

Chapter 14

Capital requirements for settlement and counterparty risk

14.1 Application and purpose

Application

14.1.1 **R** ■ BIPRU 14 applies to a *BIPRU firm*.

14.1.2 **G**

- (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 **G** 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 **R** 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 **R** 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 **R** 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 **R** ■ 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 **R** 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 **G** 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 **R** 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 **R** 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 **R** 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

- 14.3.1 **R** ■ BIPRU 14.3 applies in respect of items in the *trading book* and the *non-trading book*.
- 14.3.2 **G** 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 **R** 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 **R** 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

- 14.3.5 **R** This table belongs to ■ BIPRU 14.3.4 R

Number of working days after due settlement date	Column A (%)
5 - 15	8
16 - 30	50
31 - 45	75
46 or more	100

[Note: CAD Annex II Table 1]

- 14.3.5 **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]

14.4 Free deliveries

Scope

14.4.1 **R** ■ BIPRU 14.4 applies in respect of items in the *trading book* and the *non-trading book*.

14.4.2 **R** 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 **R** Table: Capital treatment for free deliveries

This table belongs to ■ BIPRU 14.4.2 R.

Transaction Type	Up to first contractual <i>payment leg</i> or <i>delivery leg</i>	From first contractual <i>payment leg</i> or <i>delivery leg</i> up to four days after second contractual <i>payment leg</i> or <i>delivery leg</i>	From 5 business days post second contractual <i>payment leg</i> or <i>delivery leg</i> until extinction of the transaction
<i>Free delivery</i>	No capital charge in the <i>trading book</i>	Treat as an <i>exposure</i>	Deduct value transferred plus current positive <i>exposure</i> from <i>capital resources</i>

[Note: CAD Annex II Table 2]

14.4.4 **R** (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 ■ 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]

