

Chapter 7

Market risk

7.11 Credit derivatives in the trading book

Scope

7.11.1 **R** 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

7.11.2 **R** ■ 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.

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

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

7.11.4 **R** 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.

7.11.5 **R** 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*.

- 7.11.6** **R** 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.
- 7.11.7** **R** 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*.
- 7.11.8** **R** 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.
- 7.11.9** **R** 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*.
- 7.11.10** **R** 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*.
- 7.11.11** **R** If an *n*-th-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

- 7.11.12** **R** 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 *n*th to default credit derivatives, the treatment in ■ BIPRU 7.11.12AR and ■ BIPRU 7.11.12BR applies instead of the mirror principle.

[Note: CAD Annex I point 8.B]

7.11.12A **R** 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]

7.11.12B **R** Where the n^{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^{th} -to-default products.

[Note: CAD Annex I point 8.B]

Deriving the net position in each debt security: Credit derivatives

7.11.12C **R** A *firm* must calculate both the net long and the net short positions in credit derivatives by applying ■ BIPRU 7.2.36 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

7.11.13 **R** (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]

7.11.14 **R** (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:

- the two legs consist of completely identical instruments; or
- 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*.

7.11.15 **R** 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.

7.11.16 **R**

- (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.

7.11.17 **R** 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

7.11.18 **R** [deleted]

7.11.19 **R** [deleted]

7.11.20 **R** 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

FCA

■ 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.

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]

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]
7.11.53	R	[deleted]
7.11.54	R	[deleted]
7.11.55	R	[deleted]
7.11.56	R	[deleted]
7.11.57	R	[deleted]

7.11.58 **R** [deleted]

Valuation

7.11.59 **G** ■ 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 **R** 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 **G** ■ 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 **G** ■ 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 **G** 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.

7.11.64 **G** [deleted]