

**INTERIM PRUDENTIAL SOURCEBOOK FOR BUILDING SOCIETIES
(AMENDMENT NO 3) INSTRUMENT 2002**

Powers exercised

- A. The Financial Services Authority amends the Interim Prudential sourcebook for building societies in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (the “Act”):
- (1) section 138 (General rule-making power);
 - (2) section 156 (General supplementary powers); and
 - (3) section 157(1) (Guidance).
- B. The provisions of the Act relevant to making rules and listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

- C. This instrument comes into force on 1 January 2003.

Amendments to the Interim Prudential sourcebook for building societies

- D. IPRU(BSOC) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Interim Prudential Sourcebook for Building Societies (Amendment No 3) Instrument 2002.

By order of the Board
21 November 2002

ANNEX

AMENDMENTS TO THE INTERIM PRUDENTIAL SOURCEBOOK FOR BUILDING SOCIETIES

In this Annex, underlining indicates new text and striking through indicates deleted text. Entire new sections of text (such as Annex 4B in section 1 of this Annex) are not underlined.

IPRU(BSOC) Volume 1

1.11.1G ...The FSA will discuss with societies where solo consolidation is considered appropriate or necessary, but see section 1.12 , which sets out the FSA's criteria for solo consolidation of mortgage subsidiaries. The FSA also applies these criteria to other types of subsidiaries where they are proposed for solo consolidation. Where solo consolidation occurs...

...

...

1.12.1G (2) ~~are wholly owned by the society~~ are at least 75 per cent owned by the society:...

...1 SOLVENCY CONTENTS...

1.18...

1.19

Credit derivatives 17

...1.18...

1.19

Credit Derivatives

1.19.1 G

Where societies use credit derivatives, provided that they meet the criteria set out in Annex 4B to chapter 4, the risk weighting of an asset should be based on the position after taking account of the credit derivative applied to that asset.

...

2.6.9 G ...

Controllers

2.6.10 G

Societies issuing PIBS should be aware of the requirements on controllers and potential controllers to notify the FSA under sections 178 and 190 of the Act of the acquisition of, or a change in, control, where the exemption set out in the Financial Services and Markets Act 2000

(Controllers)(Exemption)(No.2) Order (SI 2001/3338) does not apply. Guidance on when the exemption does not apply is set out in SUP 11.3.2A G. Societies should also be aware of the requirements on firms in SUP 11.4 to notify the FSA of changes in control, as well as those in SUP 16.4 to submit an annual controller report to the FSA.

...

3.3.1G

...and comply with the Principles for Approved Persons and the Code of Practice. The attention of societies is drawn to the distinction between the controlled functions of director and non-executive director set out in SUP 10.6.2 to 10.6.10.

**...4 FINANCIAL RISK
MANAGEMENT
CONTENTS...**

4A...

4B

Credit Derivatives 29

...

4.3.8G (4) ...

(5)

Credit risk: the control and mitigation of the risk of borrower default, whether relating to wholesale assets, such as large commercial loans or items of liquidity, or to retail assets such as residential mortgages. Societies should take account of the requirements at 6.2.1R and 6.2.2R for assessing the ability and willingness of borrowers to repay their loans, and for a board-approved policy statement on lending. 5B.2.4G provides guidance on credit risk on liquidity.

...

4.4.6G

The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in 4.4.5.(2) above. The factor relating to credit worthiness was added to the original list in section 9A(4)(b) by the Building Societies (Restricted Transactions) Order 2001 (SI 2001/1826). The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

...

...

4A.1.1G

...An outline description of each approach is set out below, and a table 4A.G “Summary of the five approaches” at the end of this Annex summarises the key features.

...

...

4A.4.4G ...

- (1) Exchange traded futures/options and FTSE (or similar) OTC swaps/options (options to be purchased only; ~~and~~
- (2) foreign exchange swaps and forward contracts, used to hedge currency funding- ; and
- (3) credit derivatives.

4A.7G Summary of the five approaches

POLICY APPROACH	RISK MANAGEMENT	RISK ANALYSIS	HEDGING INSTRUMENTS	FUNDING	PRUDENTIAL & OTHER LIQUIDITY	LOAN ASSETS
ADMINISTERED	CE (+FD) & board Dealing/settlement segregation (minimum 2 persons)	None (But, if fixed rate liquid assets held, then mark to market value and sensitivity analysis required)	None	Sterling only Deposit Liabilities < 35%SDL No fixed rate (> 1 Year) provided that funds received from the wholesale market do not exceed 10% SDL	Sterling only No non-marketable > 1 Yr. No marketable > 5 Yrs	No fixed rate (1 Yr. +)
MATCHED	CE/FD (or FM), (ALCO) & board Dealing/settlement segregation (minimum 2 persons)	Matching report & Monthly (minimum) Gap analysis (Reserves NFR) - No structural hedging No Interest View Minimal limits (to cover residual balances + pipeline products only)	Interest rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors (purchase only)	Sterling only Deposit Liabilities <35%SDL provided that funds received from the wholesale market do not exceed 25% SDL	Sterling only	Limit on fixed rate (1 Yr. +)
EXTENDED	(CE)/FD/Treasurer + ALCO & board Treasury segregation (front office/back office)	Monthly (minimum) Static Gap (& Static Simulation) - Reserves hedged Interest view Sensitivity limits (earnings, economic value & basis risk) No FX mismatch	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options (purchase only) FX Swaps/Forward Contracts Retail derivatives & FX contracts permitted. <u>Credit derivatives</u>	Sterling + Currency Minimum level of administered rate liabilities	Sterling + Currency (limited range of currency instruments)	Minimum Level Of administered Rate Assets
COMPREHENSIVE	FD/Treasurer/Risk Manager + ALCO & board Treasury segregation (front office/middle office/back office)	Very frequent Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR.) Sensitivity limits (earnings & economic value) Basis risk limits FX mismatch <2% Own Funds	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options Exotic Options FX Swaps/Forward Contracts/ Options Retail derivatives & FX contracts permitted. <u>Credit derivatives</u>	Sterling + Currency	Sterling + Currency	Sterling + Currency
TRADING	FD/Treasurer/Risk Manager +/- Market Risk Committee/ ALCO & board Treasury segregation (front office/middle office/back office) + banking book/ trading book	Banking Book: Daily (minimum) Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Trading Book: VaR - CAD capability	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options/ Exotic Options Retail derivatives/FX permitted. FX Swaps/Forward Contracts/ Options Equity Options <u>Credit derivatives</u>	Sterling + Currency	Sterling + Currency	Sterling + Currency

ANNEX 4B

4B Credit Derivatives

4B.1 Introduction

4B.1.1 G This annex contains guidance for building societies on credit derivatives.

4B.1.2G This annex consists of the guidance for banks on credit derivatives (chapter CD of IPRU(BANK)) as modified by additional guidance specific to building societies set out below.

4B.2 Additional Guidance for Building Societies

4B.2.1G This annex sets out additional guidance on credit derivatives for building societies over and above that set out in chapter CD of IPRU(BANK). These additions mostly arise as a result of the particular constitutional structure of building societies and the provisions of the 1986 Act. The FSA will expect societies, when planning to use credit derivatives, to consider these issues in formulating their policies.

4B.2.2G A building society intending to use credit derivatives should have effective systems to measure, record, monitor and control the exposure to each protection seller that is incurred and to identify any residual exposure (net of protection) to the underlying assets for which it is buying protection.

4B.2.3G As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the assets for which the society retains the full risk. The FSA will consider this, where relevant, in assessing a society's threshold solvency ratio.

4B.2.4G Nothing in chapter CD should be taken as contradicting the statutory requirements under the 1986 Act, in particular section 9A, which take precedence, as necessary, over chapter CD.

4B.2.5G The guidance contained in chapter CD applies to building societies with the following modifications:

- (1) All references to banks should be taken to include building societies.

- (2) References to the Capital Overview and Large Exposures chapters of IPRU(BANK) do not apply to building societies. They should be taken to refer, instead, to chapters 1 (Solvency) and 7 (Large Exposures) in Volume 1 of IPRU(BSOC). The guidance in chapter CD relating to capital requirements, large exposures, liquidity or solvency should be construed in accordance with the relevant IPRU(BSOC) rules and guidance.
- (3) References to the trading book contained elsewhere in the chapter, apart from the material set out in 4B.2.7 below, will not normally be relevant to building societies

4B.2.6G Sections 1, 2, 3, 5, 9 and 10 of chapter CD will normally apply to all building societies proposing to use credit derivatives. Section 8, which deals with credit spread options, is unlikely to be relevant to building societies.

4B.2.7G Sections 4, 6 and 7 of chapter CD will not normally be relevant to building societies, because:

- (1) section 6 of chapter CD deals with banks as protection sellers, and because of the overriding provisions of section 9A of the 1986 Act, a building society can normally use credit derivatives only as a protection buyer and not as a protection seller.
- (2) sections 4 and 7, which deal with banking/trading book division, and trading book treatments, are unlikely to apply to building societies, because all derivatives are allocated to the banking book for building societies.

4B.2.8G Societies adopting the Extended, Comprehensive and Trading approaches (see Annex 4A) are free to use credit derivatives, but not all such societies may wish to do so. The FSA considers that those societies on the Administered or Matched approaches should not use credit derivatives.

...

- 5C.2G ... fall within the “liquid assets” heading in the annual accounts. The total should also include undrawn as well as drawn amounts under committed facilities provided to other societies. This measure is to be continuous.
- 5C.3 G The FSA expects societies to invest no more than 20% of their prudential liquidity or £5m, whichever is the higher (up to a limit of 5% SDL or £5m whichever is the higher) in aggregate holdings of other societies’ liabilities.
- 5C.4G ... Only the amount drawn down (lent) will constitute a liquid asset ~~and should be taken into account when calculating the aggregate holding of other societies’ liabilities.~~ but the whole amount counts towards the aggregate exposure to other societies’ liabilities as explained above.
- 5C.5G Smaller societies (with total assets of less than £1 billion), can be, as a sub-sector, exposed to collective funding risk. Such risk would be exacerbated if smaller societies relied on committed facilities from each other. Accordingly, it would not, in the FSA’s view, be prudent for smaller societies to rely on, or to provide, committed loan facilities from, or to, other smaller societies.

“CONTENTS...

...7.8 Exemptions...

...ANNEX 7A Form
LEPR1”

...

7.2.2G...

7.2.3G Where societies are protecting large exposures by the use of credit derivatives, they should have regard to section 10 of chapter CD of IPRU(BANK) (see Annex 4B).

...

7.5.3 ... Sections 1.11 and 1.12 sets out the criteria under which the FSA considers applications for solo consolidation ~~for mortgage subsidiaries. In other cases~~ Societies will need to explain on what basis they consider it appropriate or necessary for solo consolidation to be granted...

...

7.6.2R

...using the standard reporting form, LEPR1 -, contained in Annex 7A. Exposures falling within this category should also be reported quarterly by means of Table L of QFS1.

SENSITIVE: COMMERCIAL

Building Society: Pre-Reporting Statement of Large Exposures Form Reporting Date:/...../20...
LEPR1

Name of Society:

Statement completed by:
Name: [BLOCK CAPITALS]

Address:

Post Code:

Position Held:

Signature:

Telephone:

Details of Large Exposure (£000)

The society wishes to take on the following exposure that represents more than 20% of its capital.

Lender Name	Name of counterparty or connected group	Actual Exposure	TOTAL Exposure	Security Value
.....

Please provide a brief description of the main elements of the proposed exposure

.....

.....

.....

.....

Own funds at latest financial quarter end:

SUBMISSION: This notification should be sent to the society's usual supervisory contact at the FSA.

Amount (£000)

Latest quarter end:/...../20...

...

8.3.2G

... They can consider other forms of insurance, such as excess of loss, self-insurance, and use of a captive insurance company. Credit derivatives may, appropriately used, provide an acceptable alternative to mortgage indemnity insurance (societies should refer to the guidance on credit derivatives set out at Annex 4B, which incorporates chapter CD from IPRU(BANK)).

...

CREDIT DERIVATIVES

1 INTRODUCTION

1.1 Legal Sources

1 The FSA's supervisory approach has been developed through consultation with market practitioners and other regulators internationally, and policy will be reviewed as the market continues to develop. There are no internationally agreed regulations explicitly covering credit derivatives under the Basel Accord and EU directives though the treatment of credit derivatives is relevant to the assessment of capital adequacy, and large exposures. The FSA aims to achieve consistency where possible with the capital and large exposures treatment of other similar instruments. The sources identified in the Legal Sources sections of the Capital Overview and Large Exposures chapters are relevant to this chapter.

2 The policy is set out in a separate chapter because it results from the application of a few general principles. Where these principles feed into the mechanism for calculating capital and large exposures, there are cross references to the relevant chapter of the IPRU (BANK).

1.2 Application

3 These obligations apply to all UK banks which use credit derivatives as either protection buyer or protection seller.

See s2.1

a) Protection buyer and credit risk seller are used interchangeably, as are protection seller/credit risk buyer. These terms are defined below.

4 The policy set out in this chapter does not apply to overseas and EEA banks.

1.3 How this chapter is organised

5 Section 2 outlines basic types of credit derivative and the rationale for their use by banks.

Section 3 highlights risk management issues raised by credit derivatives.

Section 4 covers the trading book/banking book division and valuation.

Sections 5 and 6 cover factors determining the capital treatment of credit derivatives in the banking book for the protection buyer and

protection seller, respectively. This section does not cover credit spread options.

Section 7 covers the capital treatment of credit derivatives in the trading book, excluding credit spread options.

Section 8 covers the capital treatment of credit spread options.

Section 9 covers risk transfer requirements.

Section 10 covers factors determining exposures recorded for large exposures purposes.

2 DEFINITIONS, RATIONALE AND TYPES OF PRODUCT

2.1 Definitions and rationale

1 *Credit derivatives* is a general term used to describe various swap and option contracts designed to transfer credit risk on loans or other assets from one party, the *protection buyer*, to another party, the *protection seller*. The protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer, which are linked to the credit standing of a *reference asset* or assets. The term credit derivative may also be used to describe cash instruments where repayment of principal is linked to the credit standing of a reference asset.

- a) *Protection buyer* and *credit risk seller* are used interchangeably in this chapter, as are *protection seller* and *credit risk buyer*.
- b) A *reference asset* is an asset to which payments under the credit derivative contract or instrument are linked; it is usually a security, but could also be a loan or another form of obligation (such as a counterparty exposure under an off balance sheet transaction).

2 Transfer of credit risk may be for the whole life of the reference asset or for a shorter period, and it may be for the full amount of the asset or part of it. A credit derivative may be referenced to a single asset or to a basket of obligations of a single *borrower* or several borrowers.

- a) *Borrower* and *obligor* are used interchangeably to describe the entity generating the reference asset.

3 Banks may use credit derivatives for a number of reasons. These include:

- reducing capital required to support assets on the balance sheet;
 - reducing *credit risk concentrations*;
 - freeing up credit lines;
 - creating *new assets and synthetic assets* to meet wider investor demand; and
 - managing assets on a portfolio basis.
- a) Credit derivatives may be used to reduce *credit risk concentrations* without damaging an existing relationship with the borrower, since there is no transfer of title of the asset.

- b) *New assets and synthetic assets* may widen investment opportunities by, for example, filling gaps in the maturity and credit quality spectrum and providing investment opportunities which some investors would otherwise be unable to access.

2.2 Types of credit derivative

2.2.1 General

4 There are four common types of credit derivative:

- credit default products;
- total return swaps;
- credit linked notes;
- credit spread options.

5 The following examples illustrate how A can assume credit risk on a bond issued by X using various types of credit derivative. B, the counterparty in these transactions, is assumed to own bond X, and is hedging (or laying off) the risk on it. B might, alternatively, have no existing exposure to bond X, in which case it would be taking an unhedged short position in bond X; or B might have an asset similar to bond X, in which case it would be partially hedging that *underlying asset*, but could be exposed to basis risk between the *underlying asset* and bond X (the *reference asset*).

- a) *An underlying asset* is the asset that a protection buyer is seeking to hedge, which is not necessarily identical to the reference asset of the credit derivative used.
- b) *Reference asset* is defined in section 2.1 above.

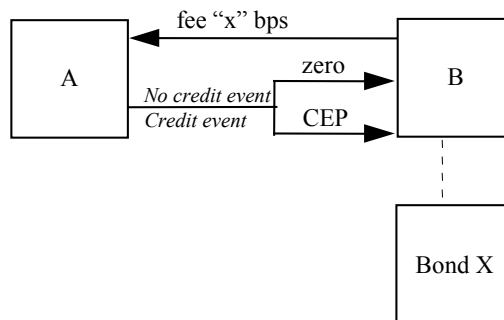
See s2.1

6 These examples assume that risk is transferred directly from the risk seller to the risk buyer. In practice, there is often an intermediate transfer to an *SPV*, which then issues notes to risk buyers.

- a) *SPV* - special purpose vehicle.
- b) Where the risk transfer is made through an unfunded credit derivative (credit default product or a total return swap), the vehicle often invests the funds received from the note issue in a *collateral security* in order to achieve a return on the cash; this return can be paid to investors in addition to the risk seller's payment for the protection.
 - i) *Collateral securities* are usually government or other bonds.

2.2.2 Credit default product

7 A sells credit protection to B for five years on \$50 million nominal of bond X. B pays A a fee of x basis points. Under the terms of the contract, if a defined *credit event* occurs on bond X, A will pay B the *credit event payment* 90 days after the event. If no credit event occurs, the contract will expire after 5 years without any payment from A to B.

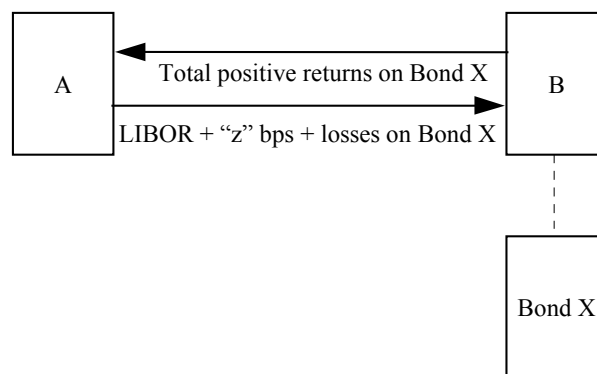


- a) Credit default products (CDPs) are structured so that a payout occurs only when a contractually defined *credit event* (or one of several events) occurs. Credit events normally include bankruptcy, and any payment default on the reference asset and reschedulings, but may also include lesser events such as ratings downgrades. In some contracts a pre-determined materiality (or loss) threshold must also be exceeded for the payment to be triggered.
- b) The *credit event payment* (CEP) is the amount that is paid following a credit event. This is defined in the contract, and is normally one of three types:
 - payment of par value in exchange for physical delivery of the reference asset; some contracts may allow delivery of a variety of assets of the reference name;
 - payment of a fixed amount (sometimes known as a *binary payout*); or
 - payment of par less recovery value. (The reference asset will normally retain some value after a credit event has triggered settlement of the contract. The recovery value is normally determined at a date up to three months after the credit event, by means of a dealer poll or auction.)
- c) Although CDPs may have some of the characteristics of an option, they are often documented as a swap and are treated as a swap by the FSA for capital purposes.

8 In the above example, A has assumed the default risk on bond X from B without funding the position. B has hedged its default risk on bond X, but has acquired a credit exposure to A, since B depends on A to make the credit event payment.

2.2.3 *Total return swap*

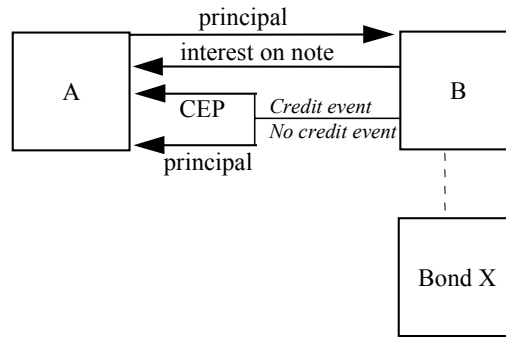
9 A and B enter into a total return swap (TRS) for five years referenced to a notional amount of \$50 million nominal of bond X. B makes periodic payments to A of all cashflows arising from bond X plus any increase in the market value of bond X since the last payment date. On the same dates, A makes payments to B of an interest rate related flow (e.g. LIBOR + z basis points) plus any decrease in the market value of bond X. (Payments may be exchanged on a net basis). If there is a defined credit event, the TRS will usually terminate and the credit event payment will be calculated as though the next normal payment date had been brought forward.



10 B has transferred to A the total performance of bond X (including market risk and default risk) for the duration of the contract, or until there is a credit event. A has assumed this risk without having to fund its position. A and B have acquired credit exposure to each other, since each depends on the other to make payments due under the swap.

2.2.4 *Credit linked note*

11 B issues \$50 million nominal of a five-year note referenced to bond X, and the note pays a fixed or floating rate interest. If no credit event occurs on bond X, the note will mature at par in five years. If a defined credit event occurs on bond X, the note will be redeemed for the credit event payment, 90 days after the credit event.



- 12 A has assumed the credit risk on bond X, and has to fund the position (in contrast to the credit default swap illustrated above). It has also acquired exposure to B of the full amount of the funding it has provided. B has hedged its risk on bond X without acquiring any credit exposure to A, as it has received full cash funding from A.

2.2.5 Credit spread product

- 13 Credit spread products are diverse. A typical example might be as follows: A sells to B a put option on \$50 million nominal of an asset swap on bond X, exercisable at any time in the next year, in exchange for a payment of premium. The option gives B the right to put the asset swap on bond X to A at a strike spread over a pre-determined benchmark rate.

- a) A credit spread option may include further features, for example, relating to a ratings downgrade of bond X.

- 14 A and B have acquired exposure to changes in the credit spread of bond X relative to the benchmark rate which are characteristic of a barrier option. B has also acquired credit exposure to A, since B depends on A to pay amounts due on exercise of the option.

3 RISK MANAGEMENT ISSUES

3.1 Introduction

1 Credit derivatives raise many of the same risk management issues as other new products, credit products, and derivatives. This section highlights areas that are of particular relevance to credit derivatives. Additional conditions to be met before risk transfer is recognised for capital adequacy purposes are set out in section 9.

3.2 Systems

2 Banks using credit derivatives should have adequate systems in place to manage the associated risks.

3 These are likely include:

- adequate management information systems to make senior management aware of the risks being undertaken. This might include information on the level of activity in each of the different products; the ability of the bank (if it is the risk buying organisation) to pursue the underlying borrower when a credit event payment has been triggered; and contractual characteristics of the products (such as fall-back provisions should a dealer poll fail to determine a recovery value following a credit event, and tailoring of standard documentation for particular transactions).
- procedures for ensuring that the credit risk of a reference asset acquired through a credit derivative transaction and any counterparty credit risk arising from an unfunded OTC credit derivative is captured within the bank's normal credit approval and monitoring regime. Banks should be able assess the initial credit risk involved in undertaking the transaction and also to monitor the credit risk on an on-going basis. Information asymmetry (between the buyer and seller of credit risk) may be a significant issue if there is no widely-traded asset of the reference obligor.
- systems to assess and take account of the possibility of default correlation between the reference asset and the protection provider.
- valuation procedures (including assessment and monitoring of the liquidity of the credit derivative and the reference asset) and procedures to determine an appropriate liquidity reserve to be held against uncertainty in valuation. This is particularly important for credit derivatives where the reference asset is illiquid (e.g., a loan), or if the derivative has multiple reference obligors.

3.3 Other operational risks

- 4 The FSA takes into account significant operational risks when setting a bank's minimum (or "trigger") capital ratio, and may in exceptional cases set an explicit capital requirement against such risk.
- 5 Banks should consider how to limit and monitor any legal and reputational risk associated with credit derivatives.
- a) Banks should consider, amongst other things, whether credit derivatives require regulation as insurance business in any of the relevant jurisdictions.
 - b) Banks should consider whether conflicts of interest might arise within the institution in respect of privileged information if there is no widely traded asset of the reference obligor.
 - c) Banks should ensure that transfer of credit risk through a credit derivative does not contravene any terms and conditions relating to the reference asset, and where necessary all consents have been obtained
 - d) Where credit risk to many obligors has been transferred as a package, the bank should consider whether the reputation of the bank might be damaged by subsequent deterioration in the quality of these assets

3.4 Liquidity

- 6 Where a bank has transferred significant credit risk using funded credit derivatives it should be able to demonstrate capability to refinance the exposures that have been transferred.
- a) For example, where the bank has bought protection of shorter maturity than the assets being protected, it should consider how it would obtain funding if a replacement contract were not to be found on maturity of the protection.
- 7 Where a bank has hedged significant credit risk using unfunded credit derivatives of shorter maturity than the underlying exposures, it should consider whether it would have sufficient capital to support the risk in the event of a replacement contract being unavailable immediately on maturity of the credit risk protection, or how such "rollover" risk could otherwise be avoided or limited.

3.5 Remaining asset base

See ch SE

- 8 As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the

assets remaining on a bank's supervisory balance sheet, in terms of both quality and spread. The FSA will consider these implications in assessing the bank's overall capital requirements.

4 TRADING BOOK/BANKING BOOK DIVISION

4.1 Introduction

4.1.1 *General principles*

1 Credit derivatives should meet the standard criteria applied to other financial instruments in order to be eligible to be held in a bank's trading book. The standard criteria include ability of the bank to mark to market positions daily on a prudent and consistent basis, and demonstration of trading intent. As with other financial instruments, inclusion of credit derivatives should be within each bank's trading book policy statement agreed with the FSA.

See s5, 6, 7 and 8

2 Credit derivatives not included in the trading book should be included in the banking book. Capital treatment of credit derivatives in the banking book is covered in sections 5, 6 and 8 and in the trading book in sections 7 and 8.

See ch CB

a) The criteria for the trading book are set out in the chapter on the trading book/banking book division.

See s9

b) The activity of issuing credit linked notes with trading intent is eligible to be included in the trading book subject to the risk transfer requirements set out in section 9.

c) Credit derivatives referenced to relatively illiquid reference assets (such as loans) are eligible to be included in the trading book, but an appropriate reserve against uncertainty in valuation should be agreed for illiquid credit risky positions in the trading book policy statement.

4.1.2 *Marking to market*

3 Where credit derivatives referenced to relatively illiquid assets are included in the trading book, the FSA may require significant extra capital to be held against uncertainty in valuation.

4.1.3 *Trading intent*

4 In assessing whether a bank has demonstrated trading intent in relation to credit derivatives business; the FSA may take into account the market structure available to support the business.

a) Factors taken into consideration could include how the positions are managed, the use of standard documentation and market conventions, the number of market makers in the product and in instruments hedging it, and the availability of screen prices.

5 BANKING BOOK - PROTECTION BUYER

5.1 Introduction

1 This section sets out the factors that determine the banking book capital treatment for a protection buyer. Capital needed will depend on the particular structure of the contract/instrument.

See s9 2 The following section assumes that the risk transfer conditions set out in section 9 of this chapter have been met.

See s8 3 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

5.2 Funded or unfunded

4 Where an asset is protected in full or in part by a *funded credit derivative*, the FSA recognises the transfer of credit risk by reducing the risk weighted exposure to the reference/underlying asset. The extent to which the risk weighted exposure can be reduced depends on the amount of the funding received and the other factors set out below.

a) A *funded credit derivative* usually refers to a credit linked note. However, both total return swaps and credit default products may also be structured so that exposure to the reference/underlying is funded at inception.

b) This treatment is parallel to that of a loan sub-participation.

See ch BC s3 5 Where an asset is protected in full or in part by an *unfunded credit derivative*, banks may choose to replace the risk weighting of the protected asset with the risk weighting of the counterparty to the credit derivative contract. The extent to which the risk weightings can be replaced depends on the amount of protection received under the contract and the other factors set out below.

a) An *unfunded credit derivative* usually refers to a total return swap or a credit default product.

b) This treatment is parallel to that of a guarantee.

c) If the risk weighting of the counterparty selling protection is higher than that of the protected asset, the risk weighting does not have to be increased.

6 *Materiality thresholds* may affect the amount of protection that is recognised. All credit derivatives involving materiality thresholds should be referred to the FSA.

- a) A *materiality threshold* may either determine the level of loss that must be reached before a credit event is triggered, or may reduce the amount of the payout.

5.3 Payout structure

7 Where the credit event payment is a fixed amount (or binary payout), exposure to the underlying is recognised as guaranteed/reduced by the amount that the bank will receive/retain if the credit event occurs.

8 Where the credit event payment is defined as par less a recovery amount or there is payment of par in exchange for physical delivery of the reference asset, exposure to the underlying asset can be recognised as guaranteed/reduced to zero for the amount protected under the contract.

5.4 Asset mismatch

9 Where the reference asset and the underlying are the same, protection will be recognised subject to the other factors listed in this section.

10 Where the reference asset and the underlying asset being hedged are different, protection can still be recognised if the following criteria are met:

- reference and underlying asset are of the same obligor; and
 - reference asset ranks *pari passu* with, or is more junior in a liquidation than the asset being hedged; and
 - there are cross default clauses between the reference asset and the underlying asset.
- a) The FSA may be prepared to accept asset mismatches where there are not cross default clauses if the bank can demonstrate, to the FSA's satisfaction that there are other structural features which eliminate the basis risk between the reference asset and the underlying asset.

5.5 Currency mismatch

11 Where the credit derivative is denominated in a different currency from the reference/underlying asset, the amount of credit protection recognised is reduced by 8% to take account of the contingent foreign currency risk.

- a) For example, a bank has a £1million asset which is protected by a \$ denominated, recovery based, single asset, maturity matched credit derivative, of, say, \$1.5million. If the exchange rate at the outset is \$1.5: £1, the amount of protection recognised would be £920k. If the amount of protection purchased were \$1.62million, the asset would be recognised as fully protected.
- b) The FSA may consider disapplying the 8% reduction in protection where a bank can demonstrate to the FSA's satisfaction that it has hedged the contingent foreign currency risk.

12 Foreign currency positions created by credit derivatives should also be recorded when measuring the bank's foreign exchange exposure. Funded credit derivatives should be treated like all other cash positions. Unfunded credit derivatives should be treated like guarantees.

See ch FX

- a) Further guidance on the calculation of a bank's foreign exchange exposure is contained in the chapter on foreign exchange risk.

5.6 Maturity of the credit derivative compared with the reference/underlying asset

13 Where the maturity of the credit derivative matches that of the underlying asset, the exposure is recognised as guaranteed/reduced and no additional capital is considered to be needed.

14 Where the maturity of the credit derivative is less than that of the underlying asset, recognition of the protection depends on the residual maturity of the credit derivative.

- a) The maturity of credit derivatives with a *step up* and call option is assumed to be the date of the call.
- b) If the protection seller has the option to terminate the credit derivative, the maturity is deemed to be the date at which the option is first exercisable.
 - i) A *step up* is an increase in the protection payment.

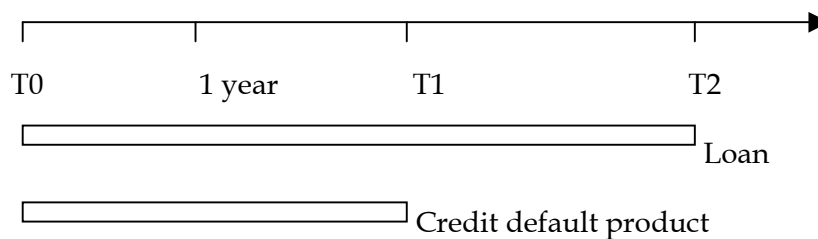
15 If the residual maturity of the credit derivative is less than one year, no protection is recognised.

See ch BC s4

16 If the residual maturity of the credit derivative is one year or over, protection is recognised, but an additional capital charge is made for forward credit exposure to the underlying asset when the credit derivative contract matures. This forward exposure is treated like a commitment with uncertain drawdown, i.e. it attracts a 50% credit conversion factor ('CCF') against the risk weight of the underlying asset.

Example :

time scale:



Suppose that the underlying asset is a loan to a corporate of a tenor equal to T2, risk weighted at 100%, and credit risk protection is bought from a Zone A bank in the form of a credit default product maturing at T1:

At T0, the risk weight on the loan is reduced to 20% (guaranteed portion of the exposure) with an additional capital charge for the forward exposure of 50% (CCF) \times 100%. So the total capital charge is 20% + 50%, = 70%.

Once the residual maturity to T1 reaches one year, protection ceases to be recognised and the risk weight of the loan reverts to 100%.

If the underlying position is an undrawn commitment, the capital treatment resulting from the acquisition of maturity mismatched unfunded protection at T0 is: 20% [risk weight for a Zone A bank] \times 50% (CCF) + 50% (original risk weight of corporate \times CCF) \times 50% (CCF). So the total capital charge is 10% + 25%, = 35%.

17 If the sum of the capital needed for the underlying asset (after protection has been recognised) plus the forward exposure exceeds the original capital requirement for the underlying asset, the credit derivative can be ignored and the underlying asset weighted as normal.

5.7 Multiple names

See s9

18 Where the credit derivative is referenced to more than one obligor (sometimes known as a basket or multiple name product) the nature of the credit protection provided depends on the structure of the contract. Additional conditions would need to be met to ensure transfer of credit risk is not jeopardised by reputational risk, as set out in section 9 of this chapter.

19 If the contract terminates and pays out on the first asset to default in the basket, then protection is only recognised against one asset in the basket. Banks may choose which asset in the basket attracts protection.

20 If the contract allocates protection proportionately amongst assets in the basket (sometimes known as a *green bottle structure*) protection is recognised in setting capital requirements against all the assets in the basket according to the proportions in the contract.

See s9

21 If a bank provides credit enhancement to a special purpose vehicle to which it has transferred credit risk through credit derivatives, the credit enhancement is treated as a deduction from capital in accordance with the FSA's policy on securitisation.

5.8 Open short positions and unrecognised protection

22 Where a bank buys protection in the absence of an underlying exposure (i.e., it has an open short position), or where bought protection is not recognised in calculating the capital needed for an underlying exposure, the credit derivative is ignored for capital adequacy purposes.

6 BANKING BOOK - PROTECTION SELLER

6.1 Introduction

1 This section sets out the factors that determine the banking book capital treatment of a protection seller.

See s8

2 This section does not apply to credit spread options. The capital treatment of credit spread options is set out in section 8.

6.2 Funded or unfunded

3 Through a funded credit derivative, a bank acquires exposure to the reference asset (since performance of the credit derivative depends on that of the reference asset), and also to the credit derivative counterparty (since the bank relies on the counterparty to pass on funds during the life of the contract, and on maturity or following a credit event). Where the counterparty is an SPV, a bank may also have exposure to the collateral securities purchased with the money received from the issuance of securities.

4 The amount at risk is limited to the funding provided, however, and this on-balance-sheet exposure is recorded at the higher of the risk weights of the reference obligor and the counterparty holding the funds and, where applicable, the collateral security.

See ch BC

5 Where a bank has sold protection through an unfunded credit derivative, it acquires exposure to the reference asset only. This *exposure* is recorded as a direct credit substitute weighted according to the risk weight of the reference asset.

a) The *exposure* will be the maximum payout under the contract.

6.3 Multiple names

See s6.2

6 Credit derivatives referenced to single names are treated as set out above.

7 Where credit derivatives are referenced to more than one obligor (a basket or multiple name product), the nature of the credit risk acquired depends on the structure of the contract.

8 If the contract terminates and pays out on the first asset to default in the basket, the bank should hold capital against all the names in the basket.

a) The FSA may consider that this is not needed where a bank can demonstrate, to the FSA's satisfaction, a very strong correlation between the assets in the basket.

- 9 This means that risk weightings are applied to the maximum payout amount under the contract for each of the names in the basket, capped at the equivalent of a deduction from capital.
- 10 A structure which is referenced to the assets in the basket proportionately should be risk weighted according to the assets in the basket in the proportions set out in the contract.

6.4 Payout structure

- 11 Where the amount of the protection is fixed in the contract, the risk weighted exposure to the reference asset(s) is the amount of the payout.
- 12 Where the credit amount payment is based on par less recovery value or where there is physical delivery in exchange for par value, the risk weighted exposure to the reference asset(s) is the maximum payout under the contract.

7 TRADING BOOK TREATMENT

7.1 Introduction

1 This section sets out the capital treatment considered to be applicable to credit derivatives in the trading book.

See s8

2 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

7.2 Models

See chs TS and TV

3 Banks may apply to the FSA to include credit derivatives in recognised models under CAD1 and also CAD2 models. Banks may apply for recognition of CAD2 models which quantify partial offsets of specific risk positions where there is a maturity or asset mismatch.

See chs TS and ch TV

4 For details of the benchmarking approach to such models see elsewhere.

See s7.3

5 Banks which do not have recognised models covering credit derivatives should follow the standard approach set out below.

7.3 Standard approach

7.3.1 Introduction

See ch II

6 This section describes the positions to be recorded for credit derivatives for the purposes of calculating specific risk and general market risk charges under the standard approach. The calculation of specific and general market risk charges is described in the chapter on interest rate position risk.

7.3.2 General principles

7 Total return swaps are represented as two legs: one is a notional position in the reference asset with general and specific risk of the reference asset; the other, representing interest payments under the swap, is a notional position in a Zone A government bond with the appropriate fixed or floating rate.

8 Credit default products are represented as a notional position in the specific risk of the reference asset only (i.e., no general risk position is created in 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.

9 Credit linked notes are treated as a position in the note itself, with an embedded credit default product. The credit linked note has specific risk of the issuer and general market risk according to the coupon or interest rate of the note. The embedded credit default product creates a notional position in the specific risk of the reference asset (with no additional general market risk position created).

7.3.3 *Specific risk - single reference asset*

See s5.2

10 As noted above, total return swaps, credit default products and credit-linked notes create a specific risk position in the reference asset; the credit risk seller has a short position and the credit risk buyer has a long position.

See ch II s5

- a) For the specific risk position to be treated as a qualifying debt item, the reference asset should meet the standard conditions for a qualifying debt item as defined in the chapter on interest rate position risk.

11 The buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer.

7.3.4 *Specific risk - multiple reference assets*

12 Where a total return swap is referenced to multiple names, and the returns on assets are exchanged according to their proportions in the basket, the bank should record long or short positions in all the reference assets according to the proportions underlying the swap.

See s5.2

13 Where credit default products and credit linked notes are referenced to multiple names the positions recorded depend on the structure of the contract.

14 The credit risk seller of a first to default product or note should record a short position in one reference asset in the basket only. Banks may choose which asset in the basket to record as a short position.

15 The credit risk buyer in a first to default product or note should record long positions in each of the assets in the basket, with the total capital charge for the product capped at the equivalent of deduction from capital, with the exception noted below.

- a) The amount of the position recorded will be the value of the note.
- b) The FSA may consider disapplying the additive treatment where a bank can demonstrate, to the FSA's satisfaction, that there is a very strong correlation between the reference assets in the basket.

16 Where the credit default product or credit linked note is a proportionate structure, positions should be recorded in the reference assets according to the proportions in the contract.

17 Where a multiple-name credit-linked note is rated such as to meet the conditions for recognition as a qualifying debt item, the buyer of credit risk may record the specific risk position in the reference assets as a single long specific risk position with specific risk of the note issuer.

See ch II s5

a) Qualifying debt items are defined in the chapter on interest rate position risk.

18 The credit risk buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer, whether the credit derivative meets the definition of qualifying or not.

7.3.5 *Specific risk offset*

19 Banks may net notional positions in reference assets created by credit derivatives with positions in underlying assets or other notional positions created by other credit derivatives if the following conditions are met:

(a) the underlying and reference assets are issued by the same obligor;

See ch II s3

(b) the underlying and reference asset specific risk positions meet the matching criteria set out in the chapter on interest rate position risk; and

See s9

(c) the conditions set out below are met.

See s7.2

Where the reference asset and the underlying asset do not meet the criteria for netting, no offset is considered to be justified under the standard approach.

20 Materiality thresholds may reduce the amount of the specific risk offset. All credit derivatives involving materiality thresholds should be referred to the FSA.

See s5.2

a) The definition of a materiality threshold is given elsewhere.

7.3.6 *Maturity mismatch*

21 Where a credit default product or credit linked note is of shorter maturity than the reference asset, a specific risk offset is allowed between long and short specific risk positions, but a forward position in specific risk of the reference asset is recorded. The net result is a single specific risk charge for the longer maturity position in the reference asset.

a) The maturity of a credit derivative with a *step up* and call option is assumed to be the date of the call.

i) A *step up* is an increase in the protection payment.

22 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.

7.3.7 *General market risk*

See ch TI s6

23 Credit default products do not normally create a general market risk position.

24 Total return swaps create a long or short position in the reference asset and a short or long position in the notional bond representing the interest rate related leg of the contract.

25 Credit linked notes create a long position in the note itself for the credit risk buyer.

7.4 **Counterparty risk**

7.4.1 *General principles*

26 Each party to a total return swap relies on the other for payment, therefore each party records a counterparty risk charge.

See ch DU and
TC

a) The counterparty risk charge is calculated as set out in chapters DU and TC

27 The credit risk seller in credit default product relies on the credit risk buyer to pay the credit event payment if a credit event occurs, and therefore records a counterparty risk charge. The credit risk buyer is exposed to the credit risk seller only if there are future premiums or interest rate related payments outstanding, and these are recorded as a sundry debtor and risk weighted in the normal way.

See chs DU and
TC

- a) The counterparty risk charge is calculated as set out in the chapters on counterparty risk treatments common to the banking and the trading book and counterparty risk in the trading book.

28 There is no counterparty risk charge for credit linked notes.

7.4.2 *Potential future credit exposure (add-on)*

29 The add-on used when calculating the counterparty exposure for an unfunded OTC credit derivative is determined by whether the reference asset is recognised as a qualifying debt item. If the reference asset is a qualifying debt item, the counterparty risk charge is calculated using interest rate add-ons. Otherwise, equity add-ons should be used.

See ch II s5

- a) Qualifying debt items are defined in the chapter on interest rate position risk.

7.5 **Foreign exchange risk**

See ch FX

30 Where the credit derivative is denominated in a currency other than the reporting bank's base currency, it will feed into the bank's monitoring of its foreign exchange position in the normal way.

8 CREDIT SPREAD OPTIONS

8.1 General

1 The capital needed for credit spread options are analogous to those of other options on credit risk assets.

8.2 Banking book

8.2.1 *Protection buyer*

2 The capital reduction/guarantee treatment set out in section 5 in respect of the underlying asset is not considered to be available to the purchaser of a credit spread option.

- a) The amount of protection provided by a credit spread option depends on its mark to market value. However the assumption underlying the banking book framework is accrual accounting.

See ch DU

3 Protection bought using a credit spread option is ignored for capital purposes.

8.2.2 *Protection seller*

4 Protection sold using a credit spread option is recorded as a direct credit substitute. The amount of exposure will be the par value of the nominal amount of the reference asset.

8.3 Trading book

5 The option carve out treatment should be used for credit spread options only after prior consultation with the FSA. Banks should normally apply for recognition of option models covering credit spread options.

9 RISK TRANSFER CRITERIA

9.1 Scope

1 This section sets out conditions to be met before risk transfer (i.e. protection)/short position is recognised in setting capital requirements for banks which buy protection using credit derivatives in the banking book (see section 6) or selling credit risk in the trading book (see section 7). This section does not apply to credit spread options (see section 8).

2 Where these criteria are not met, protection bought should be ignored in the banking book (and the bank should continue to weight the underlying asset as normal) and a short credit risk position recorded in the trading book should not be offset against another specific risk position.

3 Sections 9.2 to 9.4 apply to both the banking book and the trading book.

4 Section 9.2 applies to all credit derivatives, whether funded or unfunded, single name or multiple names.

5 Section 9.3 applies to funded credit derivatives referenced to single names or multiple names.

- a) For the purposes of section 9, first to default structures referenced to multiple names are considered to be referenced to a *single* name. This is because protection is only recognised against one asset in the basket for capital purposes.

6 Section 9.4 applies to packaged credit derivative transactions, which are funded.

- a) For the purposes of section 9, *packaged* transactions include proportionate credit derivatives referenced to multiple names, and structures which bundle together a series of single name credit derivatives.

9.2 General criteria

7 In order for the protection bought/short position to be recognised the following criteria should be met for all credit derivatives:

- (a) The credit risk transfer should not contravene any terms and conditions relating to the reference asset and where necessary all consents should have been obtained;

- a) This relates mainly to reference assets which are loans.
- (b) At a minimum, the credit events in a credit default product or credit-linked note should cover credit events in the reference asset itself; and
- (c) The credit risk buyer should have no formal recourse to the credit risk seller for losses.

9.3 Criteria for funded single name credit derivatives

8 In order for protection/offsetting short position to be recognised, the following criteria should be met:

- (a) the protection buyer should have no obligation to repay any funding received under the credit derivative except at termination or as a result of a defined credit event (in accordance with the terms of payment defined in the contract); and
 - a) The protection buyer may retain the option to repay funding, provided that the reference asset remains fully performing.
 - b) In proportionate transactions involving baskets of assets, the protection seller may retain the option to refinance where the pool of assets has been reduced by repayment to less than 10% of its maximum value but only where the reference assets are fully performing.
 - c) An exception to this restriction is where the obligation arises from warranties given in respect of the asset at the time of the transaction, provided that these are not in respect of the future creditworthiness of the reference asset.
- (b) the protection buyer should have given notice to the protection seller that it is under no obligation to repay the funding (except as defined in (a) above), nor to support any losses suffered by the protection seller, and that the protection seller acknowledges the absence of that obligation.
 - a) Notice and acknowledgement also applies to the ultimate investors, where the initial protection seller is an SPV.
 - b) This criterion may be met by a highly visible and unequivocal statement that the protection buyer does not stand behind the asset(s) and will not make good any losses suffered in the offering circular (or other analogous documentation).

- 9 For those unfunded transactions where collateral has been taken, the conditions in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

9.4 Criteria for funded packaged transactions

- 10 This section applies to funded credit derivatives referenced to multiple names which have a proportionate payout structure, or where a series of funded single name credit derivatives are packaged together. This section does not apply to unfunded structures or to multiple-name credit derivatives with a first to default structure.

- 11 Packaging of the credit risk of multiple assets for transfer may create operational risks which would be negligible for a single asset. For example, the commercial reputation of a protection buyer could be committed by association with a package of assets, and clean transfer of the risk could be jeopardised by pressure on the protection buyer subsequently to provide support to reduce losses of the credit risk buyer. Such reputational risk is less if the assets concerned are disclosed and they are freely tradable assets.

- 12 The following criteria should be met for protection/offsetting short position to be recognised. Some of these criteria may not need to be met if all the reference obligors are disclosed and all the reference assets are freely tradable assets.

- (a) The bank selling credit risk should be satisfied that the transaction protects it from any liability to the credit risk buyer and ultimate investors, except where the bank has been negligent.

a) Banks can achieve this by ensuring that their auditors and legal advisers are satisfied that the terms of the scheme protect them from liability to the credit risk buyer and ultimate investors and that the scheme meets the FSA's policy.

- (b) The credit risk should initially be transferred to a special purpose vehicle (SPV). The protection buyer should not own any share capital or other form of proprietary interest in or control over the SPV, either directly or indirectly.

a) This applies also to any other group entity within the protection buyer's group that is covered by the FSA's consolidated supervision.

- b) Share capital includes for this purpose all classes of ordinary and preference share capital.
 - c) Control, for these purposes means that the Board of the company used as a vehicle should be independent of the credit risk seller, although the credit risk seller may have one director representing it.
- (c) The name of the SPV should not include the name of the protection buyer nor imply any connection with it.
- (d) The protection buyer should not directly reimburse the vehicle for any of the recurring expenses of the scheme. Although the credit risk seller may make a one off contribution at the initiation of the scheme to enhance the credit-worthiness of the vehicle. Any credit enhancement provided will be treated as a deduction from capital.
- a) Any such credit enhancement should be disclosed in the offering circular (or analogous documentation).
- (e) The credit risk seller should not fund the vehicle (other than the initial credit enhancement described above); in particular it should not provide temporary finance to a scheme to cover cash shortfalls.
- a) The credit risk seller may enter into interest rate and currency swaps with the SPV as long as they do not provide support for losses in the vehicle.

See ch NE

13

For those unfunded transactions where collateral has been taken, the criteria in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

10 LARGE EXPOSURES

10.1 Introduction

See ch LE

1 The factors that should be considered in determining large exposures recorded for credit derivatives are the same as those for determining capital adequacy, with the exception of the factors noted in this section. Large exposures are covered fully in the chapter on large exposures.

- a) The amount of protection recognised will normally be the same for large exposures as for capital adequacy purposes.

2 Sections 10.2 to 10.5 apply to credit default products, credit linked notes and total return swaps. Section 10.6 applies to credit spread options.

10.2 Banking book and trading book – protection buyer

10.2.1 *Maturity mismatch*

3 For capital adequacy purposes forward credit exposure left by a maturity mismatched credit derivative is treated as an undrawn commitment. Undrawn commitments are treated as an exposure for large exposures purposes, and hence maturity mismatched credit derivatives do not reduce exposure to the underlying.

10.2.2 *Currency*

4 Where the base currency of a funded credit derivative is different from that of the underlying asset, no protection is recognised for large exposures purposes.

10.2.3 *Multiple names*

5 Protection bought/short position created through a credit derivative referenced to multiple names in a first to default structure is recognised for one asset in the basket only for both large exposures and capital adequacy. The same asset should be chosen in each case.

10.3 Banking book - protection buyer

10.3.1 *Unfunded*

6 Where an unfunded credit derivative is treated as a guarantee for capital purposes, banks may choose to record their exposure either to the underlying or to the counterparty in the credit derivative transaction, provided that the treatment adopted is in line with the bank's large exposures policy statement.

10.4 Banking book - protection seller

10.4.1 *Funded*

7 Where a credit derivative is funded, banks should report exposure to both the reference asset(s) and the credit derivative counterparty/issuer for large exposures purposes.

- a) First to default multiple name credit derivatives result in exposures to more than one reference asset.

10.5 Trading book

10.5.1 *Asset mismatch*

See ch LE

8 Offsetting of long and short positions should be calculated in accordance with the chapter on large exposures. Long and short positions may be offset provided the policy in that chapter is followed.

10.6 Credit spread options

This section applies to both the banking book and the trading book.

10.6.1 *Protection buyer/credit risk seller*

9 No protection/offset is recognised for the purchaser of a credit spread option for LE purposes

10.6.2 *Protection seller/credit risk buyer*

10 A credit spread option creates an exposure to the reference asset for LE purposes. The exposure is the par value of the nominal amount of the reference asset.