maturity equal to that of the borrowing or deposit, or the next date the interest rate is reset (if earlier); and

(4) has a coupon equal to:
   (a) zero, if the next interest payment date coincides with the maturity date; or
   (b) the interest rate on the borrowing or deposit, if any interest is due to be paid before the maturity date.

Derivation of notional positions: Options and warrants

7.2.32

(1) Where included in the PRR calculation in BIPRU 7.2 (see the table in BIPRU 7.2.4R), options and warrants must be treated in accordance with this rule.

(2) An option or warrant on a debt security, a basket of debt securities or a debt security index must be treated as a position in that debt security, basket or index.

(3) An option on an interest rate must be treated as a position in a zero coupon zero-specific-risk security with a maturity equal to the sum of the time to expiry of the option and the length of the period for which the interest rate is fixed.

(4) An option on a future - where the future is based on an interest rate or debt security - must be treated as:
   (a) a long position in that future for purchased call options and written put options; and
   (b) a short position in that future for purchased put options and written call options.

(5) An option on a swap must be treated as a deferred starting swap.

Derivation of notional positions: Bonds where the coupons and principal are paid in different currencies

7.2.33

Where a debt security pays coupons in one currency, but will be redeemed in a different currency, it must be treated as:

(1) a debt security denominated in the coupon's currency; and

(2) a foreign currency forward to capture the fact that the debt security's principal will be repaid in a different currency from that in which it pays coupons, specifically:
   (a) a notional forward sale of the coupon currency and purchase of the redemption currency, in the case of a long position in the debt security; or
   (b) a notional forward purchase of the coupon currency and sale of the redemption currency, in the case of a short position in the debt security.
Derivation of notional positions: Interest rate risk on other futures, forwards and options

7.2.34
Other futures, forwards, options and swaps treated under BIPRU 7.2 must be treated as positions in zero-specific-risk securities, each of which:

1. has a zero coupon;
2. has a maturity equal to that of the relevant contract; and
3. is long or short according to the table in BIPRU 7.2.35R.

Table: Interest rate risk on other futures, forwards, options and swaps

This table belongs to BIPRU 7.2.34R.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Notional positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency forward or future</td>
<td>a long position denominated in the currency purchased and a short position denominated in the currency sold</td>
</tr>
<tr>
<td>Gold forward or future</td>
<td>a long position if the forward or future involves an actual (or notional) sale of gold or a short position if the forward or future involves an actual (or notional) purchase of gold</td>
</tr>
<tr>
<td>Equity forward or future, or option (unless the interest rate PRR is calculated under the basic interest rate PRR calculation in BIPRU 7.3)</td>
<td>A long position if the contract involves an actual (or notional) sale of the underlying equity or A short position if the contract involves an actual (or notional) purchase of the underlying equity</td>
</tr>
</tbody>
</table>

Deriving the net position in each debt security: General

7.2.36
The net position in a debt security is the difference between the value of the firm’s long positions (including notional positions) and the value of its short positions (including notional positions) in the same debt security.

Deriving the net position in each debt security: Netting positions in the same debt security

7.2.37
1. A firm must not net positions (including notional positions) unless those positions are in the same debt security. This rule sets out the circumstances in which debt securities may be treated as the same for these purposes.

2. Subject to (3) long and short positions are in the same debt security, and a debt security is the same as another if and only if:
   (a) they enjoy the same rights in all respects; and
   (b) are fungible with each other.
(3) Long and short positions in different tranches of the same debt security may be treated as being in the same debt security for the purpose of (1) where:

(a) the tranches enjoy the same rights in all respects; and

(b) the tranches become fungible within 180 days and thereafter the debt security of one tranche can be delivered in settlement of the other tranche.

**Deriving the net position in each debt security: Netting the cheapest to deliver security with other deliverable securities**

7.2.38 A firm may net a short notional position in the cheapest to deliver security arising from a short future or forward (see BIPRU 7.2.13R(2)(a)) under which the seller has a choice of which debt security it may use to settle its obligations against a long position in any deliverable security up to a maximum of 90% of the common nominal amounts. The residual long and short nominal amounts must be treated as separate long and short positions.

7.2.39 The netting permitted by BIPRU 7.2.38R only relates to where the firm has sold the future or forward. It does not relate to where the firm has bought a future or forward.

**Deriving the net position in each debt security: Netting zero-specific-risk securities with different maturities**

A firm may net a notional long position in a zero-specific-risk security against a notional short position in a zero-specific-risk security if:

1. they are denominated in the same currency;
2. their coupons do not differ by more than 15 basis points; and
3. they mature:
   a. on the same day, if they have residual maturities of less than one month;
   b. within 7 days of each other, if they have residual maturities of between one month and one year; and
   c. within 30 days of each other, if they have residual maturities in excess of one year.

**Deriving the net position in each debt security: Reduced net underwriting positions in debt securities**

A firm must not net a reduced net underwriting position in a debt security with any other debt security position.

BIPRU 7.2.41R only relates to reduced net underwriting position.
7.2.42A Deriving the net position in the correlation trading portfolio

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

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

2. All reference instruments are either single-name instruments, including single-name credit derivatives, for which a liquid two-way market exists, or commonly traded indices based on reference entities which meet this criterion.

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

4. The positions do not reference a claim on a special purpose vehicle.

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

7.2.42C For the purposes of BIPRU 7.2.42A R (2) and BIPRU 7.2.42B R, a two-way market may be deemed to exist only where there are independent, bona fide offers to buy and sell, so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within one business day and settled at that price within a relatively short time conforming to trade custom.

7.2.42D A firm must calculate both the net long and the net short positions in the correlation trading portfolio by applying BIPRU 7.2.36 R and BIPRU 7.2.37 R or, where applicable, BIPRU 7.11.13 R to BIPRU 7.11.17 R.

Specific risk calculation

7.2.43 (1) A firm must calculate the specific risk portion of the interest rate PRR for each debt security by multiplying the market value of the individual net position (ignoring the sign) by the appropriate position risk adjustment from the table in BIPRU 7.2.44R or as specified by BIPRU 7.2.45R - BIPRU 7.2.48L R or by BIPRU 7.11.13 R - BIPRU 7.11.17 R.

(2) Notional positions in zero-specific-risk securities do not attract specific risk.

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

Table: specific risk position risk adjustments

This table belongs to BIPRU 7.2.43R.

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Residual maturity</th>
<th>Position risk adjuster</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt securities issued or guaranteed by central governments, issued by <em>central banks</em>, <em>international organisations</em>, <em>multilateral development banks</em> or <em>EEA States’</em> regional governments or local authorities which would qualify for <em>credit quality step 1</em> or which would receive a 0% <em>risk weight</em> under the <em>standardised approach</em> to credit risk.</td>
<td>Any</td>
<td>0%</td>
</tr>
<tr>
<td>(A) Debt securities issued or guaranteed by central governments, issued by <em>central banks</em>, <em>international organisations</em>, <em>multilateral development banks</em> or <em>EEA States’</em> regional governments or local authorities which would qualify for <em>credit quality step 2</em> or 3 under the <em>standardised approach</em> to credit risk.</td>
<td>Zero to six months over 6 and up to and including 24 months Over 24 months</td>
<td>0.25% 1% 16%</td>
</tr>
<tr>
<td>(B) Debt securities issued or guaranteed by <em>institutions</em> which would qualify for <em>credit quality step 1</em> or 2 under the <em>standardised approach</em> to credit risk.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(C) Debt securities issued or guaranteed by <em>institution</em> which would qualify for <em>credit quality step 3</em> under BIPRU 3.4.34 R (Exposures to institutions: Credit assessment based method) or which would do so if it had an original effective maturity of three months or less.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(D) Debt securities issued or guaranteed by <em>corporates</em> which would qualify for <em>credit quality step 1</em>, 2 or 3 under the <em>standardised approach</em> to credit risk.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(E) Other <em>qualifying debt securities</em> (see BIPRU 7.2.49R)</td>
<td>Any</td>
<td>8%</td>
</tr>
</tbody>
</table>

(A) Debt securities issued or guaranteed by central governments, issued by *central banks*, *international organisations*, *multilateral development banks* or *EEA States’* regional governments or local authorities or *institutions* which would qualify for *credit quality step 4* or 5 under the *standardised approach* to credit risk.

(B) Debt securities issued or guaranteed by *corporates* which would qualify for *credit quality step 4* under the *standardised approach* to credit risk.

(C) Exposures for which a credit assessment by a *nominated ECAI* is not available.
R7.2.45

(A) Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or EEA States’ regional governments or local authorities or institution which would qualify for credit quality step 6 under the standardised approach to credit risk.

(B) Debt securities issued or guaranteed by corporate which would qualify for credit quality step 5 or 6 under the standardised approach to credit risk.

(C) An instrument that shows a particular risk because of the insufficient solvency of the issuer of liquidity. This paragraph applies even if the instrument would otherwise qualify for a lower position risk adjustment under this table.

Note: The question of what a corporate is and of what category a debt security falls into must be decided under the rules relating to the standardised approach to credit risk.

[Note: CAD Annex I point 14 Table 1]

To the extent that a firm applies the IRB approach, to qualify for a credit quality step for the purpose of the table in BIPRU 7.2.44R the obligor of the exposure must have an internal rating with a PD equivalent to or lower than that associated with the appropriate credit quality step under the standardised approach to credit risk.

A debt security issued by a non-qualifying issuer must receive a specific risk position risk adjustment of 8% or 12% according to the table in BIPRU 7.2.44R. However a firm must apply a higher specific risk position risk adjustment to such a debt security and/or not recognise offsetting for the purposes of defining the extent of general market risk between such a security and any other debt securities to the extent that doing otherwise would not be a prudent treatment of specific risk or general market risk.

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

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

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

7.2.47 [deleted]

7.2.47A [deleted]

7.2.47B [deleted]

7.2.47C [deleted]

7.2.48 [deleted]

7.2.48A [deleted]

1. Subject to (3), a firm must calculate the specific risk portion of the interest rate PRR for each securitisation and resecuritisation position by multiplying the market value of the individual net position (ignoring the sign) by the appropriate position risk adjustment from the table in BIPRU 7.2.48D R or BIPRU 7.2.48E R, or in accordance with BIPRU 7.2.48F R, as applicable.

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

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

   a. the total specific risk capital charges that would apply just to the net long positions; and
   b. the total specific risk capital charges that would apply just to the net short positions.

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

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

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

7.2.48D Table: specific risk position risk adjustments - standardised approach
A firm may only apply the position risk adjustments in this table where it would have to calculate a risk weighted exposure amount in accordance with the standardised approach to securitisation and resecuritisation positions if such positions were in its non-trading book under BIPRU 9. The appropriate position risk adjustment is calculated as 8% of the risk weight that would apply to the position under the standardised approach in BIPRU 9.11.2 R, subject to the requirements of BIPRU 9.9 to BIPRU 9.11, where appropriate.

A firm may use the supervisory formula method to calculate the appropriate position risk adjustment for specific risk where:

(a) the firm is permitted to apply the supervisory formula method to the same position if it was held in its non-trading book in accordance with BIPRU 9.12; or
(b) otherwise, the firm is expressly permitted by its VaR model permission to apply the supervisory formula method to calculate the appropriate position risk adjustment for specific risk.

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

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

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

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

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

7.2.48I (1) Subject to BIPRU 7.2.48J G, BIPRU 9.15.9 R and BIPRU 9.15.10 R, where the investor, originator or sponsor of a securitisation fails to meet any of the requirements in BIPRU 9.3.18 R to BIPRU 9.3.20 R (Disclosure requirements) and BIPRU 9.15.11 R to BIPRU 9.15.16 R (investor due diligence requirements) in any material respect by reason of its negligence or omission, the appropriate regulator will use its powers under section 55J (Variation etc. on the Authority's own initiative) of the Act to impose an additional capital charge in accordance with BIPRU 7.2.48 GR. The additional capital charge imposed will be progressively increased with each relevant, subsequent infringement of the requirements in BIPRU 9.3.18 R to BIPRU 9.3.20 R and BIPRU 9.15.11 R to BIPRU 9.15.16A R, up to a maximum of 1250% risk weight.

(2) Subject to BIPRU 9.3.22 G, BIPRU 9.15.9 R and BIPRU 9.15.10 R, where a credit institution fails to meet in any material respect the requirements in BIPRU 9.15.16A R (Group level requirements), the appropriate regulator may consider using its powers under section 55J (Variation etc on the Authority's own initiative) of the Act in the manner described in (1). In order to calculate the risk weights that would apply to the credit institution, the appropriate regulator may treat the securitisation investments of the subsidiary undertaking as if they were securitisation positions held directly by the credit institution.

7.2.48J When calculating the additional capital charge it will impose under BIPRU 7.2.48G R, the appropriate regulator will take into account the exemption of certain securitisations from the scope of BIPRU 9.15.3 R under...
A securitisation exposure in the trading book that would be subject to deduction in accordance with GENPRU 2.2. (Capital resources) or to a 1250% risk weight in accordance with BIPRU 9 (Securitisation) is subject to a capital charge that is no less than that set out under those provisions, capped at the maximum possible default-risk-related loss. Unrated liquidity facilities are subject to a capital charge that is no less than that set out in BIPRU 9.

Specific risk: correlation trading portfolio

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

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

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

(2) The higher of (1)(a) and (1)(b) will be the specific risk capital charge for the correlation trading portfolio.

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

Definition of a qualifying debt security

A debt security is a qualifying debt security if:

(1) it qualifies for a credit quality step under the standardised approach to credit risk corresponding at least to investment grade; or

(2) it has a PD which, because of the solvency of the issuer, is not higher than that of the debt securities referred to under (1) under the IRB approach; or

(3) it is a debt security for which a credit assessment by a nominated ECAI is unavailable and which meets the following conditions:

(a) it is considered by the firm to be sufficiently liquid;

(b) it is of investment quality, according to the firm’s own discretion, at least equivalent to that of the debt securities referred to under (1); and

(c) it is listed on at least one regulated market or designated investment exchange; or

(4) it is a debt security issued by an institution subject to the capital adequacy requirements set out in the EU CRR or, as may be
applicable, the Banking Consolidation Directive that satisfies the following conditions:

(a) it is considered by the firm to be sufficiently liquid;

(b) its investment quality is, according to the firm’s own discretion, at least equivalent to that of the assets referred to under (1) above;

or

(5) it is a debt security issued by an institution that is deemed to be of equivalent or higher credit quality than that associated with credit quality step 2 under the standardised approach to credit risk and that is subject to supervision and regulatory arrangements comparable to those under the Capital Adequacy Directive.

A firm must not treat a debt security as a qualifying debt security if it would be prudent to consider that the debt security concerned is subject to too high a degree of specific risk for it to be treated as a qualifying debt security.

The manner in which a firm assesses a debt security for the purpose of treatment as a qualifying debt security will be subject to scrutiny by the appropriate regulator. The appropriate regulator may take action to overturn the firm’s judgement if it considers that the debt security should not be treated as a qualifying debt security.

General market risk calculation: General

A firm must calculate the general market risk portion of the interest rate PRR for each currency using either:

(1) the interest rate simplified maturity method;

(2) the interest rate maturity method; or

(3) the interest rate duration method.

A firm must not use the interest rate duration method for index-linked securities. Instead, these securities must:

(1) be attributed a coupon of 3%; and

(2) be treated separately under either the interest rate simplified maturity method or the interest rate maturity method.

General market risk calculation: Simplified maturity method

The interest rate simplified maturity method weights individual net positions to reflect their price sensitivity to changes in interest rates. The weights are related to the coupon and the residual maturity of the instrument (or the next interest rate re-fix date for floating rate items).
7.2.56 Under the interest rate simplified maturity method, the portion of the interest rate PRR for general market risk equals the sum of each individual net position (long or short) multiplied by the appropriate position risk adjustment in the table in BIPRU 7.2.57R. A firm must assign its net positions to the appropriate maturity bands in the table in BIPRU 7.2.57R on the basis of residual maturity in the case of fixed-rate instruments and on the basis of the period until the interest rate is next set in the case of instruments on which the interest rate is variable before final maturity.

7.2.57 Table: general market risk Position Risk Adjustments

This table belongs to BIPRU 7.2.56R.

<table>
<thead>
<tr>
<th>Zone</th>
<th>Maturity band</th>
<th>Coupon of 3% or more</th>
<th>Coupon of less than 3%</th>
<th>position risk adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>One</td>
<td>0 ≤ 1 month</td>
<td>0 ≤ 1 month</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 3 months</td>
<td>&gt; 1 ≤ 3 months</td>
<td>0.20%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 3 ≤ 6 months</td>
<td>&gt; 3 ≤ 6 months</td>
<td>0.4%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 6 ≤ 12 months</td>
<td>&gt; 6 ≤ 12 months</td>
<td>0.7%</td>
<td></td>
</tr>
<tr>
<td>Two</td>
<td>&gt; 1 ≤ 2 years</td>
<td>&gt; 1.0 ≤ 1.9 years</td>
<td>1.25%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 2 ≤ 3 years</td>
<td>&gt; 1.9 ≤ 2.8 years</td>
<td>1.75%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 3 ≤ 4 years</td>
<td>&gt; 2.8 ≤ 3.6 years</td>
<td>2.25%</td>
<td></td>
</tr>
<tr>
<td>Three</td>
<td>&gt; 4 ≤ 5 years</td>
<td>&gt; 3.6 ≤ 4.3 years</td>
<td>2.75%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 5 ≤ 7 years</td>
<td>&gt; 4.3 ≤ 5.7 years</td>
<td>3.25%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 7 ≤ 10 years</td>
<td>&gt; 5.7 ≤ 7.3 years</td>
<td>3.75%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 10 ≤ 15 years</td>
<td>&gt; 7.3 ≤ 9.3 years</td>
<td>4.5%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 15 ≤ 20 years</td>
<td>&gt; 9.3 ≤ 10.6 years</td>
<td>5.25%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; 20 years</td>
<td>&gt; 10.6 ≤ 12.0 years</td>
<td>6.00%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>&gt; 12.0 ≤ 20.0 years</td>
<td>8.00%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>&gt; 20 years</td>
<td>12.50%</td>
<td></td>
</tr>
</tbody>
</table>

General market risk calculation: The maturity method

7.2.58 The interest rate maturity method builds on the interest rate simplified maturity method by partially recognising offsetting positions. BIPRU 7.2.61G provides an illustration of the interest rate maturity method.

7.2.59 Under the interest rate maturity method, the portion of the interest rate PRR for general market risk is calculated as follows:

1. Step 1: each net position is allocated to the appropriate maturity band in the table in BIPRU 7.2.57R and multiplied by the corresponding position risk adjustment;

2. Step 2: weighted long and short positions are matched within:
   a. the same maturity band;
(b) the same zone (using unmatched positions from (a)); and
(c) different zones (using unmatched positions from (b) and matching between zones 1 and 2 and 2 and 3 before zone 1 and 3); and

(3) Step 3: the portion of the interest rate PRR for general market risk is the sum of:
(a) 10% of the total amount matched within maturity bands;
(b) 40% of the amount matched within zone 1 under (2)(b);
(c) 30% of the amount matched within zones 2 & 3 under (2)(b);
(d) 40% of the amounts matched between zones 1 and 2, and between zones 2 and 3;
(e) 150% of the amount matched between zones 1 and 3; and
(f) 100% of the weighted positions remaining unmatched after (2)(c).

The table in BIPRU 7.2.57R distinguishes between debt securities with a coupon of less than 3% and those with coupon in excess of 3%. However, this does not mean that the firm has to do a separate general market risk calculation for each; it merely ensures that when allocating debt securities to a particular band, their coupons are taken into account as well as their maturities. So for example, a 21 year 6% debt security falls into the same band as an 11 year 2% debt security. They are both weighted at 6%, and can be matched under BIPRU 7.2.59R(2)(a) (the first part of step two of the interest rate maturity method calculation) because they fall within the same band.
This paragraph sets out an example of a calculation under the *interest rate maturity method*. In this example, a firm with a £ sterling base currency is processing its euro denominated positions.

---

### General market risk calculation: Duration method

The *interest rate duration method* produces a more accurate measure of interest rate risk than the maturity methods but it is also more complex to calculate.

1. A firm must use the following formula to calculate modified duration for the purpose of the *interest rate duration method*:

   \[
   \text{Modified duration} = \frac{D}{1 + r}
   \]

   For the purposes of the formula (1),

   \[
   D = \sum_{t} \frac{C_t}{(1 + r)^t}
   \]

2. For the purpose of the formulae in (1) and (2):
   - \(C_t\) = cash payment at time \(t\)
   - \(m\) = total maturity
(c) \( r \) = yield to maturity. In the case of a fixed-rate debt security a firm must take the current mark to market of the debt security and thence calculate its yield to maturity, which is the implied discount rate for that instrument. In the case of a floating rate instrument, a firm must take the current mark to market of the debt security and thence calculate its yield on the assumption that the principal is due on the date that the interest rate can next be changed.

(d) \( t \) = time

7.2.64 Under the interest rate duration method, the portion of the interest rate PRR for general market risk is calculated as follows:

1. Step 1: allocate each net position to the appropriate duration zone in the table in BIPRU 7.2.65R and multiply it by:
   a. its modified duration (using the formula in BIPRU 7.2.63R); and
   b. the appropriate assumed interest rate change in the table in BIPRU 7.2.65R;

2. Step 2: match weighted long and short positions:
   a. within zones; and
   b. across zones (using unmatched positions from (2)(a) and following the process in BIPRU 7.2.59R (2)(c)); and

3. Step 3: calculate the portion of the interest rate PRR for general market risk as the sum of:
   a. 100% of the weighted positions remaining unmatched after (2)(b);
   b. 2% of the matched weighted position in each zone;
   c. 40% of the matched weighted position between zones 1 and 2, and between zones 2 and 3; and
   d. 150% of the matched weighted position between zones 1 and 3.

7.2.65 Table: Assumed interest rate change in the interest rate duration method

<table>
<thead>
<tr>
<th>Zone</th>
<th>Modified Duration</th>
<th>Assumed interest rate change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>( 0 \leq 12 ) months</td>
<td>1.00</td>
</tr>
<tr>
<td>2</td>
<td>( &gt; 12 ) months ( \leq 3.6 ) years</td>
<td>0.85</td>
</tr>
<tr>
<td>3</td>
<td>( &gt; 3.6 ) years</td>
<td>0.70</td>
</tr>
</tbody>
</table>

7.2.66 If a firm uses the interest rate duration method it must do so on a consistent basis.
7.3 Equity PRR and basic interest rate PRR for equity derivatives

General rule

R7.3.1 (1) A firm must calculate its equity PRR by:

(a) identifying which positions must be included within the PRR calculation (see BIPRU 7.3.2R);

(b) deriving the net position in each equity in accordance with BIPRU 7.3.23R;

(c) including each of those net positions in either the simplified equity method (see BIPRU 7.3.29R) or, subject to BIPRU 7.3.27R, the standard equity method (see BIPRU 7.3.32R); and

(d) summing the PRR on each net position as calculated under the simplified equity method and standard equity method.

(2) All net positions, irrespective of their signs, must be converted on a daily basis into the firm’s base currency at the prevailing spot exchange rate before their aggregation.

Scope of the equity PRR calculation

R7.3.2 A firm’s equity PRR calculation must:

(1) include all trading book positions in equities, unless:

(a) the position is fully deducted as a material holding under the calculations under the capital resources table, in which case the firm may exclude it; or

(b) the position is hedging an option or warrant which is being treated under BIPRU 7.6.26R (Table: Appropriate treatment for equities, debt securities or currencies hedging options);

(2) include notional positions arising from trading book positions in the instruments listed in the table in BIPRU 7.3.3R; and

(3) (if the firm is the transferor of equities or guaranteed rights relating to title to equities in a repurchase agreement or the lender of equities in an equities lending agreement) include such equities if those equities meet the criteria for inclusion in the trading book.

7.3.3 Table: Instruments which result in notional positions

This table belongs to BIPRU 7.3.2R(2)
### Instrument | See
--- | ---
Depository receipts | BIPRU 7.3.12R
Convertibles where:
- (a) the convertible is trading at a market price of less than 110% of the underlying equity, and the first date at which conversion can take place is less than three months ahead, or the next such date (where the first has passed) is less than a year ahead; or
- (b) the conditions in (a) are not met but the firm includes the convertible in its equity PRR calculation rather than including it in its interest rate PRR calculation set out in BIPRU 7.2 (Interest rate PRR).
Futures, forwards, CFDs and synthetic futures on a single equity | BIPRU 7.3.14R
Futures, forwards, CFDs and synthetic futures on a basket of equities or equity index equity legs of an equity swap | BIPRU 7.3.19R
Options or warrants on a single equity, an equity future, a basket of equities or an equity index (unless the firm calculates a PRR on the option or warrant under BIPRU 7.6). | BIPRU 7.3.21R

#### 7.3.4
BIPRU 7.3.2R(1) includes a **trading book position** in an equity that is subsequently repo'd under a repurchase agreement or lent under a stock lending agreement. Clearly, if the equity had initially been obtained via a reverse repurchase agreement or stock borrowing agreement, the equity would not have been included in the trading book in the first place.

#### 7.3.5
BIPRU 7.3.2R(1) includes **net underwriting positions** or reduced net underwriting positions in equities. BIPRU 7.3.27R requires a firm to use the simplified equity method in the case of reduced net underwriting positions. In the case of net underwriting positions that have not been reduced according to BIPRU 7.8.27R (Calculating the reduced net underwriting position), there is no such restriction; a firm can choose which of the two equity methods to use.

#### 7.3.6
**Firms** are reminded that the table in BIPRU 7.6.5R (Table: Appropriate PRR calculation for an option or warrant) divides equity options and warrants into:

1. those which must be treated under BIPRU 7.6 (Option PRR); and
(2) those which must be treated under either ■ BIPRU 7.3 or ■ BIPRU 7.6, the firm being able to choose whether ■ BIPRU 7.3 or ■ BIPRU 7.6 is used.

7.3.7

The table in ■ BIPRU 7.3.3R does not require every convertible to be included in ■ BIPRU 7.3’s PRR calculation. Where a convertible is not included in this PRR calculation, ■ BIPRU 7.2.3R (1) (Scope of the interest rate PRR calculation) requires that it be included in the ■ BIPRU 7.2 PRR calculation.

7.3.8

Some of the instruments listed in the table in ■ BIPRU 7.3.3R are also included in a firm’s interest rate PRR calculation. For simplicity, a firm may use the interest rate PRR calculation in ■ BIPRU 7.3 rather than the calculation in ■ BIPRU 7.2 (Interest rate PRR). ■ BIPRU 7.3.44G explains this in more detail.

Derivation of notional positions: General approach

7.3.9

■ BIPRU 7.3.10R - ■ BIPRU 7.3.21R convert the instruments listed in the table in ■ BIPRU 7.3.3R into notional positions in individual equities, equity baskets or equity indices.

7.3.10

Unless specified otherwise, the value of each notional equity position equals the quantity of that equity underlying the instrument multiplied by the current market value of the equity.

7.3.11

(1) An example of ■ BIPRU 7.3.10R is as follows. The current market value of a particular equity is £2.50. If a firm contracts to sell this equity in five year's time for £3 it would treat the notional short equity position as having a value of £2.50 when calculating the equity PRR.

(2) In effect, the forward position has been treated as being equivalent to a spot position for the purposes of calculating equity PRR. To capture the risk that the forward price changes relative to the spot price, forward equity positions are included in the firm's interest rate PRR calculation (see ■ BIPRU 7.3.45R or the table in ■ BIPRU 7.2.4R (Table: Instruments which result in notional positions)).

Derivation of notional positions: Depository receipts

7.3.12

A depository receipt must be treated as a notional position in the underlying equity.

Derivation of notional positions: Convertibles

7.3.13

Where a convertible is included in ■ BIPRU 7.3's PRR calculation (see the table in ■ BIPRU 7.3.3R):

(1) it must be treated as a position in the equity into which it converts; and

(2) the firm's equity PRR must be adjusted by making:

(a) an addition equal to the current value of any loss which the firm would make if it did convert to equity; or
(b) a deduction equal to the current value of any profit which the firm would make if it did convert to equity (subject to a maximum deduction equal to the PRR on the notional position underlying the convertible).

**Derivation of notional positions: Futures, forwards and CFDs on a single equity**

7.3.14 R A future (including a synthetic future), forward or CFD on a single equity must be treated as a notional position in that equity.

**Derivation of notional positions: Futures, forwards and CFDs on equity indices or baskets**

7.3.15 R A future (including a synthetic future), forward or CFD on an equity index or basket must be treated as either:

1. a position in each of the underlying equities; or
2. the positions shown in the table in BIPRU 7.3.16R.

7.3.16 R Table: Instruments which result in notional positions

This table belongs to BIPRU 7.3.15R(2)

<table>
<thead>
<tr>
<th>Only one country in the index or basket (see BIPRU 7.3.32R)</th>
<th>Under the simplified equity method (BIPRU 7.3.29R)</th>
<th>Under the standard equity method (BIPRU 7.3.32R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>One position in the index or basket</td>
<td>One position in the index or basket</td>
<td></td>
</tr>
<tr>
<td>More than one country in the index or basket</td>
<td>Several notional basket positions, one for each country</td>
<td>One notional basket position in a separate, notional country</td>
</tr>
</tbody>
</table>

7.3.17 G An example of BIPRU 7.3.16R is as follows. A firm decides to treat a FTSE Eurotop 300 future under the standard equity method, and furthermore, chooses to treat it as one notional position. The table in BIPRU 7.3.16R requires that this notional position be treated as if it were from a separate notional country rather than any of the countries to which the underlying equities are from.

7.3.18 R The notional positions created under BIPRU 7.3.15R have the following values:

1. where only one notional position is created, it has a value equal to the total market value of the equities underlying the contract; or
(2) where more than one notional position is created, each one has a value which reflects the relevant equity's or country's contribution to the total market value of the equities underlying the contract.

Derivation of notional positions: Equity legs of equity swaps

7.3.19 The equity leg of an equity swap must be treated as a position in the underlying equity, equity basket or equity index, which is:

1. long, if the firm has contracted to receive any increase and pay any decrease in the value of the underlying equities or equity index; and

2. short, if the firm has contracted to receive any decrease and pay any increase in the value of the underlying equities or equity index.

7.3.20 The interest rate leg of an equity swap is included in a firm's interest rate PRR calculation (see the table in BIPRU 7.2.4R (Table: Instruments which result in notional positions)) unless it is treated under BIPRU 7.3.45R.

Derivation of notional positions: Options

7.3.21 If included in BIPRU 7.3's PRR calculation (see the table in BIPRU 7.3.3R), options must be treated as follows:

1. an option on a single equity must be treated as a notional position in that equity;

2. an option on a basket of equities or equity index must be treated as a future on that basket or index; and

3. an option on an equity future must be treated as:
   a. a long position in that future, for purchased call options and written put options; and
   b. a short position in that future, for purchased put options and written call options.

Deriving the net position in each equity

7.3.22 The net position in each equity is the difference between the value of the firm's long positions (including notional positions) and the value of its short positions (including notional positions) in the same equity.

7.3.23 (1) When deriving the net position in each equity, a firm must not net long and short positions except in accordance with this rule.

(2) Subject to (3), a firm may net long and short positions in the same equity. Two equities are the same if and only if they:
   a. enjoy the same rights in all respects; and
   b. are fungible with each other.

(3) Long and short positions in different tranches of the same equity may be treated as being in the same equity for the purpose of (1), where:
(a) the tranches enjoy the same rights in all respects; and
(b) the tranches become fungible with each other within 180 days, and thereafter the equity of one tranche can be delivered in settlement of the other tranche.

7.3.24 A firm must not net a reduced net underwriting position with any other equity position.

7.3.25 ■ BIPRU 7.3.24R only relates to reduced net underwriting position.

Simplified and standard equity methods

7.3.26 ■ BIPRU 7.3.1R (1) requires that the net position in each equity be included in either the simplified equity method or the standard equity method, subject to the restriction in ■ BIPRU 7.3.27R. A firm does not have to use the same method for all equities.

7.3.27 A firm must use the simplified equity method for reduced net underwriting positions.

7.3.28 A firm may use either method for a net underwriting position; ■ BIPRU 7.3.27R only relates to reduced net underwriting positions.

Simplified equity method

7.3.29 Under the simplified equity method, the PRR for each equity, equity index, or equity basket equals the market value of the net position (ignoring the sign) multiplied by the appropriate position risk adjustment from the table in ■ BIPRU 7.3.30R. The result must be converted into the firm’s base currency at current spot foreign currency rates.

7.3.30 Table: simplified equity method position risk adjustments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Position risk adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single equities</td>
<td>16%</td>
</tr>
<tr>
<td>Qualifying equity indices (see BIPRU 7.3.38R)</td>
<td>8%</td>
</tr>
<tr>
<td>All other equity indices or baskets</td>
<td>16%</td>
</tr>
</tbody>
</table>

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

Standard equity method

7.3.31 The standard equity method divides the risk of loss from a firm’s equity positions into the risk of loss from a general move in a country’s equity market and the risk of loss from an individual equity’s price changing.
relative to that country's equity market. These are called general market risk and specific risk respectively.

7.3.32 Under the standard equity method, a firm must:

(1) group equity positions into country portfolios as follows:
(a) a position in an individual equity belongs to:
(i) the country it is listed in;
(ii) any of the countries it is listed in, if more than one; or
(iii) the country it was issued from, if unlisted;
(b) a position in an equity basket or index that is treated under BIPRU 7.3.15R(2), is allocated to one or more country portfolios based on the countries to which the underlying equities belong to under (a) or a notional country provided for in the table in BIPRU 7.3.16R; and

(2) sum:
(a) the PRRs for specific risk calculated under BIPRU 7.3.33R; and
(b) the PRRs for general market risk for each country portfolio as calculated under BIPRU 7.3.41R and BIPRU 7.3.42R.

Standard equity method: Specific risk

Under the standard equity method, a firm must calculate a PRR for specific risk based on the net position in each equity, equity index or equity basket by multiplying its market value (ignoring the sign) by the appropriate position risk adjustment from the table in BIPRU 7.3.34R.

7.3.33 Table: position risk adjustment for specific risk under the standard equity method

This table belongs to BIPRU 7.3.33R

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Position risk adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualifying equity indices (see BIPRU 7.3.38R)</td>
<td>0%</td>
</tr>
<tr>
<td>All equities, and other equity indices or equity baskets</td>
<td>8%</td>
</tr>
</tbody>
</table>

Definition of a qualifying equity

7.3.35 [deleted]

7.3.36 [deleted]

7.3.37 [deleted]
**Definition of a qualifying equity index**

A *qualifying equity index* is one which is traded on a *recognised investment exchange* or a *designated investment exchange* and:

1. is listed in the table in ▼BIPRU 7.3.39R; or
2. is not listed in the table in ▼BIPRU 7.3.39R, but is constructed in such a way that:
   a. it contains at least 20 *equities*;
   b. no single *equity* represents more than 20% of the total index; and
   c. no five *equities* combined represent more than 60% of the total index.

**Table: Qualifying equity indices**

This table belongs to ▼BIPRU 7.3.38R

<table>
<thead>
<tr>
<th>Country or territory</th>
<th>Name of index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>All Ordinaries</td>
</tr>
<tr>
<td>Austria</td>
<td>Austrian Traded Index</td>
</tr>
<tr>
<td>Belgium</td>
<td>BEL 20</td>
</tr>
<tr>
<td>Canada</td>
<td>TSE 35, TSE 100, TSE 300</td>
</tr>
<tr>
<td>France</td>
<td>CAC 40, SBF 250</td>
</tr>
<tr>
<td>Germany</td>
<td>DAX</td>
</tr>
<tr>
<td>European</td>
<td>Dow Jones Stoxx 50 Index, FTSE Eurotop 300, MSCI Euro Index</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Hang Seng 33</td>
</tr>
<tr>
<td>Italy</td>
<td>MIB 30</td>
</tr>
<tr>
<td>Japan</td>
<td>Nikkei 225, Nikkei 300, TOPIX</td>
</tr>
<tr>
<td>Korea</td>
<td>Kospi</td>
</tr>
<tr>
<td>Netherlands</td>
<td>AEX</td>
</tr>
<tr>
<td>Singapore</td>
<td>Straits Times Index</td>
</tr>
<tr>
<td>Spain</td>
<td>IBEX 35</td>
</tr>
<tr>
<td>Sweden</td>
<td>OMX</td>
</tr>
<tr>
<td>Switzerland</td>
<td>SMI</td>
</tr>
<tr>
<td>UK</td>
<td>FTSE 100, FTSE Mid 250, FTSE All Share</td>
</tr>
<tr>
<td>US</td>
<td>S&amp;P 500, Dow Jones Industrial Average, NASDAQ Composite, Russell 2000</td>
</tr>
</tbody>
</table>

**Standard equity method: General market risk: General**

Under the *standard equity method*, a *firm* must apply approach one, as set out in ▼BIPRU 7.3.41R, to each country portfolio (or part portfolio) unless the conditions in ▼BIPRU 7.3.42R(3) are met, in which case the *firm* may instead apply approach two, as set out in ▼BIPRU 7.3.42R, to the relevant country portfolios (or part portfolios).
Standard equity method: General market risk: Approach One: No offset between different country portfolios

7.3.41 Under approach one as referred to in BIPRU 7.3.40R, the PRR for general market risk equals the net value (ignoring the sign) of the country portfolio multiplied by 8%.

Standard equity method: General market risk: Approach Two: Limited offset between different country portfolios

7.3.42 (1) Under approach two as referred to in BIPRU 7.3.40R, the PRR for general market risk is calculated using the following formula:

\[ \sqrt{[8\% \times CP_1] + [8\% \times CP_2] + [8\% \times CP_3] + \cdots [8\% \times CP_n]} \]

(2) In the formula in (1) CP<sub>i</sub> denotes the net value of the <i>i</i>th country portfolio (converted to the firm's base currency using current spot foreign currency rates).

(3) The conditions referred to in BIPRU 7.3.40R that must be met for a firm to be able to use approach two as referred to in BIPRU 7.3.40R are as follows:

(a) at least four country portfolios are included (that is: n &ge; 4);
(b) only country portfolios for countries which are full members of the OECD, Hong Kong or Singapore are included;
(c) no individual country portfolio comprises more than 30% of the total gross value of country portfolios included; and
(d) the total net value of country portfolios included equals zero, that is:

\[ \sum \text{CP}_i = 0 \]

7.3.43 In order to meet BIPRU 7.3.42R(3)(d), it is likely that part of a country portfolio will have to be excluded from approach two under BIPRU 7.3.42R (and therefore included in approach one under BIPRU 7.3.41R), even if that country portfolio meets BIPRU 7.3.42R(3)(a) - (c).

Basic interest rate calculation for equity instruments

7.3.44 A basic interest rate PRR calculation is included in BIPRU 7.3 for a firm that does not wish to use the calculation in BIPRU 7.2 (Interest rate PRR). However, it tends to result in higher charges than the methods in BIPRU 7.2, largely because the interest rate PRR is calculated on each notional equity position separately and then summed without offsetting long and short positions.

7.3.45 This rule applies to a firm that does not include a forward, future, option or swap on an equity, basket of equities or equity index in the calculation of its interest rate PRR calculation under BIPRU 7.2 (Interest rate PRR). However it does not apply to cliquet as defined in BIPRU 7.6.18R (Table: Option PRR: methods for different types of option). A firm must calculate the interest rate PRR for a position being treated under this rule as follows:
(1) multiply the market value of the notional equity position underlying the instrument by the appropriate percentage from the table in §BIPRU 7.3.47R; and

(2) sum the results from (1), ignoring the sign.

7.3.46 Cliquets on equities, baskets of equities or equity indices do not attract an interest rate PRR. §BIPRU 7.3.45R excludes them from the basic interest rate PRR calculation and the table in §BIPRU 7.2.4R (Table: Instruments which result in notional positions) excludes them from the scope of the interest rate PRR calculation in §BIPRU 7.2 (Interest rate PRR).

7.3.47 Table: Percentages used in the basic interest rate PRR calculation for equity instruments

This table belongs to §BIPRU 7.3.45R(1)

<table>
<thead>
<tr>
<th>Time to expiration</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 ≤ 3 months</td>
<td>0.20</td>
</tr>
<tr>
<td>&gt; 3 ≤ 6 months</td>
<td>0.40</td>
</tr>
<tr>
<td>&gt; 6 ≤ 12 months</td>
<td>0.70</td>
</tr>
<tr>
<td>&gt; 1 ≤ 2 years</td>
<td>1.25</td>
</tr>
<tr>
<td>&gt; 2 ≤ 3 years</td>
<td>1.75</td>
</tr>
<tr>
<td>&gt; 3 ≤ 4 years</td>
<td>2.25</td>
</tr>
<tr>
<td>&gt; 4 ≤ 5 years</td>
<td>2.75</td>
</tr>
<tr>
<td>&gt; 5 ≤ 7 years</td>
<td>3.25</td>
</tr>
<tr>
<td>&gt; 7 ≤ 10 years</td>
<td>3.75</td>
</tr>
<tr>
<td>&gt; 10 ≤ 15 years</td>
<td>4.50</td>
</tr>
<tr>
<td>&gt; 15 ≤ 20 years</td>
<td>5.25</td>
</tr>
<tr>
<td>&gt; 20 years</td>
<td>6.00</td>
</tr>
</tbody>
</table>

Additional capital charge in relation to equity indices

7.3.48 If a firm nets off positions in one or more of the equities constituting an equity index future, forward or CFD against one or more positions in the equity index future, forward or CFD itself, the firm must apply an additional equity PRR to the netted position to cover the risk of loss caused by the value of the future, forward or CFD not moving fully in line with that of its constituent equities. The same applies if a firm holds opposite positions in a future, forward or CFD on an equity index that are not identical in respect of either their maturity or their composition or both.
7.4 Commodity PRR

General rule

7.4.1 A firm must calculate its commodity PRR by:

(1) identifying which commodity position must be included within the scope of the PRR calculation (see ■ BIPRU 7.4.2R);

(2) expressing each such position in terms of the standard unit of measurement of the commodity concerned;

(3) expressing the spot price in each commodity in the firm's base currency at current spot foreign exchange rates;

(4) calculating an individual PRR for each commodity (see ■ BIPRU 7.4.20R); and

(5) summing the resulting individual PRRs.

Scope of the commodity PRR calculation

7.4.2 A firm's commodity PRR calculation must, regardless of whether the positions concerned are trading book or non-trading book positions:

(1) include physical commodity positions;

(2) (if the firm is the transferor of commodities or guaranteed rights relating to title to commodities in a repurchase agreement or the lender of commodities in a commodities lending agreement) include such commodities;

(3) include notional positions arising from positions in the instruments listed in the table in ■ BIPRU 7.4.4R; and

(4) exclude positions constituting a stock financing transaction.

7.4.3 Gold positions are excluded from the scope of the commodity PRR. Instead, they are included within the scope of the foreign exchange PRR (■ BIPRU 7.5).

7.4.4 Table: Instruments which result in notional positions

This table belongs to ■ BIPRU 7.4.2R(3)
### Instrument See

<table>
<thead>
<tr>
<th>Instrument</th>
<th>See</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Forwards, futures, CFDs, synthetic futures and options on a single commodity</em> (unless the <em>firm</em> calculates a PRR on the option under BIPRU 7.6 (Option PRR))</td>
<td>BIPRU 7.4.8R</td>
</tr>
<tr>
<td>A commitment to buy or sell a single commodity at an average of spot prices prevailing over some future period</td>
<td>BIPRU 7.4.10R</td>
</tr>
<tr>
<td><em>Forwards, futures, CFDs, synthetic futures and options on a commodity index</em> (unless the <em>firm</em> calculates an PRR on the option under BIPRU 7.6)</td>
<td>BIPRU 7.4.13R - BIPRU 7.4.14R</td>
</tr>
<tr>
<td><em>Commodity swaps</em></td>
<td>BIPRU 7.4.16R - BIPRU 7.4.17R</td>
</tr>
<tr>
<td>A warrant relating to a commodity must be treated as an option on a commodity.</td>
<td></td>
</tr>
</tbody>
</table>

**7.4.5**

- **BIPRU 7.4.2R** includes a *trading book position* in a commodity that is subsequently repo’d under a *repurchase agreement* or lent under a stock lending agreement. Clearly, if the commodity had initially been obtained via a *reverse repurchase agreement* or stock borrowing agreement, the commodity would not have been included in the *trading book* in the first place.

**7.4.6**

*Firms* are reminded that the table in **BIPRU 7.6.5R** (Table: Appropriate PRR calculation for an option or warrant) divides *commodity options* into:

1. those which must be treated under **BIPRU 7.6**; and
2. those which must be treated under either **BIPRU 7.4** or **BIPRU 7.6** (Option PRR), the *firm* being able to choose whether **BIPRU 7.4** or **BIPRU 7.6** is used.

**Derivation of notional positions: General**

- **BIPRU 7.4.8R** - **BIPRU 7.4.19G** convert the instruments listed in the table in **BIPRU 7.4.4R** into notional *positions* in the relevant *commodities*. These notional *positions* are expressed in terms of quantity (tonnes, barrels, etc), not value. The maturity of the *position* is only relevant where the *firm* is using the *commodity maturity ladder approach* or the *commodity extended maturity ladder approach*.

**Derivation of notional positions: Futures, forwards, CFDs and options on a single commodity**

- **BIPRU 7.4.8** Where a *forward, future, CFD, synthetic future or option* (unless already included in the *firm’s option PRR calculation*) settles according to:

  1. the difference between the price set on trade date and that prevailing at contract expiry, the notional *position*:

     a. equals the total quantity underlying the contract; and
(b) has a maturity equal to the expiry date of the contract; and

(2) the difference between the price set on trade date and the average of prices prevailing over a certain period up to contract expiry, there is a notional position for each of the reference dates used in the averaging period to calculate the average price, which:

(a) equals a fractional share of the total quantity underlying the contract; and

(b) has a maturity equal to the relevant reference date.

7.4.9 (1) The following example illustrates BIPRU 7.4.8R (2).

(2) A firm buys a Traded Average Price Option (TAPO - a type of Asian option) allowing it to deliver 100 tonnes of Grade A copper and receive $1,750 in June. If there were 20 business days in June the short notional positions will each:

(a) equal 5 tonnes per day (1/20 of 100 tonnes); and

(b) have a maturity equal to one of the business days in June (one for each day).

(3) In this example as each business day in June goes by the quantity per day for the remaining days does not change (5 tonnes per day) only the days remaining changes. Therefore, halfway through June there are ten, 5 tonne short notional positions remaining each for the ten remaining business days in June.

Derivation of notional positions: Buying or selling a single commodity at an average of spot prices prevailing in the future

7.4.10 Commitments to buy or sell at the average spot price of the commodity prevailing over some period between trade date and maturity must be treated as a combination of:

(1) a position equal to the full amount underlying the contract with a maturity equal to the maturity date of the contract which is:

(a) long, where the firm will buy at the average price; or

(b) short, where the firm will sell at the average price; and

(2) a series of notional positions, one for each of the reference dates where the contract price remains unfixed, each of which:

(a) is long if the position under (1) is short, or short if the position under (1) is long;

(b) equals a fractional share of the total quantity underlying the contract; and

(c) has a maturity date of the relevant reference date.

7.4.11 The following guidance provides an example of BIPRU 7.4.10R. In January, a firm agrees to buy 100 tonnes of copper for the average spot price prevailing during the 20 business days in February, and will settle on 30 June. After entering into this agreement, the firm faces the risk that the average price
for February increases relative to that for 30 June. Therefore, as highlighted in the table below:

(1) the short positions reflect the fact that this could occur because any one of the remaining forward prices for February increase; and

(2) the long position reflects the fact that this loss could occur because the forward price for 30 June falls.

### Table: Example of buying at the average spot price prevailing in the future
This table belongs to BIPRU 7.4.11G

<table>
<thead>
<tr>
<th>Application of BIPRU 7.4.10R(1)</th>
<th>Application of BIPRU 7.4.10R(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>From trade date to start of averaging period</td>
<td>A series of 20 notional short positions each equal to 5 tonnes of copper. Each position is allocated a maturity equal to one of the business days in February (one for each day).</td>
</tr>
<tr>
<td>During averaging period</td>
<td>Long position in 100 tonnes of copper with a maturity of 30 June. As each business day goes by in February the price for 5 tonnes of copper is fixed and so there will be one less notional short position.</td>
</tr>
<tr>
<td>After averaging period</td>
<td>Long position in 100 tonnes of copper with a maturity of 30 June. No short positions.</td>
</tr>
</tbody>
</table>

### Derivation of notional positions: CFDs and options on a commodity index
Commodity index futures and commodity index options (unless the option is included in the firm's option PRR calculation), must be treated as follows:

(1) Step 1: the total quantity underlying the contract must be either:
   (a) treated as a single notional commodity position (separate from all other commodities); or
   (b) divided into notional positions, one for each of the constituent commodities in the index, of an amount which is a proportionate part of the total underlying the contract according to the weighting of the relevant commodity in the index;

(2) Step 2: each notional position determined in Step 1 must then be included:
   (a) when using the commodity simplified approach (BIPRU 7.4.24R), without adjustment; or
   (b) when using the commodity maturity ladder approach (BIPRU 7.4.25R) or the commodity extended maturity ladder approach (BIPRU 7.4.32R), with the adjustments in BIPRU 7.4.14R.
Table: Treatment of commodity index futures and commodity index options
This table belongs to BIPRU 7.4.13R(2)(b)

<table>
<thead>
<tr>
<th>Construction of index</th>
<th>Notional position (or positions) and maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot level of index is based on the spot price of each constituent commodity</td>
<td>Each quantity determined in Step 1 as referred to in BIPRU 7.4.13R is assigned a maturity equal to the expiry date of the contract.</td>
</tr>
<tr>
<td>Spot level of index is based on an average of the forward prices of each constituent commodity</td>
<td>Each quantity determined in Step 1 as referred to in BIPRU 7.4.13R is divided (on a pro-rata basis) into a series of forward positions to reflect the impact of each forward price on the level of the index. The maturity of each forward position equals the maturity of the relevant forward price determining the level of the index when the contract expires.</td>
</tr>
</tbody>
</table>

(1) An example of using BIPRU 7.4.13R and the table in BIPRU 7.4.14R is as follows.

(2) A firm is long a three-month commodity index future where the spot level of the index is based on the one, two and three month forward prices of aluminium, copper, tin, lead, zinc and nickel (18 prices in total).

(3) Step 1: the firm should decide whether to treat the full quantity underlying the contract as a single notional commodity position or disaggregate it into notional positions in aluminium, copper, tin, lead, zinc and nickel. In this case the firm decides to disaggregate the contract into notional positions in aluminium, copper, tin, lead, zinc and nickel.

(4) Step 2: if the firm uses the commodity simplified approach, nothing more need be done to arrive at the notional position. In this case the firm uses the commodity maturity ladder approach and so subdivides each position in each metal into three because the level of the index is based on the prevailing one, two and three month forward prices. Since the future will be settled in three months' time at the prevailing level of the index, the three positions for each metal will have maturities of four, five and six months respectively.

Derivation of notional positions: Commodity swaps

A firm must treat a commodity swap as a series of notional positions, one position for each payment under the swap, each of which:

(1) equals the total quantity underlying the contract;

(2) has a maturity corresponding to the payment date; and

(3) is long or short according to BIPRU 7.4.17R.
7.4.17 R Table: Treatment of commodity swaps

This table belongs to ■ BIPRU 7.4.16R

<table>
<thead>
<tr>
<th>Receiving amounts which are unrelated to any commodity’s price</th>
<th>Receiving the price of commodity ‘b’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paying amounts which are unrelated to any commodity’s price</td>
<td>N/A</td>
</tr>
<tr>
<td>Paying the price of commodity ‘a’</td>
<td>Short positions in commodity ‘a’</td>
</tr>
<tr>
<td></td>
<td>Short positions in commodity ‘a’ and long positions in commodity ‘b’</td>
</tr>
</tbody>
</table>

The table in ■ BIPRU 7.4.17R shows that where the legs of the swap are in different commodities, a series of forward positions are created for each commodity (that is, a series of short positions in commodity ‘a’ and a series of long positions in commodity ‘b’).

The table in ■ BIPRU 7.4.17R also covers the case where one leg is unrelated to any commodity’s price. This leg may be subject to a PRR under another part of ■ BIPRU 7; for example, an interest rate based leg would have to be included in a firm’s interest rate PRR calculation.

Calculating the PRR for each commodity: General

A firm must calculate a commodity PRR for each commodity separately using either the commodity simplified approach (■ BIPRU 7.4.24R), the commodity maturity ladder approach (■ BIPRU 7.4.25R) or the commodity extended maturity ladder approach (■ BIPRU 7.4.32R).

A firm must use the same approach for a particular commodity but need not use the same approach for all commodities.

(1) A firm must treat positions in different grades or brands of the same commodity-class as different commodities unless they:

(a) can be delivered against each other; or

(b) are close substitutes and have price movements which have exhibited a stable correlation coefficient of at least 0.9 over the last 12 months.

(2) If a firm relies on (1)(b) it must then monitor compliance with the conditions in that paragraph on a continuing basis.

If a firm intends to rely on the approach in ■ BIPRU 7.4.22R(1)(b):

(1) it must notify the appropriate regulator in writing at least 20 business days prior to the date the firm starts relying on it; and

(2) the firm must, as part of the notification under (1), provide to the appropriate regulator the analysis of price movements on which it relies.
**Calculating the PRR for each commodity: Simplified approach**

7.4.24  
A firm which calculates a commodity PRR using the commodity simplified approach must do so by summing:

1. 15% of the net position multiplied by the spot price for the commodity; and

2. 3% of the gross position (long plus short, ignoring the sign) multiplied by the spot price for the commodity;

(and for these purposes the excess of a firm's long (short) positions over its short (long) positions in the same commodity (including notional positions under BIPRU 7.4.4R) is its net position in each commodity).

**Calculating the PRR for each commodity: Maturity ladder approach**

7.4.25  
A firm using the commodity maturity ladder approach must calculate the commodity PRR following the steps in BIPRU 7.4.26R and then sum all spread charges, carry charges and outright charges that result. A firm must use a separate maturity ladder for each commodity.

7.4.26  
1. A firm must calculate the charges referred to in BIPRU 7.4.25R as follows.

2. Step 1: offset long and short positions maturing:
   (a) on the same day; or
   (b) (in the case of positions arising under contracts traded in markets with daily delivery dates) within 10 business days of each other.

3. Step 2: allocate the positions remaining after step 1 to the appropriate maturity band in the table in BIPRU 7.4.28R (physical commodity positions are allocated to band 1).

4. Step 3: match long and short positions within each band. In each instance, calculate a spread charge equal to the matched amount multiplied first by the spot price for the commodity and then by the spread rate of 3%.

5. Step 4: carry unmatched positions remaining after step 3 to another band where they can be matched, then match them. Do this until all matching possibilities are exhausted. In each instance, calculate:
   (a) a carry charge equal to the carried position multiplied by the spot price for the commodity, the carry rate of 0.6% and the number of bands by which the position is carried; and
   (b) a spread charge equal to the matched amount multiplied by the spot price for the commodity and the spread rate of 3%.

6. Step 5: calculate the outright charge on the remaining positions (which will either be all long positions or all short positions). The outright charge equals the remaining position (ignoring the sign) multiplied by the spot price for the commodity and the outright rate of 15%).
7.4.27 G The matched amount in BIPRU 7.4.26R is the lesser (ignoring the sign) of either the total long position or the total short position. For example, a band with 1000 long and 700 short results in a matched amount of 700. The unmatched amount would be 300.

7.4.28 R Table: Maturity bands for the maturity ladder approach

This table belongs to BIPRU 7.4.26R

<table>
<thead>
<tr>
<th>Band</th>
<th>Maturity of position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Band 1</td>
<td>0 ≤ 1 month</td>
</tr>
<tr>
<td>Band 2</td>
<td>&gt; 1 month ≤ 3 months</td>
</tr>
<tr>
<td>Band 3</td>
<td>&gt; 3 months ≤ 6 months</td>
</tr>
<tr>
<td>Band 4</td>
<td>&gt; 6 months ≤ 1 year</td>
</tr>
<tr>
<td>Band 5</td>
<td>&gt; 1 year ≤ 2 years</td>
</tr>
<tr>
<td>Band 6</td>
<td>&gt; 2 years ≤ 3 years</td>
</tr>
<tr>
<td>Band 7</td>
<td>&gt; 3 years</td>
</tr>
</tbody>
</table>

7.4.29 G BIPRU 7.4.30G is an example illustrating the calculation of the commodity PRR on an individual commodity using the commodity maturity ladder approach (BIPRU 7.4.26R). After the firm has carried out the pre-processing required by BIPRU 7.4.26R(2) (that is, step 1), it follows steps 2 to 5 as shown below. Because the firm is using the commodity maturity ladder approach the spread rate is 3%, the carry rate is 0.6% and the outright rate is 15%. The example assumes that the spot price for the commodity is £25.

7.4.30 G Table: Example illustrating the commodity maturity ladder approach

This table belongs to BIPRU 7.4.29G

<table>
<thead>
<tr>
<th>Band</th>
<th>Step 2 Allocate remaining positions to appropriate maturity bands</th>
<th>Step 3 Match within bands. Each matched amount incurs a spread change</th>
<th>Step 4a Carry across bands. Each carried amount incurs a carry charge</th>
<th>Step 4b Match within band. Each matched amount incurs a spread charge</th>
<th>Step 5 Remaining positions incur an outright charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 ≤ 1 month</td>
<td>1000 long 700 short</td>
<td>200 matched</td>
<td>300 carried</td>
<td>400 matched</td>
<td>200 short remains</td>
</tr>
<tr>
<td>&gt; 1 month ≤ 3 months</td>
<td>600 short</td>
<td>Nothing matched</td>
<td></td>
<td>100 matched</td>
<td></td>
</tr>
<tr>
<td>&gt; 3 months ≤ 6 months</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 6 months ≤ 1 year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 1 year ≤ 2 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 2 years ≤ 3 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 3 years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Spread charges: $250 \times 3% = 7.5$  
Carry charges: $600 \times 0.6% = 3.6$  
Outright charge: $200 \times 15% = 30$  

Total: £41.10
Calculating the PRR for each commodity: Extended maturity ladder approach

A firm may use the commodity extended maturity ladder approach to calculate the commodity PRR for a particular commodity provided the firm:

1. has a diversified commodities portfolio;
2. undertakes significant commodities business;
3. is not yet in a position to use the VaR model approach to calculate commodity PRR; and
4. at least twenty business days before the date the firm uses that approach notifies the appropriate regulator in writing of:
   a. its intention to use the commodity extended maturity ladder approach; and
   b. the facts and matters relied on to demonstrate that the firm meets the criteria in (1) - (3).

A firm using the commodity extended maturity ladder approach must calculate its commodity PRR by:

1. following the same steps as in BIPRU 7.4.26R but using the rates from the table in BIPRU 7.4.33R rather than those in BIPRU 7.4.26R; and
2. summing all spread charges, carry charges and outright charge that result.

Table: Alternative spread, carry and outright rates

This table belongs to BIPRU 7.4.32R

<table>
<thead>
<tr>
<th></th>
<th>Precious metals (excluding gold)</th>
<th>Base metals</th>
<th>Softs (agricultural)</th>
<th>Other (including energy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spread rate (%)</td>
<td>2</td>
<td>2.4</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Carry rate (%)</td>
<td>0.3</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Outright rate (%)</td>
<td>8</td>
<td>10</td>
<td>12</td>
<td>15</td>
</tr>
</tbody>
</table>

For the purposes of BIPRU 7.4.31R(1) a firm has a diversified commodity portfolio where it holds positions in more than one commodity in each of the categories set out in the table in BIPRU 7.4.33R and holds positions across different maturities in those individual commodities. A firm would not have a diversified commodity portfolio if it held positions in only one commodity in each of the categories set out in the table in BIPRU 7.4.33R. This is because the rates in the table in BIPRU 7.4.33R assume firms have positions in more than one of that category’s commodities. Different commodities within a given category are likely to exhibit different volatilities, so where a firm does not have a diversified commodity portfolio...
in that category, the rates applying to that category might underestimate the regulatory capital required for a certain commodity at certain times.

7.4.35 **G** What constitutes significant business in BIPRU 7.4.31R(2) will vary from firm to firm. The more regularly the firm undertakes trades in commodities and the more consistently it has positions in the relevant commodity, the more likely it is to be undertaking significant business for the purposes of BIPRU 7.4.31R(2).

7.4.36 **R** Where a firm is:

1. treating a commodity index derivative as if it was based on a single separate commodity (see BIPRU 7.4.13R(1)(a)); and
2. using the commodity extended maturity ladder approach to calculate the commodity PRR for that commodity;

it must determine which index constituent incurs the highest rate in the table in BIPRU 7.4.33R and apply that rate to the notional position for the purposes of BIPRU 7.4.32R.

7.4.37 **G** Where an index is only based on precious metals, BIPRU 7.4.13R and BIPRU 7.4.36R allow the firm to treat the single notional position as precious metal for the purposes of BIPRU 7.4.32R. However, if the index contained a mix of precious metals and base metals the firm would have to treat the notional position under BIPRU 7.4.36R as a base metal because base metals attract a higher rate than precious metals in the table in BIPRU 7.4.33R.

**Liquidity and other risks**

7.4.38 **R** If a short position to which BIPRU 7.4 applies falls due before a long position to which BIPRU 7.4 applies, a firm must also guard against the risk of a shortage of liquidity which may exist in some markets.

7.4.39 **G** In particular, where BIPRU 7.4.38R applies and the short position constitutes a material position compared to a firm’s total commodity positions, it should consider a further commodity PRR charge in respect of that position depending on the likelihood of a shortage of liquidity in that market.

7.4.40 **R** A firm must safeguard against other risks, apart from the delta risk, associated with commodity options.

7.4.41 **R** The interest-rate and foreign-exchange risks not covered by other provisions of BIPRU 7.4 or by the provisions of BIPRU 7.2 (Interest rate PRR) or BIPRU 7.5 (Foreign currency PRR) must be included in the calculation of general market risk for traded debt securities and in the calculation of foreign currency PRR.
7.5 Foreign currency PRR

**General rule**

**7.5.1 R** A firm must calculate its foreign currency PRR by:

1. identifying which foreign currency and gold positions to include in the PRR calculation;
2. calculating the net open position in each currency in accordance with this section (including where necessary the base currency calculated in the same way as it is for foreign currencies) and in gold;
3. calculating the open currency position for foreign currencies as calculated under BIPRU 7.5.19R and the net gold position (see BIPRU 7.5.20R); and
4. multiplying the sum of the absolutes of that open currency position and that net gold position by 8%.

**7.5.2 G** An example of the operation of BIPRU 7.5.1R is as follows. A firm has an open currency position of £100 and a net gold position of £50. The sum (ignoring the sign) is £150, and so the foreign currency PRR is £12.

**Scope of the foreign currency PRR calculation**

**7.5.3 R** A firm’s foreign currency PRR calculation must include the following items regardless of whether they are trading book or non-trading book positions:

1. all gold positions;
2. all spot positions in foreign currency (that is, all asset items less all liability items, including accrued interest, in the foreign currency in question);
3. all forward positions in foreign currency;
4. all CRD financial instruments and other items which are denominated in a foreign currency;
5. irrevocable guarantees (and similar instruments) that are certain to be called and likely to be irrecoverable to the extent they give rise to a position in gold or foreign currency; and
6. notional positions arising from the instruments listed in the table in BIPRU 7.5.5R.
(1) The following are excluded from a firm's foreign currency PRR calculation:

(a) foreign currency assets which have been deducted in full from the firm's capital resources under the calculations under the capital resources table;
(b) positions hedging (a);
(c) positions that a firm has deliberately taken in order to hedge against the adverse effect of the exchange rate on the ratio of its capital resources to its capital resources requirement; and
(d) transactions to the extent that they fully hedge net future foreign currency income or expenses which are known but not yet accrued.

(2) If a firm uses an exclusion under (1) it must:

(a) notify the appropriate regulator before it makes use of it;
(b) include in the notification in (a) the terms on which the relevant item will be excluded;
(c) not change the terms of the exclusion under (b); and
(d) document its policy on the use of that exclusion in its trading book policy statement.

(3) A position may only be excluded under (1)(b) or (c) if it is of a non-trading or structural nature.

---

**Table: instruments which result in notional foreign currency positions**

This table belongs to BIPRU 7.5.3R(6).

<table>
<thead>
<tr>
<th>Instruments</th>
<th>See</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency futures, forwards, synthetic futures and CFDs</td>
<td>BIPRU 7.5.11R</td>
</tr>
<tr>
<td>Foreign currency swaps</td>
<td>BIPRU 7.5.13R</td>
</tr>
<tr>
<td>Foreign currency options or warrants (unless the firm calculates a PRR on the option or warrant under BIPRU 7.6)</td>
<td>BIPRU 7.5.15R</td>
</tr>
<tr>
<td>Gold futures, forwards, synthetic futures and CFDs</td>
<td>BIPRU 7.5.16R</td>
</tr>
<tr>
<td>Gold options (unless the firm calculates a PRR on the option under BIPRU 7.6)</td>
<td>BIPRU 7.5.17R</td>
</tr>
<tr>
<td>Positions in CIUs</td>
<td>BIPRU 7.5.18R</td>
</tr>
</tbody>
</table>

---

7.5.6

Firms are reminded that the table in BIPRU 7.6.5R (Table: Appropriate PRR calculation for an option or warrant) divides foreign currency options and warrants into:

(1) those which must be treated under BIPRU 7.6 (Option PRR); and
(2) those which must be treated under either BIPRU 7.5 or BIPRU 7.6, the firm being able to choose whether BIPRU 7.5 or BIPRU 7.6 is used.

7.5.7 When determining the currency of denomination firms must:

(1) use the currency in which the firm accounts for the instrument where an instrument is quoted in more than one currency; and

(2) treat depository receipts as positions in the underlying security.

7.5.8 Instruments denominated in a foreign currency include, amongst other things, assets and liabilities (including accrued interest); non-foreign currency derivative; net underwriting positions; reduced net underwriting positions; and irrevocable guarantees (or similar instruments) that are certain to be called.

7.5.9 Where a contract is based on a basket of currencies, the firm can choose either to derive notional positions in each of the constituent currencies or treat it as a single notional position in a separate notional currency.

Derivation of notional positions: General

7.5.10 BIPRU 7.5.11R - BIPRU 7.5.18R derive notional currency positions for the instruments listed in the table in BIPRU 7.5.5R.

Derivation of notional positions: Foreign exchange forwards, futures, CFDs and synthetic futures

7.5.11 (1) A firm must treat a foreign currency forward, future, synthetic future or CFD as two notional currency positions as follows:

(a) a long notional position in the currency which the firm has contracted to buy; and

(b) a short notional position in the currency which the firm has contracted to sell.

(2) In (1) the notional positions have a value equal to either:

(a) the contracted amount of each currency to be exchanged in the case of a forward, future, synthetic future or CFD held in the non-trading book; or

(b) the present value of the amount of each currency to be exchanged in the case of a forward, future, synthetic future or CFD held in the trading book.

7.5.12 (1) The following example illustrates BIPRU 7.5.11R. In this example, a firm contracts to sell $106 for €108 in one year's time and the present values of each cash flow are $100 and €100 respectively.
(2) In the non-trading book, this forward would be treated as a combination of a €108 long position and a $106 short position.

(3) In the trading book, this forward would be treated as a combination of a €100 long position and a $100 short position.

(4) Firms are reminded that foreign currency forwards held in the trading book should also be included in the firm’s interest rate PRR calculation (see § BIPRU 7.2.4R (Instruments which result in notional positions for the purpose of the interest rate PRR)).

Derivation of notional positions: Foreign currency swaps

7.5.13

(1) A firm must treat a foreign currency swap as:

(a) a long notional position in the currency in which the firm has contracted to receive interest and principal; and

(b) a short notional position in the currency in which the firm has contracted to pay interest and principal.

(2) In (1) the notional positions have a value equal to either:

(a) the nominal amount of each currency underlying the swap if it is held in the non-trading book; or

(b) the present value amount of all cash flows in the relevant currency in the case of a swap held in the trading book.

7.5.14

(1) The following example illustrates § BIPRU 7.5.13R. In this example a firm enters into a five year foreign currency swap where it contracts to pay six month US$ Libor on $100 in return for receiving 6% fixed on €100. The present values of each leg are $100 and €98 respectively.

(2) In the non-trading book, this swap would be treated as a combination of a €100 long position and a $100 short position.

(3) In the trading book, this swap would be treated as a combination of a €98 long position and a $100 short position.

(4) Firms are reminded that foreign currency swaps held in the trading book should also be included in the firm’s interest rate PRR calculation (see § BIPRU 7.2.4R (Instruments which result in notional positions for the purpose of the interest rate PRR)).
Derivation of notional positions: Foreign currency options and warrants

7.5.15 Where included in BIPRU 7.5’s PRR calculation (see the table in BIPRU 7.5.5R), a foreign currency option or warrant must be treated as a foreign currency forward.

Derivation of notional positions: Gold forwards, futures, synthetic futures and CFDs

7.5.16 A forward, future, synthetic future or CFD on gold must be treated as a notional position in gold with a value equal to the amount of gold underlying multiplied by the current spot price for gold.

Derivation of notional positions: Gold options

7.5.17 If included in the PRR calculation under BIPRU 7.5 (see the table in BIPRU 7.5.5R), a gold option must be treated as a gold forward.

Derivation of notional positions: CIUs

7.5.18 (1) This rule deals with positions in CIUs.

(2) The actual foreign currency positions of a CIU must be included in a firm’s foreign currency PRR calculation under BIPRU 7.5.1 R.

(3) A firm may rely on third party reporting of the foreign currency positions in the CIU, where the correctness of this report is adequately ensured.

(4) If a firm is not aware of the foreign currency positions in a CIU, the firm must assume that the CIU is invested up to the maximum extent allowed under the CIUs mandate in foreign currency and the firm must, for trading book positions, take account of the maximum indirect exposure that it could achieve by taking leveraged positions through the CIU when calculating its foreign currency PRR. This must be done by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the investment mandate.

(5) The assumed position of the CIU in foreign currency calculated in accordance with BIPRU 7.5.18(4) must be treated as a separate currency according to the treatment of investments in gold, subject to the modification that, if the direction of the CIUs investment is available, the total long position may be added to the total long open foreign currency position and the total short position may be added to the total short open foreign currency position. No netting is allowed between such positions prior to this calculation.

Open currency position

7.5.19 A firm must calculate its open currency position by:

(1) calculating the net position in each foreign currency;
(2) converting each such net position into its base currency equivalent at current spot rates;

(3) summing all short net positions and summing all long net positions calculated under (1) and (2); and

(4) selecting the larger sum (ignoring the sign) from (3).

Net gold position

A firm must calculate its net gold position by:

(1) valuing all gold positions using the prevailing spot price for gold (regardless of the maturity of the positions);

(2) offsetting long and short positions; and

(3) converting the resulting net position into the base currency equivalent using the current spot foreign currency rate.
7.6 Option PRR

Option PRR calculation

7.6.1 A firm must calculate its option PRR by:

1. identifying which option positions must be included within the scope of the option PRR calculation under BIPRU 7.6.3R - BIPRU 7.6.5R;
2. calculating the derived position in each option in accordance with BIPRU 7.6.9R - BIPRU 7.6.15R;
3. calculating the PRR for each derived position in accordance with BIPRU 7.6.16R - BIPRU 7.6.31R;
4. summing all of the PRRs calculated in accordance with (3).

Scope of the option PRR calculation

7.6.2 Firms are reminded that the table in BIPRU 7.2.4R (Instruments which result in notional positions for the purposes of the interest rate PRR) and the table in BIPRU 7.3.3R (Instruments which result in notional positions for the purposes of the equity PRR) also require an interest rate PRR to be calculated for options on equities, baskets of equities or equities indices. The interaction between BIPRU 7.6 and the rest of Chapter 7 is illustrated in BIPRU 7.6.33G.

7.6.3 Except as permitted under BIPRU 7.6.5R, a firm's option PRR calculation must include:

1. each trading book position in an option on an equity, interest rate or debt security;
2. each trading book position in a warrant on an equity or debt security;
3. each trading book position in a CIU; and
4. each trading book and non-trading book position in an option on a commodity, currency or gold.

7.6.4 BIPRU 7.6.3R(2) includes net underwriting positions or reduced net underwriting positions in warrants.
Table: Appropriate PRR calculation for an option or warrant

This table belongs to □ BIPRU 7.6.3R

<table>
<thead>
<tr>
<th>Option type (see BIPRU 7.6.18R) or warrant</th>
<th>PRR calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>American option, European option, Bermudan option, Asian option or warrant for which the in the money percentage (see BIPRU 7.6.6R) is equal to or greater than the appropriate position risk adjustment (see BIPRU 7.6.7R and BIPRU 7.6.8R)</td>
<td>Calculate either an option PRR, or the most appropriate to the underlying position of: (a) an equity PRR; or (b) an interest rate PRR; or (c) a commodity PRR; or (d) a foreign currency PRR; or (e) a collective investment undertaking PRR.</td>
</tr>
<tr>
<td>American option, European option, Bermudan option, Asian option or warrant: (a) for which the in the money percentage (see BIPRU 7.6.6R) is less than the appropriate position risk adjustment (see BIPRU 7.6.7R and BIPRU 7.6.8R); or (b) that is at the money; or (c) that is out of the money.</td>
<td>Calculate an option PRR</td>
</tr>
<tr>
<td>All other types of option listed in BIPRU 7.6.18R (regardless of whether in the money, at the money or out of the money).</td>
<td></td>
</tr>
</tbody>
</table>

The in the money percentage

(1) The in the money percentage is calculated in accordance with this rule.

(2) For a call option:

\[
\text{Current market price of underlying - Strike price of the option} \times 100
\]

Strike price of the option

(3) For a put option:

\[
\text{Strike price of option - Current market price of underlying} \times 100
\]

Strike price of the option

(4) In the case of an option on a basket of securities a firm may not treat the option as being in the money by the relevant percentage so as to enable the firm not to apply an option PRR under □ BIPRU 7.6.5R unless the conditions in □ BIPRU 7.6.5R are satisfied with respect to each kind of underlying investment.

(5) (4) also applies to an option on a CIU if a firm is using one of the CIU look through methods.

The appropriate position risk adjustment

(1) The appropriate position risk adjustment for a position is that listed in the table in □ BIPRU 7.6.8R against the relevant underlying position.
(2) If the firm uses the commodity extended maturity ladder approach or the commodity maturity ladder approach for a particular commodity under BIPRU 7.4 (Commodity PRR) the appropriate position risk adjustment for an option on that commodity is the outright rate applicable to the underlying position (see BIPRU 7.4.26R (Calculating the PRR for each commodity: Maturity ladder approach) and BIPRU 7.4.33R (Table: Alternative spread, carry and outright rates)).

(3) If a firm does not have commodity positions treated under BIPRU 7.4 or does not have positions in the commodity in question treated under BIPRU 7.4 the restrictions in BIPRU 7.4 that regulate when a firm can and cannot use a particular method of calculating the commodity PRR apply for the purpose of establishing the appropriate position risk adjustment for the purposes of BIPRU 7.6.

(4) If a firm is using one of the CIU look through methods for an option on a CIU the leveraging requirements in BIPRU 7.7 (Position risk requirements for collective investment undertakings) apply (see BIPRU 7.7.11R). For this purpose the amount of the appropriate position risk adjustments under BIPRU 7.6.6R is increased by the amount of that leveraging (expressed as a percentage) as calculated under BIPRU 7.7, subject to a maximum appropriate position risk adjustment of 32%.

Table: Appropriate position risk adjustment

<table>
<thead>
<tr>
<th>Underlying position</th>
<th>Appropriate position risk adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>The position risk adjustment applicable to the underlying equity or equity index in the table in BIPRU 7.3.30R (Simplified equity method)</td>
</tr>
<tr>
<td>Interest rate</td>
<td>The sum of the specific risk position risk adjustment (see BIPRU 7.2.43R to BIPRU 7.2.51G (Specific risk calculation)) and the general market risk position risk adjustment (as set out in BIPRU 7.2.57R (General market risk position risk adjustments)) applicable to the underlying position</td>
</tr>
<tr>
<td>Debt securities</td>
<td>The sum of the specific risk position risk adjustment (see BIPRU 7.2.43R to BIPRU 7.2.51G (Specific risk calculation)) and the general market risk position risk adjustment (as set out in the table in BIPRU 7.2.57R (General market risk position risk adjustments)) applicable to the underlying position</td>
</tr>
<tr>
<td>Commodity</td>
<td>18% (unless BIPRU 7.6.7R requires otherwise)</td>
</tr>
<tr>
<td>Currency</td>
<td>8%</td>
</tr>
<tr>
<td>Gold</td>
<td>8%</td>
</tr>
<tr>
<td>CIU</td>
<td>32% (subject to BIPRU 7.6.6R and BIPRU 7.6.7R)</td>
</tr>
</tbody>
</table>
Calculating derived positions

7.6.9  A firm must calculate the derived position specified in the table in §BIPRU 7.6.13R for each position included in its option PRR calculation.

Netting positions

7.6.10  A firm may calculate a derived position for its net position in an option or a warrant, if the relevant options or warrants are identical or may be treated as identical under §BIPRU 7.6.11R or §BIPRU 7.6.12R.

7.6.11  A firm may treat options or warrants as identical if they have the same strike price, maturity (except for an interest rate cap or floor - see §BIPRU 7.6.12R) and underlying.

7.6.12  A firm may treat as identical a purchased interest rate cap (or floor) and a written interest rate cap (or floor) only if they mature within 30 days of each other and all other terms are identical (a cap may not be netted against a floor).

Derived positions

7.6.13  Table: Derived positions

This table belongs to §BIPRU 7.6.9R

<table>
<thead>
<tr>
<th>Underlying</th>
<th>Option (or warrant)</th>
<th>Derived position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>Option (warrant) on a single equity or option on a future/forward on a single equity</td>
<td>A notional position in the actual equity underlying the contract valued at the current market price of the equity.</td>
</tr>
<tr>
<td></td>
<td>Option (warrant) on a basket of equities or option on a future/forward on a basket of equities</td>
<td>A notional position in the actual equities underlying the contract valued at the current market price of the equities.</td>
</tr>
<tr>
<td></td>
<td>Option (warrant) on an equity index or option on a future/forward on an equity index</td>
<td>A notional position in the index underlying the contract valued at the current market price of the index.</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Option on an interest rate or an interest rate future/FRA</td>
<td>A zero coupon zero-specific-risk security in the currency concerned with a maturity equal to the sum of the time to expiry of the contract and the length of the period on which the settlement amount of the contract is calculated valued at the notional amount of the contract.</td>
</tr>
<tr>
<td>Underlying</td>
<td>Option (or warrant)</td>
<td>Derived position</td>
</tr>
<tr>
<td>------------</td>
<td>--------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Debt securities</td>
<td><strong>Option on an interest rate swap</strong></td>
<td>A zero coupon zero-specific-risk security in the currency concerned with a maturity equal to the length of the swap valued at the notional principal amount.</td>
</tr>
<tr>
<td>Interest rate cap or floor</td>
<td></td>
<td>A zero coupon zero-specific-risk security in the currency concerned with a maturity equal to the remaining period of the cap or floor valued at the notional amount of the contract.</td>
</tr>
<tr>
<td>Debt securities</td>
<td><strong>Interest rate cap or floor</strong></td>
<td>The underlying debt security with a maturity equal to the time to expiry of the option valued as the nominal amount underlying the contract at the current market price of the debt security.</td>
</tr>
<tr>
<td>Debt securities</td>
<td><strong>Option (warrant) on a debt security or option on a future/forward on a debt security</strong></td>
<td>A notional position in the actual debt securities underlying the contract valued at the current market price of the debt securities.</td>
</tr>
<tr>
<td>Debt securities</td>
<td><strong>Option (warrant) on a basket of debt securities or option on a future/forward on a basket of debt securities</strong></td>
<td>A notional position in the contract underlying the index valued at the current market price of the index.</td>
</tr>
<tr>
<td>Debt securities</td>
<td><strong>Option (warrant) on an index of debt securities or option on a future/forward on an index of debt securities</strong></td>
<td>An amount equal to the tonnage, barrels or kilos underlying the option with (in the case of a future/forward on a commodity) a maturity equal to the expiry date of the forward or Futures contract underlying the option. In the case of an option on a commodity the maturity of the position falls into Band 1 in the table in BIPRU 7.4.28R (Table: Maturity bands for the maturity ladder approach).</td>
</tr>
<tr>
<td>Commodity</td>
<td><strong>Option on a commodity or option on a future/forward on a commodity</strong></td>
<td>An amount equal to the tonnage, barrels or kilos underlying the option with a maturity equal to the length of the swap valued at the</td>
</tr>
</tbody>
</table>
Underlying | Option (or warrant)  | Derived position
---|---|---
CIU  
(These provisions about CIUs are subject to BIPRU 7.6.35R) | Option (warrant) on a single CIU or option on a future/forward on a single CIU | A notional position in the actual CIUs underlying the contract valued at the current market price of the CIU.
Gold | Option (warrant) on a basket of CIUs or option on a future/forward on a basket of CIUs | A notional position in the actual CIUs underlying the contract valued at the current market price of the CIUs.
Currency | Currency option | The amount of the underlying currency that the firm will receive if the option is exercised converted at the spot rate into the currency that the firm will sell if the option is exercised.

**Combinations of options which can be treated as one option**

A firm may treat (for the purpose of calculating an option PRR under BIPRU 7.6) an option strategy listed in the table in BIPRU 7.6.15R as the single position in a notional option specified against that strategy in the table in BIPRU 7.6.15R, if:

1. each element of the strategy is transacted with the same counterparty;
2. the strategy is documented as a single structure;
3. the underlying for each part of the composite position (including any actual holding of the underlying) is the same under the PRR identical product netting rules;
4. the netting achieved does not result overall in a greater degree of netting in the calculation of the market risk capital requirement than would be permitted under the other standard market risk PRR rules;
5. each option in the structure has the same maturity and underlying; and
(6) the constituent parts of the structure form an indivisible single contract, so that neither party can unwind or default on one part of the structure without doing so for the contract as a whole;

except that (1) and (6) only apply to the extent possible with respect to any part of the composite position held by the firm that consists of an actual holding of the underlying.

### Table: Option strategies

This table belongs to BIPRU 7.6.14R

<table>
<thead>
<tr>
<th>Option strategy (and an example)</th>
<th>Notional option (and rule it must be treated under)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bull Spread (e.g. buy 100 call and sell 101 call)</td>
<td>One purchased option (treat under BIPRU 7.6.20R)</td>
</tr>
<tr>
<td>Bear Spread (e.g. sell 100 put and buy 101 put)</td>
<td>One written option (treat under BIPRU 7.6.21R)</td>
</tr>
<tr>
<td>Synthetic Long Call (e.g. long underlying and buy 100 put)</td>
<td>One purchased option (treat under BIPRU 7.6.20R or BIPRU 7.6.24R)</td>
</tr>
<tr>
<td>Synthetic Short Call (e.g. short underlying and sell 100 put)</td>
<td>One written option (treat under BIPRU 7.6.21R or BIPRU 7.6.24R)</td>
</tr>
<tr>
<td>Synthetic Long Put (e.g. short underlying and buy 100 call)</td>
<td>One purchased option (treat under BIPRU 7.6.20R or BIPRU 7.6.24R)</td>
</tr>
<tr>
<td>Synthetic Short Put (e.g. buy underlying and sell 100 call)</td>
<td>One written option (treat under BIPRU 7.6.21R or BIPRU 7.6.24R)</td>
</tr>
<tr>
<td>Long Straddle (e.g. buy 100 call and buy 100 put)</td>
<td>One purchased option (treat under BIPRU 7.6.20R)</td>
</tr>
<tr>
<td>Short Straddle (e.g. sell 100 call and sell 100 put)</td>
<td>One written option (treat under BIPRU 7.6.21R but with no reduction for the amount the option is out of the money)</td>
</tr>
<tr>
<td>Long Strangle (e.g. buy 101 call and buy 99 put)</td>
<td>One purchased option (treat under BIPRU 7.6.20R)</td>
</tr>
<tr>
<td>Short Strangle (e.g. sell 99 call and sell 101 put)</td>
<td>One written option (treat under BIPRU 7.6.21R but with no reduction for the amount the option is out of the money)</td>
</tr>
<tr>
<td>Long Butterfly (e.g. buy one 100 call, sell two 101 calls, and buy one 102 call)</td>
<td>One purchased option (treat under BIPRU 7.6.20R)</td>
</tr>
<tr>
<td>Short Butterfly (e.g. sell one 100 put, buy two 101 puts, and sell one 102 put)</td>
<td>One written option (treat under BIPRU 7.6.21R but with no reduction for the amount the option is out of the money)</td>
</tr>
</tbody>
</table>
7.6.16 A firm must calculate the option PRR for each individual derived option position using the method specified in the table in BIPRU 7.6.18R, or, if more than one method is permitted, using one of those methods.

7.6.17 A firm must convert its positions into its base currency in accordance with the procedures that apply for whichever of the other PRR charges is appropriate (see BIPRU 7.2.1R(3), BIPRU 7.3.1R(2), BIPRU 7.4.1R(3), BIPRU 7.5.19R(2), BIPRU 7.5.20R(3) and BIPRU 7.7.1R(3)).

7.6.18 Table: Option PRR: methods for different types of option

<table>
<thead>
<tr>
<th>Option</th>
<th>Description</th>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>American option</td>
<td>An option that may be exercised at any time over an extended period up to its expiry date.</td>
<td>Option standard method or option hedging method if appropriate</td>
</tr>
<tr>
<td>European option</td>
<td>An option that can only be exercised at expiry.</td>
<td></td>
</tr>
<tr>
<td>Bermudan option</td>
<td>A cross between an American option and European option. The Bermudan option can only be exercised at specific dates during its life.</td>
<td></td>
</tr>
<tr>
<td>Asian option</td>
<td>The buyer has the right to exercise at the average rate or price of the underlying over the period (or part of the period) of the option. One variant is where the payout is based on the average of the underlying against a fixed strike price; another variant is where the payout gives at expiry the price of the underlying against the average price over the option period.</td>
<td>Option standard method or option hedging method if appropriate</td>
</tr>
<tr>
<td>Barrier option</td>
<td>An option which is either cancelled or activated if the price of the underlying reaches a pre-set level regardless of the price at which the underlying may be trading at the expiry of the option. The knock-out type is cancelled if the underlying price or rate trades through the</td>
<td></td>
</tr>
<tr>
<td>Option</td>
<td>Description</td>
<td>Method</td>
</tr>
<tr>
<td>------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Corridor option</td>
<td>Provides the holder with a pay-out for each day that the underlying stays within a defined range chosen by the investor.</td>
<td></td>
</tr>
<tr>
<td>Ladder option</td>
<td>Provides the holder with guaranteed pay-outs if the underlying trades through a pre-agreed price(s) or rate(s) at a certain point(s) in time, regardless of future performance.</td>
<td></td>
</tr>
<tr>
<td>Lock-in option</td>
<td>An option where the pay-out to the holder is locked in at the maximum (or minimum) value of the underlying that occurred during the life of the option.</td>
<td></td>
</tr>
<tr>
<td>Look-back option</td>
<td>A European style option where the strike price is fixed in retrospect, that is at the most favourable price (i.e. the lowest (highest) price of the underlying in the case of a call (put)) during the life of the option.</td>
<td></td>
</tr>
<tr>
<td>Forward starting option</td>
<td>An option that starts at a future date.</td>
<td></td>
</tr>
<tr>
<td>Compound option</td>
<td>An option where the underlying is itself an option (i.e. an option on an option).</td>
<td>Option standard method or option hedging method if appropriate</td>
</tr>
<tr>
<td>Interest rate cap</td>
<td>An interest rate option or series of options under which a counter-party contracts to pay any interest costs arising as a result of an increase in rates above an agreed rate: the effect being to provide protection to the holder against a rise above that agreed interest rate.</td>
<td>Option standard method, but no reduction for the amount the option is out of the money is permitted</td>
</tr>
<tr>
<td>Interest rate floor</td>
<td>An interest rate option or series of options under which a counter-party contracts to pay any interest costs arising as a result of an increase in rates above an agreed rate: the effect being to provide protection to the holder against a rise above that agreed interest rate.</td>
<td></td>
</tr>
<tr>
<td>Option</td>
<td>Description</td>
<td>Method</td>
</tr>
<tr>
<td>----------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------</td>
</tr>
<tr>
<td>Option</td>
<td>party contracts to pay any lost income arising as a result of a fall in rates below an agreed rate: the effect being to provide protection to the holder against a fall below that agreed interest rate.</td>
<td></td>
</tr>
<tr>
<td>Performance option</td>
<td>An option based on a reference basket comprising any number of assets, where the payout to the holder could be one of the following: the maximum of the worst performing asset, or 0; the maximum of the best performing asset, or 0; the maximum of the spreads between several pairs of the assets, or 0.</td>
<td>Option standard method or option hedging method - using the highest position risk adjustment of the individual assets in the basket</td>
</tr>
<tr>
<td>Quanto</td>
<td>Quanto stands for “Quantity Adjusted Option”. A quanto is an instrument where two currencies are involved. The payoff is dependent on a variable that is measured in one of the currencies and the payoff is made in the other currency.</td>
<td>Subject to BIPRU 7.6.31R, the option standard method</td>
</tr>
<tr>
<td>Cliquet option</td>
<td>A cliquet option consists of a series of forward starting options where the strike price for the next exercise date is set equal to a positive constant times the underlying price as of the previous exercise date. It initially acts like a vanilla option with a fixed price but as time moves on, the strike is reset and the intrinsic value automatically locked in at pre-set dates. If the underlying price is below the previous level at the reset date no intrinsic value is locked in but the strike price will be reset to the current price attained by the underlying. If the underlying price rises above the strike price, the intrinsic value is locked in.</td>
<td>Option standard method for a purchased cliquet, or the method specified in BIPRU 7.6.30R for a written cliquet</td>
</tr>
</tbody>
</table>
### Digital option
A type of option where the pay-out to the holder is fixed. The most common types are all-or-nothing and one-touch options. All-or-nothing will pay out the fixed amount if the underlying is above (call) or below (put) a set value at expiry. The one-touch will pay the fixed amount if the underlying reaches a fixed point any time before expiry.

### Any other option or warrant
The method specified for the type of instrument whose description it most closely resembles.

---

#### 7.6.19

(1) The option standard method is described in BIPRU 7.6.20 R - BIPRU 7.6.22 R.

(2) The option hedging method is described in BIPRU 7.6.23 G - BIPRU 7.6.28 R.

---

#### 7.6.20

Under the option standard method, the PRR for a purchased option or warrant is the lesser of:

1. the market value of the derived position (see BIPRU 7.6.9 R) multiplied by the appropriate position risk adjustment (see BIPRU 7.6.8 R); and

2. the market value of the option or warrant.

---

#### 7.6.21

Under the option standard method, the PRR for a written option or warrant is the market value of the derived position (see BIPRU 7.6.9 R) multiplied by the appropriate position risk adjustment (see BIPRU 7.6.8 R). This result may be reduced by the amount the option or warrant is out of the money (subject to a maximum reduction to zero).
The standard method: Underwriting or sub-underwriting an issue of warrants

Under the option standard method, the PRR for underwriting or sub-underwriting an issue of warrants is the net underwriting position (or reduced net underwriting position) multiplied by the current market price of the underlying securities multiplied by the appropriate position risk adjustment, but the result can be limited to the value of the net underwriting position (or reduced net underwriting position) calculated using the issue price of the warrant.

The hedging method

The option hedging method involves the option PRR being calculated on a combination of the option and its hedge.

Under the option hedging method a firm must calculate the option PRR for individual positions as follows:

1. for an option or warrant on an equity, basket of equities or equity index and its equity hedge(s), the firm must, to the extent specified or permitted in the table in BIPRU 7.6.26, use the calculation in the table in BIPRU 7.6.27;

2. for an option or warrant on a debt security, basket of debt securities or debt security index and its debt security hedge(s), the firm must, to the extent specified or permitted in the table in BIPRU 7.6.26, use the calculation in the table in BIPRU 7.6.27;

3. for an option on gold and its gold hedge, the firm must, to the extent specified or permitted in the table in BIPRU 7.6.26, use the calculation in the table in BIPRU 7.6.27; and

4. for an option on a currency and its currency hedge, the firm must, to the extent specified or permitted in the table in BIPRU 7.6.26, use the calculation in the table in BIPRU 7.6.28.

(1) A firm may not use the option hedging method for:
   a) an interest rate option and its hedge; or
   b) a commodity option and its hedge; or
   c) a CIU option and its hedge.

(2) A firm may only use the option hedging method if the item underlying the option or warrant is the same as the hedge of the option or warrant under the PRR identical product netting rules.

Table: Appropriate treatment for equities, debt securities or currencies hedging options

This table belongs to BIPRU 7.6.24.
### Table: The hedging method of calculating the PRR (equities, debt securities and gold)

This table belongs to BIPRU 7.6.24R(1) - BIPRU 7.6.24R(3)

<table>
<thead>
<tr>
<th>Hedge</th>
<th>PRR calculation for the hedge</th>
<th>Limits (if hedging method is used)</th>
<th>Naked position</th>
</tr>
</thead>
<tbody>
<tr>
<td>An equity (hedging an option or warrant)</td>
<td>The equity must be treated in either BIPRU 7.3 (equity PRR) or the option hedging method (see the table in BIPRU 7.6.27R)</td>
<td>The option hedging method must only be used up to the amount of the hedge that matches the notional amount underlying the option or warrant</td>
<td>To the extent that the amount of the hedge (or option or warrant) exceeds the notional amount underlying the option or warrant (or hedge), a firm must apply an equity PRR, interest rate PRR or foreign currency PRR (or the option standard method)</td>
</tr>
<tr>
<td>A debt security (hedging an option or warrant)</td>
<td>The debt security must be treated in BIPRU 7.2 (interest rate PRR) or the option hedging method (see the table in BIPRU 7.6.27R)</td>
<td>As for the first row</td>
<td>As for the first row</td>
</tr>
<tr>
<td>Gold (hedging a gold option)</td>
<td>The gold must be treated in either BIPRU 7.5 (Foreign currency PRR) or the option hedging method (see the table in BIPRU 7.6.27R)</td>
<td>As for the first row</td>
<td>As for the first row</td>
</tr>
<tr>
<td>A currency or currencies (hedging a currency option)</td>
<td>The currency must be treated in either BIPRU 7.5 (Foreign currency PRR) or the option hedging method (see the table in BIPRU 7.6.28R)</td>
<td>As for the first row</td>
<td>As for the first row</td>
</tr>
</tbody>
</table>

7.6.27
## BIPRU 7 : Market risk

### Section 7.6 : Option PRR

#### Table: The hedging method of calculating the PRR (currencies)

<table>
<thead>
<tr>
<th>Option position</th>
<th>In the money by more than 8%</th>
<th>In the money by less than 8%</th>
<th>Out of the money or at the money</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long calls &amp; long puts</td>
<td>Zero</td>
<td>$W_L$</td>
<td>$X$</td>
</tr>
<tr>
<td>Short calls &amp; short puts</td>
<td>Zero</td>
<td>$Y$</td>
<td>$X$</td>
</tr>
</tbody>
</table>

Where:

- $W_L$ means $(1.08\% \times U)$ - The market value of the underlying position
- $U$ means The amount of the underlying currency that the firm will receive if the option is exercised, converted at the strike price into the currency that the firm will sell if the option is exercised
- $X$ means The market value of the underlying position multiplied by 8%
- $Y$ means The market value of the underlying position multiplied by 8%. This result may be reduced by the market value of the option, subject to a maximum reduction to zero.

#### Specific methods and treatments: Digital options

The option PRR for a digital option is the maximum loss of the option.
Specific methods and treatments: Written cliquet options

7.6.30 The option PRR for a written cliquet option is the market value of the derived position (see BIPRU 7.6.9R) multiplied by the appropriate position risk adjustment (see BIPRU 7.6.8R) multiplied by F+1 (see the following provisions of this paragraph). This result may be reduced by the amount the option is out of the money (subject to a maximum reduction to zero). The option PRR for a written cliquet option is therefore defined by the following formula:

\[ \text{position risk adjustment} \times \text{underlying} \times (F + 1) - \text{OTM} \]

where:

(1) \( F = \min \left[ \frac{FR}{\text{max} \left( \frac{FR}{2}, Y \right)} \right] \)

(2) \( FR = \) Number of forward re-sets

(3) \( Y = \) Years to maturity

(4) \( OTM = \) the amount by which the option is out of the money

Specific methods and treatments: Quantos

7.6.31 If the pay-out to the holder of a quanto option is fixed at the inception of the transaction a firm must add 8% to the position risk adjustment when applying the option standard method.

Interaction with other chapters

7.6.32 The application of an option PRR to a position does not prevent any of the other PRR charges from applying if they would otherwise do so. In particular if a firm applies an option PRR to an equity derivative an interest rate PRR will also generally apply.

7.6.33 The following diagram illustrates the relationship between BIPRU 7.6 and the rest of BIPRU 7.
Options on a commodity

7.6.34 R BIPRU 7.4.38R to BIPRU 7.4.41R (Liquidity and other risks) apply to commodity options treated under BIPRU 7.6 as well as to those treated under BIPRU 7.4 (Commodity PRR).

Options on a CIU

7.6.35 R For the purpose of identifying the appropriate treatment for the purpose of BIPRU 7.6.5R, the underlying position for the purpose of BIPRU 7.6.8R and the derived position under BIPRU 7.6.13R a firm may choose between treating an option on a CIU as being:

(1) a position in the CIU itself; or

(2) (if the conditions in BIPRU 7.7 (Position risk requirements for collective investment undertakings) for the use of the method in question are satisfied) positions in the underlying investments or assumed positions arising through the use of the standard CIU look through method or the modified CIU look through method.

7.6.36 G (1) This paragraph gives an example of how the appropriate position risk adjustment should be calculated for the purpose of deciding whether or not an option on a CIU is sufficiently in the money for the firm to have a choice whether or not to apply an option PRR. This example assumes that there is no leveraging (see BIPRU 7.7.11R (CIU modified look through method)).

(2) Say that the CIU contains underlying equity position and the firm is using one of the CIU look through methods. The appropriate position risk adjustment for some is 8% and for the others is 12%. The firm should identify the highest appropriate position risk adjustment for the underlyings. In this case it is 12%. Therefore in this case the
option would need to be in the money by more than 12% in order for the firm to have a choice between applying the option PRR or one of the other PRR charges.

(3) However if the firm is not using one of the CIU look through methods the option would need to be in the money by more than 32% in order for the firm to have a choice between applying the option PRR or the CIU PRR.
7.7 Position risk requirements for collective investment undertakings

Collective investment undertaking PRR calculation

7.7.1 A firm must calculate its CIU PRR by:

1. identifying which CIU positions must be included within the scope of the PRR calculation (see BIPRU 7.7.2);

2. identifying which CIU positions are to be subject to the CIU PRR and which positions are to be subject to one of the other PRR charges;

3. converting on a daily basis net positions into the firm’s base currency at the prevailing spot exchange rate before their aggregation;

4. calculating an individual PRR for each position in a CIU (see BIPRU 7.7.5);

5. summing the resulting individual PRRs.

Scope of the PRR calculation for collective investment undertakings

7.7.2 (1) A firm’s PRR calculation must include all trading book positions in CIUs.

(2) A firm’s CIU PRR calculation must include all trading book positions in CIUs unless they are treated under one of the CIU look through methods and included in the PRR calculations for the relevant underlying investments or subject to an option PRR.

(3) A firm’s PRR calculation for CIUs must include notional positions arising from trading book positions in options or warrants on collective investment undertakings.

General rules

7.7.3 Unless noted otherwise, no netting is permitted between the underlying investments of a CIU and other positions held by a firm for the purposes of calculating the PRR charge for a position in a CIU.

7.7.4 A firm may rely on a third party to calculate and report PRR capital requirements for position risk (general market risk and specific risk) for positions in CIUs falling within BIPRU 7.7.9 and BIPRU 7.7.11, in
accompany with the methods set out in BIPRU 7.7, provided that the correctness of the calculation and the report is adequately ensured.

**Calculation of the collective investment undertaking PRR**

**7.7.5** Without prejudice to other provisions in BIPRU 7.7, a position in a CIU is subject to a collective investment undertaking PRR (general market risk and specific risk) of 32%. Without prejudice to provisions in BIPRU 7.5.18R (Foreign currency PRR for CIUs) or, if the firm has a VaR model permission, BIPRU 7.10.44R (Commodity risks and VaR models) taken together with BIPRU 7.5.18R, where the modified gold treatment set out in those rules is used, a position in a CIU is subject to a securities PRR requirement for position risk (general market risk and specific risk) and a foreign currency PRR of no more than 40%.

**Look through methods: General criteria**

**7.7.6** A firm may determine the securities PRR requirement for positions in CIUs which meet the criteria set out in BIPRU 7.7.7R, by one of the following methods:

1. the standard CIU look through method (BIPRU 7.7.4R and BIPRU 7.7.7R - BIPRU 7.10R); or

2. the modified CIU look through method (BIPRU 7.7.4R, BIPRU 7.7.7R - BIPRU 7.8R and BIPRU 7.11R - BIPRU 7.12R).

**7.7.7** The general eligibility criteria for using the methods in BIPRU 7.7.4R and BIPRU 7.9R - BIPRU 7.11R, for CIUs issued by companies supervised or incorporated within the EEA are that:

1. the CIU's prospectus or equivalent document must include:
   (a) the categories of assets the CIU is authorised to invest in;
   (b) if investment limits apply, the relative limits and the methodologies to calculate them;
   (c) if leverage is allowed, the maximum level of leverage; and
   (d) if investment in OTC financial derivatives or repo-style transactions are allowed, a policy to limit counterparty risk arising from these transactions;

2. the business of the CIU must be reported in half-yearly and annual reports to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period;

3. the units/shares of the CIU are redeemable in cash, out of the undertaking's assets, on a daily basis at the request of the Unitholder;

4. investments in the CIU must be segregated from the assets of the CIU manager; and

5. there must be adequate risk assessment, by the investing firm, of the CIU.
7.7.8 Third country CIUs are eligible if the requirements in BIPRU 7.7.7R (1) - BIPRU 7.7.7R (5) are met.

Standard CIU look through method: General

7.7.9 (1) Where a firm is aware of the underlying investments of the CIU on a daily basis, the firm may look through to those underlying investments in order to calculate the securities PRR for position risk (general market risk and specific risk) for those positions in accordance with the methods set out in the securities PRR requirements or, if the firm has a VaR model permission, in accordance with the methods set out in BIPRU 7.10 (Use of a Value at Risk Model).

(2) Under this approach, positions in CIUs must be treated as positions in the underlying investments of the CIU. Netting is permitted between positions in the underlying investments of the CIU and other positions held by the firm, as long as the firm holds a sufficient quantity of units to allow for redemption/creation in exchange for the underlying investments.

Standard CIU look through method: Index or basket funds

7.7.10 (1) A firm may calculate the securities PRR for position risk (general market risk and specific risk) for positions in CIUs in accordance with the methods set out in the securities PRR requirements, subject to the following conditions:

(a) the purpose of the CIU's mandate is to replicate the composition and performance of an externally generated index or fixed basket of equities or debt securities referred to in (a), subject to the following conditions:

(b) a minimum correlation of 0.9 between daily price movements of the CIU and the index or basket of equities or debt securities it tracks can be clearly established over a minimum period of six months.

(2) Correlation as referred to in (1)(b) means the correlation coefficient between daily returns on the CIU and the index or basket of equities or debt securities it tracks.

CIU modified look through method

7.7.11 Where a firm is not aware of the underlying investments of the CIU on a daily basis, the firm may calculate the securities PRR for position risk (general market risk and specific risk) in accordance with the methods set out in the securities PRR requirements, subject to the following conditions:

(1) it must be assumed that the CIU first invests to the maximum extent allowed under its mandate in the asset classes attracting the highest securities PRR for position risk (general market risk and specific risk), and then continues making investments in descending order until the maximum total investment limit is reached;
(2) the firm must take account of the maximum indirect exposure that it could achieve by taking leveraged positions through the CIU when calculating its securities PRR for position risk, by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the investment mandate; and

(3) should the securities PRR for position risk (general market risk and specific risk) under this approach exceed that set out in BIPRU 7.7.5R, the PRR charge must be capped at that level.

For the purpose of BIPRU 7.7.11R (1) the position in the CIU must be treated as a direct holding in the assumed position.

CAD 1 models and VaR models

Where BIPRU 7.7 permits a firm to calculate the PRR charge for a position in a CIU using the rules in BIPRU 7 relating to the underlying investment, a firm that has:

(1) a CAD 1 model waiver that covers positions in CIUs may use the rules as modified by that waiver; and

(2) a VaR model permission that covers positions in CIUs may use its VaR model.

Options on a CIU

An option on a CIU should be treated in accordance with BIPRU 7.6.35R to BIPRU 7.6.37G (Options on a CIU).
7.8 Securities underwriting

General rules

7.8.1 BIPRU 7.8 sets out the method for calculating a net underwriting position or reduced net underwriting position, which is then included in the PRR calculation in other parts of BIPRU 7. It also deals with concentration risk. BIPRU 7.8 only relates to new securities, which is defined in BIPRU 7.8.12R.

7.8.2 A firm which underwrites or sub-underwrites an issue of securities must, for the purposes of calculating its market risk capital component:

1. identify commitments to underwrite or sub-underwrite which give rise to an underwriting position (see BIPRU 7.8.8R);
2. identify the time of initial commitment (see BIPRU 7.8.13R); and
3. calculate the net underwriting position (set out in BIPRU 7.8.17R), reduced net underwriting position or the net underwriting exposure.

7.8.3 A firm must include the net underwriting position or reduced net underwriting position in whichever one or more of the following is or are relevant:

1. BIPRU 7.2.3R (1) where debt securities are being underwritten;
2. BIPRU 7.3.2R (1) where equities are being underwritten;
3. BIPRU 7.6.22R where warrants are being underwritten; and
4. BIPRU 7.5.3R where the equities, debt securities or warrants being underwritten are denominated in a foreign currency.

7.8.4 A firm must comply with BIPRU 7.8.3R from initial commitment (as determined under BIPRU 7.8.8R) until the end of the fifth business day after working day 0 (as determined under BIPRU 7.8.23R).

7.8.5 Sub-underwriting is a commitment given by one firm to someone other than the issuer or seller of the securities to sub-underwrite all or part of an issue of securities.
The net underwriting position calculated in BIPRU 7.8.17R will also be used in calculating the net underwriting exposure under BIPRU 7.8.34R.

The net underwriting position or reduced net underwriting position arising from underwriting or sub-underwriting a rights or warrants issue should be calculated using the current market price of the underlying security for the purposes of the equity PRR or option PRR. However, the PRR will be limited to the value of the net underwriting position calculated using the initial issue price of the rights or warrants. Where there is no market price because the rights or warrants are in relation to a new class of securities and the initial price has not been set the net underwriting position or reduced net underwriting is the amount of the commitment.

Commitment to underwriting securities

(1) For the purpose of BIPRU 7.8.2R (1), a firm has a commitment to underwrite or sub-underwrite an issue of securities where:

(a) it gives a commitment to an issuer of securities to underwrite an issue of securities; or

(b) (where BIPRU 7.8.12R (2) applies) it gives a commitment to a seller of securities to underwrite a sale of those securities;

(c) it gives a commitment to a person, other than the issuer of securities or, if BIPRU 7.8.12R (2) applies, the seller of the securities, to sub-underwrite an issue of securities; or

(d) it is a member of a syndicate or group that gives a commitment of the type described in (1)(a)-(c).

(2) Unless a rule deals with them separately or the context otherwise requires, a provision of BIPRU 7.8 that deals with underwriting also applies to sub-underwriting.

Exclusions from BIPRU 7.8

(1) Block trades, including bought deals, and private placements are not within the scope of BIPRU 7.8 because they involve an outright purchase by the firm of the relevant securities.

(2) For the purpose of BIPRU 7.8 securities include debt and equity instruments and convertibles but excludes loans.

Grey market transactions

(1) A firm that buys and sells securities before issue is dealing in the grey market for the purposes of BIPRU 7.8.

(2) BIPRU 7.8 does not apply to a firm with respect to its dealings in the grey market unless the firm:

(a) has an underwriting commitment to the issuer in respect of those securities; or

(b) has a sub-underwriting commitment in respect of those securities and is using the grey market solely for the purpose of reducing that sub-underwriting commitment.
(3) BIPRU 7.8 does not apply to a firm with respect to its dealings in the grey market if the transaction is undertaken by the proprietary trading part of the firm or is undertaken for proprietary trading purposes.

(4) BIPRU 7.8 does not apply to a firm with respect to its dealings in the grey market except as described in BIPRU 7.8.17R.

7.8.11 In BIPRU 7.8 the grey market is the market in which dealers “buy” and “sell” securities ahead of issue. In reality the dealers are buying and selling promises to deliver the securities when issued.

New securities

For the purposes of BIPRU 7.8, a firm must treat securities as being new for the purposes of the definition of underwriting if they are:

(1) securities that, prior to the allotment following the underwriting, were not in issue; or

(2) securities that do not fall within (1) but that have not previously been offered for sale or subscription to the public and have not been admitted to trading on a market operated by a recognised investment exchange or an overseas investment exchange.

Time of initial commitment

Subject to BIPRU 7.8.14R, the time of initial commitment is the earlier of:

(1) (in the case of underwriting) the time the firm agrees with the issuer of securities to underwrite those securities; or

(2) (in the case of underwriting falling under BIPRU 7.8.12R (2)) the time the firm agrees with the seller of securities to underwrite those securities; or

(3) (in the case of sub-underwriting) the time the firm agrees with the person referred to BIPRU 7.8.8R (1)(c) to sub-underwrite those securities; or

(4) (in the case of BIPRU 7.8.8R (1)(d)) the time the group or syndicate in question (or a member of that group or syndicate on behalf of the others) agrees with the issuer or other person to whom the commitment is given as referred to in BIPRU 7.8.8R (1)(d) to underwrite or sub-underwrite the securities in question; or

(5) (if the firm at that time has a commitment, whether legally or binding or not) the time the price and allocation of the issue or offer are set.

7.8.14 If a firm has an irrevocable and unfettered right to withdraw from an underwriting commitment, exercisable within a certain period, the commitment commences (and thus the time of initial commitment occurs) when that right expires.
Subject to the existence of a right described in BIPRU 7.8.14 an underwriting commitment commences even if it is subject to formal, legal or other conditions that would normally be expected to be satisfied.

A force majeure or material adverse change clause would not be a right of the sort referred to in BIPRU 7.8.14.

Calculating the net underwriting position

A firm must calculate a net underwriting position by adjusting the gross amount it has committed to underwrite for:

1. any sales or sub-underwriting commitments received that have been confirmed in writing at the time of initial commitment (but excluding any sales in the grey market as defined in BIPRU 7.8.10R (1));

2. any underwriting or sub-underwriting commitments obtained from others since the time of initial commitment;

3. any purchases or sales of the securities since the time of initial commitment (other than purchases or sales in the grey market as defined in BIPRU 7.8.10R (1));

4. (in the case of sales in the grey market as defined in BIPRU 7.8.10R (1)) any sales of the securities as at the time of initial commitment or since the time of initial commitment subject, in both cases, to the following conditions:
   a. any sales of the securities as at the time of initial commitment must be confirmed in writing at the time of initial commitment; and
   b. sales must be net of any purchases in the grey market as defined in BIPRU 7.8.10R (1); and

5. any allocation of securities granted or received, arising from the commitment to underwrite the securities, since the time of initial commitment.

If the allocation of securities has not been fixed a firm must calculate the gross amount of its commitment, for the purposes of BIPRU 7.8.17R, by reference to the maximum amount it has committed to underwrite until the time the allocation is set.

An underwriting commitment may only be reduced under BIPRU 7.8.17R on the basis of a formal agreement.

Allocations may arise, after date of initial commitment, from the agreement to underwrite. For example obligations or rights may be allocated to or from the issuer, the underwriting group or syndicate.
Over-allotment options

7.8.21

(1) This rule deals with the treatment of short positions that arise when a firm commits to distribute securities that it is underwriting in an amount that exceeds the allocation to the firm made by the issuer of the securities being underwritten.

(2) When calculating its net underwriting position, a firm may use an over-allotment option granted to it by the issuer of the securities being underwritten to reduce the short positions in (1).

(3) A firm may also use an over-allotment option granted to another member of the underwriting syndicate for the purpose in (2).

(4) (2) and (3) only apply from working day 0.

(5) (2) and (3) only apply to the extent that the treatment is consistent with the terms of the over-allotment option.

7.8.22

Except as provided in BIPRU 7.8.21R, a firm must not take into account an over-allotment option granted to it or another member of the underwriting syndicate in calculating its net underwriting position.

Working day 0

7.8.23

For the purposes of BIPRU 7.8 working day 0 is the business day on which a firm that is underwriting or sub-underwriting becomes unconditionally committed to accepting a known quantity of securities at a specified price.

7.8.24

For debt issues and securities which are issued in a similar manner, working day 0 is the later of the date on which the securities are allotted and the date on which payment for them is due.

7.8.25

For equity issues and securities which are issued in a similar manner, working day 0 is the later of the date on which the offer becomes closed for subscriptions and the date on which the allocations are made public.

7.8.26

For rights issues, working day 0 is the first day after the date on which the offer becomes closed to acceptances for subscription.

Calculating the reduced net underwriting position

7.8.27

To calculate the reduced net underwriting position a firm must apply the reduction factors in the table in BIPRU 7.8.28R to the net underwriting position (calculated under BIPRU 7.8.17R) as follows:

(1) in respect of debt securities, a firm must calculate two reduced net underwriting positions; one for inclusion in the firm’s interest rate PRR specific risk calculation (BIPRU 7.2.43R), the other for inclusion in its interest rate PRR general market risk calculation (BIPRU 7.2.52R); and
(2) in respect of equities, a firm must calculate only one reduced net underwriting position, and then include it in the simplified equity method (see BIPRU 7.3.29R).

**Table: Net underwriting position reduction factors**

This table belongs to BIPRU 7.8.27R

<table>
<thead>
<tr>
<th>Time of initial commitment until working day 0</th>
<th>Debt</th>
<th>General market risk</th>
<th>Specific risk</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working day 1</td>
<td>0%</td>
<td>100%</td>
<td>90%</td>
<td></td>
</tr>
<tr>
<td>Working day 2</td>
<td>0%</td>
<td>90%</td>
<td>90%</td>
<td></td>
</tr>
<tr>
<td>Working day 3</td>
<td>0%</td>
<td>75%</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Working day 4</td>
<td>0%</td>
<td>75%</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Working day 5</td>
<td>0%</td>
<td>50%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Working day 6 and onwards</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

The table in BIPRU 7.8.30G gives an example of the reduced net underwriting position calculation. The example is based on the firm starting with a commitment to underwrite £100 million of a new equity issue. Firms are reminded that in the case of an equity, the reduced net underwriting position should be treated under the simplified equity method (see BIPRU 7.8.27R (Simplified and standard equity methods) and BIPRU 7.8.27R).

**Table: Example of the reduced net underwriting position calculation**

This table belongs to BIPRU 7.8.29G

<table>
<thead>
<tr>
<th>Time</th>
<th>Net underwriting position (see BIPRU 7.8.17R)</th>
<th>Percentage reduction (see BIPRU 7.8.28R)</th>
<th>Reduced net underwriting position</th>
</tr>
</thead>
<tbody>
<tr>
<td>At initial commitment 9.00am Monday</td>
<td>£100m gross amount is reduced by £20m due to sales\sub-underwriting commitments confirmed in writing at the time of initial commitment (see BIPRU)</td>
<td>90%</td>
<td>£8m</td>
</tr>
</tbody>
</table>
Large exposure risk from underwriting securities: Calculating the net underwriting exposure

For the purposes of calculating the total amount of its *trading book* exposures to a person for concentration risk purposes, a *firm* must include *net underwriting exposure* to that person.

<table>
<thead>
<tr>
<th>Time</th>
<th>Net underwriting position (see BIPRU 7.8.17R)</th>
<th>Percentage reduction (see BIPRU 7.8.28R)</th>
<th>Reduced net underwriting position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Post initial commitment</td>
<td>Remaining £80m is reduced by £40m due to further sales, sub-underwriting commitments obtained and allocations granted (see BIPRU 7.8.17R (2) - (5)).</td>
<td>£40m 90%</td>
<td>£4m</td>
</tr>
<tr>
<td>9.02am Monday</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At the end of working day 1</td>
<td>Remaining £40m is reduced to £20m due to further sales.</td>
<td>£20m 90%</td>
<td>£2m</td>
</tr>
<tr>
<td>End of working day 3</td>
<td>Remaining £20m is reduced to £5m due to further sales.</td>
<td>£5m 75%</td>
<td>£1.25m</td>
</tr>
<tr>
<td>End of working day 4</td>
<td>Remaining £5m is reduced to £2m due to further sales.</td>
<td>£2m 50%</td>
<td>£1m</td>
</tr>
<tr>
<td>End of working day 5</td>
<td>Remaining £2m is reduced to £1m due to further sales.</td>
<td>£1m 25%</td>
<td>£0.75m</td>
</tr>
<tr>
<td>Start of working day 6</td>
<td>Remaining £1m = £1m remaining</td>
<td>£1m 0%</td>
<td>£1m</td>
</tr>
</tbody>
</table>

**Percentage Reduced:**

- **Post initial commitment:** £40m reduced by 90% to £4m
- **At the end of working day 1:** £20m reduced by 90% to £2m
- **End of working day 3:** £5m reduced by 75% to £1.25m
- **End of working day 4:** £2m reduced by 50% to £1m
- **End of working day 5:** £1m reduced by 25% to £0.75m
- **Start of working day 6:** £1m remaining

---

**For the purposes of calculating the total amount of its trading book exposures to a person for concentration risk purposes, a firm must include net underwriting exposure to that person.**
7.8.32  A firm must include any other exposures arising out of underwriting (including any counterparty exposures to any sub-underwriters) for the purposes of calculating the total amount of its trading book exposures to a person for concentration risk purposes.

7.8.33  [deleted]

7.8.34  Except where otherwise specified by a requirement on its Part 4A permission, a firm must calculate the net underwriting exposure to an issuer by applying the relevant reduction factors in the table in \(\text{BIPRU 7.8.35R}\) to its net underwriting position calculated under \(\text{BIPRU 7.8.17R}\).

7.8.35  Table: Calculation of net underwriting exposure

This table belongs to \(\text{BIPRU 7.8.34R}\)

<table>
<thead>
<tr>
<th>Time</th>
<th>Reduction factor to be applied to net underwriting position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial commitment to working day 0</td>
<td>100%</td>
</tr>
<tr>
<td>Working day 0</td>
<td>100%</td>
</tr>
<tr>
<td>Working day 1</td>
<td>90%</td>
</tr>
<tr>
<td>Working day 2</td>
<td>75%</td>
</tr>
<tr>
<td>Working day 3</td>
<td>75%</td>
</tr>
<tr>
<td>Working day 4</td>
<td>50%</td>
</tr>
<tr>
<td>Working day 5</td>
<td>25%</td>
</tr>
<tr>
<td>Working day 6 onwards</td>
<td>0%</td>
</tr>
</tbody>
</table>

The effect of \(\text{BIPRU 7.8.34R}\) is that there is no concentration limit for net underwriting exposures between initial commitment and the end of working day 0, except where specified by a requirement on a firm’s Part 4A permission.

Large exposure risk from underwriting securities: Monitoring and reporting concentration risk

For the purposes of concentration risk monitoring only, a firm must report its net underwriting exposure both before and after the application of the reduction factors in the table in \(\text{BIPRU 7.8.35R}\).

Risk management

A firm must take reasonable steps to establish and maintain such systems and controls to monitor and manage its underwriting and sub-underwriting business as are appropriate to the nature, scale and complexity of its underwriting and sub-underwriting business. In particular, a firm must have systems to monitor and control its underwriting exposures between the time of the initial commitment and working day one in the light of the nature of the risks incurred in the markets in question.
A firm should take reasonable steps to:

1. allocate responsibility for the management of its underwriting and sub-underwriting business;

2. allocate adequate resources to monitor and control its underwriting and sub-underwriting business;

3. satisfy itself that its systems to monitor exposure to counterparties will calculate, revise and update its exposure to each counterparty arising from its underwriting or sub-underwriting business;

4. satisfy itself of the suitability of each person who performs functions for it in connection with the firm’s underwriting and sub-underwriting business having regard to the person’s skill and experience; and

5. satisfy itself that its procedures and controls to monitor and manage its underwriting business address, on an on-going basis, the capacity of sub-underwriters to meet sub-underwriting commitments.
7.9 Use of a CAD 1 model

Introduction

7.9.1 A firm is required under GENPRU 2.1.52 R (Calculation of the market risk capital requirement) to calculate its market risk capital requirement using the rules in BIPRU 7. However, the appropriate regulator may at the firm’s request modify GENPRU 2.1.52 R to allow the firm to calculate all or part of the PRR for the positions covered by that model by using a CAD 1 model (for options risk aggregation and/or interest rate pre-processing) or a VaR model (value at risk model) instead. BIPRU 7.10 (Use of a Value at Risk Model) deals with VaR model permissions.

7.9.2 The purpose of BIPRU 7.9 is to provide guidance on the appropriate regulator’s policy for granting CAD 1 model waivers under section 138A of the Act (Modification or waiver of rules). The policy recognises that CAD 1 models may vary across firms but, as a minimum, the appropriate regulator will need to be satisfied:

(1) about the quality of the internal controls and risk management relating to the model (see BIPRU 7.9.19G - BIPRU 7.9.23G for further details);

(2) about the quality of the model standards; and

(3) that the CAD 1 model captures and produces an accurate measure of the risks inherent in the portfolio covered by the CAD 1 model (see BIPRU 7.9.25G - BIPRU 7.9.53G for further details).

7.9.3 BIPRU 7.9 also explains how the output from the CAD 1 model is fed into the market risk capital requirement calculation.

7.9.4 If a CAD 1 model waiver is granted by the appropriate regulator, the waiver will contain certain requirements. In order adequately to address individual circumstances, these may differ from what is set out in BIPRU 7.9. The waiver will also identify the rules to which the waiver applies and the scope of model recognition granted to the firm.

7.9.5 Waivers permitting the use of models in the calculation of PRR will not be granted if that would be contrary to the CAD. Any waiver which is granted will only be granted on terms that are compatible with the CAD. Accordingly, the only waivers permitting the use of models in calculating PRR
that the appropriate regulator is likely to grant are CAD 1 model waivers and VaR model permissions.

Scope of CAD 1 models

The appropriate regulator recognises two types of CAD 1 model. The table in Section 7.9.6G describes them.

Table: Types of CAD 1 model

<table>
<thead>
<tr>
<th>Options risk aggregation models</th>
<th>Interest rate pre-processing models</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Brief description and eligible instruments</strong></td>
<td><strong>May be used to calculate duration weighted positions for:</strong></td>
</tr>
<tr>
<td>Analyse and aggregate options risks for:</td>
<td>• interest rate futures;</td>
</tr>
<tr>
<td>• interest rate options;</td>
<td>• forward rate agreements (FRAs);</td>
</tr>
<tr>
<td>• equity options;</td>
<td>• forward commitments to buy or sell debt securities;</td>
</tr>
<tr>
<td>• foreign currency options;</td>
<td>• options, swaps or warrants on interest rates or debt securities and options on such swaps;</td>
</tr>
<tr>
<td>• commodity options;</td>
<td>• amortising bonds;</td>
</tr>
<tr>
<td>and</td>
<td>• equity futures, forwards, warrants and options (but only in relation to the interest rate risk inherent in these products); and</td>
</tr>
<tr>
<td>• CIU options.</td>
<td>• foreign currency futures, forwards, swaps and options, but only in relation to the interest rate risk inherent in these products.</td>
</tr>
</tbody>
</table>

The output and how it is used in the PRR calculation

Depending on the type of model and the requirements in the CAD 1 model waiver granted, the outputs from an options risk aggregation model are used as an input to the market risk capital requirement calculation.

Depending on the type of model and the requirements in the CAD 1 model waiver granted, the individual sensitivity figures produced by this type of CAD 1 model are either input into the calculation of interest rate PRR under the interest rate duration method (see BIPRU 7.2.63R) or are converted into notional position and input into the calculation of interest rate PRR under the interest rate maturity method (see BIPRU 7.2.59R).
Currently the appropriate regulator only envisages allowing recognition for options on CIUs if the CIU satisfies one of the following conditions:

1. it is a regulated collective investment scheme; or
2. the firm can demonstrate that it has characteristics that are similar to or better than an undertaking in (1) from the point of view of transparency and liquidity.

The CAD 1 model waiver application and review process

Details of the general waiver process are set out in SUP 8 (Waiver and modification of rules). Further details of the waiver process applicable to certain waivers relating to BIPRU (including CAD 1 model waivers) can be found in BIPRU 1.3 (Applications for advanced approaches). Because of the complexity of a CAD 1 model waiver, it is recommended that, as set out in SUP 8.3.4 G and BIPRU 1.3.21 G, a firm contact its usual contact at the appropriate regulator to discuss its proposed application. It should also be noted that the waiver recognition process in the case of a CAD 1 model may take longer than the timescales indicated in SUP 8.3.5 G.

In order to consider a CAD 1 model waiver request, the appropriate regulator may undertake a review to ensure that it is adequate and appropriate for the PRR calculation.

The model review process may be conducted through a series of visits covering various aspects of the firm’s control and IT environment. Before these visits the appropriate regulator may ask the firm to provide some information relating to its waiver request accompanied by some specified background material. The model review visits are organised on a timetable that allows a firm being visited sufficient time to arrange the visit and provide the appropriate pre-visit information.

As part of the model review process, the following may be reviewed: organisational structure and personnel; details of the firm’s market position in the relevant products; profit and risk information; valuation and reserving policies; operational controls; IT systems; model release and control procedures; risk management and control framework; risk appetite and limit structure and future developments relevant to model recognition.

The appropriate regulator will normally require meetings with senior management and staff from the front office, financial control, risk management, operations, systems development, information technology and audit areas.

A review by a skilled person may be used before a CAD 1 model waiver is granted to supplement the waiver process or after the waiver has been granted to review the CAD 1 model.

If the appropriate regulator grants a CAD 1 model waiver, the waiver direction will specify the particular rule which has been modified, and set...
out the requirements subject to which the waiver has been granted. These requirements may include:

(1) the details of the calculation of PRF;
(2) the CAD 1 model waiver methodology to be employed;
(3) the products covered by the model (e.g. option type, maturity, currency); and
(4) any notification requirements relating to the CAD 1 model waiver.

Where a firm operates any part of its CAD 1 model outside the United Kingdom, the appropriate regulator may take into account the results of any review of that model carried out by any overseas regulator concerned. The appropriate regulator may wish to receive information directly from that regulator.

Maintenance of model recognition

No changes should be made to a CAD 1 model unless the change is not material. Material changes to a CAD 1 model will require a renewed waiver to be issued. Materiality is measured from the time that the waiver is granted or, if the waiver has been varied in accordance with section 138A of the Act, any later time that may be specified in the waiver for these purposes. If a firm is considering making material changes to its CAD 1 model, then it should notify the appropriate regulator at once. If a firm wishes to change the products covered by the model it should apply for a variation of its CAD 1 model waiver.

If the CAD 1 model ceases to meet the requirements of the waiver, the firm should notify the appropriate regulator at once. The appropriate regulator may then revoke the waiver unless it is varied in accordance with section 138A of the Act. If the CAD 1 model waiver contains conditions it is a condition of using the CAD 1 model approach that the firm should continue to comply with those conditions.

Risk management standards

A firm with a complex portfolio is expected to demonstrate more sophistication in its modelling and risk management than a firm with a simple portfolio.

A firm should be able to demonstrate that the risk management standards set out in BIPRU 7.9 are satisfied by each legal entity with respect to which the CAD 1 model approach is being used (even though they are expressed to refer only to a firm). This is particularly important for subsidiary undertakings in groups subject to matrix management where the business lines cut across legal entity boundaries.

(1) A firm should have a conceptually sound risk management system which is implemented with integrity and should meet the minimum standards set out in this paragraph.
(2) A firm should have a risk control unit that is independent of business trading units and reports directly to senior management. The unit should be responsible for designing and implementing the firm’s risk management system. It should produce and analyse daily reports on the risks run by the business and on the appropriate measures to be taken in terms of the trading limits.

(3) A firm’s senior management should be actively involved in the risk control process and the daily reports produced by the risk control unit should be reviewed by a level of management with sufficient authority to enforce reductions of positions taken by individual traders as well as in the firm’s overall risk exposure.

(4) The risk control group should have a sufficient number of staff with appropriate skills in the use of models.

(5) A firm should have established procedures for monitoring and ensuring compliance with a documented set of appropriate internal policies and controls concerning the overall operation of the risk measurement and control framework. This should take into account the front, middle and back office functions.

(6) A firm should conduct, as part of its regular internal audit process, a review of the systems and controls relating to its CAD 1 model. This review should include the valuation process, compliance with the CAD 1 model waiver’s scope and the activities of the business trading units and the risk control units. This review should be undertaken by staff independent of the areas being reviewed.

7.9.22 In assessing whether the risk management and control framework is implemented with integrity, the appropriate regulator will consider the IT systems used to run the CAD 1 model and associated calculations. The assessment will include, where appropriate:

(1) feeder systems; risk aggregation systems; the integrity of the data (i.e. whether it is complete, coherent and correct); reconciliations and checks on completeness of capture; and

(2) system development, change control and documentation; security and audit trails; system availability and contingency procedures; network adequacy.

7.9.23 A firm should take appropriate steps to ensure that it has adequate controls relating to:

(1) the derivation of the PRR from the CAD 1 model output;

(2) CAD 1 model development, including independent validation;

(3) reserving;

(4) valuation (see GENPRU 1.3 (Valuation)), including independent validation; and

(5) the adequacy of the IT infrastructure.
Model standards

7.9.24 G A firm should take appropriate steps to ensure that its CAD 1 model captures and produces an accurate measure of the risks inherent in the portfolio covered by the CAD 1 model. These risks may include, but are not limited to, gamma, vega and rho.

Options risk aggregation models

7.9.25 G For a firm to obtain a CAD 1 model waiver for its options risk aggregation model, it should have in place an appropriate options valuation model.

7.9.26 G The appropriate regulator does not specify the methodology that a firm should employ in order to produce the appropriate outputs from its options risk aggregation CAD 1 model. However, ■ BIPRU 7.9.27G - ■ BIPRU 7.9.43G provide details of how a firm could meet the requirement to capture gamma, vega and rho risks using a scenario matrix approach. Where a firm adopts the scenario matrix approach then the standards set out in ■ BIPRU 7.9.27G - ■ BIPRU 7.9.43G should be followed. The firm should also take into account other risks not captured by the scenario matrix approach. If a firm does not use the scenario matrix approach it should use an equivalent methodology. If a firm uses an equivalent methodology it should be able to demonstrate that the approach used meets the requirements of ■ BIPRU 7.9.

7.9.27 G A scenario matrix is an approach by which an options portfolio is revalued given a number of simultaneous shifts in both the spot level of the underlying and the implied volatility.

7.9.28 G The scenario matrix approach may be employed for all types of options on all types of underlying asset.

7.9.29 G (1) This paragraph provides an outline of the initial steps to be taken when using the scenario matrix approach.

(2) A value for an option should be obtained using the firm’s options valuation model.

(3) The inputs into the options valuation model for implied volatility of the underlying asset and the price of the underlying asset should then be altered so that a new value for the option is obtained (details of the amount by which the implied volatility and the price of the underlying should be amended are set out in ■ BIPRU 7.9.30G - ■ BIPRU 7.9.36G).

(4) The difference between the original value of the option and the new value obtained following the alterations should be input into the appropriate cell in the matrix. The value in the central cell where there is no change in implied volatility or price of the underlying should therefore be zero.

(5) The process of obtaining a new price for the option should be repeated until the matrix is completed.
The alteration to the implied volatility (known as the implied volatility shift) referred to in BIPRU 7.9.29G (3) may be a proportional shift. The size of the shift depends on the remaining life of the option and the asset class of the underlying. The table in BIPRU 7.9.32G sets out the shifts that should be applied where a proportional shift is used. Alternatively, a firm may use a single shift across all maturities or use an absolute rather than a proportional implied volatility shift. Where a single shift or an absolute shift is used it should be at least as conservative as the proportional shifts. Any use of a single shift or an absolute shift should be reviewed and, if necessary, updated, on a regular basis.

A firm may choose to use a less detailed term structure than that in the table in BIPRU 7.9.32G, but the shifts used should be no less conservative than those set out in that table. For example, a firm that uses one <3 month band, rather than the two bands (≤ 1 month and 1-3 months) set out in the table, should use the most conservative shift set out in the table for the bands covered. In this example that shift is 30%.

The size of the underlying price/rate shift depends on the asset class of the underlying as referred to in BIPRU 7.9.29G (3) and is set out in the table in BIPRU 7.9.34G.

<table>
<thead>
<tr>
<th>Remaining life of option</th>
<th>Proportional shift</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equities, foreign currency and commodities</td>
</tr>
<tr>
<td>≤ 1 month</td>
<td>30%</td>
</tr>
<tr>
<td>&gt; 1 ≤ 3 months</td>
<td>20%</td>
</tr>
<tr>
<td>&gt; 3 ≤ 6 months</td>
<td>15%</td>
</tr>
<tr>
<td>&gt; 6 ≤ 9 months</td>
<td>12%</td>
</tr>
<tr>
<td>&gt; 9 ≤ 12 months</td>
<td>9%</td>
</tr>
<tr>
<td>&gt; 1 ≤ 2 years</td>
<td>6%</td>
</tr>
<tr>
<td>&gt; 2 ≤ 4 years</td>
<td>4.5%</td>
</tr>
<tr>
<td>&gt; 4 years</td>
<td>3%</td>
</tr>
</tbody>
</table>

The underlying price/rate shifts depend on the asset class of the underlying as referred to in BIPRU 7.9.29G (3) and are set out in the table in BIPRU 7.9.33G.

<table>
<thead>
<tr>
<th>Underlying asset class</th>
<th>Shift</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>±8%</td>
</tr>
<tr>
<td>Foreign currency</td>
<td>±8%</td>
</tr>
<tr>
<td>Commodities</td>
<td>±15%, (but a firm may use the percentages applicable under the commodity extended maturity ladder approach if it would qualify under BIPRU 7.4 (Commodity PRR) to use that approach).</td>
</tr>
</tbody>
</table>
### Underlying asset class and Shift

<table>
<thead>
<tr>
<th>Underlying asset class</th>
<th>Shift</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rates</td>
<td>±100bp (but a <strong>firm</strong> may use the sliding scale of shifts by maturity as applicable to the <strong>interest rate duration method</strong>).</td>
</tr>
<tr>
<td>CIU</td>
<td>±32%, (but a <strong>firm</strong> may use the percentages applicable to the underlyings if the <strong>firm</strong> applies one of the <strong>CIU look through methods</strong> under <strong>BIPRU 7.7</strong> (Position risk requirements for collective investment undertakings)).</td>
</tr>
</tbody>
</table>

---

#### 7.9.35
The shifts outlined in the table in **BIPRU 7.9.34G** are the maximum shifts required; in addition there will be a number of intermediate shifts as a result of the minimum matrix size criteria set out in **BIPRU 7.9.36G**.

#### 7.9.36
The minimum size of the scenario matrix should be 3x7, that is, three observations for implied volatility (including the actual implied volatility) and seven observations for the price of the underlying (including the actual price of the underlying). A **firm** should be able to justify its choice of granularity. Greater granularity may be required where the portfolio contains, for example, a large proportion of barrier options.

#### 7.9.37
(1) A different scenario matrix should be set up for each underlying asset type in accordance with this paragraph.

(2) For **equities** (including single **equities**, baskets and indices) there should be a separate matrix for each national market or non-decomposed basket or non-decomposed multi-national index.

(3) For **foreign currency** products there should be a separate matrix for each currency pair where appropriate.

(4) For **commodity** products there should be a separate matrix for each **commodity**. The question whether two items are the same **commodity** should be decided in accordance with **BIPRU 7.4** (Commodity PRR).

(5) For interest rate products there should be a separate matrix for each currency. In addition, a **firm** should not offset the gamma and vega exposures (except in the circumstances set out in **BIPRU 7.9.38G** arising from any one of the following types of product with the gamma and vega exposures arising from any of the other products in the list:

   (a) swaptions (**options** on interest rates);

   (b) interest rate **options** (including **options** on exchange-traded deposit or bill **futures**);

   (c) bond **options** (including **options** on exchange-traded bond **futures**); and

   (d) other types of **options** required by the **CAD 1** model **waiver** to form their own separate class of underlying asset.
(6) The other types of options referred to in (5)(d) will generally be exotic options that do not fall easily into (5)(a) - (c)).

(7) For CIUs there should be a separate matrix for each CIU fund. If the firm applies one of the CIU look through methods under BIPRU 7.7 (Position risk requirements for collective investment undertakings), then (1) - (6) apply based on what the underlyings are.

7.9.38 A firm may offset gamma and vega exposures arising from the products listed in BIPRU 7.9.37G (5) where it can demonstrate that it trades different types of interest rate-related options as a portfolio and takes steps to control the basis risk between different types of implied volatility. To the extent that this is the case an individual matrix is not required for each of the products listed in BIPRU 7.9.37G (5) and a combined scenario matrix may be used.

7.9.39 Where it is imprudent fully to offset long-dated and short-dated vega exposure owing to the risk of non-parallel shifts in the yield curve, a firm should use an appropriate number of scenario matrices to take account of non-parallel shifts in the yield curve according to the maturity of the option or underlying.

7.9.40 Following the steps outlined in BIPRU 7.9.29G, a firm then removes the portion of the values in the matrix that can be attributed to the effect that delta has had on the change in the value of the option (a process known as delta-stripping).

7.9.41 Once the effect of delta has been removed from the matrix, the values left in the matrix relate to gamma and vega risk. A firm's PRR in relation to gamma and vega risk on the individual option is the absolute of the most negative cell in the scenario matrix produced. Where all cells are positive the PRR is zero. The total PRR for the gamma and vega risk on the portfolio of options is a simple sum of the individual requirements. This amount should then be fed into a firm's PRR calculation.

7.9.42 The values that have been obtained for the delta-equivalent positions of instruments included in the scenario matrix should then be treated in the same way as positions in the underlying. Where the delta obtained relates to interest rate position risk, the delta equivalent positions may be fed into the firm's interest rate pre-processing model to the extent that the positions fall within the scope of interest rate pre-processing models as set out in BIPRU 7.9.7G and provided that the firm's CAD 1 model waiver allows the firm's CAD 1 model to be used in this way. Alternatively, the delta obtained should be fed into the standard PRR calculations in BIPRU 7.2 (Interest rate PRR), BIPRU 7.3 (Equity PRR and basic interest rate PRR for equity derivatives), BIPRU 7.4 (Commodity PRR) or BIPRU 7.5 (Foreign currency PRR) as appropriate.

7.9.43 In using the scenario matrix approach, none of the steps followed will take specific account of a firm's exposure to rho risk. Where a firm can demonstrate that for interest rate-related options the rho sensitivity is effectively included in the delta sensitivities produced, there is no separate capital requirement relating to rho. For all other options except commodity
options, a firm should calculate a rho sensitivity ladder by currency using its CAD 1 model and either feed this into the interest rate maturity method or interest rate duration method calculation or, where the firm’s CAD 1 model waiver allows the firm’s CAD 1 model to be used in this way, feed that ladder into an interest rate pre-processing model. Generally a CAD 1 model does not need to deal specifically with rho risk for commodity options.

**Interest rate pre-processing models**

7.9.44 G To the extent that a firm’s CAD 1 model waiver is for the use of an interest rate pre-processing model the firm should use it for the pre-processing of the instruments set out in §BIPRU 7.9.7G, from which the residual positions are fed into the interest rate maturity method or interest rate duration method calculation.

7.9.45 G There are a number of different methods of constructing pre-processing models but all should comply with §BIPRU 7.9.45G - §BIPRU 7.9.53G. All pre-processing models should generate positions that have the same sensitivity to defined interest rate changes as the underlying cash flows.

7.9.46 G In an interest rate pre-processing model each transaction is converted into its constituent cash flows. The cash flows are discounted using zero coupon rates derived from the firm’s own yield curves.

7.9.47 G The cash flows are then calculated again using the firm’s own yield curve shifted by the amount set out in §BIPRU 7.9.49G.

7.9.48 G The difference between the present values calculated using the firm’s own yield curve and those calculated using the firm’s curve shifted under §BIPRU 7.9.47G are known as the sensitivity figures. Alternatively, a firm may shift the yield curve by one basis point and multiply up the sensitivity figures by the appropriate amount in order to achieve the shifts set out in §BIPRU 7.9.47G. These sensitivity figures are then allocated to each of the 15 maturity bands set out in §BIPRU 7.9.49G.

7.9.49 G Table: yield curve shifts

This table belongs to §BIPRU 7.9.47G

<table>
<thead>
<tr>
<th>Zone</th>
<th>Modified duration</th>
<th>Assumed interest rate change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0 ≤ 1 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 3 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 3 ≤ 6 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 6 ≤ 12 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>1.0 ≤ 1.9 years</td>
<td>0.90</td>
</tr>
<tr>
<td></td>
<td>&gt; 1.9 ≤ 2.8 years</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>&gt; 2.8 ≤ 3.6 years</td>
<td>0.85</td>
</tr>
<tr>
<td>2</td>
<td>&gt; 3.6 ≤ 4.3 years</td>
<td>0.75</td>
</tr>
</tbody>
</table>

Table: yield curve shifts

This table belongs to §BIPRU 7.9.47G

<table>
<thead>
<tr>
<th>Zone</th>
<th>Modified duration</th>
<th>Assumed interest rate change (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0 ≤ 1 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 ≤ 3 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 3 ≤ 6 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>&gt; 6 ≤ 12 months</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>1.0 ≤ 1.9 years</td>
<td>0.90</td>
</tr>
<tr>
<td></td>
<td>&gt; 1.9 ≤ 2.8 years</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>&gt; 2.8 ≤ 3.6 years</td>
<td>0.85</td>
</tr>
<tr>
<td>2</td>
<td>&gt; 3.6 ≤ 4.3 years</td>
<td>0.75</td>
</tr>
</tbody>
</table>
7.9.50 Sensitivity figures calculated by a firm using an interest rate pre-processing model are usually produced in the format of a net sensitivity by maturity bucket or by discrete gridpoint. These maturity buckets or gridpoints should then be allocated to the 15 bands set out in BIPRU 7.9.49G. The number of maturity buckets or gridpoints used to represent a yield curve can be referred to as granularity. The granularity should always be adequate to capture the material curve risk in the portfolio. Curve risk can be defined as the risk associated with holding long and short positions at different points along the yield curve.

7.9.51 Positive and negative amounts placed in each of the different maturity bands in BIPRU 7.9.49G under the sensitivity calculation in BIPRU 7.9.50G should then be netted off to produce one figure for each of the bands. There is no capital requirement for this netting process.

7.9.52 The individual sensitivity figures produced should then be input into the interest rate duration method calculation. The individual sensitivity figures for each band should be included with the other positions in the appropriate column in the table in BIPRU 7.2.65R (Table: Assumed interest rate change in the interest rate duration method).

7.9.53 Instead of using the approach in BIPRU 7.9.52G a firm may use an approach based on the interest rate maturity method, making appropriate adjustments to the sensitivity figures.
7.10 Use of a Value at Risk Model

Application

7.10.1 BIPRU 7.10 applies to a firm with a VaR model permission.

Introduction and purpose

7.10.2 BIPRU 7.10 provides details of when the appropriate regulator expects to allow a firm to use a VaR model (value at risk model) for the purpose of calculating part or all of its PRR. It introduces the concept of a VaR model, the methodology behind it and the link to the standard market risk PRR rules. It then goes on to detail the application and review process. The bulk of BIPRU 7.10 specifies the model standards and risk management standards that firms will be required to meet in order to use a VaR model. It further stipulates requirements for stress testing, backtesting, capital calculations and finally the reporting standards expected by the appropriate regulator.

7.10.3 The models described in BIPRU 7.10 are described as VaR models in order to distinguish them from CAD 1 models, which are dealt with in BIPRU 7.9 (Use of a CAD 1 model). A VaR model is a risk management model which uses a statistical measure to predict profit and loss movement ranges with a confidence interval. From these results PRR charges can be calculated. The standards described in BIPRU 7.10, and which will be applied by the appropriate regulator, are based on and implement Annex V of the Capital Adequacy Directive.

7.10.4 The aim of the VaR model approach is to enable a firm with adequate risk management systems to be subject to a PRR requirement that is more closely aligned with the risks to which it is subject than the PRR requirements generated by the standard market risk PRR rules. This provides a firm with an incentive to measure market risks as accurately and comprehensively as possible. It is crucial that those responsible for managing market risk at a firm should be aware of the assumptions and limitations of the firm’s VaR model.

7.10.5 There are a number of general methodologies for calculating PRR using a VaR model. The appropriate regulator does not prescribe any one method of computing VaR measures. Moreover, it does not wish to discourage any firm from developing alternative risk measurement techniques. A firm should discuss the use of any alternative techniques used to calculate PRR with the appropriate regulator.
A firm should not use the VaR model approach to calculate PRR unless it has a VaR model permission. If a firm does not have such a permission it should use the standard market risk PRR rules. Therefore, a firm needs to apply for a VaR model permission in order to calculate its PRR using a VaR model instead of (or in combination with) the standard market risk PRR rules.

**Conditions for granting a VaR model permission**

A waiver or other permission allowing the use of models in the calculation of PRR will not be granted if that would be contrary to the Capital Adequacy Directive and any VaR model permission which is granted will only be granted on terms that are compatible with the Capital Adequacy Directive. Accordingly, the appropriate regulator is likely only to grant a waiver or other permission allowing the use of models in the calculation of PRR if it is a VaR model permission or a CAD 1 model waiver.

BIPRU 7.10 sets out the minimum standards that the appropriate regulator expects firms to meet before granting a VaR model permission. The appropriate regulator will not grant a VaR model permission unless it is satisfied that the requirements of BIPRU 7.10 are met and it is satisfied about the procedures in place at a firm to calculate the model PRR. In particular the appropriate regulator will not normally grant a VaR model permission unless it is satisfied about the quality of:

1. the internal controls and risk management relating to the VaR model (see BIPRU 7.10.56G - BIPRU 7.10.82R);

2. the VaR model standards (see BIPRU 7.10.24R - BIPRU 7.10.55G); and

3. stress testing and backtesting procedures relating to a VaR model (see, in addition to (2), BIPRU 7.10.83R - BIPRU 7.10.112G).

The appropriate regulator recognises that the nature of VaR models will vary between firms. The scope of and the requirements and conditions set out in a VaR model permission may therefore differ in substance or detail from BIPRU 7.10 in order to address individual circumstances adequately. However any differences will only be allowed if they are compliant with the Capital Adequacy Directive. A VaR model permission will implement any such variation by modifying BIPRU 7.10. A VaR model permission may also include additional conditions to meet the particular circumstances of the firm or the model.

**The VaR model permission application and review process**

Details of the general process for applying for a VaR model permission are set out in BIPRU 1.3 (Applications for advanced approaches). Because of the complexity of a VaR model permission, it is recommended that a firm discuss its proposed application with its usual contact at the appropriate regulator before it makes the application.

In order for a VaR model permission to be granted, the appropriate regulator is likely to undertake a review to ensure that it is adequate and appropriate for the PRR calculation.
The VaR model review process may be conducted through a series of visits covering various aspects of a firm’s control and IT environment. Before these visits the appropriate regulator may ask the firm to provide some information relating to the firm’s VaR model permission request accompanied by some specified background material. The VaR model review visits are organised on a timetable that allows the firm being visited sufficient time to arrange the visit and provide the appropriate pre-visit information.

As part of the process for dealing with an application for a VaR model permission the following may be reviewed: organisational structure and personnel; details of the firm’s market position in the relevant products; revenue and risk information; valuation and reserving policies; operational controls; information technology systems; model release and control procedures; risk management and control framework; risk appetite and limit structure; future developments relevant to model recognition.

A visit will usually involve the appropriate regulator wishing to meet senior management and staff from the front office, financial control, risk management, operations, systems development, information technology and internal audit areas.

The appropriate regulator may complement its own review of a VaR model permission request with one or more reviews by a skilled person under section 166 of the Act (Reports by skilled persons). Such a review may also be used where a VaR model permission has been granted to ensure that the requirements and of the VaR model permission continue to be met.

Conditions for a VaR model outside the United Kingdom

Where a VaR model used outside the United Kingdom differs from that used in the United Kingdom the appropriate regulator may request details of the reasons for using different models.

Where a firm operates any part of its VaR model outside the United Kingdom, the appropriate regulator may take into account the results of the home supervisor’s review of that model. The appropriate regulator may wish to receive information directly from the home supervisor.

Scope of VaR models

A firm must use the VaR model approach to calculate the PRR for a position:

(1) to the extent that the risks in relation to that position are within the scope of the VaR model permission (see BIPRU 7.10.136R (Link to standard PRR rules: Incorporation of the model output into the capital calculation)); and

(2) if the position is of a type that comes within the scope of the VaR model permission.
In accordance with §BIPRU 7.10.18R (1) a VaR model permission will set out the risk categories that it covers, which are expected to be one or more of the following types:

1. interest rate general market risk;
2. interest rate specific risk (in conjunction with interest rate general market risk);
3. equity general market risk;
4. equity specific risk (in conjunction with equity general market risk);
5. CIU risk;
6. foreign currency risk; and
7. commodity risk.

A VaR model permission will generally set out the broad classes of position within its scope. It may also specify how individual products within one of those broad classes may be brought into or taken out of the scope of the VaR model permission.

The broad classes of position referred to in §BIPRU 7.10.20G are as follows:

1. linear products, which comprise securities with linear pay-offs (e.g. bonds and equities) and derivative products which have linear pay-offs in the underlying risk factor (e.g. interest rate swaps, FRAs, total return swaps);
2. European, American and Bermudan put and call options (including caps, floors and swaptions) and investments with these features (see §BIPRU 7.6.18R (Table: Option PRR: methods for different types of option) for an explanation of some of these terms);
3. Asian options, digital options, single barrier options, double barrier options, forward starting options, compound options and investments with these features (see §BIPRU 7.6.18R for an explanation of some of these terms); and
4. all other option based products (e.g. basket options, quantos, outperformance options, timing options) and investments with these features (see §BIPRU 7.6.18R for an explanation of some of these terms).

The categorisation described in §BIPRU 7.10.21G may be amended or replaced in the case of a particular firm’s VaR model permission.

It is the appropriate regulator’s view that, where a firm uses a VaR model for one risk category as described in §BIPRU 7.10.19G, it is good practice to extend its model over time to calculate all of its PRR risk categories. A firm will typically be expected to have a realistic plan in place to do this.
Model standards: General

7.10.24 **R** A firm must comply with the minimum standards set out in BIPRU 7.10.26R - BIPRU 7.10.53R in calculating the model PRR.

7.10.25 **G** The appropriate regulator accepts that the scope and nature of VaR models varies across firms. This means that different firms are likely to calculate different estimates of market risk for the same portfolio. Systematic differences are due to length of data series, choice of methodology (historical or Monte Carlo simulation or variance-covariance method or a hybrid of these), differences in aggregating risks within and across broad risk factors, the treatment of options and other non-linear products and the specification of risk factors.

Model standards: Frequency of calculations and confidence level

7.10.26 **R** The model PRR must be computed at least once every business day, using a 99% one-tailed confidence limit.

7.10.27 **G** A firm may meet the requirement in BIPRU 7.10.26R by using different model parameters and employing a suitable adjustment mechanism to produce a figure which is equivalent to the figure produced using the parameters set out in BIPRU 7.10.26R. For example, a firm’s model may use a 95% one-tailed confidence limit if the firm has a mechanism to convert the output of the model to reflect a 99% one-tailed confidence limit.

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

Model standards: Holding period

7.10.28 **R** In calculating the VaR number, a firm must either use a ten business day holding period, or use a holding period converted to a ten business day holding period. However if the firm’s VaR model permission specifies that the firm must use a specific method, the firm must do so.

7.10.29 **G** If a firm uses a holding period other than 10 business days and converts the resulting VaR measure to a ten business day equivalent measure, it should be able to justify the choice of conversion technique. For example, the square root of time method will usually be justifiable. The appropriate regulator considers it good practice ultimately to move towards the application of an actual ten business day holding period, rather than using different holding periods.

Model standards: Observation period

7.10.30 **R** Subject to BIPRU 7.10.31R, the calculation of VaR numbers must be based on an effective historical observation period that is the longest possible consistent with a prudent VaR number. That period must be at least one year or such longer period as may be set out in the firm’s VaR model permission. However if using that prescribed observation period does not result in a sufficiently prudent way of calculating a VaR measure or a component of a
VaR measure the firm must shorten this observation period until the observation period is consistent with a prudent VaR number.

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

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

Model standards: Data series

7.10.31 A firm must ensure that the data series used by its VaR model is reliable. Where a reliable data series is not available, proxies or any other reasonable value-at-risk measurement technique must be used. A firm must be able to demonstrate that the technique is appropriate and does not materially understate the modelled risks.

7.10.32 A data series is unreliable if it has, for example, missing data points, or data points which contain stale data. Reliable data series may be difficult to obtain for new products (for example an instrument of longer dated tenor that did not previously trade) and for less liquid risk factors or positions. With regard to less liquid risk factors or positions, a firm may use a combination of prudent valuation techniques and alternative VaR estimation techniques to ensure there is a sufficient cushion against risk over the close out period which takes account of the illiquidity of the risk factor or position.

7.10.33 (1) If a weighting scheme or other similar method is used to calculate VaR numbers, then the effective observation period must be at least one year. Where a weighting scheme is used, the weighted average time lag of the individual observations must not be less than six Months.

(2) If a specific observation period or weighted average time lag is specified in a firm’s VaR model permission, the firm must comply with that if it is longer than the period specified in (1).

(3) However, if a weighting scheme in (1) or (2) would result in imprudent VaR numbers then the weighting scheme must be adjusted so that it is consistent with a prudent VaR number.

7.10.34 A firm must update data sets in accordance with the frequency set out in its VaR model permission. If volatility in market prices or rates necessitates more frequent updating in order to ensure a prudent calculation of the VaR measure the firm must do so.

7.10.35 The minimum updating frequency for the current VaR measure that can be specified in a VaR model permission is monthly.
Model standards: Aggregation across risk categories

7.10.36 R The process for determining and implementing correlations within and across risk categories must be sound, implemented with integrity and consistent with the terms of the firm’s VaR model permission.

7.10.37 R In aggregating VaR measures across risk or product categories, a firm must not use the square root of the sum of the squares approach unless the assumption of zero correlation between these categories is empirically justified. If correlations between risk categories are not empirically justified, the VaR measures for each category must simply be added in order to determine its aggregate VaR measure. But to the extent that a firm’s VaR model permission provides for a different way of aggregating VaR measures:

1. that method applies instead of this rule; and
2. if the correlations between risk categories used for that purpose cease to be empirically justified then the firm must notify the appropriate regulator at once.

Model standards: Risk factors: Introduction

7.10.38 G Subject to [BIPRU 7.10.53R](Model standards: Materiality), a VaR model should capture and accurately reflect all material risks arising on the underlying portfolio on a continuing basis insofar as those risks are within the scope of the VaR model permission. This should encompass general market risk and, to the extent that this comes within the scope of the VaR model permission, specific risk. A firm should ensure that the VaR model has sufficient risk factor granularity to be able to capture all such material risks and that these are properly documented and specified.

Model standards: Risk factors: General

7.10.39 R In the case of general market risk and risks with respect to which the standard market risk PRR rules do not distinguish between general market risk and specific risk, a firm’s VaR model must capture a sufficient number of risk factors in relation to the level of activity of the firm and in particular the risks set out in [BIPRU 7.10.40R - BIPRU 7.10.44R](Model standards: Materiality).

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

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

7.10.40 R For interest rate risk, a VaR model must incorporate a set of risk factors corresponding to the interest rate curves in each currency in which the firm has interest rate sensitive positions. A firm must ensure that it captures the
variations of volatility of rates along the yield curve. In order to achieve this, a firm must divide the yield curves of, at a minimum, the major currencies and markets in which it has material interest rate exposures into a minimum of six maturity segments. The VaR model must also capture the risk of less than perfectly correlated movements between different yield curves.

7.10.41 R For equity risk, a VaR model must use a separate risk factor at least for each of the equity markets in which the firm has material positions.

7.10.42 R For foreign currency risk, a VaR model must incorporate risk factors corresponding to the individual foreign currencies, including gold, in which the firm’s positions are denominated.

7.10.43 R For commodity risk, the VaR model must use a separate risk factor at least for each commodity in which the firm has material positions. The VaR model must also capture the risk of less than perfectly correlated movements between similar, but not identical, commodities and the exposure to changes in forward prices arising from maturity mismatches. It must also take account of market characteristics, notably delivery dates and the scope provided to traders to close out positions.

7.10.44 R (1) For CIUs the actual foreign currency positions of the CIU must be taken into account.

(2) A firm may rely on third party reporting of the foreign currency position of the CIU, where the correctness of this report is adequately ensured.

(3) If a firm is not aware of the foreign currency positions in a CIU, this position must be carved out and treated in BIPRU 7.5.18R (Derivation of notional positions in CIUs for the foreign currency PRR).

7.10.45 G (1) This paragraph contains guidance on the inclusion of CIUs in a VaR model.

(2) The appropriate regulator may allow all types of CIU to be included within the scope of a firm’s VaR model permission.

(3) BIPRU 7.10 does not distinguish between specific risk and general market risk for positions in CIUs. Therefore even if specific risk is not otherwise included within the scope of a firm’s VaR model permission, a firm should be able to demonstrate that its VaR model captures specific risk.

(4) A firm should also be able to demonstrate that its VaR model adequately captures correlations, concentration risk and risks associated with the illiquidity of the CIU itself should this be deemed necessary (see BIPRU 7.10.32G).

(5) A firm may use a look-through approach, under which the VaR model estimates are based on the underlying positions. If a firm uses a look through approach it should also ensure that all the relevant risk factors relating to the underlying positions are captured. BIPRU 7.7
(Position risk requirements for collective investment undertakings) sets out rules relating to the look through approach when a firm is using the VaR model approach.

**Model standards: Risk factors: Specific risk**

7.10.46 If a firm's VaR model covers the calculation of PRR with respect to specific risk the firm must meet the VaR specific risk minimum requirements in addition to the other requirements of BIPRU 7.10.

(2) The VaR model must explain the historical price variation in the portfolios concerned.

(3) The VaR model must capture concentration in terms of magnitude and changes of composition of the portfolios concerned.

(4) The VaR model must be robust to an adverse environment.

(5) The VaR model must capture name-related basis risk. That is the firm must be able to demonstrate that the VaR model is sensitive to material idiosyncratic differences between similar but not identical positions.

(6) The VaR model must capture event risk.

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

(8) [deleted]

7.10.47 This paragraph provides guidance on BIPRU 7.10.46 R (2). Take as an example a VaR model based on a factor model or on a historical simulation model. The ability of the model to explain price variation could be demonstrated by a statistical comparison over the same period of time between actual price changes on the portfolio and the profit and loss impact of risk factors included within the model. A firm may wish to include an estimate of residual variation not explained by the model.

7.10.48 A firm's VaR model must conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios. In addition, the VaR model must meet minimum data standards. Proxies must be appropriately conservative and may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio.

7.10.49 As techniques and best practices evolve, a firm must avail itself of these advances.
Model standards: Materiality

A firm’s VaR model must capture accurately all material price risks for positions within the scope of its VaR permission, including risks relating to options or option-like positions. The firm must ensure that, if its VaR model does not accurately capture any material risk, the firm has capital resources adequate to cover that risk. These capital resources must be additional to those required to meet its capital resources requirement.

For example, BIPRU 7.10.53R might involve creating and documenting a prudent incremental PRR charge for the risk not captured in the VaR model and holding sufficient capital resources against this risk. In that case the firm should hold capital resources at least equal to its capital resources requirement as increased by adding this incremental charge to the model PRR. Alternatively the firm may make valuation adjustments through its profit and loss reserves to cover this material risk. These reserves should be transparent to senior management and auditable. The reserves should also be consistent with GENPRU 1.3 (Valuation) while not being excessive in relation to the principles of mark-to-market accounting. Therefore, a firm should be able to satisfy the appropriate regulator that all material risks are adequately addressed, whether this be through the VaR model, through taking an incremental PRR charge or through making an adjustment through profit and loss reserves.

A firm is expected ultimately to move towards full revaluation of option positions. For portfolios containing path dependent options, an instantaneous price shock applied to a static portfolio will be acceptable provided that the risks not captured by such an approach are not material. Where a risk is immaterial and does not justify further capital resources, that immaterial risk should still be documented.

Incremental risk charge: Scope and parameters

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

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

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

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

7.10.55E  The firm's approach must be based on the assumption of a constant level of risk over the one-year capital horizon, implying that given individual trading book positions or sets of positions that have experienced default or migration over their liquidity horizon are re-balanced at the end of their liquidity horizon to attain the initial level of risk. Alternatively, a firm may choose consistently to use a one-year constant position assumption.

**Incremental risk charge: Liquidity horizons**

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

(2) Liquidity horizons must reflect actual practice and experience during periods of both systematic and idiosyncratic stresses. The liquidity horizon must be measured under conservative assumptions and must be sufficiently long that the act of selling or hedging, in itself, would not materially affect the price at which the selling or hedging would be executed.

7.10.55G  The determination of the appropriate liquidity horizon for a position or set of positions is subject to a floor of three months. The determination of the appropriate liquidity horizon for a position or set of positions must take into account a firm's internal policies relating to valuation adjustments and the management of stale positions.

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

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

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

(2) Hedging or diversification effects associated with long and short positions involving different instruments or different securities of the same obligor, as well as long and short positions in different issuers, may only be recognised by explicitly modelling gross long and short positions in the different instruments.

(3) A firm must reflect the impact of material risks that could occur during the interval between the hedge’s maturity and the liquidity horizon, as well as the potential for significant basis risks in hedging strategies by product, seniority in the capital structure, internal or external rating, maturity, vintage and other differences in the instruments. A firm must reflect a hedge only to the extent that it can be maintained even as the obligor approaches a credit or other event.

For trading book positions that are hedged via dynamic hedging strategies, a rebalancing of the hedge within the liquidity horizon of the hedged position may be recognised only if the firm:

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

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

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

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

Incremental risk charge: Nonlinear positions and model risk

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

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

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

Incremental risk charge: Validation

A firm must validate its approach to incremental risk charge. In particular, a firm must:
(1) validate that its modelling approach for correlations and price changes is appropriate for its portfolio, including the choice and weights of its systematic risk factors;

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

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

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

Incremental risk charge: Documentation and frequency of calculation

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

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

Incremental risk charge: Internal approaches based on different parameters

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

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

(2) the firm can demonstrate that its approach results in a capital requirement that is at least as high as it would be if based on an approach in full compliance with the requirements in ■ BIPRU 7.10.55A R to ■ BIPRU 7.10.55P R.

7.10.55S G The appropriate regulator will review at least annually any approach taken by the firm under ■ BIPRU 7.10.55R R.

All price risk measure: General requirements

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

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

(2) it adequately captures the following risks:

(a) the cumulative risk arising from multiple defaults, including the ordering of defaults, in *tranched* products;
(b) credit *spread risk*, including the gamma and cross-gamma effects;
(c) volatility of implied correlations, including the cross effect between spreads and correlations;
(d) *basis risk*, including both:
   (i) the basis between the spread of an index and those of its constituent single names; and
   (ii) the basis between the implied correlation of an index and that of bespoke portfolios;
(e) recovery-rate volatility, as it relates to the propensity for recovery rates to affect *tranche* prices; and
(f) to the extent that the *all price risk measure* incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing those hedges.

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

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

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

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

7.10.55Y A *firm* must calculate the capital charge under the *all price risk measure* at least weekly.
All price risk measure: Stress testing

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

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

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

7.10.55ZB  G  The appropriate regulator may use its powers under section 55J (Variation etc. on the Authority's own initiative) of the Act to impose on the firm a capital add-on to cover the material shortfall reported under BIPRU 7.10.55ZA R.

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

Risk management standards: Introduction

7.10.56  G  A firm with a complex portfolio is expected to demonstrate greater sophistication in its modelling and risk management than a firm with a simple portfolio. For example, a firm will be expected to consider, where necessary, varying degrees of liquidity for different risk factors, the complexity of risk modelling across time zones, product categories and risk factors. Some trade-off is permissible between the sophistication and accuracy of the model and the conservatism of underlying assumptions or simplifications.

7.10.57  G  A firm should be able to demonstrate that it meets the risk management standards set out in the VaR model permission on a legal entity basis. This is particularly important for a subsidiary undertaking in a group subject to matrix management where the business lines cut across legal entity boundaries.

Risk management standards: General requirement

7.10.58  R  A firm must have a conceptually sound risk management system surrounding the use of its VaR model that is implemented with integrity and that in particular meet the qualitative standards set out in BIPRU 7.10.59R - BIPRU 7.10.82R.
**Risk management standards: Use requirement**

7.10.59 R A firm must base its model PRR calculation on the output of the VaR model which is used for its internal risk management rather than one developed specifically to calculate its PRR.

7.10.60 R The VaR model must be fully integrated into the daily risk management process of the firm, and serve as the basis for reporting risk exposures to senior management of the firm.

7.10.61 G A firm's VaR model output should be an integral part of the process of planning, monitoring and controlling a firm's market risk profile. The VaR model should be used in conjunction with internal trading and exposure limits. The links between these limits and the VaR model should be consistent over time and understood by senior management. The firm should regard risk control as an essential aspect of the business to which significant resources need to be devoted.

**Risk management standards: Risk control unit**

7.10.62 R A firm must have a risk control unit which is independent from business trading units and which reports directly to senior management. It:

1. must be responsible for designing and implementing the firm's risk management system;
2. must produce and analyse daily reports on the output of the VaR model and on the appropriate measures to be taken in terms of the trading limits; and
3. conduct the initial and on-going validation of the VaR model.

**Risk management standards: Senior management**

7.10.63 R A firm's governing body and senior management must be actively involved in the risk control process, and the daily reports produced by the risk control unit must be reviewed by a level of management with sufficient authority to enforce both reductions of positions taken by individual traders as well as in the firm's overall risk exposure.

7.10.64 G It is the responsibility of a firm's own management to ensure the accuracy and integrity of its VaR model. This responsibility includes obtaining appropriate independent validation of the VaR model.

**Risk management standards: Skilled staff**

7.10.65 R A firm must have sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk control, audit and back office areas.

**Risk management standards: Controls and compliance**

7.10.66 R A firm must establish, document and maintain policies, controls and procedures to an auditable standard.
(1) concerning the operation of its VaR model approach; and
(2) for monitoring and ensuring compliance with the policies, controls and procedures in (1).

Risk management standards: Documentation

7.10.67 R A VaR model must be adequately documented.

7.10.68 G (1) An example of documents required by BIPRU 7.10.67R may be a manual that describes the basic principles of the risk management framework, clearly setting out empirical techniques, principles and assumptions used within it.

(2) This documentation should be of sufficient detail for the appropriate regulator to be able to develop a clear understanding of how the VaR model works from that documentation on its own.

Risk management standards: Track record

7.10.69 R A firm’s VaR model must have a proven track record of acceptable accuracy in measuring risk.

Risk management standards: Development validation

7.10.70 R Adequate procedures must be in place to ensure that model changes are validated before being introduced.

7.10.71 G The procedures in BIPRU 7.10.70R need not necessarily rely on backtesting using a back-run of recreated data.

Risk management standards: Stress testing

7.10.72 R (1) A firm must frequently conduct a rigorous programme of stress testing. The results of these tests must be reviewed by senior management and reflected in the policies and limits the firm sets.

(2) The programme must particularly address:
(a) concentration risk;
(b) illiquidity of markets in stressed market conditions;
(c) one way markets;
(d) event and jump to default risks;
(e) non linearity of products;
(f) deep out of the money positions;
(g) positions subject to the gapping of prices;
(h) full revaluation, or a reliable approximation, of positions;
(i) instant shocks as well as effects of longer term periods of stress;
(j) calibration changes under stressed conditions;
(k) secondary risk factors (such as volatility);
(l) basis risk;
(m) systemic and localised stresses; and
(n) other risks that may not be captured appropriately in the VaR model (for example, recovery rate uncertainty, implied correlations and skew risk).

(3) The shocks applied must reflect the nature of the portfolios and the time it could take to hedge out or manage risks under severe market conditions.

7.10.73 The stress testing under BIPRU 7.10.72R should be taken into account under the overall Pillar 2 rule.

7.10.73A The firm’s stress testing programme should be comprehensive in terms of both risk and firm coverage, and appropriate to the size and complexity of trading book positions held.

Risk management standards: Valuation

A firm must have procedures to ensure that the valuation of assets and liabilities is appropriate, that valuation uncertainty is identified and appropriate reserving is undertaken where necessary.

Risk management standards: Risk review

At least once a year, a firm must conduct, as part of its regular internal audit process, a review of its risk management process. This review must include both the activities of the business trading units and of the independent risk control unit, and must be undertaken by suitably qualified staff independent of the areas being reviewed. This review must consider, at a minimum:

(1) the adequacy of the documentation of the risk management system and process;
(2) the organisation of the risk control unit;
(3) the integration of market risk measures into daily risk management;
(4) the integrity of the management information system;
(5) the process for approving risk pricing models and valuation systems used in front and back offices;
(6) the validation of any significant changes in the risk management process;
(7) the scope of risks and products captured by the VaR model;
(8) the accuracy and completeness of position data;
(9) the process used to ensure the consistency, timeliness, independence and reliability of data sources (including the independence of such data sources);

(10) the accuracy and appropriateness of volatility and correlation assumptions;

(11) reserving policies and the accuracy of the valuation procedures and risk sensitivity calculations;

(12) the process employed to evaluate the VaR model’s accuracy, including the programme of backtesting;

(13) the controls surrounding the development of the VaR model; and

(14) the process employed to produce the calculation of the model PRR.

### Risk management standards: Validation and backtesting

7.10.76 **G** The **appropriate regulator** will require a period of initial monitoring or live testing before a VaR model can be recognised. This will be agreed on a **firm** by **firm** basis.

7.10.77 **G** In assessing the **firm’s VaR model** and risk management, the **appropriate regulator** has regard to the results of internal model validation procedures used by the **firm** to assess the **VaR model**.

7.10.78 **R** A **firm** must have processes in place to ensure that its VaR model has been adequately validated by suitably qualified parties independent of the development process to ensure that it is conceptually sound and adequately captures all material risks. This validation must be conducted when the VaR model is initially developed and when any significant changes are made to the VaR model. The validation must also be conducted on a periodic basis but especially where there have been any significant structural changes in the market or changes to the composition of the portfolio which might lead to the VaR model no longer being adequate. As techniques and best practices evolve, a **firm** must avail itself of these advances. Model validation must not be limited to backtesting, but must, at a minimum, also include the following:

1. tests to demonstrate that any assumptions made within the VaR model are appropriate and do not underestimate or overestimate the risk (including testing of the validity of the assumptions and approximations underlying the VaR model);

2. in addition to the regulatory backtesting programmes, a **firm** must carry out its own model validation tests in relation to the risks and structures of its portfolios, such as statistical validation techniques and other methods of measuring performance and validity;

3. the use of hypothetical portfolios to ensure that the VaR model is able to account for particular structural features that may arise, for example material basis risks and concentration risk; and
(4) investigation of the limitations of the VaR model including testing of the accuracy of parts of the VaR model as well as of the whole.

7.10.79 In addition to regulatory backtesting programs, testing for model validation should be carried out using additional tests which may include for example:

(a) testing carried out using hypothetical changes in portfolio value that would occur were end of day positions to remain unchanged;

(b) testing carried out for longer periods than required for the regular backtesting programme (for example, 3 years);

(c) testing carried out using confidence intervals other than the 99 percent interval required under the quantitative requirements in BIPRU 7.10; and

(d) testing of parts of portfolios.

(2) A longer time period generally improves the power of backtesting. However a longer time period may not be desirable if the VaR model or market conditions have changed to the extent that historical data is no longer relevant.

Further material on backtesting can be found in BIPRU 7.10.91G - BIPRU 7.10.112G.

Risk management standards: Information technology

7.10.81 In assessing whether the VaR model is implemented with integrity as described in BIPRU 7.10.58R (Stress testing), the appropriate regulator will consider in particular the information technology systems used to run the model and associated calculations. The assessment may include:

(1) feeder systems; risk aggregation systems; time series databases; the VaR model system; stress testing system; the backtesting system including profit and loss cleaning systems where appropriate; data quality; reconciliations and checks on completeness of capture;

(2) system development, change control and documentation; security and audit trails; system availability and contingency procedures; network adequacy; and

(3) operational statistics relating to the VaR model production process, including, for example, statistics relating to timeliness, number of re-runs required and the reliability of data feeds.

Risk management standards: Controls

7.10.82 A firm must ensure that it has adequate controls relating to:

(1) the derivation of the model PRR;

(2) the integrity of the backtesting programme, including the calculation of the profit and loss account;
(3) the integrity and appropriateness of the VaR model, including the VaR model’s geographic coverage and the completeness of data sources;

(4) the VaR model’s initial and ongoing development, including independent validation;

(5) the valuation models, including independent validation; and

(6) the adequacy, security and integrity of the information technology infrastructure.

Stress testing

7.10.83 R  BIPRU 7.10.84G—BIPRU 7.10.90G relate to stress testing of a VaR model (see BIPRU 7.10.72R (Risk management standards: Stress testing)).

7.10.84 G  Stress testing is a way of identifying the risk to a firm posed by a breakdown of model assumptions or by low-probability events. Where stress tests reveal unacceptable vulnerability to a given set of circumstances, a firm should take prompt steps to manage those risks appropriately, for example by hedging against the outcome or reducing the size of the firm’s exposure.

7.10.85 R  A firm must have the capacity to run daily stress tests.

7.10.86 R  Stress testing must involve identifying market scenarios or other low probability events in all types of risks that generate the greatest losses on a firm’s portfolio.

7.10.87 R  A firm must periodically and actively identify all the worst case scenarios that are relevant to its portfolio. Scenarios used must be appropriate to test the effect of adverse movements in market volatilities and correlations and the effect of any change in the assumptions underlying the VaR model. Scenarios involving low probability market events must nevertheless be plausible.

7.10.88 R  Stress testing must capture non-linear effects.

7.10.89 R  A firm must have procedures to assess and respond to the results produced from stress testing. In particular, stress testing results must be:

(1) used to evaluate its capacity to absorb such losses or identify steps to be taken to reduce risk; and

(2) communicated routinely to senior management and periodically to the governing body.

7.10.90 G  A firm may want to conduct the more complex stress tests at longer intervals or on an ad hoc basis.
A firm must also carry out reverse stress tests.

**Backtesting: Introduction**

Backtesting is the process of comparing value-at-risk risk measures to portfolio performance. It is intended to act as one of the mechanisms for the ongoing validation of a firm's VaR model and to provide incentives for firms to improve their VaR measures.

It is a condition for granting a VaR model permission that a firm should have a backtesting programme in place and should provide three months of backtesting history.

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

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

Backtesting of hypothetical profit and loss figures must be used for regulatory backtesting and also to calculate plus factors.

Backtesting of hypothetical profit and loss figures is also used for model validation and for reporting to the appropriate regulator.

**Backtesting: Basic testing requirements**

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

Generally the positions underlying the profit and loss account and VaR measures should not be materially different.

The one-day VaR measure for a particular business day is the VaR number for that business day calibrated to a one business day holding period and a 99% one-tailed confidence level.
Backtesting: Calculating the profit and loss

The ultimate purpose of backtesting is to assess whether capital is sufficient to absorb actual losses. Actual daily profit and loss means the day’s profit and loss arising from trading activities within the scope of the firm’s VaR model permission. This measure should, however, be ‘cleaned’ using inclusion in profit and loss of non-modelled factors.

Backtesting: Definition of backtesting exception

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

Backtesting: Obligation to notify the appropriate regulator

If a backtesting exception occurs, the firm must notify its usual supervisory contact at the appropriate regulator orally by close of business two business days after the business day for which the backtesting exception occurred. Within five business days following the end of each month, the firm must submit to the appropriate regulator a written account of the previous month’s backtesting exceptions (if any). This explanation must include the causes of the backtesting exceptions, an analysis of whether the backtesting...
exception indicate a deficiency in the firm's VaR model and the firm's planned response (if any).

**Backtesting: Summary of the backtesting cycle**

1. This paragraph gives guidance on the backtesting calculation and reporting process in BIPRU 7.10.96R - BIPRU 7.10.104R.

2. Let the day on which the loss referred to in BIPRU 7.10.100R is made be day n. The value-at-risk measure for that day will be calculated on day n-1, or overnight between day n-1 and day n. Profit and loss figures are produced on day n+1, and backtesting also takes place on day n+1. The firm's supervisor should be notified of any backtesting exceptions by close of business on day n+2.

3. Any backtesting exception initially counts for the purpose of the calculation of the plus factor even if subsequently the appropriate regulator agrees to exclude it under the process described in BIPRU 7.10.106G. Thus, where the firm experiences a backtesting exception and already has four or more backtesting exceptions for the previous 250 business days, changes to the multiplication factor arising from changes to the plus factor become effective at n+3 (using the time-line terminology in (2)).

**Backtesting: Process for disregarding backtesting exceptions**

1. This paragraph gives guidance on the process for excluding backtesting exceptions as referred to in BIPRU 7.10.103R.

2. The appropriate regulator will respond flexibly to backtesting exceptions. However, the appropriate regulator's starting assumption will be that a backtesting exception should be taken into account for the purpose of the calculation of plus factors. If the firm believes that a backtesting exception should not count for that purpose, then it should seek a variation of its VaR model permission in order to exclude that particular backtesting exception. The appropriate regulator will then decide whether to agree to such a variation.

3. One example of when a firm's backtesting exception might properly be disregarded is when it has arisen as a result of a risk that is not captured in its VaR model but against which capital resources are already held.

**Backtesting: Specific risk backtesting**

1. If a firm's VaR model permission covers specific risk, the firm must validate its VaR model through backtesting aimed at assessing whether specific risk is being accurately captured. This backtesting must be carried out in accordance with the provisions of its VaR model permission. If the VaR model permission provides for this backtesting to be performed on the basis of relevant sub-portfolios, these must be chosen in a consistent manner.

2. Specific risk backtesting involves the backtesting of a standalone specific risk VaR measure against a profit and loss series determined by reference to exposure risk factors categorised as specific risk. Alternatively specific risk
backtesting may take the form of regular backtesting of trading books and portfolios that are predominantly exposed to risk factors categorised as specific risk. The precise requirements for specific risk backtesting will be specified in the firm’s VaR model permission as will the definition of a specific risk backtesting exception.

**Backtesting: Multiple exceptions**

7.10.109 If ten or more backtesting exceptions or ten or more specific risk backtesting exceptions are recorded in a 250 business day period, a firm must take immediate corrective action.

7.10.110 Where backtesting reveals severe problems with the basic integrity of the VaR model, the appropriate regulator may withdraw model recognition. In particular, if ten or more backtesting exceptions are recorded in a 250 business day period, the appropriate regulator may apply a plus factor greater than one or the appropriate regulator may consider revoking a firm’s VaR model permission. The appropriate regulator may also consider revoking a firm’s VaR model permission if ten or more specific risk backtesting exceptions occur in such a period.

**Backtesting: Hypothetical profit and loss**

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

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

(2) [deleted]

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

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

**Capital calculations: General**

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

(1) the higher of:

(a) the VaR number for the relevant business day; and
(b) the average of its daily VaR numbers for each of the 60 business days ending with the relevant business day, multiplied by the multiplication factor for the relevant business day; and

(2) (in the case of a VaR model permission that covers specific risk) the higher of:
   (a) the incremental risk charge for the relevant business day; and
   (b) the average of the twelve-week incremental risk charge; and

(3) the higher of:
   (a) the latest stressed VaR number; and
   (b) the average of the firm’s daily stressed VaR number for the 60 business days ending with the relevant business day, multiplied by the multiplication factor applied to the stressed VaR measure for the relevant business day; and

(4) (in the case of a VaR model permission that covers all price risk measure) the higher of:
   (a) the all price risk measure for the relevant business day; and
   (b) the average of the twelve-week all price risk measure.

7.10.114 For any day that is not a business day, the model PRR is the amount for the prior business day.

7.10.115 The VaR number for any business day means the VaR measure, in respect of the previous business day’s close-of-business positions in products coming within the scope of the VaR model permission, calculated by the VaR model and in accordance with BIPRU 7.10 and any methodology set out in the VaR model permission. The VaR number must not be calculated taking into account matters on the business day for which it is the VaR number.

7.10.116 The incremental risk charge for any business day means the incremental risk charge required under the provisions in BIPRU 7.10 about specific risk, in respect of the previous business day’s close-of-business positions with respect to which those provisions apply.

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

7.10.117 The following equation expresses BIPRU 7.10.113R mathematically:

$$\text{PRR}_{\text{Var}} = \text{Max} \left\{ \text{Var}, \text{ Min} \left( \frac{T}{72}, \frac{\text{VaR}_{\text{Var}}}{72} \right) \right\} + \text{Max} \left\{ \text{SVaR}_{\text{Var}}, \text{ Min} \left( \frac{5}{72}, \frac{\text{SVaR}_{\text{Var}}}{72} \right) \right\} + \text{Max} \left\{ \text{IRC}, \text{ Min} \left( \frac{26}{72}, \frac{\text{IRC}_{\text{Var}}}{72} \right) \right\} + \text{Max} \left\{ \text{APR}, \text{ Min} \left( \frac{1}{72}, \frac{\text{APR}_{\text{Var}}}{72} \right) \right\}$$

where:

(1) $\text{PRR}_{\text{Var}}$ is a firm’s model PRR;

(2) $\text{Var}$ represents the previous day’s value-at-risk figure;
(3) $\text{VaR}_{t-i}$ represents the value-at-risk calculated for $i$ business days earlier;

(4) $f$ is the multiplication factor for VaR;

(5) $\text{SVAR}_t$ represents the latest stressed VaR figure;

(6) $\text{SVAR}_{t-i}$ represents the stressed VaR calculated for $i$ business days earlier;

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

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

(9) $\text{IRC}_t$ represents the latest incremental risk charge;

(10) $\text{IRC}_{t-i}$ represents the incremental risk charge calculated for $i$ business days earlier;

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

(12) $\text{APR}_t$ represents the latest all price risk measure;

(13) $\text{APR}_{t-i}$ represents the all price risk measure calculated for $i$ business days earlier; and

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

**Capital calculations: Multiplication factors**

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

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

7.10.120 G The minimum multiplication factor, for VaR and stressed VaR, will never be less than three. If the appropriate regulator does set the minimum multiplication factor, for VaR and stressed VaR, above three the VaR model permission will have a table that sets out the reasons for that add on and specify how much of the add on is attributable to each reason (see BIPRU 7.10.121R). If there are weaknesses in the VaR model that may otherwise be considered a breach of the minimum standards referred to in BIPRU 7.10.24R the appropriate regulator may apply such an add on to act as a mitigant for those weaknesses.

7.10.121 R Somethings that would otherwise be a breach of the minimum standards in BIPRU 7.10.26R - BIPRU 7.10.53R is not a breach to the extent that that thing is identified in the firm’s VaR permission as a reason for an increase in the minimum multiplication factor, for VaR and stressed VaR, above 3.
Typically, any add on will be due to a specific weakness in systems and controls identified during the appropriate regulator’s review that the appropriate regulator does not consider material enough to justify withholding overall model recognition. The firm will be expected to take action to address the reasons for any add on. The appropriate regulator will then review these periodically and, where satisfactory action has been taken, the add on will be removed through a variation of the VaR model permission.

The plus factor system is designed so that the more often a VaR model has under-predicted losses in the past, the higher should be the capital requirement based on the VaR model. It is intended to provide a capital incentive for the firm to continue to improve the accuracy of its VaR model.

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

Table: Backtesting plus factors

<table>
<thead>
<tr>
<th>Zone</th>
<th>Number of recorded exceptions</th>
<th>Plus factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green</td>
<td>4 or less</td>
<td>0.00</td>
</tr>
<tr>
<td>Yellow</td>
<td>5</td>
<td>0.40</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>0.50</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>0.65</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>0.75</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>0.85</td>
</tr>
<tr>
<td>Red</td>
<td>10 or more</td>
<td>1.00</td>
</tr>
</tbody>
</table>

A VaR model that correctly predicts a one-tailed 99% confidence level is expected to produce, on average, 2.5 backtesting exceptions every 250 days. Random events may cause the number of backtesting exceptions actually observed to vary. The plus factor system is designed to take this into account. Hence plus factors are only imposed on the firm if it has five or more recorded backtesting exceptions. Therefore, where a backtesting exception appears to be caused simply by chance, it will not be appropriate for a VaR model permission to be varied to exclude that backtesting exception as described in BIPRU 7.10.106G (Backtesting: Process for disregarding backtesting exceptions).

Capital calculations: Specific risk surcharge: transitional requirements

Firms who gained model recognition before 1 January 2007 will be permitted to calculate PRR for specific risk in accordance with the methodology they were permitted to use immediately before that date.
instead of capturing event and default risk in their models (see BIPRU TP 14 (Market risk: VaR models)). This treatment will not be available to a firm that gains model recognition after that date.

Reporting procedures and requirements

A VaR model permission will contain requirements for what the firm should report to the appropriate regulator and the procedures for reporting. The precise requirements will vary from VaR model permission to VaR model permission. BIPRU 7.10.129R and BIPRU 7.10.130R set out what the appropriate regulator regards as the standard requirements.

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

1. methodological changes and developments to the VaR model;
2. the introduction of all new pricing models used in connection with the VaR model and any changes to any pricing models used in connection with the VaR model, including details of any material associated valuation or risk management issues;
3. a summary of backtesting performance against profit and loss figures (if calculated) and hypothetical profit and loss figures, which must be provided in electronic format as stipulated by the VaR model permission;
4. (if the VaR model permission covers specific risk) the results of the specific risk backtesting including specific risk backtesting exceptions;
5. any change to any feeder or pre-processing systems in connection with the VaR model, including changes to any of the systems set out in the list described in BIPRU 7.10.131G (1) (as it exists at the date of the VaR model permission), and any introduction of a new such system;
6. any changes to the products coming within the scope of the VaR model;
7. any material changes or additions to any of the matters referred to in the firm’s internal documentation in relation to the VaR model (as it exists at the date of the VaR model permission) or to any matters subsequently notified under (7);
8. any changes in senior management;
9. an up-to-date list of products covered by the VaR model permission showing all changes made since the VaR model permission was granted;
10. where applicable (nil returns are not required), details of:
(a) any use of a changed historical observation period in accordance with BIPRU 7.10.30R or any change in the use of any weighting scheme as described in BIPRU 7.10.33R;

(b) any data series becoming unreliable as described in BIPRU 7.10.31R and any subsequent use of alternative value-at-risk measurement techniques;

(c) the frequency of updating data sets being increased in accordance with BIPRU 7.10.34R;

(d) any change in the method employed to derive 10-day VaR measure (see BIPRU 7.10.28R);

(e) to the extent that the use of correlations is permitted by a firm’s VaR model permission, a summary of any notifications that are required under BIPRU 7.10.37R; and

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

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

7.10.130

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

Updating the VaR model permission

7.10.131

The VaR model permission will generally contain a list of the following:

1) feeder systems and pre-processing systems;

2) products covered by the VaR model permission; and

3) the firm’s internal documentation in relation to the VaR model.

7.10.132

The information in BIPRU 7.10.131G will vary over time. It is therefore not included in a VaR model permission as a rule but for information only. The appropriate regulator will update that information regularly in accordance with information supplied under BIPRU 7.10.129R. That updating will not amount to a variation of the VaR model permission.

Link to standard PRR rules: Incorporation of the model output into the capital calculation

7.10.133

A VaR model permission will modify GENPRU 2.1.52 R (Calculation of the market risk capital requirement) to provide that a firm should calculate its market risk capital requirement in accordance with BIPRU 7.10 to the extent set out in the VaR model permission.
By modifying GENPRU 2.1.52 R (Calculation of the market risk capital requirement) to allow the firm to use the VaR model to calculate all or part of its PRR for certain positions, the appropriate regulator is treating it like an application rule. The modification means that the PRR calculation set out in BIPRU 7.10 supersedes the standard market risk PRR rules for products and risks coming within the scope of the VaR model permission.

To the extent that a position does not fall within the scope of a firm's VaR model permission the firm must calculate the PRR under the standard market risk PRR rules or, as applicable, those provisions as modified by the firm's CAD 1 waiver.

(1) This rule applies to a position of a type that comes within the scope of a firm's VaR model permission.

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

(3) If, where the standard market risk PRR rules apply, a position is subject to one or more PRR charges and the firm's VaR model permission does not cover all the risks to which those PRR charges relate, the firm must calculate the PRR for that position under the VaR model approach (for those risks that are covered) and under the standard market risk PRR rules (for those other risks).

(4) Where the standard market risk PRR rules distinguish between specific risk and general market risk a firm's VaR model permission covers specific risk to the extent that it says it does. If the firm's VaR model permission does not cover specific risk, BIPRU 7.10.143R and BIPRU 7.10.144R apply.

(5) If a firm's VaR model permission covers positions in CIUs it covers specific risk with respect to those positions.

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

A firm may exclude from the VaR model approach immaterial risks within the scope of its VaR model approach. If a firm does so it must instead apply the standard market risk PRR rules to those risks.

(1) If a firm calculates its market risk capital requirement using a combination of the standard market risk PRR rules and either the VaR model approach or the VaR model approach with the CAD 1 model approach the PRR from each method must be added together.
(2) A firm must take appropriate steps to ensure that all of the approaches are applied in a consistent manner.

7.10.139 G An example of the effect of BIPRU 7.10.138R is that where a firm normally calculates the PRR for a particular portfolio using a VaR model, a firm should not switch to the standard market risk PRR rules purely to achieve a more attractive PRR.

7.10.140 R If:

(1) the standard market risk PRR rules provide for a choice of which of the PRR charges to use or specify that one type must be used in some circumstances and that another type must be used in other circumstances;

(2) one of those types is disapplied under BIPRU 7.10.136R; and

(3) the other type is not disapplied;

the firm:

(4) must use the VaR model approach if under the standard market risk PRR rules the firm must use the standard market risk PRR rules in (2); and

(5) may use the VaR model approach if under the standard market risk PRR rules the firm may use the standard market risk PRR rules in (2).

7.10.141 G The treatment of a convertible is an example of a situation in which BIPRU 7.10.140R applies. The table in BIPRU 7.3.3R (Table: Instruments which result in notional positions) shows that there are circumstances in which under the standard market risk PRR rules a firm should calculate an equity PRR and that there are circumstances in which a firm may choose between calculating an equity PRR and an interest rate PRR. BIPRU 7.10.140R would be relevant if a firm’s VaR model permission only covers one of equity risk and interest rate risk.

7.10.142 R The standard market risk PRR rules for the option PRR are only disapplied to the extent that the derived positions arising under BIPRU 7.6.13R (Table: Derived positions) come within the scope of the VaR model permission.

Link to standard PRR rules: General market risk only

7.10.143 R If a firm’s VaR model permission covers interest rate general market risk but not interest rate specific risk, the firm must calculate the interest rate PRR so far as it relates to interest rate specific risk in accordance with the standard market risk PRR rules except that the firm must not use the basic interest rate PRR calculation in BIPRU 7.3.45R (Basic interest rate calculation for equity instruments).
If a firm's VaR model permission covers equity general market risk but not equity specific risk, the firm must calculate the equity PRR so far as it relates to equity specific risk in accordance with the standard market risk PRR rules except that the PRR for equity specific risk must be calculated under the standard equity method.

(1) To the extent that a firm's VaR model permission does not allow it to use an approach set out in BIPRU 7.10 the relevant provisions in BIPRU 7.10 do not apply to that firm.

(2) If a provision of the Handbook refers to BIPRU 7.10, that reference must, in the case of a particular firm with a VaR model permission, be treated as excluding provisions of BIPRU 7.10 that do not apply under the VaR model permission and as taking into account any modifications to BIPRU 7.10 made by the VaR model permission. Such references also include requirements and conditions contained in the VaR model permission but not BIPRU 7.10 and to the rules modified by the VaR model permission.

A VaR model must be a value-at-risk model. It must provide an estimate of the worst expected loss on a portfolio resulting from market movements over a period of time with the specified confidence level.

If a firm ceases to meet any of the requirements set out in BIPRU 7.10, the appropriate regulator's policy is that the VaR model permission should cease to have effect. In part this will be achieved by making it a condition of a firm's VaR model permission that it complies at all times with the minimum standards referred to in BIPRU 7.10.26R - BIPRU 7.10.53R. Even if they are not formally included as conditions, the appropriate regulator is likely to consider revoking the VaR model permission if the requirements are not met.

If a firm ceases to meet the conditions or requirements in its VaR model permission or BIPRU 7.10 it must notify the appropriate regulator at once.

A firm may change its VaR model to such extent as it sees fit, except that it must not make a change that (either on its own or together with other changes since the date of VaR model permission) would:

(1) be inconsistent with VaR model permission or BIPRU 7.10; or

(2) mean that backtesting in accordance with BIPRU 7.10 and the VaR model permission would result in the use of data that is inappropriate for the purposes of measuring the performance of the VaR model.
7.11 Credit derivatives in the trading book

Scope

This section applies to the treatment of credit derivatives in the trading book.

Establishment of positions created by credit derivatives:
Treatment of the protection seller

- BIPRU 7.11.3R - BIPRU 7.11.11R relate to the treatment of the protection seller for the purpose of calculating the securities PRR. Positions are determined in accordance with BIPRU 7.11.4R - BIPRU 7.11.11R.

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

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

A total return swap creates a long position in the general market risk of the reference obligation and a short position in the general market risk of a zero-specific-risk security with a maturity equivalent to the period until the next interest fixing and which is assigned a 0% risk weight under the standardised approach to credit risk. It also creates a long position in the specific risk of the reference obligation.

A credit default swap does not create a position for general market risk. For the purposes of specific risk, a firm must record a synthetic long position in an obligation of the reference entity, unless the derivative is rated externally and meets the conditions for a qualifying debt security, in which case a long position in the derivative is recorded. If premium or interest payments are due under the product, these cash flows must be represented as notional positions in zero-specific-risk securities.
A single name credit linked note creates a long position in the general market risk of the note itself, as an interest rate product. For the purpose of specific risk, a synthetic long position is created in an obligation of the reference entity. An additional long position is created in the issuer of the note. Where the credit linked note has an external rating and meets the conditions for a qualifying debt security, a single long position with the specific risk of the note need only be recorded.

In addition to a long position in the specific risk of the issuer of the note, a multiple name credit linked note providing proportional protection creates a position in each reference entity, with the total notional amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting determines the specific risk.

Where a multiple name credit linked note has an external rating and meets the conditions for a qualifying debt security, a single long position with the specific risk of the note need only be recorded.

A first-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity. If the size of the maximum credit event payment is lower than the PRR requirement under the method in the first sentence of this rule, the maximum payment amount may be taken as the PRR requirement for specific risk.

A second-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity less one (that with the lowest specific risk PRR requirement). If the size of the maximum credit event payment is lower than the PRR requirement under the method in the first sentence of this rule, this amount may be taken as the PRR requirement for specific risk.

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

Establishment of positions created by credit derivatives:
Treatment of the protection buyer

For the protection buyer, the positions are determined as the mirror principle of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection. In the case of first-to-default credit derivatives and nth to default credit derivatives, the treatment in BIPRU 7.11.12AR and BIPRU 7.11.12B R applies instead of the mirror principle.

[Note: CAD Annex I point 8.8]
Where a firm obtains credit protection for a number of reference entities underlying a credit derivative under the terms that the first default among the assets will trigger payment and that this credit event will terminate the contract, the firm may off-set specific risk for the reference entity to which the lowest specific risk percentage charge among the underlying reference entities applies according to the Table in BIPRU 7.2.44R.

[Note: CAD Annex I point 8.B]

Where the n\textsuperscript{th} default among the exposures triggers payment under the credit protection, the protection buyer may only off-set specific risk if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In those cases, the methodology set out in BIPRU 7.11.12AR for first-to-default credit derivatives must be followed, appropriately modified for n\textsuperscript{th}-to-default products.

[Note: CAD Annex I point 8.B]

Deriving the net position in each debt security: Credit derivatives

A firm must calculate both the net long and the net short positions in credit derivatives by applying BIPRU 7.2.36 R and BIPRU 7.2.37 R and, where applicable, BIPRU 7.2.42A R to BIPRU 7.2.42C R or BIPRU 7.11.13 R to BIPRU 7.11.17 R.

Recognition of hedging provided by credit derivatives

(1) BIPRU 7.11.14R - BIPRU 7.11.17R relate to specific risk PRR for trading book positions hedged by credit derivatives for the purposes of the calculation of the securities PRR.

(2) A firm may take an allowance for protection provided by credit derivatives for the purposes in (1) in accordance with the principles set out in the rules referred to in (1).

(3) [deleted]

(1) A firm may take full allowance when the value of two legs always move in the opposite direction and broadly to the same extent.

(2) This will be the case in the following situations:

(a) the two legs consist of completely identical instruments; or

(b) a long cash position is hedged by a total rate of return swap (or vice versa) and there is an exact match between the reference obligation and the underlying exposure (i.e., the cash position).

(3) The maturity of the swap itself may be different from that of the underlying exposure for the purposes of (2)(b).

(4) In these situations, a firm must not apply a specific risk PRR to either side of the position.
An 80% offset may be applied when the value of two legs always move in the opposite direction and where there is an exact match in terms of the reference obligation, the maturity of both the reference obligation and the credit derivative, and the currency of the underlying exposure. In addition, key features of the credit derivative contract must not cause the price movement of the credit derivative materially to deviate from the price movements of the cash position. To the extent that the transaction transfers risk, an 80% specific risk offset may be applied to the side of the transaction with the higher PRR, while the specific risk requirements on the other side are zero.

(1) A firm may take partial allowance when the value of two legs usually move in the opposite direction. This would be the case in the situations set out in (2) - (4).

(2) The first situation referred to in (1) is that the position falls under BIPRU 7.11.16 R (2)(b) but there is an asset mismatch between the reference obligation and the underlying exposure. However, the positions meet the following requirements:

(a) the reference obligation ranks pari passu with or is junior to the underlying obligation; and

(b) the underlying obligation and reference obligation share the same obligor and have legally enforceable cross-default or cross-acceleration clauses.

(3) The second situation referred to in (1) is that the position falls under BIPRU 7.11.14 R (2)(a) or BIPRU 7.11.15 R but there is a currency or maturity mismatch between the credit protection and the underlying asset (currency mismatches must be included in the normal reporting with respect to the foreign currency PRR).

(4) The third situation referred to in (1) is that the position falls under BIPRU 7.11.15 R but there is an asset mismatch between the cash position and the credit derivative. However, the underlying asset is included in the (deliverable) obligations in the credit derivative documentation.

(5) In each of those situations, rather than adding the specific risk PRR requirements for each side of the transaction, only the higher of the two PRR requirements applies.

In all situations not falling under BIPRU 7.11.14 R - BIPRU 7.11.16 R, a firm must assess a specific risk PRR charge against both sides of the positions.

Specific risk calculation

[deleted]

[deleted]

The specific risk portion of the interest rate PRR for credit derivatives in the trading book must be calculated in accordance with BIPRU 7.2.43 R to
BIPRU 7 : Market risk

Section 7.11 : Credit derivatives in the trading book

| 7.11.21 | R | [deleted] |
| 7.11.22 | R | [deleted] |
| 7.11.23 | R | [deleted] |
| 7.11.24 | R | [deleted] |
| 7.11.25 | R | [deleted] |
| 7.11.26 | R | [deleted] |
| 7.11.27 | R | [deleted] |
| 7.11.28 | R | [deleted] |
| 7.11.29 | R | [deleted] |
| 7.11.30 | R | [deleted] |
| 7.11.31 | R | [deleted] |
| 7.11.32 | R | [deleted] |
| 7.11.33 | R | [deleted] |
| 7.11.34 | R | [deleted] |
| 7.11.35 | R | [deleted] |
| 7.11.36 | R | [deleted] |
| 7.11.37 | R | [deleted] |

■ BIPRU 7.2.46A G (Specific risk calculation), ■ BIPRU 7.2.48A R to ■ BIPRU 7.2.48K R (Specific risk: securitisations and re-securitisations), ■ BIPRU 7.2.48L R (Specific risk: Correlation trading portfolio), ■ BIPRU 7.2.49 R to ■ BIPRU 7.2.51 G (Definition of a qualifying debt security) and the other provisions of ■ BIPRU 7.11, as applicable.
BIPRU 7 : Market risk

Section 7.11 : Credit derivatives in the trading book

7.11.38  R  [deleted]
7.11.39  R  [deleted]
7.11.40  R  [deleted]
7.11.41  R  [deleted]
7.11.42  R  [deleted]
7.11.43  R  [deleted]
7.11.44  R  [deleted]
7.11.45  R  [deleted]
7.11.46  R  [deleted]
7.11.47  G  [deleted]
7.11.48  R  [deleted]
7.11.49  R  [deleted]
7.11.50  R  [deleted]
7.11.51  R  [deleted]
7.11.52  R  [deleted]
Valuation

7.11.59 GENPRU 1.3.29 R - GENPRU 1.3.35 G (General requirements: Valuation adjustments or reserves) are particularly relevant for a firm trading credit derivatives, especially for credit default swaps that are also securitisation positions.

Other risks relating to credit derivatives

7.11.60 A firm must be able to describe, demonstrate and explain to the appropriate regulator its trading strategies in relation to credit derivatives both in theory and in practice.

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

7.11.62 BIPRU 7.11.5 R requires a firm to recognise any premiums payable or receivable under the contract as notional zero-specific-risk securities. These positions are then entered into the general market risk framework. As premium payments paid under such contracts are contingent on no credit event occurring, a credit event could significantly change the general market risk capital requirement. A firm should consider, under the overall Pillar 2 rule, whether this risk means that the capital requirements under this section materially understate the firm's general market risk position.

7.11.63 If a firm recognises profits on a non-accrual basis it should consider whether the capital requirements for its credit derivatives business adequately cover the risk that any recognised profit may not be achieved due to a credit event occurring. This includes positions for which the firm may have a perfect hedge in place.
Chapter 8

Group risk consolidation
8.1 Application

This chapter applies to:

1. a BIPRU firm that is a member of a UK consolidation group;
2. a BIPRU firm that is a member of a non-EEA sub-group; and
3. [deleted]
4. a firm that is not a BIPRU firm and is a parent financial holding company in a Member State in a UK consolidation group.

This chapter does not apply to a firm in BIPRU 8.1.1R (1) to BIPRU 8.1.1R (3) which is a member of the UK consolidation group or non-EEA sub-group if the interest of the relevant UK consolidation group or non-EEA sub-group in that firm is no more than a participation.

A firm is not subject to consolidated supervision under BIPRU 8 where any of the following conditions are fulfilled:

1. the firm is included in the supervision on a consolidated basis of the group of which it is a member by the FCA or PRA under the EU CRR; or
2. the firm is included in the supervision on a consolidated basis of the group of which it is a member by a competent authority other than the FCA under the EU CRR as implemented by that competent authority.

Where a group includes one or more BIPRU firms and one or more IFPRU investment firms which has permission under article 19 of the EU CRR (Exclusion from the scope of prudential consolidation) from the FCA not to be included in the supervision on a consolidated basis of the group of which it is a member, consolidated supervision under BIPRU 8 applies to those IFPRU investment firms and the BIPRU firms.

Purpose

Pursuant to the third paragraph of article 95(2) of the EU CRR, this chapter implements articles 71, 73(1) and (2), 125, 126, 127(1), 133 and 134 of the Banking Consolidation Directive and articles 2 (in part), 22-27 and 37(1) (in part) of the Capital Adequacy Directive.
How this chapter is organised

8.1.4 G BIPRU 8.2 sets out the definition of UK consolidation group and the basic requirement to apply financial resources and concentration risk requirements to that group on a consolidated basis.

8.1.5 G BIPRU 8.3 sets out the definition of a non-EEA sub-group and the basic requirement to apply financial resources and concentration risk requirements to that group on a consolidated basis.

8.1.6 G BIPRU 8.4 sets out how a group of CAD investment firms can apply for a waiver from consolidated capital requirements although remaining subject to consolidated supervision (including reporting requirements).

8.1.7 G BIPRU 8.5 sets out the basis for including and excluding undertakings within the group for the purposes of consolidation.

8.1.8 G BIPRU 8.6 sets out the calculation of the consolidated capital resources of a group and the limits that apply.

8.1.9 G BIPRU 8.7 sets out the calculation of the consolidated capital resources requirement of a group.

8.1.10 G BIPRU 8.8 deals with the application of advanced prudential calculation approach on a consolidated basis.

8.1.11 G BIPRU 8.9 sets out consolidated concentration risk requirements.

Consolidation requirements for BIPRU firms elsewhere in the Handbook

8.1.12 G SYSC 12 (Group risk systems and controls requirement) deals with systems and controls requirements for groups.

8.1.13 G GENPRU 1.2 (Adequacy of financial resources) deals with the detail about how GENPRU 1.2 applies on a consolidated basis although the underlying requirement to apply it on a consolidated basis is in BIPRU 8.2 and BIPRU 8.3.

8.1.14 G BIPRU 11 (Disclosure) itself deals with how that chapter is applied on a consolidated basis.

8.1.15 G GENPRU 3.1 (Cross sector groups) deals with financial conglomerates.

8.1.16 G GENPRU 3.2 (Prudential rules for third country groups) deals, amongst other things, with banking and investment services groups headed by a parent undertaking outside the EEA.
8.2 Scope and basic consolidation requirements for UK consolidation groups

Main consolidation rule for UK consolidation groups

8.2.1 A firm that is a member of a UK consolidation group must comply, to the extent and in the manner prescribed in BIPRU 8.5, with the obligations laid down in GENPRU 1.2 (Adequacy of financial resources) and the main BIPRU firm Pillar 1 rules (but not the base capital resources requirement) on the basis of the consolidated financial position of:

(1) where either Test 1A or Test 1B in BIPRU 8 Annex 1 (Decision tree identifying a UK consolidation group) apply, the parent institution in a Member State in the UK consolidation group; or

(2) where either Test 1C or Test 1D in BIPRU 8 Annex 1 apply, the parent financial holding company in a Member State or the parent mixed financial holding company in a Member State.

8.2.2 Further to BIPRU 8.2.1 R, a firm that is a member of a UK consolidation group must at all times ensure that the consolidated capital resources of the UK consolidation group are equal to or exceed its consolidated capital resources requirement.

8.2.3 The base capital resources requirement does not apply on a consolidated basis.

Definition of UK consolidation group

8.2.4 A firm’s UK consolidation group means a group that is identified as a UK consolidation group in accordance with the decision tree in BIPRU 8 Annex 1 R (Decision tree identifying a UK consolidation group); the members of that group are:

(1) where either Test 1A or Test 1B in BIPRU 8 Annex 1 R apply, the members of the consolidation group made up of the sub-group of the parent institution in a Member State identified in BIPRU 8 Annex 1 R together with any other person who is a member of that consolidation group because of a consolidation Article 12(1) relationship or an Article 134 relationship; or

(2) where either Test 1C or Test 1D in BIPRU 8 Annex 1 R apply, the members of the consolidation group made up of the sub-group of
the parent financial holding company in a Member State or the parent mixed financial holding company in a Member State identified in BIPRU 8 Annex 1 R together with any other person who is a member of that consolidation group because of a consolidation Article 12(1) relationship or an Article 134 relationship;

in each case only persons included under BIPRU 8.5 (Basis of consolidation) are included in the UK consolidation group.

8.2.5 R For the purposes of this chapter, what would otherwise be a UK consolidation group is not a UK consolidation group if all the members of that UK consolidation group wholly form part of another UK consolidation group.

8.2.6 G

8.2.7 G BIPRU 8 Annex 1 (Decision tree identifying a UK consolidation group) shows that Articles 125 and 126 of the Banking Consolidation Directive are important in deciding whether the appropriate regulator is obliged to supervise a group or part of a group and hence whether that group or part of a group is a UK consolidation group. BIPRU 8 Annex 4 (Text of Articles 125 and 126 of the Banking Consolidation Directive) sets out these articles together with an explanation of how those articles should be read in the case of a group which also contains CAD investment firms.
8.3 Scope and basic consolidation requirements for non-EEA sub-groups

Main consolidation rule for non-EEA sub-groups

8.3.1 A BIPRU firm that is a subsidiary undertaking of a BIPRU firm or of a financial holding company or of a mixed financial holding company must apply the requirements laid down in GENPRU 1.2 (Adequacy of financial resources) and the main BIPRU firm Pillar 1 rules (but not the base capital resources requirement) on a sub-consolidated basis if the BIPRU firm, or the parent undertaking where it is a financial holding company or a mixed financial holding company, have a third country investment services undertaking as a subsidiary undertaking or hold a participation in such an undertaking.

8.3.2 Further to BIPRU 8.3.1 R, a firm that is a member of a non-EEA sub-group must at all times ensure that the consolidated capital resources of that non-EEA sub-group are equal to or exceed its consolidated capital resources requirement.

8.3.3 The base capital resources requirement does not apply on a consolidated basis.

8.3.4 The sub-group identified in BIPRU 8.3.1 R is called a non-EEA sub-group.

How to identify a non-EEA sub-group

8.3.5

8.3.6 The remainder of this section sets out a process for identifying a non-EEA sub-group in straightforward cases.

8.3.7 A firm will not be a member of a non-EEA sub-group unless it is also a member of a UK consolidation group. So the first step is to identify each
undertaking in the firm’s UK consolidation group that satisfies the following conditions:

1. It is a CAD investment firm, financial institution or asset management company whose head office is outside the EEA (a third country investment services undertaking);

2. One of the following applies:
   a. It is a subsidiary undertaking of a BIPRU firm in that UK consolidation group; or
   b. A BIPRU firm in that UK consolidation group holds a participation in it; and

3. That BIPRU firm is not a parent institution in a Member State.

**8.3.8** The sub-group of the BIPRU firm identified in BIPRU 8.3.7G (2)(a) or BIPRU 8.3.7G (2)(b) is a potential non-EEA sub-group.

**8.3.9** If more than one BIPRU firm is a direct or indirect parent undertaking in accordance with BIPRU 8.3.7G (2)(a) then the sub-groups of each of them are all potential non-EEA sub-groups.

**8.3.10** Similarly if there is more than one BIPRU firm that holds a participation in the third country investment services undertaking in accordance with BIPRU 8.3.7G (2)(b) then the sub-group of each such BIPRU firm is a potential non-EEA sub-group.

**8.3.11** The effect of BIPRU 8.3.7G (3) is that a non-EEA sub-group cannot be headed by a parent institution in a Member State.

**8.3.12** The firm should then identify each undertaking in the firm’s UK consolidation group that satisfies the following conditions:

1. It is a CAD investment firm, financial institution or asset management company whose head office is outside the EEA (a third country investment services undertaking);

2. One of the following applies:
   a. It is a subsidiary undertaking of a financial holding company in that UK consolidation group; or
   b. A financial holding company in that UK consolidation group holds a participation in it;

3. The head office of that financial holding company is in the United Kingdom; and

4. That financial holding company has a subsidiary undertaking that is a BIPRU firm.
The sub-group of the financial holding company identified in BIPRU 8.3.12G (2)(a) or BIPRU 8.3.12G (2)(b) is a potential non-EEA sub-group.

The financial holding company identified in BIPRU 8.3.12G may be a parent financial holding company in a Member State.

If more than one financial holding company is a direct or indirect parent undertaking in accordance with BIPRU 8.3.12G (2)(a) then the sub-groups of each of them are all potential non-EEA sub-groups.

Similarly if there is more than one financial holding company that holds a participation in the third country investment services undertaking in accordance with BIPRU 8.3.12G (2)(b) then the sub-group of each such financial holding company is a potential non-EEA sub-group.

The firm should apply the process in BIPRU 8.3.12 G to a third country investment services undertaking even though it may be also be part of a potential non-EEA sub-group under BIPRU 8.3.7 G.

Having identified potential non-EEA sub-groups for each third country investment services undertaking in its UK consolidation group the firm should then eliminate overlapping potential non-EEA sub-groups in the following way. If:

1. one potential non-EEA sub-group is contained within a wider potential non-EEA sub-group; and
2. the third country investment services undertaking in the two potential non-EEA sub-groups are the same;

then the smaller potential non-EEA sub-group is eliminated.

If there is a chain of three or more potential non-EEA sub-groups, each with the same third country investment services undertaking, the elimination process may remove all but the highest.

Each remaining potential non-EEA sub-group is a non-EEA sub-group, even though it may be part of a wider non-EEA sub-group.

If a UK consolidation group is headed by a parent financial holding company in a Member State the result of the elimination process may be that a firm’s UK consolidation group contains only one non-EEA sub-group and that the non-EEA sub-group is the same as the UK consolidation group. In theory that means that there are two sets of consolidation requirements, one in relation to the UK consolidation group and one in relation to the non-EEA sub-group. However as the UK consolidation group and the non-EEA sub-group
are the same, in practice this means that the additional non-EEA sub-group consolidation disappears.

8.3.23 Even where the requirements for a non-EEA sub-group are absorbed into those for the UK consolidation group a firm should still make clear in its regulatory reporting that the consolidation figures relate to a UK consolidation group and a non-EEA sub-group and that they both contain the same members.

8.3.24 The examples in this section have so far assumed that the only EEA State involved is the United Kingdom. If a potential non-EEA sub-group that would otherwise be regulated by the appropriate regulator contains a potential non-EEA sub-group in another EEA State then the United Kingdom one is eliminated if the third country investment services undertaking in the UK potential non-EEA sub-group and the potential non-EEA sub-group in the other EEA State are the same. The intention here is that the EEA competent authority closest to the third country investment services undertaking should be responsible for the non-EEA sub-group subconsolidation. Example 6 in BIPRU 8 Annex 3 (Examples of how to identify a non-EEA sub-group) illustrates this situation.
8.4 CAD Article 22 groups and investment firm consolidation waiver

Application

8.4.1 R This section applies to a BIPRU firm with an investment firm consolidation waiver.

8.4.1A G An investment firm consolidation waiver may be applied for by a BIPRU firm only.

The effect of an investment firm consolidation waiver and the conditions for getting one

8.4.2 G A BIPRU firm may apply for a waiver of the requirement in this chapter to apply capital requirements on a consolidated basis. Such a waiver is called an investment firm consolidation waiver.

8.4.3 G An investment firm consolidation waiver will waive the application of BIPRU 8.2.1 R and BIPRU 8.2.2 R (if it applies with respect to a UK consolidation group) or BIPRU 8.3.1 R and BIPRU 8.3.2 R (if it applies with respect to a non-EEA sub-group). The effect will be to switch off this chapter with respect to the group in question apart from this section.

8.4.4 G The FCA will not grant an investment firm consolidation waiver unless:

(1) the UK consolidation group or non-EEA sub-group meets the conditions for being a CAD Article 22 group;

(2) the FCA is satisfied that each BIPRU firm in the UK consolidation group or non-EEA sub-group will be able to meet its capital requirements using the calculation of capital resources in GENPRU 2 Annex 6R (Capital resources table for a BIPRU firm with a waiver from consolidated supervision); and

(3) the firm demonstrates that the requirements in BIPRU 8.4.11 R to BIPRU 8.4.18 R will be met.

8.4.5 G The standards in BIPRU 8.4.4 G are minimum standards. Satisfaction of these conditions does not automatically mean the FCA will give an investment firm consolidation waiver. The FCA will in addition also apply the tests in Section 138A of the Act (Modification or waiver of rules).
Meeting the terms of an investment firm consolidation waiver

If a firm has an investment firm consolidation waiver with respect to its UK consolidation group or non-EEA sub-group but that UK consolidation group or non-EEA sub-group ceases to meet the definition of a CAD Article 22 group the firm must comply with the rest of this chapter rather than this section notwithstanding the investment firm consolidation waiver.

Compliance with the capital requirements set out in BIPRU 8.4.11 R is a condition under the Capital Adequacy Directive for the exemption from capital requirements. Thus if they are breached the FCA is likely to revoke the investment firm consolidation waiver.

Definition of a CAD Article 22 group

(1) A CAD Article 22 group means a UK consolidation group or non-EEA sub-group that meets the conditions in this rule.

(2) There must be no bank, building society or credit institution in the UK consolidation group or non-EEA sub-group and any investment firm in the UK consolidation group or non-EEA sub-group must not be subject to consolidated supervision under the EU CRR.

(3) Each CAD investment firm in the UK consolidation group or non-EEA sub-group which is an EEA firm must use the definition of own funds given in the CRD implementation measure of its EEA State for Article 16 of the Capital Adequacy Directive.

(4) Each CAD investment firm in the UK consolidation group or non-EEA sub-group must be a:

   (a) limited activity firm; or
   (b) limited licence firm.

(5) Each CAD investment firm in the UK consolidation group or non-EEA sub-group which is an EEA firm must:

   (a) meet the requirements imposed by the CRD implementation measures of its EEA State for Articles 18 and Article 20 of the Capital Adequacy Directive on an individual basis; and
   (b) deduct from its own funds any contingent liability in favour of other members of the UK consolidation group or non-EEA sub-group.

(6) Each BIPRU firm in the UK consolidation group or non-EEA sub-group must comply with the main BIPRU firm Pillar 1 rules on an individual basis.

GENPRU 2.2 (Capital resources) says that a BIPRU firm with an investment firm consolidation waiver should calculate its capital resources on a solo basis using GENPRU 2 Annex 6 (Capital resources table for a BIPRU firm with a
waiver from consolidated supervision). GENPRU 2 Annex 6 requires a BIPRU firm to deduct contingent liabilities in favour of other members of the UK consolidation group or non-EEA sub-group. Therefore BIPRU 8.4.9R (5)(b) only imposes the requirement to deduct them on EEA firms.

**Capital adequacy obligations relating to a CAD Article 22 group: General rule**

8.4.11 R

If a firm has an investment firm consolidation waiver, it must ensure that any financial holding company in the UK consolidation group or the non-EEA sub-group that is the UK parent financial holding company in a Member State of a CAD investment firm in the UK consolidation group or non-EEA sub-group has capital resources, calculated under BIPRU 8.4.12 R, in excess of the sum of the following (or any higher amount specified in the investment firm consolidation waiver):

(1) the sum of the solo notional capital resources requirements for each CAD investment firm, financial institution, asset management company and ancillary services undertaking in the UK consolidation group or the non-EEA sub-group, as calculated in accordance with BIPRU 8.4.13 R; and

(2) the total amount of any contingent liability in favour of CAD investment firms, financial institutions, asset management companies and ancillary services undertakings in the UK consolidation group or non-EEA sub-group.

**Capital adequacy obligations relating to a CAD Article 22 group: Capital resources**

8.4.12 R

A firm must calculate the capital resources of the parent financial holding company in a Member State for the purpose of BIPRU 8.4.11 R as follows:

(1) the capital resources are the sum of capital resources calculated at stages D (Total tier one capital before deductions) and I (Total tier two capital) of the version of the capital resources table in GENPRU 2 Annex 4R (Capital resources table for a BIPRU firm deducting material holdings) as adjusted in accordance with this rule;

(2) capital resources at stage D must not include innovative tier one capital resources, but they may be included at stage I if (5) allows this;

(3) the amount of the items which may be included at stage I must not exceed the amount calculated at stage D of the capital resources table;

(4) the amount of the items which may be included in lower tier two capital in stage I must not exceed 50% of the amount calculated at stage D of the capital resources table; and

(5) GENPRU 2.2.25 R (Limits on the use of different forms of capital: Use of higher tier capital in lower tiers) and GENPRU 2.2.27 R (Use of innovative tier one capital in lower stages of capital) apply.
### Capital adequacy obligations relating to a CAD Article 22 group: Capital resources requirement

**8.4.13**
- The solo notional capital resources requirement as referred to in BIPRU 8.4.11R (1) is calculated in the same way as the capital resources requirement for a BIPRU firm.

**8.4.14**
- A firm must exclude material holdings in the notional calculation of the credit risk capital requirement for the purposes of BIPRU 8.4.13 R. A firm must identify whether it has any material holdings and the amount of them in accordance with GENPRU 2.2 (Capital resources) and GENPRU 2 Annex 4 (Capital resources table for a BIPRU firm deducting material holdings).

**8.4.15**
- The notional capital resources requirement calculated under BIPRU 8.4.13 R need not include a credit charge for material holdings. However it should include one for illiquid assets.

**8.4.16**
- Intra-group exposures must not be netted for the purpose of BIPRU 8.4.11 R.

### Capital adequacy obligations relating to a CAD Article 22 group: Advanced prudential calculation approaches

**8.4.17**
- A firm may not use an advanced prudential calculation approach for the purpose of BIPRU 8.4.11 R.

### Additional rules that apply to a firm with an investment firm consolidation waiver

**8.4.18**
- If a firm has an investment firm consolidation waiver, it must:
  1. ensure that each CAD investment firm in the UK consolidation group or non-EEA sub-group which is a firm or an EEA firm has in place systems to monitor and control the sources of capital and funding of all the members in the UK consolidation group or non-EEA sub-group;
  2. notify the FCA of any serious risk that could undermine the financial stability of the UK consolidation group or non-EEA sub-group, as soon as the firm becomes aware of that risk, including those associated with the composition and sources of the capital and funding of members of the UK consolidation group or non-EEA sub-group;
  3. report the amount of the consolidated capital resources and consolidated capital resources requirement of the UK consolidation group or non-EEA sub-group on a periodic basis as set out in the investment firm consolidation waiver;
  4. report any large exposures risks of members of the UK consolidation group or non-EEA sub-group including any undertakings not located in an EEA State on a periodic basis set out in the investment firm consolidation waiver;
  5. notify the FCA immediately it becomes aware that the UK consolidation group or non-EEA sub-group has ceased to meet the conditions for being a CAD Article 22 group; and
(6) notify the FCA immediately it becomes aware of any breach of BIPRU 8.4.11 R.

8.4.19 Although an investment firm consolidation waiver switches off most of this chapter, a firm should still carry out the capital adequacy calculations in BIPRU 8.3 to BIPRU 8.8 as if those parts of this chapter still applied to the UK consolidation group or non-EEA sub-group and report these to the FCA. It should also still monitor large exposure risk on a consolidated basis.
8.5 Basis of consolidation

### Undertakings to be included in consolidation

**8.5.1** A firm must include only the following types of undertaking in a UK consolidation group or non-EEA sub-group for the purposes of this chapter:

1. a **BIPRU firm**;
2. [deleted]
3. a **financial institution**;
4. an **asset management company**;
5. a **financial holding company**;
6. a **mixed financial holding company**; and
7. an **ancillary services undertaking**.

Although an undertaking falling outside **8.5.1** will not be included in a UK consolidation group or non-EEA sub-group it may be relevant in deciding whether one undertaking in the banking sector or the investment services sector is a subsidiary undertaking of another with the result that they should be included in the same UK consolidation group or non-EEA sub-group.

**8.5.2** An example of **8.5.2** is as follows. Say that the undertaking at the head of a BIPRU firm’s UK group is a parent financial holding company in a Member State. One of its subsidiary undertakings is the firm. The parent financial holding company in a Member State also has an insurer as a subsidiary undertaking. That insurer has several BIPRU firms as subsidiary undertakings. Say that the UK group is not a financial conglomerate. The UK consolidation group will include the parent financial holding company in a Member State and the firm. It will also include the BIPRU firms that are subsidiary undertakings of the insurer. This is because the BIPRU firms are subsidiary undertakings of the parent financial holding company in a Member State through the parent financial holding company in a Member State’s holding in the insurer. However it will not include the insurer itself.

### Basis of inclusion of undertakings in consolidation

**8.5.4** A firm must include any subsidiary undertaking in the UK consolidation group or non-EEA sub-group in full in the calculations in this chapter.
8.5.5 R  In carrying out the calculations for the purposes of this chapter a firm must only include the relevant proportion of an undertaking that is a member of the UK consolidation group or non-EEA sub-group:

(1) by virtue of a consolidation Article 12(1) relationship;

(2) by virtue of an Article 134 relationship; or

(3) because the group holds a participation in it.

8.5.6 R  In BIPRU 8.5.5 R, the relevant proportion is either:

(1) (in the case of a participation) the proportion of shares issued by the undertaking held by the UK consolidation group or the non-EEA sub-group; or

(2) (in the case of a consolidation Article 12(1) relationship or an Article 134 relationship), such proportion (if any) as stated in the Part 4A permission of the firm.

Basis of inclusion of collective portfolio management investment firms in consolidation

8.5.7 R  GENPRU 2.1.46 R (Adjustment of the variable capital requirement calculation for collective portfolio management investment firms) does not apply for the purpose of this chapter.

8.5.8 G  In general a collective portfolio management investment firm only calculates its capital and concentration risk requirements in relation to its designated investment business and does not calculate them with respect to managing an AIF or managing a UCITS. The effect of BIPRU 8.5.7 R is that this does not apply on a consolidated basis. For the purpose of this chapter the calculations are carried out with respect to the whole of the activities of a collective portfolio management investment firm.

Exclusion of undertakings from consolidation: Balance sheet size

8.5.9 R  A firm may, having first notified the appropriate regulator in writing in accordance with SUP 15.7 (Form and method of notification), exclude a BIPRU firm, asset management company, financial institution or ancillary services undertaking that is a subsidiary undertaking in, or an undertaking in which a participation is held by, the UK consolidation group or non-EEA sub-group if the balance sheet total of that undertaking is less than the smaller of the following two amounts:

(1) 10 million Euros;

(2) 1% of the balance sheet total of the parent undertaking or the undertaking that holds the participation.

8.5.10 R  A firm must include undertakings, to which BIPRU 8.5.9 R would otherwise apply, if the balance sheet total of those undertakings taken together breaches the limit in BIPRU 8.5.9 R.
Exclusion of undertakings from consolidation: Other reasons

8.5.11 Article 73(1) of the Banking Consolidation Directive allows the appropriate regulator to decide to exclude a BIPRU firm, financial institution, asset management company or ancillary services undertaking that is a subsidiary undertaking in, or an undertaking in which a participation is held by, the UK consolidation group or non-EEA sub-group for the purposes of this chapter in the following circumstances:

1. where the head office of the undertaking concerned is situated in a country outside the EEA where there are legal impediments to the transfer of the necessary information; or

2. where, in the opinion of the appropriate regulator, the undertaking concerned is of negligible interest only with respect to the objectives of monitoring BIPRU firms; or

3. where, in the opinion of the appropriate regulator, the consolidation of the financial situation of the undertaking concerned would be inappropriate or misleading as far as the objectives of the supervision of BIPRU firms are concerned.

8.5.12 If a firm wishes to exclude an undertaking on the basis of any of the grounds set out in 8.5.11 it should apply to the appropriate regulator for a waiver. The appropriate regulator will consider such applications in the light of the criteria in Section 138A of the Act.

8.5.13 If several undertakings meet the criteria in 8.5.11(2), the appropriate regulator will not agree to a waiver to exclude them all from consolidation where collectively they are of non-negligible interest with respect to the objectives of the supervision of institutions.

Information about excluded undertakings

8.5.14 The appropriate regulator may require a firm to provide information about the undertakings excluded from consolidation of the UK consolidation group or non-EEA sub-group pursuant to this section.
8.6 Consolidated capital resources

General

8.6.1 A firm must calculate the consolidated capital resources of its UK consolidation group or its non-EEA sub-group by applying GENPRU 2.2 (Capital resources) to its UK consolidation group or non-EEA sub-group on an accounting consolidation basis, treating the UK consolidation group or non-EEA sub-group as a single undertaking. The firm must adjust GENPRU 2.2 in accordance with this section for this purpose.

Notification of issuance of capital instruments

8.6.1A This section applies to a firm if another member of its group intends to issue a capital instrument on or after 1 March 2012 for inclusion in the firm’s capital resources or consolidated capital resources of its UK consolidation group or non-EEA sub-group.

8.6.1B A firm must notify the appropriate regulator in writing of the intention of another member of its group which is not a firm to issue a capital instrument which the firm intends to include within its capital resources or the consolidated capital resources of its UK consolidation group or non-EEA sub-group as soon as it becomes aware of the intention of the group undertaking to issue the capital instrument. When giving notice, a firm must:

1. provide details of the amount of capital to be raised through the intended issue and whether the capital is intended to be issued to external investors or within its group;
2. identify the stage of the capital resources table the capital instrument is intended to fall within;
3. include confirmation from a senior manager of the firm responsible for authorising the inclusion of the issue within capital resources or consolidated capital resources that the capital instrument complies with the rules applicable to instruments included in the stage of the capital resources table identified in (2); and
4. provide details of any features of the capital instrument which are novel, unusual or different from a capital instrument of a similar nature previously issued by the firm or widely available in the market or not specifically contemplated by GENPRU 2.2.

This rule does not apply to a firm if a group undertaking intends to issue a capital instrument listed in BIPRU 8.6.1E R.
A firm must provide a further notification to the appropriate regulator in writing including all the information required in BIPRU 8.6.1BR (1) to (4) as soon as it becomes aware of any changes that are proposed to the intended date of issue, amount of issue, type of investors, stage of capital or any other feature of the capital instrument previously notified to the appropriate regulator.

If a group undertaking proposes to establish a debt securities program for the issue of capital instruments which the firm intends to include within its capital resources or the consolidated capital resources of its UK consolidation group or non-EEA sub-group, it must:

1. notify the appropriate regulator of the establishment of the program;

2. provide the information required by BIPRU 8.6.1BR (1) to (4);

as soon as it becomes aware of the proposed establishment. The appropriate regulator must be notified of any changes, in accordance with BIPRU 8.6.1C R.

The capital instruments to which BIPRU 8.6.1B R does not apply are:

1. ordinary shares issued by a group undertaking which:
   a. are the most deeply subordinated capital instrument issued by that group undertaking;
   b. meet the criteria set out in GENPRU 2.2.83R (2) and GENPRU 2.2.83R (3) and GENPRU 2.2.83A R; and
   c. are the same as ordinary shares previously issued by that group undertaking;

2. debt instruments issued from a debt securities program established by a group undertaking, provided the program was notified to the appropriate regulator prior to its first drawdown, in accordance with BIPRU 8.6.1D R; and

3. capital instruments which are not materially different in terms of their characteristics and eligibility for inclusion in a particular tier of capital to capital instruments previously issued by a group undertaking for inclusion in the firm’s capital resources or consolidated capital resources of its UK consolidation group or non-EEA sub-group.

A firm must notify the appropriate regulator in writing, no later than the date of issue, of the intention of a group undertaking to issue a capital instrument listed in BIPRU 8.6.1E R which the firm intends to include within its capital resources or the consolidated capital resources of its UK consolidation group or non-EEA sub-group. When giving notice a firm must:

1. provide the information set out at BIPRU 8.6.1BR (1) to (3); and
(2) confirm that the terms of the capital instrument have not changed since the previous issue of that type of capital instrument by that group undertaking.

Limits on the use of different forms of capital

8.6.2  The capital resources gearing rules apply for the purposes of calculating consolidated capital resources. They apply to the UK consolidation group or non-EEA sub-group on an accounting consolidation basis, treating the UK consolidation group or non-EEA sub-group as a single undertaking.

8.6.3  As the various components of capital differ in the degree of protection that they offer, the capital resources gearing rules as applied on a consolidated basis place restrictions on the extent to which certain types of capital are eligible for inclusion in a UK consolidation group or non-EEA sub-group's consolidated capital resources. GENPRU 2.2.25 R (Limits on the use of different forms of capital: Use of higher tier capital in lower tiers) also applies.

8.6.4  The prohibition in GENPRU 2.2 (Capital resources) on including innovative tier one capital in tier one capital for the purposes of meeting capital resources requirements applies under this section. However GENPRU 2.2.27 R (innovative tier one capital may be included in lower stages of capital when excluded from tier one capital) also applies. So, for example, a firm should not include consolidated indirectly issued capital in tier one capital but should generally include it as upper tier two capital.

8.6.5  The rules in GENPRU 2.2 (Capital resources) on what tier two capital and tier three capital can be used for also apply under this section.

8.6.6

8.6.7

Calculation of consolidated capital resources for a BIPRU firm group

8.6.8  A firm must calculate the consolidated capital resources of its UK consolidation group or non-EEA sub-group using the calculation of capital resources in GENPRU 2 Annex 4 (Capital resources table for a BIPRU firm deducting material holdings) or GENPRU 2 Annex 5 (Capital resources table for a BIPRU firm deducting illiquid assets).

8.6.9  A firm must give one Month's prior notice to the appropriate regulator before starting to use or stopping using the method in GENPRU 2 Annex 5 (Capital resources table for a BIPRU investment firm deducting illiquid assets).
Treatment of minority interests

8.6.10  This rule sets out how to determine whether minority interests in an undertaking in a UK consolidation group or non-EEA sub-group may be included in tier one capital, tier two capital or tier three capital for the purpose of calculating consolidated capital resources (each referred to as a “tier” of capital in this rule).

8.6.11  A firm must identify the item of capital of the undertaking in question that gives rise to that minority interest.

8.6.12  A firm must include the minority interest in the tier of capital in which that undertaking would have to include the capital referred to in (2) if it were a firm calculating its capital resources on a solo basis under whichever method applies to the group under BIPRU 8.6.6 R to BIPRU 8.6.8 R.

8.6.13  This rule does not apply to a minority interest created by consolidated indirectly issued capital.

Indirectly issued capital and group capital resources

8.6.11  For the purposes of this chapter, GENPRU 2.2.123 R to GENPRU 2.2.137 R (Indirectly issued tier one capital (BIPRU firm only)) do not apply. A firm may only include consolidated indirectly issued capital in consolidated capital resources (whether as a minority interest or otherwise) in accordance with this section.

8.6.12  Consolidated indirectly issued capital means any capital instrument issued by a member of the UK consolidation group or non-EEA sub-group where:

8.6.13  A firm may only include consolidated indirectly issued capital in the consolidated capital resources of its UK consolidation group or non-EEA sub-group if:

8.6.14  Consolidated indirectly issued capital that is eligible for inclusion in the consolidated capital resources of a UK consolidation group or non-EEA sub-
group may only be included as a minority interest created by the capital instrument issued by the SPV referred to in BIPRU 8.6.13 R. If it is eligible, it is innovative tier one capital.

8.6.15  R  For the purposes of this section, an undertaking is an SPV if the main activity of the SPV is to raise funds for undertakings in:

(1) (in the case of a UK consolidation group) that UK consolidation group; or

(2) (in the case of a non-EEA sub-group) that non-EEA sub-group or any UK consolidation group of which it forms part.

8.6.16  R  The SPV referred to in BIPRU 8.6.13 R must satisfy the conditions in GENPRU 2.2.127 R (Conditions that an SPV has to satisfy if indirectly issued capital is to be included in capital resources on a solo basis) as modified by the following:

(1) references in GENPRU 2.2.127R (1) to being controlled by the firm are to being controlled by a member of the firm's UK consolidation group or non-EEA sub-group as the case may be; and

(2) references to the firm's group are to the firm's UK consolidation group or non-EEA sub-group as the case may be.

8.6.17  R  The capital issued by the SPV referred to in BIPRU 8.6.13 R must satisfy the conditions in GENPRU 2.2.129 R (Conditions that capital issued by an SPV has to satisfy if indirectly issued capital is to be included in capital resources on a solo basis) as modified by the following:

(1) references to the firm's group are to the firm's UK consolidation group or non-EEA sub-group as the case may be;

(2) the substitution obligation in GENPRU 2.2.129R (2) need not be the firm's but may apply to any member of the UK consolidation group or non-EEA sub-group as the case may be; and

(3) that substitution obligation applies if the consolidated capital resources of the UK consolidation group or non-EEA sub-group, as the case may be, fall, or are likely to fall, below its consolidated capital resources requirement.

8.6.18  R  The SPV referred to in BIPRU 8.6.13 R must invest the funds raised from the issue of capital by the SPV by subscribing for capital resources issued by an undertaking that is a member of the UK consolidation group or non-EEA sub-group. Those capital resources must satisfy the following conditions:

(1) those capital resources must at least comply with the requirements for lower tier two capital; and

(2) the first call date or fixed maturity date (if any) of those capital resources must not arise before the first call date on the instrument issued by the SPV.
In relation to the obligation to substitute described in BIPRU 8.6.17R (2), a firm must take all reasonable steps to ensure that the undertaking in question has at all times sufficient authorised and unissued tier one instruments other than innovative tier one instruments (and authority to issue them) to enable it to discharge the obligation to substitute.

A firm must comply with the requirements set out in GENPRU 2.2.135R (Notifying the appropriate regulator of unusual transactions in relation to indirectly issued capital) and GENPRU 2.2.137 R (Contents of marketing documents in relation to indirectly issued capital) in relation to consolidated indirectly issued capital included in consolidated capital resources.
8.7 Consolidated capital resources requirements

General approach

8.7.1 The calculation of the consolidated capital resources requirement of a firm’s UK consolidation group or non-EEA sub-group involves taking the individual components that make up the capital resources requirement on a solo basis and applying them on a consolidated basis. Those components are the capital charge for credit risk (the credit risk capital requirement), the capital charge for market risk (the market risk capital requirement) and the fixed overheads requirement.

8.7.2 Each of the capital charges in BIPRU 8.7.1 G, as applied on a consolidated basis, is called a consolidated requirement component. The name of each consolidated requirement component reflects the solo capital charge on which it is based. Solo capital charges are called risk capital requirements. Thus for example the consolidated requirement component for market risk is called the consolidated market risk requirement. The calculation of the consolidated market risk requirement is based on the calculation of the capital charge for market risk that applies on a solo basis (the market risk capital requirement). So the risk capital requirement applicable to the consolidated market risk requirement is the market risk capital requirement.

8.7.3

8.7.4

8.7.5 In general a firm should calculate each consolidated requirement component using the appropriate regulator’s rules, even in the case of group members who are subject to the capital requirements of an overseas regulator. However this section sets out certain circumstances in which a firm may use the capital requirements of an overseas regulator.

8.7.6 BIPRU 8.8 (Advanced prudential calculation approaches) says that a firm should not apply an advanced prudential calculation approach on a consolidated basis unless the advanced prudential calculation approach permission allowing the firm to use the advanced prudential calculation approach specifically allows it to be used on consolidated basis.
8.7.7 BIPRU 8.8 (Advanced prudential calculation approaches) has further details about how capital requirements are calculated on a consolidated basis if a firm uses an advanced prudential calculation approach.

8.7.8 A firm has a choice about how it should apply a risk capital requirement to the group. It may do this by treating the whole of the group as a single entity and applying the risk capital requirement to the group (a line by line approach), calculating a separate risk capital requirement for each group member (an aggregation approach) or a mixture of the two.

8.7.9 A firm may make the choice between an aggregation and a line by line approach differently for each consolidated requirement component. So for example a firm may decide to calculate the consolidated market risk requirement on an aggregation basis and the consolidated fixed overheads requirement on a line by line basis.

Method of calculation to be used

8.7.10 A firm must calculate the consolidated capital resources requirement of its UK consolidation group or non-EEA sub-group as the higher of the following consolidated requirements components:

(1) the sum of the consolidated credit risk requirement and the consolidated market risk requirement; and

(2) the consolidated fixed overheads requirement.

Calculation of the consolidated requirement components

8.7.11 A firm must calculate a consolidated requirement component by applying the risk capital requirement applicable to that consolidated requirement component to the UK consolidation group or non-EEA sub-group in accordance with BIPRU 8.7.13 R. Except where BIPRU 8.7.34 R to BIPRU 8.7.38 R allow the requirements of another regulator to be used, the risk capital requirement must be calculated in accordance with the appropriate regulator’s rules. The risk capital requirement applicable to a consolidated requirement component is the one specified in the second column of the table in BIPRU 8.7.12 R.

8.7.12 Table: Capital charges relating to consolidated requirement components

<table>
<thead>
<tr>
<th>Consolidated requirement component</th>
<th>Rules on which the consolidated requirement component are based (the applicable risk capital requirement)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated credit risk requirement</td>
<td>Credit risk capital requirement</td>
</tr>
<tr>
<td>Consolidated fixed overheads requirenent</td>
<td>Fixed overheads requirement</td>
</tr>
<tr>
<td>Consolidated market risk requirement</td>
<td>Market risk capital requirement</td>
</tr>
</tbody>
</table>
Choice of consolidation method

8.7.13 R

(1) A firm must calculate a consolidated requirement component by using one of the methods in this rule.

(2) Under the first method a firm must:

(a) apply the risk capital requirement set out in BIPRU 8.7.12 R to each undertaking in the UK consolidation group or non-EEA sub-group; and

(b) add the risk capital requirements together.

(3) Under the second method a firm must:

(a) treat the whole UK consolidation group or non-EEA sub-group as a single undertaking; and

(b) apply the risk capital requirement set out in BIPRU 8.7.12 R to the group on an accounting consolidation basis.

(4) The third method is a mixture of methods one and two. Under the third method a firm must:

(a) treat one or more parts of the UK consolidation group or non-EEA sub-group as separate single undertakings;

(b) apply the risk capital requirement set out in BIPRU 8.7.12 R to each such part of the group on an accounting consolidation basis;

(c) apply the risk capital requirement set out in BIPRU 8.7.12 R to each of the remaining undertakings in the UK consolidation group or non-EEA sub-group (if any); and

(d) add the risk capital requirements together.

(5) A firm may use different methods for different consolidated requirement components.

8.7.14 G

An accounting consolidation basis means applying the rules in BIPRU 8.7.12 R on a line by line consolidation basis rather than an aggregation basis.

8.7.15 G

The provisions of this section on credit risk and market risk restrict the choice given by BIPRU 8.7.13 R in certain circumstances.

Notifying the appropriate regulator of the choice of consolidation technique

8.7.16 R

A firm must notify the appropriate regulator which method under BIPRU 8.7.13 R it applies for which consolidated requirement component and to which parts of the UK consolidation group or non-EEA sub-group it is applying an aggregation approach and to which parts it is applying an accounting consolidation approach.

Special rules for the consolidated credit risk requirement

8.7.17 R

BIPRU 8.7.18 G to BIPRU 8.7.23 R relate to the calculation of the consolidated credit risk requirement.
The credit risk capital requirement (on which the consolidated credit risk requirement is based) is split into two capital charges. One relates to credit risk in the non-trading book (the credit risk capital component). One relates to credit risk in the trading book (the counterparty risk capital component).

8.7.20 A firm may use a combination of the CCR standardised method, the CCR mark to market method and the CCR internal model method on a permanent basis with respect to the firm’s UK consolidation group or non-EEA sub-group for the purposes of calculating the consolidated credit risk requirement. In particular, where the firm is permitted to apply the CCR internal model method on a consolidated basis with respect to its UK consolidation group or non-EEA sub-group, it may combine the use of CCR standardised method and CCR mark to market method on a permanent basis for financial derivative instruments and long settlement transactions not covered by its CCR internal model method permission.

8.7.21 A firm may only treat an exposure as exempt under BIPRU 3.2.25 R (Zero risk-weighting for intra-group exposures) as applied on a consolidated basis if the member of the UK consolidation group or non-EEA sub-group that has the exposure:

(a) is a BIPRU firm and that exposure is exempt under BIPRU 3.2.25 R as it applies to that BIPRU firm on a solo basis; or

(b) meets the conditions in BIPRU 3.2.25 R (1)(d) (Condition relating to establishment in the UK) and that exposure would be exempt under (a) if that member was a BIPRU firm.

(2) The notification obligation in BIPRU 3.2.35 R applies.

Special rules for the consolidated market risk requirement

8.7.24 For the purposes of calculating the consolidated market risk requirement of a UK consolidation group or non-EEA sub-group, a firm must apply BIPRU 1.2.3 R (Definition of the trading book) and BIPRU 1.2.17 R (Size thresholds for the purposes of the definition of the trading book) to the whole UK consolidation group or non-EEA sub-group as if the group were a single undertaking.

8.7.25 A firm may not apply the second method in BIPRU 8.7.13R (3) (accounting consolidation for the whole group) or apply accounting consolidation to parts of its UK consolidation group or non-EEA sub-group under method...
three as described in BIPRU 8.7.13R (4)(a) for the purposes of the calculation of the consolidated market risk requirement unless the group or sub-group and the undertakings in that group or sub-group satisfy the conditions in this rule. Instead the firm must use the aggregation approach described in BIPRU 8.7.13R (2) (method one) or BIPRU 8.7.13R (4)(c). Those conditions are as follows:

(1) each of the undertakings in that group or sub-group is an institution that is:
   (a) a BIPRU firm;
   (b) an EEA firm that is a CAD investment firm; or
   (c) a recognised third country investment firm;
   (d) a recognised third country investment firm;

(2) each of the undertakings referred to in (1) that is a BIPRU firm has capital resources that are equal to or in excess of its capital resources requirement;

(3) each of the undertakings referred to in (1) that is an EEA firm complies with the CRD implementation measures in its EEA State that correspond to the requirements in (2);

(4) each of the undertakings referred to in (1) that is a recognised third country investment firm complies with laws in the state or territory in which it has its head office that are equivalent to the requirements of the Banking Consolidation Directive or Capital Adequacy Directive relating to capital adequacy;

(5) there is no material legal, regulatory or contractual impediment to the transfer of funds between those undertakings in that group or sub-group;

(6) there is no material legal, regulatory or contractual impediment to mutual financial support between those undertakings in that group or sub-group;

(7) the market risk position of the undertakings are monitored and managed on a co-ordinated basis; and

(8) there is satisfactory allocation of capital within the group or sub-group.

8.7.26 [deleted]

8.7.27 [deleted]
Special rules for calculating specific consolidated requirement components

8.7.28  G  BIPRU 8.7.21 R to BIPRU 8.7.26 R are generally examples of the application of the general principles in BIPRU 8.2.1 R (Main consolidation rule for UK consolidation groups) and BIPRU 8.3.1 R (Main consolidation rule for non-EEA sub-groups). BIPRU 8.7.20 R and BIPRU 8.7.25 R are exceptions to those principles.

Elimination of intra-group transactions

8.7.29  R  In accordance with BIPRU 8.2.1 R and BIPRU 8.3.1 R (The basic consolidation rules for a UK consolidation group or non-EEA sub-group), a firm may exclude that part of the risk capital requirement that arises as a result of:

1. (in respect of the consolidated credit risk requirement) intra-group balances; or
2. (in respect of the consolidated fixed overheads requirement) intra-group transactions;

with other undertakings in the UK consolidation group or non-EEA sub-group.

Other provisions about calculating risk capital requirements

8.7.30  R

If a firm is calculating a risk capital requirement for an undertaking that is not a BIPRU firm it should calculate it as if the undertaking were a BIPRU firm.

8.7.31  G

A firm should not use an advanced prudential calculation approach for calculating a risk capital requirement unless this is permitted as explained in BIPRU 8.8 (Advanced prudential calculation approaches).

Use of the solo requirements of another EEA competent authority

8.7.34  R

A firm may calculate the risk capital requirement for an institution in the firm’s UK consolidation group or non-EEA sub-group that is an EEA firm in accordance with the CRD implementation measures in the EEA firm’s EEA State that correspond to the appropriate regulator’s rules that would otherwise apply under this section if the institution is subject to those CRD implementation measures.

8.7.35  R

1. [deleted]
2. [deleted]
Use of the consolidated requirements of another EEA competent authority

8.7.37  (1) This rule applies if:

(a) a firm is applying an accounting consolidation approach to part of its UK consolidation group or non-EEA sub-group under method three as described in BIPRU 8.7.13R (4)(a); and

(b) the part of the group in (a) constitutes the whole of a group subject to the consolidated capital requirements of a competent authority under the CRD implementation measures relating to consolidation under the Banking Consolidation Directive or the Capital Adequacy Directive.

(2) If the conditions in this rule are satisfied, a firm may apply the consolidated capital requirement in (1)(b) as the risk capital requirement for the group identified in (1)(a) so far as that consolidated capital requirement corresponds to the appropriate regulator’s rules that would otherwise apply under this section.

Prohibition on using the standardised rules of a regulator outside the EEA

8.7.38A  (1) This rule applies to a firm if:

(a) an institution in its UK consolidation group or non-EEA sub-group is subject to any of the rules or requirements of, or administered by, a third-country competent authority applicable to its financial sector that correspond to the sectoral rules applicable to that financial sector (“corresponding sectoral rules”); or
(b) a part of its UK consolidation group or non-EEA sub-group constitutes the whole of a group subject to the consolidated capital requirements of a third-country competent authority under the corresponding sectoral rules applicable to the banking sector or the investment services sector for a state or territory outside the EEA.

(2) A firm may not use the requirements under any of the corresponding sectoral rules of a state or territory outside the EEA in order to calculate the consolidated capital resources requirement of its UK consolidation group or non-EEA sub-group for the purpose of this chapter.

Use of an advanced prudential calculation approach under the rules of an overseas regulator

A firm should not use the requirements of an overseas regulator if that would involve the use of an advanced prudential calculation approach unless this is permitted under BIPRU 8.8 (Advanced prudential calculation approaches).
8.8 Advanced prudential calculation approaches

General

8.8.1 A firm must not apply any advanced prudential calculation approach for the purposes of this chapter unless it has an advanced prudential calculation approach permission and that advanced prudential calculation approach permission requires the firm to use that advanced prudential calculation approach for those purposes.

8.8.2 [BIPRU 1.3 (Applications for advanced approaches) deals with how to apply for an advanced prudential calculation approach permission.]

Prohibition on using the rules of an overseas regulator

8.8.3 Even if a firm has an advanced prudential calculation approach permission that allows it to use an advanced prudential calculation approach for the purposes of this chapter, the firm may not use the requirements of another state or territory to the extent they provide for that advanced prudential calculation approach. Therefore a firm may not use [BIPRU 8.7.34 R and BIPRU 8.7.37 R (Use of the capital requirements of another EEA competent authority) if that would involve using an advanced prudential calculation approach.]

Special provisions relating to the internal ratings based approach

8.8.4 The conditions in [BIPRU 4.2.26 R (Combined use of methodologies under the IRB approach) apply to a firm’s UK consolidation group or non-EEA sub-group as if that group were a single undertaking.

8.8.5

8.8.6

8.8.7
Special provisions relating to the CCR internal model method

8.8.8  ■ BIPRU 8.7.17 R deals with the combination of the CCR internal model method with other approaches to calculating exposure values on a group level.

Corporate governance arrangement for the IRB approach and the AMA

8.8.9  ■ The governance arrangements that apply to the governing body, the senior management and any designated committee of a firm in relation to the IRB approach also apply to the body or persons with equivalent powers with respect to the UK consolidation group or non-EEA sub-group. Where the parent undertaking and its subsidiary undertakings use rating systems on a unified basis, the approval and reporting process described in § BIPRU 4.3.12 G (Approval and reporting arrangements for the IRB approach where rating systems are used on a unified group basis) apply for the purpose of this paragraph too.
Decision tree identifying a UK consolidation group

Test 1A: Is the firm a parent institution in a Member state (PIMS)?

No

Test 1B: Is the firm a subsidiary undertaking of a parent institution in a Member State?

No

Test 1C: Is the firm a parent financial holding company in a Member State (PFC HS)?

No

Test 1D: Is the firm a subsidiary undertaking of a parent financial holding company in a Member State?

Yes

Test 2: Is the appropriate regulator required to supervise the group headed by a PIMS or PFC HS under Article 125 or 136(1) or (2) of the CRD or those Articles as applied by the CAD?

Yes

Yes

UK CONSOLIDATION GROUP is the PIMS or PFC HS and its group

No

Test 3: Has it been agreed pursuant to Article 136(3) of the CRD that the appropriate regulator shall supervise the group headed by a PIMS or PFC HS?

Yes

BUT A UK CONSOLIDATION GROUP

No
Text of Articles 125 and 126 of the Banking Consolidation Directive

Article 125

1. Where a parent undertaking is a parent credit institution in a Member State or an EU parent credit institution, supervision on a consolidated basis shall be exercised by the competent authorities that authorised it under Article 6.

2. Where the parent of a credit institution is a parent financial holding company in a Member State, a parent mixed financial holding company in a Member State an EU parent financial holding company or an EU parent mixed financial holding company, supervision on a consolidated basis shall be exercised by the competent authorities that authorised that credit institution under Article 6.

Article 126

1. Where credit institutions authorised in two or more Member States have as their parent the same parent financial holding company in a Member State, the same mixed parent financial holding company in a Member State, the same EU parent financial holding company or the same EU parent mixed financial holding company, supervision on a consolidated basis shall be exercised by the competent authorities of the credit institution authorised in the Member State in which the financial holding company or mixed financial holding company is established.

Where the parents of credit institutions authorised in two or more Member States comprise more than one financial holding company or mixed financial holding company which have their head offices in different Member States and there is a credit institution in each of these States, supervision on a consolidated basis shall be exercised by the competent authority of the credit institution with the largest balance sheet total.

2. Where more than one credit institution authorised in the Union has as its parent the same financial holding company or the same mixed financial holding company and none of these credit institutions has been authorised in the Member State in which the financial holding company or the mixed financial holding company is established, supervision on a consolidated basis shall be exercised by the competent authority that authorised the credit institution controlled by an EU parent financial holding company or an EU parent mixed financial holding company.

3. In particular cases, the competent authorities may by common agreement waive the criteria referred to in paragraphs 1 and 2 if their application would be inappropriate, taking into account the credit institutions and the relative importance of their activities in different countries, and appoint a different competent authority to exercise supervision on a consolidated basis. In these cases, before taking their decision, the competent authorities shall give the EU parent credit institution, EU parent financial holding company, the EU parent mixed financial holding company, or credit institu-
4. Note

The Capital Adequacy Directive says that generally references in Articles 125 and 126 of the Banking Consolidation Directive to credit institution should be read as including ones to CAD investment firms. Also, the Banking Consolidation Directive and the Capital Adequacy Directive apply to the EEA. Therefore for the purposes of BIPRU 8 Articles 125 and 126 of the Banking Consolidation Directive should be read with the following adjustments:

(1) a reference to a credit institution should be read as being one to a credit institution or CAD investment firm;

(2) a reference to a parent credit institution in a Member State should be read as being one to a parent institution in a Member State;

(3) a reference to a EU parent credit institution should be read as being one to an EEA parent institution;

(4) a reference to a EU parent financial holding company should be read as being one to an EEA parent financial holding company;

(4a) a reference to a EU parent mixed financial holding company should be read as being one to an EEA parent mixed financial holding company;

(5) a reference to a Member State should be read as being one to an EEA State;

(6) a reference to a credit institution authorised in the Community should be read as being one to a credit institution or CAD investment firm authorised in an EEA State.

Parent financial holding company in a Member State, financial holding company, parent mixed financial holding company in a Member State and mixed financial holding company have the same meaning as they do in the Glossary.
Non-EEA regulators' requirements deemed CRD-equivalent for individual risks

<table>
<thead>
<tr>
<th>Regime regulators</th>
<th>Market risk</th>
<th>Credit risk</th>
<th>Operational Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>✓</td>
<td>X*</td>
<td>✓</td>
</tr>
<tr>
<td>Office of the Comptroller of the Currency</td>
<td>✓</td>
<td>X*</td>
<td>✓</td>
</tr>
<tr>
<td>Board of Governors of the Federal Reserve System</td>
<td>✓</td>
<td>X*</td>
<td>✓</td>
</tr>
<tr>
<td>* a US banking subsidiary will be deemed equivalent for credit risk if:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• it is categorised as well capitalised; and</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• it scales up its US Basel 1 credit risk requirement by 25%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Australian Prudential Regulation Authority [APRA]</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Canada</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Office of the Superintendent of Financial Institutions [OSFI]</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Switzerland</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Swiss Financial Market Supervisory Authority [FINMA]</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Japan</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Financial Services Agency, Japan [JFSA]</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>South Africa</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>South African Reserve Bank [SARB]</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Hong Kong Monetary Authority [HKMA]</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Singapore</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Monetary Authority of Singapore [MAS]</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Regime regulators</td>
<td>Market risk</td>
<td>Credit risk</td>
<td>Operational Risk</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>-------------</td>
<td>-------------</td>
<td>------------------</td>
</tr>
<tr>
<td>India</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Reserve Bank of India [RBI]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Financial Supervisory Service [FSS]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jersey</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Guernsey</td>
<td>X</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Isle of Man</td>
<td>X</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

Note 1: A ✓ denotes that the requirements have been assessed as equivalent to EEA standards. A X denotes that the requirements have been assessed as not being equivalent to EEA standards.

Note 2: ✓ International standardised approach only. The treatment of the Lombard loans is not equivalent and they must be treated under the appropriate regulator’s rules.

<table>
<thead>
<tr>
<th>Regime regulators</th>
<th>Market risk</th>
<th>Credit risk</th>
<th>Operational Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Sydney Futures Exchange</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Australian Stock Exchange</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Ontario Securities Commission</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Quebec Securities Commission</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>British Columbia Securities Commission</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Alberta Securities Commission</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment dealers Association of Canada</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Hong Kong Monetary Authority [HKMA]</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Hong Kong Securities and Futures Commission</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Financial Services Agency, Japan [JFSA]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Monetary Authority of Singapore [MAS]</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Regime regulators</td>
<td>Market risk</td>
<td>Credit risk</td>
<td>Operational Risk</td>
</tr>
<tr>
<td>---------------------------------------</td>
<td>-------------</td>
<td>-------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Stock Exchange of Singapore</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>South Africa</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>South African Futures Exchange</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Johannesburg Stock Exchange</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Bond Exchange of South Africa</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Switzerland</td>
<td>✓</td>
<td>✓ Note 2</td>
<td>✓</td>
</tr>
<tr>
<td>Swiss Federal Banking Commission [EBK]</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>✓ Note 3</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Securities &amp; Exchange Commission (SEC): Net Capital rule only</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Commodities and Futures Trading Commission</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note 1: A ✓ denotes that the requirements have been assessed as equivalent to EEA standards. A ✗ denotes that the requirements have been assessed as not being equivalent to EEA standards.

Note 2: ✓ International standardised approach only. The treatment of Lombard loans is not equivalent and they must be treated under the appropriate regulator’s rules.

Note 3: ✓ Where entities are subject to a local regulatory capital requirement.
Chapter 9

Securitisation
9.1 Application and purpose

Application

9.1.1 R BIPRU 9.1 applies to a BIPRU firm.

Purpose

9.1.2 G Pursuant to the third paragraph of article 95(2) of the EU CRR, the purpose of BIPRU 9 is to implement:

(1) Articles 94 to 96, paragraphs (1) and (5) of Article 97, Article 99, Article 100(1) and Article 101;

(2) Points 8 and 9 of Annex V; and

(3) Parts 2, 3 (in part) and 4 of Annex IX;

of the Banking Consolidation Directive.

General obligations: Risk-weighted exposures

9.1.3 R A firm must calculate the risk weighted exposure amount for securitisation positions in accordance with BIPRU 9.

9.1.4 G A firm should apply the securitisation framework set out in this chapter for determining regulatory capital requirements on exposures arising from traditional securitisations and from synthetic securitisations and from structures that contain features of both.

9.1.5 G Since transactions may be structured in many different ways, the capital treatment of a position should be determined on the basis of its economic substance rather than merely its legal form. A firm should look to the economic substance of a transaction to determine whether the securitisation framework is applicable for purposes of determining regulatory capital. A firm should consult the appropriate regulator when there is uncertainty about whether a given transaction should be considered a securitisation.

General obligations: Systems

9.1.6 R The risks arising from securitisation transactions in relation to which a firm is investor, originator or sponsor, including reputational risks, must be evaluated and addressed through appropriate policies and procedures, to
ensure in particular that the economic substance of the transaction is fully reflected in risk assessment and management decisions.

[Note: BCD Annex V point 8]

9.1.7 A firm that is a party to a securitisation should fully understand the risks it has assumed or retained. In particular it should do so in order that it can correctly determine in accordance with BIPRU 9 the capital effects of the securitisation.

9.1.8 The appropriate regulator expects an originator to continue to monitor any risks that it may be subject to when it has excluded the securitised exposures from its calculation of risk weighted exposure amounts. The originator should consider capital planning implications where risks may return and the impact that securitisation has on the quality of the remaining exposures held by the originator.

9.1.8A (1) The appropriate regulator expects firms to conduct regular stress testing in relation to their securitisation activities and off-balance sheet exposures. The stress tests should consider the firm-wide impact of those activities and exposures in stressed market conditions and the implications for other sources of risk, for example, credit risk, concentration risk, counterparty risk, market risk, liquidity risk and reputational risk. Stress testing of securitisation activities should take into account both existing securitisations and pipeline transactions, as there is a risk that these would not be completed in a stressed market scenario.

(2) The frequency and extent of the stress testing should be determined by the materiality of the firm’s securitisation activities and off-balance sheet exposures.

(3) A firm should have procedures in place to assess and respond to the results produced from the stress testing and these should be taken into account under the overall Pillar 2 rule.

Trading book and non-trading book

9.1.9 BIPRU 9 deals with:

(1) requirements for investors, originators and sponsors of securitisations of non-trading book exposures;

(2) the calculation of risk weighted exposure amount for securitisation positions for the purposes of calculating either the credit risk capital component or the counterparty risk capital component; and

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

9.1.10 BIPRU 7 sets out the calculation of the market risk capital requirement for securitisation positions held in the trading book.
9.2 Approach to be used

9.2.1 **R**

(1) Where a firm uses the standardised approach set out in ■ BIPRU 3 (Standardised approach to credit risk) for the calculation of risk weighted exposure amount for the standardised credit risk exposure class to which the securitised exposures would otherwise be assigned under ■ BIPRU 3, then it must calculate the risk weighted exposure amount for a securitisation position in accordance with the standardised approach to securitisations set out in ■ BIPRU 9.9, ■ BIPRU 9.10, ■ BIPRU 9.11 and ■ BIPRU 9.13.

(2) In all other cases it must calculate a risk weighted exposure amount in accordance with the IRB approach to securitisations set out in ■ BIPRU 9.9, ■ BIPRU 9.10, ■ BIPRU 9.12, ■ BIPRU 9.13 and ■ BIPRU 9.14.

[Note: BCD Article 94]
9.3 Requirements for originators and sponsors

9.3.1 (1) Where significant credit risk associated with securitised exposures has been transferred from the originator in accordance with the terms of BIPRU 9.4 or BIPRU 9.5, that originator may:

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

(b) in the case of a synthetic securitisation, calculate risk weighted exposure amounts and, as relevant, expected loss amounts in respect of such exposures, in accordance with the provisions of BIPRU 9.5.

(2) Where (1) applies, the originator must calculate the risk weighted exposure amounts prescribed in this chapter for the positions it may hold in the securitisation.

(3) Where the originator fails to transfer significant credit risk in accordance with (1), it need not calculate risk weighted exposure amounts for any positions it may hold in the securitisation in question.

[Note: BCD Article 95]
An originator should not adjust its assessment of the transfer of risk in order to reflect uncertainties related to the effectiveness of a securitisation under BIPRU 9.4 or BIPRU 9.5. Instead the originator should treat the terms of BIPRU 9.4 or BIPRU 9.5 as not having been satisfied.

Significant credit risk will be considered to have been transferred for originators in the following cases:

1. the risk weighted exposure amounts of the mezzanine securitisation positions held by the originator in the securitisation do not exceed 50% of the risk weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;

2. where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator does not hold more than 20% of the exposure values of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight.

[Note: BCD, Annex IX, Part 2, Point 1, paragraph 1a and Point 2 paragraph 2a]

An originator must notify the appropriate regulator that it is relying on the deemed transfer of significant credit risk under BIPRU 9.3.7R within a reasonable period before or after a relevant transfer, not being later than one month after the date of the transfer. The notification must include the following information:

1. the risk weighted exposure amount of the securitised exposures and retained securitisation positions;

2. the exposure value of the securitised exposures and the retained securitisation positions;

3. details of the securitisation positions, including rating, exposure value broken down by securitisation positions sold and retained;

4. a statement that sets out why the firm is satisfied that the reduction in risk weighted exposure amounts is justified by a commensurate transfer of credit risk to third parties;

5. any relevant supporting documents, for example, a summary of the transaction.

In the event that the appropriate regulator decides that the possible reduction in risk weighted exposure amounts which the originator would achieve by the securitisation referred to in BIPRU 9.3.7R is not justified by a commensurate transfer of credit risk to third parties, it will use its powers under section 55J of the Act (Variation etc on the Authority’s own initiative) to require the firm to increase its risk weighted exposure amount to an amount commensurate with the appropriate regulator’s assessment of the transfer of credit risk to third parties.
An originator may be granted a waiver of the requirements in BIPRU 9.3.7R and BIPRU 9.3.8R.

An originator’s application for a waiver of the requirements in BIPRU 9.3.7R and BIPRU 9.3.8R must demonstrate that the following conditions are satisfied:

1. it has policies and methodologies in place which ensure that the possible reduction of capital requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties; and

2. that such transfer of credit risk to third parties is also recognised for the purposes of the originator’s internal risk management and its internal capital allocation.

(Note: BCD, Annex IX, Part 2, Point 1, paragraph 1c and Point 2 paragraph 2c)

BIPRU 1.3.10 G sets out the appropriate regulator’s approach to the granting of waivers. The conditions in BIPRU 9.3.11D are minimum requirements. Satisfaction of those does not automatically mean the appropriate regulator will grant the relevant waiver. The appropriate regulator will in addition also apply the tests in section 138A (Modification or waiver of rules) of the Act.

When considering an application for a waiver of the requirements in BIPRU 9.3.7R and BIPRU 9.3.8R, the appropriate regulator may undertake a visit to the firm in order to examine the firm’s risk management and governance arrangements. Before such a visit, the appropriate regulator may request information from the firm additional or supplementary to that provided in the waiver application.

An originator should clearly state the scope of the waiver of the requirements in BIPRU 9.3.7R and BIPRU 9.3.8R it is seeking in its application. For example, residential mortgage backed securities may be subdivided into prime and sub-prime with only one sub-category within the scope of the waiver. Relevant asset classes may therefore be defined according to a firm’s internal usage of terms.

Origination criteria

An originator may be granted a waiver of the requirements in BIPRU 9.3.7R and BIPRU 9.3.8R.
9.3.20 **R**

9.3.21 **G** Subject to BIPRU 9.3.22G, BIPRU 9.15.9R and BIPRU 9.15.10R, where the originator or sponsor of a securitisation fails to meet any of the requirements in BIPRU 9.3.18R to BIPRU 9.3.20R (disclosure requirements) in any material respect by reason of its negligence or omission, the appropriate regulator will use its powers under section 55J (Variation etc on the Authority's own initiative) of the Act to impose an additional risk weight of no less than 250% (capped at 1250%) of the risk weight that would otherwise apply to the relevant securitisation positions under the rules in BIPRU 9.11 to BIPRU 9.14. The additional risk weight imposed will be progressively increased with each relevant, subsequent infringement of the requirements in BIPRU 9.3.18R to BIPRU 9.3.20R.

[Note: BCD, Article 122a, paragraph 5]

9.3.22 **G** When calculating the additional risk weight it will impose, the appropriate regulator will take into account the exemption of certain securitisations from the scope of BIPRU 9.15.3R under BIPRU 9.15.9R and BIPRU 9.15.10R and, if those exemptions are relevant, reduce the risk weight it would otherwise impose.

[Note: BCD, Article 122a, paragraph 5]
9.4 Traditional securitisation

Minimum requirements for recognition of significant credit risk transfer

9.4.1 The originator of a traditional securitisation may exclude securitised exposures from the calculation of risk weighted exposure amounts and expected loss amounts if either of the following conditions is fulfilled:

(1) significant credit risk associated with the securitised exposures is considered to have been transferred to third parties; or

(2) the originator applies a 1250% risk weight to all securitisation positions it holds in the securitisation or deducts these securitisation positions from capital resources according to GENPRU 2.2.237 R;

and the transfer complies with the conditions in BIPRU 9.4.2R BIPRU 9.4.14R.

[Note: BCD Annex IX Part 2 point 1, paragraph 1]

9.4.2 The securitisation documentation must reflect the economic substance of the transaction.

[Note: BCD Annex IX Part 2 point 1 (part)]

9.4.3 The securitised exposures must be put beyond the reach of the originator and its creditors, including in bankruptcy and receivership. This must be supported by the opinion of qualified legal counsel.

[Note: BCD Annex IX Part 2 point 1 (part)]

9.4.4 Legal counsel's opinions should be reviewed as necessary. For example, an opinion should be reviewed if a relevant statutory provision is amended or where a new decision or judgment of a court might have a bearing on the conclusions reached.

9.4.5 The securities issued must not represent payment obligations of the originator.

[Note: BCD Annex IX Part 2 point 1 (part)]

9.4.6 The transferee must be a securitisation special purpose entity.

[Note: BCD Annex IX Part 2 point 1 (part)]
The originator must not maintain effective or indirect control over the transferred exposures.

[Note: BCD Annex IX Part 2 point 1 (part)]

Where there is a clean-up call option, the following conditions must be satisfied:

1. the clean-up call option is exercisable at the discretion of the originator;
2. the clean-up call option may only be exercised when 10% or less of the original value of the exposures securitised remains unamortised; and
3. the clean-up call option is not structured to avoid allocating losses to credit enhancement positions or other positions held by investors and is not otherwise structured to provide credit enhancement.

[Note: BCD Annex IX Part 2 point 1 (part)]

The securitisation documentation must not contain clauses that:

1. other than in the case of early amortisation provisions, require positions in the securitisation to be improved by the originator including but not limited to altering the underlying credit exposures or increasing the yield payable to investors in response to a deterioration in the credit quality of the securitised exposures; or
2. increase the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool.

[Note: BCD Annex IX Part 2 point 1 (part)]

For the purposes of BIPRU 9.4.7, an originator will be considered to have maintained effective control over the transferred exposures if it has the right to repurchase from the transferee the previously transferred exposures in order to realise their benefits or if it is obligated to re-assume transferred risk. The originator’s retention of servicing rights or obligations in respect of the exposures does not of itself constitute indirect control of the exposures.

[Note: BCD Annex IX Part 2 point 1 (part)]

Significant credit risk will be considered to be transferred for an originator in the following cases:

1. the risk weighted exposure amounts of the mezzanine securitisation positions held by the originator in the securitisation do not exceed 50% of the risk weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;
2. where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight exceeds a
reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator does not hold more than 20% of the exposure values of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight.

[Note: BCD, Annex IX, Part 2, Point 1, paragraph 1a]

9.4.12 An originator must notify the appropriate regulator that it is relying on the deemed transfer of significant credit risk under BIPRU 9.4.11R within a reasonable period before or after a relevant transfer, not being later than one month after the date of the transfer. The notification must include the following information:

1. the risk weighted exposure amount of the securitised exposures and retained securitisation positions;
2. the exposure value of the securitised exposures and the retained securitisation positions;
3. details of the securitisation positions, including rating, exposure value broken down by securitisation positions sold and retained;
4. a statement that sets out why the firm is satisfied that the reduction in risk weighted exposure amounts is justified by a commensurate transfer of credit risk to third parties;
5. any relevant supporting documents, for example, a summary of the transaction.

In the event that the appropriate regulator decides that the possible reduction in risk weighted exposure amounts which the originator would achieve by the securitisation referred to in BIPRU 9.4.11R is not justified by a commensurate transfer of credit risk to third parties, it will use its powers under section 55J (Variation etc on the Authority’s own initiative) of the Act to require the firm to increase its risk weight exposure amount to an amount commensurate with the appropriate regulator’s assessment of the transfer of credit risk to third parties.

9.4.13 An originator may be granted a waiver of the requirements in BIPRU 9.4.11R and BIPRU 9.4.12R.

9.4.14 An originator’s application for a waiver of the requirements in BIPRU 9.4.11R and BIPRU 9.4.12R must demonstrate that the following conditions are satisfied.

1. it has policies and methodologies in place which ensure that the possible reduction of capital requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties; and
(2) that such a transfer of credit risk to third parties is also recognised for the purposes of all the firm's internal risk management and internal capital allocation.

[Note: BCD, Annex IX, Part 2, Point 1, paragraph 1c]

9.4.16  ■ BIPRU 1.3.10 G sets out the appropriate regulator's approach to the granting of waivers. The conditions in ■ BIPRU 9.4.15D are minimum requirements. Satisfaction of those does not automatically mean the appropriate regulator will grant the relevant waiver. The appropriate regulator will in addition also apply the tests in section 138A (Modification or waiver of rules) of the Act.

9.4.17  ■ When considering an application for a waiver of the requirements in ■ BIPRU 9.4.11R and ■ BIPRU 9.4.12R, the appropriate regulator may undertake a visit to the firm in order to examine the firm's risk management and governance arrangements. Before such a visit, the appropriate regulator may request information from the firm additional or supplementary to that provided in the waiver application.

9.4.18  ■ An originator should clearly state the scope of the waiver of the requirements in ■ BIPRU 9.4.11R and ■ BIPRU 9.4.12R it is seeking in its application. For example, residential mortgage backed securities may be subdivided into prime and sub-prime with only one sub-category within the scope of the waiver. Relevant asset classes may therefore be defined according to a firm's internal usage of terms.
9.5 Synthetic securitisation

Minimum requirements for recognition of significant credit risk transfer

9.5.1 An originator of a synthetic securitisation may calculate risk weighted exposure amounts, and, as relevant, expected loss amounts, for the securitised exposures in accordance with BIPRU 9.5.3 R and BIPRU 9.5.4 R, if either of the following conditions is fulfilled:

(a) significant credit risk is considered to have been transferred to third parties, either through funded or unfunded credit protection; or

(b) the originator applies a 1250% risk weight to all securitisation positions he holds in this securitisation or deducts these securitisation positions from capital resources according to GENPRU 2.2.237 R;

and the transfer complies with the conditions in (2)-(8).

[Note: BCD, Annex IX, Part 2, Point 2, paragraph 2]

(2) The securitisation documentation must reflect the economic substance of the transaction.

(3) The credit protection by which the credit risk is transferred must comply with the eligibility and other requirements under BIPRU 5 (Credit risk mitigation) and, so far as applicable, BIPRU 4.10 (Credit risk mitigation under the IRB approach) for the recognition of such credit protection. For the purposes of this rule, securitisation special purpose entities must not be recognised as eligible unfunded protection providers.

(4) The instruments used to transfer credit risk must not contain terms or conditions that:

(a) impose significant materiality thresholds below which credit protection is deemed not to be triggered if a credit event occurs;

(b) allow for the termination of the protection due to deterioration of the credit quality of the underlying exposures;

(c) other than in the case of early amortisation provisions, require positions in the securitisation to be improved by the originator; or

(d) increase the originator's cost of credit protection or the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool.
(5) An opinion must be obtained from qualified legal counsel confirming the enforceability of the credit protection in all relevant jurisdictions.

[Note: BCD Annex IX Part 2 point 2]

(6) Significant credit risk will be considered to have been transferred if either of the following conditions is met:

(a) the risk weighted exposure amounts of the mezzanine securitisation positions which are held by the originator in this securitisation do not exceed 50% of the risk weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;

(b) where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator does not hold more than 20% of the exposure values of the securitisation positions that would be subject to deduction from capital resources or a 1250% risk weight.

[Note: BCD, Annex IX, Part 2, Point 2, paragraph 2a]

(7) An originator must notify the appropriate regulator that it is relying on the deemed transfer of significant credit risk under BIPRU 9.5.1R (6) within a reasonable period before or after a relevant transfer, not being later than one month after the date of the transfer. The notification must include the following information:

(a) the risk weighted exposure amount of the securitised exposures and retained securitisation positions;

(b) the exposure value of the securitised exposures and the retained securitisation positions;

(c) details of the securitisation positions, including rating, exposure value broken down by securitisation positions sold and retained;

(d) a statement that sets out why the firm is satisfied that the reduction in risk weighted exposure amounts is justified by a commensurate transfer of credit risk to third parties;

(e) any relevant supporting documents, for example, a summary of the transaction.

An originator may be granted a waiver of the requirements in BIPRU 9.5.1R (6) and (7).

An originator’s application for a waiver of the requirements in BIPRU 9.5.1R (6) and (7) must demonstrate that the following conditions are satisfied:

(1) it has policies and methodologies in place which ensure that the possible reduction of capital requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties; and
(2) that such transfer of credit risk to third parties is also recognised for the purposes of all the originator’s internal risk management and its internal capital allocation.

[Note: BCD, Annex IX, Part 2, Point 2, paragraph 2c]

9.5.1C G ■ BIPRU 1.3.10 G sets out the appropriate regulator approach to the granting of waivers. The conditions in ■ BIPRU 9.5.1BD are minimum requirements. Satisfaction of those does not automatically mean the appropriate regulator will grant the relevant waiver. The appropriate regulator will in addition also apply the tests in section 138A (Modification or waiver of rules) of the Act.

9.5.1D G When considering an application for a waiver of the requirements in ■ BIPRU 9.5.1R (6) and ■ (7), the appropriate regulator may undertake a visit to the firm in order to examine the firm’s risk management and governance arrangements. Before such a visit, the appropriate regulator may request information from the firm additional or supplementary to that provided in the waiver application.

9.5.1E G An originator should clearly state the scope of the waiver of the requirements in ■ BIPRU 9.5.1R (6) and ■ (7) it is seeking in its application. For example, residential mortgage backed securities may be subdivided into prime and sub-prime with only one sub-category within the scope of the waiver. Relevant asset classes may therefore be defined according to a firm’s internal usage of terms.

9.5.1F G In the event that the appropriate regulator decides that the possible reduction in risk weighted exposure amounts which the originator credit institution would achieve by the securitisation referred to in ■ BIPRU 9.5.1R (6) is not justified by a commensurate transfer of credit risk to third parties, it will use its powers under section 55J (Variation etc on the Authority’s own initiative) of the Act to require the firm to increase its risk weight exposure amount to an amount commensurate with the appropriate regulator’s assessment of the transfer of credit risk to third parties.

Originators' calculation of risk-weighted exposure amounts for exposures securitised in a synthetic securitisation

9.5.2 R ■ BIPRU 9.5.3 R ■ BIPRU 9.5.8 R apply to the calculation by an originator of risk weighted exposure amounts for exposures securitised in a synthetic securitisation.

9.5.3 R (1) In calculating risk weighted exposure amounts for the securitised exposures, where the conditions in ■ BIPRU 9.5.1 R are met, the originator of a synthetic securitisation must, subject to the treatment of maturity mismatches set out in ■ BIPRU 9.5.6 R ■ BIPRU 9.5.8 R, use the relevant calculation methodologies set out in ■ BIPRU 9.9- ■ BIPRU 9.14 and not those set out in ■ BIPRU 3 (Standardised credit risk) or ■ BIPRU 4 (IRB approach).
(2) For firms calculating risk weighted exposure amounts and expected loss amounts under the IRB approach, the expected loss amount in respect of such exposures must be zero.

(3) For clarity, this paragraph refers to the entire pool of exposures included in the securitisation.

[Note: BCD Annex IX Part 2 point 3 and point 4 (part)]

9.5.4 R

Subject to the treatment of maturity mismatches set out in §BIPRU 9.5.6 R- §BIPRU 9.5.8 R, the originator must calculate risk weighted exposure amounts in respect of all tranches in the securitisation in accordance with the provisions of §BIPRU 9.9- §BIPRU 9.14. For example, where a tranche is transferred by means of unfunded credit protection to a third party, the risk weight of that third party must be applied to the tranche in the calculation of the originators risk weighted exposure amount.

[Note: BCD Annex IX Part 2 point 4 (part)]

Treatment of maturity mismatches in synthetic securitisations

9.5.5 R

§BIPRU 9.5.6 R- §BIPRU 9.5.8 R apply to the treatment of maturity mismatches in a synthetic securitisation.

9.5.6 R

For the purposes of calculating risk weighted exposure amounts in accordance with §BIPRU 9.5.3 R, any maturity mismatch between the credit protection by which the tranching is achieved and the securitised exposures must be taken into consideration in accordance with §BIPRU 9.5.7 R- §BIPRU 9.5.8 R.

[Note: BCD Annex IX Part 2 point 5]

9.5.7 R

The maturity of the securitised exposures must be taken to be the longest maturity of any of those exposures subject to a maximum of five years. The maturity of the credit protection must be determined in accordance with §BIPRU 5 (Credit risk mitigation) and, so far as relevant, §BIPRU 4.10 (Credit risk mitigation under the IRB approach).

[Note: BCD Annex IX Part 2 point 6]

9.5.8 R

(1) An originator must ignore any maturity mismatch in calculating risk weighted exposure amounts for tranches appearing pursuant to §BIPRU 9.9- §BIPRU 9.14 with a risk weight of 1250%. For all other tranches the maturity mismatch treatment prescribed in §BIPRU 5.8 (Maturity mismatches) must be applied in accordance with the following formula:

\[ RW^* \text{ is } [RW(\text{SP}) \times (t-t^*)/(T-t^*)] + [RW(\text{Ass}) \times (T-t)/(T-t^*)] \]

(2) The following apply for the purposes of the formula in (1):

(a) RW* is risk weighted exposure amounts;

(b) RW(Ass) is risk weighted exposure amounts for exposures if they had not been securitised calculated on a pro-rata basis;
(c) $\text{RW(SP)}$ is risk weighted exposure amounts calculated under BIPRU 9.6.3 G as if there was no maturity mismatch;

(d) $T$ is maturity of the underlying exposures expressed in years;

(e) $t$ is maturity of credit protection expressed in years; and

(f) $t^*$ is 0.25.

[Note: BCD Annex IX Part 2 point 7]
9.6 Implicit support

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

[Note: BCD Article 101(1)]

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

[Note: BCD Article 101(1)]

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

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

(2) disclose publicly:
   (a) that it has provided non-contractual support; and
   (b) the regulatory capital impact of doing so.

[Note: BCD Article 101(2)]

9.6.3 R (1) Securitisation documentation should make clear, where applicable, that any repurchase of securitised exposures or securitisation positions by the originator or sponsor beyond its contractual obligations is not mandatory and may only be made at fair market value. In general, any such repurchase should be subject to a firm's credit review and approval process, which should be adequate to ensure that the repurchase complies with BIPRU 9.6.1 R.

(2) If an originator or sponsor repurchases securitised exposures or securitisation positions, it should be able to satisfy the appropriate regulator that it has adequately considered the following:
   (a) the price of the repurchase;
(b) the firm’s capital and liquidity position before and after repurchase;
(c) the performance of the securitised exposures; and
(d) the performance of the issued securities;
and has concluded that, taking into account those factors and any other relevant factors, the repurchase is not structured to provide support.

(3) A firm should keep adequate records of the matters in (1) and (2).

9.6.4 If a firm is found to have provided implicit support to a securitisation, that fact increases the expectation that the firm will provide future support to its securitisations thus failing to achieve a significant transfer of risk. The appropriate regulator will consider taking appropriate measures to reflect this increased expectation after an instance of implicit support is found.

9.6.5 A firm may need to consider three main situations to determine whether there is a breach of the prohibition against implicit support in BIPRU 9.6.1 R:

(1) support given under a contractual obligation;
(2) support given under the contractual documentation for the securitisation which the firm is entitled, but not obliged, to give; and
(3) support which is not provided for under the contractual documentation for the securitisation.

9.6.6 (1) The support described in BIPRU 9.6.5 G (1) is permitted by BIPRU 9.6.1 R.
(2) The support described in BIPRU 9.6.5 G (3) is not permitted by BIPRU 9.6.1 R.
(3) The support described in BIPRU 9.6.5 G (2) may be permitted by BIPRU 9.6.1 R under the following conditions:
(a) the fact that the firm may give it is expressly set out in the contractual and marketing documents for the securitisation;
(b) the nature of the support that the firm may give is precisely described in the documentation;
(c) the maximum degree of support that can be given can be ascertained at the time of the securitisation both by the firm and by a person whose only information comes from the marketing documents for the securitisation;
(d) the assessment of whether there has been significant risk transfer and the amount of that transfer is made on the basis that the firm will provide support to the maximum degree possible; and
(e) the firm’s capital resources and capital resources requirement are adjusted at the time of the securitisation on the basis that the firm has provided support to the maximum degree possible, whether by an immediate deduction from capital or appropriate risk weighting.
A waiver of the right to future margin income may not breach the prohibition against implicit support:

(1) the degree of support that can be given can be defined precisely by reference to the securitisation contractual documentation, albeit the amount of support may not be ascertainable in absolute monetary terms; and

(2) no adjustment to the firm's capital resources or capital resources requirement is required, as a firm should not in any case reflect future margin income in its income or capital resources.

For the purposes of □ BIPRU 9.6.2 R (2), firms will be expected to include disclosure of implicit support in accordance with the general and technical requirements on public disclosure, as outlined in □ BIPRU 11 (Disclosure).
9.7 Recognition of credit assessments of ECAIs

9.7.1 An ECAI's credit assessment may be used to determine the risk weight of a securitisation position in accordance with BIPRU 9.9 only if the ECAI is an eligible ECAI.

[Note: BCD Article 97(1)]

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

(2) There must be no mismatch between the types of payments reflected in the credit assessment and the types of payment to which the firm is entitled under the contract giving rise to the securitisation position in question.

(3) The credit assessment must be available publicly to the market. Credit assessments may only be treated as publicly available if:
   (a) they have been published in a publicly accessible forum, and
   (b) they are included in the ECAI's transition matrix.

(4) Credit assessments that are made available only to a limited number of entities may not be treated as publicly available.

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

(6) In the case of a credit assessment referred to in (5), the firm must consider the relevant position as if it were not rated and must apply the relevant treatment of unrated positions as set out in BIPRU 9.11 and BIPRU 9.12.

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

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

9.7.3 The guidance in BIPRU 3.3 (Recognition of ratings agencies) applies for the purposes of BIPRU 9 as it does to exposure risk weighting in BIPRU 3, save that the reference in BIPRU 3.3 to the regulation 22 of the Capital Requirements Regulations 2006 should be read as a reference to regulation 23 of the Capital Requirements Regulations 2006 for the purposes of BIPRU 9.

9.7.4 Where BIPRU 9.7.2R (5) applies to securitisation positions in an ABCP programme, the firm may be granted a waiver which allows it to use the risk weight assigned to a liquidity facility in order to calculate the risk weighted exposure amount for the positions in the ABCP programme, provided that the liquidity facility ranks pari passu with the positions in the ABCP programme so that they form overlapping positions and 100% of the commercial paper issued by the ABCP programme is covered by liquidity facilities. For the purposes of this provision, overlapping positions means that the positions represent, wholly or partially, an exposure to the same risk such that, to the extent of the overlap, there is a single exposure.

[Note: BCD, Annex IX, Part 4, Point 5]
9.8 Use of ECAI credit assessments for the determination of applicable risk weights

9.8.1 The use of ECAIs’ credit assessments for the calculation of a firm’s risk weighted exposure amounts under BIPRU 9 must be consistent and in accordance with BIPRU 9.8.2 R and BIPRU 9.8.7 R. Credit assessments must not be used selectively.

[Note: BCD Article 99]

9.8.2 A firm may nominate one or more eligible ECAIs the credit assessments of which must be used in the calculation of its risk weighted exposure amounts under BIPRU 9 (a nominated ECAI).

[Note: BCD Annex IX Part 3 point 2]

9.8.3 Subject to BIPRU 9.8.5 R and BIPRU 9.8.7 R, a firm must use credit assessments from nominated ECAIs consistently in respect of its securitisation positions.

[Note: BCD Annex IX Part 3 point 3]

9.8.4 Subject to BIPRU 9.8.5 R and BIPRU 9.8.6 R, a firm must not use an ECAI’s credit assessments for its positions in some tranches and another ECAI’s credit assessments for its positions in other tranches within the same structure that may or may not be rated by the first ECAI.

[Note: BCD Annex IX Part 3 point 4]

9.8.5 Where a position has two credit assessments by nominated ECAIs, the firm must use the less favourable credit assessment.

[Note: BCD Annex IX Part 3 point 5]

9.8.6 Where a position has more than two credit assessments by nominated ECAIs, the two most favourable credit assessments must be used. If the two most favourable assessments are different, the least favourable of the two must be used.

[Note: BCD Annex IX Part 3 point 6]

9.8.7 (1) Where credit protection eligible under BIPRU 5 (Credit risk mitigation) and, if applicable, BIPRU 4.10 (Credit risk mitigation...
under the IRB approach) is provided directly to the SSPE, and that protection is reflected in the credit assessment of a position by a nominated ECAI, the risk weight associated with that credit assessment may be used.

(2) If the protection is not eligible under BIPRU 5 (Credit risk mitigation) and, if applicable, BIPRU 4.10 (Credit risk mitigation under the IRB approach), the credit assessment must not be recognised.

(3) In the situation where the credit protection is not provided to the SSPE but rather is provided directly to a securitisation position, the credit assessment must not be recognised.

[Note: BCD Annex IX Part 3 point 7]
9.9 Calculation of risk-weighted exposure amounts for securitisation positions

9.9.1 To calculate the risk weighted exposure amount of a securitisation position, the relevant risk weight must be assigned to the exposure value of the position in accordance with BIPRU 9.9 - BIPRU 9.14 based on the credit quality of the position.

[Note: BCD Article 96(1) (part) and Annex IX, Part 4 point 1]

9.9.2 For the purpose of BIPRU 9.9.1 R, the credit quality of a position may be determined by reference to an ECAI credit assessment or otherwise, as set out in BIPRU 9.9 - BIPRU 9.14.

[Note: BCD Article 96(1) (part)]

9.9.3 (1) Where there is an exposure to different tranches in a securitisation, the exposure to each tranche must be considered a separate securitisation position.

(2) The providers of credit protection to securitisation positions must be treated as holding positions in the securitisation.

(3) securitisation positions include exposures to a securitisation arising from interest rate or currency derivative contracts.

[Note: BCD Article 96(2)]

9.9.4 Subject to BIPRU 9.9.5 R,

(1) where a firm calculates risk weighted exposure amounts under the standardised approach to securitisations outlined in BIPRU 9.11, the exposure value of an on-balance sheet securitisation position must be its balance sheet value;

(2) where a firm calculates risk weighted exposure amounts under the IRB approach to securitisations outlined in BIPRU 9.12, the exposure value of an on-balance sheet securitisation position must be measured gross of value adjustments;

(3) the exposure value of an off-balance sheet securitisation position must be its nominal value multiplied by a conversion figure as prescribed in this chapter; and
(4) the conversion figure referred to in (3) must be 100% unless otherwise specified.

[Note: BCD Annex IX Part 4 point 2]

| 9.9.5 | R | The exposure value of a securitisation position arising from a financial derivative instrument must be determined in accordance with BIPRU 13 (Treatment of derivative instruments).
[Note: BCD Annex IX Part 4 point 3] |
| 9.9.6 | R | Where a securitisation position is subject to funded credit protection, the exposure value of that position may be modified in accordance with BIPRU 5 (Credit risk mitigation) as further specified in BIPRU 9.11.13 R and BIPRU 9.14.
[Note: BCD Annex IX Part 4 point 4] |
| 9.9.7 | R | Where a securitisation position is subject to funded or unfunded credit protection the risk weight to be applied to that position may be modified in accordance with BIPRU 5 (Credit risk mitigation) and, if applicable, BIPRU 4.10 (Credit risk mitigation under the IRB approach) read in conjunction with BIPRU 9.14.
[Note: BCD Article 96(3)] |
| 9.9.8 | R | (1) Where a firm has two or more overlapping positions in a securitisation the firm must, to the extent that the positions overlap, include in its calculation of risk weighted exposure amounts only the position, or portion of a position, producing the higher risk weighted exposure amounts. The firm may also recognise such an overlap between capital charges for specific risk in relation to positions in the trading book and capital charges for positions in the non-trading book, provided that the firm is able to calculate and compare the capital charges for the relevant positions.
(2) For the purposes of (1), overlapping means that the positions, wholly or partially, represent an exposure to the same risk such that to the extent of the overlap there is a single exposure.
[Note: BCD Annex IX Part 4 point 5] |
| 9.9.9 | R | Subject to the provisions of GENPRU that deal with the deduction of securitisation positions at stage M in the relevant capital resources table, the risk weighted exposure amount must be included in the firm's total of risk weighted exposure amounts for the purposes of the calculation of its credit risk capital requirement.
[Note: BCD Article 96(4)] |
| 9.9.10 | G | Where BIPRU 9.7.2R (5) applies to securitisation positions in an ABCP programme, the firm may be granted a waiver in the terms described in BIPRU 9.7.4 G.
[Note: BCD, Annex IX, Part 4, Point 5] |
9.10 Reduction in risk-weighted exposure amounts

9.10.1 BIPRU 9.10 applies as follows:

(1) BIPRU 9.10.2 R and BIPRU 9.10.3 R apply to both the standardised approach and the IRB approach; and

(2) BIPRU 9.10.4 R and BIPRU 9.10.7 R apply to the IRB approach.

9.10.2 In respect of a securitisation position in respect of which a 1250% risk weight is assigned, a firm may, as an alternative to including the position in its calculation of risk weighted exposure amounts, deduct from its capital resources the exposure value of the position. For these purposes, the calculation of the exposure value may reflect eligible funded protection in a manner consistent with BIPRU 9.14.

[Note: BCD Annex IX Part 4 points 35, 74 and 75(b)]

9.10.3 Where a firm applies BIPRU 9.10.2 R, 12.5 times the amount deducted in accordance with that paragraph must, for the purposes of BIPRU 9.11.5 R and BIPRU 9.12.8 R, be subtracted from the amount specified in whichever of those rules applies as the maximum risk weighted exposure amount to be calculated by a firm to which one of those rules applies.

[Note: BCD Annex IX Part 4 point 36 and point 76]

9.10.4 The risk weighted exposure amount of a securitisation position to which a 1250% risk weight is assigned may be reduced by 12.5 times the amount of any value adjustments made by the firm in respect of the securitised exposures.

[Note: BCD Annex IX Part 4 point 72 (part)]

9.10.5 To the extent that value adjustments are taken account of for the purposes of BIPRU 9.10.4 R they must not be taken account of for the purposes of the calculation indicated in BIPRU 4.3.8 R (Treatment of expected loss amounts).

[Note: BCD Annex IX Part 4 point 72 (part)]
9.10.6  

The risk weighted exposure amount of a securitisation position may be reduced by 12.5 times the amount of any value adjustments made by the firm in respect of the position.

[Note: BCD Annex IX Part 4 point 73]

9.10.7  

For the purposes of BIPRU 9.10.2 R (as it applies to the IRB approach):

(1) the exposure value of the position may be derived from the risk weighted exposure amounts taking into account any reductions made in accordance with BIPRU 9.10.4 R BIPRU 9.10.6 R;

(2) where the supervisory formula method is used to calculate risk weighted exposure amounts and L/K_{IRBR} and [L+T] > K_{IRBR} the position may be treated as two positions with L equal to K_{IRBR} for the more senior of the positions.

[Note: BCD Annex IX Part 4 point 75(a) and (c)]
9.11 Calculation of risk weighted exposure amounts under the standardised approach to securitisations

9.11.1 Subject to BIPRU 9.11.5 R, the risk weighted exposure amount of a rated securitisation position or resecuritisation position must be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated, as prescribed in BIPRU 9.11.2 R.

[Note: BCD Annex IX Part 4 point 6]

9.11.2 Table:
This table belongs to BIPRU 9.11.1 R

<table>
<thead>
<tr>
<th>Credit Quality step</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4 (only for credit assessments other than short-term credit assessments)</th>
<th>All other credit quality steps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securitisation positions</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>350%</td>
<td>1250%</td>
</tr>
<tr>
<td>Resecuritisation positions</td>
<td>40%</td>
<td>100%</td>
<td>225%</td>
<td>650%</td>
<td>1250%</td>
</tr>
</tbody>
</table>

[Note: For mapping of the credit quality step to the credit assessments of eligible ECAIs, refer to: http://www.fca.org.uk/your-fca/documents/fsa-ecais-securitisation for the FCA and http://www.bankofengland.co.uk/pra/Documents/publications/ss/2013/ss913.pdf for the PRA]

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

9.11.3 [deleted]
Subject to BIPRU 9.11.6 and BIPRU 9.11.12, the risk weighted exposure amount of an unrated securitisation position must be calculated by applying a risk weight of 1250%.

[Note: BCD Annex IX Part 4 point 7]

**Originator and sponsor firms**

For an originator or sponsor, the risk weighted exposure amounts calculated in respect of its positions in a securitisation may be limited to the risk weighted exposure amounts which would be calculated for the securitised exposures had they not been securitised subject to the presumed application of a 150% risk weight to all past due items and items belonging to regulatory high risk categories (see BIPRU 3.4.104 and BIPRU 3 Annex 3) amongst the securitised exposures.

[Note: BCD Annex IX Part 4 point 8]

**Treatment of unrated securitisation positions**

1. A firm having an unrated securitisation position may apply the treatment set out in this paragraph for calculating the risk weighted exposure amount for that position provided the composition of the pool of exposures securitised is known at all times.

2. A firm may apply the weighted-average risk weight that would be applied to the securitised exposures referred to in (1) under the standardised approach by a firm holding the exposures multiplied by a concentration ratio.

3. This concentration ratio is equal to the sum of the nominal amounts of all the tranches divided by the sum of the nominal amounts of the tranches junior to, or pari passu with, the tranche in which the position is held including that tranche itself.

4. The resulting risk weight must not be higher than 1250% or lower than any risk weight applicable to a rated more senior tranche.

5. Where the firm is unable to determine the risk weights that would be applied to the securitised exposures under the standardised approach, it must apply a risk weight of 1250% to the position.

[Note: BCD Annex IX Part 4 points 9 and 10]

1. This provision contains guidance on the requirement in BIPRU 9.11.6 (1) that the composition of the pool of exposures securitised must be known at all times.

2. The composition should be known sufficiently at the time of purchase for the firm to be able accurately to calculate the risk weighted exposure amounts of the pool under the standardised approach.

3. Thereafter, any change to the composition of the pool during the life of the transaction that would lead to an increase in the risk weighted exposure amount of the pool of exposures under the standardised approach should be either:

   a) prohibited by the documentation; or
(b) included in the firm's capital calculations.

(4) It would be sufficient for the purposes of (2) for the composition of the pool to be reported to the firm at least daily, via information service providers, secure web-sites or other appropriate sources.

Treatment of securitisation positions in a second loss tranche or better in an ABCP programme

Subject to the availability of a more favourable treatment by virtue of the provisions concerning liquidity facilities in BIPRU 9.11.10 R, BIPRU 9.11.12 R, a firm may apply to securitisation positions meeting the conditions set out in BIPRU 9.11.9 R a risk weight that is the greater of:

(1) 100%, or

(2) the highest of the risk weights that would be applied to any of the securitised exposures under the standardised approach by a firm holding the exposures.

[Note: BCD Annex IX Part 4 point 11]

For the treatment in BIPRU 9.11.8 R to be available,:

(1) the securitisation position must be in an ABCP programme;

(2) the securitisation position must be in a tranche which is economically in a second loss position or better in the securitisation and the first loss tranche must provide meaningful credit enhancement to the second loss tranche;

(3) the securitisation position must be of a quality the equivalent of investment grade or better; and

(4) the firm in question must not hold a position in the first loss tranche.

[Note: BCD Annex IX Part 4 point 12]

Treatment of unrated liquidity facilities

When the conditions in this paragraph have been met, and in order to determine its exposure value, a conversion figure of 50% may be applied to the nominal amount of a liquidity facility. The risk weight to be applied is the highest risk weight that would be applied to any of the securitised exposures under the standardised approach by a firm holding the exposures. Those conditions are as follows:

(1) the liquidity facility documentation must clearly identify and limit the circumstances under which the facility may be drawn;

(2) it must not be possible for the facility to be drawn so as to provide credit support by covering losses already incurred at the time of draw for example, by providing liquidity in respect of exposures in default at the time of draw or by acquiring assets at more than fair value;

(3) the facility must not be used to provide permanent or regular funding for the securitisation;
(4) repayment of draws on the facility must not be subordinated to the claims of investors other than to claims arising in respect of interest rate or currency derivative contracts, fees or other such payments, nor be subject to waiver or deferral;

(5) it must not be possible for the facility to be drawn after all applicable credit enhancements from which the liquidity facility would benefit are exhausted; and

(6) the facility must include a provision that results in an automatic reduction in the amount that can be drawn by the amount of exposures that are in default, where default has the meaning given to it for the purposes of the IRB approach, or where the pool of securitised exposures consists of rated instruments, that terminates the facility if the average quality of the pool falls below investment grade.

[Note: BCD Annex IX Part 4 point 13]

Liquidity facilities that may be drawn only in the event of a general market disruption

9.11.11 [deleted]

Cash advance facilities

9.11.12 R

To determine its exposure value, a conversion figure of 0% may be applied to the nominal amount of a liquidity facility that is unconditionally cancellable provided that the conditions set out at [BIPRU 9.11.10 R] are satisfied and that repayment of draws on the facility are senior to any other claims on the cash flows arising from the securitised exposures.

[Note: BCD Annex IX Part 4 point 15]

Standardised approach: recognition of credit risk mitigation on securitisation positions

9.11.13 R

Where a firm calculates the risk weighted exposure amount of a securitisation position under the standardised approach, where credit protection is obtained on a securitisation position, the calculation of risk weighted exposure amounts may be modified in accordance with [BIPRU 5 (Credit risk mitigation)].

[Note: BCD Annex IX Part 4 point 34]
9.12 Calculation of risk-weighted exposure amounts under the IRB approach

9.12.1 ■ BIPRU 9.12 applies to the calculation of risk weighted exposure amounts of securitisation positions under the IRB approach.

[Note: BCD Annex IX Part 4 point 37 (part)]

Hierarchy of methods

9.12.2 R For a rated position or a position in respect of which an inferred rating may be used, the ratings based method must be used to calculate the risk weighted exposure amount.

[Note: BCD Annex IX Part 4 point 38]

9.12.3 R For an unrated position the supervisory formula method must be used except where a firm uses the ABCP internal assessment approach.

[Note: BCD Annex IX Part 4 point 39]

9.12.4 G In cases where both the ABCP internal assessment approach and the supervisory formula method are available, a firm should determine the most appropriate approach and apply that approach consistently.

9.12.5 R A firm other than an originator or a sponsor may not use the supervisory formula method unless its IRB permission expressly permits it to do so.

[Note: BCD Annex IX Part 4 point 40]

9.12.6 R Subject to any IRB permission of the type described in ■ BIPRU 9.12.28 G, in the case of an originator or sponsor unable to calculate \( K_{\text{IRB}} \) and which has not obtained approval to use the ABCP internal assessment approach, and in the case of other firms where they have not obtained approval to use the supervisory formula method or, for positions in ABCP programmes, the ABCP internal assessment approach, a risk weight of 1250% must be assigned to securitisation positions which are unrated and in respect of which an inferred rating may not be used.

[Note: BCD Annex IX Part 4 point 41]
Use of inferred ratings

When the following minimum operational requirements are satisfied a firm must attribute to an unrated position an inferred credit assessment equivalent to the credit assessment of those rated positions (the reference positions) which are the most senior positions which are in all respects subordinate to the unrated securitisation position in question:

1. the reference positions must be subordinate in all respects to the unrated securitisation position;
2. the maturity of the reference positions must be equal to or longer than that of the unrated position in question; and
3. on an ongoing basis, any inferred rating must be updated to reflect any changes in the credit assessment of the reference positions.

[Note: BCD Annex IX Part 4 point 42]

Maximum risk-weighted exposure amounts

For an originator, a sponsor, or for other firms which can calculate $K_{IRB}$, the risk weighted exposure amounts calculated in respect of its positions in a securitisation may be limited to that which would produce an amount in respect of its credit risk capital requirement equal to the sum of 8% of the risk weighted exposure amount which would be produced if the securitised assets had not been securitised and were on the balance sheet of the firm plus the expected loss amounts of those exposures.

[Note: BCD Annex IX Part 4 point 45]

Ratings based method

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

[Note: BCD Annex IX Part 4 point 46]

Table:

This table belongs to BIPRU 9.12.10 R

<table>
<thead>
<tr>
<th>Credit Quality Step</th>
<th>Securitisation positions</th>
<th>Resecuritisation positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit assessments other than short term</td>
<td>Short-term credit assessments</td>
<td>A</td>
</tr>
<tr>
<td>1</td>
<td>1</td>
<td>7%</td>
</tr>
</tbody>
</table>
### Section 9.12: Calculation of risk-weighted exposure amounts under the IRB approach

#### 9.12.12

[deleted]

#### 9.12.13

For the purposes of § BIPRU 9.12.10 R:

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

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

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

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

#### 9.12.14

When determining under § BIPRU 9.12.13 R whether a tranche is the most senior for these purposes, a firm need not take into consideration amounts

---

<table>
<thead>
<tr>
<th>Credit Quality Step</th>
<th>Securitisation positions</th>
<th>Resecuritisation positions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>2</td>
<td>8%</td>
<td>15%</td>
</tr>
<tr>
<td>3</td>
<td>10%</td>
<td>18%</td>
</tr>
<tr>
<td>4 2</td>
<td>12%</td>
<td>20%</td>
</tr>
<tr>
<td>5</td>
<td>20%</td>
<td>35%</td>
</tr>
<tr>
<td>6</td>
<td>35%</td>
<td>50%</td>
</tr>
<tr>
<td>7 3</td>
<td>60%</td>
<td>75%</td>
</tr>
<tr>
<td>8</td>
<td>100%</td>
<td>200%</td>
</tr>
<tr>
<td>9</td>
<td>250%</td>
<td>300%</td>
</tr>
<tr>
<td>10</td>
<td>425%</td>
<td>500%</td>
</tr>
<tr>
<td>11</td>
<td>650%</td>
<td>750%</td>
</tr>
<tr>
<td>all other, unrated</td>
<td>1250%</td>
<td></td>
</tr>
</tbody>
</table>

[Note: For mapping of the credit quality step to the credit assessments of eligible ECAIs, refer to: [http://www.fca.org.uk/your-fca/documents/fsa-ecais-securitisation](http://www.fca.org.uk/your-fca/documents/fsa-ecais-securitisation) for the FCA and [http://www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/ecaissecuritisation.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/ecaissecuritisation.pdf) for the PRA.]
due under interest rate or currency derivative contracts, fees due, or other similar payments.

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

9.12.15 G A senior liquidity facility need not be taken into account for the purposes of determining the most senior tranche under BIPRU 9.12.13 R.

[deleted]

9.12.17 R In calculating the effective number of exposures securitised, multiple exposures to one obligor must be treated as one exposure. The effective number of exposures is calculated as:

\[ N = \frac{\left(\sum_i EAD_i \right)^2}{\sum_i (EAD_i)^2} \]

where \( EAD_i \) represents the sum of the exposure values of all exposures to the \( i \)th obligor. If the portfolio share associated with the largest exposure, \( C_1 \), is available, the firm may compute \( N \) as \( 1/C_1 \).

[Note: BCD Annex IX Part 4 point 49] [deleted] [deleted]

The ABCP internal assessment approach

9.12.20 R (1) If:

(a) a firm’s IRB permission allows it to use this treatment; and

(b) the conditions in (2)(16) are satisfied,

a firm may attribute to an unrated position in an asset backed commercial paper programme a derived rating as laid down in (3).

(2) Positions in the commercial paper issued from the programme must be rated positions.

(3) Under the ABCP internal assessment approach, the unrated position must be assigned by the firm to one of the rating grades described in (5). The position must be attributed a derived rating that is the same as the credit assessments corresponding to that rating grade as laid down in (5). Where this derived rating is, at the inception of the securitisation, at the level of investment grade or better, it must be treated in the same way as an eligible credit assessment by an eligible ECAI for the purposes of calculating risk weighted exposure amounts.

(4) The internal assessment methodology must be used in the firms internal risk management processes, including its decision making, management information and capital allocation processes.

(5) The firms internal assessment methodology must include rating grades. There must be a correspondence between such rating grades
and the credit assessments of eligible ECAIs. This correspondence must be explicitly documented.

(6) The firm must be able to satisfy the appropriate regulator that its internal assessment of the credit quality of the position reflects the publicly available assessment methodology of one or more eligible ECAIs, for the rating of securities backed by the exposures of the type securitised.

(7) If a firm’s IRB permission permits this, a firm need not comply with the requirement for the assessment methodology of the ECAI to be publicly available where it can demonstrate that due to the specific features of the securitisation for example its unique structure - there is as yet no publicly available ECAI assessment methodology.

(8) The ECAIs, the methodology of which must be reflected as required by (6), must include those ECAIs which have provided an external rating for the commercial paper issued from the programme. Quantitative elements such as stress factors used in assessing the position to a particular credit quality must be at least as conservative as those used in the relevant assessment methodology of the ECAIs in question.

(9) In developing its internal assessment methodology the firm must take into consideration relevant published ratings methodologies of the eligible ECAIs that rate the commercial paper of the ABCP programme. This consideration must be documented by the firm and updated regularly, as outlined in (15).

(10) The ABCP programme must have collections policies and processes that take into account the operational capability and credit quality of the servicer. The programme must mitigate seller/servicer risk through various methods, such as triggers based on current credit quality that would preclude commingling of funds.

(11) The ABCP programme must incorporate structural features for example wind down triggers - into the purchase of exposures in order to mitigate potential credit deterioration of the underlying portfolio.

(12) The ABCP programme must incorporate underwriting standards in the form of credit and investment guidelines. In deciding on an asset purchase, the programme administrator must consider the type of asset being purchased, the type and monetary value of the exposures arising from the provision of liquidity facilities and credit enhancements, the loss distribution, and the legal and economic isolation of the transferred assets from the entity selling the assets. A credit analysis of the asset sellers risk profile must be performed and must include analysis of past and expected future financial performance, current market position, expected future competitiveness, leverage, cash flow, and interest coverage, and debt rating. In addition, a review of the sellers underwriting standards, servicing capabilities, and collection processes must be performed.

(13) The ABCP programme’s underwriting standards must establish minimum asset eligibility criteria that, in particular,

   (a) exclude the purchase of assets that are significantly past due or defaulted;
(b) limit excess concentration to individual obligor or geographic area; and

(c) limit the tenor of the assets to be purchased.

(14) The aggregated estimate of loss on an asset pool that the ABCP programme is considering purchasing must take into account all sources of potential risk, such as credit risk and dilution risk. If the seller-provided credit enhancement is sized based on only credit-related losses, then a separate reserve must be established for dilution risk, if dilution risk is material for the particular exposure pool. In addition, in sizing the required enhancement level, the programme must review several years of historical information, including losses, delinquencies, dilutions, and the turnover rate of the receivables.

(15) Internal or external auditors, an ECAI, or the firm’s internal credit review or risk management function must perform regular reviews of the internal assessment process and the quality of the internal assessments of the credit quality of the firm’s exposures to an ABCP programme. If the firm’s internal audit, credit review, or risk management functions perform the review, then these functions must be independent of the ABCP programme business line, as well as the customer relationship.

(16) The firm must track the performance of its internal ratings over time to evaluate the performance of its internal assessment methodology and must make adjustments, as necessary, to that methodology when the performance of the exposures routinely diverges from that indicated by the internal ratings.

[Note: BCD Annex IX Part 4 points 43 and 44]

**Supervisory formula method**

9.12.21 Subject to any permission of the type described in BIPRU 9.12.28 G, under the supervisory formula method, the risk weight for a securitisation position must be the risk weight to be applied in accordance with BIPRU 9.12.22 R. However, the risk weight must be no less than 20% for resecuritisation positions and no less than 7% for all other securitisation positions.

[Note: BCD Annex IX Part 4 point 52]

9.12.22 (1) Subject to any permission of the type described in BIPRU 9.12.28 G, the risk weight to be applied to the exposure amount must be:

\[ 12.5 \left( S[L+T] - S[L] \right) / T \]

(2) The remaining provisions of this paragraph define the terms used in the formulae in (1) and (3).
In these expressions, Beta [x; a, b] refers to the cumulative beta distribution with parameters a and b evaluated at x.

T (the thickness of the tranche in which the position is held) is measured as the ratio of (a) the nominal amount of the tranche to (b) the sum of the exposure values of the exposures that have been securitised. For these purposes the exposure value of a financial derivative instrument must, where the current replacement cost is not a positive value, be the potential future credit exposure calculated in accordance with BIPRU 13 (Treatment of derivative instruments).

K_{IRB} is the ratio of (a) K_{IRB} to (b) the sum of the exposure values of the exposures that have been securitised. K_{IRB} is expressed in decimal form (for example, K_{IRB} equal to 15% of the pool would be expressed as K_{IRB} of 0.15).

L (the credit enhancement level) is measured as the ratio of the nominal amount of all tranches subordinate to the tranche in which the position is held to the sum of the exposure values of the
exposures that have been securitised. Capitalised future income must not be included in the measured L. Amounts due by counterparties to financial derivative instruments that represent tranches more junior than the tranche in question may be measured at their current replacement cost (without the potential future credit exposures) in calculating the enhancement level.

(19) N is the effective number of exposures calculated in accordance with BIPRU 9.12.17 R - BIPRU 9.12.18 R. In the case of resecuritisations, the firm must look at the number of securitisation exposures in the pool and not the number of underlying exposures in original pools from which the underlying securitisation exposures stem.

(20) ELGD, the exposure-weighted average loss-given-default, is calculated as follows:

\[ ELGD = \frac{\sum LGD \times EAD}{\sum EAD} \]

(21) In (20) LGD\(_i\) represents the average LGD associated with all exposures to the \(i^{th}\) obligor, where LGD is determined in accordance with BIPRU 4. In the case of resecuritisation, an LGD of 100% must be applied to the securitised positions. When default risk and dilution risk for purchased receivables are treated in an aggregate manner within a securitisation (e.g. a single reserve or over-collateralisation is available to cover losses from either source), the LGD input must be constructed as a weighted average of the LGD for credit risk and the 75% LGD for dilution risk. The weights are the stand-alone capital charges for credit risk and dilution risk respectively.

[Note: BCD Annex IX Part 4 point 53 (part)]

**Simplified inputs**

(1) Under the supervisory formula method, if the exposure value of the largest securitised exposure, \(C_1\), is no more than 3% of the sum of the exposure values of the securitised exposures, then for the purposes of the supervisory formula method the firm may set LGD equal 50% and N equal to either:

(a) \[ h \left( \frac{C_1}{C_n} + \left( \frac{C_n - C_1}{n-1} \right) \max \{ 1 - n C_1, 0 \} \right) \]

; or

(b) \( N = 1 / C_1 \).

(2) \(C_m\) is the ratio of the sum of the exposure values of the largest 'm' exposures to the sum of the exposure values of the exposures securitised. The level of m may be set by the firm.

(3) For securitisations involving retail exposures, the supervisory formula method may be implemented using the simplifications: \( h = 0 \) and \( v = 0 \).

[Note: BCD Annex IX Part 4 point 53 (part)]
Where a securitisation of retail exposures has a sufficiently low value of N for the simplification in BIPRU 9.12.23 R (3) to result in a material change in the capital charge as compared to the position if the approach in BIPRU 9.12.23 R were not taken, a firm should discuss with the appropriate regulator the suitability of its use.

**Liquidity Facilities**

The provisions in BIPRU 9.12.26 R to BIPRU 9.12.28 G apply for the purposes of determining the exposure value of an unrated securitisation position in the form of certain types of liquidity facility.

[Note: BCD Annex IX Part 4 point 55]

Liquidity facilities only available in the event of general market disruption

A conversion figure of 0% may be applied to the nominal amount of a liquidity facility that meets the conditions set out in BIPRU 9.11.12 R.

[Note: BCD Annex IX Part 4 point 57]

Exceptional treatment for liquidity facilities where KIRB cannot be calculated

(1) When it is not practical for the firm to calculate the risk weighted exposure amounts for the securitised exposures as if they had not been securitised and the position does not qualify for the ABCP internal assessment approach, a firm may apply to the appropriate regulator for a variation of its IRB permission under which, on an exceptional basis, it may temporarily apply the method in (2) for the calculation of risk weighted exposure amounts for an unrated securitisation position in the form of a liquidity facility that meets the conditions to be a liquidity facility set out in BIPRU 9.11.10 R.

(2) Under the method in this paragraph, the highest risk weight that would be applied under the standardised approach to any of the securitised exposures had they not been securitised may be applied to the securitisation position represented by the liquidity facility. To determine the exposure value of the position a conversion figure of 50% may be applied to the nominal amount of the liquidity facility if the facility has an original maturity of one year or less. In other cases a conversion factor of 100% must be applied.

[Note: BCD Annex IX Part 4 points 58 and 59]
9.13 Securitisations of revolving exposures with early amortisation provisions

9.13.1 Where there is a securitisation of revolving exposures subject to an early amortisation provision, the originator must calculate an additional risk weighted exposure amount in accordance with this section in respect of the risk that the levels of credit risk to which it is exposed may increase following the operation of the early amortisation provision. Accordingly this section sets out how an originator must calculate a risk weighted exposure amount when it sells revolving exposures into a securitisation that contains an early amortisation provision.

[Note: BCD Article 100(1), Annex IX Part 4 points 16 and 68]

Additional capital requirements for securitisations of revolving exposures with early amortisation provisions

9.13.2 A firm must calculate a risk weighted exposure amount in respect of the sum of the originators interest and the investors interest.

[Note: BCD Annex IX Part 4 point 17]

9.13.3 For securitisation structures where the securitised exposures comprise revolving exposures and non-revolving exposures, an originator must apply the treatment set out in this section to that portion of the underlying pool containing revolving exposures.

[Note: BCD Annex IX Part 4 point 18]

9.13.4 For the purposes of this section, subject to BIPRU 9.13.6 R:

1) originators interest means the exposure value of that notional part of a pool of drawn amounts sold into a securitisation, the proportion of which in relation to the amount of the total pool sold into the structure determines the proportion of the cash-flows generated by principal and interest collections and other associated amounts which are not available to make payments to those having securitisation positions in the securitisation;

2) to qualify as such the originators interest may not be subordinate to the investors interest; and
(3) Investors interest means the exposure value of the remaining notional part of the pool of drawn amounts.

[Note: BCD Annex IX Part 4 point 19]

9.13.5  Subject to 9 BIPRU 9.13.7 R, the exposure of the originator associated with its rights in respect of the originators interest must not be treated as a securitisation position but as a pro rata exposure to the securitised exposures as if they had not been securitised.

[Note: BCD Annex IX Part 4 point 20]

9.13.6  (1) For firms using the IRB approach set out in 9 BIPRU 4, this paragraph applies in place of 9 BIPRU 9.13.4 R.

(2) For the purposes of this section, originators interest means the sum of:

(a) the exposure value of that notional part of a pool of drawn amounts sold into a securitisation, the proportion of which in relation to the amount of the total pool sold into the structure determines the proportion of the cash-flows generated by principal and interest collections and other associated amounts which are not available to make payments to those having securitisation positions in the securitisation; and

(b) the exposure value of that part of the pool of undrawn amounts of the credit lines, the drawn amounts of which have been sold into the securitisation, the proportion of which to the total amount of such undrawn amounts is the same as the proportion of the exposure value described in (a) to the exposure value of the pool of drawn amounts sold into the securitisation.

(3) To qualify as such the originators interest may not be subordinate to the investors interest.

(4) Investors interest means the exposure value of the notional part of the pool of drawn amounts not falling within (2)(a) plus the exposure value of that part of the pool of undrawn amounts of credit lines, the drawn amounts of which have been sold into the securitisation, not falling within (2)(b).

[Note: BCD Annex IX Part 4 points 69 and 70]

9.13.7  For firms using the IRB approach set out in 9 BIPRU 4, this paragraph applies in place of 9 BIPRU 9.13.5 R. The exposure of the originator associated with its rights in respect of that part of the originators interest described in 9 BIPRU 9.13.6 R (2)(a) must not be treated as a securitisation position but as a pro rata exposure to the securitised drawn amounts as if they had not been securitised in an amount equal to that described in 9 BIPRU 9.13.6 R (2)(a). The originator must also be considered to have a pro rata exposure to the undrawn amounts of the credit lines, the drawn amounts of which have been sold into the securitisation, in an amount equal to that described in 9 BIPRU 9.13.6 R (2)(b).

[Note: BCD Annex IX Part 4 point 71]
### Exemptions from early amortisation treatment

**9.13.8 R** Originators of the following types of securitisation are exempt from the capital requirement in §BIPRU 9.13.1 R:

1. securitisations of revolving exposures whereby investors remain fully exposed to all future draws by borrowers so that the risk on the underlying facilities does not return to the originator even after an early amortisation event has occurred; and

2. securitisations where any early amortisation provision is solely triggered by events not related to the performance of the securitised assets or the originator, such as material changes in tax laws or regulations.

[Note: BCD Annex IX Part 4 point 21]

### Maximum capital requirement

**9.13.9 R** For an originator subject to the capital requirement in §BIPRU 9.13.1 R the total of the risk weighted exposure amounts in respect of its positions in the investors interest (as defined in §BIPRU 9.13.4 R or §BIPRU 9.13.6 R) and the risk weighted exposure amounts calculated under §BIPRU 9.13.1 R must be no greater than the greater of:

1. the risk weighted exposure amounts calculated in respect of its positions in the investors interest (as so defined); and

2. the risk weighted exposure amounts that would be calculated in respect of the securitised exposures by a firm holding the exposures as if they had not been securitised in an amount equal to the investors interest (as so defined).

[Note: BCD Annex IX Part 4 point 22]

### Calculation of risk-weighted exposure amounts

**9.13.10 R** Deduction of net gains, if any, arising from the capitalisation of future income required under §GENPRU 2.2.90 R (Core tier one capital: profit and loss account and other reserves: Securitisation) must be treated outside the maximum amount indicated in §BIPRU 9.13.9 R.

[Note: BCD Annex IX Part 4 point 23]

The risk weighted exposure amount to be calculated in accordance with §BIPRU 9.13.1 R must be determined by multiplying the amount of the investors interest (as defined in §BIPRU 9.13.4 R or §BIPRU 9.13.6 R) by the product of:

1. the appropriate conversion figure as indicated in §BIPRU 9.13.16 R, §BIPRU 9.13.19 R or §BIPRU 9.13.20 R; and

2. the weighted average risk weight that would apply to the securitised exposures if the exposures had not been securitised.

[Note: BCD Annex IX Part 4 point 24]
9.13.12 R An early amortisation provision must be treated as controlled for the purposes of this section where the following conditions are met:

1. the originator has an appropriate capital/liquidity plan in place to ensure that it has sufficient capital and liquidity available in the event of an early amortisation;

2. throughout the duration of the transaction there is a pro rata sharing between the originators interest and the investors interest (as defined in BIPRU 9.13.4 R or BIPRU 9.13.6 R) of payments of interest and principal, expenses, losses and recoveries based on the balance of receivables outstanding at one or more reference points during each month;

3. the amortisation period is considered sufficient for 90% of the total debt (originators and investors interest (as defined in BIPRU 9.13.4 R or BIPRU 9.13.6 R)) outstanding at the beginning of the early amortisation period to have been repaid or recognised as in default; and

4. the speed of repayment is no more rapid than would be achieved by straight-line amortisation over the period set out in (3).

[Note: BCD Annex IX Part 4 point 25]

9.13.13 R In the case of a securitisation meeting the following conditions:

1. it is subject to an early amortisation provision;

2. the securitisation is of retail exposures which are uncommitted and unconditionally cancellable without prior notice; and

3. the early amortisation is triggered by the excess spread level falling to a specified level.

A firm must, to calculate the appropriate conversion figure referred to in BIPRU 9.13.11 R, compare the three-month average excess spread level with the excess spread levels at which excess spread is required to be trapped.

[Note: BCD Annex IX Part 4 point 26]

9.13.14 R Where the securitisation does not require excess spread to be trapped, the trapping point is deemed to be 4.5 percentage points greater than the excess spread level at which an early amortisation is triggered.

[Note: BCD Annex IX Part 4 point 27]

9.13.15 R The conversion figure to be applied must be determined by the level of the actual three month average excess spread in accordance with BIPRU 9.13.16 R.

[Note: BCD Annex IX Part 4 point 28]

9.13.16 R Table: Conversion figures

This table belongs to BIPRU 9.13.15 R
Securitisations of revolving exposures with early amortisation provisions

### Table

<table>
<thead>
<tr>
<th>3 months average excess spread</th>
<th>Conversion figure</th>
<th>Conversion figure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above level A</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Level A</td>
<td>1%</td>
<td>5%</td>
</tr>
<tr>
<td>Level B</td>
<td>2%</td>
<td>15%</td>
</tr>
<tr>
<td>Level C</td>
<td>10%</td>
<td>50%</td>
</tr>
<tr>
<td>Level D</td>
<td>20%</td>
<td>100%</td>
</tr>
<tr>
<td>Level E</td>
<td>40%</td>
<td>100%</td>
</tr>
</tbody>
</table>

### 9.13.17

In BIPRU 9.13.16 R:

1. Level A means levels of excess spread less than 133.33% of the trapping level of excess spread but not less than 100% of that trapping level;
2. Level B means levels of excess spread less than 100% of the trapping level of excess spread but not less than 75% of that trapping level;
3. Level C means levels of excess spread less than 75% of the trapping level of excess spread but not less than 50% of that trapping level;
4. Level D means levels of excess spread less than 50% of the trapping level of excess spread but not less than 25% of that trapping level; and
5. Level E means levels of excess spread less than 25% of the trapping level of excess spread.

[Note: BCD Annex IX Part 4 point 29]

### 9.13.18

In the case of a securitisation meeting the conditions in this paragraph, a firm may apply to the appropriate regulator for a waiver that would allow a treatment which approximates closely to that prescribed in BIPRU 9.13.13 R to BIPRU 9.13.17 R for determining the conversion figure indicated. If a firm wants such a waiver, it should satisfy the appropriate regulator that:

1. the securitisation is subject to an early amortisation provision of retail exposures;
2. those retail exposures are uncommitted and unconditionally cancellable without prior notice;
3. the early amortisation is triggered by a quantitative value in respect of something other than the three month average excess spread;
4. the firm can establish a quantitative measure equivalent, in relation to the value in (3), to the trapping level of excess spread; and
(5) that treatment is a prudent measure of the risk that the levels of credit risk to which it is exposed may increase following the operation of the early amortisation provision (referred to in BIPRU 9.13.1R).

[Note: BCD Annex IX Part 4 point 30]

9.13.19 R All other securitisations subject to a controlled early amortisation provision of revolving exposures are subject to a credit conversion figure of 90%.

[Note: BCD Annex IX Part 4 point 32]

9.13.20 R All other securitisations subject to a non-controlled early amortisation provision of revolving exposures are subject to a credit conversion figure of 100%.

[Note: BCD Annex IX Part 4 point 33]

Liquidity plans

9.13.21 R A firm which is an originator of a revolving securitisation transaction involving early amortisation provisions should have liquidity plans to address the implications of both scheduled and early amortisation.

[Note: BCD Annex V point 9]
9.14 Recognition of credit risk mitigation on securitisation positions under the IRB approach

9.14.1 This section applies to credit risk mitigation in relation to a securitisation position for a firm calculating risk weighted exposure amounts using the IRB approach.

[Note: BCD Annex IX Part 4 point 37 (part)]

9.14.2 Where a firm uses the ratings based method to calculate the risk weighted exposure amounts of securitisation positions, the firm may recognise credit risk mitigation in accordance with R9.14.4 R to R9.14.6 R.

[Note: BCD Annex IX Part 4 point 51]


[Note: BCD Annex IX Part 4 point 54]

**Funded protection**

9.14.4 Eligible funded protection is limited to that which is eligible for the calculation of risk weighted exposure amounts under the standardised approach as laid down under R9.14.4. R and recognition is subject to compliance with the relevant minimum requirements as laid down under R9.14.4.

[Note: BCD Annex IX Part 4 point 60]

**Unfunded credit protection**

9.14.5 Eligible unfunded credit protection and unfunded protection providers are limited to those which are eligible under R9.14.4 (Credit risk mitigation) and R9.14.10 (Credit risk mitigation under the IRB approach) and recognition is subject to compliance with the relevant minimum requirements laid down under those provisions.

[Note: BCD Annex IX Part 4 point 61]
Credit risk mitigation under the ratings based method

9.14.6 R
Where risk weighted exposure amounts are calculated using the ratings based method, the exposure value and/or the risk weighted exposure amount for a securitisation position in respect of which credit protection has been obtained may be modified in accordance with the provisions of BIPRU 5 (Credit risk mitigation) as they apply for the calculation of risk weighted exposure amounts under the standardised approach set out in BIPRU 3.

[Note: BCD Annex IX Part 4 point 62]

Credit risk mitigation under the supervisory formula method

full credit protection

9.14.7 R
BIPRU 9.14.8 R BIPRU 9.14.10 R apply where risk weighted exposure amounts are calculated using the supervisory formula method where there is full credit protection.

[Note: BCD Annex IX Part 4 point 63 (part)]

9.14.8 R
A firm must determine the effective risk weight of the position. It must do this by dividing the risk weighted exposure amount of the position by the exposure value of the position and multiplying the result by 100.

[Note: BCD Annex IX Part 4 point 63 (part)]

9.14.9 R
In the case of funded credit protection, the risk weighted exposure amount of the securitisation position must be calculated by multiplying the funded protection-adjusted exposure amount of the position (E*, as calculated under BIPRU 5.4.28 R (3), taking the amount of the securitisation position to be E) by the effective risk weight.

[Note: BCD Annex IX Part 4 point 64]

9.14.10 R
In the case of unfunded credit protection, the risk weighted exposure amount of the securitisation position must be calculated by multiplying G_A (the amount of the protection adjusted for any currency mismatch and maturity mismatch in accordance BIPRU 5.7.23 R (2)) by the risk weight of the protection provider; and adding this to the amount arrived at by multiplying the amount of the securitisation position minus G_A by the effective risk weight.

[Note: BCD Annex IX Part 4 point 65]

Credit risk mitigation under the supervisory formula method

partial protection

9.14.11 R
If the credit risk mitigation covers the first loss or losses on a proportional basis on the securitisation position, a firm may apply BIPRU 9.14.7 R to BIPRU 9.14.10 R.

[Note: BCD Annex IX Part 4 point 66]

In other cases the firm must treat the securitisation position as two or more positions with the uncovered portion being the position with the lower credit quality. For the purposes of calculating the risk weighted exposure amount for this position, the provisions in BIPRU 9.12.22 R to BIPRU 9.12.24 G apply subject to the modifications that T is adjusted to e* in the case of funded credit protection; and to T-g in the case of unfunded credit protection, where e* denotes the ratio of E* to the total notional amount of the underlying pool, where E* is the adjusted exposure amount of the securitisation position calculated in accordance with BIPRU 5.4.28 R (3) taking the amount of the securitisation position to be E; and g is the ratio of the nominal amount of credit protection (adjusted for any currency or maturity mismatch in accordance with the provisions of BIPRU 5 (Credit risk mitigation)) to the sum of the exposure amounts of the securitised exposures. In the case of unfunded credit protection the risk weight of the protection provider must be applied to that portion of the position not falling within the adjusted value of T.

[Note: BCD Annex IX Part 4 point 67]
9.15 Requirements for investors

9.15.1 R
9.15.1A R
9.15.1B G
9.15.2 G
9.15.3 R
9.15.4 R
9.15.5 R
9.15.6 R
9.15.7 R
9.15.8 R
9.15.9 R
9.15.10 R
9.15.11 R
9.15.12 R
9.15.13 R
| 9.15.14 | R |
| 9.15.15 | R |
| 9.15.16 | R |
| 9.15.16A | R |
| 9.15.16B | R |
| 9.15.16C | G |
| 9.15.16D | G |
| 9.15.16E | G |
| 9.15.17 | G |
| 9.15.18 | G |
Chapter 11

Disclosure (Pillar 3)
11.1 Application and purpose

Application

11.1.1 BIPRU 11 applies to a BIPRU firm.

Purpose

11.1.2 Pursuant to the third paragraph of article 95(2) of the EU CRR, the purpose of BIPRU 11 is to implement:

1. (a) Article 68(3);
   (b) Article 72;
   (c) Articles 145 to 149; and
   (d) Annex XII;
   of the Banking Consolidation Directive; and

2. (a) Article 2, in part;
   (b) Point 3 of Article 23, in part; and
   (c) Article 39;
   of the Capital Adequacy Directive.
11.2 Basis of disclosures

Disclosure on an individual basis

11.2.1 The following must comply with the obligations laid down in BIPRU 11.3 on an individual basis:

(1) a firm which is neither a parent undertaking nor a subsidiary undertaking;

(2) a firm which is excluded from a UK consolidation group or non-EEA sub-group pursuant to BIPRU 8.5; and

[Note: BCD Article 68(3)]

(3) a firm which is part of a group which has been granted an investment firm consolidation waiver under BIPRU 8.4;

[Note: CAD Article 23]

EEA parent institutions

11.2.2 A firm which is an EEA parent institution must comply with the obligations laid down in BIPRU 11.3 on the basis of its consolidated financial situation.

[Note: BCD Article 72(1)]

11.2.3 A firm which is a significant subsidiary of an EEA parent institution must disclose the information specified in BIPRU 11.4.5 R on an individual or sub-consolidated basis.

Firms controlled by an EEA parent financial holding company

11.2.4 A firm controlled by an EEA parent financial holding company or an EEA parent mixed financial holding company must comply with the obligations laid down in BIPRU 11.3 on the basis of the consolidated financial situation of that EEA parent financial holding company or EEA parent mixed financial holding company.

[Note: BCD Article 72(2)]

11.2.5 A firm which is a significant subsidiary of an EEA parent financial holding company or an EEA parent mixed financial holding company must disclose the information specified in BIPRU 11.4.5 R on an individual or sub-consolidated basis.
Waiver: Comparable disclosures provided on a consolidated basis by a parent undertaking established in a third country

11.2.6 A firm which is included within comparable disclosures provided on a consolidated basis by a parent undertaking whose head office is not in an EEA State may apply for a waiver from the relevant disclosure requirements in BIPRU 11.2.2 R - BIPRU 11.2.5 R. The appropriate regulator’s approach to granting waivers is set out in the Supervision manual (see SUP 8).

[Note: BCD Article 72(3)]

11.2.7 A firm applying for a waiver from one or more of the disclosure requirements in BIPRU 11.2.2 R - BIPRU 11.2.5 R will need to:

(1) satisfy the appropriate regulator that it is included within comparable disclosures provided on a consolidated basis by a parent undertaking whose head office is not in an EEA State; and

(2) notify the appropriate regulator of the location where the comparable disclosures are provided.
11.3 Disclosures: Information to be disclosed; Frequency, media and location of disclosures; Verification

### Information to be disclosed

#### 11.3.1
A firm must publicly disclose the information laid down in § BIPRU 11.5 subject to the provisions laid down in § BIPRU 11.3.5 R to § BIPRU 11.3.7 R.

[Note: BCD Article 145(1), CAD Article 39]

#### 11.3.2

1. A firm which has an IRB permission must publicly disclose the information laid down in § BIPRU 11.6.1 R to § BIPRU 11.6.4 R.

2. A firm which recognises credit risk mitigation in accordance with § BIPRU 5 must publicly disclose the information laid down in § BIPRU 11.6.5 R.

3. [deleted]

[Note: BCD Article 145(2), CAD Article 39]

### Disclosure policy

#### 11.3.3

1. A firm must adopt a formal policy to comply with the disclosure requirements laid down in § BIPRU 11.3.1 R and § BIPRU 11.3.2 R and have policies for assessing the appropriateness of its disclosures, including their verification and frequency.

2. A firm must also have policies for assessing whether its disclosures convey its risk profile comprehensively to market participants. Where those disclosures do not convey its risk profile comprehensively to market participants, a firm must publicly disclose the information necessary in addition to that required according to § BIPRU 11.3.3R (1). However, a firm may omit one or more items of information if those items are not, in the light of the criterion specified in § BIPRU 11.4.1 R, regarded as material, or if those items are, in the light of the criteria specified in § BIPRU 11.4.2 R and § BIPRU 11.4.3 R, regarded as proprietary or confidential.

[Note: BCD Article 145(3)]

### Rating decisions

#### 11.3.4
A firm must, if requested, explain its rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when
asked. The administrative costs of the explanation have to be at an appropriate rate to the size of the loan.

[Note: BCD Article 145(4)]

### Exemption from disclosure: Materiality

**11.3.5** A firm may omit one or more of the disclosures listed in BIPRU 11.5 if the information provided by such disclosures is not, in the light of the criterion specified in BIPRU 11.4.1 R, regarded as material.

[Note: BCD Article 146(1)]

### Exemption from disclosure: Proprietary or confidential information

**11.3.6** A firm may omit one or more items of information included in the disclosures listed in BIPRU 11.5 and BIPRU 11.6 if those items include information which, in the light of the criteria specified in BIPRU 11.4.2 R and BIPRU 11.4.3 R, is regarded as proprietary or confidential.

[Note: BCD Article 146(2)]

**11.3.7** In the exceptional cases referred to in BIPRU 11.3.6 R, a firm must:

1. state in its disclosures:
   a. the fact that the specific items of information are not disclosed; and
   b. the reason for non-disclosure; and
2. publish more general information about the subject matter of the disclosure requirement, except where these are to be classified as secret or confidential under the criteria set out in BIPRU 11.4.2 R and BIPRU 11.4.3 R.

[Note: BCD Article 146(3)]

### Frequency of publication

**11.3.8** A firm must:

1. publish the disclosures required under BIPRU 11.3.1 R to BIPRU 11.3.5 R on an annual basis at a minimum;
2. publish disclosures as soon as practicable.

[Note: BCD Article 147(1)]

**11.3.9** A firm must also determine whether more frequent publication than is provided for in BIPRU 11.3.8 R is necessary in the light of the criteria set out in BIPRU 11.4.4 R.

[Note: BCD Article 147(2)]
Media and location of publication

(1) A firm may determine the appropriate medium, location and means of verification to comply effectively with the disclosure requirements laid down in BIPRU 11.3.1 R to BIPRU 11.3.4 R.

(2) To the degree feasible, a firm must provide all disclosures in one medium or location.

(3) Equivalent disclosures made by a firm under accounting, listing or other requirements may be deemed to constitute compliance with BIPRU 11.3.1 R to BIPRU 11.3.4 R.

(4) If disclosures are not included in the financial statements, a firm must indicate where they can be found.

[Note: BCD Article 148]
11.4 Technical criteria on disclosure: General criteria

Criterion for materiality

11.4.1 A firm must regard information as material in disclosures if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

[Note: BCD Annex XII Part 1 point 1]

Criteria: Proprietary or confidential information

11.4.2 (1) A firm must regard information as proprietary information if sharing that information with the public would undermine its competitive position.

(2) Proprietary information may include information on products or systems which, if shared with competitors, would render a firm’s investments therein less valuable.

[Note: BCD Annex XII Part 1 point 2]

11.4.3 A firm must regard information as confidential if there are obligations to customers or other counterparty relationships binding the firm to confidentiality.

[Note: BCD Annex XII Part 1 point 3]

Criteria: Frequency of publication

11.4.4 (1) A firm must assess the need to publish some or all disclosures more frequently than annually in the light of the relevant characteristics of its business such as:

(a) scale of operations;
(b) range of activities;
(c) presence in different countries;
(d) involvement in different financial sectors;
(e) participation in international financial markets; and
(f) participation in payment, settlement and clearing systems.

(2) In making its assessment under (1) a firm must pay particular attention to the possible need for more frequent disclosure of:
(a) items of information laid down in BIPRU 11.5.3 R (2) and BIPRU 11.5.3 R (5), and BIPRU 11.5.4 R (2) - BIPRU 11.5.4 R (5);

(b) information on risk exposure and other items prone to rapid change.

[Note: BCD Annex XII Part 1 point 4]

Disclosures: Significant subsidiaries

A firm which is a significant subsidiary of:

(1) an EEA parent institution; or

(2) an EEA parent financial holding company; or

(3) an EEA parent mixed financial holding company;

must disclose the information specified in BIPRU 11.5.3 R to BIPRU 11.5.4 R on an individual or sub-consolidated basis.

[Note: BCD Annex XII Part 1 point 5]
11.5 Technical criteria on disclosure: General requirements

Disclosure: Risk management objectives and policies

11.5.1 A firm must disclose its risk management objectives and policies for each separate category of risk, including the risks referred to under R11.5.1 to R11.5.17. These disclosures must include:

(1) the strategies and processes to manage those risks;
(2) the structure and organisation of the relevant risk management function or other appropriate arrangements;
(3) the scope and nature of risk reporting and measurement systems; and
(4) the policies for hedging and mitigating risk, and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants.

[Note: BCD Annex XII Part 2 point 1]

Disclosure: Scope of application of directive requirements

11.5.2 A firm must disclose the following information regarding the scope of application of the requirements of the Banking Consolidation Directive:

(1) the name of the firm which is the subject of the disclosures;
(2) an outline of the differences in the basis of consolidation for accounting and prudential purposes, with a brief description of the entities that are:
   (a) fully consolidated;
   (b) proportionally consolidated;
   (c) deducted from capital resources;
   (d) neither consolidated nor deducted;
(3) any current or foreseen material practical or legal impediment to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiary undertakings;
(4) the aggregate amount by which the actual capital resources are less than the required minimum in all subsidiary undertakings not included in the consolidation, and the name or names of such subsidiary undertakings; and
(5) if applicable, the circumstance of making use of the provisions laid down in BIPRU 2.1 (Solo consolidation waiver).

[Note: BCD Annex XII Part 2 point 2]

Disclosure: Capital resources

11.5.3 ▶ A firm must disclose the following information regarding its capital resources:

(1) summary information on the terms and conditions of the main features of all capital resources items and components thereof, including:
   (a) hybrid capital;
   (b) capital instruments which provide an incentive for the firm to redeem them; and
   (c) capital instruments which the firm treats as tier one capital under GENPRU TP8A;

(2) tier one capital resources, with separate disclosure of:
   (a) all positive items and deductions;
   (b) the overall amount of hybrid capital, with specification of those instruments treated as tier one capital under GENPRU TP8A.1; and
   (c) the overall amount of capital instruments that provide for an incentive to redeem them, with specification of those instruments treated as tier one capital under GENPRU TP8A.1;

(3) the total amount (for the purposes of (3), the total amount must be stated gross of deductions) of:
   (a) tier two capital resources plus any innovative tier one capital resources; and
   (b) tier three capital resources;

(4) deductions from tier one capital resources and tier two capital resources, with separate disclosure of items referred to in GENPRU 2.2.236 R; and

(5) total capital resources, net of deductions in GENPRU 2.2 and limits laid down in GENPRU 2.2.25 R to GENPRU 2.2.30 R and GENPRU 2.2.42 R to GENPRU 2.2.50 R.

[Note: BCD Annex XII Part 2 point 3]

Disclosure: Compliance with BIPRU 3, BIPRU 4, BIPRU 7 and the overall Pillar 2 rule

11.5.4 ▶ A firm must disclose the following information regarding compliance with BIPRU 3, BIPRU 4, BIPRU 7, and the overall Pillar 2 rule:

(1) a summary of the firm’s approach to assessing the adequacy of its internal capital to support current and future activities;
(2) for a firm calculating risk weighted exposure amounts in accordance with the standardised approach to credit risk, 8% of the risk weighted exposure amounts for each of the standardised credit risk exposure classes;

(3) for a firm calculating risk weighted exposure amounts in accordance with the IRB approach, 8% of the risk weighted exposure amounts for each of the IRB exposure classes;

[Note: BCD Annex XII Part 2 point 4 (part)]

(4) the firm’s minimum capital requirements for the following:

(a) in respect of its trading-book business, its:
   (i) interest rate PRR;
   (ii) equity PRR;
   (iii) option PRR;
   (iv) collective investment schemes PRR;
   (v) counterparty risk capital component; and
   (vi) [deleted]

(b) in respect of all of its business activities, its:
   (i) commodity PRR; and
   (ii) foreign currency PRR.

(5) [deleted]

11.5.5 For retail exposures, the requirement under BIPRU 11.5.4 R (3) applies to each of the following categories:

(1) exposures to retail SMEs;
(2) retail exposures secured by real estate collateral;
(3) qualifying revolving retail exposures; and
(4) other retail exposures.

[Note: BCD Annex XII Part 2 point 4(part)]

11.5.6 For equity exposures, the requirement under BIPRU 11.5.4 R (3) applies to:

(1) each of the approaches (the simple risk weight approach, the PD/LGD approach and the internal models approach) provided for in BIPRU 4.7.5 R to BIPRU 4.7.6 R, BIPRU 4.7.9 R to BIPRU 4.7.11 R, BIPRU 4.7.14 R to BIPRU 4.7.16 R, BIPRU 4.7.24 R to BIPRU 4.7.25 R;

(2) exchange traded exposures, private equity exposures in sufficiently diversified portfolios, and other exposures;

(3) exposures subject to supervisory transition regarding capital requirements; and
A firm must disclose the following information regarding its exposure to counterparty credit risk:

1. A discussion of the methodology used to assign internal capital and credit limits for counterparty credit exposures;
2. A discussion of policies for securing collateral and establishing credit reserves;
3. A discussion of policies with respect to wrong-way risk exposures;
4. A discussion of the impact of the amount of collateral the firm would have to provide given a downgrade in its credit rating;
5. Gross positive fair value of contracts, netting benefits, netted current credit exposure, collateral held and ‘net derivatives credit exposure’, where ‘net derivatives credit exposure’ is the credit exposure on derivatives transactions after considering both the benefits from legally enforceable netting agreements and collateral arrangements;
6. Measures for exposure value under the CCR mark to market method, the CCR standardised method or the CCR internal model method, whichever is applicable;
7. The notional value of credit derivative hedges, and the distribution of current credit exposure by types of credit exposure;
8. Credit derivative transactions (notional), segregated between use for the firm’s own credit portfolio, as well as in its intermediation activities, including the distribution of the credit derivatives products used, broken down further by protection bought and sold within each product group; and
9. The estimate of alpha (\(\alpha\)) if the firm’s CCR internal model method permission permits it to estimate \(\alpha\).

Disclosure: Credit risk and dilution risk

A firm must disclose the following information regarding its exposure to credit risk and dilution risk:

1. The definitions for accounting purposes of past due and impaired;
2. A description of the approaches and methods adopted for determining value adjustments and provisions;
3. The total amount of exposures after accounting offsets and without taking into account the effects of credit risk mitigation, and the average amount of the exposures over the period broken down by different types of exposure classes;
The information to be disclosed under BIPRU 11.5.8 R (9) must comprise:

(1) a description of the type of value adjustments and provisions;

(2) the opening balances;

(3) the amounts taken against the provisions during the period;

(4) the amounts set aside or reversed for estimated probable losses on exposures during the period, any other adjustments including those determined by exchange rate differences, business combinations, acquisitions and disposals of subsidiary undertakings, and transfers between provisions; and

(5) the closing balances.

[Note: BCD Annex XII Part 2 point 6 (part)]

Disclosure: Firms calculating risk weighted exposure amounts in accordance with the standardised approach

For a firm calculating risk weighted exposure amounts in accordance with the standardised approach to credit risk, the following information must be disclosed for each of the standardised credit risk exposure classes:

(1) the names of the nominated ECAs and export credit agencies and the reasons for any changes;
(2) the standardised credit risk exposure classes for which each ECAI or export credit agency is used;

(3) a description of the process used to transfer the issuer and issue credit assessments onto items not included in the trading book;

(4) the association of the external rating of each nominated ECAI or export credit agency with the credit quality steps prescribed in BIPRU 3, taking into account that this information need not be disclosed if the firm complies with the credit quality assessment scale; and

(5) the exposure values and the exposure values after credit risk mitigation associated with each credit quality step prescribed in BIPRU 3, as well as those deducted from capital resources.

[Note: BCD Annex XII Part 2 point 7]

Disclosure: Firms calculating risk weighted exposure amounts using the IRB approach

11.5.11 R A firm calculating risk weighted exposure amounts for specialised lending exposures in accordance with BIPRU 4.5.8 R to BIPRU 4.5.10 R or equity exposures in accordance with BIPRU 4.7.9 R to BIPRU 4.7.10 R (the simple risk weight approach) must disclose the exposures assigned:

(1) to each category of the table in BIPRU 4.5.9 R; or

(2) to each risk weight mentioned in BIPRU 4.7.9 R to BIPRU 4.7.10 R.

[Note: BCD Annex XII Part 2 point 8]

Disclosure: Market risk

11.5.12 R A firm must disclose its capital resources requirements separately for each risk referred to in (1), (2) and (3):

(1) in respect of its trading-book business, its:
   (a) interest rate PRR;
   (b) equity PRR;
   (c) option PRR;
   (d) collective investment schemes PRR;
   (e) counterparty risk capital component; and
   (f) [deleted]

(2) in respect of all of its business activities, its:
   (a) commodity PRR; and
   (b) foreign currency PRR; and

(3) its specific interest-rate risk of securitisation positions.

[Note: BCD Annex XII Part 2 point 9]
 Disclosure: Use of VaR model for calculation of market risk capital requirement

11.5.13 R The following information must be disclosed by a firm which calculates its market risk capital requirement using a VaR model:

(1) for each sub-portfolio covered:
   (a) the characteristics of the models used;
   (b) a description of stress testing applied to the sub-portfolio;
   (c) a description of the approaches used for back-testing and validating the accuracy and consistency of the internal models and modelling processes;
   (d) for the capital charges calculated according to the incremental risk charge and the all price risk measure separately, the methodologies used and the risks measured through the use of an internal model, including a description of the approach used by the firm to determine liquidity horizons, the methodologies used to achieve a capital assessment that is consistent with the required soundness standard and the approaches used in the validation of the model;

(2) the scope of the firm’s VaR model permission;

(3) a description of the extent and methodologies for compliance with the requirements set out in GENPRU 1.3.13 R (2) and GENPRU 1.3.13 R (3) and GENPRU 1.3.14 R to GENPRU 1.3.34 R;

(4) the highest, the lowest and the mean of the following:
   (a) the daily VaR measures over the reporting period and the VaR measure as per the period end;
   (b) the stressed VaR measures over the reporting period and the stressed VaR measure as per the period end;
   (c) the capital charge according to the incremental risk charge over the reporting period and as per the period end;
   (d) the capital charge according to the all price risk measure over the reporting period and as per the period end;

(5) the amount of capital according to the incremental risk charge and the amount of capital according to the all price risk measure shown separately, together with the weighted average liquidity horizon for each sub-portfolio covered; and

(6) a comparison of the daily end-of-day VaR measures to the one-day changes of the portfolio’s value by the end of the subsequent business day together with an analysis of any important overshooting during the reporting period.

[Note: BCD Annex XII Part 2 point 10]

Disclosure: Non-trading book exposures in equities

11.5.15 R A firm must disclose the following information regarding the exposures in equities not included in the trading book:
(1) the differentiation between exposures based on their objectives, including for capital gains relationship and strategic reasons, and an overview of the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation and any significant changes in these practices;

(2) the balance sheet value, the fair value and, for those exchange-traded, a comparison to the market price where it is materially different from the fair value;

(3) the types, nature and amounts of exchange-traded exposures, private equity exposures in sufficiently diversified portfolios, and other exposures;

(4) the cumulative realised gains or losses arising from sales and liquidations in the period; and

(5) the total unrealised gains or losses, the total latent revaluation gains or losses, and any of these amounts included in tier one, tier two or tier three capital resources.

[Note: BCD Annex XII Part 2 point 12]

Disclosures: Exposures to interest rate risk in the non-trading book

11.5.16 A firm must disclose the following information on its exposure to interest rate risk on positions not included in the trading book:

(1) the nature of the interest rate risk and the key assumptions (including assumptions regarding loan prepayments and behaviour of non-maturity deposits), and frequency of measurement of the interest rate risk; and

(2) the variation in earnings, economic value or other relevant measure used by the management for upward and downward rate shocks according to management’s method for measuring the interest rate risk, broken down by currency.

[Note: BCD Annex XII Part 2 point 13]

Disclosures: Securitisation

11.5.17 A firm calculating risk weighted exposure amounts in accordance with BIPRU 9 or capital resource requirements according to BIPRU 7.2.48A R to BIPRU 7.2.48K R must disclose the following information, where relevant separately for its trading book and non-trading book:

(1) a description of the firm’s objectives in relation to securitisation activity;

(1A) the nature of other risks, including liquidity risk inherent in securitised assets;

(1B) the type of risks in terms of seniority of underlying securitisation positions and in terms of assets underlying these latter securitisation positions assumed and retained with resecuritisation activity;
(2) the different roles played by the firm in the securitisation process;

(3) an indication of the extent of the firm’s involvement in each of them;

(3A) a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures, including how the behaviour of the underlying assets impacts securitisation positions and a description of how those processes differ for resecuritisation positions;

(3B) a description of the firm’s policy governing the use of hedging and unfunded protection to mitigate the risks of retained securitisation and resecuritisation positions, including identification of material hedge counterparties by relevant type of risk exposure;

(4) the approaches to calculating risk weighted exposure amounts that the firm follows for its securitisation activities, including the types of securitisation exposures to which each approach applies;

(4A) the types of SSPEs that the firm, as sponsor, uses to securitise third-party exposures, including whether, and in what form, and to what extent, the firm has exposures to these SSPEs, separately for on and off-balance sheet exposures, as well as a list of the entities that the firm manages, or advises, and that invest in either the securitisation positions that the firm has securitised or in SSPEs that the firm sponsors;

(5) a summary of the firm’s accounting policies for securitisation activities, including:

(a) whether the transactions are treated as sales or financings;

(b) the recognition of gains on sales;

(c) the methods, key assumptions, inputs and the changes from the previous period for valuing securitisation positions;

(d) the treatment of synthetic securitisations if this is not covered by other accounting policies;

(e) how assets awaiting securitisation are valued and whether they are recorded in the firm’s non-trading book or trading book; and

(f) policies for recognising liabilities on the balance sheet for arrangements that could require the firm to provide financial support for securitised assets;

(6) the names of the ECAIs used for securitisations and the types of exposure for which each agency is used;

(6A) where applicable, a description of the ABCP internal assessment approach as set out in BIPRU 9.12.20 R including the structure of the internal assessment process and relation between internal assessment and external ratings, the use of internal assessment other than for ABCP internal assessment approach capital purposes, the control mechanisms for the internal assessment process (including discussion of independence, accountability, and internal assessment process review), the exposure types to which the internal assessment process is applied and the stress factors used for determining credit enhancement levels, by exposure type;
(68) an explanation of significant changes to any of the quantitative disclosures in (8) and (13) to (15) since the last reporting period;

(7) [deleted]

(8) for the non-trading book and for exposures securitised by the firm, the amount of impaired and past due exposures securitised, and the losses recognised by the firm during the current period, broken down by exposure type;

(9) [deleted]

(10) [deleted]

(11) [deleted]

(12) [deleted]

(13) separately for the trading book and the non-trading book, the following information broken down by exposure type:
   
   (a) the total outstanding amount of exposures securitised by the firm, separately for traditional securitisations and synthetic securitisations, and securitisations for which the firm acts only as sponsor;
   
   (b) the aggregate amount of on-balance sheet securitisation positions retained or purchased, and off-balance sheet securitisation exposures;
   
   (c) the aggregate amount of assets awaiting securitisation;
   
   (d) for securitised facilities subject to an early amortisation provision, the aggregate drawn-down exposures attributed to the originator’s and investors’ interests respectively, the aggregate capital resources requirement incurred by the firm against the originator’s interest and the aggregate capital resources requirement incurred by the firm against the investors’ shares of drawn balances and undrawn lines;
   
   (e) the amount of securitisation positions that have been risk weighted at 1250% or deducted; and
   
   (f) a summary of the securitisation activity of the current period, including the amount of exposures securitised and recognised gain or loss on sale;

(14) separately for the trading book and the non-trading book, the following information:

   (a) the aggregate amount of securitisation positions retained or purchased and the associated capital resources requirements, broken down by securitisation and resecuritisation exposures, and further broken down into a meaningful number of risk weight or capital resources requirement bands, for each capital resources requirement approach used; and
   
   (b) the aggregate amount of resecuritisation exposures retained or purchased, broken down according to the exposure before and after hedging or insurance, and the exposure to financial guarantors, broken down according to guarantor credit worthiness categories or guarantor name; and
(15) for the **trading book**, the total outstanding **exposures securitised** by the **firm** and subject to a **market risk capital requirement**, broken down into **traditional and synthetic**, and by **exposure type**.

**Note:** BCD Annex XII Part 2 point 14

### Disclosures: remuneration

A **firm** must disclose the following information, including regular, at least annual, updates, regarding its remuneration policy and practices for those categories of staff whose professional activities have a material impact on its risk profile:

1. information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;

2. information on the link between pay and performance;

3. the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria;

4. information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;

5. the main parameters and rationale for any variable component scheme and any other non-cash benefits;

6. aggregate quantitative information on remuneration, broken down by business area;

7. aggregate quantitative information on remuneration, broken down by senior management and members of staff whose actions have a material impact on the risk profile of the **firm**, indicating the following:
   - (a) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries;
   - (b) the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types;
   - (c) the amounts of outstanding deferred remuneration, split into vested and unvested portions;
   - (d) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;
   - (e) new sign-on and severance payments made during the financial year, and the number of beneficiaries of those payments;
(f) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person.

[Note: Paragraph 15 of Annex XII to the Banking Consolidation Directive.]

11.5.19  
The appropriate regulator would normally consider the requirements to publish disclosures in accordance with BIPRU 11.3.8 R and 11.3.9 R in respect of BIPRU 11.5 as a whole to meet the requirement in paragraph 15 of Annex XII to the Banking Consolidation Directive to publish "regular, at least annual, updates" (as implemented in BIPRU 11.5.18 R).

11.5.20  
(1) A firm that is significant in terms of its size, internal organisation and the nature, scope and the complexity of its activities must also disclose the quantitative information referred to in BIPRU 11.5.18 R at the level of senior personnel.

(2) Firms must comply with the requirements set out in BIPRU 11.5.18 R in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to the UK or other national transposition of Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

[Note: Paragraph 15 of Annex XII to the Banking Consolidation Directive.]

[Note: The appropriate regulator has given guidance for the purpose of providing a framework for complying with the disclosure requirements of BIPRU 11.5.18 R in accordance with the proportionality test set out in BIPRU 11.5.20 R (2).]

11.5.21  
In the appropriate regulator’s view, the exemptions from disclosure provided for in BIPRU 11.3.5 R (materiality) and BIPRU 11.3.6 R (proprietary or confidential information) are unlikely to apply to the disclosure required by BIPRU 11.5.18 R (having regard, amongst other things, to the fact that the requirements set out in BIPRU 11.5.18 R are to be complied with in the manner described in BIPRU 11.5.20 R (2)).
11.6 Qualifying requirements for the use of particular instruments or methodologies

Disclosures: Firms using the IRB approach

A firm calculating risk weighted exposure amounts in accordance with the IRB approach must disclose the following information:

1. the scope of the firm’s IRB permission;
2. an explanation and review of:
   a. the structure of internal rating systems and relation between internal and external ratings;
   b. the use of internal estimates other than for calculating risk weighted exposure amounts in accordance with the IRB approach;
   c. the process for managing and recognising credit risk mitigation;
   d. the control mechanisms for rating systems including a description of independence, accountability, and rating systems review;
3. a description of the internal ratings process, provided separately for the following IRB exposure classes:
   a. central governments and central banks;
   b. institutions;
   c. corporate, including SMEs, specialised lending and purchased corporate receivables;
   d. retail, for exposures to retail SMEs exposures, retail exposures secured by real estate collateral, qualifying revolving retail exposures, and other retail exposures; and
   e. equities;
4. the exposure values for each of the IRB exposure classes;
5. for each of the IRB exposure classes central governments and central banks, institutions, corporate and equity, and across a sufficient number of obligor grades (including default) to allow for a meaningful differentiation of credit risk, a firm must disclose:
   a. the total exposures (for the IRB exposure classes central governments and central banks, institutions and corporate exposures, the sum of outstanding loans and exposure values for
undrawn commitments; for *equity exposures*, the outstanding amount;

(b) for a *firm* using own *LGD* estimates for the calculation of *risk weighted exposure amounts*, the *exposure-weighted average LGD* in percentage;

(c) the *exposure-weighted average risk weight*; and

(d) for a *firm* using own estimates of *conversion factors* for the calculation of *risk weighted exposure amounts*, the amount of undrawn commitments and *exposure-weighted average exposure values* for each *IRB exposure class*;

(6) for the *retail exposure class* and for each of the categories of:

(a) *exposures to retail SMEs*;

(b) *retail exposures* secured by real estate collateral;

(c) *qualifying revolving retail exposures*; and

(d) *other retail exposures*;

either the disclosures outlined under (5) (if applicable, on a pooled basis), or an analysis of *exposures* (outstanding loans and *exposure values* for undrawn commitments) against a sufficient number of *EL grades* to allow for a meaningful differentiation of credit risk (if applicable, on a pooled basis);

(7) the actual value adjustments in the preceding period for each *IRB exposure class* (for *retail exposures*, for each of the categories in (6)(a) to (d)) and how they differ from past experience;

(8) a description of the factors that impacted on the loss experience in the preceding period (for example, whether the *firm* experienced higher than average *default rates*, or higher than average *LGDs* and *conversion factors*); and

(9) the *firm’s estimates* against actual outcomes over a longer period including, at a minimum, information on estimates of losses against actual losses in each *IRB exposure class* (for *retail exposures*, for each of the categories in (6)(a) to (d)) over a period sufficient to allow for a meaningful assessment of the performance of the internal rating processes for each *IRB exposure class* (for *retail exposures*, for each of the categories in (6)(a) to (d)).

[Note: BCD Annex XII Part 3 point 1 (part)]
11.6.4 For the purposes of BIPRU 11.6.1 R (9), where appropriate, a firm must further decompose the information to provide analysis of PD and, for a firm using own estimates of LGDs and/or conversion factors, LGD and conversion factor outcomes against estimates provided in the quantitative risk assessment disclosures under BIPRU 11.6.1 R to BIPRU 11.6.4 R.

[Note: BCD Annex XII Part 3 point 1 (part)]

Disclosures: Credit risk mitigation

A firm applying credit risk mitigation techniques must disclose the following information:

(1) the policies and processes for, and an indication of the extent to which the firm makes use of, on- and off-balance sheet netting;

(2) the policies and processes for collateral valuation and management;

(3) a description of the main types of collateral taken by the firm;

(4) the main types of guarantor and credit derivative counterparty and their creditworthiness;

(5) information about market risk or credit risk concentrations within the credit mitigation taken;

(6) for firms calculating risk weighted exposure amounts using the standardised approach to credit risk or the IRB approach, but not providing own estimates of LGDs or conversion factors in respect of the exposure class, separately for each exposure class, the total exposure value (after, where applicable, on- or off-balance sheet netting) that is covered - after the application of volatility adjustments - by eligible financial collateral, and other eligible collateral; and

(7) for firms calculating risk weighted exposure amounts using the standardised approach or the IRB approach, separately for each exposure class, the total exposure (after, where applicable, on- or off-balance sheet netting) that is covered by guarantees or credit derivatives; for equity exposures, this requirement applies to each of the approaches (the simple risk weight approach, the PD/LGD approach and the internal models approach) provided for in BIPRU 4.7.5 R to BIPRU 4.7.6 R, BIPRU 4.7.9 R to BIPRU 4.7.11 R, BIPRU 4.7.14 R to BIPRU 4.7.16 R, BIPRU 4.7.24 R to BIPRU 4.7.25 R.

[Note: BCD Annex XII Part 3 point 2]
Chapter 12

Liquidity standards
12.1 Application

12.1.1

Subject to BIPRU 12.1.2 R, BIPRU 12 applies to:

(1) an IFPRU investment firm; and

(2) a BIPRU firm.

12.1.2

BIPRU 12.5 (Individual Liquidity Adequacy Standards), BIPRU 12.6 (Simplified ILAS), BIPRU 12.7 (Liquid assets buffer) and BIPRU 12.9 (Individual liquidity guidance and regulatory intervention points) apply only to an ILAS BIPRU firm.

12.1.3

A firm that is an An exempt full scope IFPRU investment firm is not an ILAS BIPRU firm.

12.1.4

(1) An exempt full scope IFPRU investment firm is a full-scope IFPRU investment firm that at all times has total net assets which are less than or equal to £50 million.

(2) In this rule, total net assets are the sum of a firm's total trading book assets and its total non-trading book assets, less the sum of its called up share capital, reserves and minority interests.

(3) For the purpose of (2), the value attributed to each of the specified balance sheet items must be that which is reported to the FCA in the firm’s most recent data item.

12.1.5

The effect of BIPRU 12.1.4R is therefore to require the firm to sum the values of cell entries 20A and 20B in data item FSA001 and deduct from that total the sum of the values of cell entries 42, 43 and 44 in the same data item.

12.1.6

There are some provisions in other sections of BIPRU 12 which apply only to an ILAS BIPRU firm. Where this is the case, the provision in question says so.
12.1.7 In relation to an incoming EEA firm or a third country BIPRU firm, this chapter applies only with respect to the activities of the firm's UK branch.
12.2 Adequacy of liquidity resources

The overall liquidity adequacy rule

12.2.1 R

(1) A firm must at all times maintain liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

(2) For the purpose of (1):

(a) a firm may not include liquidity resources that can be made available by other members of its group;

(b) an incoming EEA firm or a third country BIPRU firm may not, in relation to its UK branch, include liquidity resources other than those which satisfy the conditions in  BIPRU 12.2.3R;

(c) a firm may not include liquidity resources that may be made available through emergency liquidity assistance from a central bank (including the European Central Bank).

12.2.2 G

■ BIPRU 12.2.1R is the overall liquidity adequacy rule.

Branch liquidity resources

12.2.3 R

The conditions to which ■ BIPRU 12.2.1R (2)(b) refers are that the firm’s liquidity resources are:

(1) under the day-to-day control of the UK branch’s senior management;

(2) held in an account with one or more custodians in the sole name of the UK branch;

(3) unencumbered; and

(4) for the purpose of the overall liquidity adequacy rule only, attributed to the balance sheet of the UK branch.

12.2.4 G

The effect of ■ BIPRU 12.2.1R (2)(b) and ■ BIPRU 12.2.3 R is to require an incoming EEA firm or a third country BIPRU firm to maintain a local operational liquidity reserve in relation to the activities of its UK branch. ■ BIPRU 12.9 contains further guidance on this point.
Liquidity resources: general

12.2.5 G For the purposes of the overall liquidity adequacy rule, liquidity resources are not confined to the amount or value of a firm’s marketable, or otherwise realisable, assets. Rather, in assessing the adequacy of those resources, a firm should have regard to the overall character of the resources available to it which enable it to meet its liabilities as they fall due. Therefore, for the purposes of that rule, a firm should ensure that:

(1) it holds sufficient assets which are marketable, or otherwise realisable;

(2) it is able to generate funds from those assets in a timely manner;

(3) it maintains a prudent funding profile in which its assets are of appropriate maturities, taking account of the expected timing of that firm’s liabilities; and

(4) it is able to generate unsecured funding of appropriate tenor in a timely manner.

12.2.6 G The overall liquidity adequacy rule is expressed to apply to each firm on a solo basis. Each firm must be able to satisfy that rule relying solely on its own liquidity resources. Where the firm is an incoming EEA firm or a third country BIPRU firm, compliance with the overall liquidity adequacy rule with respect to the UK branch must be achieved relying solely on liquidity resources that satisfy the conditions in BIPRU 12.2.3R.

12.2.7 G The starting point, therefore, is that each firm, or where relevant its UK branch, must be self-sufficient in terms of its own liquidity adequacy. The appropriate regulator does, however, recognise that there are circumstances in which it may be appropriate for a firm or branch to rely on liquidity support provided by other entities in its group or from elsewhere within the firm. A firm wishing to rely on support of this kind, whether for itself or for its UK branch, may only do so with the consent of the appropriate regulator, given by way of a waiver under section 138A (Modification or waiver of rules) of the Act to the overall liquidity adequacy rule.

Liquid assets buffer and funding profile

12.2.8 R For the purposes of the overall liquidity adequacy rule, an ILAS BIPRU firm must also ensure that:

(1) its liquidity resources contain an adequate buffer of high quality, unencumbered assets; and

(2) it maintains a prudent funding profile.

12.2.9 G The purpose of BIPRU 12.2.8R is to ensure that an ILAS BIPRU firm has a buffer of liquid assets which are available to meet those liabilities which fall due in periods of stress experienced by that firm. Those periods of stress may be both market-wide and idiosyncratic in nature. The appropriate regulator acknowledges that in periods of stress a firm’s liquid assets buffer may be eroded.
12.2.10 The **appropriate regulator** recognises, however, that it may take time for a **firm** to build a buffer which is of a sufficient size and quality to help reduce the effect of periods of stress on the **firm**. In particular, the **appropriate regulator** recognises that the transition from the **appropriate regulator**'s liquidity regime in force immediately prior to the **BIPRU 12** regime is likely to be a gradual one for many **firms**. The **appropriate regulator** will seek to agree with a **firm** an appropriate period of time over which its liquid assets buffer ought to be built. The **appropriate regulator** will, in any event, incorporate into the **individual liquidity guidance** which it gives to the **firm** details of the steps that it expects the **firm** to take so that it may establish an appropriately robust liquid assets buffer.

12.2.11 In complying with **BIPRU 12.2.8R**, a **simplified ILAS BIPRU firm** must ensure that its liquid assets buffer is at least equal to the amount of liquidity resources required by the **simplified buffer requirement**.

12.2.12 The **appropriate regulator** is likely to regard a **simplified ILAS BIPRU firm** whose liquid assets buffer accords with the **simplified buffer requirement** as having an adequate buffer of assets and a prudent funding profile for the purpose of **BIPRU 12.2.8R**. Further **guidance** on this matter is provided in **BIPRU 12.6.5G**.

12.2.13 **BIPRU 12.7** contains more detailed **rules** and **guidance** about the type of assets that an **ILAS BIPRU firm** is permitted to hold in order to satisfy **BIPRU 12.2.8R**.

### Individual assessments of liquidity adequacy

12.2.14 The adequacy of an **ILAS BIPRU firm**'s liquidity resources needs to be assessed both by that **firm** and by the **appropriate regulator**. This process involves:

1. in the case of a **standard ILAS BIPRU firm**, an **Individual Liquidity Adequacy Assessment (ILAA)** which such a **firm** is obliged to carry out in accordance with **BIPRU 12.5**;

2. in the case of a **simplified ILAS BIPRU firm**, an **Individual Liquidity Systems Assessment (ILSA)** which such a **firm** is obliged to carry out in accordance with **BIPRU 12.6**; and

3. a **Supervisory Liquidity Review Process (SLRP)**, which is conducted by the **appropriate regulator**.

12.2.15 **BIPRU 12.5** sets out the **ILAS** framework. That section describes some of the stress tests that a **standard ILAS BIPRU firm** must carry out in conducting its **ILAA** and identifies a number of sources of **liquidity risk** in relation to which a **firm** is required to assess the impact of those stresses. For a **standard ILAS BIPRU firm**, the requirements in **BIPRU 12.5** are in addition to the stress testing requirements in **BIPRU 12.4**. The **rules** in **BIPRU 12.5** require a **standard ILAS BIPRU firm** to report the results of both sets of stress tests in its **ILAA**, while the **rules** in **BIPRU 12.6** require a **simplified ILAS BIPRU firm** to report those results in its **ILSA**.
As part of its SLRP, the appropriate regulator will, having regard to the liquidity risk profile of the firm, consider:

(1) the adequacy, both as to amount and quality, of the liquidity resources (including the liquid assets buffer) held by the firm; and

(2) the degree of prudence reflected in the firm's funding profile.

In assessing the adequacy of those resources, the appropriate regulator will consider a firm's overall ability to generate funding in a way that ensures that it can meet its liabilities as they fall due both in stressed and in ordinary business conditions.

After completing a review of the ILAA as part of the SLRP, the appropriate regulator will give a standard ILAS BIPRU firm individual liquidity guidance, advising it of the amount and quality of liquidity resources which the appropriate regulator considers are appropriate having regard to the liquidity risk profile of the firm. In giving individual liquidity guidance, the appropriate regulator will also advise the firm of what it considers to be a prudent funding profile for the firm. In giving the firm individual liquidity guidance as to its funding profile, the appropriate regulator will consider the extent to which the firm's liabilities are adequately matched by assets of appropriate maturities. Although the appropriate regulator may have given a firm individual liquidity guidance, this does not remove the need for the firm to monitor its liquidity risk profile on an ongoing basis and to consider whether it should be holding liquidity resources that are greater in amount or higher in quality, or maintaining a more prudent funding profile, than those advised in its individual liquidity guidance.

BIPRU 12.5 sets out in greater detail the appropriate regulator's ILAS regime. BIPRU 12.9 sets out in greater detail the appropriate regulator's process for issuing an ILAS BIPRU firm with individual liquidity guidance and its approach to monitoring a firm's adherence to that guidance or, as the case may be, to the simplified buffer requirement.
12.3 Liquidity risk management

12.3.1 The approach taken in BIPRU 12.3 is to set out:

(1) overarching systems and controls provisions in relation to a firm’s management of its liquidity risk;

(2) provisions outlining the responsibilities of that firm’s governing body and senior managers for the oversight of liquidity risk;

(3) more detailed provisions covering a number of specific areas, including:
   (a) pricing liquidity risk;
   (b) intra-day management of liquidity;
   (c) management of collateral;
   (d) management of liquidity across legal entities, business lines and currencies; and
   (e) funding diversification and market access.

12.3.2 BIPRU 12.4 contains further rules and guidance on stress testing and contingency funding plans. These are both extensions of the overarching systems and controls provisions in BIPRU 12.3. In formulating the rules and guidance in these two sections, the appropriate regulator has taken account of the Principles for Sound Liquidity Management and Supervision dated September 2008 issued by the Basel Committee on Banking Supervision. It is intended that the content of BIPRU 12.3 and BIPRU 12.4 be consistent with those Principles.

12.3.3 BIPRU 12.5.4R provides that, in relation to a standard ILAS BIPRU firm, it must include in its ILAA an assessment of its compliance with the standards set out in BIPRU 12.3 and BIPRU 12.4, including the results of the stress tests required by the rules in BIPRU 12.4. A simplified ILAS BIPRU firm is not subject to BIPRU 12.5 and consequently it is not required to prepare an ILAA. Instead, the rules in BIPRU 12.6 provide that such a firm is to carry out an ILSA, being alone an assessment of that firm’s compliance with the standards set out in BIPRU 12.3 and BIPRU 12.4.
Overarching liquidity systems and controls requirements

12.3.4 R

A firm must have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that it maintains adequate levels of liquidity buffers. These strategies, policies, processes and systems must be tailored to business lines, currencies, branches and legal entities and must include adequate allocation mechanisms of liquidity costs, benefits and risks.

[Note: article 86(1) of the CRD]

12.3.4A G

The strategies, policies, processes and systems referred to in BIPRU 12.3.4 R should include those which enable it to assess and maintain on an ongoing basis the amounts, types and distribution of liquidity resources that it considers adequate to cover:

1. the nature and level of the liquidity risk to which it is or might be exposed;

2. the risk that the firm cannot meet its liabilities as they fall due; and

3. in the case of an ILAS BIPRU firm, the risk that its liquidity resources might in the future fall below the level, or differ from the quality and funding profile, of those resources advised as appropriate by the appropriate regulator in that firm's individual liquidity guidance or, as the case may, its simplified buffer requirement.

12.3.5 R

The strategies, policies, processes and systems referred to in BIPRU 12.3.4 R must be proportionate to the complexity, risk profile and scope of operation of the firm, and the liquidity risk tolerance set by the firm's governing body in accordance with BIPRU 12.3.8 R, and must reflect the firm's importance in each EEA State, in which it carries on business.

[Note: article 86(2) (part) of the CRD]

12.3.5A R

12.3.6 E

(1) [deleted]

(2) [deleted]

(3) A firm should ensure that its strategies, policies, processes and systems in relation to liquidity risk enable it to identify, measure, manage and monitor its liquidity risk positions for:

   a) all sources of contingent liquidity demand (including those arising from off-balance sheet activities);

   b) all currencies in which that firm is active; and

   c) correspondent, custody and settlement activities.

(4) [deleted]

(5) A firm should ensure that it has in place early warning indicators to identify immediately the emergence of increased liquidity risk or
vulnerabilities, including indicators that signal whether embedded triggers in funding or security arrangements such as warranties, covenants, events of default, conditions precedent or terms having similar effect are likely to, or will, be breached, occur or fail to be satisfied, or contingent risks will or are likely to crystallise, in either case with the result that access to liquidity resources may be impaired.

(6) A firm should ensure that it has in place reliable management information systems to provide its governing body, senior managers and other appropriate personnel with timely and forward-looking information on the liquidity position of the firm.

(7) Contravention of any of (3), (5) and (6) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

12.3.7

As well as the rules in BIPRU 12.3 requiring a firm to have robust systems to enable it to identify, measure, manage and monitor liquidity risk, an ILAS BIPRU firm is also subject to obligations in SUP 16 (Reporting requirements) requiring it to report quantitative data about its liquidity position to the appropriate regulator. That chapter of SUP sets out the applicable data items and the rules governing the frequency of their submission to the appropriate regulator. Absent a firm-specific liquidity stress or a market liquidity stress, the rules in SUP 16 do not require daily (weekly for a low frequency liquidity reporting firm and a simplified ILAS BIPRU firm) reporting of data items. An ILAS BIPRU firm should, however, note that those rules do require that it has systems in place to ensure that it is able at all times to meet the requirements for daily (or weekly as applicable) reporting of applicable data items even if there is no firm-specific liquidity stress or market liquidity stress and none is expected.

12.3.7A

A firm must, taking into account the nature, scale and complexity of its activities, have liquidity risk profiles that are consistent with and not in excess of those required for a well-functioning and robust system.

[Note: article 86(3) of the CRD]

Governing body and senior management oversight: liquidity risk tolerance

12.3.8

A firm must ensure that:

1. its governing body establishes that firm's liquidity risk tolerance and that this is appropriately documented;
2. its liquidity risk tolerance is appropriate for its business strategy and reflects its financial condition and funding capacity; and
3. its liquidity risk tolerance is communicated to all relevant business lines.

[Note: article 86(2) of the CRD]
12.3.9  G  As part of the SLRP, the appropriate regulator will assess the appropriateness of the liquidity risk tolerance adopted by an ILAS BIPRU firm to ensure that this risk tolerance is consistent with maintenance by the firm of adequate liquidity resources for the purpose of the overall liquidity adequacy rule. The appropriate regulator will expect a firm to provide it with an adequately reasoned explanation for the level of liquidity risk which that firm's governing body has decided it should assume. In assessing the appropriateness of the liquidity risk tolerance adopted by a firm, the appropriate regulator will consider whether the tolerance adopted is consistent with the firm's satisfaction of threshold condition 2E, 3D, 4E or 5E as applicable. Consistent with the appropriate regulator's statutory objectives under the Act, in assessing the appropriateness of a firm's adopted liquidity risk tolerance the appropriate regulator will also have regard to the role and importance of a firm in the UK financial system.

Governing body and senior management oversight: approval and review of arrangements

12.3.10  R  A firm must ensure that its governing body approves the firm's strategies, policies, processes and systems relating to the management of liquidity risk, including those described in BIPRU 12.3.4R.

12.3.11  R  A firm must ensure that its governing body reviews regularly (and not less frequently than annually):

(1) the continued adequacy of any strategies, policies, processes and systems approved in accordance with BIPRU 12.3.10R; and

(2) the firm's liquidity risk tolerance.

12.3.12  R  A firm must ensure that its senior managers:

(1) continuously review that firm's liquidity position, including its compliance with the overall liquidity adequacy rule; and

(2) report to its governing body on a regular basis adequate information as to that firm's liquidity position and its compliance with the overall liquidity adequacy rule and with BIPRU 12.3.4R.

12.3.12A  R

12.3.13  G  Although a firm's senior managers are likely to develop strategies, policies and practices for the management of that firm's liquidity risk, it is the responsibility of a firm's governing body to approve those strategies, policies and practices as adequate. In determining the adequacy of those strategies, policies and practices, a firm's governing body should have regard to that firm's liquidity risk tolerance established in accordance with BIPRU 12.3.8R.

12.3.14  G  The appropriate regulator will assess the adequacy of an ILAS BIPRU firm's liquidity risk management framework as part of the SLRP.
### Pricing liquidity risk

12.3.15  **E**  

(1) In relation to all significant business activities, a *firm* should ensure that it accurately quantifies liquidity costs, benefits and risks and fully incorporates them into:

   (a) product pricing;

   (b) performance measurement and incentives; and

   (c) the approval process for new products.

(2) For the purposes of (1), a *firm* should ensure that it:

   (a) includes significant business activities whether or not they are accounted for on-balance sheet; and

   (b) carries out the exercise of quantification and incorporation both in normal financial conditions and under the stresses required by BIPRU 12.4.1R.

(3) A *firm* should ensure that the liquidity costs, benefits and risks are clearly and transparently attributed to business lines and are understood by business line management.

(4) Contravention of any of (1), (2) or (3) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

### Intra-day management of liquidity

12.3.16  **G**  
The incorporation of liquidity pricing into a *firm’s* processes assists in aligning the risk-taking incentives of individual business lines within that *firm* with the *liquidity risk* to which the *firm* as a whole is exposed as a result of their activities. It is important that all significant business activities are addressed, including activities which involve the creation of contingent exposures which may not have an immediate balance sheet impact.

12.3.17  **R**  

A *firm* must actively manage its intra-day liquidity positions and any related risks so that it is able to meet its payment and settlement obligations on a timely basis.

12.3.18  **G**  

In complying with BIPRU 12.3.17R, a *firm* should take into account all obligations arising from its acting as a custodian, a correspondent bank or a settlement agent.

12.3.19  **R**  

For the purposes of BIPRU 12.3.17R, a *firm* must ensure that:

(1) it is able to meet its payment and settlement obligations on a timely basis under both normal financial conditions and under the stresses required by BIPRU 12.4.1R; and

(2) its arrangements for the management of intra-day liquidity enable it to identify and prioritise the most time-critical payment and settlement obligations.
The appropriate regulator considers that a firm's ability to meet its payment and settlement obligations on an intra-day basis is important not just for that firm, but also for the liquidity position of that firm's counterparties and for the smooth functioning of payment and settlement systems as a whole.

A firm should ensure that its intra-day liquidity management arrangements enable it, in relation to the markets in which it is active and the currencies in which it has significant positions, to:

1. measure expected daily gross liquidity inflows and outflows, anticipate the intra-day timing of these flows where possible, and forecast the range of potential net funding shortfalls that might arise at different points during the day;
2. monitor its intra-day liquidity positions against expected activities and available resources;
3. identify gross liquidity inflows and outflows attributable to any correspondent, custodian or settlement agency services provided by that firm;
4. manage the timing of its liquidity outflows such that priority is given to that firm's most time-critical obligations;
5. deal with unexpected disruptions to its intra-day liquidity flows;
6. acquire sufficient intra-day funding such that it is able to meet its most time-critical obligations when expected and other less time-critical obligations as soon as possible thereafter; and
7. manage and mobilise collateral as necessary for the purposes of achieving the aim in (f).

Contravention of any of (1)(a) to (g) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

Management of collateral

A firm must actively manage its collateral positions.

A firm must distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. A firm must also take into account the legal entity in which assets reside, the country where assets are legally recorded either in a register or in an account as well as their eligibility and must monitor how assets can be mobilised in a timely manner.

[Note: article 86(5) of the CRD]

A firm must also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the EEA.

[Note: article 86(6) of the CRD]
For the purposes of ■ BIPRU 12.3.22R, a firm must, in relation to all currencies in which it has significant positions and all jurisdictions in which it carries on significant business activities, ensure that it:

1. can calculate all of its collateral positions, including assets currently provided as collateral, relative to the total amount of security required;
2. can calculate the amount of unencumbered assets available to it to be provided as collateral;
3. can mobilise collateral in a timely manner;
4. monitors the location of available collateral;
5. takes into account the extent to which counterparties with which it has deposited collateral may have re-hypothecated that collateral;
6. has access to adequately diversified sources of collateral;
7. assesses the eligibility of each major asset class that it holds for use as collateral with central banks;
8. assesses on an ongoing basis the acceptability of its assets to major counterparties and providers of funds in secured funding markets; and
9. monitors and manages the impact that the terms of existing funding or security arrangements, such as warranties, covenants, events of default, negative pledges and cross default clauses could have on its ability to mobilise collateral including for use in borrowing under any central bank facility (in particular, emergency liquidity assistance on a secured basis).

For the purposes of ■ BIPRU 12.3.23R (8) and ■ (9), a firm should take into account the impact of the stresses that it conducts under ■ BIPRU 12.4.1R on the requirements which may be imposed on the provision of its assets as collateral (for example, haircuts) and also the availability of funds from private counterparties during such periods of stress.

12.3.24 A firm should ensure that its arrangements for the management of liquidity risk:

(a) enable it to monitor shifts between intra-day and overnight or term collateral usage;
(b) enable it to appropriately adjust its calculation of available collateral to account for assets that are part of a tied hedge;
(c) include adequate consideration of the potential for uncertainty around, or disruption to, intra-day asset flows; and
(d) take into account the potential for additional collateral requirements under the terms of contracts governing existing
Managing liquidity across legal entities, business lines and currencies

In complying with \textbf{BIPRU 12.3.4 R}, a firm must ensure that:

1. it actively manages its liquidity risk exposures and related funding needs; and
2. it takes into account:
   a. the impact on its own liquidity position of its forming part of a group;
   b. the need to manage the liquidity position of individual business lines in addition to that of the firm as a whole; and
   c. the liquidity risk arising from its taking positions in foreign currencies; and
3. where it forms part of a group, it understands and has regard to any legal, regulatory, operational or other constraints on the transferability to it of funds and collateral by other entities in that group.

A firm must develop methodologies for the identification, measurement, management and monitoring of funding positions. Those methodologies must include the current and projected material cash-flows in and arising from assets, liabilities, off-balance-sheet items, including contingent liabilities and the possible impact of reputational risk.

[Note: article 86(4) of the CRD]

In its liquidity risk management plans, a firm should identify clearly its assumptions regarding the transferability of funds and collateral. A firm should expect that the appropriate regulator will scrutinise those assumptions.

Funding diversification and market access

In complying with \textbf{BIPRU 12.3.4 R}, a firm must ensure that it has access to funding which is adequately diversified, both as to source and tenor.

A firm must ensure that its governing body:

1. is aware of the composition, characteristics and degree of diversification of its assets and funding sources; and
(2) regularly reviews its funding strategy in the light of any changes in the environment in which it operates.

12.3.31 **G** Funding diversification should not be considered an end in its own right. Rather, the purpose of diversification is to ensure that a firm has in place alternative sources of funding that strengthen its capacity to withstand a variety of severe yet plausible institution-specific and market-wide liquidity shocks.

12.3.32 **E** (1) A firm should ensure that funding diversification is taken into account in that firm’s business planning process.

(2) A firm should ensure that its funding arrangements take into account correlations between market conditions and the ability to access funds from different sources.

(3) A firm should ensure that in establishing adequate diversification it sets limits on its funding according to the following variables:
   (a) maturity;
   (b) nature of depositor or counterparty;
   (c) levels of secured and unsecured funding;
   (d) instrument type;
   (e) securitisation vehicle;
   (f) currency; and
   (g) geographic market.

(4) A firm should ensure that it maintains an ongoing presence in its chosen funding markets and strong relationships with its chosen providers of funds.

(5) A firm should regularly test its capacity to raise funds quickly from its chosen funding sources to provide short, medium and long-term liquidity.

(6) A firm should ensure that its senior managers identify the main factors that affect its ability to raise funds and should monitor those factors closely to ensure that their estimates of fund raising capacity remain valid.

(7) Contravention of any of (1) to (6) may be relied upon as tending to establish contravention of **BIPRU 12.3.4 R**.

**Asset encumbrance**
12.4 Stress testing and contingency funding

12.4.-2 A firm must consider different liquidity risk mitigation tools, including a system of limits and liquidity buffers in order to be able to withstand a range of different stress events and an adequately diversified funding structure and access to funding sources. Those arrangements must be reviewed regularly.

[Note: article 86(7) of the CRD]

Stress testing

12.4.-1 A firm must consider alternative scenarios on liquidity positions and on risk mitigants and must review the assumptions underlying decisions concerning the funding position at least annually. For these purposes, alternative scenarios must address, in particular, off-balance sheet items and other contingent liabilities, including those of securitisation special purpose entities (SSPEs) or other special purpose entities, as referred to in the EU CRR, in relation to which the firm acts as sponsor or provides material liquidity support.

[Note: article 86(8) of the CRD]

12.4.1 In order to ensure compliance with the overall liquidity adequacy rule and with § BIPRU 12.3.4R and § BIPRU 12.4.-1 R, a firm must:

(1) conduct on a regular basis appropriate stress tests so as to:
   (a) identify sources of potential liquidity strain;
   (b) ensure that current liquidity exposures continue to conform to the liquidity risk tolerance established by that firm’s governing body; and
   (c) identify the effects on that firm’s assumptions about pricing; and

(2) analyse the separate and combined impact of possible future liquidity stresses on its:
   (a) cash flows;
   (b) liquidity position;
   (c) profitability; and
   (d) solvency.

12.4.1A
In accordance with BIPRU 12.3.11R, BIPRU 12.4.2R and BIPRU 12.4.1R, a firm must ensure that its governing body reviews regularly the stresses and scenarios tested to ensure that their nature and severity remain appropriate and relevant to that firm.

Consistent with BIPRU 12.3.5R, the expects that the extent and frequency of such testing, as well as the degree of regularity of governing body review under BIPRU 12.4.2R, should be proportionate to the nature scale and complexity of a firm’s activities, as well as to the size of its liquidity risk exposures. Consistent with the appropriate regulator’s statutory objectives under the Act, in assessing the adequacy of a firm’s stress testing arrangements (including their frequency and the regularity of governing body review) the appropriate regulator will also have regard to the role and importance of that firm in the UK financial system. The appropriate regulator will, however, expect stress testing and governing body review to be carried out no less frequently than annually. The appropriate regulator expects that a firm will build into its stress testing arrangements the capability to increase the frequency of those tests in special circumstances, such as in volatile market conditions or where requested by the appropriate regulator.

For the purposes of BIPRU 12.4.2R, a review should take into account:

1. changes in market conditions;
2. changes in the nature, scale or complexity of the firm's business model and activities; and
3. the firm's practical experience in periods of stress.

A firm must consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time periods and varying degrees of stressed conditions must be considered.

[Note: article 86(9) of the CRD]

The appropriate regulator expects every firm, including a firm with an apparently strong liquidity profile, to consider the potential impact of severe stress scenarios.

In conducting its stress testing, a firm should also, where relevant, consider the impact of its chosen stresses on the appropriateness of its assumptions relating to:

1. correlations between funding markets;
(2) the effectiveness of diversification across its chosen sources of funding;

(3) additional margin calls and collateral requirements;

(4) contingent claims, including potential draws on committed lines extended to third parties or to other entities in that firm’s group;

(5) liquidity absorbed by off-balance sheet vehicles and activities (including conduit financing);

(6) the transferability of liquidity resources;

(7) access to central bank market operations and liquidity facilities;

(8) estimates of future balance sheet growth;

(9) the continued availability of market liquidity in a number of currently highly liquid markets;

(10) ability to access secured and unsecured funding (including retail deposits);

(11) currency convertibility; and

(12) access to payment or settlement systems on which the firm relies.

12.4.8 A firm should ensure that the results of its stress tests are:

(a) reviewed by its senior managers;

(b) reported to that firm’s governing body, specifically highlighting any vulnerabilities identified and proposing appropriate remedial action;

(c) reflected in the processes, strategies and systems established in accordance with §BIPRU 12.3.4R;

(d) used to develop effective contingency funding plans;

(e) integrated into that firm’s business planning process and day-to-day risk management; and

(f) taken into account when setting internal limits for the management of that firm’s liquidity risk exposure.

(2) Contravention of any of (1)(a) to (f) may be relied upon as tending to establish contravention of §BIPRU 12.3.4 R.

12.4.9 A firm must ensure that the results of its stress tests are reported to the appropriate regulator in a timely manner.

Contingency funding plans

12.4.10 A firm must adjust its strategies, internal policies and limits on liquidity risk and develop an effective contingency funding plan, taking into account the outcome of the alternative scenarios referred to in §BIPRU 12.4.1 R.

[Note: article 86(10) of the CRD]
12.4.11 A firm must have in place liquidity recovery plans setting out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls, including in relation to branches established in another EEA State. Those plans must be tested at least annually, updated on the basis of the outcome of the alternative scenarios set out in BIPRU 12.4.1R, and be reported to and approved by the firm’s governing body, so that internal policies and processes can be adjusted accordingly. A firm must take the necessary operational steps in advance to ensure that liquidity recovery plans can be implemented immediately.

[Note: article 86(11) (part) of the CRD]

12.4.11A [Note: article 86(11) (part) of the CRD]

12.4.12 A contingency funding plan sets out a firm’s strategies for addressing liquidity shortfalls in emergency situations. Its aim should be to ensure that, in each of the stresses required by BIPRU 12.4.1R, it would still have sufficient liquidity resources to ensure that it can meet its liabilities as they fall due.

12.4.12A

12.4.13 A firm must ensure that its contingency funding plan:

(1) outlines strategies, policies and plans to manage a range of stresses;

(2) establishes a clear allocation of roles and clear lines of management responsibility;

(3) is formally documented;

(4) includes clear invocation and escalation procedures;

(5) is regularly tested and updated to ensure that it remains operationally robust;

(6) outlines how that firm will meet time-critical payments on an intra-day basis in circumstances where intra-day liquidity resources become scarce;

(7) outlines that firm’s operational arrangements for managing a retail funding run;

(8) in relation to each of the sources of funding identified for use in emergency situations, is based on a sufficiently accurate assessment of:
   (a) the amount of funding that can be raised from that source; and
   (b) the time needed to raise funding from that source;

(9) is sufficiently robust to withstand simultaneous disruptions in a range of payment and settlement systems;
BIPRU 12 : Liquidity standards

Section 12.4 : Stress testing and contingency funding

(10) outlines how that firm will manage both internal communications and those with its external stakeholders; and

(11) establishes mechanisms to ensure that the firm’s governing body and senior managers receive management information that is both relevant and timely.

12.4.13A R

12.4.14 E

(1) In designing a contingency funding plan a firm should ensure that it takes into account:

(a) the impact of stressed market conditions on its ability to sell or securitise assets;

(b) the impact of extensive or complete loss of typically available market funding options;

(c) the financial, reputational and any other additional consequences for that firm arising from the execution of the contingency funding plan itself;

(d) its ability to transfer liquid assets having regard to any legal, regulatory or operational constraints; and

(e) its ability to raise additional funding from central bank market operations and liquidity facilities.

(2) Contravention of any of (1)(a) to (e) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

12.4.14A E

12.4.15 G

A firm should ensure that its contingency funding plan takes into account the terms and conditions of any central bank liquidity facilities to which it has access, including both facilities that form part of normal liquidity management operations and emergency liquidity assistance on a secured basis. Where a firm includes in its contingency funding plan the use of central bank liquidity facilities it should consider the nature of those facilities, collateral eligibility, haircuts to which its collateral might be subject, terms in its existing or available funding arrangements which might impact its ability to access central bank facilities, operational arrangements for accessing those facilities and the potential reputational consequences for that firm in accessing them. In formulating its contingency funding plan, a firm should not rely on expectations it may have about future changes to central bank facilities, either in relation to their normal liquidity management operations or in relation to the availability of specific liquidity facilities in exceptional circumstances.

12.4.16 G

The appropriate regulator expects that a firm’s contingency funding plan will encompass a range of actions that the firm might take in anticipation of or in response to changes in its funding position. These changes could result from either firm-specific or general developments. The appropriate regulator anticipates that different actions in a contingency funding plan would be taken at different stages of a developing situation.
12.5 Individual Liquidity Adequacy Standards

Individual Liquidity Adequacy Assessment

12.5.1 R This section applies to a standard ILAS BIPRU firm.

12.5.2 R A firm must carry out an individual liquidity adequacy assessment (ILAA) in accordance with this section.

12.5.3 G In conducting its ILAA, a firm is obliged to comply with the stress testing and related requirements which appear in this section. The rules in this section also provide that in its ILAA a firm must include an assessment of the firm’s compliance with the standards set out in BIPRU 12.3 and BIPRU 12.4.

12.5.4 R A firm must ensure that:

(1) it regularly carries out an ILAA;

(2) it makes a written record of its ILAA;

(3) its ILAA is proportionate to the nature, scale and complexity of its activities;

(4) its ILAA takes into account whole-firm and group-wide liquidity resources only to the extent that reliance on these is permitted by the appropriate regulator;

(5) its ILAA includes an assessment of the results of the stress tests required by BIPRU 12.5.6 R; and

(6) its ILAA includes an assessment of the firm’s compliance with BIPRU 12.3 and BIPRU 12.4, including the results of the stress tests required by the rules in BIPRU 12.4.

12.5.5 G A firm should carry out an ILAA at least annually, or more frequently if changes in its business or strategy or the nature, scale or complexity of its activities or the operational environment suggest that the current level of liquidity resources is no longer adequate. A firm should expect that its usual supervisory contact at the appropriate regulator will ask for the ILAA to be submitted as part of the ongoing supervisory process.
A firm must ensure that in carrying out its ILAA it considers how that firm’s liquidity resources change as a result of:

1. the stress in BIPRU 12.5.8 R (the first liquidity stress);
2. the stress in BIPRU 12.5.11 R (the second liquidity stress); and
3. the first and second liquidity stresses occurring simultaneously.

The appropriate regulator will review the results of a firm’s ILAA, including the results of the stress tests required by BIPRU 12.5.6 R, as part of its Supervisory Liquidity Review Process (SLRP). The appropriate regulator’s review of the stress test results will assist it assessing the adequacy of a firm’s liquidity resources relative to other ILAS BIPRU firms and, consequently, in calibrating the individual liquidity guidance that it gives to that firm. BIPRU 12.9.2 G sets out the appropriate regulator’s approach to assessing the adequacy of a firm’s liquidity resources and indicates that, among other factors, it will have regard to the firm’s ILAA. It is not, therefore, the case that the amount of liquidity resources advised to the firm as being adequate in its individual liquidity guidance will necessarily equate to the amount needed to meet its liabilities as they fall due in the stresses required by BIPRU 12.5.6 R. The appropriate regulator will assess the adequacy of a firm’s liquidity resources on a case-by-case basis and, accordingly, the amount of liquidity resources judged as adequate in the firm’s individual liquidity guidance might be either above or below the amount needed to survive the stresses required by BIPRU 12.5.6 R.

The first liquidity stress to which BIPRU 12.5.6 R refers is an unforeseen, name-specific, liquidity stress in which:

1. financial market participants and retail depositors consider that in the short-term the firm will be or is likely to be unable to meet its liabilities as they fall due;
2. the firm’s counterparties reduce the amount of intra-day credit which they are willing to extend to it;
3. the firm ceases to have access to foreign currency spot and swap markets; and
4. over the longer-term the firm’s obligations linked to its credit rating crystallise as a result of a reduction in that credit rating.

For the purpose of BIPRU 12.5.8 R (1) to (3), a firm must assume that the initial, short-term, period of stress lasts for at least two weeks.

For the purpose of BIPRU 12.5.8 R (4), a firm should consider the effect of credit rating downgrades of varying degrees of severity. In doing so, it should also consider the cumulative effect of successive credit rating downgrades to its long-term credit rating.
Second liquidity stress

12.5.11 The second liquidity stress to which BIPRU 12.5.6R refers is an unforeseen, market-wide liquidity stress of three months duration.

12.5.12 For the purpose of BIPRU 12.5.11R, a firm must assume that the second liquidity stress is characterised by:

1. uncertainty as to the accuracy of the valuation attributed to that firm’s assets and those of its counterparties;
2. inability to realise, or ability to realise only at excessive cost, particular classes of assets, including those which represent claims on other participants in the financial markets or which were originated by them;
3. uncertainty as to the ability of a significant number of firms to ensure that they can meet their liabilities as they fall due; and
4. risk aversion among participants in the markets on which the firm relies for funding.

ILAA methodology

12.5.13 In carrying out the liquidity stresses required by BIPRU 12.5.6R, a firm must:

1. analyse each of the sources of risk identified in BIPRU 12.5.14R;
2. record the evidence which supports any behavioural assumptions that it makes in carrying out those stress tests;
3. record the evidence which supports its assessment of the adequacy of its liquid assets buffer; and
4. identify those of the measures set out in its contingency funding plan that it would implement.

12.5.14 The sources of risk referred to in BIPRU 12.5.13R are:

1. wholesale secured and unsecured funding risk;
2. retail funding risk;
3. intra-day liquidity risk;
4. intra-group liquidity risk;
5. cross-currency liquidity risk;
6. off-balance sheet liquidity risk;
7. franchise-viability risk;
8. marketable assets risk;
(9) non-marketable assets risk; and

(10) funding concentration risk.

**Wholesale secured and unsecured funding risk**

**12.5.15** For the purpose of assessing its wholesale funding risk, a firm must estimate the gross wholesale outflows that could occur under the liquidity stresses required by **BIPRU 12.5.6R**.

**12.5.16** In assessing its wholesale funding risk, a firm must:

1. identify its wholesale liabilities;
2. determine how those liabilities behave under normal financial conditions;
3. assess how they will behave under the stresses required by **BIPRU 12.5.6R**; and
4. divide its wholesale liabilities into funding which the firm assesses as having a higher than average likelihood of withdrawal in response to actual or perceived changes in the firm's credit-worthiness (Type A wholesale funding) and other funding (Type B wholesale funding).

**12.5.17** In assessing how its liabilities behave under stress, the firm should categorise its liabilities according to value, maturity and estimated speed of outflow. The firm should bear in mind that wholesale funding risk may crystallise as an acute loss of funds in the short term, or as a longer-term gradual leakage of funds, or as both.

**12.5.18** In the appropriate regulator's view, Type A wholesale funding is likely to include at least funding which:

1. is accepted from a credit institution, local authority, insurance undertaking, pension fund, money market fund, asset manager (including a hedge fund manager), government-sponsored agency, sovereign government, or sophisticated non-financial corporation; or
2. is accepted through the treasury function of a sophisticated non-financial corporation which may be assumed to respond swiftly to negative news about a firm's credit-worthiness; or
3. is accepted on wholesale market terms as a part of a firm's money market operations; or
4. is accepted from a depositor with whom a firm does not have a long-established relationship or to whom a firm does not supply a range of services; or
5. is accepted from overseas counterparties (other than those in the country or territory of incorporation of a firm's parent undertaking or, in the case of a UK branch, of the firm of which it forms part); or
(6) is obtained through unsecured debt instruments (such as certificates of deposit, medium-term notes and commercial paper); or

(7) is not obtained through repo against assets of the type described in BIPRU 12.7.2R (1) or BIPRU 12.7.2R (2); or

(8) is obtained from counterparties with a relatively low creditor seniority on the liquidation of the firm.

12.5.19 For the purpose of BIPRU 12.5.15R, a firm must assume that it is unable to roll any of its Type A wholesale funding in the first two weeks of the stresses.

Retail funding risk

12.5.20 In this part of BIPRU 12.5, retail funding is funding that is accepted from a consumer.

12.5.21 For the purpose of assessing its retail funding risk, a firm must:

(1) estimate the gross retail outflows that could occur under the liquidity stresses required by BIPRU 12.5.6R;

(2) identify the stress, or combination of stresses, to which it considers its retail funding to be most vulnerable and estimate the gross retail outflows that could occur under that stress or combination of stresses; and

(3) divide its retail funding into funding which the firm assesses as having a higher than average likelihood of withdrawal in response to actual or perceived changes in the firm’s credit-worthiness (Type A retail funding) and other funding (Type B retail funding).

12.5.22 In general, the appropriate regulator expects a firm’s retail funding to be less responsive than its wholesale funding to actual or perceived changes in the firm’s credit-worthiness. However, a firm should nevertheless make its own assessment of the relative responsiveness of its wholesale and retail funding.

12.5.23 For the purposes of assessing behaviour under stress, a firm should categorise its retail liabilities according to: value, maturity, estimated speed of outflow, product type, interest rate applied and any other factor that it considers relevant to its retail deposit structure.

12.5.24 A firm should also be mindful that its retail funding profile is unlikely to be constant. In carrying out its ILAA, a firm should have regard to any changes to its retail funding profile since the previous ILAA and also to the possible impact of any future changes on its ability to maintain retail funding during periods of stress. In its ILAA submission to the appropriate regulator, a firm should include an analysis of:

(1) its retail funding profile as at the date of its ILAA;
In the appropriate regulator’s view Type A retail funding is likely to include at least funding which:

1. has been accepted through the internet; or
2. is considered to have a more than average sensitivity to interest rate changes (such as a deposit whose acceptance can reasonably be attributed to the use of price-focused advertising by the firm accepting the deposit); or
3. in relation to any individual depositor exceeds to a significant extent the amount of that individual’s deposits with the accepting firm that are covered by a national deposit guarantee scheme; or
4. is not accepted from a depositor with whom the firm has had a long relationship; or
5. is accepted from retail depositors who can access their deposits before their residual contractual maturity subject to a loss of interest or payment of another form of early access charge (as a general proposition, the behaviour of liabilities to retail depositors is likely to depend in part on the contractual terms and conditions which give rise to those liabilities); or
6. is not held in an account which is maintained for transactional purposes.

For the purpose of assessing its intra-day liquidity risk arising from its direct participation in a payment or settlement system, a firm must in relation to each such system in which it participates:

1. calculate on an intra-day basis the net amounts of collateral and cash required by that firm to fund participation in that system; and
2. estimate how the amounts in (1) could change under the liquidity stresses required by BIPRU 12.5.6 R.

For the purpose of calculating the net amounts of collateral and cash under BIPRU 12.5.26 R, a firm should separately analyse:

1. the amounts of collateral and cash needed in relation to both its own payments and those of its customers; and
(2) the intra-day timing of the payment of cash and the posting of the collateral, including the time at which the demand for its collateral and cash is greatest.

12.5.28 For the purpose of BIPRU 12.5.26R, a firm should ensure that it takes into account, in both normal financial conditions and in periods of stress, the effect of:

(1) other participants in a payment system withholding some or all of the payments expected from them; and

(2) its customers increasing either or both the volume and value of their payments.

12.5.29 At the same time as it carries out the calculation and estimation in BIPRU 12.5.26R, a firm which participates directly in one or more payment or settlement systems must also estimate the impact on its liquidity position of the customer to which it has the largest intra-day credit exposure defaulting on its payment obligations to the firm:

(1) under normal financial conditions; and

(2) under the stresses required by BIPRU 12.5.6R.

12.5.30 For the purpose of BIPRU 12.5.29R, a firm should assume that the effect of that default is that the exposure is rolled overnight.

12.5.31 A firm must, as part of its ILAA submission to the appropriate regulator:

(1) identify those payment and settlement systems in which it is a direct participant; and

(2) provide details of the intra-day credit policies that it applies, including the criteria against which it sets credit limits, when extending credit to a customer which is not a direct participant in the payment or settlement system in question.

12.5.32 For the purpose of BIPRU 12.5.31R, the appropriate regulator would expect a firm, in relation to each payment or settlement system in which it participates directly, to provide details of:

(1) that firm's charges for providing intra-day credit;

(2) any collateral requirements which it applies to its customers;

(3) the credit limits that it imposes (and the circumstances, if any, in which credit may be provided notwithstanding a limit breach);

(4) the extent to which the customers of that firm make use of the credit extended to them; and
(5) where relevant, the points during the day at which a customer is required to settle, or provide assets as collateral to cover, that firm’s credit exposure to it.

12.5.33 R BIPRU 12.5.34R applies to a firm which:

(1) is not a direct participant in a given payment or settlement system;

(2) is a customer of a firm that is a direct participant in such a system for the purposes of gaining access to that system; and

(3) receives intra-day credit from that participant firm or prefunds its account with such a firm.

12.5.34 R For the purpose of assessing its intra-day liquidity risk a firm to which BIPRU 12.5.33R applies must assess the effect on its own position of a participant firm from which it receives intra-day credit or with which it has a prefunded account being unable to perform its obligations to that firm:

(1) under normal financial conditions; and

(2) under the stresses required by BIPRU 12.5.6 R.

12.5.35 G As part of its ILAA submission to the appropriate regulator, a firm to which BIPRU 12.5.33R applies should include:

(1) details of any alternative arrangements that it has in place to ensure that it continues to be able to meet its liabilities as they fall due in the circumstances set out in BIPRU 12.5.34R; and

(2) details of the policies governing the use of intra-day credit provided to it by a firm which is a direct participant in a given payment or settlement system, including details of the criteria against which that participant will decide whether to reduce or cease the provision of intra-day credit.

Intra-group liquidity risk

Where a firm has an intra-group liquidity modification permitting it to rely on liquidity from other members of its group in order to satisfy the overall liquidity adequacy rule, or may be exposed to calls on its own liquidity resources from others in its group, then in assessing its intra-group liquidity risk it must:

(1) take into account:

(a) the extent to which it and other entities in its group have access to central bank funding;

(b) in relation to any group entity on which a firm relies for liquidity support, the legal and regulatory regime to which that entity is subject, in particular that covering liquidity regulation; and

(c) the contractual arrangements governing any agreed forms of intra-group liquidity support (including committed funding lines); and
(2) assume that in periods of stress, group entities will not repay loans or deposits made by the firm to them, but that the firm will meet its liabilities that fall due to other group entities during the period of the relevant stress.

12.5.37 G For the purpose of BIPRU 12.5.36R, a firm should consider the full range of legal and regulatory restrictions on the availability to it of liquidity support from other members of its group. A firm should ensure that it understands restrictions in force in other jurisdictions, as well as the potential for such restrictions to be imposed in the future, as to the allowable size of intra-group exposures. A firm should also consider the circumstances in which it may find itself obliged to transfer liquidity resources to other entities in its group.

12.5.38 R In relation to an incoming EEA firm or third country BIPRU firm which does not have a whole-firm liquidity modification, that firm must assess the risk that its UK branch may be exposed to calls on liquidity under its control from its head office:

(1) in normal financial conditions; and

(2) under the liquidity stresses required by BIPRU 12.5.6 R.

12.5.39 G In complying with BIPRU 12.5.38R a firm is therefore assessing its exposure to inter-office liquidity risk, rather than intra-group liquidity risk. It is the appropriate regulator’s assessment of the firm’s inter-office liquidity risk that is one of the factors that will inform the appropriate regulator’s decision as to the appropriate size for the firm’s local operational liquidity reserve (as described in BIPRU 12.2).

Cross-currency liquidity risk

12.5.40 R For the purpose of assessing its cross-currency liquidity risk, a firm must:

(1) in relation to each currency in which it has significant positions, calculate its gross outflows and gross inflows having regard to their respective maturities;

(2) where it identifies a net outflow in (1), assess how it will fund that outflow; and

(3) estimate how the amounts in (1) and the assessment in (2) could change under the liquidity stresses required by BIPRU 12.5.6 R.

12.5.41 R A firm must, as part of its ILAA submission to the appropriate regulator, in relation to each currency in which it has significant positions:

(1) identify the type of financial instruments which that firm uses to raise funding in that currency;

(2) identify the main counterparties which provide funding to that firm in that currency; and
(3) describe the arrangements that it has in place to fund net outflows in that currency on a timely basis.

**Off-balance sheet liquidity risk**

12.5.42 For the purpose of assessing its off-balance sheet liquidity risk, a firm must:

1. identify all off-balance sheet activities that might affect its cash flows;
2. calculate the effect on its cash flows of those activities in normal financial conditions; and
3. estimate the effect on its cash flows of those activities under the liquidity stresses required by BIPRU 12.5.6R.

12.5.43 For the purpose of BIPRU 12.5.42R, a firm must take into account the circumstances in which it may choose to provide liquidity support in respect of its off-balance sheet activities beyond its contractual obligations (if any) to do so.

12.5.44 For the purpose of BIPRU 12.5.42R, a firm must in particular consider the impact on its cash flows of:

1. derivatives positions;
2. contingent liabilities;
3. commitments given; and
4. liquidity facilities to support securitisation programmes.

12.5.45 In relation to derivatives positions, a firm should:

1. assess the effect on its cash flows arising from the maturity, exercise and repricing of derivatives in which it holds a position, including the impact of counterparties:
   a. who may require the posting of additional margin or collateral in the event of a decline in that firm's credit rating;
   b. who may require the posting of additional margin or collateral (or the return to them of margin or collateral) in the event of a change in the value of a derivative or of the posted collateral;
   c. who (in the case of those that are any of a recognised investment exchange, a designated investment exchange or a recognised clearing house) may require the posting of additional margin in volatile market conditions;
   d. who may choose to terminate an OTC derivative which they have entered into with the firm rather than post additional margin or collateral;
   e. who, in periods of name-specific liquidity stress experienced by the firm, may choose to terminate out of the money derivatives which they have entered into with that firm; and
(f) who, in periods of stress, may choose to post less liquid collateral than would likely be the case in normal financial conditions; and

(2) assume that under the stresses required by BIPRU 12.5.6 R there may be uncertainty as to the accuracy of the valuation attributed to a derivative contract.

12.5.46 In relation to its contingent liabilities, a firm should:

(1) calculate the impact on its cash flows of those of its contingent obligations that will be triggered in normal financial conditions; and

(2) estimate the impact on its cash flows of those of its contingent obligations that may be triggered under the liquidity stresses required by BIPRU 12.5.6 R.

12.5.47 For the purpose of BIPRU 12.5.46G, a firm should therefore assess the impact on its cash flows of the triggering of contingent obligations contained in all contractual documentation to which it is party, including: acceptances, endorsements, guarantees, underwriting agreements, standby letters of credit, documentary credits, warrants, indemnities, undrawn note issuance facilities and other revolving credit facilities. A firm should also assess the degree of concentration in its total contingent liabilities as respects obligations arising from particular types of contract, counterparty and market sector.

12.5.48 In relation to its commitments (other than liquidity facilities to support securitisation programmes)), a firm should:

(1) calculate its maximum contractual exposure arising from those commitments;

(2) calculate the effect on its cash flows of the drawing of those commitments in normal financial conditions; and

(3) estimate the effect on its cash flows of the drawing of those commitments under the liquidity stresses required by BIPRU 12.5.6 R.

12.5.49 For the purpose of BIPRU 12.5.48G, a firm should:

(1) consider its contractual exposure to the following types of commitment: committed funding facilities, undrawn loans and advances to wholesale counterparties, mortgages that have been agreed but not yet been drawn down, credit cards, overdrafts (and other retail lending facilities);

(2) ensure that its analysis of each type of commitment is sufficiently granular to enable that firm to:

(a) assess the circumstances in which counterparties will draw down;

(b) identify the extent of any correlations as between counterparties in deciding whether or not to draw down;
(c) identify the extent to which decisions by the firm’s counterparties to draw down may be correlated to a decline in the firm’s own liquidity resources; and

(d) assess the proportion of its total commitments attributable to particular counterparties; and

(3) assess the extent to which draw down requires the counterparty in question to deliver to the firm collateral in the form of marketable assets, while also assessing the anticipated effect of such a requirement on:

(a) the likelihood that the counterparty in question will draw down; and

(b) the firm’s liquidity position if the counterparty in question delivers collateral on draw down; and

(4) assess the impact on its cash flows of its commitment counterparties experiencing liquidity stress at the same time as that firm is subject to the stresses required by BIPRU 12.5.6 R.

In relation to liquidity facilities to support securitisation programmes, a firm should:

(1) assess the extent of its contractual obligations to provide liquidity support to sponsored and third-party structured vehicles;

(2) identify the circumstances in which support will, or is likely to, be called; and

(3) assess the impact on that firm’s cash flows of such support being called:

(a) in normal financial conditions; and

(b) under the liquidity stresses required by BIPRU 12.5.6R.

For the purpose of BIPRU 12.5.50G (2), a firm should consider the impact of the following events on the likelihood of a call for liquidity support: inability of a vehicle to roll over commercial paper (due either to disruption in the CP market or to concern as to the quality of the assets securitised) and, in relation to sponsored vehicles, concern as to the solvency of that firm as sponsor and, separately, the possibility of draw down of undrawn commitments entered into by the sponsored vehicle in its own right.

Franchise-viability risk

For the purposes of assessing its franchise-viability risk, a firm must assess, under the liquidity stresses required by BIPRU 12.5.6 R, the liquidity resources required to maintain its core business franchise and reputation.

Franchise-viability risk is the risk that in the stresses required by BIPRU 12.5.6R a firm may not have sufficient liquidity resources to maintain its core business franchise and reputation.
In complying with BIPRU 12.5.52R, a firm should assess the extent to which it can and realistically will:

1. restrict new retail lines without significantly damaging customer relationships;
2. restrict new wholesale lending without significantly damaging its ability to resume such lending following the period of stress in question;
3. cease to provide liquidity support to its sponsored vehicles;
4. decline to exercise call options whose effect if not exercised might be to cause market participants to question the firm’s ability to continue to meet its liabilities as they fall due; and
5. continue any regular programme of buying back its issued debt.

For the purpose of BIPRU 12.5.54G (5), a firm may wish to continue repurchasing its debt to help demonstrate that a two-way market continues to be made in its paper and, more generally, in order to maintain the long-term viability of its debt issuance programme. Equally, a firm may wish to continue repaying retail depositors before the contractual maturity of those deposits in order to maintain confidence in its ability to continue to meet its liabilities as they fall due.

**Marketable assets risk**

For the purpose of assessing its exposure to marketable assets risk, a firm must assess how the marketable assets comprised in its liquidity resources will behave:

1. under normal financial conditions; and
2. under the liquidity stresses identified in BIPRU 12.5.6R, including an assessment of the effect of these stresses on:
   a. its ability to derive funding from its marketable assets in a timely fashion;
   b. the potential for using those assets as collateral to raise secured funding and the size of the haircut likely to be required by a counterparty;
   c. the likelihood and extent of forced-sale loss; and
   d. the effect on its business activities of any changes in (a) to (c) identified as likely to result from those liquidity stresses.

In complying with BIPRU 12.5.56R, a firm should consider all marketable assets which count towards its liquidity resources for the purposes of meeting the overall liquidity adequacy rule. A firm should therefore include in this assessment any assets that it holds in its liquid assets buffer.

The appropriate regulator regards as marketable those of a firm’s assets that it is able to sell outright or repo. For liquidity management purposes, a firm...
would ordinarily expect to hold a stock of assets of this kind in order to reduce the likelihood that it may need to borrow unsecured at short notice. To the extent that these assets may behave differently under stress conditions than under normal financial conditions, a firm is subject to marketable assets risk.

12.5.59 G As a general proposition, the speed with which a firm may be able to realise a marketable asset, and the price impact of doing so, will depend to a significant extent on the volume of those assets which that firm wishes to realise and the market conditions prevailing at the time.

12.5.60 G The behaviour of a firm's marketable assets under conditions of stress is likely to depend on a number of different factors, including:

(1) the depth and competitiveness of the market for the marketable asset in question, the size of the bid-offer spread, the presence of committed market-makers, the nature of the information available to potential counterparties, the degree of structural complexity of the assets in question and the assets eligibility in central bank market operations and liquidity facilities; and

(2) that firm's operational capability to generate funding from those assets in a timely manner.

12.5.61 G In considering its operational capability to generate funding from assets, a firm should be aware that its capability in this regard is likely to depend on:

(1) whether it has in place arrangements for repo;

(2) the extent to which that firm already holds a significant proportion of the market for the marketable asset in question;

(3) the extent to which that firm periodically realises some or all of its holdings of that asset; and

(4) that firm's accounting treatment and valuation of that asset.

12.5.62 R For the purpose of its ILAA submission to the appropriate regulator, a firm must provide the appropriate regulator with an analysis of the profile of its marketable assets as at the date of submission in a way that:

(1) separately identifies its marketable assets according to asset class, maturity, currency, their eligibility for use in central bank monetary operations and liquidity facilities and any other characteristic that it uses in its liquidity management; and

(2) assesses the degree of diversification achieved across its marketable assets.
Non-marketable assets risk

12.5.63 R For the purpose of assessing its exposure to non-marketable assets risk, a firm must assess how the non-marketable assets in its liquidity resources will behave:

(1) under normal financial conditions; and

(2) under the liquidity stresses required by BIPRU 12.5.6 R, including an assessment of the effect of these stresses on:

(a) the firm’s ability to derive funding from its non-marketable assets; and

(b) the impact on the firm’s liquidity position of any consequences for its funding ability identified in (a).

12.5.64 G In complying with BIPRU 12.5.63 R, a firm should consider all non-marketable assets which count towards its liquidity resources for the purposes of meeting the overall liquidity adequacy rule.

12.5.65 G BIPRU 12.2.5 G notes that a firm should include in its liquidity resources sufficient assets which are marketable or otherwise realisable. The appropriate regulator considers those assets which are capable of realisation, but other than through repo or outright sale, as non-marketable assets. To the extent that these assets may behave differently under stress conditions than under normal financial conditions, a firm is subject to non-marketable assets risk. Different forms of non-marketable assets risk arise, particularly in relation to:

(1) retail loans; and

(2) unsecured wholesale assets.

12.5.66 G In addition to realising a firm’s marketable assets, a firm can meet its outflows in part by expected inflows from maturing non-marketable assets such as retail loans. Inflows from these assets (principal and interest) may in stressed conditions be affected by counterparty behaviour, exposing that firm to non-marketable assets risk.

12.5.67 R For the purpose of assessing its exposure to non-marketable assets risk a firm must assess the extent to which the behaviour of inflows from retail loans under the liquidity stresses required by BIPRU 12.5.6 R may differ from that suggested by their contractual terms.

12.5.68 G For the purpose of the assessment in BIPRU 12.5.67 R, a firm should ensure that it assesses repayment behaviour at a level of granularity sufficient to enable it to draw informed conclusions about its liquidity exposure. The appropriate regulator would expect a firm’s assessment to analyse separately the non-marketable assets risk associated with each of its relevant products and with each type of counterparty from whom it is expecting repayments.
For the purpose of the assessment in BIPRU 12.5.67R, a firm should in particular have regard to the risk associated with:

1. repayment defaults; and
2. exercise by its counterparties of contractual rights to repay before the expected maturity date or to delay repayment beyond that date.

A firm may also use its unsecured wholesale assets to generate liquidity, otherwise than by outright sale or repo. A firm may, for example, choose to generate funding from some of the assets included in its liquidity resources by using them in securitisation or covered bond programmes. Assets that are typically used to raise liquidity in this manner include residential mortgage loans; commercial mortgage and other loans; credit card and automobile receivables, which have been packaged for the wholesale markets. To the extent that the ability to fund from these non-marketable assets may be limited under stressed conditions, a firm may be exposed to non-marketable assets risk.

The assessment required by BIPRU 12.5.63R is particularly important for a firm which:

1. ordinarily does not raise funding from its non-marketable assets in this way; or
2. places proportionately greater reliance on securitisation programmes as compared to other funding strategies to generate liquidity.

In complying with BIPRU 12.5.63R, a firm must in particular assess the non-marketable assets risk associated with asset securitisations, having regard to:

1. the existence of early amortisation triggers and the consequences of their operation; and
2. its financing of assets which are warehoused prior to their securitisation.

A firm which chooses to warehouse assets in the way described in BIPRU 12.5.72R should consider the particular risks that arise from the method of financing that it uses to pre-fund those assets. For example, financing of warehoused assets by means of short-term (rather than long-term) funding is more likely to put that firm under liquidity pressure in the event that its proposed securitisation is not completed (either at all, or at the expected date).

Funding concentration risk

A firm with a sufficiently flexible funding strategy should be able to reduce its liquidity risk by diversifying its liquidity resources.
As part of its ILAA, a firm must assess the impact on the degree of diversification in its liquidity resources of the stresses required by BIPRU 12.5.6R.

For the purpose of BIPRU 12.5.75R, a firm should take into account the extent to which its liquidity resources are diversified according to:

1. type of instrument and product;
2. currency;
3. counterparty;
4. liability term structure; and
5. market for their realisation (provided that such market is open to the firm as counterparty).

A firm should be aware that the degree of diversification in its liquidity resources can be compromised, particularly in periods of stress, by a number of factors, including:

1. reduced or terminated funding provision from some counterparties as a result of that firm's credit-rating being downgraded or its financial condition deteriorating;
2. disputes over the terms of legally binding commitments to lend which delay the provision of funding;
3. markets previously used by the firm for raising funding ceasing to be open or operating but at reduced capacity;
4. reliance on a small number of brokers to access funding sources; and
5. positive correlations in the behaviour of different instruments and products.
12.6 Simplified ILAS

12.6.1 The appropriate regulator recognises that it may not always be appropriate to apply BIPRU 12.5 (Individual Liquidity Adequacy Standards) to every ILAS BIPRU firm. For a firm which operates a relatively simple business model, it may instead be appropriate to allow the firm to calculate the size and content of its liquid assets buffer according to a simplified approach prescribed in the Handbook in advance of any review of that firm’s liquidity risk conducted by the appropriate regulator. This section sets out the simplified ILAS approach to maintaining a liquid assets buffer and a firm that operates that approach is a simplified ILAS BIPRU firm.

12.6.2 An ILAS BIPRU firm that wishes to operate the simplified ILAS approach must:

(1) satisfy the conditions in BIPRU 12.6.6R to BIPRU 12.6.8R; and

(2) obtain a simplified ILAS waiver from the appropriate regulator.

12.6.3 A firm will therefore lose the benefit of its simplified ILAS waiver if it ceases to satisfy the conditions in BIPRU 12.6.6R to BIPRU 12.6.8R. Consistent with Principle 11 (Relations with regulators), if a firm anticipates that it may breach those conditions, it should notify the appropriate regulator promptly.

12.6.4 A simplified ILAS BIPRU firm must calculate the size of its simplified buffer requirement in accordance with BIPRU 12.6.9R to BIPRU 12.6.18R.

12.6.5 The appropriate regulator is likely to regard a simplified ILAS BIPRU firm whose liquid assets buffer accords with the simplified buffer requirement as having an adequate buffer of assets and a prudent funding profile for the purpose of BIPRU 12.2.8R. However, the simplified ILAS approach does not relieve a simplified ILAS BIPRU firm from the obligation to hold liquidity resources which are adequate for the purpose of meeting the overall liquidity adequacy rule or from the obligation in BIPRU 12.3.4R to assess and maintain on an ongoing basis the adequacy of its liquidity resources. Consequently, where a firm’s own assessment of the adequacy of its liquidity resources indicates that its liquid assets buffer should be larger in size than that produced by the application of the simplified buffer requirement, the appropriate regulator will expect that firm to maintain a liquid assets buffer which is consistent with the results of its own assessment. Equally, following any review by the appropriate regulator of the liquidity risk to which a simplified ILAS BIPRU firm is exposed, the appropriate regulator may give...
that firm individual liquidity guidance advising it that its liquid assets buffer should be bigger than that which is produced by the application of the simplified buffer requirement.

**Simplified ILAS conditions**

12.6.6 The first condition is that:

1. no less than 75% of the firm’s total liabilities are accounted for by retail deposits and:
   1. the firm’s total assets do not exceed 250 million; or
   2. the firm’s total assets do not exceed 1 billion and no less than 70% of those assets are accounted for by:
      1. assets of the kind that fall into BIPRU 12.7.2 R and which the firm counts towards its simplified buffer requirement; and
      2. retail loans; or
   3. no less than 70% of the firm’s total assets are accounted for by retail loans; or
   4. no less than 70% of the firm’s total assets are accounted for by:
      1. money-market instruments with a residual contractual maturity of three months or less; or
      2. sight deposits held with a credit institution; or
      3. term deposits with a residual contractual maturity of three months or less held with a credit institution; or
2. no less than 80% of the firm’s total liabilities are accounted for by liabilities owed to its parent undertaking and the amount of the firm’s total assets does not exceed 1 billion.
   1. [deleted]
   2. [deleted]
   3. [deleted]

12.6.6A For the purpose of BIPRU 12.6.6 R, a firm must calculate:

1. its total assets by reference to its most recent FSA001 data item; and
2. its retail loans as the total of its lending to the retail sector recorded in cell 11A in its most recent FSA015 data item.

12.6.7 In this section:

1. a retail deposit is a deposit accepted from a consumer; and
2. SME deposits are deposits accepted from, and account balances where the account holders are, small and medium-sized enterprises (or partnerships or sole traders or charities which would be small and medium-sized enterprises if they were companies).
The second condition is that no less than 99.5% of the firm’s total assets and no less than 99.5% of its total liabilities are denominated in sterling, euros or United States dollars.

### Size of the simplified buffer requirement

12.6.9

1. A simplified ILAS BIPRU firm must ensure that the size of its liquid assets buffer is at all times greater than or equal to 50% of the amount produced by adding:
   (a) the wholesale net cash outflow component;
   (b) the retail and SME deposit component; and
   (c) the credit pipeline component.

2. This is the simplified buffer requirement.

### The wholesale net cash outflow component

12.6.10

1. The wholesale net cash outflow component is a firm’s peak cumulative wholesale net cash outflow over the next three months where the peak is established by:
   (a) calculating the daily wholesale net cash flow by reference to a firm’s wholesale assets maturing that day and its wholesale liabilities falling due on that day;
   (b) for each of the business days in the next three months, calculating the cumulative total of such daily net cash flows as at the business day in question; and
   (c) identifying the minimum cumulative total figure out of all of the cumulative total figures calculated in accordance with (b).

2. The figure identified in (1)(c) is the peak cumulative wholesale net cash outflow.

3. For the purpose of calculating the peak cumulative wholesale net cash outflow, a firm must:
   (a) exclude from the calculation in (1)(a) cash flows attributable to repo and reverse repo, forward sales, forward purchases, redemptions and any other transactions entered into by the firm where the security leg of the transaction in question is in respect of securities of the type described in BIPRU 12.7.2R (1) and (2);
   (b) include wholesale cash outflows in that calculation according to their earliest contractual maturity;
   (c) exclude wholesale cash flows attributable to reserves in the form of sight deposits with a central bank and designated money market funds that it includes in its liquid assets buffer in accordance with the rules on asset eligibility in BIPRU 12.7; and
   (d) exclude any retail deposits or SME deposits.

### The retail and SME deposit component

12.6.11

1. The retail and SME deposit component is the sum represented by:
   (a) 20% of a firm’s Type A retail deposits;
(b) 10% of a firm’s Type B retail deposits; and
(c) 20% of a firm’s SME deposits.

(2) A firm must:
(a) assess the likelihood that retail deposits that it holds will be withdrawn in response to actual or perceived changes in the firm’s credit-worthiness;
(b) calculate the amount of retail deposits that it assesses as having a higher than average likelihood of withdrawal in the circumstances described in (a) (Type A retail deposits); and
(c) class all other of its retail deposits as Type B retail deposits.

12.6.12 In the appropriate regulator’s view, a Type A retail deposit is likely to include one which:

(1) has been accepted through the internet; or
(2) is considered to have a more than average sensitivity to interest rate changes (such as a deposit whose acceptance can reasonably be attributed to the use of price-focused advertising by the firm accepting the deposit); or
(3) in relation to any individual depositor exceeds to a significant extent the amount of that individual’s deposits with the accepting firm that are covered by a national deposit guarantee scheme; or
(4) is not accepted from a depositor with whom the firm has had a long relationship; or
(5) is accepted from retail depositors who can access their deposits before their residual contractual maturity subject to a loss of interest or payment of another form of early access charge (as a general proposition, the behaviour of liabilities to retail depositors is likely to depend in part on the contractual terms and conditions which give rise to those liabilities); or
(6) is not held in an account which is maintained for transactional purposes.

12.6.13 Before applying for a simplified ILAS waiver, a firm must prepare a written policy statement recording its approach to assessing the likelihood of withdrawal of its retail deposits in the circumstances described in BIPRU 12.6.11R (2)(a) and ensure that:

(1) the firm’s governing body approves and conducts appropriate reviews of the policy statement; and
(2) the firm submits a copy of the policy statement to its usual supervisory contact at the appropriate regulator.

12.6.14 In considering a firm’s application for a simplified ILAS waiver, the appropriate regulator will take into account the firm’s policy statement submitted to it under BIPRU 12.6.13R and form a view about the
appropriateness of the assumptions on which the policy statement is based. Where a policy statement submitted after the grant of a simplified ILAS waiver reflects a materially different assessment to that set out in the policy statement considered as part of a firm’s waiver application, a firm should expect that the appropriate regulator will wish to review the continued appropriateness of the firm’s simplified ILAS waiver and in so doing will re-examine afresh all matters to which it had regard when the waiver in question was granted. The appropriate regulator expects a firm to review the appropriateness of its policy statement as often as is necessary and in any event no less frequently than annually. A firm should always review the continued appropriateness of its policy statement following a material change to the nature of the firm’s business. Where a firm updates or otherwise changes its policy statement it should submit promptly to the appropriate regulator the new document.

The credit pipeline component

12.6.15 R

The credit pipeline component is the sum represented by 25% of a firm’s credit facilities offered to its customers but which are yet to be drawn down, including:

(1) offers to make loans secured on residential property;

(2) overdraft facilities; and

(3) credit card facilities.

Buffer securities restriction

12.6.16 R

(1) A simplified ILAS BIPRU firm may only include in its liquid assets buffer eligible government and designated multilateral development bank debt securities up to the value of the buffer securities restriction.

(2) For the purpose of calculating the buffer securities restriction, a firm must:

(a) calculate its daily net flow in government and designated multilateral development bank debt securities eligible as classes of assets for inclusion in the firm’s liquid assets buffer;

(b) for each of the business days in the next three months calculate the cumulative total of such daily securities flows, including the opening balance, as at the business day in question; and

(c) identify the minimum cumulative total figure out of all of the cumulative total figures calculated in accordance with (b).

(3) For the purpose of (2)(a), a firm must include:

(a) all contractual inflows and outflows of eligible debt securities arising from repo, reverse repo, forward sales, forward purchases, redemptions and any other transactions involving those securities; and

(b) those cash flows excluded under BIPRU 12.6.10 R (3)(a).
In mathematical terms the calculation in BIPRU 12.6.9R and BIPRU 12.6.16R may be represented as follows:

\[ \text{Liquidity buffer} = FSA048_{18.1} + FSA048_{18.2} + FSA048_{16.1} + FSA048_{16.2} + FSA048_{15.3} + FSA048_{15.4} + \inf (f(x), x = 1,2,3,y) \]
where:
\[ f(x) = \sum_{n=1}^{y} FSA047_{x,n} + \sum_{n=1}^{y} FSA047_{x,2n} + \sum_{n=1}^{y} FSA047_{x,3n} \]

\[ \text{Retail and SME deposit component} = 0.2 \times \sum_{n=1}^{y} FSA048_{16.8n} + 0.1 \times \sum_{n=1}^{y} FSA048_{15.9n} \]

\[ \text{Credit pipeline component} = 0.25 \times \left( \sum_{n=1}^{y} FSA048_{16.8n} \right) \]

\[ \text{Wholesale net cash outflow component} = \min \left[ \left( \sum_{n=1}^{y} FSA048_{16.8n} \right) + \sum_{n=1}^{y} FSA048_{16.9n} + \sum_{n=1}^{y} FSA048_{16.1n} + \inf (g(x), x = 1,2,3,y) \right] \]
where:
\[ g(x) = \sum_{n=1}^{y} FSA047_{16.8n} + FSA048_{16.9n} + FSA048_{16.1n} + FSA047_{15.2n} \]

\[ \text{Where:} \]
\[ y = \text{number of business days in three months} \]

\[ FSA048_{x,n} = \text{The entry in FSA048 row x column n} \]

\[ \inf (f(x), x = 1,2,3) \text{ represents the greatest lower bound of the function } f(x) \text{ over the range } x = 1,2,3 \]

**Foreign currency positions**

(1) Subject to (3), a simplified ILAS BIPRU firm that has assets or liabilities denominated in either or both euros and United States dollars must carry out separate calculations under BIPRU 12.6.9R in relation to its positions in each of those currencies, in addition to that which it carries out in relation to its sterling positions (if any).

(2) A firm to which (1) applies must ensure that, for the purpose of meeting the simplified buffer requirement, it holds in its liquid assets buffer assets denominated in either or both euros and United States dollars (as relevant) greater than or equal to the amount produced by the calculation in the corresponding currency required under (1), in addition to any sterling liquid assets that it is required to hold in its buffer in respect of its sterling positions.

(3) Paragraph (1) does not apply to a simplified ILAS BIPRU firm that hedges fully its positions in either or both euros and United States dollars such that the firm is not exposed to any cross-currency liquidity risk in respect of those positions.
Content of the simplified ILAS liquid assets buffer

12.6.19 The rules in BIPRU 12.7 set out the sorts of assets that are eligible for the liquid assets buffer of an ILAS BIPRU firm. Every ILAS BIPRU firm may include in its buffer reserves in the form of sight deposits at a central bank and high quality debt securities issued by governments and designated multilateral development banks subject to the eligibility rules in BIPRU 12.7. BIPRU 12.7 provides that a simplified ILAS BIPRU firm may also include in its buffer investments in a designated money market fund.

12.6.20 A simplified ILAS BIPRU firm may include in the liquid assets buffer any combination of the eligible assets permitted by the rules in BIPRU 12.7.

ILSA

12.6.21 (1) A simplified ILAS BIPRU firm must regularly carry out an ILSA which contains an assessment of the firm’s compliance with the standards set out in BIPRU 12.3 and BIPRU 12.4, including the results of the stress tests required by the rules in BIPRU 12.4.

(2) The firm must make a written record of its ILSA.

(3) The ILSA must be proportionate to the nature, scale and complexity of that firm’s activities.

(4) The ILSA must take into account group-wide liquidity resources only to the extent that reliance on these is permitted by the appropriate regulator.

12.6.22 For the purpose of BIPRU 12.6.21R, a firm should carry out an ILSA at least annually, or more frequently if changes in its business or strategy or the nature, scale or complexity of its activities or the operational environment suggest that the current level of liquidity resources is no longer adequate. A firm should expect that the firm’s usual supervisory contact at the appropriate regulator will ask for the ILSA to be submitted as part of the ongoing supervisory process.
12.7 Liquid assets buffer

12.7.1 BIPRU 12.2 provides that an ILAS BIPRU firm must ensure that its liquidity resources contain an adequate buffer of high quality, unencumbered assets. BIPRU 12.7 describes in more detail the nature of the assets that are eligible for inclusion in that buffer. The rules in this section provide that some types of assets are eligible for use only by a simplified ILAS BIPRU firm.

12.7.2 For the purpose of satisfying BIPRU 12.2.8R, a firm to which this section applies may include in its liquid assets buffer only:

(1) high quality debt securities issued by a government or central bank;
(2) securities issued by a designated multilateral development bank;
(3) reserves in the form of sight deposits with a central bank of the kind specified in BIPRU 12.7.5R and BIPRU 12.7.6R; and
(4) in the case of a simplified ILAS BIPRU firm only, investments in a designated money market fund.

12.7.2A Subject to BIPRU 12.7.4R, for the purpose of BIPRU 12.7.2R (1), a firm may include only a debt security which is:

(1) issued by the central government or central bank of an EEA State; or
(2) issued by the central government or central bank of Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.

12.7.3 For the purpose of BIPRU 12.7.3R, a firm may not include a debt security unless:

(1) the central government or central bank in question has been assessed by at least two eligible ECAIs as having a credit rating associated with credit quality step 1 in the table set out in BIPRU 12 Annex 1R (Mapping of credit assessments of ECAIs to credit quality steps); and
(2) that debt security is either:
12.7.5 Subject to BIPRU 12.7.6R, for the purpose of BIPRU 12.7.2R (3) a firm may include only reserves in the form of sight deposits held by the firm with the central bank of:

(a) an EEA State; or

(b) Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.

12.7.6 For the purpose of BIPRU 12.7.5R, a firm may not include reserves held at a central bank unless:

(1) the central bank in question has been assessed by at least two eligible ECAIs as having a credit rating associated with credit quality step 1 in the table set out in BIPRU 12 Annex 1R (Mapping of credit assessments of ECAIs to credit quality steps); and

(2) those reserves are denominated in the domestic currency of the central bank in question.

12.7.6A For the purpose of BIPRU 12.7.2R (2), a firm may not include securities issued by a designated multilateral development bank unless:

(1) the designated multilateral development bank in question has been assessed by at least two eligible ECAIs as having a credit rating associated with credit quality step 1 in the table set out in BIPRU 12 Annex 1R (Mapping of credit assessments of ECAIs to credit quality steps); and

(2) those securities are denominated in any of Canadian dollars, euros, Japanese yen, sterling, Swiss francs or United States dollars.

12.7.7 It is important that a firm identifies and understands the range of central bank facilities in which it is eligible to participate. A firm may be eligible to participate in some facilities of this kind by virtue of its having a branch in a particular country. In addition to identifying the central bank facilities to which it has access, a firm should ensure that it has in place appropriate legal and administrative arrangements to enable it to draw on those facilities in a timely manner.

12.7.8 In deciding on the precise composition of its liquid assets buffer, a firm should ensure that it tailors the contents of the buffer to the needs of its business and the liquidity risk that it faces. In particular, a firm should ensure that it holds assets in its buffer which can be realised with the speed necessary to meet its liabilities as they fall due. In doing so, a firm should have regard to the currencies in which its liabilities are denominated and
should take into account the potential effect of stressed conditions on its ability to access spot and *swap* foreign exchange markets in a manner consistent with the settlement cycles of foreign exchange settlement systems. A *firm* should have regard to the results of its *ILAA* or, as the case may be, its *ILSA*, in assessing the speed with which its liabilities fall due in stressed and non-stressed conditions.

12.7.8A  

12.7.8B  

12.7.9  

For the purposes of ▲ BIPRU 12.7.2R (1) and ▲ (2), a *firm* must only count securities:

(1) which are unencumbered;

(2) (a) to which it has legal title; or

(b) to which a *central bank* has legal title but which meet the requirements of ▲ BIPRU 12.7.9AR (1), subject to ▲ BIPRU 12.7.9AR (2); and

(3) which that *firm* realises on a regular basis.

12.7.9A  

(1) For the purposes of ▲ BIPRU 12.7.9R (2)(b) the requirements are that:

(a) the securities are in excess of the amount of collateral required to be held by that *central bank*; and

(b) the *firm* is entitled to regain legal title to such securities without any encumbrance.

(2) The *firm* may only count securities that meet the requirements of ▲ BIPRU 12.7.9 R and ▲ BIPRU 12.7.9AR (1) from the point in time when the *firm* would regain legal title to the securities from the *central bank*, subsequent to any required notice period.

(3) For the purposes of ▲ BIPRU 12.7.9AR (2) any required notice period is deemed to commence on the first *business day* that the *central bank* could receive notice from the *firm*.

12.7.10  

The *appropriate regulator* regards as encumbered any asset which the *firm* in question has provided as collateral. Therefore, where assets have been used as collateral in this way (*for example, in a repo*), they should not be included in the *firm*s liquid assets buffer. However, any assets provided by the *firm* to a *central bank* as collateral which meet the requirements in ▲ BIPRU 12.7.9A R will be recognised as unencumbered by the for the purposes of ▲ BIPRU 12.7.9R (1). For the avoidance of doubt, there is no need for notice to have actually been served to meet the requirements in ▲ BIPRU 12.7.9AR (2).

12.7.11  

(1) For the purpose of ▲ BIPRU 12.7.9R (3), a *firm* must periodically realise a proportion of the assets in its liquid assets buffer through *repo* or outright sale to the market.
(3) A firm must ensure that in carrying out such periodic realisation:
   
   (a) it does so without reference to the firm's day-to-day liquidity needs;
   
   (b) it realises in varying amounts the assets in its liquid assets buffer;
   
   (c) the cumulative effect of its periodic realisation over any twelve month period is that a significant proportion of the assets in its liquid assets buffer is realised; and
   
   (d) in repo to the market it enters into transactions of varying durations.

(4) A firm must establish and maintain a written policy setting out its approach to periodic realisation of its assets.

(5) A firm must also ensure that it periodically tests its operational ability to raise funds, through the use of central bank liquidity facilities to which it has access, using a proportion of those of its assets not in its liquid assets buffer.

12.7.12 The appropriate regulator will, as part of its review of a firm's ILAA or, as the case may be, its ILSA, assess the adequacy of a firm's periodic realisation policy and its implementation in practice.
12.8 Cross-border and intra-group management of liquidity

12.8.1 Every firm subject to §BIPRU 12 is subject to the overall liquidity adequacy rule. The effect of that rule is that every firm is required to be self-sufficient in terms of liquidity adequacy and to be able to satisfy that rule relying on its own liquidity resources. Where the firm is an incoming EEA firm or third country BIPRU firm compliance with the overall liquidity adequacy rule with respect to the UK branch must be achieved relying solely on liquidity resources that satisfy the conditions in §BIPRU 12.2.3 R.

12.8.2 However, the appropriate regulator recognises that there may be circumstances in which it would be appropriate for a firm to rely on liquidity resources which can be made available to it by other members of its group, or for a firm to rely on liquidity resources elsewhere in the firm for the purposes of ensuring that its UK branch has adequate liquidity resources in respect of the activities carried on from the branch. Where the appropriate regulator is satisfied that the statutory tests in section 138A (Modification or waiver of rules) of the Act are met, the appropriate regulator will consider modifying the overall liquidity adequacy rule to permit reliance on liquidity support of this kind.

12.8.3 §BIPRU 12.8 provides guidance on two types of modification to the overall liquidity adequacy rule and to other rules in §BIPRU 12 for which the appropriate regulator considers a firm may wish to apply, namely:

1. an intra-group liquidity modification; and
2. a whole-firm liquidity modification.

12.8.4 In considering whether the statutory tests in section 138A of the Act have been met, the appropriate regulator will, amongst others, have regard to the factors detailed below in relation to an intra-group liquidity modification (of the kind permitting the inclusion in a firm’s liquidity resources of parent undertaking liquidity support) and a whole-firm liquidity modification. In practice it is likely that the appropriate regulator will view these as preconditions to the grant of an intra-group liquidity modification of that type or a whole-firm liquidity modification and will therefore ordinarily need to be satisfied fully that each has been adequately addressed. They include matters on which the appropriate regulator will need to reach agreement with the Home State regulator, third country competent authority, or other relevant supervisor, and also matters which it will need to agree directly with a firm or the parent undertaking of a firm. It is likely that a number of these matters will be reflected as requirements or conditions in the modification.
### Section 12.8 : Cross-border and intra-group management of liquidity

**12.8.5**

This section represents merely an indication of the matters to which the **appropriate regulator** will have regard in considering an application for a **whole-firm liquidity modification** or an **intra-group liquidity modification**. In considering such an application, the **appropriate regulator** will always take into account anything that it reasonably considers to be relevant for the purposes of assessing whether the statutory tests in section 138A of the Act are met. In doing so, it will have regard to the role and importance of a **firm** or **UK branch** in the **UK financial system**.

**12.8.6**

The **appropriate regulator** anticipates that an application to modify the **overall liquidity adequacy rule** may be accompanied by an application to waive or modify other rules in **BIPRU 12** (for example, the stress testing and contingency funding plan rules in **BIPRU 12.4**). The **appropriate regulator** offers some **guidance** in this section on applications of this type.

#### Intra-group liquidity modification: general

**12.8.7**

The **appropriate regulator** recognises that a **firm** may be part of a wider **group** which manages its liquidity on a **group-wide** basis. A **firm** which considers that the statutory tests in section 138A of the Act are met may apply for an **intra-group liquidity modification** permitting it to rely on liquidity support from elsewhere in its **group**. Until a **firm** has such a modification it will need to meet the **overall liquidity adequacy rule** from its **own liquidity resources**. The effect of an **intra-group liquidity modification** is to modify the **overall liquidity adequacy rule** to recognise the extent to which the **appropriate regulator** is prepared to accept liquidity resources from other entities in a **firm’s group** for the purposes of the **firm’s own compliance with the overall liquidity adequacy rule**. **BIPRU 12.8.11G** offers additional **guidance** on the likely extent of this recognition.

**12.8.8**

**BIPRU 12.8.14 G** to **BIPRU 12.8.20 G** set out the **appropriate regulator’s likely approach** in considering an application for an **intra-group liquidity modification** in which a **firm** seeks to rely on support from a **parent undertaking** which is constituted under the law of a country or territory outside the **United Kingdom**.

**12.8.9**

The **appropriate regulator** may also consider an application for an **intra-group liquidity modification** where a **firm** wishes to rely on liquidity resources from an entity in its **group** other than an **overseas parent undertaking**. The **appropriate regulator** recognises that a **firm** incorporated in the **United Kingdom** and to which **BIPRU 12** applies may wish to rely on liquidity support from another such **firm**. In practice, the **appropriate regulator** anticipates that a **firm** applying for an **intra-group liquidity modification** in these circumstances will be asking for permission to rely on support from its **parent undertaking** in the **United Kingdom**. In any event, the **appropriate regulator** will consider such applications on a case-by-case basis and will apply the approach outlined in **BIPRU 12.8.14 G** to **BIPRU 12.8.20 G** where relevant and by analogy.

**12.8.10**

The **appropriate regulator** also recognises that a **firm** incorporated in the **United Kingdom** and to which **BIPRU 12** applies may wish to rely on liquidity support from a **subsidiary undertaking** of that **firm** which is incorporated in a country or territory outside the **United Kingdom**. The **appropriate regulator**
is, however, likely to consider that an application for an *intra-group liquidity modification* that contemplates reliance for liquidity support on only, or mostly, an applicant firm's overseas subsidiary undertakings is unlikely to satisfy the tests in section 138A of the Act. As a general principle, and unless persuaded otherwise by an applicant firm's arguments in support of its application for an *intra-group liquidity modification*, the appropriate regulator is likely to take the view that a firm's overseas subsidiary undertakings are likely to be constrained in their ability to provide meaningful levels of liquidity support to their parent undertaking.

12.8.11 In each application for an *intra-group liquidity modification*, the appropriate regulator will consider the extent to which it is appropriate to modify the overall liquidity adequacy rule to allow reliance by an applicant firm on liquidity resources elsewhere in a firm’s group. However, it is unlikely that the appropriate regulator would consider the conditions in section 138A of the Act to be met in circumstances in which the overall liquidity adequacy rule was modified to allow unlimited reliance on liquidity resources that are not the applicant firm's own. As a general principle, the appropriate regulator is likely to wish to ensure that, having regard to the results of an applicant firm’s ILAA:

1. once modified, the overall liquidity adequacy rule still requires the firm to have adequate liquidity resources to enable it to wind down its business in an orderly and controlled manner in circumstances in which its business ceases to be viable; and
2. the amount of liquidity support permitted in the modification is a reasonable one having regard to the total liquidity resources of the group entity on which it is proposed that reliance should be placed.

12.8.12 In determining the appropriate duration of an *intra-group liquidity modification*, the appropriate regulator will have regard to the role and importance of the firm in question in the UK financial system. In some cases, the appropriate regulator may take the view that an *intra-group liquidity modification* covering a firm whose role and importance in the UK financial system are significant ought to be reviewed more regularly than one granted in respect of a less systemically significant firm. The appropriate regulator will consider this issue in determining the appropriate duration of such a modification.

12.8.13 In modifying the overall liquidity adequacy rule by means of an *intra-group liquidity modification*, the appropriate regulator may also modify the stress testing and contingency funding plan rules in BIPRU 12.4 such that an applicant firm may achieve compliance with those rules by its parent undertaking conducting group-wide stress testing and preparing a group-wide contingency funding plan which gives adequate recognition to the position of the applicant firm.

**Consideration of an application for an intra-group liquidity modification**

12.8.14 Consideration of an application for an intra-group liquidity modification where permission is sought to rely on support
In relation to the regime of liquidity regulation imposed by the authority that regulates for liquidity purposes an applicant firm's parent undertaking which is constituted under the law of a country or territory outside the United Kingdom, the appropriate regulator will ordinarily expect to be satisfied that:

(1) the regime of liquidity regulation to which that undertaking is subject delivers outcomes as regards the regulation of that undertaking's liquidity risk that are broadly equivalent to those intended by BIPRU 12; and

(2) there is clarity as to any legal constraints imposed by the authority which regulates that undertaking for liquidity purposes on the provision of liquidity from that undertaking to the applicant firm.

It will not always be the case that an applicant firm wishes to rely on a parent undertaking, or other group entity, that is itself subject to a regime of liquidity regulation, whether or not equivalent to the appropriate regulator's. In assessing a firm's application for an intra-group liquidity modification, the appropriate regulator will always have regard to the regulatory framework to which the entity on which it is proposed to rely for liquidity support is subject. Other things being equal, however, the appropriate regulator is more likely to be persuaded that the tests in section 138A of the Act are met in circumstances in which the entity on which it is proposed to rely for liquidity support is itself subject to an appropriate degree of regulation. Even where the parent undertaking, or other group entity, in question is subject to a regime of liquidity regulation, the appropriate regulator will in principle be more likely to grant an intra-group liquidity modification in circumstances in which the applicant firm does not accept a significant amount of retail deposits.

In relation to an applicant firm wishing to rely on liquidity support from a parent undertaking constituted under the law of a country or territory outside the United Kingdom, the appropriate regulator will ordinarily expect to reach agreement with the authority that regulates that undertaking for liquidity purposes in a number of areas, including agreement that:

(1) it will notify the appropriate regulator of any material or persistent breaches by that undertaking of that authority's liquidity rules, or of risks that such breaches are imminent;

(2) it is satisfied with the adequacy of the parent undertaking's arrangements for liquidity risk management;

(3) it is satisfied as to the adequacy of the parent undertaking's liquidity resources including:
   (a) the size and quality of its liquid assets buffer; and
   (b) the size and quality of any liquidity resources that are held in the United Kingdom for the purpose of meeting the liabilities of an applicant firm as they fall due;
(4) it does not object to any undertakings given by that parent undertaking in respect of an applicant firm to ensure that the firm has adequate liquidity resources; and

(5) it will have due regard to the views of the appropriate regulator in its supervision of the liquidity position of that parent undertaking.

12.8.18 In relation to an applicant firm wishing to rely on liquidity support from a parent undertaking constituted under the law of a country or territory outside the United Kingdom, the appropriate regulator will, before granting an intra-group liquidity modification, ordinarily expect to have reached agreement with that parent undertaking that:

(1) it will make available liquidity resources at all times to that applicant firm if needed;

(2) it will enter into an undertaking in a suitable form with an applicant firm committing it to provide liquidity support to that firm on the occurrence of certain defined events;

(3) it will ensure that the applicant firm maintains liquidity resources of appropriate size and quality in the United Kingdom for the purposes of meeting the liquidity needs of that firm;

(4) it will maintain arrangements, including having adequate liquidity resources, to ensure that it, the applicant firm and any other entities in its group to which it provides liquidity support are able to wind down their businesses in an orderly and controlled manner in circumstances where its, or their, businesses cease to be viable;

(5) it will make available to the appropriate regulator information in an appropriate format on group liquidity; and

(6) it will participate in the appropriate regulator’s thematic supervisory work in relation to liquidity when requested to do so by the appropriate regulator.

12.8.19 The appropriate regulator will wish to ensure that it has adequate data at the time of consideration of the intra-group liquidity modification application and, if the application is granted, on a continuing basis thereafter, about the liquidity position of any group entity on which the applicant firm proposes to rely for liquidity purposes. It is therefore likely that an applicant firm will be asked to provide as part of its application relevant liquidity data items populated by the entities on which the applicant firm proposes to rely. It is also likely that an applicant firm will be asked to ensure as a condition of the modification, if granted, that the entities on which it is given permission to rely for the purpose of meeting the overall liquidity adequacy rule provide completed relevant data items to the appropriate regulator on a continuing basis. The frequency of data item submission will be determined as part of the appropriate regulator’s consideration of the applicant firm’s case but is in any event likely to be reflective of the appropriate regulator’s assessment of the liquidity risk profile of the entities on which liquidity support is permitted.
In addition, the *appropriate regulator* will also wish to understand in relation to any *group* entity on which an applicant *firm* proposes to rely for liquidity support the legal structure of the *group* and the extent to which that structure, or any relevant legal principles, may restrict the provision of timely liquidity support in appropriate amounts to the applicant *firm* when required.

### Ongoing requirements

The *appropriate regulator* also anticipates that an *intra-group liquidity modification* would be made subject to a number of ongoing conditions and requirements. These are likely to include:

1. The *appropriate regulator* receiving annual confirmation from the authority that regulates the applicant *firm’s parent undertaking* for liquidity purposes that it remains satisfied with the arrangements in respect of that *undertaking* for liquidity supervision and their operation; and

2. An annual meeting with the same authority to discuss liquidity supervision of that *undertaking*.

#### Whole-firm liquidity modification: general

In relation to an *incoming EEA firm* or *third country BIPRU firm*, the *overall liquidity adequacy rule* provides that, for the purpose of complying with that rule, a *firm* may not, in relation to its *UK branch*, include liquidity resources other than those which satisfy the conditions in BIPRU 12.2.3 R. Those conditions seek to ensure that a *firm* of this kind has a reserve of liquidity for operational purposes that is under the control of, and available for use by, that *firm’s UK branch*. Further guidance is given in BIPRU 12.5.39 G in relation to the local operational liquidity reserve. In addition, BIPRU 12.9.10 G explains how the *appropriate regulator* will approach the giving of individual liquidity guidance to an *incoming EEA firm* or *third country BIPRU firm*. The *appropriate regulator* does, however, recognise that there are circumstances in which it may be appropriate for a *UK branch* to rely on the availability of liquidity resources from elsewhere within the *firm*. A *firm* wishing to rely on support of this kind for its *UK branch* may apply for a modification to the *overall liquidity adequacy rule* where it considers that the statutory tests in section 138A of the Act are met.

Although an *incoming EEA firm* or *third country BIPRU firm* may apply to modify the *overall liquidity adequacy rule* and other rules in BIPRU 12, in relation to its *UK branch*, the *appropriate regulator* anticipates that many such *firms* will wish to apply for a modification in the form which the *appropriate regulator* defines as a *whole-firm liquidity modification*. In the *appropriate regulator’s* view, a modification to the *overall liquidity adequacy rule* for a *firm* of this kind will tend to be appropriate where an applicant *firm* manages its liquidity on an integrated, whole-*firm* basis. Where that is the case, and having regard to the matters outlined in the *guidance* in this section, the *appropriate regulator* is likely to consider it more appropriate for the *UK branch* to be subject, in large part, to the same regulatory liquidity regime which applies to the rest of the *firm*. In granting a *whole-firm liquidity modification* the *appropriate regulator* therefore recognises that in certain circumstances a *UK branch* can have adequate liquidity.
resources in circumstances where the liquidity resources upon which the firm seeks to rely do not meet the criteria set out in §BIPRU 12.2.3 R.

Accordingly, a whole-firm liquidity modification envisages:

1. a modification to the overall liquidity adequacy rule so as to permit reliance by the firm, in relation to its UK branch, on liquidity resources wherever held in the firm for the purposes of meeting that rule; and

2. a waiver of the remainder of the substantive rules in §BIPRU 12, with the effect that the UK branch of the applicant firm becomes subject for the purpose of day-to-day liquidity supervision to the liquidity regime of the Home State regulator or third country competent authority in question.

The effect of a whole-firm liquidity modification is that the appropriate regulator will in its supervision of the liquidity of the UK branch place reliance on the liquidity regime of the Home State regulator or third country competent authority in question. The appropriate regulator will wish to ensure that it has adequate data at the time of consideration of the whole-firm liquidity modification application and, if the application is granted, on a continuing basis thereafter, about the liquidity position of the firm as a whole. It is therefore likely that an applicant firm will be asked to provide as part of its application relevant liquidity data items covering the liquidity position of the firm as a whole. It is also likely that an applicant firm will be asked, as part of its application, to provide an appropriately detailed account as to the activities conducted by its UK branch as at the date of the application. In addition, the appropriate regulator anticipates that an applicant firm will be asked to ensure as a condition of the modification, if granted, that it provides relevant data items, covering the whole-firm liquidity position, to the appropriate regulator on a continuing basis at a frequency to be determined as part of the appropriate regulator’s consideration of the applicant firm’s case but in any event likely to be reflective of the appropriate regulator’s assessment of the liquidity risk profile of the firm.

Consideration of an application for a whole-firm liquidity modification

In relation to the Home State regulator’s or third country competent authority’s regime of liquidity regulation, the appropriate regulator will, before granting a whole-firm liquidity modification, ordinarily expect to be satisfied that:

1. the regime in question delivers outcomes as regards the regulation of the applicant firm’s liquidity risk that are broadly equivalent to those intended by this chapter; and

2. there is clarity as to any legal constraints imposed by the Home State regulator or third country competent authority on the provision of liquidity by a firm to its UK branch, as well as the potential for such restrictions to be imposed in the future.
In relation to the applicant firm in question, the appropriate regulator will, before granting a whole-firm liquidity modification, ordinarily expect to have reached agreement with the Home State regulator or third country competent authority in a number of areas, including agreement that:

1. it will notify the appropriate regulator promptly of any material or persistent breaches by that firm of its liquidity rules, or of risks that such breaches are imminent;
2. it is satisfied with the adequacy of the arrangements in place for firm-wide liquidity risk management;
3. it is satisfied as to the adequacy of that firm’s liquidity resources including the size and quality of its liquid assets buffer;
4. it does not object to any undertakings given by that firm in respect of its UK branch to ensure that the branch has adequate liquidity resources; and
5. it will have due regard to the views of the appropriate regulator in its supervision of that firm’s liquidity position.

In relation to the applicant firm in question, the appropriate regulator will, before granting a whole-firm liquidity modification, ordinarily expect to have reached agreement with that firm in a number of areas, including agreement that:

1. it will make available liquidity resources at all times to its UK branch if needed;
2. it will make available to the appropriate regulator information in an appropriate format on firm-wide liquidity;
3. it will notify the appropriate regulator at the same time as it notifies the Home State regulator or third country competent authority of any issues relevant to the liquidity position of its UK branch or compliance with the rules to which it is subject in respect of its liquidity (including with the terms of its whole-firm liquidity modification);
4. its UK branch will continue to be fully integrated with the rest of the firm for liquidity risk management purposes; and
5. it will participate in the appropriate regulator’s thematic supervisory work in relation to liquidity when requested to do so by the appropriate regulator.

The appropriate regulator also anticipates that a whole-firm liquidity modification would be made subject to a number of ongoing conditions and requirements. These are likely to include:

1. the appropriate regulator receiving annual confirmation from the Home State regulator or third country competent authority that it
remains satisfied with the arrangements in respect of that firm for liquidity supervision and their operation;

(2) an annual meeting with the Home State regulator or third country competent authority to discuss liquidity supervision of that firm;

(3) the appropriate regulator receiving annual confirmation from the firm, approved by its governing body, that it remains in full compliance with the terms of its whole-firm liquidity modification; and

(4) as at the first anniversary of the grant of the whole-firm liquidity modification and on each anniversary thereafter, the appropriate regulator receiving from the firm:

(a) an appropriate account of the activities conducted by the UK branch over the previous year; and

(b) a copy of the firm’s latest business plan where this differs from that previously sent to the appropriate regulator after grant of its whole-firm liquidity modification.

12.8.30 In determining the appropriate duration of a whole-firm liquidity modification, the appropriate regulator will have regard to the role and importance of the UK branch in question in the UK financial system. In some cases, the appropriate regulator may take the view that a whole-firm liquidity modification, covering a UK branch whose role and importance in the UK financial system are significant, ought to be reviewed more regularly than one granted in respect of a less systemically significant branch. The appropriate regulator will consider this issue in determining the appropriate duration of such a modification. The appropriate regulator is also likely to consider it appropriate in modifications other than those of short duration to reflect in the terms of the modification representations made either in an applicant firm’s business plan or direct to the appropriate regulator as part of the application process, but in either case as to the expected nature and size of the UK branch’s activities over the course of the duration of the modification. Where requirements are included in a modification in relation to these matters, a firm that anticipates that it will breach those requirements will need to apply in advance of any such event for a variation to its then existing whole-firm liquidity modification. In considering an application to vary, the appropriate regulator will consider afresh whether the tests in section 138A of the Act continue to be met for the grant of a whole-firm liquidity modification to the firm in question.
12.9 Individual liquidity guidance and regulatory intervention points

Appropriate regulator assessment process

12.9.1 The appropriate regulator will give individual liquidity guidance to a standard ILAS BIPRU firm. Ordinarily, the appropriate regulator will give individual liquidity guidance after a review of a standard ILAS BIPRU firm’s ILAA. The appropriate regulator will, however, issue individual liquidity guidance to such a firm whenever it is considered appropriate.

12.9.2 In assessing the adequacy of an ILAS BIPRU firm’s liquidity resources, the appropriate regulator draws on more than just a review of the submitted ILAA, or in the case of a simplified ILAS BIPRU firm, the submitted ILSA. Use is made of wider supervisory knowledge of a firm and of wider market developments and practices. When forming a view of the individual liquidity guidance to be given to an ILAS BIPRU firm, the appropriate regulator will also consider the regulator’s firm risk assessment and any other issues arising from day-to-day supervision.

12.9.3 The appropriate regulator will take a risk-based and proportionate approach to the review of a firm’s ILAA or ILSA, focusing where appropriate on that firm’s approach to dealing with the risks it faces.

12.9.4 As part of the SLRP, the appropriate regulator will give a standard ILAS BIPRU firm individual liquidity guidance advising it of the amount and quality of liquidity resources which the appropriate regulator considers are appropriate, having regard to the liquidity risk profile of that firm. In giving individual liquidity guidance, the appropriate regulator will also advise the firm of what it considers to be a prudent funding profile for the firm. In giving the firm individual liquidity guidance as to its funding profile, the appropriate regulator will consider the extent to which the firm’s liabilities are adequately matched by assets of appropriate maturities. In both cases, the appropriate regulator will have regard to the adequacy of a firm’s systems and controls in relation to liquidity risk when judged against the standard described in the rules and guidance in BIPRU 12.3 and BIPRU 12.4. Individual liquidity guidance will therefore have two components:

(1) guidance about the firm’s liquid assets buffer; and

(2) guidance about the firm’s funding profile.
The appropriate regulator will ordinarily not expect to give individual liquidity guidance to a simplified ILAS BIPRU firm. However, if after review of such a firm’s ILSA, the appropriate regulator is not satisfied that the simplified buffer requirement delivers an adequate amount and quality of liquidity resources for that firm, having regard to its liquidity risk profile, the appropriate regulator will issue the firm with individual liquidity guidance and may also consider revoking the firm’s simplified ILAS waiver.

In giving individual liquidity guidance, the appropriate regulator seeks a balance between delivering consistent outcomes across the individual liquidity guidance that it gives to every ILAS BIPRU firm and recognising that such guidance should reflect the individual features of a firm. Comparison with the assumptions used by other firms will be used to trigger further enquiry.

Following an internal validation process, the appropriate regulator will write to the standard ILAS BIPRU firm whose ILAA it has reviewed, providing both quantitative and qualitative feedback on the results of the appropriate regulator’s assessment. This letter will notify that firm of the individual liquidity guidance that the appropriate regulator considers appropriate together with its reasons for concluding that such guidance is appropriate. The appropriate regulator will adopt the same process where it chooses to give individual liquidity guidance to a simplified ILAS BIPRU following a review of that firm’s ILSA.

Where the amount and quality of liquidity resources which the appropriate regulator considers a firm needs having regard to its liquidity risk profile are not the same as the firm’s own assessment of those resources under its ILAA, the appropriate regulator expects to discuss any such difference with the firm.

Consistent with Principle 11 (Relations with regulators), the appropriate regulator will expect a firm to notify it if the firm does not propose to follow its individual liquidity guidance. The appropriate regulator will expect any such notification to be accompanied by a clear account of the firm’s reasons for considering the individual liquidity guidance to be inappropriate. The appropriate regulator will expect to receive any such notification within one month from the date on which it gives individual liquidity guidance to the firm. If agreement through further analysis and discussion cannot be reached (including through use of the appropriate regulator’s powers under section 166 (Reports by skilled persons) of the Act), then the appropriate regulator will consider using its powers under the Act (for example, its power under section 55J to vary, on its own initiative, a firm’s Part IV permission or its power of intervention under section 196) so as to require a firm to hold such liquidity resources as the appropriate regulator considers are adequate having regard to the liquidity risk profile of the firm.

Additional guidance for branches

In relation to an incoming EEA firm or third country BIPRU firm, where the appropriate regulator gives that firm individual liquidity guidance in relation to its UK branch, it will have regard to the liquidity risk profile of the branch. In the absence of a whole-firm liquidity modification, the effect of...
BIPRU 12 : Liquidity standards

Section 12.9 : Individual liquidity guidance and regulatory intervention points

12.9.11 G  ■ BIPRU 12.2.9 G records the appropriate regulator’s recognition that in periods of stress a firm’s liquid assets buffer may be eroded. It may also be the case that in such periods a firm’s funding profile deteriorates such that it no longer conforms to the prudent liquidity profile described in the individual liquidity guidance given to the firm. Deviation by a firm from the terms of the individual liquidity guidance given to it by the appropriate regulator or, as the case may be, from the simplified buffer requirement, does not automatically mean that the appropriate regulator will consider that the firm is in breach of, or likely to breach, threshold conditions.

12.9.12 G The appropriate regulator will examine any deviation on its own facts and will always want to understand clearly the reasons for that deviation and the firm’s plans for remedying it. Deviation is, however, likely to prompt a re-examination by the appropriate regulator of the firm’s compliance, and likely future compliance, with threshold conditions. The appropriate regulator will have regard to the information provided by the firm and to any other relevant factors in assessing the firm’s continuing ability to satisfy threshold conditions. ■ BIPRU 12.9.13 R to ■ BIPRU 12.9.18 R set out a number of requirements which apply to an ILAS BIPRU firm that deviates from its individual liquidity guidance, or as the case may be, from the simplified buffer requirement.

12.9.12A G The appropriate regulator expects that a firm will respond dynamically to any deterioration in its liquidity position and will take contingent action as set out in its contingency funding plan well in advance of a potential event.

12.9.13 R As soon as a firm becomes aware of the occurrence or expected occurrence of the events identified in ■ BIPRU 12.9.14 R, it must immediately provide to the appropriate regulator:

(1) notification in writing of the event;

(2) an adequately reasoned explanation for the event; and

(3) an indication of the management actions the firm has taken to date to address the event, including actions from its contingency funding plan.
For the purpose of BIPRU 12.9.13, the events in question are:

(1) in the case of a simplified ILAS BIPRU firm only, breach of the simplified buffer requirement unless this has been superseded by individual liquidity guidance that it has accepted;

(2) in the case of a standard ILAS BIPRU firm or a simplified ILAS BIPRU firm, being a firm which in either case has accepted individual liquidity guidance given to it by the appropriate regulator:

(a) its liquid assets buffer falling below the level advised in the guidance; or

(b) its funding profile ceasing to conform to that advised in the guidance.

As part of the appropriate regulator's enquiry into the reasons for a firm's deviation, or expected deviation, from its individual liquidity guidance or, as the case may be, its simplified buffer requirement, the appropriate regulator may ask for further assessments and analyses of a firm's liquidity resources and the risks faced by the firm. The appropriate regulator may consider the use of its powers under section 166 of the Act to assist in such circumstances.

Consistent with Principle 11 of the appropriate regulator's Principles for Businesses (Relations with regulators), if a firm has not accepted individual liquidity guidance given by the appropriate regulator it should, nevertheless, notify the appropriate regulator as soon as it becomes aware of either of the events identified in BIPRU 12.9.14(2)(a) or (b).

No later than two days after the day on which a firm notifies the appropriate regulator under BIPRU 12.9.13(1), the firm must submit a liquidity remediation plan to the appropriate regulator.

For the purposes of BIPRU 12.9.17, a firm's liquidity remediation plan must:

(1) be communicated in writing;

(2) detail the firm's forward estimates of the evolution of the size of the firm's liquid assets buffer and of its funding profile;

(3) in relation to any of the events identified in BIPRU 12.9.14 that has occurred, or is expected to occur, detail the actions that the firm intends to take to remedy the event, or avoid the expected event, as the case may be, including information about:

(a) the amount of funding that it is intended to raise;

(b) the intended funding providers; and

(c) the maturity profile of the intended funding;

(4) identify clear timescales for achieving each of the actions that it details in accordance with BIPRU 12.9.18(3); and
(5) include an adequately reasoned assessment of the likelihood of the timely achievement of the actions that it details in accordance with BIPRU 12.9.18R (3).

12.9.19 G The appropriate regulator will assess the adequacy of the liquidity remediation plan submitted by a firm, including the likelihood of its success. A firm should expect that the appropriate regulator will want to discuss the terms of the liquidity remediation plan submitted to it under BIPRU 12.9.18 R. In its re-examination of the firm's compliance, and likely future compliance, with threshold conditions taken as a whole, the appropriate regulator will have regard to the adequacy of the firm's liquidity remediation plan.

12.9.20 G Other things being equal, the appropriate regulator will expect a firm which is not experiencing a period of stress to restore its liquidity resources more rapidly than one which is under stress at the time that it deviates from its individual liquidity guidance or, as the case may be, from its simplified buffer requirement.

12.9.21 G If agreement through discussion with the appropriate regulator cannot be reached as to the necessary actions and timescales to remedy deviation from that guidance, the appropriate regulator will consider using its powers under the Act (for example, its power under section 55J to vary, on its own initiative, a firm's Part 4A permission or its power of intervention under section 196) so as to require the firm to take such actions as the appropriate regulator considers are necessary to return the firm to conformity with the terms of its individual liquidity guidance or, as the case may be, with its simplified buffer requirement.

12.9.22 G Although BIPRU 12.9.17 R to BIPRU 12.9.21 G set out the appropriate regulator's likely approach, the appropriate regulator will take whatever action it considers appropriate in the particular circumstances of a given case.

12.9.23 G A firm that deviates from current individual liquidity guidance that it has accepted or, as the case may be, from its simplified buffer requirement, will be experiencing a firm-specific liquidity stress for the purpose of the reporting rules in SUP 16 (Reporting requirements). Those rules require the firm to report specified data items more frequently than would otherwise be the case. Additionally, a firm that is implementing a liquidity remediation plan should expect that the appropriate regulator will wish to monitor its implementation of that plan. The firm's progress in achieving the remedial actions identified in its plan is a matter to which the appropriate regulator will have regard in considering the firm's compliance, and likely future compliance, with threshold conditions.

Monitoring requirement

12.9.24 R An ILAS BIPRU firm must monitor on each business day whether it is in conformity with individual liquidity guidance that it has accepted or, as the case may be, with the simplified buffer requirement.
Mode of notification

12.9.25 R Notification to the *appropriate regulator* under ■ BIPRU 12.9.13R (1) and submission to the *appropriate regulator* under ■ BIPRU 12.9.17 R must be made to the following *appropriate regulator* email address: data_collection@fca.org.uk.

12.9.26 G Although ■ BIPRU 12.9.25 R requires notification and submission in the way prescribed in that rule, the *appropriate regulator* expects that a *firm* would also bring to the attention of its usual supervisory contact at the *appropriate regulator* the fact that it had made such a notification or submission.

12.9.27 G For the purpose of the notification expected under ■ BIPRU 12.9.26 G, the *appropriate regulator* would expect any such notification to be made in the way envisaged in ■ BIPRU 12.9.25 R.
## Mapping of credit assessments of ECAIs to credit quality steps

<table>
<thead>
<tr>
<th>Credit Quality Step</th>
<th>Fitch’s assessment</th>
<th>Moody’s assessments</th>
<th>S&amp;P’s assessments</th>
<th>DBRS’ assessments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AAA to AA-</td>
<td>Aaa to Aa3</td>
<td>AAA to AA-</td>
<td>AAA to AAL</td>
</tr>
<tr>
<td>2</td>
<td>A+ to A-</td>
<td>A1 to A3</td>
<td>A+ to A-</td>
<td>AH to AL</td>
</tr>
<tr>
<td>3</td>
<td>BBB+ to BBB-</td>
<td>Baa1 to Baa3</td>
<td>BBB+ to BBB-</td>
<td>BBBH to BBBL</td>
</tr>
<tr>
<td>4</td>
<td>BB+ to BB-</td>
<td>Ba1 to Ba3</td>
<td>BB+ to BB-</td>
<td>BBH to BBL</td>
</tr>
<tr>
<td>5</td>
<td>B+ to B-</td>
<td>B1 to B3</td>
<td>B+ to B-</td>
<td>BH to BL</td>
</tr>
<tr>
<td>6</td>
<td>CCC+ and below</td>
<td>Caa1 and below</td>
<td>CCC+ and below</td>
<td>CCCH and below</td>
</tr>
</tbody>
</table>
Chapter 13

The calculation of counterparty risk exposure values for financial derivatives, securities financing transactions and long settlement transactions
13.1 Application and Purpose

Application

13.1.1 R BIPRU 13 applies to a BIPRU firm.

13.1.2 R (1) BIPRU 13 applies to items in the non-trading book.

(2) BIPRU 13 applies to trading book items for the purposes of BIPRU 14.

13.1.3 G The requirement to calculate the counterparty credit risk capital charge for trading book items is set out in BIPRU 14.

Purpose

13.1.4 G Pursuant to the third paragraph of article 95(2) of the EU CRR, BIPRU 13 implements:

(1) Article 78(2) and (4);

(2) point 3 of Part 1, and Parts 2, 3, 5, 6 and 7 of Annex III; and

(3) Annex IV;

of the Banking Consolidation Directive.

13.1.5 G BIPRU 13.3 sets out the calculations of exposure values for financial derivative instrument, long settlement transactions and certain other transactions under the standardised approach and, subject to BIPRU 4, under the IRB approach. BIPRU 13.4, 13.5 and 13.6 set out the provisions relating to the CCR mark to market method, the CCR standardised method and the CCR internal model method in turn.

13.1.6 G BIPRU 13.8 sets out a summary of the treatment of securities financing transactions.
13.2 Unusual Transactions

13.2.1 If the calculation of the amount of an exposure or of a combination of exposures under BIPRU 13 would materially understate the amount of the counterparty credit risk the firm must increase the amount of the credit risk capital requirement by an amount sufficient to compensate for that understatement.

13.2.2 If a firm in relation to an exposure covered by BIPRU 13:

(1) has an exposure of a non-standard type; or

(2) an exposure that is part of a non-standard arrangement; or

(3) has an exposure that, taken together with other exposures (whether or not they are subject to BIPRU 13), gives rise to a non-standard counterparty credit risk; or

(4) is subject to the rule in BIPRU 13.2.1 R;

it must notify the appropriate regulator as soon as practicable of that fact, the counterparty involved, the nature of the exposure or arrangement and the treatment of those exposures it has adopted for the purpose of the calculation of the credit risk capital requirement.

13.2.3 BIPRU 13.2.2 R does not apply to exposures which are within the scope of a firm's CCR internal model method permission.

13.2.4 A firm must judge the question of what is non-standard for the purposes of BIPRU 13.2.2 R by reference to the standards:

(1) prevailing at the time the rule is being applied; and

(2) of firms generally who carry on business which might give rise to exposures covered by BIPRU 13 rather than merely by reference to the firm's own business.

13.2.5 The methodologies which have been developed assume instruments with standard characteristics. There are many examples, however, of instruments which, although based on a standard contract, contain structural features which make the rules, as stated, inappropriate. In such circumstances a firm should consult the appropriate regulator.
13.3 Calculation of exposure values for financial derivatives and long settlement transactions: General provisions

Financial derivative instruments

13.3.1 A firm must determine the exposure value of a financial derivative instrument in accordance with BIPRU 13, with the effects of contracts of novation and other netting agreements taken into account for the purposes of those methods in accordance with BIPRU 13.

[Note: BCD Article 78(2) first sentence]

13.3.2 Subject to BIPRU 13.3, a firm must determine the exposure value for financial derivative instruments with the CCR mark to market method, the CCR standardised method or the CCR internal model method.

[Note: BCD Annex III, Part 2 point 1]

Definition of financial derivative instrument

13.3.3 Each of the following is a financial derivative instrument:

(1) an interest-rate contract, being:
   (a) a single-currency interest rate swap;
   (b) a basis-swap;
   (c) a forward rate agreement;
   (d) an interest-rate future;
   (e) a purchased interest-rate option; and
   (f) other contracts of similar nature.

(2) a foreign currency contract or contract concerning gold, being:
   (a) a cross-currency interest-rate swap;
   (b) a forward foreign currency contract;
   (c) a currency future;
   (d) a currency option purchased;
   (e) other contracts of a similar nature; and
   (f) a contract concerning gold of a nature similar to (2)(a) to (e).
(3) a contract of a nature similar to those in 1(a) to (e) and 2(a) to (d) concerning other reference items or indices, including as a minimum all instruments specified in points 4 to 7, 9 and 10 of Section C of Annex I to the MiFID not otherwise included in (1) or (2).

[Note: BCD Annex IV]

### Long settlement transactions

**13.3.4** A firm must calculate the exposure value of a long settlement transaction in accordance with either:

(1) **BIPRU 13**; or

(2) the master netting agreement internal models approach, if it has a master netting agreement internal models approach waiver which permits it to apply that approach.

[Note: BCD Article 78(2) second sentence, in respect of long settlement transaction]

**13.3.5** A firm may determine exposures arising from long settlement transactions using any of the CCR mark to market method, the CCR standardised method and the CCR internal model method, regardless of the methods chosen for treating financial derivatives instruments and repurchase transactions, securities or commodities lending or borrowing transactions, and margin lending transactions. In calculating capital requirements for long settlement transactions, a firm that uses the IRB approach may apply the risk weights under the standardised approach on a permanent basis and irrespective of the materiality of such positions.

[Note: BCD Annex III Part 2 point 7]

**13.3.6** A firm is not required to calculate the exposure value of a transaction as a long settlement transaction for the purposes of BIPRU 13 if the transaction is a financial derivative instrument or a securities financing transaction and the firm chooses to calculate the capital requirement for the transaction according to the methods applicable to those exposures.

### General netting

**13.3.7** Under the CCR mark to market method, the CCR standardised method and the CCR internal model method, a firm must determine the exposure value for a given counterparty as equal to the sum of the exposure values calculated for each netting set with that counterparty.

[Note: BCD Annex III Part 2 point 5]
A firm may only recognise netting for the purposes of BIPRU 13.4, BIPRU 13.5 and BIPRU 13.6 if the requirements in BIPRU 13.7 are met.

The combined use of the CCR mark to market method, the CCR standardised method and the CCR internal model method is not permitted. The combined use of the CCR mark to market method and the CCR standardised method is permitted where one of the methods is used for the cases set out in BIPRU 13.5 R to BIPRU 13.10 R.

[Note: BCD Annex III Part 2 point 1(part)]

The combined use of different approaches may be used across a group as described in BIPRU 8.7.8 G and BIPRU 8.7.9 G.

Notwithstanding BIPRU 13.3.1 R and BIPRU 13.3.5 R, a firm may determine the exposure value of a credit risk exposure outstanding with a central counterparty in accordance with BIPRU 13.3.13 R, provided that the central counterparty’s counterparty credit risk exposure with all participants in its arrangements are fully collateralised on a daily basis.

[Note: BCD Article 78(4) in respect of financial derivatives and long settlement transactions]

A firm may attribute an exposure value of zero for CCR to derivative contracts and long settlement transactions, or to other exposures arising in respect of those contracts or transactions (but excluding an exposure arising from collateral held to mitigate losses in the event of the default of other participants in the central counterparty’s arrangements) where they are outstanding with a central counterparty and have not been rejected by the central counterparty.

[Note: BCD Annex III Part 2 point 6 in respect of financial derivatives and long settlement transactions]

When a firm purchases credit derivative protection against a non-trading book, exposure or against a CCR exposure, it must compute its capital requirement for the hedged asset in accordance with:

1. BIPRU 5.7.16 R to BIPRU 5.7.25 R and BIPRU 4.10.49 R (4) to (6) (Unfunded credit protection: Valuation and calculation of risk-weighted exposure amounts and expected loss amounts); or

2. where a firm calculates risk weighted exposure amounts in accordance with the IRB approach:
   a. BIPRU 4.4.79 R (Double default); or
   b. BIPRU 4.10.40 R to BIPRU 4.10.48 R. (Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives).
(3) [deleted]

[Note: BCD Annex III Part 2 point 3 (part)]

13.3.15 R

(1) In the cases in BIPRU 13.3.14R, and where the option in the second sentence of BIPRU 14.2.10R is not applied, the exposure value for CCR for these credit derivatives is set to zero.

(2) However, a firm may choose consistently to include for the purposes of calculating capital requirements for counterparty credit risk all credit derivatives not included in the trading book and purchased as protection against a non-trading exposure or against a CCR exposure where the credit protection is recognised under the BCD.

[Note: BCD Annex III Part 2 point 3 (part)]

13.3.16 R

A firm must set the exposure value for CCR from sold credit default swaps in the non-trading book, where they are treated as credit protection provided by the firm and subject to a capital requirement for credit risk for the full notional amount, to zero.

[Note: BCD Annex III Part 2 point 4]
13.4 CCR mark to market method

General

13.4.1 The rules in BIPRU 13.4 set out the CCR mark to market method.

13.4.2 A firm must obtain the current replacement cost of all contracts with positive values by attaching current market values to contracts (marking to market).

[Note: BCD Annex III Part 3, Step (a)]

13.4.3 A firm must obtain a figure for potential future credit exposure by multiplying the notional principal amounts or underlying values by the percentages in the table in BIPRU 13.4.5 R.

[Note: BCD Annex III Part 3, Step (b) (part)]

13.4.4 BIPRU 13.4.3 R does not apply in the case of single-currency "floating/floating" interest rate swaps.

[Note: BCD Annex III Part 3, Step (b) (part)]

Table: multiples to be applied to notional principal amounts or underlying values

13.4.5 This table belongs to BIPRU 13.4.5 R

<table>
<thead>
<tr>
<th>Residual maturity</th>
<th>Interest-rate contracts</th>
<th>Contracts concerning foreign currency rates and gold</th>
<th>Contracts concerning equities</th>
<th>Contracts concerning precious metals except gold</th>
<th>Contracts concerning commodities other than precious metals</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year or less</td>
<td>0%</td>
<td>1%</td>
<td>6%</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>Over one year, not exceeding five years</td>
<td>0,5%</td>
<td>5%</td>
<td>8%</td>
<td>7%</td>
<td>12%</td>
</tr>
<tr>
<td>Over five years</td>
<td>1.5%</td>
<td>7.5%</td>
<td>10%</td>
<td>8%</td>
<td>15%</td>
</tr>
</tbody>
</table>

[Note: BCD Annex III Part 3, Table 1]
13.4.6 R A firm must treat a contract which does not fall within one of the five categories indicated in the table in BIPRU 13.4.5 R as a contract concerning commodities other than precious metals.

[Note: BCD Annex III Part 3, Table 1 footnote 25]

13.4.7 R For contracts with multiple exchanges of principal, a firm must multiply the percentages in the table in BIPRU 13.4.5 R by the number of remaining payments still to be made according to the contract.

[Note: BCD Annex III Part 3, Table 1 footnote 26]

13.4.8 R 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, a firm must treat the residual maturity as equal to the time until the next reset date.

[Note: BCD Annex III Part 3, Table 1 footnote 27 (part)]

13.4.9 R In the case of interest-rate contracts that meet the criteria in BIPRU 13.4.8 R and have a remaining maturity of over one year, a firm must apply a percentage no lower than 0.5%.

[Note: BCD Annex III Part 3, Table 1 footnote 27 (part)]

13.4.10 R For the purpose of calculating the potential future credit exposure in accordance with BIPRU 13.4.3 R a firm may apply the percentages in the table in BIPRU 13.4.11 R instead of those prescribed in the table in BIPRU 13.4.5 R provided that it makes use of the commodity extended maturity ladder approach for contracts relating to commodities other than gold.

Table: alternative multiples to be applied to notional principal amounts or underlying values

<table>
<thead>
<tr>
<th>Residual maturity</th>
<th>Precious metals (except gold)</th>
<th>Base metals</th>
<th>Agricultural products (softs)</th>
<th>Other, including energy products</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year or less</td>
<td>2%</td>
<td>2.5%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>Over one year, not exceeding five years</td>
<td>5%</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
</tr>
<tr>
<td>Over five years</td>
<td>7.5%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
</tr>
</tbody>
</table>

[Note: BCD Annex III Part 3, Table 2]

13.4.12 R A firm must calculate the exposure value as the sum of:

1. the current replacement cost calculated under BIPRU 13.4.2 R; and
(2) the potential future credit exposure calculated under ▪ BIPRU 13.4.3 R.

[Note: BCD Annex III Part 3, Step (c)]

13.4.13 G Contracts with a negative replacement cost should still be subject to an add-on if there is a possibility of the replacement costs becoming positive before maturity. Written options should therefore be exempt from add-ons.

13.4.14 G For the purposes of calculating the replacement cost, where an exposure relates to collateral posted to cover a negative mark to market position on a derivative contract, the negative mark to market exposure may be offset against the collateral exposure if the requirements in ▪ BIPRU 5 are met.

Alternative approach

13.4.15 R

A firm must ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where, for instance, the contract provides for a multiplication of cash flows, a firm must adjust the notional amount in order to take into account the effects of the multiplication on the risk structure of that contract.

[Note: BCD Annex III Part 2 point 8]

Netting: Contracts for novation

13.4.16 R

The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. For the purposes of the CCR mark to market method, a firm may obtain:

(1) in ▪ BIPRU 13.4.2 R, the current replacement cost; and

(2) in ▪ BIPRU 13.4.3 R, the notional principal amounts or underlying values;

by taking account of the contract for novation.

[Note: BCD Annex III Part 7 point c(i)]

Netting: Other netting agreements

13.4.17 R

In application of the CCR mark to market method:

(1) in ▪ BIPRU 13.4.2 R a firm may obtain the current replacement cost for the contracts included in a netting agreement by taking account of the actual hypothetical net replacement cost which results from the agreement; in the case where netting leads to a net obligation for the firm calculating the net replacement cost, the current replacement cost is calculated as "0"; and

(2) in ▪ BIPRU 13.4.3 R a firm may reduce the figure for potential future credit exposure for all contracts included in a netting agreement according to the following formula:

\[ PCE_{\text{red}} = 0.4 \times PCE_{\text{gross}} + 0.6 \times NGR \times PCE_{\text{gross}} \]

where:
(a) \( \text{PCE}_{\text{red}} = \text{the reduced figure for potential future credit exposure} \) for all contracts with a given counterparty included in a legally valid bilateral netting agreement;

(b) \( \text{PCE}_{\text{gross}} = \text{the sum of the figures for potential future credit exposure} \) for all contracts with a given counterparty which are included in a legally valid bilateral netting agreement and are calculated by multiplying their notional principal amounts by the percentages set out in the table in \( \text{BIPRU 13.4.5 R} \); and

(c) \( \text{NGR} = \text{"net-to-gross ratio";} \) the quotient of the net replacement cost for all contracts included in a legally valid bilateral netting agreement with a given counterparty (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counterparty (denominator).

\[\text{Note: BCD Annex III Part 7 point c(ii) (part)}\]

13.4.18 For the calculation of the potential future credit exposure according to the formula in \( \text{BIPRU 13.4.17 R} \) perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts.

\[\text{Note: BCD Annex III Part 7 point c(ii) (part)}\]

13.4.19 For the purposes of \( \text{BIPRU 13.4.18 R} \) a perfectly matching contract is a forward foreign currency contract or similar contract in which a notional principal is equivalent to cash flows if the cash flows fall due on the same value date and fully or partly in the same currency.

\[\text{Note: BCD Annex III Part 7 point c(ii) (part)}\]
13.5 CCR standardised method

Scope

13.5.1 A firm may use the CCR standardised method only for financial derivative instruments and long settlement transactions.

[Note: BCD Annex III Part 5 point 1 (part)]

Derivation of risk position: payment legs

13.5.2 (1) When a financial derivative instrument transaction with a linear risk profile stipulates the exchange of a financial instrument for a payment, the payment Part is referred to as the payment leg.

(2) Transactions that stipulate the exchange of payment against payment consist of two payment legs.

(3) The payment legs consist of the contractually agreed gross payments, including the notional amount of the transaction.

(4) A firm may disregard the interest rate risk from payment legs with a remaining maturity of less than one year for the purposes of the calculations in ■BIPRU 13.5.

(5) A firm may treat transactions that consist of two payment legs that are denominated in the same currency, such as interest rate swaps, as a single aggregate transaction. The treatment for payment legs applies to the aggregate transaction.

[Note: BCD Annex III Part 5 point 2]

Derivation of risk position: mapping

13.5.3 (1) Transactions with a linear risk profile with equities (including equity indices), gold, other precious metals or other commodities as the underlying financial instruments must be mapped to a risk position in the respective equity (or equity index) or commodity (including gold and other precious metals) and an interest rate risk position for the payment leg.

(2) If the payment leg is denominated in a foreign currency, it must be additionally mapped to a risk position in the respective currency.

[Note: BCD Annex III Part 5 point 3]
(1) Transactions with a linear risk profile with a debt instrument as the underlying instrument must be mapped to an interest rate risk position for the debt instrument and another interest rate risk position for the payment leg.

(2) Transactions with a linear risk profile that stipulate the exchange of payment against payment, including foreign exchange forwards, must be mapped to an interest rate risk position for each of the payment legs.

(3) If the underlying debt instrument is denominated in a foreign currency, the debt instrument must be mapped to a risk position in that foreign currency.

(4) If a payment leg is denominated in foreign currency, the payment leg must be again mapped to a risk position in that foreign currency.

(5) The exposure value to be assigned to a foreign exchange basis swap transaction is zero.

[Note: BCD Annex III Part 5 point 4]

Derivation of risk position: calculating the size of the risk position

A firm must calculate the risk position of the transaction or instrument in column 1 of the table in BIPRU 13.5.6 R in accordance with column 2 of that table.

This table belongs to BIPRU 13.5.5 R.

<table>
<thead>
<tr>
<th>Transaction or instrument</th>
<th>Calculation of size of risk position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction with linear risk profile except for debt instruments.</td>
<td>The effective notional value (market price multiplied by quantity) of the underlying financial instruments (including commodities) converted to the firm's domestic currency.</td>
</tr>
<tr>
<td>Debt instruments and payment legs.</td>
<td>The effective notional value of the outstanding gross payments (including the notional amount) converted to the firm's base currency, multiplied by the modified duration of the debt instrument, or payment leg, respectively.</td>
</tr>
<tr>
<td>Credit default swap</td>
<td>The notional value of the reference debt instrument multiplied by the remaining maturity of the credit default swap.</td>
</tr>
<tr>
<td>Nth to default credit default swap</td>
<td>The effective notional value of the reference debt instrument, multiplied by the modified duration of the nth to default derivative with respect to a change in the credit spread of the reference debt instrument.</td>
</tr>
<tr>
<td>Subject to BIPRU 13.5.9 R to BIPRU 13.5.10 R, financial derivative instrument</td>
<td>Equal to the delta equivalent effective notional value of the financial instrument.</td>
</tr>
</tbody>
</table>
BIPRU 13 : The calculation of counterparty risk exposure values for financial derivatives,...

Section 13.5 : CCR standardised method

Transaction or instrument | Calculation of size of risk position
--- | ---
ment with a non-linear risk profile, including options and swaptions except in the case of an underlying debt instrument. | strument that underlies the transaction.
Subject to BIPRU 13.5.9 R to BIPRU 13.5.10 R, financial derivative instrument with a non-linear risk profile, including options and swaptions, of which the underlying is a debt instrument or a payment leg. | Equal to the delta equivalent effective notional value of the financial instrument or payment leg multiplied by the modified duration of the debt instrument, or payment leg, respectively.

[Note: BCD Annex III Part 5 points 5 to 9 and 15 (part)]

Derivation of risk position: effective notional value

A firm may use the following formulae to determine the size and sign of a risk position:

1. for all instruments other than debt instruments:
   effective notional value, or delta equivalent
   notional value = \( P_{\text{ref}} \left( \frac{V}{p} \right) \)
   where:
   (a) \( P_{\text{ref}} \) = price of the underlying instrument, expressed in the reference currency;
   (b) \( V \) = value of the financial instrument (in the case of an option this is the option price; in the case of a transaction with a linear risk profile this is the value of the underlying instrument itself);
   (c) \( p \) = price of the underlying instrument, expressed in the same currency as \( V \);

2. for debt instruments and the payment legs of all transactions:
   effective notional value multiplied by the modified duration, or delta equivalent in notional value multiplied by the modified duration
   \( \frac{V}{r} \)
   where:
   (a) \( V \) = value of the financial instrument (in the case of an option this is the option price; in the case of a transaction with a linear risk profile this is the value of the underlying instrument itself or of the payment leg, respectively);
   (b) \( r \) = interest rate level.

3. If \( V \) is denominated in a currency other than the reference currency, the derivative must be converted into the reference currency by multiplication with the relevant exchange rate.

[Note: BCD Annex III Part 5 point 11]

Derivation of risk position: treatment of collateral

For the determination of risk positions, a firm must treat collateral received from a counterparty like a claim on the counterparty under a derivative...
contract (long position) that is due today, while collateral posted must be treated as an obligation to the counterparty (short position) that is due today.

[Note: BCD Annex III Part 5 point 10]

**Derivation of risk position: non-linear risks**

**13.5.9** A firm must apply the CCR mark to market method to transactions with a non-linear risk profile or for payment legs and transactions with debt instruments as underlying if:

1. the firm does not have a CAD 1 model permission or a VaR model permission; or
2. where the firm does have a CAD 1 model permission or a VaR model permission but cannot determine the delta or the modified duration, respectively, with its CAD 1 model permission or VaR model permission.

[Note: BCD Annex III Part 5 point 19 (part)]

**13.5.10** A firm must not recognise netting for the purpose of applying the CCR mark to market method to an exposure treated under **BIPRU 13.5.9** R (that is, the exposure value must be determined as if there were a netting set that comprises just the individual transaction).

[Note: BCD Annex III Part 5 point 19 (part)]

**Hedging sets: assignment**

**13.5.11** A firm must group the risk positions into hedging sets and, for each hedging set, compute the absolute value amount of the sum of the resulting risk positions. This sum is termed the net risk position and is represented by:

\[
((\sum_i RPT_{ij}) - (\sum_l RPC_{lj}))
\]

in the formulae set out in **BIPRU 13.5.24** R.

[Note: BCD Annex III Part 5 point 12]

**Hedging sets: description**

**13.5.12** For interest rate risk positions from money deposits received from the counterparty as collateral, from payment leg and from underlying debt instruments, to which according to the table in BIPRU 7.2.44R a capital charge of 1.60% or less applies, there are six hedging sets for each currency, as set out in the table in **BIPRU 13.5.13** R. Hedging sets are defined by a combination of the criteria maturity and referenced interest rates.

[Note: BCD Annex III Part 5 point 13]

**Table: Hedging sets**

**13.5.13** This table belongs to **BIPRU 13.5.12** R:
For interest rate risk positions from underlying debt instruments or payment legs for which the interest rate is linked to a reference interest rate that represents a general market interest level, the remaining maturity is the length of the time interval up to the next re-adjustment of the interest rate. In all other cases, it is the remaining life of the underlying debt instrument, or in the case of a payment leg the remaining life of the transaction.

There is one hedging set for each issuer of a reference debt instrument that underlies a credit default swap. Nth to default basket credit default swaps must be treated as follows:

1. the size of a risk position in a reference debt instrument in a basket underlying an nth to default credit default swap is the effective notional value of the reference debt instrument, multiplied by the modified duration of the nth to default derivative, with respect to a change in the credit spread of the reference debt instrument;

2. there is one hedging set for each reference debt instrument in a basket underlying a given nth to default credit default swap; risk positions from different nth to default credit default swaps must not be included in the same hedging set; and

3. the CCR multiplier applicable to each hedging set created for one of the reference debt instruments of an nth to default derivative is 0.3% for reference debt instruments that have a credit assessment from a recognised ECAI equivalent to credit quality step 1 to 3, and 0.6% for other debt instruments.

For equities, similar instruments are those of the same issuer. An equity index is treated as a separate issuer.
(3) For precious metals, similar instruments are those of the same metal. A precious metal index is treated as a separate precious metal.

(4) For electric power, similar instruments are those delivery rights and obligations that refer to the same peak or off-peak load time interval within any 24 hour interval.

(5) For commodities, similar instruments are those of the same commodity. A commodity index is treated as a separate commodity.

[Note: BCD Annex III Part 5 point 17 (part)]

**Hedging sets: collateral**

13.5.18 R

1. For interest rate risk positions from money deposits that are posted with a counterparty as collateral when that counterparty does not have debt obligations of low specific risk outstanding and from underlying debt instruments, to which according to the table in ▉BIPRU 7.2.44 R a capital charge of more than 1.60% applies, there is one hedging set for each issuer.

2. When a payment leg emulates such a debt instrument, there is also one hedging set for each issuer of the reference debt instrument.

3. A firm may assign risk positions that arise from debt instruments of a certain issuer, or from reference debt instruments of the same issuer that are emulated by payment legs, or that underlie a credit default swap, to the same hedging set.

[Note: BCD Annex III Part 5 point 16]

13.5.19 R

A firm that makes use of collateral to mitigate its CCR must have internal procedures to verify that, prior to recognising the effect of collateral in its calculations, the collateral meets the legal certainty standards set out in ▉BIPRU 5 modified, where relevant, by ▉BIPRU 4.10.

[Note: BCD Annex III Part 5 point 21]

**Hedging sets: netting**

13.5.20 R

A firm must have internal procedures to verify that, prior to including a transaction in a hedging set, the transaction is covered by a legally enforceable netting contract that meets the requirements set out in ▉BIPRU 13.7.

[Note: BCD Annex III Part 5 point 20]

**Credit conversion factors : Table**

13.5.21 R

A firm must apply the CCR multipliers for the different hedging set categories according to the Table in ▉BIPRU 13.5.22 R.

[Note: BCD Annex III Part 5 point 18]

13.5.22 R

This table belongs to ▉BIPRU 13.5.21 R.
### Hedging set categories vs. CCR Multiplier (CCRM)

<table>
<thead>
<tr>
<th>Hedging set categories</th>
<th>CCR Multiplier (CCRM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Interest Rates</td>
<td>0.2%</td>
</tr>
<tr>
<td>(2) Interest Rates for risk positions from a reference debt instrument that underlies a credit default swap and to which a capital charge of 1.60%, or less, applies under BIPRU 7.2.44 R.</td>
<td>0.3%</td>
</tr>
<tr>
<td>(3) Interest Rates for risk positions from a debt instrument or reference debt instrument to which a capital charge of more than 1.60% applies under BIPRU 7.2.44 R.</td>
<td>0.6%</td>
</tr>
<tr>
<td>(4) Exchange Rates</td>
<td>2.5%</td>
</tr>
<tr>
<td>(5) Electric power</td>
<td>4.0%</td>
</tr>
<tr>
<td>(6) Gold</td>
<td>5.0%</td>
</tr>
<tr>
<td>(7) Equity</td>
<td>7.0%</td>
</tr>
<tr>
<td>(8) Precious Metals (except gold)</td>
<td>8.5%</td>
</tr>
<tr>
<td>(9) Other commodities (excluding precious metals and electricity power)</td>
<td>10.0%</td>
</tr>
<tr>
<td>(10) Reference debt instruments of an nth to default derivative that have a credit assessment from a recognised ECAI equivalent to credit quality step 1 to 3</td>
<td>0.3%</td>
</tr>
<tr>
<td>(11) Reference debt instruments of an nth to default derivative that do not have a credit assessment from a recognised ECAI equivalent to credit quality step 1 to 3</td>
<td>0.6%</td>
</tr>
<tr>
<td>(12) Underlying instruments of financial derivative instrument that are not in any of the above categories.</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

[Note: BCD Annex III Part 5 Table 5 and Part 5 point 15 (c)]

A firm must assign underlying instruments of financial derivatives instruments (in line 10 of the Table in BIPRU 13.5.22 R) to separate individual hedging sets for each category of underlying instrument.
13.5.24 R

A firm must calculate the exposure value separately for each netting set.

[Note: BCD Annex III Part 5 point 1, second sentence]

13.5.25 R

A firm must determine the exposure value net of collateral, as follows:

\[ \text{exposure value} = \text{max}(\text{CMV} - \text{CMC}; (i)(\text{RPT}_{ij} - (l)(\text{RPC}_{lj})) \times \text{CCRM}_j) \]

where:

- \( \text{CMV} \) = current market value of the portfolio of transactions within the netting set with a counterparty gross of collateral.
- \( \text{CMC} \) = current market value of the collateral assigned to the netting set.

That is, where:

\[ \text{CMV} = (i)(\text{CMVi}) \]

where:

- \( \text{CMVi} \) = the current market value of transaction \( i \);

\[ \text{CMC} = (l)(\text{CMCl}) \]

where

- \( \text{CMCl} \) = the current market value of collateral \( l \);

\( i \) = index designating transaction;

\( l \) = index designating collateral;

\( j \) = index designating hedging set category. These hedging sets correspond to risk factors for which risk positions of opposite sign can be offset to yield a net risk position on which the exposure measure is then based;

- \( \text{RPT}_{ij} \) = risk position from transaction \( i \) with respect to hedging set \( j \);

- \( \text{RPC}_{lj} \) = risk position from collateral \( l \) with respect to hedging set \( j \);

- \( \text{CCRM}_j \) = CCR Multiplier set out in the Table in BIPRU 13.5.22R with respect to the hedging set \( j \);

\[ = 1.4. \]

[Note: BCD Annex III Part 5 point 1 (part)]

13.5.26 R

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

[Note: BCD Annex III Part 5 point 1 (part)]

13.5.27 R

A firm may only recognise collateral for this method if it is collateral that is eligible under ■ BIPRU 5.4.8 R and ■ BIPRU 14.2.12 G to ■ BIPRU 14.2.13 R.

[Note: BCD Annex III Part 5 point 1 (part)]

13.5.28 G

A worked example showing a US Dollar (USD)-based firm, single counterparty, single netting set, Risk-positions \( R_{ij} \) by hedging sets \( j \) is set out in ■ BIPRU 13 Annex 1 G
13.6 CCR internal model method

Introduction

13.6.1 R • BIPRU 13.6 sets out the rules relating to the CCR internal model method.

13.6.2 R A firm may only use the CCR internal model method if it has a CCR internal model method permission.

13.6.3 G • BIPRU 1.3 sets out the process for applying for a CCR internal model method permission.

13.6.4 G A firm’s CCR internal model method permission will modify BIPRU 13.6.2 R and will require the firm to use only the CCR internal model method, except to the extent that BIPRU 13 permits the firm to combine the use of the CCR internal model method with one or more other methods.

13.6.5 R (1) A reference in the Handbook to a provision of the CCR internal model method, in relation to a firm:

(a) excludes any provision of the CCR internal model method set out in the Handbook which is not applied to that firm by its CCR internal model method permission;

(b) includes any additional provision contained in the CCR internal model method permission; and

(c) takes into account any other amendments made to the provisions in the Handbook relating to the CCR internal model method made by the CCR internal model method permission.

(2) To the extent that a firm’s CCR internal model method permission does not allow it to use a particular approach in the Handbook relating to the CCR internal model method, the Handbook provision does not apply to the firm.

Scope

13.6.6 R A firm may determine the exposure value for:

(1) financial derivative instruments;

(2) repurchase transactions;
(3) securities or commodities lending or borrowing transactions;

(4) margin lending transactions; and

(5) long settlement transactions

using the CCR internal model method.

[Note: BCD Annex III Part 2 point 2]

13.6.7 **R** A firm may use the CCR internal model method to calculate the exposure value for:

(1) the transactions in ■ BIPRU 13.6.6 R (1); or

(2) the transactions in ■ BIPRU 13.6.6 R (2), ■ (3) and ■ (4); or

(3) the transactions in ■ BIPRU 13.6.6 R (1) to ■ (4).

[Note: BCD Annex III Part 6 point 1 (part)]

13.6.8 **R** In each of ■ BIPRU 13.6.7 R (1), ■ (2) and ■ (3), a firm may include long settlement transactions as well.

[Note: BCD Annex III Part 6 point 1 (part)]

**Use of other models**

13.6.9 **G** Point 2 of Part 6 of Annex III of the Banking Consolidation Directive provides that a firm using the CCR internal model method may use a type of model other than the type set out in ■ BIPRU 13.6. If the appropriate regulator agrees to this the details of the model and the necessary calculations will be set out in the CCR internal model method permission, which will modify ■ BIPRU 13.6 to the extent necessary. The appropriate regulator would not expect to agree to such a request unless the firm was able to satisfy the appropriate regulator that the method was at least as conservative as the method set out in BIPRU 13.6 and in particular that, for every counterparty, any method was more conservative than alpha multiplied by effective EPE calculated according to the equation in ■ BIPRU 13.6.27 R.

[Note: BCD Annex III Part 6 point 2 (second sentence) and point 11]

**Partial use**

13.6.10 **R** For all financial derivative instruments and for long settlement transactions which are outside the scope of a firm’s CCR internal model method permission, a firm must use the CCR mark to market method or the CCR standardised method.

[Note: BCD Annex III Part 6 point 3 first sentence]

13.6.11 **R** Under ■ BIPRU 13.6.10 R, combined use of the CCR mark to market method and the CCR standardised method is only permitted where one of the methods is used for the cases set out in ■ BIPRU 13.5.9 R to ■ BIPRU 13.5.10 R.

[Note: BCD Annex III Part 6 point 3 second sentence]
Notwithstanding ■ BIPRU 13.3.10 R (Combined use), a firm may choose not to apply the CCR internal model method to exposures that are immaterial in size and risk.

[Note: BCD Annex III Part 6 point 1 third sentence]

If permitted by its CCR internal model method permission, and subject to its terms, a firm may carry out the implementation of the CCR internal model method sequentially across different transaction types; and during this period the firm may use the CCR mark to market method or the CCR standardised method.

[Note: BCD Annex III Part 6 point 2]

After the initial period following the granting of its CCR internal model method permission, as referred to in ■ BIPRU 13.6.13 R, a firm should extend the use of the CCR internal model method to cover any new business within a product category covered by its CCR internal model method permission. Subject to ■ BIPRU 13.6.10 R to ■ BIPRU 13.6.13 R, the firm should do so within a reasonable period of time. If the firm decides to exclude any business on, for example, the basis of materiality, it should document its reasons clearly.

In principle, the use of different measures of exposure within the CCR internal model method is possible within the same product category, including on a permanent basis. The appropriate regulator may allow a firm, through the CCR internal model method permission, to use a more conservative measure of exposure that is less risk sensitive (for instance a measure based on conservative haircuts) for certain parts of the business if justified on a cost-benefit basis. However, a firm would still need to meet the use test for these more conservative measures and would need to demonstrate that the aggregation of CCR exposures that come from different approaches and have different degrees of conservatism makes sense and is used for its CCR management purposes.

The appropriate regulator may, through the CCR internal model method permission, require a firm to apply a multiplier to the measures of exposures coming out of a less risk-sensitive approach to calculating exposures as referred to in ■ BIPRU 13.6.15 G where the appropriate regulator considers this to be appropriate due to the complexity of the business or the nature of the risks involved.

Use of CCR internal model method

Subject to ■ BIPRU 13.6.10 R to ■ BIPRU 13.6.16 G, a firm that has a CCR internal model method permission must not use the CCR mark to market method or the CCR standardised method for transactions within the scope of the firm’s CCR internal model method permission.

[Note: BCD Annex III Part 6 point 4 (part)]
A firm which wishes to revert to the CCR mark to market method or the CCR standardised method will need to request the appropriate regulator to revoke or vary its CCR internal model method permission.

[Note: BCD Annex III Part 6 point 4 (part)]

The appropriate regulator will not agree to a firm’s request to revoke or vary its CCR internal model method permission except for demonstrated good cause.

[Note: BCD Annex III Part 6 point 4 (part)]

If a firm ceases to comply with the requirements set out in BIPRU 13.6, it must either present to the appropriate regulator a plan for a timely return to compliance or demonstrate that the effect of non-compliance is immaterial.

[Note: BCD Annex III Part 6 point 4 (part)]

If a firm ceases to comply with the requirements set out in BIPRU 13.6, the appropriate regulator may revoke the CCR internal model method permission or take other appropriate supervisory action.

[Note: BCD Annex III Part 6 point 4 (part)]

Exposure value

(1) A firm must measure the exposure value at the level of the netting set.

(2) The model must specify the forecasting distribution for changes in the market value of the netting set attributable to changes in market variables, such as interest rates, foreign exchange rates.

(3) The model must then compute the exposure value for the netting set at each future date given the changes in the market variables.

(4) For margined counterparties, the model may also capture future collateral movements.

[Note: BCD Annex III Part 6 point 5]

A firm may include eligible financial collateral as defined in BIPRU 5.4.8 R (Eligible collateral under financial collateral comprehensive method) and BIPRU 14.2.15 R to BIPRU 14.2.17 R in its forecasting distributions for changes in the market value of the netting set, if the quantitative, qualitative and data requirements for the CCR internal model method are met for the collateral.

[Note: BCD Annex III Part 6 point 6]

A firm must calculate the exposure value as the product of alpha (\(\alpha\)), as set out in BIPRU 13.6.31 R, times effective EPE:
Exposure value = effective EPE

[Note: BCD Annex III Part 6 point 7 first part]

**Effective EPE**

A firm must compute effective EPE by estimating expected exposure (EEt) as the average exposure at future date t, where the average is taken across possible future values of relevant market risk factors. The model estimates EE at a series of future dates t1, t2, t3, etc.

[Note: BCD Annex III Part 6 point 7 third part]

A firm must compute effective EE recursively as:

\[\text{Effective EE}_{tk} = \max(\text{effective EE}_{tk-1}; \text{EE}_{tk})\]

where:

the current date is denoted as t0 and Effective EE0 equals current exposure.

[Note: BCD Annex III Part 6 point 8]

For the purposes of BIPRU 13.6.25 R:

1. effective EPE is the average effective EE during the first year of future exposure;
2. if all contracts in the netting set mature within less than one year, effective EPE is the average of effective EE until all contracts in the netting set mature.

[Note: BCD Annex III Part 6 point 9, first part]

A firm must compute effective EPE as a weighted average of effective EE:

\[\text{Effective EPE} = \sum_{k=1}^{\min(1 \text{ year}; \text{maturity})} [(\text{Effective EE}_{tk})^*(t_k)]\]

where:

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

[Note: BCD Annex III Part 6 point 9, second part]

A firm must calculate EE or peak exposure measures based on a distribution of exposures that accounts for the possible non-normality of the distribution of exposures.

[Note: BCD Annex III Part 6 point 10]

[deleted]
For the purposes of BIPRU 13.6.24 R, alpha (\(\alpha\)) is 1.4 or any higher amount specified in the firm's CCR internal model method permission.

[Note: BCD Annex III Part 6 point 7 second part]

If the appropriate regulator does specify an alpha greater than 1.4, the reasons will be set out in the firm's CCR internal model method permission.

If a firm's CCR internal model method permission permits it, the firm may use its own estimates of \(\alpha\), subject to a floor of 1.2, where must equal the ratio of internal capital from a full simulation of CCR exposure across counterparties (numerator) and internal capital based on EPE (denominator).

[Note: BCD Annex III Part 6 point 12 (part)]

For the purposes of BIPRU 13.6.33 R:

1. in the denominator, EPE must be used as if it were a fixed outstanding amount;

2. a firm must be able to demonstrate that its internal estimates of capture in the numerator material sources of stochastic dependency of distribution of market values of transactions or of portfolios of transactions across counterparties;

3. internal estimates of must take account of the granularity of portfolios.

[Note: BCD Annex III Part 6 point 12 (part)]

A firm must ensure that the numerator and denominator of are computed in a consistent fashion with respect to the modelling methodology, parameter specifications and portfolio composition. The approach used must be based on the firm's internal capital approach, be well-documented and be subject to independent validation. In addition, a firm must review their estimates on at least a quarterly basis, and more frequently when the composition of the portfolio varies over time. A firm must also assess the model risk.

[Note: BCD Annex III Part 6 point 13]

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

[Note: BCD Annex III Part 6 point 14]

In reviewing its estimate of, a firm may not need to perform a full recalculation each quarter if it can demonstrate by other means that the estimate would not be materially different. A full recalculation should however be performed at least annually. If there is a structural change in the firm's portfolio that is likely to have the effect that the existing estimate of
will be inappropriate, the firm should also recalculate it. A firm should have procedures in place to identify any such structural changes.

### Maturity adjustment

**13.6.37** A firm using the IRB approach for risk weighting of exposures arising from a CCR internal model method should also apply a different maturity adjustment as set out in □ BIPRU 4.4.67 R □ BIPRU 4.4.70 R.

### Margin agreement

**13.6.38** If the netting set is subject to a margin agreement, a firm must use one of the following EPE measures:

1. **Effective EPE** without taking into account the margin agreement;

2. The margin threshold, if positive, under the margin agreement plus an add-on that reflects the potential increase in exposure over the margin period of risk:
   a. The add-on is computed as the expected increase in the netting set's exposure beginning from a current exposure of zero over the margin period of risk;
   b. A floor of five business days for netting sets consisting only of repo-style transactions subject to daily remargining and daily mark-to-market, and ten business days for all other netting sets is imposed on the margin period of risk used for this purpose.

3. If the model captures the effects of margining when estimating EE, the model's EE measure may be used directly in the equation in □ BIPRU 13.6.28 R (Computation of effective EE), unless the firm's CCR internal model method permission does not apply this provision or does not permit that use.

   **Note:** BCD Annex III Part 6 point 15

**13.6.39** Where the effects of margining are captured by the model itself, the appropriate regulator does not prescribe any floors for the margin period of risk but will challenge a firm that looks to use periods shorter than 5 days for repurchase agreements or reverse repurchase agreements or 10 days for financial derivative instruments.

### Operational requirements: General

**13.6.40** A firm's EPE model must meet the operational requirements set out in □ BIPRU 13.6.41 R to □ BIPRU 13.6.66 R.

   **Note:** BCD Annex III Part 6 point 16

### Operational requirements: CCR control

**13.6.41** The firm must have a control unit that is responsible for the design and implementation of its CCR management system, including the initial and on-going validation of the model.
(2) This unit must control input data integrity and produce and analyse reports on the output of the firm’s risk measurement model, including an evaluation of the relationship between measures of risk exposure and credit and trading limits.

(3) This unit must be:

(a) independent from units responsible for originating, renewing or trading exposures and free from undue influence;
(b) it must be adequately staffed; and
(c) it must report directly to the senior management of the firm.

(4) The work of this unit must be closely integrated into the day-to-day credit risk management process of the firm; its output must, accordingly, be an integral part of the process of planning, monitoring and controlling the firm’s credit and overall risk profile.

[Note: BCD Annex III Part 6 point 17]

13.6.42 R

(1) A firm must have CCR management policies, processes and systems that are conceptually sound and implemented with integrity.

(2) A sound CCR management framework must include the identification, measurement, management, approval and internal reporting of CCR.

[Note: BCD Annex III Part 6 point 18]

13.6.43 R

(1) A firm’s risk management policies must take account of market risk, liquidity risk, and legal and operational risk that can be associated with CCR.

(2) The firm must not undertake business with a counterparty without assessing its creditworthiness and must take due account of settlement and pre-settlement credit risk.

(3) These risks must be managed as comprehensively as practicable at the counterparty level (aggregating CCR exposures with other credit exposures) and at the firm-wide level.

[Note: BCD Annex III Part 6 point 19]

13.6.44 R

A firm’s governing body and senior management must be actively involved in the CCR control process and must regard this as an essential aspect of the business to which significant resources need to be devoted. Senior management must be aware of the limitations and assumptions of the model used and the impact these can have on the reliability of the output. Senior management must also consider the uncertainties of the market environment and operational issues and be aware of how these are reflected in the model.

[Note: BCD Annex III Part 6 point 20]

13.6.45 R

A firm must ensure that the daily reports prepared on its exposures to CCR are reviewed by a level of management with sufficient seniority and
authority to enforce both reductions of positions taken by individual credit managers or traders and reductions in the firm's overall CCR exposure.

[Note: BCD Annex III Part 6 point 21]

13.6.46  
(1) A firm's CCR management system must be used in conjunction with internal credit and trading limits.

(2) A firm must ensure that its credit and trading limits are related to its risk measurement model in a manner that is:
   (a) consistent over time; and
   (b) well understood by credit managers, traders and senior management.

[Note: BCD Annex III Part 6 point 22]

13.6.47  
(1) A firm's measurement of CCR must include measuring daily and intra-day usage of credit lines.

(2) The firm must measure current exposure gross and net of collateral.

(3) At portfolio and counterparty level, the firm must calculate and monitor peak exposure or potential future exposure (PFE) at the confidence interval chosen by the firm.

(4) The firm must take account of large or concentrated positions, including by groups of related counterparties, by industry, by market, etc.

[Note: BCD Annex III Part 6 point 23]

13.6.48  
(1) A firm must have a routine and rigorous program of stress testing in place as a supplement to the CCR analysis based on the day-to-day output of the firm's risk measurement model.

(2) The results of this stress testing must be reviewed periodically by senior management and must be reflected in the CCR policies and limits set by management and the governing body.

(3) Where stress tests reveal particular vulnerability to a given set of circumstances, prompt steps must be taken to manage those risks appropriately.

[Note: BCD Annex III Part 6 point 24]

13.6.49  
(1) A firm must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operation of the CCR management system.

(2) The firm's CCR management system must be well documented and must provide an explanation of the empirical techniques used to measure CCR.

[Note: BCD Annex III Part 6 point 25]
A firm must conduct an independent review of the CCR management system regularly through its own internal auditing process. This review must include both the activities of the business units referred to in BIPRU 13.6.41 R and of the independent CCR control unit. A review of the overall CCR management process must take place at regular intervals and must specifically address, at a minimum:

1. the adequacy of the documentation of the CCR management system and process;
2. the organisation of the CCR control unit;
3. the integration of CCR measures into daily risk management;
4. the approval process for risk pricing models and valuation systems used by front and back-office personnel;
5. the validation of any significant change in the CCR measurement process;
6. the scope of CCR captured by the risk measurement model;
7. the integrity of the management information system;
8. the accuracy and completeness of CCR data;
9. the verification of the consistency, timeliness and reliability of data sources used to run models, including the independence of such data sources;
10. the accuracy and appropriateness of volatility and correlation assumptions;
11. the accuracy of valuation and risk transformation calculations; and
12. the verification of the model's accuracy through frequent back-testing.

[Note: BCD Annex III Part 6 point 26]

Operational requirements: Use test

The distribution of exposures generated by the model used to calculate effective EPE must be closely integrated into the day-to-day CCR management process of the firm. The model's output must accordingly play an essential role in the credit approval, CCR management, internal capital allocation, and corporate governance of the firm.

[Note: BCD Annex III Part 6 point 27]

A firm must have a track record in the use of models that generate a distribution of exposures to CCR. Thus, the firm must be able to demonstrate that it has been using a model to calculate the distribution of exposures upon which the EPE calculation is based that meets, broadly, the minimum requirements set out in BIPRU 13.6 for at least one year prior to the date of its CCR internal model method permission.

[Note: BCD Annex III Part 6 point 28]
(1) A firm must ensure that the model used to generate a distribution of exposures to CCR is part of a CCR management framework that includes the identification, measurement, management, approval and internal reporting of CCR. This framework must include the measurement of usage of credit lines (aggregating CCR exposures with other credit exposures) and internal capital allocation.

(2) In addition to EPE, a firm must measure and manage current exposures.

(3) Where appropriate, the firm must measure current exposure gross and net of collateral.

(4) The use test is satisfied if a firm uses other CCR measures, such as peak exposure or PFE (see BIPRU 13.6.47 R), based on the distribution of exposures generated by the same model to compute EPE.

[Note: BCD Annex III Part 6 point 29]

A firm must have the systems capability to estimate EE daily if necessary, unless it is able to demonstrate to the appropriate regulator that its exposures to CCR warrant less frequent calculation. The firm must compute EE along a time profile of forecasting horizons that adequately reflects the time structure of future cash flows and maturity of the contracts and in a manner that is consistent with the materiality and composition of the exposures.

[Note: BCD Annex III Part 6 point 30]

(1) Exposure must be measured, monitored and controlled over the life of all contracts in the netting set (not just to the one year horizon).

(2) A firm must have procedures in place to identify and control the risks for counterparties where the exposure rises beyond the one-year horizon.

(3) A firm must input the forecast increase in exposure into the firm’s internal capital model.

[Note: BCD Annex III Part 6 point 31]

Operational requirements: Stress testing

(1) A firm must have in place sound stress testing processes for use in the assessment of capital adequacy for CCR.

(2) These stress measures must be compared with the measure of EPE and considered by the firm as part of the process set out in GENPRU 1.2.42 R.

(3) Stress testing must also involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a firm’s credit exposures and an assessment of the firm’s ability to withstand such changes.

[Note: BCD Annex III Part 6 point 32]
13.6.57 A firm must stress test its CCR exposures, including jointly stressing market risk and credit risk factors.

(2) In its stress tests of CCR, a firm must consider concentration risk (to a single counterparty or groups of counterparties), correlation risk across market risk and credit risk, and the risk that liquidating the counterparty's positions could move the market.

(3) In its stress tests a firm must also consider the impact on its own positions of such market moves and integrate that impact in its assessment of CCR.

[Note: BCD Annex III Part 6 point 33]

Operational requirements: Wrong-way risk

13.6.58 A firm must give due consideration to exposures that give rise to a significant degree of general wrong-way risk.

[Note: BCD Annex III Part 6 point 34]

13.6.59 A firm must have procedures in place to identify, monitor and control cases of specific wrong-way risk, beginning at the inception of a transaction and continuing through the life of the transaction.

[Note: BCD Annex III Part 6 point 35]

Operational requirements: Integrity of modelling process

13.6.60 A firm must ensure that:

(1) the model reflects transaction terms and specifications in a timely, complete, and conservative fashion;

(2) such terms include at least:

(a) contract notional amounts;
(b) maturity;
(c) reference assets;
(d) margining arrangements; and
(e) netting arrangements;

(3) the terms and specifications are maintained in a database that is subject to formal and periodic audit;

(4) the process for recognising netting arrangements requires:

(a) signoff by legal staff to verify the legal enforceability of netting and
(b) input into the database by an independent unit;

(5) the transmission of transaction terms and specifications data to the model is also subject to internal audit; and

(6) formal reconciliation processes are in place between the model and source data systems to verify on an ongoing basis that transaction
terms and specifications are being reflected in EPE correctly or at least conservatively.

[Note: BCD Annex III Part 6 point 36]

### 13.6.61

A **firm** must ensure that:

1. the model employs current market data to compute current exposures;
2. when using historical data to estimate volatility and correlations, at least three years of historical data are used and updated quarterly or more frequently if market conditions warrant;
3. the data covers a full range of economic conditions, such as a full business cycle;
4. a unit independent from the business unit validates the price supplied by the business unit;
5. the data is acquired independently of the lines of business, fed into the model in a timely and complete fashion, and maintained in a database subject to formal and periodic audit;
6. it has a well-developed data integrity process to clean the data of erroneous and/or anomalous observations; and
7. to the extent that the model relies on proxy market data, including for new products where three years of historical data may not be available, internal policies identify suitable proxies and the **firm** demonstrates empirically that the proxy provides a conservative representation of the underlying risk under adverse market conditions.

[Note: BCD Annex III Part 6 point 37]

### 13.6.62

If the model includes the effect of collateral on changes in the market value of the netting set, a **firm** must have adequate historical data to model the volatility of the collateral.

### 13.6.63

A **firm** must ensure that the model is subject to a validation process which:

1. is clearly articulated in **firms'** policies and procedures;
2. specifies the kind of testing needed to ensure model integrity
3. identifies conditions under which assumptions are violated and may result in an understatement of EPE; and
4. includes a review of the comprehensiveness of the model.

[Note: BCD Annex III Part 6 point 38]
A firm must monitor the appropriate risks and have processes in place to adjust its estimation of EPE when those risks become significant. This includes the following:

1. The firm must identify and manage its exposures to specific wrong-way risk;

2. For exposures with a rising risk profile after one year, the firm must compare on a regular basis the estimate of EPE over one year with EPE over the life of the exposure; and

3. For exposures with a residual maturity below one year, the firm must compare on a regular basis the replacement cost (current exposure) and the realised exposure profile, and/or store data that would allow such a comparison.  
   [Note: BCD Annex III Part 6 point 39]

A firm must have internal procedures to verify that, prior to including a transaction in a netting set, the transaction is covered by a legally enforceable netting contract that meets the requirements set out in BIPRU 13.7.  
[Note: BCD Annex III Part 6 point 40]

A firm that makes use of collateral to mitigate its CCR must have internal procedures to verify that, prior to recognising the effect of collateral in its calculations, the collateral meets the legal certainty standards set out in BIPRU 5 as modified, where relevant, by BIPRU 4.10.  
[Note: BCD Annex III Part 6 point 41]

Validation requirements

(1) A firm’s CCR internal model method model must meet the validation requirements in (2) to (8).

(2) The qualitative validation requirements set out in BIPRU 7.10 must be met.

(3) Interest rates, foreign currency rates, equity prices, commodities, and other market risk factors must be forecast over long time horizons for measuring CCR exposure. The performance of the forecasting model for market risk factors must be validated over a long time horizon.

(4) The pricing models used to calculate CCR exposure for a given scenario of future shocks to market risk factors must be tested as part of the CCR internal model method model validation process. Pricing models for options must account for the nonlinearity of option value with respect to market risk factors.

(5) The CCR internal model method model must capture transaction-specific information in order to aggregate exposures at the level of the netting set. A firm must verify that transactions are assigned to the appropriate netting set within the model.
(6) The CCR internal model method model must also include transaction-specific information to capture the effects of margining. It must take into account both the current amount of margin and margin that would be passed between counterparties in the future. Such a model must account for the nature of margin agreements (unilateral or bilateral), the frequency of margin calls, the margin period of risk, the minimum threshold of unmargined exposure the firm is willing to accept, and the minimum transfer amount. Such a model must either model the mark-to-market change in the value of collateral posted or apply the rules set out in ■ BIPRU 5 as modified, where relevant, by ■ BIPRU 4.10.

(7) Static, historical backtesting on representative counterparty portfolios must be part of the CCR internal model method model validation process. At regular intervals, a firm must conduct such backtesting on a number of representative counterparty portfolios (actual or hypothetical). These representative portfolios must be chosen based on their sensitivity to the material risk factors and correlations to which the firm is exposed.

(8) If backtesting indicates that the CCR internal model method model is not sufficiently accurate, a firm must increase the credit risk capital component and, where ■ BIPRU 13 is applied for the purposes of ■ BIPRU 14, the counterparty risk capital component by an amount which is conservatively estimated to compensate for the inaccuracy of the model.

[Note: BCD Annex III Part 6 point 42 (part)]

13.6.68 If backtesting indicates that the CCR internal model method model is not sufficiently accurate, the appropriate regulator may revoke a firm’s CCR internal model method permission or take appropriate measures to ensure that the model is improved promptly. Measures taken by the appropriate regulator may include the use of its own-initiative power to require the firm to hold more capital resources.

[Note: BCD Annex III Part 6 point 42 (part)]
13.7 Contractual netting

Scope

13.7.1 BIPRU 13.7 applies for the purpose of:

(1) the CCR mark to market method;
(2) the CCR standardised method;
(3) if the firm has a CCR internal model method permission, the CCR internal model method.

Types of netting recognised

13.7.2 For the purpose of BIPRU 13.7:

(1) counterparty means any entity (including natural persons) that has the power to conclude a contractual netting agreement; and
(2) contractual cross product netting agreement means a written bilateral agreement between a firm and a counterparty which creates a single legal obligation covering all included bilateral master agreements and transactions belonging to different product categories.

[Note: BCD Annex III Part 7 point (a) (part)]

13.7.3 Contractual cross product netting agreements do not cover netting other than on a bilateral basis.

[Note: BCD Annex III Part 7 point (a) (part)]

13.7.4 For the purposes of cross product netting, the following are considered different product categories:

(1) repurchase transactions, reverse repurchase transactions, securities or commodities lending or borrowing transactions;
(2) margin lending transactions; and
(3) financial derivative instruments.

[Note: BCD Annex III Part 7 point (a) (part)]
A firm may recognise as risk-reducing the following types of contractual netting:

1. bilateral contracts for novation between a firm and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts;

2. other bilateral agreements between a firm and its counterparty; and

3. a firm that has a CCR internal model method permission may recognise Contractual cross product netting agreements for transactions falling within the scope of its CCR internal model method permission; netting across transactions entered by members of a group is not recognised for the purposes of calculating capital requirements.

[Note: BCD Annex III Part 7 point (a) (part)]

Conditions for recognition

A firm may treat contractual netting as risk-reducing only under the following conditions:

1. the firm must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty’s failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the firm would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

2. the firm must be in a position to provide to the appropriate regulator, if requested, written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (1), find that the firm’s claims and obligations would be limited to the net sum, as described in (1), under:

   a) the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located;

   b) the law that governs the individual transactions included; and

   c) the law that governs any contract or agreement necessary to effect the contractual netting;

3. the firm must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws;

4. the firm must maintain all required documentation in its files;

5. the effects of netting must be factored into the firm’s measurement of each counterparty’s aggregate credit risk exposure and the firm must manage its CCR on such a basis; and
(6) the firm must aggregate credit risk to each counterparty to arrive at a single legal exposure across transactions; this aggregation must be factored into credit limit purposes and internal capital purposes.

[Note: BCD Annex III Part 7 point (b) (part)]

13.7.7 R If any of the competent authorities concerned is not satisfied that the contractual netting is legally valid under the law of each of the relevant jurisdictions, the firm must not treat the contractual netting agreement as risk-reducing.

[Note: BCD Annex III Part 7 point (b) (part)]

13.7.8 R A legal opinion required under ■ BIPRU 13.7.6 R (2) may be in the form of a reasoned legal opinion drawn up by type of contractual netting.

[Note: BCD Annex III Part 7 point (b) (part)]

13.7.9 R A firm must not recognise as risk-reducing any contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a "walkaway" clause).

[Note: BCD Annex III Part 7 point (b) (part)]

13.7.10 R In addition to the requirements in ■ BIPRU 13.7.2 R to ■ BIPRU 13.7.9 R, for contractual cross product netting agreements the following criteria must be met:

(1) the net sum referred to in ■ BIPRU 13.7.6 R (1) must be the net sum of the positive and negative close out values of any included individual bilateral master agreement and of the positive and negative mark-to-market value of the individual transactions (the Cross-Product Net Amount);

(2) the written and reasoned legal opinions referred to in ■ BIPRU 13.7.6 R (2) must address the validity and enforceability of the entire contractual cross product netting agreement under its terms and the impact of the netting arrangement on the material provisions of any included individual bilateral master agreement; a legal opinion must be generally recognised as such by the legal community in the United Kingdom or a memorandum of law that addresses all relevant issues in a reasoned manner;

(3) the firm must have procedures in place under ■ BIPRU 13.7.6 R (3) to verify that any transaction which is to be included in a netting set is covered by a legal opinion; and

(4) taking into account the contractual cross product netting agreement, the firm must continue to comply with the requirements for the recognition of bilateral netting and the requirements of ■ BIPRU 4.10 and ■ BIPRU 5 for the recognition of credit risk mitigation, as applicable, with respect to each included individual bilateral master agreement and transaction.

[Note: BCD Annex III Part 7 point (b) (part)]
Effects of recognition

For the purposes of the CCR mark to market method, the CCR standardised method and the CCR internal model method a firm must recognise netting as set out in ■ BIPRU 13.3 and ■ BIPRU 13.6.

[Note: BCD Annex III Part 7 point (b) (part)]
13.8 Securities financing transactions

Purpose

13.8.1 G BIPRU 13.8 summarises the treatment for securities financing transactions.

Calculation of exposure value for SFTs

13.8.2 R Subject to BIPRU 13.8.3 R, in respect of a securities financing transaction, if a firm:

(1) has a CCR internal model method permission which covers the transaction; or

(2) has a master netting agreement internal models approach permission which covers the transaction;

then the firm must use the CCR internal model method approach or the master netting agreement internal models approach, as applicable, to calculate the exposure value for that transaction unless an exception in BIPRU 13 or BIPRU 5 allows the firm to use another method.

[Note: BCD Article 78(2), second sentence, in respect of SFTs]

13.8.3 R If a firm has a CCR internal model method permission and a master netting agreement internal models approach permission, and both cover a securities financing transaction, then the firm may choose which of those approaches it wishes to use to calculate the exposure value for that transaction.

13.8.4 R Where BIPRU 13.8.2 R does not apply, a firm must use one of the following approaches to determine the exposure value of a securities financing transaction, as appropriate:

(1) if the transaction is covered by a master netting agreement which satisfies the requirements for recognition set out in BIPRU 5.6.1 R to BIPRU 5.6.3 R, a firm may calculate the exposure value under the master netting agreement method set out in BIPRU 5.6.5 R to BIPRU 5.6.11 R (Calculation of the fully adjusted exposure value: the supervisory volatility adjustments approach and the own estimates of volatility adjustments approach);

(2) otherwise, a firm must calculate the exposure value of the transaction as its on-balance sheet value.
A firm calculating risk weighted exposure amounts under the standardised approach to credit risk will not be eligible to use the approach in BIPRU 13.8.4 R (1) if it is using the financial collateral simple method to determine the effects of credit risk mitigation, as set out in BIPRU 5.4.16 R.

If a firm calculates the exposure value of a securities financing transaction as its on-balance sheet value, in accordance with BIPRU 13.8.4 R (2), it may recognise the effects of financial collateral in the same way as for its other exposures, for example by using either the financial collateral simple method or the financial collateral comprehensive method. However firms should note that the financial collateral simple method is not available:

1. to a firm using the IRB approach (BIPRU 5.4.16 R); or
2. for securities financing transactions in the trading book (BIPRU 14.2.11 R).

Exposure to a central counterparty

A firm may attribute an exposure value of zero for CCR to a securities financing transaction or to any other exposures in respect of that transaction (but excluding an exposure arising from collateral held to mitigate losses in the event of the default of other participants in the central counterparty’s arrangements) which is outstanding with a central counterparty and has not been rejected by the central counterparty.

[Note: BCD Annex III Part 2 point 6 in respect of SFTs]
BIPRU 13 : The calculation of counterparty risk exposure values for financial derivatives,...

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>Interest rate risk hedging sets</th>
<th>FX risk hedging sets</th>
<th>Equities risk</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
<td>EUR</td>
<td>JPY</td>
</tr>
<tr>
<td></td>
<td>non-</td>
<td>non-</td>
<td>non-</td>
</tr>
<tr>
<td></td>
<td>gov</td>
<td>gov</td>
<td>gov</td>
</tr>
<tr>
<td></td>
<td>M&lt;1</td>
<td>M&gt;5</td>
<td>M&lt;1</td>
</tr>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>million</td>
</tr>
<tr>
<td>$ years</td>
<td>years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$ million</td>
<td>million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 USD IR swap receiver leg</td>
<td>80</td>
<td>8</td>
<td>-6</td>
</tr>
<tr>
<td>1 USD IR swap payer leg</td>
<td>80</td>
<td>-0.25</td>
<td>-20</td>
</tr>
<tr>
<td>2 USD IR swap receiver leg</td>
<td>300</td>
<td>0.125</td>
<td>37.5</td>
</tr>
<tr>
<td>2 USD IR swap payer leg</td>
<td>300</td>
<td>-6</td>
<td>2</td>
</tr>
<tr>
<td>3 EUR FX swap receiver leg</td>
<td>100</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>3 USD FX swap payer leg</td>
<td>100</td>
<td>-</td>
<td>-12.5</td>
</tr>
<tr>
<td>4 EUR cross ccy swap receiver leg</td>
<td>60</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>4 JPY cross ccy swap payer leg</td>
<td>60</td>
<td>-7</td>
<td>-420</td>
</tr>
<tr>
<td>5 DAX Total return swap in EUR receiver leg</td>
<td>150</td>
<td>0.125</td>
<td>4</td>
</tr>
<tr>
<td>5 DAX Total return swap payer leg</td>
<td>150</td>
<td>not applicable</td>
<td>-150</td>
</tr>
</tbody>
</table>
### The calculation of counterparty risk exposure values for financial derivatives

<table>
<thead>
<tr>
<th></th>
<th>Interest rate risk hedging sets</th>
<th>FX risk hedging sets</th>
<th>Equity risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sum of risk positions RPTij by hedging setj</td>
<td>5 18.75 1920 -420 310 -60 -150</td>
<td>1160</td>
<td></td>
</tr>
<tr>
<td>Absolute amount</td>
<td></td>
<td>1160 18.75 1920 420 310 60 150</td>
<td></td>
</tr>
<tr>
<td>Credit conversion factors CCFj by hedging setj</td>
<td>0.20% 0.20% 0.20% 0.20% 250% 250% 7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCFj x</td>
<td></td>
<td>0.0100 23200 0.0375 38400 0.8400 7.7500 1.5000 105000</td>
<td></td>
</tr>
<tr>
<td>Sum of (CCFj x</td>
<td></td>
<td>26.7975</td>
<td></td>
</tr>
<tr>
<td>CMV: sum of current market values CMVi of the transactions</td>
<td></td>
<td>1.000</td>
<td></td>
</tr>
<tr>
<td>Max(CMV, sum of (CCFj x</td>
<td></td>
<td>26.7975</td>
<td></td>
</tr>
<tr>
<td>Beta:</td>
<td></td>
<td>1.4000</td>
<td></td>
</tr>
<tr>
<td>EAD</td>
<td>37.5165</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Chapter 14

Capital requirements for settlement and counterparty risk
14.1 Application and purpose

Application

14.1.1 BIPRU 14 applies to a BIPRU firm.

14.1.2

(1) BIPRU 14.2 deals with the calculation of the capital requirement for CCR for trading book positions arising from financial derivative instruments, securities financing transactions and long settlement transactions. The approaches used to calculate exposure values and risk weighted exposure amounts for these positions are largely based on the approaches applicable to non-trading book positions (BIPRU 3, BIPRU 4, BIPRU 5 and BIPRU 13). However, there are some treatments that are specific to the trading book. These are set out in BIPRU 14.2.

(2) The calculation of the capital requirement for CCR for trading book positions is the first element of the counterparty risk capital component in BIPRU 14.2.1 R. The second element of the counterparty risk capital component is for unsettled transactions in both the trading book and the non-trading book. It is calculated under BIPRU 14.3.

(3) BIPRU 14.4 sets out the treatment for free deliveries.

Purpose

14.1.3 Pursuant to the third paragraph of article 95(2) of the EU CRR, BIPRU 14 implements:

(1) Article 3(1)(h), Article 17(1), and Article 40; and

(2) Annex II;

of the Capital Adequacy Directive.
14.2 Calculation of the capital requirement for CCR

Calculation of the counterparty risk capital component

14.2.1 A firm must calculate the counterparty risk capital component as the sum of:

(1) the capital requirement calculated under BIPRU 14.2.13 R; and

(2) the amount calculated under BIPRU 14.3.

14.2.2 A firm must hold capital calculated in accordance with BIPRU 14.2.13 R against the CCR arising from exposures arising in the trading book due to the following:

(1) free deliveries (where BIPRU 14.4 requires it to be treated as an exposure);

(2) financial derivative instruments and credit derivatives;

(3) repurchase agreements, reverse repurchase agreements, securities or commodities lending or borrowing transaction based on securities or commodities included in the trading book;

(4) margin lending transactions based on securities or commodities; and

(5) long settlement transactions.

[Note: CAD Annex II point 5]

Credit derivatives

14.2.3 For the purposes of the calculation of the counterparty risk capital component, a financial derivative instrument means:

(1) an item falling within BIPRU 13.3.3 R other than an item to which an exposure value of zero is attributed under BIPRU 13.3.13 R or BIPRU 13.8.8 R (Exposure to a central counterparty); and

(2) a credit derivative.

[Note: CAD Article 3(1)(h) and Annex II point 7 first sentence]

14.2.4 BIPRU 14.2.5 R to BIPRU 14.2.8 R apply for the purposes of BIPRU 13.4 (CCR mark to market method).
14.2.5 R In the case of total return swap credit derivatives and credit default swap credit derivatives, a firm must obtain a figure for potential future credit exposure by multiplying the nominal amount of the instrument by the following percentages:

1. 5% where the reference obligation is one that if it gave rise to a direct exposure of the firm would be a qualifying debt security for the purposes of BIPRU 7.2;

2. 10% where the reference obligation is one that if it gave rise to a direct exposure of the firm would not be a qualifying debt security for the purposes of BIPRU 7.2.

[Note: CAD Annex II point 7 (part)]

14.2.6 R In the case of a credit default swap, a firm the exposure of which arising from the swap represents a long position in the underlying may use a figure of 0% for potential future credit exposure, unless the credit default swap is subject to closeout upon the insolvency of the entity the exposure of which arising from the swap represents a short position in the underlying, even though the underlying has not defaulted, in which case the potential for future credit exposure of the firm must be limited to the amount of premia which are not yet paid by the entity to the firm.

[Note: CAD Annex II point 7]

14.2.7 G BIPRU 14.2.6 R permits the seller of credit protection to determine potential future credit exposure as 0%, unless the protection is subject to close-out on the insolvency of the buyer.

14.2.8 R Where the credit derivative provides protection in relation to 'nth to default' amongst a number of underlying obligations, a firm must apply the percentage figure in BIPRU 14.2.5 R applicable to the obligation with the nth lowest credit quality determined by whether it is one that if incurred by the firm would be a qualifying debt security for the purposes of BIPRU 7.2.

14.2.9 G The operation of BIPRU 14.2.8 R can be illustrated by an example as follows: where the credit derivative is a first to default transaction, the appropriate percentage for the potential future credit exposure will be determined by the lowest credit quality of the underlying obligations in the basket. If there are non-qualifying items in the basket, the percentage applicable to the non-qualifying reference obligation should be used. For second and subsequent to default transactions, underlying assets should continue to be allocated according to credit quality: i.e. for a second to default transaction, the applicable percentage figure is the percentage applicable to the second lowest credit quality.

14.2.10 R Where a credit derivative included in the trading book forms part of an internal hedge and the credit protection is recognised under the BCD, there is deemed to be no counterparty risk arising from the position in the credit derivative. Alternatively, a firm may consistently include for the purposes of calculating capital requirements for counterparty credit risk all credit derivatives included in the trading book forming part of internal hedges or
purchased as protection against **CCR exposure** where the credit protection is recognised under the **BCD**.

**Note:** CAD Annex II point 11

### Calculation

14.2.11 Subject to ■ BIPRU 14.2.3 R to ■ BIPRU 14.2.5 R and ■ BIPRU 14.2.14 R to ■ BIPRU 14.2.17 R, a **firm** must calculate exposure values and **risk weighted exposure amounts** for the exposures falling under ■ BIPRU 14.2.2 R (1) to ■ BIPRU 14.2.2R (5) in accordance with:

1. the **standardised approach** to credit risk; or
2. if the **firm** has an **IRB permission**, the **IRB approach** in accordance with the terms of the **firm’s IRB permission**.

**Note:** CAD Annex II point 6

14.2.12 For the purpose of calculating counterparty exposure values for **financial derivative instruments**, **securities financing transactions** and **long settlement transactions**, or for **credit risk mitigation**, the effect of ■ BIPRU 14.2.11 R is to direct a **firm** to ■ BIPRU 13 or ■ BIPRU 5 as appropriate.

14.2.13 A **firm** must calculate the capital requirement for the purposes of ■ BIPRU 14.2.2 R as 8% of the total **risk weighted exposure amounts**.

**Note:** CAD Annex II point 12

### Collateral

14.2.14 For the purposes of ■ BIPRU 14.2.11 R, in calculating **risk weighted exposure amounts** a **firm** must not use the **financial collateral simple method** for the recognition of the effects of financial collateral.

**Note:** CAD Annex II point 8

14.2.15 For the purposes of ■ BIPRU 14.2.11 R:

1. in the case of **repurchase transactions** and **securities or commodities lending or borrowing transactions** booked in the **trading book**, all **CRD financial instruments** and **commodities** that are eligible to be included in the **trading book** may be recognised as eligible collateral;

2. for exposures due to **financial derivative instruments and long settlement transactions** booked in the **trading book**, **commodities** that are eligible to be included in the **trading book** may also be recognised as eligible collateral;

3. for the purposes of calculating volatility adjustments where such **CAD financial instruments or commodities** which are not eligible under ■ BIPRU 5 and ■ BIPRU 4.10 are lent, sold or provided, or borrowed, purchased or received by way of collateral or otherwise under such a transaction, and the **firm** is using the **supervisory volatility adjustments approach**, such instruments and commodities must be treated in the same way as non-main index equities listed on a
recognised investment exchange or a designated investment exchange.

[Note: CAD Annex II point 9 (part)]

14.2.16  R

(1) Where a firm is using the own estimates of volatility adjustments approach in respect of CAD financial instruments or commodities which are not eligible under BIPRU 5 and BIPRU 4.10 it must calculate volatility adjustments for each individual item.

(2) Where a firm is using the master netting agreement internal models approach set out in BIPRU 5, it may also apply this approach in the trading book.

[Note: CAD Annex II point 9 (part)]

14.2.17  R

For the purposes of BIPRU 14.2.11 R, in relation to the recognition of master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions netting across positions in the trading book and the non-trading book may only be recognised when the netted transactions fulfil the following conditions:

(1) all transactions are marked to market daily;

(2) any items borrowed, purchased or received under the transactions may be recognised as eligible financial collateral under BIPRU 5 and BIPRU 4.10 without the application of BIPRU 14.2.14 R to BIPRU 14.2.15 R.

[Note: CAD Annex II point 9 (part)]

Treatment of expected loss amounts under the IRB approach

14.2.18  R

Where a firm calculates risk weighted exposure amounts for the purposes of BIPRU 14 in accordance with the IRB approach, then for the purposes of the calculation provided for in BIPRU 4.3.8 R, the following will apply:

(1) value adjustments made to take account of the credit quality of the counterparty may be included in the sum of value adjustments and provisions made for the exposures indicated in BIPRU 14; and

(2) unless the firm’s IRB permission does not permit it, if the credit risk of the counterparty is adequately taken into account in the valuation of a position included in the trading book the expected loss amount for the counterparty risk exposure must be zero.

[Note: CAD Article 17(1)]

14.2.19  R
[deleted]
Exposures to recognised third-country investment firms, recognised clearing houses and designated investment exchanges

14.2.20  R  For the purposes of the calculation of the counterparty risk capital component, without prejudice to BIPRU 13.3.13 R and BIPRU 13.8.8 R (Exposure to a central counterparty) exposures to recognised third-country investment firms and exposures incurred to recognised clearing houses and designated investment exchanges must be treated as exposures to institutions.

[Note: CAD Article 40]

Netting of trading book exposures against non-trading book exposures

14.2.21  R  For the purposes of counterparty credit risk, a firm may net exposures arising from items in the trading book against exposures arising from items in the non-trading book.

14.2.22  R  Where a firm carries out netting under BIPRU 14.2.21 R, it must allocate the net exposure to:

(1) the trading book for the purposes of the calculation under BIPRU 14.2.11 R, if the gross trading book exposures exceed gross non-trading book exposures; and

(2) the non-trading book for the purposes of BIPRU 13, if the gross non-trading book exposures exceed gross trading book exposures.

14.2.23  R  A firm may only net exposures under BIPRU 14.2.21 R if it continues to meet other GENPRU and BIPRU requirements applicable to the trading book or non-trading book in respect of those exposures.

14.2.24  G  For example, in relation to BIPRU 14.2.23 R, collateral which is eligible only against trading book exposures will not be applicable against non-trading book exposures; and the large exposures limits on non-trading book positions will also remain applicable.
14.3 Unsettled transactions

Scope


14.3.2 The capital requirement for unsettled transactions is an element of the counterparty risk capital component set out in BIPRU 14.2.1 R.

Calculation

14.3.3 In the case of transactions in which debt instruments, equities, foreign currencies and commodities (excluding repurchase agreements and reverse repurchase agreements and securities or commodities lending and securities or commodities borrowing) are unsettled after their due delivery dates, a firm must calculate the price difference to which it is exposed, being the difference between the agreed settlement price for the debt instrument, equity, foreign currency or commodity in question and its current market value, where the difference could involve a loss for the firm.

[Note: CAD Annex II point 1 (part)]

14.3.4 A firm must multiply the price difference calculated under BIPRU 14.3.3 R by the appropriate factor in column A of the Table in BIPRU 14.3.4 R in order to calculate its capital requirement for the purposes of BIPRU 14.3.

[Note: CAD Annex II point 1 (part)]

Table: Factors for the multiplication of price differences

<table>
<thead>
<tr>
<th>Number of working days after due settlement date</th>
<th>Column A (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 - 15</td>
<td>8</td>
</tr>
<tr>
<td>16 - 30</td>
<td>50</td>
</tr>
<tr>
<td>31 - 45</td>
<td>75</td>
</tr>
<tr>
<td>46 or more</td>
<td>100</td>
</tr>
</tbody>
</table>

[Note: CAD Annex II Table 1]

14.3.5 In cases of a system wide failure of a settlement or clearing system, a firm should refer to the emergency provisions in GEN 1.3. Where the
requirements of GEN 1.3.2 R are met, until the situation is rectified failure of a counterparty to settle a trade will not be deemed a default for purposes of credit risk.

[Note: CAD Annex II point 4]
14.4 Free deliveries

Scope


14.4.2 A firm must hold capital resources with respect to a free delivery, as set out in the Table in BIPRU 14.4.3 R, if:

1. it has paid for securities, foreign currencies or commodities before receiving them or it has delivered securities foreign currencies or commodities before receiving payment for them; and
2. in the case of cross-border transactions, one day or more has elapsed since it made that payment or delivery.

[Note: CAD Annex II point 2]

Exposure

14.4.3 Table: Capital treatment for free deliveries

This table belongs to BIPRU 14.4.2 R.

<table>
<thead>
<tr>
<th>Transaction Type</th>
<th>From first contractual payment leg or delivery leg up to four days after second contractual payment leg or delivery leg</th>
<th>From 5 business days post second contractual payment leg or delivery leg until extinction of the transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free delivery</td>
<td>No capital charge in the trading book</td>
<td>Treat as an exposure Deduct value transferred plus current positive exposure from capital resources</td>
</tr>
</tbody>
</table>

[Note: CAD Annex II Table 2]

14.4.4 (1) In the case of the non-trading book, a firm must treat an exposure falling into columns 2 and 3 of the table in BIPRU 14.4.3 R in accordance with the relevant provisions of the standardised approach to credit risk or the IRB approach, as the case may be.
(2) In the case of the trading book, a firm must apply the treatment set out in BIPRU 14.4.5 R.

[Note: CAD Annex II point 3 (part)]

14.4.5 R

(1) In applying a risk weight to free delivery exposures treated according to column 3 of the table in BIPRU 14.4.3 R, a firm using the IRB approach may assign PD to counterparties, for which they have no other non-trading book exposure, on the basis of the counterparty's external rating.

(2) A firm using own estimates of LGDs may apply the LGD set out in BIPRU 4.4.34 R to BIPRU 4.4.35 R (IRB foundation approach: LGDs) to free delivery exposures treated according to column 3 of the table in BIPRU 14.4.3 R, provided that it applies it to all such exposures.

(3) Alternatively, a firm using the IRB approach may apply the risk weights, as set out in the standardised approach to credit risk provided that it applies them to all such exposures or may apply a 100% risk weight to all such exposures.

[Note: CAD Annex II point 3 (part)]

14.4.6 R

If the amount of positive exposure resulting from free delivery transactions is not material, a firm may apply a risk weight of 100% to these exposures.

14.4.7 G

In cases of a system wide failure of a settlement or clearing system, a firm should refer to the emergency provisions in GEN 1.3. Where the requirements of GEN 1.3.2 R are met, until the situation is rectified failure of a counterparty to settle a trade will not be deemed a default for purposes of credit risk.

[Note: CAD Annex II point 4]
The Prudential Sourcebook For Banks, Building Societies And Investment Firms

BIPRU TP 2
Capital floors for a firm using the IRB approach

Application

2.1 R Subject to BIPRU TP 2.2R, this section applies to a BIPRU firm that applies the IRB approach.

2.2 R BIPRU TP 2.30R to BIPRU TP 2.34G apply to any firm to which BIPRU 8 (Group risk - consolidation) applies and which applies the IRB approach on a consolidated basis.

Purpose

2.3 G Pursuant to the third paragraph of article 95(2) of the EU CRR, this section in part implements Articles 152(1) - (7) of the Banking Consolidation Directive and Article 43 of the Capital Adequacy Directive.

2.4 G The purpose of this section is to limit the amount of capital reduction arising from the implementation of the Banking Consolidation Directive and the Capital Adequacy Directive compared with the requirements arising from the previous versions of those Directives. As such it is effectively a comparison of the capital resource requirements arising from BIPRU with those arising from the appropriate IPRU sourcebook that would have applied as at 31 December 2006. However the effect of changes to the market risk requirements is removed by requiring BIPRU 7 (Market risk) to be used for both sides of the comparison.

How to apply the capital floors

2.5 G This section does not require a firm to continue to have capital resources equal to a fixed percentage of the capital requirement that applied to it as at 31 December 2006. Instead a firm should apply the requirements in this section to its business as it changes over time. So for example if a firm is calculating its capital requirements as at 31 December 2008 it will have two calculations. The first is carried out under BIPRU and GENPRU. The second is carried out under IPRU and this section. Both sets of requirements are applied to the firm’s figures as at 31 December 2008.

2.6 G The Directive provisions on which this section is based are written as a floor on a firm’s capital resources requirement. This section however is written as a second capital resources requirement that sits beside the general capital resources requirements of BIPRU and GENPRU. The reason for
this is that a *firm* should meet the general capital resources requirements of *BIPRU* and *GENPRU* using *capital resources* calculated under *GENPRU 2.2* (Capital resources). On the other hand a *firm* should meet the capital resources requirements of this section (which are based on *IPRU*) using the relevant *IPRU* definition. In practice the two sets of definitions of capital resources are similar apart from the provisions about expected loss. Therefore as shown by the example in *BIPRU TP 2.12G* and *BIPRU TP 2.13G*, in practice a *firm* is subject to a single capital resources requirement.

2.7 G [deleted]

**Capital floors: solo**

2.8 R A firm calculating risk weighted exposure amounts in accordance with the *IRB approach* must during the following twelve-month periods after 31 December 2006 provide capital resources that equal or exceed the following amounts:

1. for the first twelve-month period, 95%;
2. for the second twelve-month period, 90%; and
3. for the third and each subsequent twelve-month period, 80%;

of the solo capital resources requirement that applies to the *firm* under whichever part of *IPRU* applies under *BIPRU TP 1.4R*.

2.9 R [deleted]

**Capital resources: solo**

2.10 R A *firm* must calculate its capital resources in accordance with whichever part of *IPRU* applies under *BIPRU TP 1.4R*.

2.11 R Compliance with the requirements of this section must be on the basis of amounts of capital resources fully adjusted to reflect differences in the calculation of capital resources under *IPRU* and the calculation of *capital resources* under *GENPRU* and *BIPRU* deriving from the separate treatments of expected loss and unexpected loss under the *IRB approach*.

**Waiver from IPRU capital resources requirement**

2.11A G Article 152(5d) and (5e) of the *Banking Consolidation Directive* allows the appropriate regulator to waive the capital floor calculation based on the *IPRU* capital resources requirement in *BIPRU TP 2.8R(3)* on a case-by-case basis only if a *firm* started to use the *IRB approach* on or after 1 January 2010. The appropriate regulator will consider an application for such a waiver in the light of the criteria in section 138A of the *Act* (Modification or waiver of rules).

2.11B R If a *firm* has a waiver referred to in *BIPRU TP 2.11AG*, it must provide capital resources that equal or exceed 80% of the capital resources re
2.12 G [deleted]
2.13 G [deleted]

Adjustments to the calculation of capital resources

2.14 R A firm may treat any capital instrument that complies with the requirements of GENPRU 2.2 (Capital resources) as complying with the corresponding requirements of IPRU.

2.15 G An example of BIPRU TP 2.14R is that a firm may treat subordinated debt with a term of five years or over that qualifies as lower tier two capital for the purposes of GENPRU as complying with the corresponding provisions for five year subordinated debt under IPRU.

Market risk

2.16 R A firm must substitute the requirements in BIPRU for the calculation of the market risk capital requirement (excluding those provisions to the extent that they would involve using the IRB approach) for the corresponding provisions of IPRU.

2.17 G BIPRU TP 4 to BIPRU TP 9 (Pre CRD capital requirements applying on a solo basis during 2007) explain which parts of IPRU correspond to the market risk capital requirement.

CAD 1 model and VaR model

2.18 R If a firm has a CAD 1 permission or a VaR model permission it must also use it for the purposes of the capital floor calculations in this section.

2.19 G In applying BIPRU TP 2.18R, a firm should not adjust the CAD 1 permission approach or VaR model approach (including the scope of the CAD 1 permission or VaR model permission) so that it is consistent with Directive 93/6 (the Capital Adequacy Directive) as it stood on 31 December 2006.

Individual capital guidance

2.20 R [deleted]
2.21 G Any further capital resource requirements that a firm is required to meet under GENPRU 1.2 (Adequacy of financial resources) (i.e. Pillar 2) should not be taken into account.

How to apply IPRU

2.22 R If the part of IPRU that applies to a firm applies different calculations to different types of firm the firm must use the calculations that it would have to use under BIPRU TP 3 (Pre CRD capital requirements applying on a solo basis during 2007) as applicable before its expiry.

2.23 R If the part of IPRU that applies to a firm gives the firm a choice between methods of calculating capital resources or capital resources requirements it...
BIPRU Capital floors for a firm using the IRB approach

2.24 G BIPRU TP 4 to BIPRU TP 9 (Pre CRD capital requirements applying on a solo basis during 2007) as applicable before their expiry explain how concepts in IPRU and GENPRU map onto the ones in IPRU. This will enable a firm to decide which calculations it should use for the purposes of BIPRU TP 2.22R and BIPRU TP 2.23R.

2.25 G [deleted]
2.26 R [deleted]
2.27 G [deleted]
2.28 R The calculations under this section do not take into account the base capital resources requirement or the part of the IPRU solo capital resources requirement that corresponds to the base capital resources requirement.

Solo consolidation

2.29 R If a firm has a solo consolidation waiver it also applies for the purpose of this section in place of any corresponding provision of IPRU.

Capital floors: consolidation

2.30 R If a firm calculates risk weighted exposure amounts on a consolidated basis in accordance with the IRB approach on a consolidated basis, BIPRU TP 2.8R to BIPRU TP 2.27G apply on a consolidated basis in accordance with BIPRU TP 2.30R to BIPRU TP 2.31R.

2.31 R A firm must calculate the consolidation requirements under BIPRU TP 2.30R for the group in question (the group in question is specified in BIPRU TP 2.32R) in accordance with the following:

1. [deleted]
2. [deleted]
3. if the group is an investment firm group as defined in BIPRU TP 1.7R, chapter 14 of IPRU(INV) applies.

2.32 R The scope of the consolidation under BIPRU TP 2.30R and any exemption from consolidation is determined in accordance with BIPRU 8 (Group...
risk - consolidation) rather than *IPRU*. In particular, the following adjustments apply:

1. **if a firm is a member of a UK consolidation group** and applies the IRB approach with respect to that UK consolidation group, *BIPRU TP 2.30R* applies with respect to that UK consolidation group; and

2. **if a firm is a member of a non-EEA sub-group** and applies the IRB approach with respect to that non-EEA sub-group, *BIPRU TP 2.30R* applies with respect to that non-EEA sub-group.

### Capital floors: waiver from consolidation

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.33 G</td>
<td>If for example the consolidation rules that apply for the purposes of this section are those in chapter 14 of <em>IPRU(INV)</em> (Consolidated supervision of investment firms) then <em>IPRU(INV) 14.1 (Application)</em> and 14.2 (Scope of consolidation) do not apply. <em>BIPRU 8.2 (Scope and basic consolidation requirements for UK consolidation groups)</em>, <em>BIPRU 8.3 (Scope and basic consolidation requirements for non-EEA sub-groups)</em>, <em>BIPRU 8.4 (CAD Article 22 groups and investment firm consolidation waiver)</em> and <em>BIPRU 8.5 (Basis of consolidation)</em> apply instead.</td>
</tr>
<tr>
<td>2.34 G</td>
<td>If a firm has an investment firm consolidation waiver and it is applying the IRB approach, the waiver will explain how the investment firm consolidation waiver applies for the purpose of this section.</td>
</tr>
</tbody>
</table>
## BIPRU TP 15
Commodities firm transitionals: Exemption from capital requirements

<table>
<thead>
<tr>
<th>Section</th>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.1 R</td>
<td>Application</td>
<td>Subject to BIPRU TP 15.2R, BIPRU TP 15 applies to a BIPRU firm: (1) whose main business consists exclusively of the provision of investment services or investment activities in relation to the financial instruments set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to the MiFID; and (2) to whom the ISD would not have applied if it had remained in force in the form it was in on 31 December 2006.</td>
</tr>
<tr>
<td>15.2 R</td>
<td>Purpose</td>
<td>BIPRU TP 15.13R to BIPRU TP 15.14G apply to any firm to which BIPRU 8 (Group risk - consolidation) applies.</td>
</tr>
<tr>
<td>15.3 G</td>
<td>Duration of exemption</td>
<td>BIPRU TP 15 implements Article 48(1) of the Capital Adequacy Directive as applied pursuant to the discretion in the third paragraph of article 95(2) of the EU CRR.</td>
</tr>
<tr>
<td>15.4 R</td>
<td>Duration of exemption</td>
<td>BIPRU TP 15 applies until the entry into force of any amendments to BIPRU TP 15 under any legislative amendments to CRD and EU CRR following from the Commission’s report under article 508(3) of the EU CRR on an appropriate prudential regime for the prudential supervision of investment firms and firms referred to in article 4(1)(2)(b) and (c) of the EU CRR.</td>
</tr>
<tr>
<td>15.5 G</td>
<td>Exemption</td>
<td>[deleted]</td>
</tr>
<tr>
<td>15.6 R</td>
<td>Exemption</td>
<td>The provisions of GENPRU and BIPRU on capital requirements and GENPRU 1.2 (Adequacy of financial resources) do not apply to a firm to which BIPRU TP 15 applies.</td>
</tr>
<tr>
<td>15.7 G</td>
<td>[deleted]</td>
<td></td>
</tr>
<tr>
<td>15.8 G</td>
<td>Exemption</td>
<td>An exempt BIPRU commodities firm (which is the name in the Glossary given to a firm with the benefit of the exemption in BIPRU TP 15.6R) may be subject to the requirements of Chapter 3 of IPRU(INV). Details of which exempt BIPRU commodities firm are subject to those requirements can be found in Chapter 3 of IPRU(INV).</td>
</tr>
</tbody>
</table>
### 15.9 G

The table in BIPRU TP 15.10G provides an indication of which parts of GENPRU and BIPRU generally apply to an exempt BIPRU commodities firm and which parts in general do not apply. If a section is shown as not in general applying the table also identifies any significant aspects of that section that do apply.

### 15.10 G

Table: Parts of GENPRU and BIPRU that apply to exempt BIPRU commodities firms

This table belongs to BIPRU TP 15.9G

<table>
<thead>
<tr>
<th>GENPRU and BIPRU provisions</th>
<th>A Y denotes that the provision generally does apply</th>
<th>An N denotes that generally it does not apply</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>GENPRU TP (Transitional provisions)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 1.1 (Application and scope)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 1.2 (Adequacy of financial resources)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 1.3 (Valuation)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 1.4 (Actions for damages)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 1.5 (Application of GENPRU 1 to Lloyd’s)</td>
<td>Not applicable as does not apply to BIPRU firms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 2.1 (Calculation of capital resources requirements)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 2.2 (Capital resources)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 2.3 (Application of GENPRU 2 to Lloyd’s)</td>
<td>Not applicable as does not apply to BIPRU firms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GENPRU 3.1 (Cross sector groups)</td>
<td>Y</td>
<td></td>
<td>Only applies if the firm is a member of a financial conglomerate</td>
</tr>
<tr>
<td>GENPRU 3.2 (Third-country groups)</td>
<td>Y</td>
<td></td>
<td>Provisions about financial conglomerate only apply if the firm is a member of a financial conglomerate. See remarks on BIPRU 8 for provisions about a third-country banking and investment group</td>
</tr>
<tr>
<td>BIPRU TP (Transitional provisions)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 1.1 (Application and scope)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 1.2 (Definition of the trading book)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 1.3 (Application for advanced approaches)</td>
<td>N</td>
<td></td>
<td>Provisions about BIPRU 2.1 and BIPRU 8 apply to the extent those parts of BIPRU apply. Otherwise does not apply.</td>
</tr>
<tr>
<td>BIPRU 1.4 (Actions for damages)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 2.1 (Solo consolidation)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Commodities firm transitionals: Exemption from capital requirements

<table>
<thead>
<tr>
<th>GENPRU and BIPRU provisions</th>
<th>A Y denotes that the provision generally does apply</th>
<th>An N denotes that generally it does not apply</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIPRU 2.2 (Adequacy of financial resources)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 2.3 (Interest rate risk in the non-trading book)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 3 (Standardised approach to credit risk)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 4 (The IRB approach)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 5 (Credit risk mitigation)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 6 (Operational risk)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 7 (Market risk)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 8 (Group risk - consolidation)</td>
<td>Y</td>
<td></td>
<td>BIPRU 7.8.38 R and BIPRU 7.3.39 R (Risk management systems and controls) apply in theory although it is unlikely that a firm will be able to carry out these activities without losing the exemption in BIPRU TP 15.</td>
</tr>
<tr>
<td>BIPRU 9 (Securitisation)</td>
<td>N</td>
<td></td>
<td>BIPRU 9.1.6R to BIPRU 9.1.8G (Risk systems) apply</td>
</tr>
<tr>
<td>BIPRU 11 (Disclosure)</td>
<td>Y</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 12</td>
<td></td>
<td></td>
<td>Chapter does not yet exist</td>
</tr>
<tr>
<td>BIPRU 13 (Financial derivatives, SFTs and long settlement transactions)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BIPRU 14 (Capital requirements for settlement and counterparty risk)</td>
<td>N</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

**Definitions**

The terms financial instrument, investment services and investment activities have the same meaning as they do in the **MIFID**.

**Consolidation**

BIPRU TP 15 does not apply for the purposes of BIPRU 8 with respect to a firm’s UK consolidation group or, as the case may be, non-EEA sub-group unless the following conditions are satisfied:

1. there is no credit institution in that group;
2. each CAD investment firm in the group meets the conditions in BIPRU TP 15.1R(1);
3. each CAD investment firm whose head office is in an EEA State satisfies the conditions in BIPRU TP 15.1R(2); and

---

SYSC applies to an exempt BIPRU commodities firm.
any CAD investment firm whose head office is outside the EEA would have fallen into BIPRU TP 15.1R(2) if:

(a) its head office had been in an EEA State; and

(b) it had carried on all its business in the EEA and had obtained whatever authorisations for doing so were required under the ISD in the form that Directive was in on 31 December 2006.

15.14 G If an exempt BIPRU commodities firm is a member of a group that meets the conditions in BIPRU TP 15.13R, BIPRU 8 will not apply to the group. Chapter 14 of IPRU(INV) (Consolidation) applies instead.
BIPRU TP 21
Close substitutes for commodities

21.1 R

Application
This section applies to a BIPRU firm that on 31 December 2006 was applying the approach referred to in the first column of the table in BIPRU TP 21.3R with respect to particular grades or brands of the same commodity-class.

Commodities: close substitutes
A notice given under the IPRU provision in the second column of the table in BIPRU TP 21.3R is treated as having been given under BIPRU 7.4.23 R (Notice to the appropriate regulator about treatment of different grades or brands of the same commodity) for the purposes of BIPRU 7.4.22 R (Treatment of different grades or brands of the same commodity) with respect to the commodity grades or brands referred to in BIPRU TP 21.1R.

21.3 R

Table: Commodity treatments under IPRU
This table belongs to BIPRU TP 21.2R

IPRU provisions setting out commodity approach
Paragraph 22(2) of appendix 6 of chapter 10 of IPRU(INV)
[deleted]

IPRU provisions under which notice given
Paragraph 23 of appendix 6 of chapter 10 of IPRU(INV)

21.4 G

Explanation
BIPRU 7.4.22 R (1)(b) says that a firm should treat positions in different grades or brands of the same commodity-class as different commodities unless they are close substitutes and have price movements which have exhibited a stable correlation coefficient of at least 0.9 over the last
12 months. BIPRU 7.4.23 R says that a firm should notify the FCA in writing at least 20 business days prior to the date the firm starts relying on this treatment. The purpose of this section is to allow a notice given under the corresponding provisions of chapter 10 of IPRU(INV) to continue to have effect without the firm having to serve a new notice under BIPRU 7.4.23 R.
Prudential sourcebook for Banks, Building Societies and Investment Firms

BIPRU TP 29
Liquid assets buffer scalar: simplified ILAS BIPRU firms

<table>
<thead>
<tr>
<th>Application</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>29.1</td>
<td>R</td>
<td>[deleted]</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Duration of transitional provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>29.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transitional provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>29.3</td>
</tr>
<tr>
<td>29.4</td>
</tr>
<tr>
<td>29.5</td>
</tr>
</tbody>
</table>
The Prudential Sourcebook For Banks, Building Societies And Investment Firms

Schedule 3
Fees and other requirement payments

Sch 3 G
There are no requirements for fees or other payments in BIPRU.
The Prudential Sourcebook For Banks, Building Societies And Investment Firms

Schedule 4
Powers exercised

4.1 G
[deleted]

Sch 4.2 G
[deleted]

Sch 4.3 G
[deleted]
The Prudential Sourcebook For Banks, Building Societies And Investment Firms

Schedule 5
Rights of action for damages

Sch 5 G

1. The table below sets out the rules in BIPRU contravention of which by an authorised person may be actionable under section 138D of the Act (Actions for damages) by a person who suffers loss as a result of the contravention.

2. If a "Yes" appears in the column headed "For private person", the rule may be actionable by a private person under section 138D (or, in certain circumstances, his fiduciary or representative; see article 6(2) and (3)(c) of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)). A "Yes" in the column headed "Removed" indicates that the appropriate regulator has removed the right of action under section 138D(3) of the Act. If so, a reference to the rule in which it is removed is also given.

3. The column headed "For other person" indicates whether the rule may be actionable by a person other than a private person (or his fiduciary or representative) under article 6(2) and (3) of those Regulations. If so, an indication of the type of person by whom the rule may be actionable is given.

<table>
<thead>
<tr>
<th>Chapter/Appendix</th>
<th>Section/Annex</th>
<th>Right of action under section 138D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>For private person</td>
</tr>
<tr>
<td><strong>All rules in BIPRU</strong></td>
<td></td>
<td>No</td>
</tr>
</tbody>
</table>
The rules in BIPRU may be waived by the appropriate regulator under section 138A of the Act (Modification or waiver of rules). However, if the rules incorporate requirements laid down in European directives, it will not be possible for the appropriate regulator to grant a waiver that would be incompatible with the United Kingdom’s responsibilities under those directives. It therefore follows that if a rule in BIPRU contains provisions which derive partly from a directive, and partly not, the appropriate regulator will be able to consider a waiver of the latter requirements only, unless the directive provisions are optional rather than mandatory.