FSA 2001/57

INTERIM PRUDENTIAL SOURCEBOOK FOR INVESTMENT BUSINESSES (AMENDMENT) INSTRUMENT 2001

Powers exercised

1. The Financial Services Authority amends the interim Prudential sourcebook for investment businesses and the Supervision manual in the exercise of the powers and related provisions in or under the Financial Services and Markets Act 2000 (the "Act") listed in the schedule to this instrument.

2. The provisions of or under the Act relevant to the making of rules and listed in the schedule are specified for the purpose of section 153(2) of the Act.

Commencement

3. This instrument comes into force at the beginning of the day on which section 19 of the Act (the general prohibition) comes into force.

Amendments

4. Chapter 3 of the Interim prudential sourcebook for investment businesses is amended as specified in Annex C.

5. Chapter 5 of the Interim prudential sourcebook for investment businesses is amended as specified in Annex D.

6. Chapter 10 of the Interim prudential sourcebook for investment businesses is amended as specified in Annex E.

7. Chapter 13 of the Interim prudential sourcebook for investment businesses is amended as specified in Annex F.

8. Annex 10R to Chapter 16 of the Supervision manual is amended as specified in Annex H.

Citation

9. This instrument may be cited as the Interim Prudential Sourcebook for Investment Businesses (Amendment) Instrument 2001.

By order of the Board, 15 November 2001

Schedule - Powers exercised

1. The powers in articles 4(1) of the Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Rules) Order 2001 have been exercised by the Financial Services Authority ("FSA") to designate the rules identified in the tables in Annex A as they are in force at the date of this instrument (the "continued provisions").

2. The powers in section 138 of the Act have been exercised by the FSA to make the provisions set out in paragraph E of Annex C and paragraphs F and G of Annex D.

3. The powers in article 11(1) of the The Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Rules) Order 2001 and section 157(1) of the Act have been exercised by the FSA to give the guidance on the continued provisions.

4. The continued provisions and the guidance on them are applicable to:

   (a) securities and futures firms (as defined by the Glossary annexed to the General Provisions and Glossary Instrument 2001) to the extent that they were provisions made by the Securities and Futures Authority Limited and appearing as part of its rulebook;

   (b) investment management firms (as defined by the Glossary annexed to the General Provisions and Glossary Instrument 2001) to the extent that they were provisions made by the Investment Management Regulatory Organisation Limited and appearing as part of its rulebook;

   (c) personal investment firms (as defined by the Glossary annexed to the General Provisions and Glossary Instrument 2001) to the extent that they were provisions made by the Personal Investment Authority Limited and appearing as part of its rulebook;

   and are modified:

   (1) so as to be interpreted in accordance with and to apply subject to the General provisions contained in the General Provisions and Glossary Instrument 2001;

   (2) in the manner identified in the tables in Annex A.

   The continued provisions are to be treated as having effect under section 138 of the Act (General rule making power). The statements of compatability and purpose required under article 4(1) of the Financial Services and Markets Act 2000 (Transitional Provisions and Savings) (Rules) Order 2001 are set out in Annex B.

5. All of the rules in IPRU(INV) as amended can be waived using the powers exercisable under section 148 of the Act.

ANNEX A

[The Continued Provisions]

Provisions made by the Securities and Futures Authority Limited And appearing as part of its rulebook		
Designated Provision	**Modifications**	
	Changes in text	**Where the designated provision (as modified) appears in IPRU(INV)**
3-79	In each of (1) and (2) delete "SFA may at its desretion require a *firm* to" and replace with "A *firm* must", and delete "an amount" and replace with "any amount specified in any *requirement*". In the guidance delete the first sentence; delete "SFA" and replace with "the FSA" throughout; delete "whether a *firm* must include a secondary requirement" and replace with "whether to impose a requirement on a *firm*"; in the final sentence delete "have typically been applied" and replace with "may be applied, for example,".	3-79
3-170(11)	No changes	3-170(11)
3-190	In (1) delete "SFA otherwise permits" and replace with "otherwise permitted"; In (2) delete "SFA informs the *firm* that it" and replace with "the *FSA*"; After (2) add guidance paragraph - "The *FSA* will notify the *firm* if it is not the consolidating superviser for the group."; In (3) delete "in a manner agreed with SFA" and replace with "and notify the *FSA* of the manner in which the shortfall will be made good"; In (4) delete ", and as further specified by SFA, SFA will also specify the form of reporting for the test" and replace with "and the *firm* must make appropriate reports to the *FSA*"; After (4) add guidance paragraph - "The *firm* may use the consolidated reporting statement forms required under *SUP* 16.7.25R.".	3-190

3-191	In (2) (which becomes guidance) delete the words before (a) and replace with "The *FSA* may exercise its powers (whether through imposing a *requirement* or by using its general information gathering powers) to obtain information about the structure of a *firm's* group for the purposes of consolidated supervision including the position of any of the following:"; In the guidance following (2) delete the first sentence and replace "SFA" with "the *FSA*" throughout; In (3) delete "with SFA's prior written approval" and replace with "having first notified the *FSA* in writing"; Delete (4) and the guidance to it.	3-191
3-192	No changes	3-192
3-193	In (2) delete "the higher of: (a)"; delete "; and" and replace with "if any."; delete paragraph (b); In (3) delete "the higher of"; delete "and any requirement imposed in accordance with rule 3-193(4)" and replace with "if any"; In (4) delete "a requirement calculated" and replace with "any alternative requirement calculated"; delete "if SFA so requires" and replace with "which is imposed on it by a *requirement*"; In the guidance after (4) delete the first word and replace with "Any"; In (5) (which becomes guidance) delete "be required" and replace with "seek a modification or waiver permitting it"; delete ", if SFA so requires".	3-193
3-194	Delete "SFA may permit the *firm* to" and replace with "A *firm* may"; Delete the guidance after (c) and insert the provisions from "provided that" to the end of paragraph (g) as set out in the modified form of the rule at paragraph B of annex C to this instrument.	3-194

3-195	In the heading delete "Waiver" and replace with "Exemption"; Delete the words before (a) and replace with "A *firm* need not apply rules 3-190 to 3-194 to its group if:" Before (d) delete "and"; At the end of (d) delete "." and insert "; (e) the *firm* first notifies the *FSA* in writing that it intends to rely upon this rule.".	3-195
10-68(2)	No changes	10-68(2)
Guidance to 10-74(2)	No changes	Guidance after 10-74(2)(b)
10-80(6)	Delete "the *firm* must immediately seek guidance from SFA on the *PRR* treatment to apply and until an appropriate treatment is determined must calculate a *PRR* of 100% of the current *mark to market* value of the position" and replace with "it must calculate a *PRR* of an appropriate percentage of the current *mark to market* value of the position and the *firm* must immediately notify the *FSA* of the details of the instrument, the *PRR* calculated and the reasons for the calculation".	10-80(6)
10-120	No changes	10-120
10-170(10)	No changes	10-170(10)
Definition of "*EEA parent*"	No changes	In appendix 1 to each of IPRU(INV) 3 and 10
Board Notices 292 and 353	As shown in annex G	Appendix 62 to each of IPRU(INV) 3 and 10
Board Notices 414, 482 and 520	As shown in annex G	Appendix 63 to IPRU(INV) 10

Provisions made by the Securities and Futures Authority Limited and appearing as part of its rulebook		
Designated Provision	**Modifications**	
	Changes in text	**Where the designated provision (as modified) appears in SUP**
3-41 (1) to (6) and (8)	In the main heading add "and audited annual financial statements" at the end. In (1) delete "*of SFA*" and replace with ", and subject to (2) below"; delete "*financial reporting statements*" and replace with "financial reporting statements and audited annual financial statements"; insert "accounting principles and rules" after "Companies Act 1985 including those"; delete ", subject to (2) below" at the end. In (2) delete "items" and replace with "each item"; delete "*financial reporting statements*" and replace with "financial reporting statements and audited annual financial statements"; insert "and balances" at the end. In (3) delete "*trade date accounting*" and replace with "trade date accounting". In (4) delete ", and SFA may require it to,". In (5) delete "*sole trader*" and replace with "sole trader"; add "For this purpose, the definition of a sole trader in the glossary in IPRU(INV) 10 applies." at the end. In (6) add "or physical commodities" after "*securities*" throughout; add "For this purpose, the definition of a physical commodity in the glossary in IPRU(INV) 10 applies." at the end. Re-number (8) as (7).	SUP 16 Annex 10R, as new 4 at end of section 6
10-41 (1) to (6) and (8)	In the main heading add "and audited annual financial statements" at the end. In (1) delete "*of SFA*"; delete "*financial reporting statements*" and replace with "financial reporting statements and audited annual financial statements"; delete "as" after "which the *firm* would apply". In (2) delete "*financial reporting statements*"	SUP 16 Annex 10R, as new 4 at end of section 6

	and replace with "financial reporting statements and audited annual financial statements". In (4) delete ", and SFA may require it to,". In (5) delete "*sole trader*" and replace with "sole trader"; add "For this purpose, the definition of a sole trader in the glossary in IPRU(INV) 10 applies." at the end. In (6) delete "*physical commodities*" and replace with "physical commodities" throughout; add "For this purpose, the definition of a physical commodity in the glossary in IPRU(INV) 10 applies." at the end. Re-number (8) as (7).	

Provisions made by the Investment Management Regulatory Organisation Limited And appearing as part of its rulebook		
Designated Provision	**Modifications**	
	Changes in text	**Where the designated provision (as modified) appears in IPRU(INV)**
Definition of "Group of Connected Counterparties"	In (a) delete ", unless it is shown otherwise to the satisfaction of IMRO,"; Change to lower case and italics for defined terms.	In appendix 1 to IPRU(INV) 5
Definition of "Large Exposure"	Change to lower case and italics for defined terms.	In appendix 1 to IPRU(INV) 5

Provisions made by the Personal Investment Authority Limited And appearing as part of its rulebook		
Designated Provision	**Modifications**	
	Changes in text	**Where the designated provision (as modified) appears in IPRU(INV)**
Table 13.6.2(2), second paragraph under "Special Limits"	Delete "per cent." and replace with "%"; delete "your" and replace with "the *firm's*".	Table 13.6.2(2), second paragraph under "Special Limits"
Rule 13.12.5(2)	Delete "You" and replace with "A *Category B firm*"; delete "your" and replace with "its"; delete "(1)(a) above" and replace with "13.12.5(1)"; delete "(1)(b) above" and replace with "13.12.5(2)"	13.12.5A

ANNEX B

[Statement of Purpose and Compatibility for the Continued Provisions]

The purpose of the continued provisions is to supplement the requirements of the provisions contained in IPRU(INV) that a firm must maintain adequate financial resources, taking into account the nature and scale of its business, and also to supplement in SUP 16 Annex 10R the reporting requirements applying to securities and futures firms. The continued provisions provide for continuation of provisions which were only incorporated into SFA's rulebook in the most recent release, and to correct some technical errors in relation to the SFA, IMRO and PIA rules carried forward into the IPRU(INV) and SUP 16 Annex 10R.

Statement of compatibility with the FSA's regulatory objectives

The FSA considers that including the continued provisions together with the other provisions in IPRU(INV) and SUP will contribute to meeting two of the FSA's regulatory objectives – maintaining market confidence and consumer protection. In particular they will contribute to the reduction of the risk of investment business firms being unable to meet their liabilities and their commitments to investors and counterparties as they fall due. Although the continued provisions are not intended to contribute to the regulatory objectives of increasing public awareness and reducing financial crime, the FSA believes them to be compatible with those objectives.

Market confidence

IPRU(INV) (including the continued provisions) sets out standards relating to minimum financial resources, risk management and notifications. The continued provisions set out requirements about consolidated supervision for some firms, the treatement of units in collective investment schemes and note issuance facilities and use of secondary requirements. SUP 16 Annex 10R (including the continued provisions) sets out requirements for reporting financial positions and financial resources and the continued provisions specify the accounting policies to be followed in preparing those reports. Requiring firms to meet the standards in IPRU(INV) and SUP 16 Annex 10R, including these, will reduce the risk that firms are unable to meet their commitments as they fall due.

Consumer Protection

As with the market confidence objective, requiring firms to meet prudential standards and to keep appropriate accounting records will reduce the risk that firms are unable to meet their commitments, including their commitments to consumers, as they fall due. Inadequate financial resources relative to the scale and nature of a firm's commitments or inadequate systems and controls expose an investment firm to the risk of failure, for example in stressed market conditions, leading to potential loss to customers as well as disruption to the market. Prudential standards, where complied with fully, do not eliminate the risk of such failure but can reduce the likelihood of failure or minimise the adverse consequences for customers where a failure does occur. The FSA has had regard to the matters set out in section 5(2) of the Act, but they are not directly relevant to the continued provisions.

How the continued provisions are most appropriate for meeting the regulatory objectives

IPRU(INV) and SUP 16 are based on the prudential standards set out in the legislation, rulebooks and other material of the previous regulators. For the reasons described above its provisions (including those of the continued provisions) will contribute to meeting at least two of the regulatory objectives. The continued provisions add to the carry forward of existing regulatory standards. The FSA considers that this particular approach is the most appropriate way of meeting the objectives at this stage (i.e. when the new legislation takes effect) because:

◊ it builds on existing regulators' approaches to setting standards for the same risks; and

◊ it is consistent with enabling us to introduce a new set of standards covering all market sectors over the medium term, leaving adequate time for the preparation and implementation of such standards and taking account as far as possible of recent international developments in the area of prudential standards.

Principles of good regulation

Section 2(3) of the Act sets out various principles to which the FSA must have regard in exercising its general functions. The FSA's reasons for believing that making the provisions of IPRU(INV) and SUP 16 Annex 10R are compatible with these principles are set out below.

The need to use its resources in the most efficient and economic way

IPRU(INV) as amended by this instrument essentially carries forward the prudential standards contained in various legislation and rulebooks for firms previously regulated by IMRO, PIA, SFA and FSA (formerly SIB), professional firms, wholesale market brokers and non-bank principals. SUP 16 Annex 10R essentially carries forward the prudential reporting requirements for firms previously regulated by SFA.

The proposals for the Integrated prudential sourcebook are still out for consultation and the FSA has decided that firms and the FSA would be best served by preserving continuity for firms through the carry forward of existing standards. The inclusion of the continued provisions in the IPRU(INV) and SUP 16 Annex 10R are necessary to the achievement of that approach.

For this reason, we believe that the most efficient and economic way to set standards regarding the matters contained in the continued provisions is to continue those provisions.

The responsibilities of those who manage the affairs of authorised persons

Nothing in IPRU(INV) or SUP 16 Annex 10R as amended or the provisions continued by this instrument removes from the senior management of firms the obligation to run their businesses in a sound and prudent way.

The principle that a burden or restriction…should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction

Given that the continued provisions maintain an existing standard, we do not believe that any cost benefit issues will arise for a firm in maintaining that standard. As explained above, we believe that carrying forward the continued provisions is a proportionate approach at this stage.

The desirability of facilitating innovation in connection with regulated activities

The continued provisions will not restrict the scope of management to develop their regulated activities in an innovative manner, provided they meet the business standards set out in other parts of the Handbook.

The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

Given that the continued provisions maintain an existing standard, we do not believe that they will have any impact on the competitive position of the United Kingdom.

The need to minimise the adverse affects on competition that may arise from any exercise of its general functions

Although the continued rules carry forward existing differences in the regulatory regimes of the previous regulators, we believe that any adverse effects on competition are small and are outweighed by the advantages of maintaining the existing standards as explained above.

The desirability of facilitating competition between those who are subject to any form of regulation by the Authority

The FSA is currently consulting on an integrated approach to setting prudential standards in the near future, which should lead to a harmonisation of standards. We believe that until those integrated standards are ready, the most appropriate approach is to maintain the existing standards.

ANNEX C
Amendments to IPRU(INV) 3

A. After IPRU(INV) 3-78 insert:

SECONDARY REQUIREMENT

Risk Profile

3-79 R (1) A *firm* must include in its secondary requirement any amount specified in any *requirement* to cover an unusual risk profile.

Operational risks

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

G In assessing whether to impose a *requirement* on a *firm* to cover an unusual risk profile or operational risks, the *FSA* will consider various criteria. Relevant *guidance* can be found in sections 4 and 5 of Appendix 48 to IPRU(INV) 10. In addition, the *FSA* will take into account material group risks to a *firm*, where these have not been captured in a group financial resources test. Secondary requirements may be applied, for example, where there has been a major failure on the part of a *firm* to maintain adequate controls, as a means of providing an additional capital buffer whilst these problems are addressed.

B. Delete IPRU(INV) 3-170(11) and replace with:

Netting

3-170 (11) R A *firm* which has offsetting exposures in similar types of transactions with a *counterparty* may offset these in accordance with rules 3-171(2A), 3-173(2A), 3-173A(3), 3-176(3), 3-180(2A), 3-181(1) and 3-182(4A) when calculating *CRR* if it has a contractual netting agreement with that *counterparty*, which:

(a) covers the transactions which the *firm* is seeking to net;

(b) creates a single obligation in each currency or a single overall obligation to pay (or receive) a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances;

(c) does not include a *walkaway clause*;

(d) is supported by written and reasoned independent legal opinions to the effect that, in the event of a legal challenge, the relevant courts would find the *firm's* exposure to be the single net amount mentioned in (b) above.

C. After IPRU(INV) 3-82(5) insert:

CONSOLIDATED SUPERVISION

Scope of test

3-190 R (1) A *firm* must at all times ensure that its group maintains externally generated group *financial resources* in excess of its group *financial resources requirement*, unless otherwise permitted under rule 3-195.

R (2) A *firm* is exempt from (1) above when the *FSA* is not the consolidating supervisor for the *firm*'s group.

G The *FSA* will notify the *firm* if it is not the consolidating superviser for the group.

R (3) Should such a test reveal a shortfall in group *financial resources* with respect to the group's *financial resources requirement*, the *firm* must ensure that its group makes good the shortfall, and notify the *FSA* of the manner in which the shortfall will be made good.

R (4) The test is to be applied in accordance with rules 3-191 to 3-194 below and the *firm* must make appropriate reports to the *FSA*.

G The *firm* may use the consolidated reporting statement forms required under *SUP* 16.7.25R.

Constituents of a group

3-191 R (1) For the purposes of the test in 3-190 above, a *firm's* group must include the following:

(a) any *EEA subsidiary* of the *firm* which is a *credit institution*, *investment firm* or *financial institution*;

(b) any *EEA participation* of the *firm* which is a *credit institution*, *investment firm* or *financial institution*;

(c) any *EEA parent* which is a *financial holding company*; and

(d) any *EEA credit institution*, *investment firm* or *financial institution* which is a *subsidiary* or *participation* of the *firm's EEA parent* which is a *financial holding company*.

G (2) The *FSA* may exercise its powers (whether through imposing a *requirement* or by using its general information gathering powers) to obtain information about the structure of a *firm's* group for the purposes of consolidated supervision including the position of any of the following:

(a) any of the *firm*'s *subsidiaries* or *participations* which are incorporated or have their head offices outside the *EEA*;

(b) any of the *firm*'s *subsidiaries* or *participations* which are not *credit institutions*, *investment firms* or *financial institutions*;

(c) the *firm*'s *parent* if it is incorporated or has its head office outside of the *EEA*;

(d) the *firm*'s *parent* if it is not a *financial holding company*;

(e) any of the *parent*'s other *subsidiaries* or *participations* which are incorporated or have their head offices outside the *EEA*; and

(f) any of the *parent*'s other *subsidiaries* or *participations* which are not *credit institutions*, *investment firms*, or *financial institutions*.

G The *FSA's* intention in defining the scope of a group for the purposes of a group financial resources test is to capture financial activities. 'Financial activities' is defined for these purposes as any *investment business* or *credit institution,* or other entity whose principal activity is to undertake their activities. It is not the *FSA's* intention to capture commercial activities. The *FSA* does not exclude the possibility that it may judge it necessary to capture a commercial entity; but were such circumstances to arise – for instance because financial risks had been moved from a *firm* to a commercial enterprise, and the *FSA* judged the consequences to the *firm* to be sufficiently material as to justify a response – the *FSA* would usually expect to address these risks through applying a secondary requirement, rather than extending the scope of the consolidated group to the commercial entity. Similarly, the *FSA* will not – other than in the most exceptional circumstances – consolidate any non-EEA parent entities of the *firm*.

Exemptions

R (3) A firm may, having first notified the *FSA* in writing, exclude from the group defined in (1), the following:

(a) any *subsidiary* or *participation*, the total assets of which are less than the lower of euro 10 million or 1% of the total assets of the *firm*; and

(b) any *subsidiary*, *participation* or *firm's parent*, the inclusion of which within the group would lead to a misleading or inappropriate consolidation,

provided that in aggregate the total assets of such *subsidiaries* and *participations* would still statisfy (a) above.

Group financial resources

3-192 R A *firm* must calculate the externally generated *financial resources* of its group as the sum of:

(a) the *financial resources* of the most senior undertaking in the group; and

(b) for each *subsidiary* or *participation*, the group's share of the *financial resources* of the *subsidiary* or *participation*, which was not provided by undertakings within the group subject to consolidated supervision, provided that:

(i) these *financial resources* are freely transferable and suitable for the purposes of covering the group's *financial resources requirement*; or

(ii) if not, they are limited to the value of the *subsidiary*'s or *participation*'s *financial resources requirement* from which they originate.

G Where there is no senior undertaking in the defined group because, for example, the *firm's parent* is not included and only affiliates of the *firm* rather than any of its direct *subsidiaries* or *participations* are included, then the *financial resources* of the group is calculated as the sum of the externally generated *financial resources* of its constituents (i.e. excluding amounts provided by undertakings within the group subject to consolidated supervision), subject to the conditions in (i) and (ii) above.

Group financial resources requirement

3-193 R (1) A firm must calculate the group *financial resources requirement* as the aggregate of the *financial resources requirements* of the *firm* and any constituents of the defined group, as determined in accordance with rule 3-191.

(2) The *financial resources requirement* of any *subsidiary* or *participation* of the *firm* or its *parent* is the *subsidiary* or *participation*'s local regulatory capital requirement if any.

(3) The *financial resources requirement* of the most senior undertaking within the group likewise is its local regulatory capital requirement if any.

(4) Where a *firm* has a *parent*, *subsidiary* or *participation* which is not subject to local regulatory capital requirements, it must include in the group *financial resources requirement* any alternative requirement calculated on the business of that *parent*, *subsidiary* or *participation*, or the group's investment in that *subsidiary* or *participation*, which is imposed on it by a *requirement*.

G Any *requirement* will be calculated by applying the *Financial Rules* to the entity's business.

G (5) Where a *firm* has a *parent*, *subsidiary* or *participation* which is subject to local regulatory capital requirements, it may seek a modification or waiver permitting it to adopt an alternative methodology of determining the group's *financial resources requirement*.

Intra-group offsets and netting

3-194 R A *firm* may take into account:

(a) the benefits of netting intra-group counterparty exposures;

(b) offsetting positions, for the purposes of calculating its position risk requirements, held by different group companies; and

(c) the group's share of capital surpluses in *subsidiaries* not subject to local regulatory capital requirements,

provided that:

(d) the *firm* can ensure that the group has sufficient *financial resources* to cover its *financial resources requirements* at all times between *consolidated reporting statements*;

(e) there is satisfactory allocation of capital within the group;

(f) the regulatory, legal and contractual framework is sufficient to guarantee mutual financial support within the group; and

(g) such intra-group benefits are only recognised where no regulations exist in the country of incorporation of the entity which might significantly affect the transfer of funds within the group.

Exemption from consolidated supervision

3-195 R A *firm* need not apply rules 3-190 to 3-194 to its group if:

(a) There are no *credit institutions* in the group;

(b) all *firms* within the group:

(i) deduct from their *financial resources*, calculated in accordance with Table 3-61, any *material holdings* in *credit institutions* and *financial institutions*; and

(ii) meet their applicable primary, secondary and position/counterparty risk requirements (rules 3-70 to 3-78, 3-79 and 3-80 to 3-182 respectively);

(c) all other entities comply with applicable local regulatory capital requirements;

(d) the *firm's* group has in place systems to monitor and control the sources of capital and funding of all its constituents; and

(e) the *firm* first notifies the *FSA* in writing that it intends to rely upon this rule.

D. In the glossary at appendix 1, after the definition of "*EEA*" insert:

EEA parent	means a *firm's* direct or indirect *parent* which is incorporated or has its head office in the *EEA*, or a *firm's parent* which is incorporated or has its head office outside the *EEA* but which in turn has a *parent* incorporated or which has its head office in the *EEA*;

E. Delete the existing Appendix 33 and replace with:

Appendix 33 **(exchanges)**

LIST OF RECOGNISED INVESTMENT, DESIGNATED INVESTMENT AND APPROVED EXCHANGES

1 Recognised investment exchanges

UK

COREDEAL
International Petroleum Exchange (IPE)
Jiway
London International Financial Futures and Options Exchange (LIFFE)
London Metal Exchange (LME)
London Stock Exchange (LSE)
OM London Exchange (formerly OMLX)
virt-x (formerly Tradepoint)

Overseas

Cantor Financial Futures Exchange (CFFE)

Chicago Board of Trade (CBOT)

Chicago Mercantile Exchange (CME)

Eurex Zurich

NASDAQ

New York Mercantile Exchange (NYMEX)

New Zealand Futures and Options Exchange (NZFOE)

Swiss Exchange (SWX)

Sydney Futures Exchange (SFE)

Warenterminborse Hannover

2 Designated investment exchanges

American Stock Exchange

Australian Stock Exchange

Bolsa Mexicana de Valores

Bourse de Montreal Inc

Chicago Board of Trade

Chicago Board Options Exchange

Chicago Stock Exchange

Coffee, Sugar and Cocoa Exchange, Inc

Euronext Amsterdam Commodities Market

Hong Kong Exchanges and Clearing Limited

International Securities Market Association

Johannesburg Stock Exchange

Kansas City Board of Trade

Korea Stock Exchange

MidAmerica Commodity Exchange
Minneapolis Grain Exchange
New York Cotton Exchange
New York Futures Exchange
New York Stock Exchange
New Zealand Stock Exchange
Osaka Securities Exchange
Pacific Exchange
Philadelphia Stock Exchange
Singapore Exchange
South African Futures Exchange (SAFEX)
Tokyo International Financial Futures Exchange (TIFFE)
Tokyo Stock Exchange
Toronto Stock Exchange

3 Approved exchanges

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

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

Swiss Exchange (SWX)
Taiwan Stock Exchange
Tel Aviv Stock Exchange
The Stock Exchange of Thailand
Valencia Stock Exchange (Bolsa de Valores de Valencia)

F. After the end of appendix 59 insert:

Appendix 62

NETTING

Similar Types of Transactions

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

Derivative Transactions

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

Guidance On The Netting Of Counterparty Exposures

Introduction

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

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

Scope

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

Background

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

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

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

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

Principles of Offset

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

   (a) covers the transactions which the firm is seeking to net;

   (b) creates a single obligation in each currency or a single obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances;

   (c) does not include a walkaway clause; and

(d) is supported by written and reasoned independent legal opinions to the effect that, in the event of a legal challenge, the relevant courts would find the firm's exposure to be the single net amount mentioned in (b) above.

Statement of Law on Netting

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

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

Legal Requirements

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

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

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

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

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

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

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

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

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

Compliance with the Legal Requirements

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

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

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

    - the applicability of the netting agreement to the counterparties, jurisdictions and transactions involved;

    - the applicability of the opinions to the counterparties, jurisdictions and transactions involved;

    - where more than one jurisdiction is involved, the potential for conflicts in law;

    - all documentation is complete and still valid and that the agreement has been properly executed (i.e. that the acceptance of terms have been evidenced);

    - the nature and effect of any qualifications in the legal opinions and assessment that these do not impair the obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances; and

    - where an industry standard agreement is used upon which a generic legal opinion has been obtained, identification of those clauses which if altered during the course of negotiating the agreement would affect the right to offset. Internal legal counsel is to evidence review of these agreements to ensure that the effectiveness of the set off clauses has not been altered directly or indirectly by virtue of other clauses being added or deleted.

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

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

Cross-Product Netting

Introduction

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

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

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

1. For the types of transaction which the firm is seeking to net, the firm must have the capability to monitor, and must in practice manage, the resultant exposures on a net basis.

2. All transactions which the firm is seeking to net must be covered by valid netting agreements and supported by legal opinions, in accordance with the requirements of the FSA's Financial Rules; and

3. Where underlying netting agreements are linked by a master netting agreement, the legal opinion must address the enforceability of the netting arrangements in their entirety;

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

ANNEX D
Amendments to IPRU(INV) 5

A. In the glossary at appendix 1, after the definition of "*group*" insert:

group of connected counterparties	means: (a) two or more natural or legal persons who constitute a single risk because one of them, directly or indirectly, has *control* over the other or others; or (b) two or more natural or legal persons between whom there is no relationship of *control* as in (a) but 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 difficulties in performing its or their obligations.

B. In the glossary at appendix 1, after the definition of "*ISD investment services*" insert:

large exposure	means any *exposure* to a *counterparty* or *group of connected counterparties* which exceeds 10 per cent of a *firm's own funds*.

ANNEX E
Amendments to IPRU(INV) 10

A. After 10-68 (1)(b) insert:

Note issuance and revolving underwriting facilities

R (2) A *firm* must calculate a requirement for each note issuance and revolving underwriting facility as 4% of the facility multiplied by the appropriate counterparty weight, where:

the date of commencement of the commitment is the date when the facility agreement becomes legally binding; and

the date of the maturity of the commitment is the date of termination of the facility agreement.

B. After 10-74(2)(b) insert:

G Firms may apply a reduced secondary requirement in the following cases:

- The following non-trading book investments attract a reduced secondary requirement of 17%:
- Gilts, US treasuries, EIB and World Bank securities;
- Listed Equities i.e. stocks that are constituents of the table of constituent indices in Appendix 49;
- London Stock Exchange shares;
- LCH: contributions to the Member Default Fund - Board Notice 352. Secondary Requirement need only be calculated as 92% of the excess of the value of the contribution over the 10% threshold (rule 10-74(2)(b), as opposed to 92% of the full value of the contribution. (This concession is not a precedent which can be extended to other types of deposit);
- LIFFE seats/shares: reduction only where the seat is unused by the firm or another lessee and is purely held for investment purposes;
- Loans to the extent that the loan is secured by unencumbered acceptable collateral.

Firms may apply for the Secondary Requirement to be reduced, giving reasons why the Secondary Requirement on illiquid assets should be reduced.

C. Delete the existing rule 10-80(6) and replace with:

Instruments for which no PRR treatment has been specified

10-80(6) **R** **Where the *firm* has a position in an instrument for which no *PRR* treatment has been specified, it must calculate a *PRR* of an appropriate percentage of the current *mark to market* value of the position and the *firm* must immediately notify the *FSA* of the details of the instrument, the *PRR* calculated and the reasons for the calculation.**

D. Delete the existing rule 10-120 and replace with:

COLLECTIVE INVESTMENT SCHEMES

Eligible collective investment schemes

10-120 **R** **(1) A *firm* must calculate the *PRR* for a position in an *eligible collective investment scheme* as the *mark to market* value of the *firm's* aggregate position multiplied by:**

(a) 8%, provided that:

(i) the scheme only invests in *qualifying debt securities* and *qualifying deposits;*

(ii) the maturities of *qualifying debt securities* does not exceed 2 years; and

(iii) any right to restrict the withdrawal of funds has not been exercised.

(b) 16 % in the case of other *eligible collective investment schemes.*

Other collective investment schemes

(2) (a) A *firm* must calculate the *PRR* for a position in any other *collective investment scheme* as the *mark to market* value of the *firm's* aggregate position multiplied by 16%, provided that:

(i) 100% of the scheme funds are invested in liquid and readily realisable *securities* which are *marketable investments* or held in cash;

(ii) **the *firm* knows the underlying constituents of the scheme on a daily basis;**

(iii) **shares or units can be created or redeemed in exchange for underlying constituents;**

(iv) **investment in the scheme results in an equivalent or higher *PRR* than the underlying constituents would attract if directly held; and**

(v) **any right to restrict the withdrawal of funds has not been exercised.**

(b) **A *firm* must calculate the *PRR* for a position in any other *collective investment scheme* as the *mark to market* value of the *firm*'s aggregate position multiplied by 100%.**

G For the purposes of 10-120(1)(a), the scheme may invest in other financial instruments but for hedging purposes only.

E. In the glossary at appendix 1, after the definition of "*EEA*" insert:

EEA parent	means a *firm's* direct or indirect *parent* which is incorporated or has its head office in the *EEA*, or a *firm's parent* which is incorporated or has its head office outside the *EEA* but which in turn has a *parent* incorporated or which has its head office in the *EEA*;

F. Delete the existing Appendix 33 and replace with:

Appendix 33 **(exchanges)**

LIST OF RECOGNISED INVESTMENT, DESIGNATED INVESTMENT AND APPROVED EXCHANGES

1 Recognised investment exchanges

UK

COREDEAL
International Petroleum Exchange (IPE)
Jiway
London International Financial Futures and Options Exchange (LIFFE)

London Metal Exchange (LME)
London Stock Exchange (LSE)
OM London Exchange (formerly OMLX)
virt-x (formerly Tradepoint)

Overseas

Cantor Financial Futures Exchange (CFFE)

Chicago Board of Trade (CBOT)

Chicago Mercantile Exchange (CME)

Eurex Zurich

NASDAQ

New York Mercantile Exchange (NYMEX)

New Zealand Futures and Options Exchange (NZFOE)

Swiss Exchange (SWX)

Sydney Futures Exchange (SFE)

Warenterminborse Hannover

2 Designated investment exchanges

American Stock Exchange

Australian Stock Exchange

Bolsa Mexicana de Valores

Bourse de Montreal Inc

Chicago Board of Trade

Chicago Board Options Exchange

Chicago Stock Exchange

Coffee, Sugar and Cocoa Exchange, Inc

Euronext Amsterdam Commodities Market

Hong Kong Exchanges and Clearing Limited

International Securities Market Association

Johannesburg Stock Exchange

Kansas City Board of Trade

Korea Stock Exchange

MidAmerica Commodity Exchange

Minneapolis Grain Exchange

New York Cotton Exchange

New York Futures Exchange

New York Stock Exchange

New Zealand Stock Exchange

Osaka Securities Exchange

Pacific Exchange

Philadelphia Stock Exchange

Singapore Exchange

South African Futures Exchange (SAFEX)

Tokyo International Financial Futures Exchange (TIFFE)

Tokyo Stock Exchange
Toronto Stock Exchange

3 Approved exchanges

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

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

G. Delete the existing appendix 57 and replace with:

Appendix 57

List of recognised exchanges and recognised clearing houses

1 Recognised Exchanges

American Stock Exchange LLC
Athens Stock Exchange (ASE) - Thessaloniki Stock Exchange Centre (TSEC)
Australian Stock Exchange Ltd.
Baden-Wurttemberg Stock Exchange Stuttgart (Bayrische Börse)
Barcelona Stock Exchange (La Bolsa de Valores de Barcelona)
Bavarian Stock Exchange Munich (Bayrische Börse)
Belgian Futures and Options Exchange (BELFOX)
Berlin Stock Exchange (Berliner Wertpapierbörse)
Bilbao Stock Exchange (Bolsa de Bilbao)
Bolsa de Valores de Lisboa e Porto (BVLP)
Bourse de Montréal
Bremen Stock Exchange (Bremer Wertpapierbörse)
Canadian Venture Exchange
Chicago Board of Trade
Chicago Board Options Exchange Inc.
Chicago Mercantile Exchange
Coffee, Sugar and Cocoa Exchange
Copenhagen Stock Exchange (Københavns Fondsbørs)
Eurex Deutschland
Eurex Zurich
Euronext Amsterdam Commodity Market
Euronext Amsterdam NV
Euronext Brussels Ltd.
Euronext Paris SA
Frankfurt Stock Exchange (Frankfurter Wertpapierbörse)
Hanseatic Stock Exchange Hamburg (Hanseatische Wertpapierbörse Hamburg)
Helsinki Exchanges
Hong Kong Exchanges and Clearing
International Petroleum Exchange of London Ltd.
Irish Stock Exchange

Italian Exchange
Kansas City Board of Trade
London International Financial Futures and Options Exchange (LIFFE)
London Metal Exchange Ltd.
London Stock Exchange Ltd.
Luxembourg Stock Exchange (Société de la Bourse de Luxembourg SA)
Madrid Stock Exchange (La Bolsa de Valores de Madrid)
MEFF Renta Fija
MEFF Renta Variable
Mercato Italiano Derivati (IDEM)
Mercato Italiano Futures (MIF)
Munich Stock Exchange (Bayerische Borse in Munchen)
Nagoya Stock Exchange
Nasdaq Stock Exchange
New York Mercantile Exchange
New York Stock Exchange
OM London
OM Stockholm Exchange
Osaka Securities Exchanges
Oslo Stock Exchange (Oslo Bors)
Pacific Exchange
Rhine-Westphalian Stock Exchange Dusseldorf (Rheinisch-Westfälische Börse zu Dûsseldorf)
Singapore Exchange
Stock Exchange of Lower Saxony Hannover (Niedersächsische Börse zu Hannover)
Sydney Futures Exchange
Tokyo International Financial Futures Exchange
Tokyo Stock Exchange
Toronto Stock Exchange
Valencia Stock Exchange (La Bolsa de Valores de Valencia)
Wiener Borse AG

2 Clearing Houses

ASX Settlement and Transfer Corporation Pty Ltd (ASTC)
Austrian Kontroll Bank (OKB)
Board of Trade Clearing Corporation
Cassa di Compensazione e Garanzia S.p.A (CCG)
Commodity Clearing Corporation
Emerging Markets Clearing Corporation
FUTOP Clearing Centre (FUTOP Clearingcentralen A/S)

Hong Kong Futures Exchange Clearing Corporation Ltd
Hong Kong Securities Clearing Company Ltd
Kansas City Board of Trade Clearing Corporation
London Clearing House (LCH)
Norwegian Futures & Options Clearing House (Norsk Oppsjonssentral A.S. (NOS))
N.V. Nederlandse Liquidatiekas (NLKKAS)
OM Stockholm Exchange
Options Clearing Corporation
Options Clearing House Pty Ltd (OCH)
Sydney Futures Exchange Clearing House (SFECH Ltd)
TNS Clearing Pty Ltd (TNSC)

H. After the end of appendix 59 insert:

Appendix 62

NETTING

Similar Types of Transactions

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

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

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

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    - the nature and effect of any qualifications in the legal opinions and assessment that these do not impair the obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances; and

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

1. For the types of transaction which the firm is seeking to net, the firm must have the capability to monitor, and must in practice manage, the resultant exposures on a net basis.

2. All transactions which the firm is seeking to net must be covered by valid netting agreements and supported by legal opinions, in accordance with the requirements of the FSA's Financial Rules; and

3. Where underlying netting agreements are linked by a master netting agreement, the legal opinion must address the enforceability of the netting arrangements in their entirety;

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

Appendix 63

GUIDANCE ON CREDIT DERIVATIVES

THIS APPENDIX APPLIES TO FIRMS WHICH TAKE, OR INTEND TO TAKE, POSITIONS IN CREDIT DERIVATIVE PRODUCTS

INTRODUCTION

Over the past few years, there has been an increasing amount of interest and activity in credit derivatives, a class of products that includes credit-linked notes, total return swaps and default options and swaps. For at least some of these products, the commodity being traded is 'pure' credit risk. Through these instruments firms are no longer seeking to contain a risk which is incurred as a by-product of their mainstream trading activity, but are increasingly moving towards trading that very risk. The FSA requires firms to operate robust internal control systems; the advent of credit derivatives highlights the need for increased vigilance in the assessment, monitoring and control of market risk, credit risk and operational risk. **The primary purpose of this Appendix is to underscore the importance of internal control procedures, particularly in circumstances where firms are trading new risks, or new combinations of risk.**

In addition, this Appendix gives some general guidance on capital issues. The non-homogeneity of products under the umbrella term 'credit derivatives' makes it difficult for the FSA to write explicit rules which cover all circumstances. Furthermore, an apparently small change in contract specification might require a significant change in capital treatment. Matters are further complicated by constraints on regulatory capital treatment imposed by European Directives.

To date, the FSA has provided guidance to firms on an ad-hoc basis, and it intends to continue with this practice for the time being. That said, the FSA is able to give a flavour of the capital treatments by way of the brief explanations and examples below. This should not, however, be taken as a definitive guide. **Any firm which has positions in credit derivatives, or intends to acquire such positions, should seek advice from the FSA on the capital to be set aside for regulatory purposes.**

INTERNAL CONTROL ISSUES

Most of the risks to which credit derivatives give rise are familiar, as the same types of risk are present in longer-established instruments. However, they may be present in different combinations in new credit products, and this can add challenges to the manner in which risk is measured, monitored and controlled. For this reason it is of particular importance that any firm engaging in credit derivatives, or one which is intending to undertake such activity, considers whether additions or amendments to established procedures and control routines are required in order to capture and monitor the particular combinations of risks inherent in the products they intend to trade.

The following remarks are not intended as an exhaustive review of the matters which firms may need to address in considering the control of their credit derivatives business, but are merely illustrative of some of the issues which are pertinent. While they relate primarily to credit default type products, many of the considerations will be equally applicable to other credit derivative structures. Firms should also note that procedures for the control of credit derivatives cannot be viewed in isolation: they must mesh seamlessly with the procedures in place for the control of other forms of risk.

New product approval

Before a firm enters into any new type of business, it must ensure that it has in place systems and controls that are adequate to record and monitor the risks of that business. Control issues should be addressed by the firm's senior management, although the level and nature of the controls to be considered during the new product approval process will depend on a variety of factors, including the type and volume of business that will be entered into.

Among the factors which should be considered during the new product process are the following -

- whether the new business falls within the risk appetite of the firm, as established by the Board or equivalent management body;
- an exact description of the type of products to be introduced;
- accounting policies (which firms may wish to discuss with their external auditors);
- valuation methodology, and systems for ensuring that this policy is adhered to;
- authority and level of knowledge of risk managers and/or independent price-checkers;
- format and content of risk reports;
- limits, and systems for measuring and monitoring usage of those limits;
- type of documentation to be used, and other legal risks;
- clearing and settlement procedures;
- adequacy of the firm's computer systems for representing the new transaction type(s);
- reliance on key staff;
- risks arising from the remuneration strategy.

Senior management should approve the procedures and controls and management at all levels must understand and enforce them.

Risk appetite

It is crucial that a firm understands the risks to which credit derivatives give rise, and that resulting exposures are consistent with the overall risk appetite of the firm, as approved by the Board or equivalent management body. At the highest level, firms

will need to consider their objectives in using such instruments. Are they buying and selling credit protection in order to diversify or hedge their portfolio of credit risk? Are they offering credit protection to others, thereby incurring risks which may need to be hedged? Are they seeking to make a turn from buying and selling credit protection? Or, as is most likely, a mixture of all three? The level of control required will, as ever, be a function of the trading strategy.

Understanding the products

Although many of risks to which credit derivatives give rise are familiar, it is important to understand the significant differences between these instruments and more traditional products of a similar nature.

For example, many commentators have drawn parallels between credit derivatives and products such as guarantees or insurance. While some credit derivatives exhibit many of the characteristics of both of these instruments, it is important to recognise a credit derivative as a product in its own right with its own set of associated risks. An over-reliance on similarities between products can lead to the obscuring of genuine differences between their risk characteristics.

Many default options have an economic structure similar to that of guarantees: if issuer A defaults in the repayment on maturity of a bond held by Firm X, Firm X can immediately put the defaulted bond to Firm Y at par in exchange for full payment. It is tempting to see this as analogous to a first on demand guarantee, where on a default by the guaranteed party the guarantor pays the guaranteed party's debt as if it were its own.

However, there is a strong argument that the legal risk in the derivative transaction is greater than that in the guarantee, since guarantee documentation has been tested in the courts over centuries, whereas the default option documentation is as yet untried. It can therefore be argued that while the economic intent may be similar in the two products, there is greater risk engendered by following the credit derivative path rather than the well-trodden guarantee route.

Given that the market is still in a fairly early stage of development, and that structures and terminologies are not yet standardised, participants should be aware of the transactional risks involved and ensure that they have fully understood (and exchanged confirmation of) the exact commercial terms of the transactions entered into.

Credit approval

Firms will need to consider the mechanisms in place for approval of the acquisition of credit risk. Will the sale of credit protection be subject to appropriate levels of credit approval, and will the process be the same as that for other credit exposures the firm incurs? Is the approval process separate from the dealing function? Are those making the decisions fully aware of the particular risks of credit derivatives? It would plainly be dangerous for product originators, whose prime motivation will often be the provision of innovative financial engineering solutions for clients, to be committing the firm to acquiring risk, without the nature of that risk being fully understood, and

consequently approved, by those responsible for the protection of the firm's assets. There may be a need for education of those making credit decisions in the peculiar risks inherent in credit derivatives, particularly if the decision to incur risk is truly to be kept separate (in management terms) from those who are trading it.

Mismatches and imperfect hedges

In documenting credit derivatives, firms should review the degree to which default criteria match in the reference asset and the derivative. In the simplest asset structures, mere failure to pay constitutes default; if this is matched in the derivative the credit hedge is clearly highly effective. If, alternatively, further conditionality is imposed in the default criteria of the derivative - for example, the payoff is triggered only when a payment has failed and this fact has become public and the price of the underlying has been affected by more than a certain amount - then the hedge is less effective.

Consideration should also be given to maturity mismatches. Where the underlying credit exposure continues beyond the maturity of the hedge, firms may wish to consider the appropriate exposure reporting treatment. For example, where the underlying credit risk is deteriorating, and default is considered probable, but not before the expiry of any protection held, is it prudent to consider the risk to be transferred at all? Arguably not only is the risk not transferred, but firms should be giving consideration to provisioning.

Where firms sell credit protection, the question of the firm's rights in a receivership or bankruptcy will be crucial. For example, if a firm receives an underlying bond when it is called under any protection sold, then it will clearly have rights in any eventual receivership. However, a structure where a firm merely undertakes to pay an amount to a protection buyer in the event of the default of the reference asset, and the protection seller acquires no rights in bankruptcy against the defaulting party, will have a wholly different risk profile.

The degree of correlation between the default of the reference asset and that of the protection seller must be considered. Where the two are highly correlated, it will plainly be inappropriate to regard the risk as effectively transferred. Would it be prudent to consider exposure to a sovereign issuer to be reduced by the purchase of protection from an entity located in the same country? Is protection sold by a subsidiary a valid hedge against a parent company exposure? (In the latter case firms may also wish to consider any legal restrictions which there may be on the support of parent companies by subsidiaries).

None of the foregoing is to say that firms should not enter in to imperfect credit hedges, merely that they should be aware of the risks involved in doing so, and ensure that these are reflected in the monitoring and review procedures applied.

Monitoring of credit exposures

A firm's systems must be capable of aggregating credit exposures arising from credit derivatives with other exposures to a given entity. Furthermore, systems must be capable of reflecting the "dual" credit risk exhibited by many credit derivatives: where

protection is bought for an asset held in the firm's portfolio, the firm has credit exposure both to the issuer of the reference asset and to the protection seller. Similarly, where cash flows are swapped, a firm may acquire a dual risk, depending on the exact nature of the structure. Firms should ensure that they have monitoring systems which are capable of reflecting this dual risk, so that exposure to both the issuer of the reference asset and to the protection seller can be monitored.

Credit review and provisioning procedures

In considering the ongoing credit review of exposures, firms will again need to address the dual nature of the exposure to which most credit derivatives give rise. They will need to review both the financial strength of the underlying credit risk and the creditworthiness of the protection seller from whom protection has been bought. In this regard firms may wish to investigate fully the rights they have to financial information on the underlying credit risk and whether any restrictions in access to information would put a seller of protection at a disadvantage compared to a holder of the underlying credit risk, and whether any such disadvantage significantly alters the risk profile. Plainly where there is a lack of transparency, and firms may not be party to information which holders of the reference asset may receive, there will be a need for greater vigilance in monitoring.

Traditionally, securities houses have rarely become involved in "work outs". However, where firms become the ultimate bearer of the credit risk of a certain counterparty, they will need to consider whether they have the necessary expertise in insolvency to make the best recovery possible. While it can be argued that even defaulted instruments can be sold "at a price", such a sale may result in greater financial loss than if the firm managed the recovery itself.

Scenario testing

It is important that any firm which incurs significant trading risk undertakes a rigorous and comprehensive programme of scenario testing covering all major types of risk, including market risk, credit risk and operational risk. Routine scenario testing should be undertaken in order to aid the measurement and control of risks in 'normal' circumstances. In addition 'stress' scenarios should be designed to test the potential for losses under extreme conditions, or to highlight possible risk control problems that may arise. These should include -

- abnormal market movements;
- periods of inactivity or illiquidity; and
- the break-down of key assumptions.

Individual firms will need to devise tests which are meaningful to their particular situations; in each case the criteria should explicitly identify plausible events or influences to which the firm could be exposed. Of crucial importance in the case of credit derivatives is that the results should be capable of clear interpretation even where, by the very nature of the instruments, the distinction between market risk and credit risk becomes somewhat blurred. In addition, credit pricing is evolving as the derivatives market develops, and subjective judgements may need to be made in

order to price or mark to market these instruments, which may in turn affect the performance of the hedge. Such judgements should be routinely reviewed and their potential effect included within the scenario testing.

The results of scenario testing should be regularly communicated to senior management, and to the Board or equivalent body, and should be reflected in the policies and limits set by management.

Reality testing

The essence of reality testing is the comparison of actual trading results with expected outcomes. Firms are familiar with the idea of checking whether their assumptions about the direction of markets have held, but have been slower to apply similar techniques to credit spreads, ratings migration and default.

Any firm which incurs credit risk in its trading activities should ensure that it has a mechanism to test whether, and to what extent, its assumptions have been robust. There should also be a recognised route for the results of reality testing to feed back into the process governing the way in which the firm limits its risk-taking activity.

REGULATORY CAPITAL TREATMENT

Some of the products which are by common consent termed credit derivatives are covered by the FSA's rules (for example, options on an individual bond or equity). Other instruments, however, show characteristics of a type not explicitly covered by the rules, and for these products the FSA has in the past provided guidance on an ad-hoc, though consistent basis. Both the credit derivatives market, and indeed the international regulatory capital regime, are evolving, and the FSA does not believe it is appropriate at this stage to propose rule changes to accommodate the full range of new products.

The following paragraphs outline the general approach which the FSA will follow, and show the way in which capital charges might be calculated for some given examples of transactions. However, **any firm with a position in a credit derivative product should seek guidance on its treatment from the FSA.** There is as yet little standardisation of products, and an apparently small difference in specification might require a significant change in capital treatment. Furthermore, the FSA is constrained by the requirements of the Capital Adequacy Directive, and associated pieces of legislation; it is possible that what seems a common-sense approach could be illegal.

Mark to market

Valuation is fundamental to the question of capital adequacy, as it has a direct effect on firms' financial resources. The FSA requires marking on a 'close-out' basis - a long position should be valued at the bid side of the market, and a short position at the offered side. Where a product is illiquid, the bid-offer spread available in the market will tend to be wide, and this must be reflected in the mark to market value. Firms are also required to take account of factors such as the size of the position.

For example, if the size is larger that that for which a market bid-offer spread would hold, the spread must be widened to take account of this.

Credit derivatives offer certain additional challenges to the valuation process, but the FSA believes that the principles remain the same. There are many products commonly traded by authorised firms which, because of their peculiar characteristics, are complex to value, but which the FSA nonetheless requires to be marked to market. In all cases, the valuation must reflect the level at which a firm realistically expects to be able to liquidate the position. Where there is any uncertainty, the overriding principle is that of prudence.

Notwithstanding this, the reliability of the pricing process for some credit default products may leave regulators with a residual concern. For this reason, **a firm's proposed methodology for marking to market must be agreed with the FSA**. In extreme cases, the FSA may require extra buffers to be included in the valuation, and may even restrict any unrealised profit from inclusion in a firm's financial resources.

For the sake of clarity it should be noted that all credit derivatives must be marked to market, whether or not they are trading book positions, and that they must be marked on a close-out basis.

Trading book/non-trading book

The FSA believes that it is likely that most credit derivative transactions entered into by firms will be trading book items, and will therefore be subject to PRR and CRR. Some firms are aiming to develop a two-way market, and others have bought protection for specific assets or asset classes in their trading book. Where a credit derivative position is clearly not a trading book item, it will be subject to a liquidity adjustment of either 100% or 8% (depending on which method a firm uses to calculate its financial resources).

Position Risk Requirement

Most credit derivative products can be slotted into the standard calculation methodologies (i.e. equity methods 1-4, and interest rate methods 1-3). The PRR calculation is divided into two distinct parts, being 'general market risk' and 'specific risk'. Some credit default products may not give rise to general market risk; where this is the case, instruments are likely to incur only the specific risk component of the relevant PRR charge.

Example 1: Credit default option

Firm A purchases option from Firm B.

A Credit Event is defined in terms of the default of XYZ Co. 8% notes 1999. Should a Credit Event occur, Firm B will pay Firm A £1m against delivery of £1m nominal of XYZ Co. 8% notes 1999.

For firm A -

General market risk: Nil

Specific risk: PRA of reference asset * nominal amount

Where the default protection is embedded in a credit-linked note issued by a third party, it is likely that both general market risk and specific risk charges will apply. Since there is a dual issuer risk, two specific risk charges should be calculated.

Example 2: Credit-linked note

Firm A holds a note issued by ABC Co, maturity 5 years, coupon 8%.

Should a Credit Event occur, the note is terminated. The Credit Event is defined in terms of the default of a bond issued by a third party - XYZ Co.

General market risk: 5 year PRA for relevant currency * mark to market value of note.

Specific risk: (PRA ABC Co + PRA XYZ Co) * mark to market value of note.

A total return swap should be treated as two notional positions, representing respectively the interest rate leg, and a position in the reference asset.

Example 3: Total return swap

Firm A pays 3 months LIBOR and any price depreciation on 100 XYZ Co shares;

Firm B pays dividend and any price appreciation on 100 XYZ Co shares.

Firm A: short debt equivalent position at three months; long equity equivalent position in 100 XYZ Co.

Firm B: long debt equivalent position at three months; short equity equivalent position in 100 XYZ Co.

Firms are reminded that if they are in any doubt as to the appropriate PRR treatment for any position or exposure, they should seek guidance from the FSA.

Offset for capital adequacy purposes

The Capital Adequacy Directive allows the competent authorities to recognise certain offsets for general market risk, but requires that the specific risk charge is applied to gross positions.

Where a position in a credit derivative has been represented as a notional debt or equity position, it automatically becomes eligible for the netting provisions set out in 10-83 and 10-102.

Example 4: Total return swap + hedge

Firm A pays 3 months LIBOR and any price depreciation on 100 XYZ Co shares;

Firm B pays any price appreciation and dividends on 100 XYZ Co shares.

Firm A is short 100 shares in XYZ Co.

Firm A's long equity equivalent position arising from the swap may be netted with its short position, giving rise to a zero PRR for the equity position.

PRR must still be calculated on the LIBOR leg.

Where a firm has a position in a credit default product that incurs only a specific risk charge, together with a position in the reference asset, the FSA may permit the two specific risk charges to be offset, provided that the credit events specified in the default product are to all intents and purposes the same as those specified for the reference asset.

Example 5: Credit default option + position in reference asset

Firm A holds option described in example 1.

Firm A is long £1m nominal XYZ Co. 8% notes 1999.

General market risk: 2 year PRA for relevant currency * mark to market value of bond.

Specific risk: nil

There may be other circumstances in which it is both legal and appropriate to recognise the hedging benefits of certain credit derivatives. **Firms are encouraged to discuss individual strategies with the FSA**.

Counterparty risk requirement

OTC credit derivatives, whether structured as swaps or options, give rise to counterparty risk. CRR for most credit derivative transactions will fall under rule 10-174: the appropriate part of Table 10-174(3) to be used in calculating the 'credit equivalent amount' should be determined by the nature of the reference asset.

> Example 6: Credit default option
>
> Firm A purchases from Firm B the option described in Example 1.
>
> Credit equivalent amount = replacement cost + £50,000 [i.e. 0.5% of £1m]

Some firms may use credit derivatives to reduce their exposure to a counterparty. EU law does not permit the recognition of such hedging in all cases, but the FSA is prepared to consider on a case-by-case basis whether the protection provider may be substituted for the counterparty for the purposes of the CRR rules. **Firms wishing to investigate this possibility should contact the FSA**.

Large exposures

Exposures incurred in both buying and writing credit derivatives should of course be taken into account for the purposes of calculating a firm's large exposures requirement. Where a firm holds an asset together with a hedge that is recognised as such by the FSA, it may choose to calculate its large exposures capital requirement in terms either of the exposure to the underlying or of the exposure to the entity providing the protection. This is not an entirely free choice, however: firms must be consistent in how they view credit protection. For example, if the protection has been taken into account when calculating PRR, an exposure to the provider must be reflected for large exposures purposes.

For the purposes of internal and regulatory monitoring of large exposures, the exposure to both the reference asset and to the protection provider should be indicated.

Multiple name risk

Where a firm is exposed to issuer risk of more than one issuer, for example where writing a credit default derivative which pays out on the default any one of a number of specified instruments: in general PRR should be calculated with reference to the

aggregate of the specific risk weightings of the instruments in the reference basket (ie. on an additive basis).

However, in cases where the derivative instrument/credit linked note has been afforded a credit rating by a 'relevant agency' which accords with the definition of 'qualifying debt security' firms may apply to the FSA to use the relevant single specific risk weighting from Appendix 53.

Risk assessment models

In the light of the forthcoming CADII package of directives, firms may also wish to consider whether to approach the FSA for permission to use an appropriate risk assessment model as the basis for calculating regulatory capital requirements.

SPECIFIC RISK TREATMENT OF CREDIT DERIVATIVES

Introduction

The following guidance is to clarify the specific risk treatments applicable to 'plain vanilla' credit derivatives such as credit default products, total return swaps and credit-linked notes.

Where a firm has a position in a more complex credit derivative instrument for which no PRR treatment has been specified, the firm must immediately seek guidance from the FSA. Until an appropriate treatment has been determined a PRR of 100% of the current mark to market value of the position must be applied.

Default Events

The following guidance applies only in circumstances where the default events, as drafted under the terms of the credit derivative, match those relating to the underlying reference asset. If default events are different, no hedging benefit should be recognised.

Specific Risk

Specific interest rate risk is the risk that the price of a specific security will change relative to prices of securities generally. Such a change is generally attributable to a change in the perceived creditworthiness of the issuer.

Credit derivatives are represented as a notional long or short position in the specific risk of the reference asset. If premium or interest payments are due under the swap, these cashflows are represented as a notional position in a Zone A government bond with the appropriate fixed or floating rate coupon.

Netting

A firm may net long and short positions in the same equity, debt and derivative instruments (under Chapter 10 rule 10-83 for equities based instruments and rule 10-102 for interest-rate based products) before the specific risk charge is applied to the resultant net long or short position. **Instruments are considered to be the same where the issuer is the same, they have equivalent ranking in liquidation, and the currency, coupon and maturity are the same.** These netting criteria are taken from Annex I (Position Risk) of the Capital Adequacy Directive ("CAD I")

Specific risk offset

Firms may net notional specific risk positions in reference assets resulting from credit derivative positions against actual positions in the reference asset or other notional positions created by other credit derivatives providing the conditions set out in rules 10-83 or 10-102 are met (see 'Netting' above).

Example 1

A firm holds a position of £10mn nominal of XYZ Ltd 6% 2004 bond. The firm has bought protection (short credit risk) on this bond with a £10mn notional credit default swap referenced to this bond. The maturity of the credit default swap is 2004.

Under rule 10-102(1) the firm may net the notional position in specific risk created as a result of the swap against the actual position in the bond leaving a flat position. Therefore no specific risk charge is incurred. As credit default products do not attract a general market risk charge, general market risk is calculated on the cash position only.

Example 2

A firm has sold protection (long credit risk) via a credit default swap on £5mn notional of ABC Ltd 8% 2000. It has backed out the risk by buying £5mn of protection on the same reference asset. Documentation relating to the two transactions is identical.

Again, under rule 10-102(2) the firm may net the long and short notional positions in the reference asset leaving a flat position. No specific risk charge is incurred.

Maturity Mismatch

Where a credit default product or credit linked note is of shorter maturity than the reference asset, a specific risk offset is allowed between the long and short specific risk positions. However, the unhedged period creates a forward position in specific risk of the reference asset. The net result is a single specific risk charge for the longer maturity position in the reference asset. This is the treatment agreed with the UK Supervisory Group on Credit Derivatives.

Note: This treatment does not apply to total return swaps, where no forward position in specific risk of the reference asset is recorded in cases of maturity mismatch because of the way the TRS resets, i.e. the TRS will compensate for movements in the market value which go beyond that of a

credit event (a CLN/CDS will only provide protection at maturity where there has been a credit event).

Example

A firm is holding £3mn DEF Ltd 8.5% 2003 bond. It hedges this position by entering into a credit default swap referenced to this asset but with maturity of 2002.

The notional position in specific risk resulting from the credit default swap may be netted against the actual position in the bond. However, after 2002 the position is unhedged. This results in a forward position in the specific risk of the reference asset. An appropriate specific risk charge should be applied to the longer maturity position in the reference asset from commencement of the transaction.

Asset Mismatch

Where a firm enters into a credit derivative hedge referenced to an asset other than the underlying asset they are seeking to hedge, there is basis risk between the reference asset and the underlying asset. Specific risk offsets are not available under the standard FSA rules in the case of an asset mismatch.

If a firm is hedging a long position in a credit default option with a short position, specific risk offsets are available only if the two notional positions in the reference assets meet the requirements of Rule 10-102(3).

Example

A firm hedges £3mn GHI Ltd 7% 2005 bond by buying protection via a credit default swap. The maturity of the swap matches that of the underlying asset, however the swap is referenced to GHI Ltd 10% 2005 bond.

The short notional position created as a result of the swap is not eligible for netting against the underlying position as it does not meet the netting criteria of rule 10-102. Unlike the situation with maturity mismatches where some netting benefit is recognised, two specific risk charges must be calculated – one on the underlying asset and one on the notional position.

ANNEX F
Amendments to IPRU(INV) 13

A. In rule 13.5.2 number each sub-paragraph as (1), (2) and (3).

B. In Table 13.6.2(2), under the heading "Special Limits", delete the second indented paragraph and replace with:

> "- (where any excess has lasted for more than 10 days)
> that excess, or the total of such excesses,
> must not exceed 600% of the *firm's* own funds."

C. After rule 13.12.5 insert a new rule 13.12.5A:

> "A *Category B firm* must treat as a liability in the calculation or its financial resources any amount by which the sum of 13.12.5(1) exceeds the product of 13.12.5(2)."

Appendix 62

~~Board Notice 292~~

NETTING

~~20 December 1995~~

~~**GUIDANCE**~~

~~**This Board Notice applies to all firms subject to the counterparty risk requirement rules**~~

~~**Introduction**~~

~~This board notice supplements Board Notices 228 and 249 by giving guidance on the netting of counterparty exposures for purposes of the counterparty risk rules. ISD firms should note that whilst SFA wishes to allow netting from 1 January 1996, should the "Netting Directive" not be passed by the European Parliament prior to that date SFA may not be permitted to allow such netting for products covered by the Solvency Ratio Directive. SFA will keep firms informed of developments. This guidance will apply:~~
~~(1) from 1 January 1996 (or such later date as the "Netting Directive" shall be passed by the European Parliament) to firms which are subject to the Investment Services Directive (ISD) and Capital Adequacy Directive (CAD), and should therefore be read in the context of Board Notice 249; and~~
~~(2) upon the confirmation of Board Notice 228 which sets out the amendments to the current counterparty risk rules to be followed by Non-ISD firms (i.e. those firms which do not fall within the definition of "investment firm" in the ISD) who will continue to be subject to SFA's existing Chapter 3 financial rules.~~

Similar Types of Transactions

The rules set out the requirements to be met by firms before offsetting exposures in 'similar types of transactions' with a counterparty (i.e. being those transactions falling under a particular counterparty risk rule). The netting of exposures within a particular rule is to be applied on a first in first out basis. ~~SFA is presently considering cross-product netting and will issue guidance on this at a later date.~~

Derivative Transactions

Firms may offset the negative replacement cost on written OTC options against the positive replacement cost of OTC purchased options with the same counterparty. ~~This form of offset will be incorporated into rule X-174(6) at a later date.~~

~~**General Waiver**~~
~~SFA has granted until 1 March 1996 a waiver of the netting requirements where a firm wishes to offset transactions in derivatives listed on an exchange or cleared through a clearing house with a counterparty. After this date firms must comply with rule book requirements in order to net exposures to counterparties in exchange traded derivatives.~~
~~For repurchase and reverse repurchase, securities lending and borrowing and sale and buy back agreements SFA will give firms until 1 March 1996 to put in place the required independent legal opinions.~~

~~**Contents of this Notice**~~
~~The Schedule to this Notice contains Appendix X to the financial rules which will implement the CAD as set out in Board Notice 249 and which also applies to Board Notice 228.~~

~~**Questions**~~
~~Any questions regarding the contents of the Notice should be directed to Larry Aylward or John-Paul Dryden of the Financial Risk Division (telephone 0171-378 9000).~~

~~**BY ORDER OF THE BOARD**~~
~~**W. NIXON**~~
~~**SECRETARY**~~

~~Appendix X -~~ Guidance On The Netting Of Counterparty Exposures

Introduction

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

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

Scope

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

Background

3. Agreements which can effect set-off of counterparty exposures exist in two forms–

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

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

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

Principles of Offset

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

(a) covers the transactions which the firm is seeking to net;

(b) creates a single obligation in each currency or a single obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances;

(c) does not include a walkaway clause; and

(d) is supported by written and reasoned independent legal opinions to the effect that, in the event of a legal challenge, the relevant courts would find the firm's exposure to be the single net amount mentioned in (b) above.

Statement of Law on Netting

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

or not there is any contractual entitlement to set-off and cannot be excluded by agreement between the parties.

6. As mentioned above mutuality is required in order for there to be complete set-off of transactions. Accordingly, firms are expected to have procedures in place to identify the counterparty and the capacity in which the counterparty is acting. Firms proposing to rely on the Statement of Law on netting must satisfy themselves of the appropriateness of such reliance and, where in doubt, obtain legal advice. It is important to note that the Insolvency ~~Rules~~ Rule ~~1986~~ 4.90 do not apply to building societies, statutory organisations generally, mutual societies, partnerships and individuals.

Legal Requirements

7. Legal opinions ~~must relate to the~~ will be needed for the:

   - law of the jurisdiction in which the counterparty is organised;

   - law of the jurisdiction in which any branch involved is located;

   - law that governs the agreement and, if different, the law that governs individual transactions pursuant to it; and

   - law that governs the legal status of the counterparty who is entering into transactions of the type which the firm is seeking to net.

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

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

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

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

   - a firm has no assets or exposure in that jurisdiction;

- any judgement obtained in that jurisdiction against a firm would not be enforceable under any of the rules in the UK relating to the enforcement of foreign judgements; or

- there are no other factors relating to that jurisdiction which would affect the ability of a firm to make net payments as contemplated by the netting agreement.

12. Where a firm believes that the law of the jurisdiction in which a counterparty is organised is not relevant, that point must be addressed in the legal opinion supporting the netting agreement. The ability to exclude the law of the jurisdiction in which a counterparty is organised does not extend to the netting of those off balance sheet exposures listed in the Solvency Ratio Directive~~1~~: the amendment to this directive (to permit netting) specifically requires this matter to be addressed in the legal opinion.

~~1 Off balance sheet products subject to the Solvency Ratio Directive (as per Annex III) include:~~

~~***Interest rate contracts***~~
~~***Foreign exchange contracts***~~

~~*- single-currency interest rate swaps*~~
~~*- Cross currency interest rate swaps*~~
~~*- Basis swaps*~~
~~*- forward foreign exchange contracts*~~
~~*- Forward rate agreements*~~
~~*- Currency futures*~~
~~*- Interest rate futures*~~
~~*- Currency options purchased*~~
~~*- Interest rate options purchased*~~
~~*- Other contracts of a similar nature*~~
~~*- Other contracts of a similar nature*~~

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

14. Legal opinions on netting agreements must be obtained from independent legal advisers with sufficient expertise and experience in this area of law. Opinions from in-house counsel will not be acceptable. Where the regulator in

the jurisdiction of the counterparty is satisfied that the netting agreement is not enforceable under the laws of that jurisdiction, the netting agreement cannot be relied upon regardless of the opinions obtained by a firm.

Compliance with the Legal Requirements

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

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

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

    - the applicability of the netting agreement to the counterparties, jurisdictions and transactions involved;

    - the applicability of the opinions to the counterparties, jurisdictions and transactions involved;

    - where more than one jurisdiction is involved, the potential for conflicts in law;

    - all documentation is complete and still valid and that the agreement has been properly executed (i.e. that the acceptance of terms have been evidenced);

    - the nature and effect of any qualifications in the legal opinions and assessment that these do not impair the obligation to pay a net sum of cash in the event of default, bankruptcy, liquidation or similar circumstances; and

    - where an industry standard agreement is used upon which a generic legal opinion has been obtained, identification of those clauses which if altered during the course of negotiating the agreement would affect the right to offset. Internal legal counsel is to evidence review of these agreements to ensure that the effectiveness of the set off clauses has not been altered directly or indirectly by virtue of other clauses being added or deleted.

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

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

~~Board Notice 353~~

CROSS-PRODUCT NETTING

~~9 August, 1996~~

~~**INFORMATION**~~

~~**THIS BOARD NOTICE APPLIES TO FIRMS WHICH ARE FINANCIALLY REGULATED BY SFA**~~

Introduction

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

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

~~Board Notices 292 and 293 which were published in December 1995, stated that 'SFA is currently considering cross-product netting'. Until a full review of the netting allowances in SFA's CRR Rules has been undertaken, SFA is willing to entertain applications for waivers. Waivers will be granted at SFA's discretion, though as a matter of general guidance, the following requirements must be met:~~

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

1. For the types of transaction which the firm is seeking to net, the firm must have the capability to monitor, and must in practice manage, the resultant exposures on a net basis.

2. All transactions which the firm is seeking to net must be covered by valid netting agreements and supported by legal opinions, in accordance with the requirements of ~~SFA~~ the FSA's Financial Rules; and

3. Where underlying netting agreements are linked by a master netting agreement, the legal opinion must address the enforceability of the netting arrangements in their entirety;

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

~~**Applications for Waivers**~~

~~Applications for waivers should be made in writing with all pertinent details of product types and netting arrangements to Sarah Varney (0171-378 5758) or John-Paul Dryden (0171-378 5756) of the Financial Risk Division.~~

~~**Questions**~~

~~Any questions regarding the contents of the Notice should be directed to Sarah Varney or John-Paul Dryden, as above.~~

~~**BY ORDER OF THE BOARD**~~
~~**W. NIXON**~~
~~**SECRETARY**~~

Appendix 63

GUIDANCE ON CREDIT DERIVATIVES

THIS APPENDIX APPLIES TO ISD FIRMS WHICH TAKE, OR INTEND TO TAKE, POSITIONS IN CREDIT DERIVATIVE PRODUCTS

~~Board Notice 414~~

~~**GUIDANCE ON CREDIT DERIVATIVES**~~

~~**THIS GUIDANCE APPLIES TO ISD FIRMS WHICH TAKE, OR INTEND TO TAKE, POSITIONS IN CREDIT DERIVATIVE PRODUCTS**~~

~~17 April 1997~~

INTRODUCTION

Over the past few years, there has been an increasing amount of interest and activity in credit derivatives, a class of products that includes credit-linked notes, total return swaps and default options and swaps. For at least some of these products, the commodity being traded is 'pure' credit risk. Through these instruments firms are no longer seeking to contain a risk which is incurred as a by-product of their mainstream trading activity, but are increasingly moving towards trading that very risk. The FSA ~~SFA has always~~ requiresd firms to operate robust internal control systems; the advent of credit derivatives highlights the need for increased vigilance in the assessment, monitoring and control of market risk, credit risk and operational risk. **The primary purpose of this Appendix ~~Board Notice~~ is to underscore the importance of internal control procedures, particularly in circumstances where firms are trading new risks, or new combinations of risk.**

In addition, this ~~Board Notice~~ Appendix gives some general guidance on capital issues. The non-homogeneity of products under the umbrella term 'credit derivatives' makes it difficult for ~~SFA~~ the FSA to write explicit rules which cover all circumstances. Furthermore, an apparently small change in contract specification might require a significant change in capital treatment. Matters are further complicated by constraints on regulatory capital treatment imposed by European Directives.

To date, ~~SFA~~ the FSA has provided guidance to firms on an ad-hoc basis, and it intends to continue with this practice for the time being. That said, ~~SFA~~ the FSA is able to give a flavour of the capital treatments by way of the brief explanations and examples below. This should not, however, be taken as a definitive guide. **Any firm which has positions in credit derivatives, or intends to acquire such positions, should seek advice from ~~SFA~~ the FSA on the capital to be set aside for regulatory purposes.**

INTERNAL CONTROL ISSUES

Most of the risks to which credit derivatives give rise are familiar, as the same types of risk are present in longer-established instruments. However, they may be present in different combinations in new credit products, and this can add challenges to the manner in which risk is measured, monitored and controlled. For this reason it is of particular importance that any firm engaging in credit derivatives, or one which is intending to undertake such activity, considers whether additions or amendments to established procedures and control routines are required in order to capture and monitor the particular combinations of risks inherent in the products they intend to trade.

The following remarks are not intended as an exhaustive review of the matters which firms may need to address in considering the control of their credit derivatives business, but are merely illustrative of some of the issues which are pertinent. While they relate primarily to credit default type products, many of the considerations will be equally applicable to other credit derivative structures. Firms should also note that procedures for the control of credit derivatives cannot be viewed in isolation: they must mesh seamlessly with the procedures in place for the control of other forms of risk.

New product approval

Before a firm enters into any new type of business, it must ensure that it has in place systems and controls that are adequate to record and monitor the risks of that business. Control issues should be addressed by the firm's senior management, although the level and nature of the controls to be considered during the new product approval process will depend on a variety of factors, including the type and volume of business that will be entered into.

Among the factors which should be considered during the new product process are the following -

- whether the new business falls within the risk appetite of the firm, as established by the Board or equivalent management body;
- an exact description of the type of products to be introduced;
- accounting policies (which firms may wish to discuss with their external auditors);
- valuation methodology, and systems for ensuring that this policy is adhered to;
- authority and level of knowledge of risk managers and/or independent price-checkers;
- format and content of risk reports;
- limits, and systems for measuring and monitoring usage of those limits;
- type of documentation to be used, and other legal risks;
- clearing and settlement procedures;
- adequacy of the firm's computer systems for representing the new transaction type(s);

- reliance on key staff;
- risks arising from the remuneration strategy.

Senior management should approve the procedures and controls and management at all levels must understand and enforce them.

Risk appetite

It is crucial that a firm understands the risks to which credit derivatives give rise, and that resulting exposures are consistent with the overall risk appetite of the firm, as approved by the Board or equivalent management body. At the highest level, firms will need to consider their objectives in using such instruments. Are they buying and selling credit protection in order to diversify or hedge their portfolio of credit risk? Are they offering credit protection to others, thereby incurring risks which may need to be hedged? Are they seeking to make a turn from buying and selling credit protection? Or, as is most likely, a mixture of all three? The level of control required will, as ever, be a function of the trading strategy.

Understanding the products

Although many of risks to which credit derivatives give rise are familiar, it is important to understand the significant differences between these instruments and more traditional products of a similar nature.

For example, many commentators have drawn parallels between credit derivatives and products such as guarantees or insurance. While some credit derivatives exhibit many of the characteristics of both of these instruments, it is important to recognise a credit derivative as a product in its own right with its own set of associated risks. An over-reliance on similarities between products can lead to the obscuring of genuine differences between their risk characteristics.

Many default options have an economic structure similar to that of guarantees: if issuer A defaults in the repayment on maturity of a bond held by Firm X, Firm X can immediately put the defaulted bond to Firm Y at par in exchange for full payment. It is tempting to see this as analogous to a first on demand guarantee, where on a default by the guaranteed party the guarantor pays the guaranteed party's debt as if it were its own.

However, there is a strong argument that the legal risk in the derivative transaction is greater than that in the guarantee, since guarantee documentation has been tested in the courts over centuries, whereas the default option documentation is as yet untried. It can therefore be argued that while the economic intent may be similar in the two products, there is greater risk engendered by following the credit derivative path rather than the well-trodden guarantee route.

Given that the market is still in a fairly early stage of development, and that structures and terminologies are not yet standardised, participants should be aware of the transactional risks involved and ensure that they have fully understood (and exchanged confirmation of) the exact commercial terms of the transactions entered into.

Credit approval

Firms will need to consider the mechanisms in place for approval of the acquisition of credit risk. Will the sale of credit protection be subject to appropriate levels of credit approval, and will the process be the same as that for other credit exposures the firm incurs? Is the approval process separate from the dealing function? Are those making the decisions fully aware of the particular risks of credit derivatives? It would plainly be dangerous for product originators, whose prime motivation will often be the provision of innovative financial engineering solutions for clients, to be committing the firm to acquiring risk, without the nature of that risk being fully understood, and consequently approved, by those responsible for the protection of the firm's assets. There may be a need for education of those making credit decisions in the peculiar risks inherent in credit derivatives, particularly if the decision to incur risk is truly to be kept separate (in management terms) from those who are trading it.

Mismatches and imperfect hedges

In documenting credit derivatives, firms should review the degree to which default criteria match in the reference asset and the derivative. In the simplest asset structures, mere failure to pay constitutes default; if this is matched in the derivative the credit hedge is clearly highly effective. If, alternatively, further conditionality is imposed in the default criteria of the derivative - for example, the payoff is triggered only when a payment has failed and this fact has become public and the price of the underlying has been affected by more than a certain amount - then the hedge is less effective.

Consideration should also be given to maturity mismatches. Where the underlying credit exposure continues beyond the maturity of the hedge, firms may wish to consider the appropriate exposure reporting treatment. For example, where the underlying credit risk is deteriorating, and default is considered probable, but not before the expiry of any protection held, is it prudent to consider the risk to be transferred at all? Arguably not only is the risk not transferred, but firms should be giving consideration to provisioning.

Where firms sell credit protection, the question of the firm's rights in a receivership or bankruptcy will be crucial. For example, if a firm receives an underlying bond when it is called under any protection sold, then it will clearly have rights in any eventual receivership. However, a structure where a firm merely undertakes to pay an amount to a protection buyer in the event of the default of the reference asset, and the protection seller acquires no rights in bankruptcy against the defaulting party, will have a wholly different risk profile.

The degree of correlation between the default of the reference asset and that of the protection seller must be considered. Where the two are highly correlated, it will plainly be inappropriate to regard the risk as effectively transferred. Would it be prudent to consider exposure to a sovereign issuer to be reduced by the purchase of protection from an entity located in the same country? Is protection sold by a subsidiary a valid hedge against a parent company exposure? (In the latter case firms may also wish to consider any legal restrictions which there may be on the support of parent companies by subsidiaries).

None of the foregoing is to say that firms should not enter in to imperfect credit hedges, merely that they should be aware of the risks involved in doing so, and ensure that these are reflected in the monitoring and review procedures applied.

Monitoring of credit exposures

A firm's systems must be capable of aggregating credit exposures arising from credit derivatives with other exposures to a given entity. Furthermore, systems must be capable of reflecting the "dual" credit risk exhibited by many credit derivatives: where protection is bought for an asset held in the firm's portfolio, the firm has credit exposure both to the issuer of the reference asset and to the protection seller. Similarly, where cash flows are swapped, a firm may acquire a dual risk, depending on the exact nature of the structure. Firms should ensure that they have monitoring systems which are capable of reflecting this dual risk, so that exposure to both the issuer of the reference asset and to the protection seller can be monitored.

Credit review and provisioning procedures

In considering the ongoing credit review of exposures, firms will again need to address the dual nature of the exposure to which most credit derivatives give rise. They will need to review both the financial strength of the underlying credit risk and the creditworthiness of the protection seller from whom protection has been bought. In this regard firms may wish to investigate fully the rights they have to financial information on the underlying credit risk and whether any restrictions in access to information would put a seller of protection at a disadvantage compared to a holder of the underlying credit risk, and whether any such disadvantage significantly alters the risk profile. Plainly where there is a lack of transparency, and firms may not be party to information which holders of the reference asset may receive, there will be a need for greater vigilance in monitoring.

Traditionally, securities houses have rarely become involved in "work outs". However, where firms become the ultimate bearer of the credit risk of a certain counterparty, they will need to consider whether they have the necessary expertise in insolvency to make the best recovery possible. While it can be argued that even defaulted instruments can be sold "at a price", such a sale may result in greater financial loss than if the firm managed the recovery itself.

Scenario testing

It is important that any firm which incurs significant trading risk undertakes a rigorous and comprehensive programme of scenario testing covering all major types of risk, including market risk, credit risk and operational risk. Routine scenario testing should be undertaken in order to aid the measurement and control of risks in 'normal' circumstances. In addition 'stress' scenarios should be designed to test the potential for losses under extreme conditions, or to highlight possible risk control problems that may arise. These should include -

- abnormal market movements;
- periods of inactivity or illiquidity; and
- the break-down of key assumptions.

Individual firms will need to devise tests which are meaningful to their particular situations; in each case the criteria should explicitly identify plausible events or influences to which the firm could be exposed. Of crucial importance in the case of credit derivatives is that the results should be capable of clear interpretation even where, by the very nature of the instruments, the distinction between market risk and credit risk becomes somewhat blurred. In addition, credit pricing is evolving as the derivatives market develops, and subjective judgements may need to be made in order to price or mark to market these instruments, which may in turn affect the performance of the hedge. Such judgements should be routinely reviewed and their potential effect included within the scenario testing.

The results of scenario testing should be regularly communicated to senior management, and to the Board or equivalent body, and should be reflected in the policies and limits set by management.

Reality testing

The essence of reality testing is the comparison of actual trading results with expected outcomes. Firms are familiar with the idea of checking whether their assumptions about the direction of markets have held, but have been slower to apply similar techniques to credit spreads, ratings migration and default.

Any firm which incurs credit risk in its trading activities should ensure that it has a mechanism to test whether, and to what extent, its assumptions have been robust. There should also be a recognised route for the results of reality testing to feed back into the process governing the way in which the firm limits its risk-taking activity.

REGULATORY CAPITAL TREATMENT

Some of the products which are by common consent termed credit derivatives are covered by ~~SFA's~~ the FSA's rules (for example, options on an individual bond or equity). Other instruments, however, show characteristics of a type not explicitly covered by the rules, and for these products ~~SFA~~ the FSA has in the past provided guidance on an ad-hoc, though consistent basis. Both the credit derivatives market, and indeed the international regulatory capital regime, are evolving, and ~~SFA~~ the FSA does not believe it is appropriate at this stage to propose rule changes to accommodate the full range of new products.

The following paragraphs outline the general approach which ~~SFA~~ the FSA will follow, and show the way in which capital charges might be calculated for some given examples of transactions. However, **any firm with a position in a credit derivative product should seek guidance on its treatment from ~~SFA~~ the FSA.** There is as yet little standardisation of products, and an apparently small difference in specification might require a significant change in capital treatment. Furthermore, ~~SFA~~the FSA is constrained by the requirements of the Capital Adequacy Directive, and associated pieces of legislation; it is possible that what seems a common-sense approach could be illegal.

Mark to market

Valuation is fundamental to the question of capital adequacy, as it has a direct effect on firms' financial resources. ~~SFA~~ The FSA requires marking on a 'close-out' basis - a long

position should be valued at the bid side of the market, and a short position at the offered side. Where a product is illiquid, the bid-offer spread available in the market will tend to be wide, and this must be reflected in the mark to market value. Firms are also required to take account of factors such as the size of the position. For example, if the size is larger that that for which a market bid-offer spread would hold, the spread must be widened to take account of this.

Credit derivatives offer certain additional challenges to the valuation process, but SFA the FSA believes that the principles remain the same. There are many products commonly traded by authorised firms which, because of their peculiar characteristics, are complex to value, but which SFA FSA nonetheless requires to be marked to market. In all cases, the valuation must reflect the level at which a firm realistically expects to be able to liquidate the position. Where there is any uncertainty, the overriding principle is that of prudence.

Notwithstanding this, the reliability of the pricing process for some credit default products may leave regulators with a residual concern. For this reason, **a firm's proposed methodology for marking to market must be agreed with SFA the FSA**. In extreme cases, SFA the FSA may require extra buffers to be included in the valuation, and may even restrict any unrealised profit from inclusion in a firm's financial resources.

For the sake of clarity it should be noted that all credit derivatives must be marked to market, whether or not they are trading book positions, and that they must be marked on a close-out basis.

Trading book/non-trading book

The FSASFA believes that it is likely that most credit derivative transactions entered into by firms will be trading book items, and will therefore be subject to PRR and CRR. Some firms are aiming to develop a two-way market, and others have bought protection for specific assets or asset classes in their trading book. Where a credit derivative position is clearly not a trading book item, it will be subject to a liquidity adjustment of either 100% or 8% (depending on which method a firm uses to calculate its financial resources).

Position Risk Requirement

Most credit derivative products can be slotted into the standard calculation methodologies (i.e. equity methods 1-4, and interest rate methods 1-3). The PRR calculation is divided into two distinct parts, being 'general market risk' and 'specific risk'. Some credit default products may not give rise to general market risk; where this is the case, instruments are likely to incur only the specific risk component of the relevant PRR charge.

Example 1: Credit default option

Firm A purchases option from Firm B.

A Credit Event is defined in terms of the default of XYZ Co. 8% notes 1999. Should a Credit Event occur, Firm B will pay Firm A £1m against delivery of £1m nominal of XYZ Co. 8% notes 1999.

For firm A -

General market risk: Nil

Specific risk: PRA of reference asset * nominal amount

Where the default protection is embedded in a credit-linked note issued by a third party, it is likely that both general market risk and specific risk charges will apply. Since there is a dual issuer risk, two specific risk charges should be calculated.

Example 2: Credit-linked note

Firm A holds a note issued by ABC Co, maturity 5 years, coupon 8%.

Should a Credit Event occur, the note is terminated. The Credit Event is defined in terms of the default of a bond issued by a third party - XYZ Co.

General market risk: 5 year PRA for relevant currency * mark to market value of note.

Specific risk: (PRA ABC Co + PRA XYZ Co) * mark to market value of note.

A total return swap should be treated as two notional positions, representing respectively the interest rate leg, and a position in the reference asset.

Example 3: Total return swap

Firm A pays 3 months LIBOR and any price depreciation on 100 XYZ Co shares;

Firm B pays dividend and any price appreciation on 100 XYZ Co shares.

Firm A: short debt equivalent position at three months; long equity equivalent position in 100 XYZ Co.

Firm B: long debt equivalent position at three months; short equity equivalent position in 100 XYZ Co.

Firm*s* are reminded that if they are in any doubt as to the appropriate PRR treatment for any position or exposure, they should seek guidance from ~~SFA~~ the FSA.

Offset for capital adequacy purposes

The Capital Adequacy Directive allows the competent authorities to recognise certain offsets for general market risk, but requires that the specific risk charge is applied to gross positions.

Where a position in a credit derivative has been represented as a notional debt or equity position, it automatically becomes eligible for the netting provisions set out in 10-83 and 10-102.

Example 4: Total return swap + hedge

Firm A pays 3 months LIBOR and any price depreciation on 100 XYZ Co shares;

Firm B pays any price appreciation and dividends on 100 XYZ Co shares.

Firm A is short 100 shares in XYZ Co.

Firm A's long equity equivalent position arising from the swap may be netted with its short position, giving rise to a zero PRR for the equity position.

PRR must still be calculated on the LIBOR leg.

Where a firm has a position in a credit default product that incurs only a specific risk charge, together with a position in the reference asset, ~~SFA~~ the FSA may permit the two specific risk charges to be offset, provided that the credit events specified in the default product are to all intents and purposes the same as those specified for the reference asset.

Example 5: Credit default option + position in reference asset

Firm A holds option described in example 1.

Firm A is long £1m nominal XYZ Co. 8% notes 1999.

General market risk: 2 year PRA for relevant currency * mark to market value of bond.

Specific risk: nil

There may be other circumstances in which it is both legal and appropriate to recognise the hedging benefits of certain credit derivatives. **Firms are encouraged to discuss individual strategies with ~~SFA~~the FSA**.

Counterparty risk requirement

OTC credit derivatives, whether structured as swaps or options, give rise to counterparty risk. CRR for most credit derivative transactions will fall under rule 10-174: the appropriate part of Table 10-174(3) to be used in calculating the 'credit equivalent amount' should be determined by the nature of the reference asset.

Example 6: Credit default option

Firm A purchases from Firm B the option described in Example 1.

Credit equivalent amount = replacement cost + £50,000 [i.e. 0.5% of £1m]

Some firms may use credit derivatives to reduce their exposure to a counterparty. EU law does not permit the recognition of such hedging in all cases, but ~~SFA~~ the FSA is prepared to consider on a case-by-case basis whether the protection provider may be substituted for the counterparty for the purposes of the CRR rules. **Firms wishing to investigate this possibility should contact ~~SFA~~ the FSA**.

Large exposures

Exposures incurred in both buying and writing credit derivatives should of course be taken into account for the purposes of calculating a firm's large exposures requirement. Where a firm holds an asset together with a hedge that is recognised as such by ~~SFA~~ the FSA, it may choose to calculate its large exposures capital requirement in terms either of the exposure to the underlying or of the exposure to the entity providing the protection. This is not an entirely free choice, however: firms must be consistent in how they view credit protection. For example, if the protection has been taken into account when calculating PRR, an exposure to the provider must be reflected for large exposures purposes.

For the purposes of internal and regulatory monitoring of large exposures, the exposure to both the reference asset and to the protection provider should be indicated.

~~**Questions**~~

~~Any questions regarding this Notice should be addressed to Rose Gibson, Financial Risk Division (Tel: 0171-378 5751).~~

~~**BY ORDER OF THE BOARD**~~

~~**W NIXON**~~

~~**SECRETARY**~~

Board Notice 482

GUIDANCE ON CREDIT DERIVATIVES

RULE CHANGE – CONSULTATION DOCUMENT

THIS BOARD NOTICE APPLIES TO ALL ISD FIRMS

22 July 1998

Introduction

This Board Notice should be read in conjunction with the attached FSA Report of Consultation on Credit Derivatives which sets out the background to these policy proposals and details of the pre-consultation process undertaken with trade associations. Firms should be aware that FSA Banking Supervisory Policy Guidelines applicable to UK incorporated banks are to be published simultaneously.

Firms will recall that in April 1997 SFA published Board Notice 414: Guidance on Credit Derivatives - at a time when the UK credit derivatives market was nascent. The credit derivatives market has without doubt developed in the intervening period, but it is SFA's view that the policy which was detailed in Board Notice 414 remains appropriate and in particular, emphasis on the overarching importance of robust internal controls for firms which are dealing in such products. Firms will recall that Board Notice 414 gave guidance on (inter alia): new product approval processes including the importance of full consideration of legal risks (including netting and offset) and appropriate documentation; risk appetite; understanding the products; credit approval processes; mismatches and imperfect hedges; monitoring of credit exposures; credit review and provisioning procedures; scenario testing and reality testing. Further, it is repeated that **'any firm which has positions in credit derivatives, or intends to acquire such positions, must agree with SFA its regulatory valuation methodology and should seek advice from SFA on the capital to be set aside for regulatory purposes'.**

However, over the intervening period, SFA and FSA (former Bank of England) have, in informal consultation with ISDA, LIBA and the BBA, considered whether it would be appropriate to amend guidance given to date, or indeed to make rules changes. **Firms are referred to the attached FSA Report of Consultation on Credit Derivatives Board Notice for further detail on the background to the policy proposals contained in this Board Notice.** FSA Banking Supervisory Policy Guidelines applicable to UK incorporated banks are to be published simultaneously to this Board Notice. . The Banking Guidelines are not attached, but may be obtained by application to the FSA Publications Department, 25 The North Colonnade, Canary Wharf, London

~~E14 5HS. Firms should note that credit derivatives policy of SFA and FSA/Bank of England is now more closely aligned than formerly and it is intended that this process of alignment will continue. In addition, it is clear that further careful consideration must be given to what development of the international regulatory capital regime is desirable.~~

~~Rule Change~~

~~The schedule to this Board Notice details a change to the CRR Rules applicable to OTC derivatives (Rule 10-174). Whilst this change came out a review of the regulatory treatment of credit default derivatives,~~ **~~firms should note that the change is applicable to all OTC derivatives referenced on bonds~~**~~. The result of the change is that firms will be required to calculate a credit equivalent amount (credit exposure) with reference to the pitential future "add-on" applicable to equity derivatives for derivatives referenced on bonds which do not meet the criteria for a "*qualified debt security*". For derivatives referenced on bonds which are "*qualifying*" firms may continue to calculate CRR using the relevant interest rate "add-on".Guidance~~

~~The following paragraph provides additional general guidance on the regulatory capital treament of some credit derivatives. This is complementary to the guidance issued in Board Notice 414:~~

~~1.~~ **Multiple name risk**

Where a firm is exposed to issuer risk of more than one issuer, for example where writing a credit default derivative which pays out on the default any one of a number of specified instruments: in general PRR should be calculated with reference to the aggregate of the specific risk weightings of the instruments in the reference basket (ie. on an additive basis).

However, in cases where the derivative instrument/credit linked note has been afforded a credit rating by a 'relevant agency' which accords with the definition of '*qualifying debt security'* firm*s* may apply to ~~SFA~~ the FSA to use the relevant single specific risk weighting from Appendix 53.

~~2.~~ **Risk assessment models**

In the light of the forthcoming CADII package of directives, firm*s* may also wish to consider whether to approach ~~SFA~~ the FSA for permission to use an appropriate risk assessment model as the basis for calculating regulatory capital requirements.

~~Contents of this Notice~~

~~This notice contains guidance on credit derivatives which is complementary to the guidance which SFA published in Board Notice 414.~~

~~In addition, this notice seeks to consult upon the rule change relating to the CRR treatment of OTC derivatives referenced on bonds. The rule drafting changes may be found in the schedule attached to this notice.~~

~~Costs of Compliance~~

~~Comments on the costs of compliance are sought from firms. SFA believes that the proposed change to the CRR rules may require some firms to incur costs as a result of systems changes. However, it is also SFA's view that, for the purposes of calculating potential credit exposure, application of the interest-rate add-ons to derivatives on bonds which are not *qualifying debt securities* may not adequately reflect the specific risk of the reference asset (i.e. price movements in the underlying which would affect the derivative exposure during the close out period following a potential counterparty default).~~

~~Consultation Period~~

~~All comments relating to this Board Notice should be addressed in writing to the Secretary, the Securities and Futures Authority, at the above address, by 28 August 1998.~~

~~Firms are asked to note that FSA intends to implement the Banking Supervisory Policy Guidelines applicable to UK incorporated banks from 30 September 1998. It would be SFA's intention to issue confirmation of the rules changes proposed in this Board Notice shortly thereafter.~~

~~Questions~~

~~Any enquiries regarding the contents of this Notice should be addressed to: Sarah Varney Tel:(0171 378 5758) or Shane Henderson Tel:(0171 378 5735) of Complex Groups Division Policy Department.~~

~~BY ORDER OF THE BOARD~~

~~W NIXON~~

~~SECRETARY~~

[delete Schedule to Board Notice]

~~Board Notice 520~~

SPECIFIC RISK TREATMENT OF CREDIT DERIVATIVES

~~**SPECIFIC RISK TREATMENT OF CREDIT DERIVATIVES**~~
~~**CONSULTATION DOCUMENT**~~

~~**THIS BOARD NOTICE APPLIES TO ISD FIRMS WHICH ARE FINANCIALLY REGULATED BY SFA**~~

~~16 August 1999~~

Introduction

~~SFA published its initial guidance to firms dealing in credit derivatives in Board Notice 414, issued in April 1997.~~

~~In the intervening period, SFA in conjunction with FSA (for UK incorporated banks), convened a UK Supervisory Group on Credit Derivatives, with a membership of some firms known to be active in this market and ISDA, LIBA and the BBA. The group considered the development of the market and technical expertise in this area, and in addition, issues relating to the regulatory capital treatment of these products.~~

~~Subsequently, in July 1998, SFA published consultation Board Notice 482 (an update to BN 414), together with the FSA Report of consultation on Credit Derivatives. At the same time, the FSA issued amended guidelines for banks. These documents demonstrate the alignment of SFA policy and guidelines for banks relating to credit derivatives and the development of policy within the current framing of the Basle Accord and European Directives.~~

~~**The primary purpose of this Board Notice**~~ **The following guidance** is to clarify the specific risk treatments applicable to ‘plain vanilla’ credit derivatives such as credit default products, total return swaps and credit-linked notes.

Where a firm has a position in a more complex credit derivative instrument for which no PRR treatment has been specified, the firm must immediately seek guidance from ~~SFA~~ the FSA. Until an appropriate treatment has been determined a PRR of 100% of the current *mark to market* value of the position must be applied.

~~**GUIDANCE**~~

Default Events

The following guidance applies only in circumstances where the default events, as drafted under the terms of the credit derivative, match those relating to the underlying reference asset. If default events are different, no hedging benefit should be recognised.

Specific Risk

Specific interest rate risk is the risk that the price of a specific security will change relative to prices of securities generally. Such a change is generally attributable to a change in the perceived creditworthiness of the issuer.

Credit derivatives are represented as a notional long or short position in the specific risk of the reference asset. If premium or interest payments are due under the swap, these cashflows are represented as a notional position in a Zone A government bond with the appropriate fixed or floating rate coupon.

Netting

A firm may net long and short positions in the same equity, debt and derivative instruments (under Chapter 10 rule 10-83 for equities based instruments and rule 10-102 for interest-rate based products) before the specific risk charge is applied to the resultant net long or short position. **Instruments are considered to be the same where the issuer is the same, they have equivalent ranking in liquidation, and the currency, coupon and maturity are the same.** These netting criteria are taken from Annex I (Position Risk) of the Capital Adequacy Directive ("CAD I").

Specific risk offset

Firms may net notional specific risk positions in reference assets resulting from credit derivative positions against actual positions in the reference asset or other notional positions created by other credit derivatives providing the conditions set out in rules 10-83 or 10-102 are met (see 'Netting' above).

Example 1

A firm holds a position of £10mn nominal of XYZ Ltd 6% 2004 bond. The firm has bought protection (short credit risk) on this bond with a £10mn notional credit default swap referenced to this bond. The maturity of the credit default swap is 2004.

Under rule 10-102(1) the firm may net the notional position in specific risk created as a result of the swap against the actual position in the bond leaving a flat position. Therefore no specific risk charge is incurred. As credit default products do not attract a general market risk charge, general market risk is calculated on the cash position only.

Example 2

A firm has sold protection (long credit risk) via a credit default swap on £5mn notional of ABC Ltd 8% 2000. It has backed out the risk by buying £5mn of protection on the same reference asset. Documentation relating to the two transactions is identical.

Again, under rule 10-102(2) the firm may net the long and short notional positions in the reference asset leaving a flat position. No specific risk charge is incurred.

Maturity Mismatch

Where a credit default product or credit linked note is of shorter maturity than the reference asset, a specific risk offset is allowed between the long and short specific risk positions. However, the unhedged period creates a forward position in specific risk of the reference asset. The net result is a single specific risk charge for the longer maturity position in the reference asset. This is the treatment agreed with the UK Supervisory Group on Credit Derivatives.

> Note: This treatment does not apply to total return swaps, where no forward position in specific risk of the reference asset is recorded in cases of maturity mismatch because of the way the TRS resets, i.e. the TRS will compensate for movements in the market value which go beyond that of a credit event (a CLN/CDS will only provide protection at maturity where there has been a credit event).

Example

A firm is holding £3mn DEF Ltd 8.5% 2003 bond. It hedges this position by entering into a credit default swap referenced to this asset but with maturity of 2002.

the notional position in specific risk resulting from the credit default swap may be netted against the actual position in the bond. However, after 2002 the position is unhedged. This results in a forward position in the specific risk of the reference asset. An appropriate specific risk charge should be applied to the longer maturity position in the reference asset from commencement of the transaction.

Asset Mismatch

Where a firm enters into a credit derivative hedge referenced to an asset other than the underlying asset they are seeking to hedge, there is basis risk between the reference asset and the underlying asset. Specific risk offsets are not available under the standard ~~SFA~~ FSA rules in the case of an asset mismatch.

If a firm is hedging a long position in a credit default option with a short position, specific risk offsets are available only if the two notional positions in the reference assets meet the requirements of Rule 10-102(3).

Example

A firm hedges £3mn GHI Ltd 7% 2005 bond by buying protection via a credit default swap. The maturity of the swap matches that of the underlying asset, however the swap is referenced to GHI Ltd 10% 2005 bond.

The short notional position created as a result of the swap is not eligible for netting against the underlying position as it does not meet the netting criteria of rule 10-102. Unlike the situation with maturity mismatches where some netting benefit is recognised, two specific risk charges must be calculated - one on the underlying asset and one on the notional position.

~~Cost of Compliance~~

~~Rule changes are not being introduced as a result of this Board Notice. This Notice provides guidance on the application of the current rules which are reflective of SFA's legal obligation to enforce the requirements of the European Directives.~~

~~Consultation Period~~

~~All comments relating to this Notice should be addressed in writing to The Secretary, the Securities and Futures Authority, at the above address, by 30th September 1999.~~

~~Questions~~

~~Any questions regarding the contents of this Notice may be directed to Barry Pope (0207-676 1824) or Peter Rose (0207-676 1606) of the Complex Groups Policy Department, FSA.~~

~~BY ORDER OF THE BOARD~~

~~T ARMSTRONG~~

~~SECRETARY~~

ANNEX H

Amendments to SUP 16, Annex 10R

After part 3 in Section 6 insert new part 4:

4 Table Accounting policies for financial reporting statements and audited annual financial statements

		General rule
1.1.3	(1)	Unless otherwise provided in the *rules*, and subject to (2) below, a *firm* must determine amounts included in respect of items shown in a *firm's* financial reporting statements and audited annual financial statements in accordance with this rule and the accounting principles and rules which the *firm* would apply if it were drawing up financial statements under the Companies Act 1985 including those accounting principles and rules contained in the United Kingdom Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs) effective at the relevant time.
		Substance over legal form
	(2)	A *firm* must include each item in its financial reporting statements and audited annual financial statements in such a way as to reflect the substance and not merely the legal form of the underlying transactions and balances.
		Trade date accounting
	(3)	A *firm* must use trade date accounting.
		Doubtful debts and liabilities
	(4)	A *firm* must promptly make adequate provision for doubtful debts and accrue for all liabilities.
		Provision for taxation
	(5)	A *firm* must make adequate provision for both current and deferred taxation; a partnership or sole trader may make a provision for taxation of an amount at least equivalent to the tax that would be payable if they had ceased business at the relevant balance sheet date. For this purpose, the definition of a sole trader in the glossary in IPRU(INV) 10 applies.
		Securities lending
	(6)	A *firm* which is a lender of *securities* or physical commodities must record and value the *securities* or physical commodities lent as part of its own positions. For this purpose, the definition of a physical commodity in the glossary in IPRU(INV) 10 applies.
		Foreign currency
	(7)	A *firm* must translate assets and liabilities denominated in currencies other than the reporting currency into the reporting currency using the closing mid-market rate of exchange, or, where appropriate, the rates of exchange fixed under the terms of related or matching forward contracts.

In schedule 4, insert after paragraph 1(16) "(17) Article 4(1) of The Financial Services and Markets Act 2000 (Transitional Provisions and Savings)(Rules) Order 2001", and insert after paragraph 2(1) "(2) Article 11(1) of The Financial Services and Markets Act 2000 (Transitional Provisions and Savings)(Rules) Order 2001".