Subsidiary Legislation made under s. 53 of the Financial Services Act 1989.

# FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007

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**EU Legislation/International Agreements involved:**

Directive 86/635/EEC
Directive 93/6/EEC
Directive 98/26/EC
Directive 2000/12/EC
Directive 2002/87/EC
Directive 2002/92/EC
Directive 2003/6/EC
Directive 2003/41/EC
Directive 2003/71/EC
Directive 2004/39/EC
Directive 2004/109/EC
Directive 2005/60/EC
Directive 2006/48/EC
Directive 2006/49/EC
Directive 2009/27/EC
Directive 2009/65/EC
Directive 2009/111/EC
Directive 2010/76/EU
Directive 2010/78/EU
Regulation (EU) No 1093/2010

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# FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007

## FINANCIAL SERVICES ACT 1989

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**FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007**

*In exercise of the powers conferred on him by section 53 of the Financial Services Act 1989 and all other enabling powers, the Minister has made the following regulations to transpose into the law of Gibraltar Council Directive 2006/49/EC, of the European Parliament and of the Council, of 14 June 2006 which recasts the Capital Adequacy Directive 93/6/EEC in order to establish a new way of calculating capital requirements for investment firms.*

**PART I**

*Preliminary*

**Title and commencement.**

1.(1) These Regulations may be cited as the Financial Services (Capital Adequacy of Investment Firms) Regulations 2007 and, subject to sub-regulation (2), shall be deemed to have come into operation on 1 January 2007.

(2) Regulations 14 and 16 shall come into operation on 1 January 2008.

**Interpretation.**

2.(1) In this Act, unless the context otherwise requires–

"ancillary services undertaking" means an undertaking whose principal activity consists in owning or managing property, managing data processing services or any other activity of one or more investment firms;

"capital" means own funds;

"clearing member" means a member of the exchange or the clearing house which has a direct contractual relationship with the central counter party (market guarantor);

"credit institution" means–

(a) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account;

(b) any other undertaking which issues means of payment in the form of electronic money;

"EBA" means the European Banking Authority established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory

Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC;

"European parent investment firm" means a parent investment firm in an EEA State which is not a subsidiary of another institution authorised in any such State, or of a financial holding company set up in any such State;

"FSCACI Regulations" means the Financial Services (Capital Adequacy of Credit Institutions) Regulations transposing Directive 2006/48/EC;

"financial holding company" means a financial institution–

(a) the subsidiary undertakings of which are either exclusively or mainly investment firms or other financial institutions, at least one of which is an investment firm; and

(b) which is not a mixed financial holding company;

"financial institution" means an undertaking which is not a credit institution whose principal activity is to acquire holdings or to carry on one or more of the activities mentioned in paragraphs 2 to 12 of Schedule 1 of the FSCACI Regulations;

"financial instruments" means any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party and shall include both primary financial instruments or cash instruments, and derivative financial instruments the value of which is derived from the price of an underlying financial instrument or a rate or an index or the price of an underlying other item and include as a minimum the instruments specified in Section C of Annex I of Directive 2004/39/EC.

"initial capital" shall comprise–

(a) all amounts, regardless of their actual designation, which, in accordance with an investment firm's legal structure, are regarded as equity capital subscribed by shareholders or other proprietors in so far as it has been paid up, plus share premium account accounts but excluding cumulative preferential shares; and

(b) all types of reserves shown separately in the investment firm's balance sheet and profit and losses brought forward as a result of the application of the final profit or loss;

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"investment firm" means–

(a) any legal person, whether or not a licensee, whose regular occupation or business is the provision of one or more investment services to third parties or the performance of one or more investment activities on a professional basis; or

(b) any natural person, whether or not a licensee, whose services involve the holding of third parties' funds or transferable securities and, without prejudice to the requirements of these Regulations and Directive 93/6/EEC, he complies with the following conditions–

(i) especially in the event of the insolvency of the firm or of its proprietors, seizure, set off or any other action by creditors of the firm or of its proprietors;

(ii) the firm must be subject to rules designed to monitor the firm's solvency and that of its proprietors; and

(iii) the firm's annual accounts must be audited by qualified auditors; and

(iv) where the firm has only one the ownership rights of third parties in instruments and funds shall be safeguarded, proprietor, he must make provision for the protection of investors in the event of the firm's cessation of business following his death, his incapacity or any other such event;

but "investment firm" shall not include–

(c) a credit institution;

(d) a local firm;

(e) a firm which is only authorised to provide the service of investment advice or receive and transmit orders from investors without holding money or securities belonging to their clients and which for that reason may not at any time place itself in debit with its clients;

and for the purposes of applying supervision on a consolidated basis, includes a non-European investment firm;

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"investment services and activities" means any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I of Directive 2004/39/EC;

"local firm" means a firm dealing on own account on markets in financial-futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deals for the accounts of other members of those markets and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets;

"mixed financial holding company" means a parent undertaking, other than a regulated entity, which together with its subsidiaries, at least one of them is a regulated entity which has its head office in an EEA State, and other entities constitute a financial conglomerate;

"original own funds" has the meaning assigned to it by regulation 8;

"own funds" has the meaning assigned to it in the FSCACI Regulations;

"parent financial holding company in an EEA State" means a financial holding company which is not itself a subsidiary of a credit institution or an investment firm authorised in the same EEA State, or of a financial holding company set up in the same EEA State;

"parent investment firm in an EEA State" means an investment firm which has an investment firm or credit institution or financial institution as a subsidiary or which holds a participation in such entities, and which is not itself a subsidiary of an investment firm or credit institution authorised in the same EEA State, or of a financial holding company set up in the same EEA State;

"parent undertaking" means an undertaking which, in the opinion of the Authority, effectively exercises a dominant influence over another undertaking;

"recast Directive" means Directive 2006/49/EC of 14 June 2006, (as extended, where applicable, by the EEA Agreement);

"recognised non-European investment firm" means a firm which–

(a) if it were established in an EEA State, would be covered by the definition of investment firm;

(b) is authorised in a non-EEA State;

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(c) is subject to and complies with the prudential rules considered by the Authority as at least as stringent as those laid down in these Regulations;

"securitisation position" and "re-securitisation position" mean, respectively, securitisation position and re-securitisation position as defined in the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007;

"subsidiary undertaking" means an undertaking over which, in the opinion of the Authority, a parent undertaking effectively exercises a dominant influence and for this purpose all subsidiaries of subsidiary undertakings shall also be considered subsidiaries of the undertaking which is their original parent.

(2) For the purposes of these Regulations–

(a) a category 1 investment firm is one to which regulation 5(8) applies;

(b) a category 2 investment firm is one to which regulation 5(1) applies; and

(c) a category 3 investment firm is one to which regulation 5(2) applies.

(3) Expressions used in these Regulations which are also used in the Financial Services Acts 1989 and 1998 shall have the same meaning for the purposes of these Regulations as they have for the purposes of those Acts.

**Application of these Regulations.**

3.(1) Subject to regulations 14, 16, 18 to 28, 30 and 34, regulations 16 to 21 of the FSCACI Regulations shall apply mutatis mutandis to investment firms.

(2) In applying regulations 18 to 20 of the FSCACI Regulations to investment firms, every reference to a parent credit institution in an EEA State shall be construed as a reference to a parent investment firm in an EEA State and every reference to a European parent credit institution shall be construed as a reference to a European parent investment firm.

(3) Where a credit institution has, as a parent undertaking, a parent investment firm in an EEA State, only that parent investment firm shall be

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subject to requirements on a consolidated basis in accordance with regulations 19 to 21 of the FSCACI Regulations.

(4) Where an investment firm has, as a parent undertaking, a parent credit institution in an EEA State, only that parent credit institution shall be subject to requirements on a consolidated basis in accordance with regulations 19 to 21 of the FSCACI Regulations.

(5) When a group covered by sub-regulations (3) and (4) does not include a credit institution, the FSCACI Regulations shall apply in a manner such as that every reference to a credit institution shall be construed as a reference to an investment firm.

(6) Regulation 91(8) to (14) of the FSCACI Regulations shall apply mutatis mutandis for the purposes of these Regulations subject to paragraphs (a) which shall apply where the discretion referred to in regulation 152(8) of the FSCACI Regulations is exercised–

(a) references in paragraph 7 of Schedule 2 to Directive 2006/48/EC shall be read as references to Directive 2000/12/EC as it stood prior to the 1 January 2007;

(b) paragraph 4 of Schedule 2 shall apply as it stood prior to the 1 January 2007.

**Competent Authority.**

4. The Authority shall be the competent authority for the purposes of the recast Directive and the Minister shall ensure that the EBA and the European Commission are informed accordingly.

## PART II
*Capital requirements*

**Obligation to hold initial capital.**

5.(1) A Gibraltar investment firm which does not deal in any financial instruments for its own account or underwrites issues of financial instruments on a firm commitment basis, but which holds clients' money or securities and which offers–

(a) the reception and transmission of investors' orders for financial instruments; or

(b) the execution of investors' orders for financial instruments; or

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(c) the management of individual portfolios of investments in financial instruments;

shall have an initial capital of EUR 125,000 or its equivalent in sterling.

(2) The Authority may reduce the amount of initial capital required under sub-regulation (1) to EUR 50,000 or its equivalent in sterling for a Gibraltar investment firm which is not authorised to hold clients' money or securities, to deal for its own account or underwrite issues on a firm commitment basis.

(3) A Gibraltar investment firm which executes investors' orders for financial instruments may apply to the Authority to be authorised to hold such instruments for its own account if it meets the following conditions–

(a) such positions arise only as a result of the firm's failure to match investors' orders precisely;

(b) the total market value of all such positions is subject to a ceiling of 15% of the firm's initial capital;

(c) the requirements laid down in regulations 14,16 and 24; and

(d) such positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

(4) For the purposes of this regulation, the holding of non-trading-book positions in financial instruments in order to invest own funds shall not be considered as dealing in relation to the services referred to in sub-regulation (1) or for the purposes of sub-regulation (2).

(5) A Gibraltar investment firm which is a local firm, in so far as it benefits from the freedom of establishment or to provide services specified in articles 31 or 32 of Directive 2004/39/EC shall have an initial capital of EUR 50,000 or its equivalent in sterling.

(6) A Gibraltar investment firm which is only authorised to provide investment advice or receive and transmit orders from clients without holding their money or securities and which for that reason may not at any time place itself in debt with clients, shall meet one of the following requirements–

(a) possess an initial capital of EUR 50,000 or its equivalent in sterling;

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(b) hold professional indemnity insurance with EEA-wide cover or some other comparable guarantee against liability arising from professional negligence, representing at least EUR 1,000,000 applying to each claim and in aggregate EUR 1,500,000 per year for all claims; or

(c) a combination of initial capital and professional indemnity insurance in a form resulting in a level of coverage equivalent to that referred to in paragraph (a) or (b).

(7) A Gibraltar investment firm which is only authorised to provide investment advice or receive and transmit orders from clients without holding their money or securities and which for that reason may not at any time place itself in debt with clients and which is also registered under Directive 2002/92/EC shall comply with article 4(3) of that Directive and shall meet one of the following requirements–

(a) possess an initial capital of EUR 25,000 or its equivalent in sterling;

(b) hold professional indemnity insurance with EEA-wide cover or some other comparable guarantee against liability arising from professional negligence acceptable to the Authority, representing at least EUR 500,000 applying to each claim and in aggregate EUR 750,000 per year for all claims; or

(c) a combination of initial capital and professional indemnity insurance in a form resulting in a level of coverage equivalent to that referred to in paragraph (a) or (b).

(8) A Gibraltar investment firm other than one to which sub-regulations (1) to (7) applies shall have an initial capital of EUR 730,000 or its equivalent in sterling.

**Own funds of Gibraltar investment firm.**

6.(1) The own funds of a Gibraltar investment firm and of an investment firm to which regulation 5(5) applies shall not fall below the level specified in regulation 5(1), (2), (5) or (8).

(2) An investment firm to which sub-regulation (1) applies and which fails to comply with the provisions of that sub-regulation may apply to the Authority to be allowed a specified period of time to so comply and a failure to comply within that period of time may result in the cancellation or suspension of the firm's licence.

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## PART III
*Trading book*

**Trading book.**

7(1) The trading book of an investment firm shall consist of all positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book and which shall either be free of any restrictive covenants on their tradability or able to be hedged.

(2) For the purposes of sub-regulation (1)–

(a) positions held with trading intent shall be those held intentionally for short-term resale or with the intention of benefiting from actual or expected short-term price differences between the buying and selling prices or from other price or interest rate variations;

(b) "positions" shall include proprietary positions, positions arising from client servicing and market making.

(3) Trading intent shall be evidenced based on the strategies, policies and procedures set up by the investment firm to manage the position or portfolio in accordance with Part A of Schedule 7.

(4) An investment firm shall establish and maintain systems and controls to manage its trading book in accordance with the provisions of Parts B and D of Schedule 7.

(5) Internal hedges may be included in the trading book of investment firms on condition that they comply with the provisions of Part C of Schedule 7.

## PART IV
*Own funds*

**Interpretation.**

8. For the purposes of this Part, "original own funds" means the aggregate of the amounts represented by–

(a) the capital, which for the purposes of this regulation shall be taken to include all amounts, regardless of their actual designation, which, in accordance with an investment firm's legal structure, are regarded as equity capital subscribed by shareholders or other proprietors in so far as it has been paid up, plus the related share premium accounts, it fully absorbs

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losses in going concern situations and in the event of bankruptcy or liquidation ranks after all other claims;

(b) the funds which the investment firm decides to put aside to cover particular risks associated with investment services and activities where that is required by the particular risks;

(ba) instruments other than those referred to in paragraph which meet the requirements of regulations 12(a), (c), (d) and (e) and 12A of the FSCACI Regulations,

less the total of the amount represented by–

(c) the own shares at book value;

(d) the intangible assets specified in article 4(9) of Directive 86/635/EEC;

(e) the material losses of the current financial year.

**Assessment of own funds.**

9.(1) Subject to sub-regulations (2) to (7) and regulations 10 to 13, the own funds of an investment firm shall be determined in the same manner as the own funds of a credit institution determined in accordance with the FSCACI Regulations.

(2) An investment firm which is required to meet its capital requirement calculated in accordance with regulations 17 and 24 to 28 and Schedules I and 3 to 6, may apply to the Authority to be authorised to use, for that purpose only, an alternative determination of own funds:

Provided that no part of the own funds used for that purpose shall be used simultaneously to meet other capital requirements.

(3) Any alternative determination authorised under sub-regulation (2) shall be the aggregate of the amounts in paragraphs (a) to (c) less, if the Authority so requires it, the amount in paragraph (d) below–

(a) own funds excluding those mentioned in regulation 7(1)(k) to (p) of the FSCACI Regulation for an investment firm which is required to deduct paragraph (d) from the total of this paragraph and paragraphs (b) and (c);

(b) net trading-book profits net of any foreseeable charges or dividends, less net losses on other business provided that none

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of those amounts has already been included in paragraph (a) as one of the items in regulation 7(b) or (j) of those Regulations;

(c) subordinated loan capital or the items referred to in sub-regulation (7), subject to the conditions set out in sub-regulations (4) and (5) and in regulation 10;

(d) illiquid assets as specified in regulation 11.

(4) The subordinated loan capital referred to in sub-regulation (3)(c) shall–

(a) have an initial maturity of at least two years;

(b) be fully paid up and the loan agreement shall not include any clause providing that in specified circumstances (other than the winding-up of the investment firm) the debt will become repayable before the agreed repayment date, unless the Authority approves the repayment;

(c) be such that neither its principal nor the interest on it may be repaid if such repayment would mean that the own funds of the investment firm would then amount to less than 100% of that investment firm's overall requirements.

(5) The subordinated loan capital referred to in sub-regulation (3)(c) shall not exceed a maximum of 150% of the original own funds left to meet the requirements calculated in accordance with regulations 17 and 24 to 28 and Schedules 1 to 6 and shall approach that maximum in such circumstances as are acceptable to the Authority.

(6) The Authority may authorise an investment firm to replace the subordinated loan capital referred to in sub-regulation (3)(c) with that referred to in regulation 7(1)(d) to (g) of the FSCACI Regulations.

(7) An investment firms shall report to the Authority all repayments on a subordinated loan capital as soon as its own funds fall below 120% of its overall capital requirements.

**Subordinated loan capital.**

10.(1) The Authority may authorise an investment firm to exceed the ceiling for subordinated loan capital set out in Regulation 9(5) if it considers it prudentially adequate to do so.

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(2) The Authority shall not grant an authority under sub-regulation (1) if the total of the subordinated loan capital and that referred to in regulation 9(6) does not exceed–

(a) 200% of the original own funds left to meet the requirements calculated in accordance with regulations 17 and 24 to 28 and Schedules 1 and 3 to 6; or

(b) 250% of the same amount where an investment firm deducts the item set out in regulation 9(3)(d) when calculating its own funds.

(3) The Authority may authorise the ceiling for subordinated loan capital set out in regulation 9(5) to be exceeded by a credit institution, if it considers it prudentially adequate to do so.

(4) The Authority shall not grant approval under sub-regulation (3) if the total of the subordinated loan capital and that referred to in regulation 7(1)(d) to (g) of the FSCACI Regulations exceed 250 % of the original own funds left to meet the requirements calculated in accordance with regulations 24 to 28 and Schedules I and 3 to 6.

**Illiquid assets.**

11.(1) Illiquid assets referred to in regulation 9(3)(d) shall include–

(a) tangible fixed assets, except to the extent that land and buildings may be allowed to count against the loans which they are securing;

(b) holdings in and subordinated claims on credit or financial institutions which may be included in the own funds of those institutions provided that they have not been deducted under regulation 7(1)(k) to (p) of the FSCACI Regulations or under sub-regulation (d) below;

(c) holdings and other investments in undertakings other than credit or financial institutions which are not readily marketable;

(d) deficiencies in subsidiaries;

(e) deposits made which are not available for repayment within 90 days and which do not include payments in connection with margined futures or options contracts;

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(f) loans and other amounts due which are not due for repayment within 90 days;

(g) physical stocks which are not subject to capital requirements at least as stringent as those set out in regulations 14 and 16.

(2) An investment firm may apply to the Authority for it to waive the application of sub-regulation (1)(b) for the purposes of this regulation–

(a) where shares in a credit or financial institution are held temporarily for the purpose of a financial assistance operation designed to reorganise and save that institution; or

(b) in respect of those shares which are included in an investment firm's trading book.

**Other provisions concerning own funds.**

12. An investment firm which is part of a group which has been granted the waiver provided for in regulation 18 shall calculate its own funds in accordance with regulations 9 to 11 subject to the following variations–

(a) the illiquid assets referred to in regulation 9(3)(d) shall be deducted;

(b) the exclusion referred to in regulation 9(3)(a) shall not cover those components referred to in regulation 7(1)(k) to (p) of the FSCACI Regulations which an investment firm holds in respect of undertakings included in the scope of consolidation;

(c) the limits referred to in regulation 15(1)(a) and (b) of the FSCACI Regulations shall be calculated with reference to the original own funds less the components of regulation 7(1)(k) to (p) of those Regulations which are elements of the original own funds of the undertakings referred to in paragraph (b);

(d) the components of regulation 7(1)(k) to (p) of the FSCACI Regulations shall be deducted from the original own funds and not from the total of all items mentioned in regulation 15(2) of those Regulations for the purposes of regulations 9(5) and (6) and 10.

PART V

*Provisions against risks*

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FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007

**Calculation of risk-weighted exposure.**

13.(1) An institution which, for the purposes of Schedule 2, calculates risk-weighted exposure amounts in accordance with the provisions of regulations 34 to 39 of the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007, the following shall apply for the purposes of the calculation provided for in point 36 of Part I of Schedule 7 of those Regulations−

(a) value adjustments made to take account of the credit quality of the counter party may be included in the sum of value adjustments and provisions made for the exposures indicated in Schedule 2;

(b) subject to the approval of the Authority, if the credit risk of the counter party is adequately taken into account in the valuation of a position included in the trading book the expected loss amount for the counter party risk exposure shall be zero.

(2) For the purposes of sub-regulation (1)(a), such value adjustments shall not be included in own funds other than in accordance with sub-regulation (1).

(3) For the purposes of this regulation, regulations 92 and 93 of the FSCACI Regulations shall apply.

**Provisions against risks.**

14.(1) An investment firm shall, at all times, have own funds amounting to or exceeding the capital requirements, calculated in accordance with the methods and options in–

(a) regulations 24 to 28 and Schedules 1, 2 and 6 and, where appropriate, Schedule 5, for their trading-book business and points 1 to 4 of Schedule 2 for their non-trading book business;

(b) schedules 3 and 4 and, where appropriate, Schedule 5, for all of their other business activities.

(2) An investment firm may apply to the Authority to be authorised to calculate the capital requirements for its trading book business in accordance with regulation 23(a) of the FSCACI Regulations and paragraphs 6, 7, and 9 of Schedule 2 where the size of the trading book business–

(a) does not normally exceed 5% of its total business;

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(b) does not normally exceed EUR 15 million;

(c) never exceeds 6% of its total business and its total trading-book positions never exceed EUR 20 million.

(3) For the purposes of sub-regulation (2)(a) and (c), the Authority may refer either to the size of the combined on- and off-balance-sheet business, to the profit and loss account or to the own funds of the investment firm, or to a combination of those measurements.

(4) When the size of on- and off-balance-sheet business is assessed–

(a) debt instruments shall be valued at their market prices or their principal values;

(b) equities shall be valued at their market prices; and

(c) derivatives shall be valued according to the nominal or market values of the instruments underlying them;

and permitting long positions and short positions to be aggregated regardless of their signs.

(5) For the purposes of sub-regulation (4) long positions and short positions shall be aggregated irrespective of their signs.

(6) An investment firm which exceeds either or both of the limits imposed–

(a) in sub-regulation (2)(a) and (b); or

(b) in sub-regulation (2)(c);

shall meet the requirements imposed in sub-regulation (1)(a) in respect of its trading-book business and shall inform the Authority accordingly as soon as reasonably practicable.

**Specific risk.**

15.(1) For the purposes of paragraph 14 of Schedule 1, a 0% weighting may be assigned to debt securities issued by the entities listed in table 1 of Schedule 1, where these debt securities are denominated and funded in sterling.

(2) Notwithstanding the requirements of paragraphs 13 and 14 of Schedule 1, specific risk requirements for any bonds falling within paragraphs 69 to 70 of Part I of Schedule 6 of the FSCACI Regulations may be taken as equal to

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the specific risk requirement for a qualifying item with the same residual maturity as such a bond, reduced in accordance with the percentages given in paragraph 71 of that Part.

(3) If, in accordance with paragraph 52 of Schedule 1, an EEA State approves a non-European collective investment undertaking as eligible, the Authority may make use of this recognition without conducting its own assessment.

**Exemption concerning own funds.**

16.(1) Subject to sub-regulations (2) to (5) and regulation 30, the requirements in regulation 23 of the FSCACI Regulations shall apply to investment firms.

(2) An investment firm which is not authorised to deal on own account or to underwrite financial instruments or place financial instruments on a firm commitment basis, may apply to the Authority to be authorised to provide own funds which are at least equal to the higher of–

(a) the sum of the capital requirements in accordance with regulation 23(a) to (c) of the FSCACI Regulations; or

(b) the amount laid down in regulation 17.

(3) An investment firm which holds initial capital as set out in regulation 5(8) and to which sub-regulation (4) applies, may apply to the Authority to be authorised to provide own funds which are at least equal to the sum of the capital requirements calculated in accordance with regulation 23(a) to (c) of the FSCACI Regulations and the amount prescribed in regulation 17.

(4) The investment firm referred to in sub-regulation (3) is–

(a) one which deals on its own account only for the purpose of fulfilling or executing a client order or for the purpose of gaining entrance to a clearing and settlement system or a recognised exchange when acting in an agency capacity or executing a client order;

(b) one–

(i) which does not hold clients' money or securities;

(ii) which undertakes only dealing on own account;

(iii) which has no external customers;

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(iv) whose transactions are executed and settled under the responsibility of a clearing institution which guarantees them.

(5) An investment firm to which this regulation applies, shall remain subject to all operational risk provisions specified in Schedule 5 of the FSCACI Regulations

**Further exemption on own funds.**

17.(1) An investment firm to which regulation 16(2) or (3) or regulation 36(8) to (11) applies, shall hold own funds equivalent to one quarter of its preceding financial year's fixed overheads.

(2) The Authority may authorise the adjustment of the requirement of sub-regulation (1) in the event of a material change in the investment firm's business since the end of its preceding financial year.

(3) Where a firm has not completed a year's business, the requirement in sub-regulation (1) shall be a quarter of the fixed overheads figure projected in its business plan unless an adjustment to that plan has been required by the Authority.

## PART VI
*Application of requirements on a consolidated basis*

**Waiving of consolidation of capital requirements.**

18.(1) Where the Authority supervises a group on a consolidated basis it may waive the application of capital requirements on a consolidated basis provided that–

(a) every European investment firm in such a group uses the calculation of own funds given in regulation 12;

(b) every investment firm in such a group falls within the categories in regulation 16(2) to (4);

(c) every European investment firm in such a group meets the requirements in regulations 14 and 16 on an individual basis and at the same time deducts from its own funds any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated;

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(d) any parent financial holding company in an EEA State of an investment firm in such a group holds at least as much capital as the amount of the items in regulation 7(1)(a) to (g) of the FSCACI Regulations, as the sum of–

(i) the full book value of any holdings, subordinated claims, and instruments referred to in regulation 7 of those Regulations in investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated; and

(ii) the total amount of any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated.

(2) Where the criteria in sub-regulation (1) are met, a European investment firm shall monitor and control the sources of capital and funding of all financial holding companies, investment firms, financial institutions, asset management companies and ancillary services undertakings within the group.

(3) A parent financial holding company in an EEA State of an investment firm in such a group, may apply to the Authority to be authorised to use a value lower than the value calculated in accordance with sub-regulation (1)(d):

Provided that the value is not lower than the sum of–

(i) the requirements imposed in regulations 19 and 21 on an individual basis to investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated; and

(ii) the total amount of any contingent liability in favour of investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated.

(4) For the purposes of sub-regulation (3), the capital requirement for a non-European investment firm, financial institution, asset management company and ancillary services undertaking shall be a notional capital requirement.

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(5) Where the Authority waives the application of capital requirements on a consolidated basis provided for in this regulation, it shall notify the European Commission and EBA.

**Reporting of risks.**

19.(1) An investment firm in a group which has been granted a regulation 18 waiver shall report to the Authority the risks which could undermine its financial positions, including those associated with the composition and sources of its capital and funding.

(2) The Authority shall require the investment firm to take measures including, if necessary, limitations on the transfer of capital from such firm to group entities if it considers that the financial position of the investment firm is not adequately protected.

(3) Where the Authority waives the obligation of supervision on a consolidated basis provided for in regulation 18 it shall take other appropriate measures to monitor the risks, namely large exposures, of the whole group, including any undertakings not located in an EEA State.

(4) Where the Authority waives the application of capital requirements on a consolidated basis provided for in regulation 18, the requirements of regulations 79 and 87 to 90 of the FSCACI Regulations shall apply on an individual basis and the requirements of regulation 80 of those Regulations shall apply to the supervision of investment firms on an individual basis.

**Exemption from consolidated capital requirements.**

20.(1) An investment firm may apply to the Authority to be exempted from the consolidated capital requirement in regulation 3(6), provided that all the investment firms in the group fall within regulation 16(2) and the group does not include a credit institution.

(2) Where the requirements of sub-regulation (1) are met, a parent investment firm in an EEA State shall provide own funds at a consolidated level of an amount which is at least equal to the greater of the following two amounts, calculated on the basis of the parent investment firm's consolidated financial position and in accordance with regulations 22 and 23–

(a) the sum of the capital requirements in accordance with regulation 23(a) to (c) of the FSCACI Regulations; or

(b) the amount prescribed in regulation 17.

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(3) Where the requirements of sub-regulation (1) are met, an investment firm controlled by a financial holding company shall provide own funds at a consolidated level which are at least equal to the greater of the following two amounts, calculated on the basis of the financial holding company's consolidated financial position and in accordance with Regulations 22 and 23–

(a) the sum of the capital requirements in accordance with regulation 23(a) to (c) of the FSCACI Regulations; or

(b) the amount prescribed in regulation 17.

**Further exemption from consolidated capital requirements.**

21.(1) An investment firm may apply to the Authority to be exempted from the consolidated capital requirement in regulation 3(6), provided that all the investment firms in the group fall within regulation 16(2) to (4) and the group does not include a credit institution.

(2) Where the requirements of sub-regulation (1) are met, a parent investment firm in an EEA State shall provide own funds at a consolidated level which are at least equal to the amount calculated in accordance with regulation 23(a) to (c) of the FSCACI Regulations and the amount prescribed in regulation 17, calculated on the basis of the parent investment firm's consolidated financial position and in compliance with regulations 22 and 23.

(3) Where the requirements of sub-regulation (1) are met, an investment firm controlled by a financial holding company shall provide own funds at a consolidated level which are at least equal to the amount calculated in accordance with regulation 23(a) to (c) of the FSCACI Regulations and the amount prescribed in Regulation 17, calculated on the basis of the financial holding company's consolidated financial position and in compliance with regulations 22 and 23.

## PART VII
*Calculation of Consolidated Requirements*

**Offsetting of trading book etc.**

22.(1) Where a regulation 18 waiver is not exercised, the Authority may, for the purposes of calculating the capital requirements set out in Schedules 1 and 5 and the exposures to clients set out in regulations 24 to 28 and Schedule 6 on a consolidated basis, permit positions in the trading book of an investment firm to offset positions in the trading book of another

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investment firm in accordance with regulations 24 to 28 and Schedules 1, 5 and 6.

(2) The Authority may allow foreign-exchange positions in an investment firm to offset foreign-exchange positions in another investment firm in accordance with Schedule 3 or 5.

(3) The Authority may allow commodities positions in an investment firm to offset commodities positions in another investment firm in accordance with Schedule 4 or 5.

(4) The Authority may allow offsetting of the trading book and of the foreign-exchange and commodities positions, respectively, of an investment firm located in a non-EEA State, if the following conditions are met–

(a) the investment firm has been authorised in such a State and is a recognised non-European investment firm;

(b) the investment firm complies, on an individual basis, with capital adequacy rules equivalent to those laid down in these Regulations;

(c) no regulations exist in such a State which might significantly affect the transfer of funds within the group.

(5) The Authority may allow the offsetting in sub-regulation (1) between investment firms within a group that have been authorised in an EEA State if–

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

(b) the regulatory, legal or contractual framework in which the investment firm operates is such as to guarantee mutual financial support within the group.

(6) The Authority may allow the offsetting in sub-regulation (1) between investment firms within a group that fulfil the conditions imposed in sub-regulation (5) and any investment firm included in the same group which has been authorised in an EEA State provided that the investment firm meets the capital requirements in regulations 14, 16 and 24 on an individual basis.

**Discretion relating to own funds.**

23(1) Regulation 14 of the FSCACI Regulations shall apply in the calculation of own funds on a consolidated basis.

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(2) The Authority, where it is the EU consolidated supervisor may recognise the validity of the specific own-funds definitions applicable to the investment firm concerned under regulations 8 to 13 in the calculation of its consolidated own funds.

## PART VIII

*Monitoring and control of large exposures*

**Monitoring of large exposures.**

24.(1) An investment firm other than one which fulfils the criteria in regulation 16(2) or (3) shall monitor and control its large exposures in accordance with regulations 56 to 59, 63 to 70 and 75 of the FSCACI Regulations.

(2) An investment firm which calculates the capital requirements for its trading-book business in accordance with Schedules 1 and 2, and, as appropriate, Schedule 5, shall monitor and control its large exposures in accordance with sub-regulation (1) but may take advantage of the variations in regulations 25 to 28.

**Exposure to individual clients.**

25.(1) An investment firm's exposures to individual clients which arise on its trading book shall be the aggregate of–

(a) the excess (where positive) of its long positions over its short positions in all the financial instruments issued by a client, with the net position in each of the different instruments being calculated in accordance with Schedule 1;

(b) the net exposure, in the case of the underwriting of a debt or an equity instrument; and

(c) the exposures due to the transactions, agreements and contracts referred to in Schedule 2 with the client calculated in accordance with that Schedule, for the calculation of exposure values.

(2) For the purposes of sub-regulation (1)(b)–

(a) the net exposure shall be calculated by deducting those underwriting positions which are subscribed or sub-underwritten by third parties on the basis of a formal agreement reduced by the factors in paragraph 41 of Schedule 1;

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(b) an investment firm shall monitor and control its underwriting exposures between the time of the initial commitment and working day one in the light of the nature of the risks incurred in the markets.

(3) For the purposes of sub-regulation (1)(c), regulations 34 to 39 of the FSCACI Regulations shall be excluded from the reference in paragraph 6 of Schedule 2.

(4) The exposures to an investment firm's groups of connected clients on the trading book shall be calculated in accordance sub-regulation (1) by aggregating the exposures to individual clients in a group.

**Overall exposure to individual clients.**

26.(1) An investment firm's overall exposures to individual clients or groups of connected clients shall be calculated by aggregating the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account regulations 65 to 70 of the FSCACI Regulations.

(2) An investment firm's exposure on the non-trading book shall be calculated by taking the exposure arising from assets which are deducted from own funds by virtue of regulation 9(3)(d) to be zero.

(3) An investment firm shall report to the Authority in accordance with Regulation 63 of the FSCACI Regulations, its overall exposures to individual clients and groups of connected clients calculated in accordance with sub-regulation (6).

(4) Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to clients and groups of connected clients for reporting purposes under sub-regulation (3) shall not include the recognition of credit risk mitigation.

(5) The sum of the exposures to an individual client or group of connected clients in sub-regulation (1) shall be limited in accordance with regulations 64 to 70 of the FSCACI Regulations.

(6) The Authority may allow assets constituting claims and other exposures on recognised non-European investment firms and recognised clearing houses and exchanges in financial instruments to be subject to the same treatment accorded to those investment firms in regulations 57(4)(c) and 64(1) of the FSCACI Regulations.

**Exposure on the non-trading book.**

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27. The Authority may authorise an investment firm to exceed the limits laid down in regulations 64 to 70 of the FSCACI Regulations if the following conditions are met–

(a) the exposure on the non-trading book to the client or group of clients shall not exceed the limit in regulation 64(1) of those Regulations, calculated with reference to own funds in accordance with those Regulations, so that the excess arises entirely on the trading book;

(b) the applicant meets an additional capital requirement on the excess in respect of the limit in regulation 64(1) of those Regulations, calculated in accordance with Schedule 6;

(c) where 10 days or less has elapsed since the excess occurred, the trading-book exposure to the client or group of connected clients shall not exceed 500% of the applicant's own funds;

(d) any excesses which have persisted for more than 10 days shall not, in aggregate, exceed 600% of the applicant's own funds; and

(e) the applicant shall report to the Authority every three months all cases where the limit laid down in regulation 64(1) of those Regulations has been exceeded during the preceding three months and the names of the clients concerned.

**Control over exposures.**

28.(1) The Authority shall establish procedures to prevent investment firms from deliberately avoiding the additional capital requirements on exposures, exceeding the limits laid down in regulation 64(1) of the FSCACI Regulations, once those exposures have been maintained for more than 10 days–

(a) by means of temporarily transferring those exposures to another company, whether within the same group or not; or

(b) by undertaking artificial transactions to close out the exposure during the 10 day period and create a new exposure;

or both.

(1A) The Authority shall notify the European Commission, the European Council and EBA of the procedures established under subregulation (1).

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(2) An investment firm shall maintain systems to ensure that any transfer which has the effect referred to in sub-regulation (1) is immediately reported to the Authority.

(3) The Authority may authorise an investment firm which is allowed to use the alternative determination of own funds under regulation 10(2) to use that determination for the purposes of regulations 26(3) to (5) and 27:

Provided that the applicant meets all of the obligations set out in regulations 63 to 70 of the FSCACI Regulations, in respect of the exposures which arise outside its trading book by using own funds.

## PART IX
*Miscellaneous*

**Valuation of positions for reporting purposes.**

29.(1) Trading book positions shall be subject to the prudent valuation rules in Part B of Schedule 7.

(2) An investment firm shall ensure that the value applied to each of its trading book positions appropriately reflects the current market value and that it contains an appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness, the mode of operation and purpose of capital requirements in respect of trading book positions.

(3) Trading book positions shall be re-valued at least daily.

(4) The Authority may in the absence of readily available market prices, waive the requirement imposed by this regulation and if so shall require the investment firm to use alternative methods of valuation approved by the Authority.

**Risk management and capital assessment.**

30. An investment firm shall, in addition to meeting the requirements in Article 13 of Directive 2004/39/EC, meet the requirements in regulation 79 of the FSCACI Regulations, subject to the provisions on level of application in regulations 16 to 21 of the those Regulations.

**Reporting requirements.**

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31.(1) An investment firm shall provide the Authority with all the information necessary for the assessment of its compliance with these Regulations and shall maintain internal control mechanisms and administrative and accounting procedures which permit the verification of such compliance.

(2) An investment firm shall report to the Authority in the manner specified by the latter at least once every month in the case of firms covered by regulation 5(8), at least once every three months in the case of firms covered by regulation 5(1) and at least once every six months in the case of firms covered by regulation 5(2).

(3) Notwithstanding sub-regulation (2), an investment firm covered by regulations 5(1) and (8) shall be required to provide the information on a consolidated or sub-consolidated basis once every six months.

(4) An investment firm shall report to the Authority immediately any case in which its counter-parties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions, default on their obligations.

(5) An investment firm shall comply with the requirements of regulation 22 (2) of the FSCACI Regulations as regards the format of the reports and their frequency of submission to the Authority as from the 31 December 2012.

**Supervision.**

32.(1) Regulations 80 to 83 and 86 of the FSCACI Regulations shall apply mutatis mutandis to the supervision of investment firms and references to regulations 78 and 79 of those Regulations shall be construed as a references to regulation 30.

(2) Where a European parent financial holding company has as subsidiary both a credit institution and an investment firm, regulations 80 to 83 and 86 of the FSCACI Regulations shall apply to its supervision as if references to credit institutions were to investment firms.

(3) The requirements set out in regulation 81(3) of the FSCACI Regulations shall apply to the recognition of internal models of investment firms under Schedule 5 where the application is submitted–

(a) by a European parent credit institution and its subsidiaries;

(b) a European parent investment firm and its subsidiaries; or

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(c) jointly by the subsidiaries of a European parent financial holding company.

**Cooperation with other authorities and EBA.**

33.(1) The Authority shall cooperate closely with the competent authorities of EEA States in the performance of the duties provided for in the recast Directive, particularly where investment services are provided on a services basis or through the establishment of branches.

(2) The Authority shall on request supply the competent authorities of EEA States with all information likely to facilitate the supervision of the capital adequacy of investment firms, in particular the verification of their compliance with the rules laid down in the recast Directive.

(2A) The Authority shall cooperate with EBA for the purposes of these Regulations and the recast Directive, in accordance with Regulation (EU) No 1093/2010.

(2B) Where EBA makes a request the Authority shall without delay provide it with all the information necessary to enable EBA to carry out its duties under the recast Directive and in accordance with Article 35 of Regulation (EU) No 1093/2010.

(3) Any exchange of information between competent authorities which is provided for in the recast Directive in respect of investment firms shall be subject to the obligations of professional secrecy imposed by article 54 and 58 of Directive 2004/39/EC.

(4) Regulation 82A of the FSCACI Regulations, except its sub-regulation (2)(b), shall apply mutatis mutandis to the supervision of investment firms if the firms are not able to meet the criteria specified in regulations 16(2) and (3) and 36(8).

**Disclosure.**

34. The requirements set out in regulations 87 to 90 of the FSCACI Regulations shall apply to investment firms.

**Further provisions on exposure.**

35.(1) For the purposes of the calculation of minimum capital requirements for counter party risk under these Regulations and for credit risk under the FSCACI Regulations and without prejudice to the provisions of paragraph 6 of Part2 of Schedule 3 to those Regulations, exposures to recognised non-European investment firms and exposures incurred to recognised clearing

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houses and exchanges shall be treated as exposures to credit institutions and investment firms.

(2) Regulation 91(1) to (7) of the FSCACI Regulations shall apply, in accordance with Regulations 3 and 18 to 23, to an investment firm calculating risk-weighted exposure amounts, for the purposes of Schedule 2, in accordance with Regulations 34 to 39 of the FSCACI Regulations, or using the advanced measurement approach as specified in Regulations 55 of those Regulations for the calculation of its capital requirements for operational risk.

**Transitional and exemptions provisions**

36.(1) The Authority may permit an investment firm to exceed the limits on large exposures in Regulations 64 of the FSCACI Regulations.

(2) Any excesses need not be included by the investment firm in its calculation of capital requirements exceeding such limits, as set out in regulation 23(b) of those Regulations.

(3) The discretion in this regulation may be used until 31 December 2014 or the date of coming into force of any modifications consequent on the treatment of large exposures, pursuant to article 119 of the recast Directive whichever is the earlier.

(4) In order to exercise the discretion in sub-regulation (3), the following conditions shall be met–

(a) the investment firm provides investment services or investment activities related to the financial instruments listed in sub-regulation (16);

(b) the investment firm does not provide such investment services or undertake such investment activities for, or on behalf of, retail clients;

(c) breaches of the limits in this regulation arise in connection with exposures resulting from contracts which are financial instruments listed in paragraph (a) and relate to commodities or underlyings within the meaning of sub-regulation (16)(e) and are calculated in accordance with Schedules 3 and 4 of the FSCACI Regulations or from contracts concerning the delivery of commodities or emission allowances;

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(d) the investment firm has a documented strategy for managing, controlling and limiting risks arising from the concentration of exposures.

(5) The investment firm shall inform the Authority of the strategy it has adopted in compliance with sub-regulation (4)(d) and of any changes the investment firm effects to it, without delay.

(6) The investment firm shall continuously monitor the creditworthiness of borrowers, according to their impact on concentration risk which shall enable the investment firm to react adequately and sufficiently promptly to any deterioration in that creditworthiness.

(7) Where the investment firm exceeds the internal limits set according to the strategy referred to in sub-regulation (4)(d) it shall report to the Authority without delay of the size and nature of the excess and the counter party.

(8) Notwithstanding regulation 16(1), the Authority may choose, until 31 December 2011, not to apply the capital requirements arising from regulation 23(d) of the FSCACI Regulations in respect of an investment firm to which regulation 16(2) and (3) do not apply and whose total trading book positions never exceed EUR 50 million and whose average number of relevant employees during the financial year does not exceed 100.

(9) Where the Authority postpones the application of sub-regulation (8) it shall apply capital requirements amounting to the lower of–

(a) the capital requirements arising from Regulation 23(d) of the FSCACI Regulations; and

(b) 12/88 of the higher of–

(i) the sum of the capital requirements contained in regulation 23(a) to (c) of those Regulations; and

(ii) the amount laid down in regulation 17, notwithstanding regulation 17(1).

(10) Where the Authority applies sub-regulation (9)(b), an incremental increase shall be applied on at least an annual basis.

(11) The Authority’s postponement of the application of sub-regulation (8) shall be applied in a way that does not result in a decrease in the overall level of capital requirements for an investment firm, in comparison to the

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requirements at 31 December 2006, unless such a reduction is prudentially justified by a reduction in the size of the investment firm's business.

(12) *Repealed*

(13) The provisions on capital requirements in these Regulations and the FSCACI Regulations shall not apply to investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in sub-regulation (16) and to whom Directive 93/22/EEC did not apply on 31 December 2006.

(14) The exemption in sub-regulation (13) is available until 31 December 2014 or the date of coming into operation of any modifications pursuant to sub-regulations (15) and (16), whichever is the earlier.

(15) The relevant indicator for an investment firm's trading and sales business line which represents not less than 50% of the total relevant indicators for all its business lines calculated in accordance with regulation 16 and paragraphs 1 to 4 of Part 2 of Schedule 10 to the FSCACI Regulations, may until 31 December 2012 apply 15% to the trading and sales business line.

(16) The financial instruments referred to in sub-regulation (4)(a) are–

(a) options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities which are to be settled in cash or may be so settled at the option of one of the parties (otherwise than by reason of a default or other termination event);

(b) options, futures, swaps and any other derivative contracts relating to commodities which can be physically settled provided that they are traded on a regulated market or an MTF;

(c) options, futures, swaps, forwards and any other derivative contracts relating to commodities which can be physically settled not included in paragraph (b) and not being for commercial purposes which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

(d) financial contracts for differences; and

(e) options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, fright rates, emission allowances or inflation rates or other economic statistics which are to be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

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**FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007**

**SCHEDULE 1**

Regulations 9, 10, 14, 15, 22, 24 and 25

**Calculating Capital Requirements for Position Risk**

GENERAL PROVISIONS

**Netting.**

1. The excess of an investment firm's long (short) positions over its short (long) positions in the same equity, debt and convertible issues and identical financial futures, options, warrants and covered warrants shall be its net position in each of those different instruments. In calculating the net position the Authority shall allow positions in derivative instruments to be treated, as laid down in paragraphs 4 to 7, as positions in the underlying (or notional) security or securities. Investment firms' holdings of their own debt instruments shall be disregarded in calculating specific risk under paragraph 14.

2. No netting shall be allowed between a convertible and an offsetting position in the instrument underlying it, unless the Authority adopts an approach under which the likelihood of a particular convertible's being converted is taken into account or have a capital requirement to cover any loss which conversion might entail.

3. All net positions, irrespective of their signs, shall be converted on a daily basis into sterling at the prevailing spot exchange rate before their aggregation.

**Particular instruments.**

4. Interest rate futures, forward rate agreements ("FRA") and forward commitments to buy or sell debt instruments shall be treated as combinations of long and short positions. Thus a long interest rate futures position shall be treated as a combination of a borrowing maturing on the delivery date of the futures contract and a holding of an asset with maturity date equal to that of the instrument or notional position underlying the futures contract in question. Similarly a sold FRA shall be treated as a long position with a maturity date equal to the settlement date plus the contract period, and a short position with maturity equal to the settlement date. Both the borrowing and the asset holding shall be included in the first category set out in Table 1 in paragraph 14 in order to calculate the capital required against specific risk for interest rate futures and FRAs. A forward commitment to buy a debt instrument shall be treated as a combination of a borrowing maturing on the delivery date and a long (spot) position in the debt instrument itself. The

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borrowing shall be included in the first category set out in Table 1 in paragraph 14 for purposes of specific risk, and the debt instrument under whichever column is appropriate for it in the same table.

The Authority may allow the capital requirement for an exchange-traded future to be equal to the margin required by the exchange if it is fully satisfied that it provides an accurate measure of the risk associated with the future and that it is at least equal to the capital requirement for a future that would result from a calculation made using the method set out in this Schedule or applying the internal models method described in Schedule 5. The Authority may also allow the capital requirement for an OTC derivatives contract of the type referred to in this paragraph cleared by a clearing house recognised by it to be equal to the margin required by the clearing house if it is fully satisfied that it provides an accurate measure of the risk associated with the derivatives contract and that it is at least equal to the capital requirement for the contract in question that would result from a calculation made using the method set out in the this Schedule or applying the internal models method described in Schedule 5.

For the purposes of this paragraph, “long position” means a position in which an investment firm has fixed the interest rate it will receive at some time in the future, and “short position” means a position in which it has fixed the interest rate it will pay at some time in the future.

5. Options on interest rates, debt instruments, equities, equity indices, financial futures, swaps and foreign currencies shall be treated as if they were positions equal in value to the amount of the underlying instrument to which the option refers, multiplied by its delta for the purposes of this Schedule. The latter positions may be netted off against any offsetting positions in the identical underlying securities or derivatives. The delta used shall be that of the exchange concerned, that calculated by the Authority or, where that is not available or for OTC-options, that calculated by the investment firm itself, subject to the Authority being satisfied that the model used by the investment firm is reasonable.

The Authority may also prescribe that investment firms calculate their deltas using a methodology specified by it.

Other risks, apart from the delta risk, associated with options shall be safeguarded against. The Authority may allow the requirement against a written exchange traded option to be equal to the margin required by the exchange if it is fully satisfied that it provides an accurate measure of the risk associated with the option and that it is at least equal to the capital requirement against an option that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5. The Authority may also

allow the capital requirement for an OTC option cleared by a clearing house recognised by it to be equal to the margin required by the clearing house if it is fully satisfied that it provides an accurate measure of the risk associated with the option and that it is at least equal to the capital requirement for an OTC option that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5. In addition the Authority may allow the requirement on a bought exchange traded or OTC option to be the same as that for the instrument underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement against a written OTC option shall be set in relation to the instrument underlying it.

6. Warrants relating to debt instruments and equities shall be treated in the same way as options under paragraph 5.

7. Swaps shall be treated for interest rate risk purposes on the same basis as on balance sheet instruments. An interest rate swap under which an investment firm receives floating rate interest and pays fixed rate interest shall be treated as equivalent to a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed rate instrument with the same maturity as the swap itself.

**A. TREATMENT OF THE PROTECTION SELLER**

8. When calculating the capital requirement for market risk of the party who assumes the credit risk (the "protection seller"), unless specified differently, the notional amount of the credit derivative contract shall be used. Notwithstanding the first sentence, the institution may elect to replace the notional value by the notional value, minus any market value changes of the credit derivative since trade inception. For the purpose of calculating the specific risk charge, other than for total return swaps, the maturity of the credit derivative contract, rather than the maturity of the obligation, shall apply. Positions are determined as follows:

(i) A total return swap creates a long position in the general market risk of the reference obligation and a short position in the general market risk of a government bond with a maturity equivalent to the period until the next interest fixing and which is assigned a 0 % risk weight under Schedule 6 of the FSCACI Regulations. It also creates a long position in the specific risk of the reference obligation.

(ii) A credit default swap shall not create a position for general market risk. For the purposes of specific risk, the

investment firm shall record a synthetic long position in an obligation of the reference entity, unless the derivative is rated externally and meets the conditions for a qualifying debt item, in which case a long position in the derivative is recorded. If premium or interest payments are due under the product, these cash flows shall be represented as notional positions in government bonds.

(iii) A single name credit linked note creates a long position in the general market risk of the note itself, as an interest rate product. For the purpose of specific risk, a synthetic long position is created in an obligation of the reference entity. An additional long position is created in the issuer of the note. Where the credit linked note has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note need only be recorded.

(iv) In addition to a long position in the specific risk of the issuer of the note, a multiple name credit linked note providing proportional protection creates a position in each reference entity, with the total notional amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting shall determine the specific risk.

Where a multiple name credit linked note has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note need only be recorded.

(v) A first-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity. If the size of the maximum credit event payment is lower than the capital requirement under the method in the first sentence of this paragraph, the maximum payment amount may be taken as the capital requirement for specific risk.

A second-asset-to-default credit derivative creates a position for the notional amount in an obligation of each reference entity less one (that with the lowest specific risk capital requirement). If the size of the maximum credit

event payment is lower than the capital requirement under the method in the first sentence of this paragraph, this amount may be taken as the capital requirement for specific risk.

Where an n-th-to-default credit derivative is externally rated, the protection seller shall calculate the specific risk capital charge using the rating of the derivative and apply the respective securitisation risk weights as applicable.

**B. TREATMENT OF THE PROTECTION BUYER**

(1) For the party who transfers credit risk (the protection buyer), the positions are determined as the mirror principle of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection. In the case of first-to-default credit derivatives and nth-to-default credit derivatives, the following treatment applies instead of the mirror principle.

**First-to-default credit derivatives**

(2) Where an investment firm obtains credit protection for a number of reference entities underlying a credit derivative under the terms that the first default among the assets shall trigger payment and that this credit event shall terminate the contract, the investment firm may offset specific risk for the reference entity to which the lowest specific risk percentage charge among the underlying reference entities applies according to Table 1 of paragraph 14.

**Nth-to-default credit derivatives**

(3) Where the nth default among the exposures triggers payment under the credit protection, the protection buyer may only offset specific risk if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases, the methodology set out above for first-to-default credit derivatives shall be followed appropriately modified for nth-to-default products.”.

(2) Table 1 of paragraph 14 of Schedule 1 is amended as follows−

(a) in the first column of the second row, “paragraph 28” is substituted by “paragraph 29” and “step 1 or 2” is substituted by “step 1, 2 or 3”;

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(b) in the third indent in the second column of the second row, “final” is omitted;

(c) in the first column of the third row, “step 3 or 4” is substituted by step 4

9. Investment firms which mark to market and manage the interest rate risk on the derivative instruments covered in paragraphs 4 to 7 on a discounted cash flow basis may use sensitivity models to calculate the positions referred to in those paragraphs and may use them for any bond which is amortised over its residual life rather than via one final repayment of principal. Both the model and its use by the investment firm shall be approved by the Authority. These models should generate positions which have the same sensitivity to interest rate changes as the underlying cash flows. This sensitivity shall be assessed with reference to independent movements in sample rates across the yield curve, with at least one sensitivity paragraph in each of the maturity bands set out in Table 2 of paragraph 20. The positions shall be included in the calculation of capital requirements according to the provisions laid down in paragraphs 17 to 32.

10. Investment firms which do not use models under paragraph 9 may, with the approval of the Authority, treat as fully offsetting any positions in derivative instruments covered in paragraphs 4 to 7 which meet the following conditions at least–

(a) the positions are of the same value and denominated in the same currency;

(b) the reference rate (for floating rate positions) or coupon (for fixed rate positions) is closely matched; and

(c) the next interest-fixing date or, for fixed coupon positions, residual maturity corresponds with the following limits:

(i) less than one month hence: same day;

(ii) between one month and one year hence: within seven days; and

(iii) over one year hence: within 30 days.

11. The transferor of securities or guaranteed rights relating to title to securities in a repurchase agreement and the lender of securities in a securities lending shall include these securities in the calculation of its capital requirement under this Schedule provided that such securities meet the criteria laid down in regulation 7.

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**Specific and general risks.**

12. The position risk on a traded debt instrument or equity (or debt or equity derivative) shall be divided into two components in order to calculate the capital required against it. The first shall be its specific risk component — this is the risk of a price change in the instrument concerned due to factors related to its issuer or, in the case of a derivative, the issuer of the underlying instrument. The second component shall cover its general risk — this is the risk of a price change in the instrument due (in the case of a traded debt instrument or debt derivative) to a change in the level of interest rates or (in the case of an equity or equity derivative) to a broad equity-market movement unrelated to any specific attributes of individual securities.

**Traded Debt Instruments**

13. Net positions shall be classified according to the currency in which they are denominated and shall calculate the capital requirement for general and specific risk in each individual currency separately.

**Specific risk.**

14. The institution shall assign its net positions in the trading book in instruments that are not securitisation positions as calculated in accordance with point 1 to the appropriate categories in Table 1 on the basis of their issuer/obligor, external or internal credit assessment, and residual maturity, and then multiply them by the weightings shown in that table. It shall sum its weighted positions resulting from the application of this point (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk. It shall calculate its capital requirement against specific risk for positions that are securitisation positions in accordance with point 16a.

For the purposes of this point and points 14a and 16a, the institution may cap the product of the weight and the net position at the maximum possible default-risk related loss. For a short position, that limit may be calculated as a change in value due to the underlying names immediately becoming default risk-free.

***Table 1***

| Categories | Specific risk capital charge |
|---|---|
| Debt securities issued or guaranteed by central | 0 % |

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| | |
|---|---|
| governments, issued by central banks, international organisations, multilateral development banks or Member States' regional government or local authorities which would qualify for credit quality step 1 or which would receive a 0 % risk weight under the rules for the risk weighting of exposures under regulations 28 to 33 of the FSCACI Regulations. | |
| Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities which would qualify for credit quality step 2 or 3 under the rules for the risk weighting of exposures under regulations 28 to 33 of the FSCACI Regulations, and debt securities issued or guaranteed by investment firms which would qualify for credit quality step 1 or 2 under the rules for the risk weighting of exposures under regulations 28 to 33 of those Regulations, and debt securities issued or guaranteed by investment firms which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under paragraph 28 of Part 1 of Schedule 6 of those Regulations, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 1 or 2 under the rules for the risk weighting of exposures under regulations 28 to 33 of those Regulations.<br>Other qualifying items as defined in paragraph 15 | 0.25 % (residual term to final maturity 6 months or less).<br><br>1.00 % (residual term to final maturity greater than 6 and up to and including 24 months).<br><br>1.60 % (residual term to final maturity exceeding 24 months) |
| Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities or investment firms which would qualify for credit quality step 4 or 5 under the rules for the risk weighting of exposures under regulations 28 to 33 of the FSCACI Regulations, and debt securities issued or guaranteed by investment firms which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under paragraph 26 of Part 1 of Schedule 6 of those | 8.00 % |

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| | |
|---|---|
| Regulations, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 3 or 4 under the rules for the risk weighting of exposures under regulations 28 to 33 of those Regulations.<br>Exposures for which a credit assessment by a nominated External Credit Assessment Institution is not available. | |
| Debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional governments or local authorities or investment firms which would qualify for credit quality step 6 under the rules for the risk weighting of exposures under regulations 28 to 33 of the FSCACI Regulations, and debt securities issued or guaranteed by corporates which would qualify for credit quality step 5 or 6 under the rules for the risk weighting of exposures under regulations 28 to 33 of those Regulations. | 12.00 % |

For investment firms which apply the rules for the risk weighting of exposures under regulations 34 to 39 of the FSCACI Regulations, to qualify for a credit quality step the obligor of the exposure shall have an internal rating with a probability of default equivalent to or lower than that associated with the appropriate credit quality step under the rules for the risk weighting of exposures to corporates under regulations 28 to 33 of those Regulations.

Instruments issued by a non-qualifying issuer shall receive a specific risk capital charge of 8 % or 12 % according to Table 1. The Authority may require investment firms to apply a higher specific risk charge to such instruments or to disallow offsetting for the purposes of defining the extent of general market risk between such instruments and any other debt instruments.

Securitisation exposures which would be subject to a deduction treatment as set out in regulation 15(2) to (4) of the FSCACI Regulations, or risk-weighted at 1250 % as set out in Part 4 of Schedule 9 of those Regulations, shall be subject to a capital charge that is no less than that set out under those treatments. Unrated liquidity facilities shall be subject to a capital charge that is no less than that set out in Part 4 of Schedule 9 of those Regulations.

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14a. By way of derogation from point 14, an institution may determine the larger of the following amounts as the specific risk capital charge for the correlation trading portfolio:

(a) the total specific risk capital charges that would apply just to the net long positions of the correlation trading portfolio;

(b) the total specific risk capital charges that would apply just to the net short positions of the correlation trading portfolio.

14b. The correlation trading portfolio shall consist of securitisation positions and n-th-to-default credit derivatives that meet the following criteria:

(a) the positions are neither re-securitisation positions, nor options on a securitisation tranche, nor any other derivatives of securitisation exposures that do not provide a pro-rata share in the proceeds of a securitisation tranche; and

(b) all reference instruments are either single-name instruments, including single-name credit derivatives for which a liquid two-way market exists, or commonly-traded indices based on those reference entities. A two-way market is deemed to exist where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within 1 day and settled at such price within a relatively short time conforming to trade custom.

14c. Positions which reference either of the following shall not be part of the correlation trading portfolio:

(a) an underlying that is capable of being assigned to the exposure classes referred to in regulation 29 (1)(h) and (i) of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 in an institution's non-trading book; or

(b) a claim on a special purpose entity.

An institution may include in the correlation trading portfolio positions which are neither securitisation positions nor n-th-to-default credit derivatives but which hedge other positions of that portfolio, provided that a liquid two-way market as described in point 14b(b) exists for the instrument or its underlyings.

15. For the purposes of paragraph 14 qualifying items shall include–

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(a) long and short positions in assets qualifying for a credit quality step corresponding at least to investment grade in the mapping process described in regulations 28 to 33 of the FSCACI Regulations;

(b) long and short positions in assets which, because of the solvency of the issuer, have a PD which is not higher than that of the assets referred to under sub-paragraph (a), under the approach described in regulations 34 to 39 of the FSCACI Regulations;

(c) long and short positions in assets for which a credit assessment by a nominated external credit assessment institution is not available and which meet the following conditions:

(i) they are considered by the investment firms concerned to be sufficiently liquid;

(ii) their investment quality is, according to the investment firm's own discretion, at least equivalent to that of the assets referred to under paragraph (a); and

(iii) they are listed on at least one regulated market in an EEA State or on a stock exchange in a non-EEA State provided that the exchange is recognised by the competent authority of the relevant EEA State;

(d) long and short positions in assets issued by investment firms subject to the capital adequacy requirements set out in the FSCACI Regulations which are considered by the investment firms concerned to be sufficiently liquid and whose investment quality is, according to the investment firm's own discretion, at least equivalent to that of the assets referred to under paragraph (a); and

(e) securities issued by investment firms which are deemed to be of equivalent, or higher, credit quality than those associated with credit quality step 2 under the rules for the risk weighting of exposures to investment firms set out in regulations 28 to 33 of the FSCACI Regulations and that are subject to supervisory and regulatory arrangements comparable to those under these Regulations.

The manner in which the debt instruments are assessed shall be subject to scrutiny by the Authority, which shall overturn the judgment of the

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investment firm if it considers that the instruments concerned are subject to too high a degree of specific risk to be qualifying items.

16. The Authority shall require an investment firm to apply the maximum weighting shown in Table 1 to paragraph 14 to instruments that show a particular risk because of the insufficient solvency of the issuer.

16a. For instruments in the trading book that are securitisation positions, the institution shall weight with the following its net positions as calculated in accordance with point 1:

(a) for securitisation positions that would be subject to the Standardised Approach for credit risk in the same institution's non-trading book, 8 % of the risk weight under the Standardised Approach as set out in Part 4 of Schedule 9 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007;

(b) for securitisation positions that would be subject to the Internal Ratings Based Approach in the same institution's non-trading book, 8 % of the risk weight under the Internal Ratings Based Approach as set out in Part 4 of Schedule 9 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007.

For the purpose of points (a) and (b), the Supervisory Formula Method may be used only with supervisory approval by institutions other than an originator institution that may apply it for the same securitisation position in its non-trading book. Where relevant, estimates of PD and LGD as inputs to the Supervisory Formula Method shall be determined in accordance with regulations 34 to 39 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 or alternatively and subject to separate supervisory approval, based on estimates that are derived from an approach set out in point 5a of Schedule 5 of these Regulations and that are in line with the quantitative standards for the Internal Ratings Based Approach. The Committee of European Banking Supervisors shall establish guidelines in order to ensure a convergent use of estimates of PD and LGD as inputs when those estimates are based on the approach set out in point 5a of Schedule 5 of these Regulations.

Notwithstanding points (a) and (b), for securitisation positions that would be subject to a risk weight in accordance with regulation 78A of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007 if they were in the same institutions' non-trading book, 8 % of the risk weight in accordance with that regulation shall be applied.

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The institution shall sum its weighted positions resulting from the application of this point (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk.

By way of derogation from the fourth paragraph, for a transitional period ending 31 December 2013, the institution shall sum separately its weighted net long positions and its weighted net short positions. The larger of those sums shall constitute the specific risk capital requirement. The institution shall, however, report to the home Member State competent authority the total sum of its weighted net long and net short positions, broken down by types of underlying assets.

**General risk.**

(a) Maturity-based

17. The procedure for calculating capital requirements against general risk involves two basic steps. First, all positions shall be weighted according to maturity (as explained in paragraph 18), in order to compute the amount of capital required against them. Second, allowance shall be made for this requirement to be reduced when a weighted position is held alongside an opposite weighted position within the same maturity band. A reduction in the requirement shall also be allowed when the opposite weighted positions fall into different maturity bands, with the size of this reduction depending both on whether the two positions fall into the same zone, or not, and on the particular zones they fall into. There are three zones (groups of maturity bands) altogether.

18. An investment firm shall assign its net positions to the appropriate maturity bands in column 2 or 3, as appropriate, in Table 2 in paragraph 20. It shall do so on the basis of residual maturity in the case of fixed-rate instruments and on the basis of the period until the interest rate is next set in the case of instruments on which the interest rate is variable before final maturity. It shall also distinguish between debt instruments with a coupon of 3 % or more and those with a coupon of less than 3 % and thus allocate them to column 2 or column 3 in Table 2. It shall then multiply each of them by the weighing for the maturity band in question in column 4 in Table 2.

19. The investment firm shall then work out the sum of the weighted long positions and the sum of the weighted short positions in each maturity band. The amount of the former which are matched by the latter in a given maturity band shall be the matched weighted position in that band, while the residual long or short position shall be the unmatched weighted position for the same band. The total of the matched weighted positions in all bands shall then be calculated.

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20. The investment firm shall compute the totals of the unmatched weighted long positions for the bands included in each of the zones in Table 2 in order to derive the unmatched weighted long position for each zone. Similarly, the sum of the unmatched weighted short positions for each band in a particular zone shall be summed to compute the unmatched weighted short position for that zone. That part of the unmatched weighted long position for a given zone that is matched by the unmatched weighted short position for the same zone shall be the matched weighted position for that zone. That part of the unmatched weighted long or unmatched weighted short position for a zone that cannot be thus matched shall be the unmatched weighted position for that zone.

***Table 2***

| Zone | Maturity band | | Weighting (in %) | Assumed interest rate change (in %) |
|---|---|---|---|---|
| | Coupon of 3 % or more | Coupon of less than 3 % | | |
| One | 0 ≤ 1 month | 0 ≤ 1 month | 0.00 | -- |
| | > 1 ≤ 3 months | >1 ≤ 3 months | 0.20 | 1.00 |
| | > 3 ≤ 6 months | > 3 ≤ 6 months | 0.40 | 1.00 |
| | > 6 ≤ 12 months | > 6 ≤ 12 months | 0.70 | 1.00 |
| Two | > 1 ≤ 2 years | > 1.0 ≤ 1.9 years | 1.25 | 0.90 |
| | > 2 ≤ 3 years | > 1.9 ≤ 2.8 years | 1.75 | 0.80 |
| | > 3 ≤ 4 years | > 2.8 ≤ 3.6 years | 2.25 | 0.75 |
| Three | > 4 ≤ 5 years | > 3.6 ≤ 4.3 years | 2.75 | 0.75 |
| | > 5 ≤ 7 years | > 4.3 ≤ 5.7 years | 3.25 | 0.70 |
| | > 7 ≤ 10 years | > 5.7 ≤ 7.3 years | 3.75 | 0.65 |
| | > 10 ≤ 15 years | > 7.3 ≤ 9.3 years | 4.50 | 0.60 |
| | > 15 ≤ 20 years | > 9.3 ≤ 10.6 years | 5.25 | 0.60 |
| | > 20 years | > 10.6 ≤ 12.0 years | 6.00 | 0.60 |
| | | > 12.0 ≤ 20.0 years | 8.00 | 0.60 |
| | | > 20 years | 12.50 | 0.60 |

21. The amount of the unmatched weighted long (short) position in zone one which is matched by the unmatched weighted short (long) position in zone two shall then be computed. This shall be referred to in paragraph 25 as

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the matched weighted position between zones one and two. The same calculation shall then be undertaken with regard to that part of the unmatched weighted position in zone two which is left over and the unmatched weighted position in zone three in order to calculate the matched weighted position between zones two and three.

22. The investment firm may, if it wishes, reverse the order in paragraph 21 so as to calculate the matched weighted position between zones two and three before calculating that position between zones one and two.

23. The remainder of the unmatched weighted position in zone one shall then be matched with what remains of that for zone three after the latter's matching with zone two in order to derive the matched weighted position between zones one and three.

24. Residual positions, following the three separate matching calculations in paragraphs 21, 22 and 23, shall be summed.

25. The investment firm's capital requirement shall be calculated as the sum of:

(a) 10 % of the sum of the matched weighted positions in all maturity bands;

(b) 40 % of the matched weighted position in zone one;

(c) 30 % of the matched weighted position in zone two;

(d) 30 % of the matched weighted position in zone three;

(e) 40 % of the matched weighted position between zones one and two and between zones two and three (see paragraph 21);

(f) 150 % of the matched weighted position between zones one and three; and

(g) 100 % of the residual unmatched weighted positions.

(b) Duration-based

26. The Authority may allow investment firms in general or on an individual basis to use a system for calculating the capital requirement for the general risk on traded debt instruments which reflects duration, instead of the system set out in paragraphs 17 to 25, provided that the investment firm does so on a consistent basis.

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27. Under a system referred to in paragraph 26 an investment firm shall take the market value of each fixed-rate debt instrument and thence calculate its yield to maturity, which is implied discount rate for that instrument. In the case of floating rate instruments, the investment firm shall take the market value of each instrument and thence calculate its yield on the assumption that the principal is due when the interest rate can next be changed.

28. The investment firm shall then calculate the modified duration of each debt instrument on the basis of the following formula: modified duration = ((duration (D))/(1 + r)), where–

$$D = ((\sum_{t} = 1^{m} ((t\,C_t)/((1+r)^t)) / (\sum_{t} = 1^{m} ((C_t)/((1+r)^t))))$$

Where–

R = yield to maturity (see paragraph 25),
$C_t$ = cash payment in time t,
M= total maturity (see paragraph 25).

29. The investment firm shall then allocate each debt instrument to the appropriate zone in Table 3. It shall do so on the basis of the modified duration of each instrument.

***Table 3***

| Zone | Modified duration (in years) | Assumed interest (change in %) |
|---|---|---|
| One | $> 0 \leq 1.0$ | 1.0 |
| Two | $> 1.0 \leq 3.6$ | 0.85 |
| Three | $> 3.6$ | 0.7 |

30. The investment firm shall then calculate the duration-weighted position for each instrument by multiplying its market price by its modified duration and by the assumed interest-rate change for an instrument with that particular modified duration (see column 3 in Table 3).

31. The investment firm shall calculate its duration-weighted long and its duration-weighted short positions within each zone. The amount of the

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former which are matched by the latter within each zone shall be the matched duration weighted position for that zone.

The investment firm shall then calculate the unmatched duration-weighted positions for each zone. It shall then follow the procedures laid down for unmatched weighted positions in paragraphs 21 to 24.

32. The investment firm's capital requirement shall then be calculated as the sum of–

(a) 2 % of the matched duration-weighted position for each zone;

(b) 40 % of the matched duration-weighted positions between zones one and two and between zones two and three;

(c) 150 % of the matched duration-weighted position between zones one and three; and

(d) 100 % of the residual unmatched duration-weighted positions.

EQUITIES

33. The investment firm shall sum all its net long positions and all its net short positions in accordance with paragraph 1. The sum of the two figures shall be its overall gross position. The difference between them shall be its overall net position.

**Specific risk.**

34. The institution shall sum all its net long positions and all its net short positions in accordance with point 1. It shall multiply its overall gross position by 8 % in order to calculate its capital requirement against specific risk.

35. *Deleted*

**General risk.**

36. An investment firm's capital requirement against general risk shall be its overall net position multiplied by 8 %.

**Stock-index futures.**

37. Stock-index futures, the delta-weighted equivalents of options in stock-index futures and stock indices collectively referred to hereafter as 'stock-index futures', may be broken down into positions in each of their

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constituent equities. These positions may be treated as underlying positions in the equities in question, and may, subject to the approval of the Authority, be netted against opposite positions in the underlying equities themselves.

38. The Authority shall ensure that any investment firm which has netted off its positions in one or more of the equities constituting a stock-index future against one or more positions in the stock index future itself has adequate capital to cover the risk of loss caused by the future's values not moving fully in line with that of its constituent equities; it shall also do this when an investment firm holds opposite positions in stock index futures which are not identical in respect of either their maturity or their composition or both.

39. Notwithstanding paragraphs 37 and 38, stock-index futures which are exchange traded and — in the opinion of the Authority — represent broadly diversified indices shall attract a capital requirement against general risk of 8 %, but no capital requirement against specific risk. Such stock-index futures shall be included in the calculation of the overall net position in paragraph 33, but disregarded in the calculation of the overall gross position in the same paragraph.

40. If a stock-index future is not broken down into its underlying positions, it shall be treated as if it were an individual equity. However, the specific risk on this individual equity may be ignored if the stock-index future in question is exchange traded and, in the opinion of the Authority, represents a broadly diversified index.

UNDERWRITING

41. In the case of the underwriting of debt and equity instruments, the Authority may allow an investment firm to use the following procedure in calculating its capital requirements. Firstly, the investment firm shall calculate the net positions by deducting the underwriting positions which are subscribed or sub-underwritten by third parties on the basis of formal agreements. Secondly, it shall reduce the net positions by the reduction factors in Table 4

***Table 4***

| | |
|---|---|
| working day 0: | 100% |
| working day 1: | 90% |
| working days 2 to 3: | 75% |
| working day 4: | 50% |

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| | |
|---|---|
| working day 5: | 25% |
| after working day 5: | 0% |

"Working day zero" shall be the working day on which the investment firm becomes unconditionally committed to accepting a known quantity of securities at an agreed price.

Thirdly, it shall calculate its capital requirements using the reduced underwriting positions.

The Authority shall ensure that the investment firm holds sufficient capital against the risk of loss which exists between the time of the initial commitment and working day 1.

SPECIFIC RISK CAPITAL CHARGES FOR TRADING BOOK POSITIONS HEDGED BY CREDIT DERIVATIVES

42. An allowance shall be given for protection provided by credit derivatives, in accordance with the principles set out in paragraphs 43 to 46.

43. Full allowance shall be given when the value of two legs always move in the opposite direction and broadly to the same extent. This will be the case in the following situations–

(a) the two legs consist of completely identical instruments; or

(b) a long cash position is hedged by a total rate of return swap (or vice versa) and there is an exact match between the reference obligation and the underlying exposure (i.e., the cash position). The maturity of the swap itself may be different from that of the underlying exposure.

In these situations, a specific risk capital charge shall not be applied to either side of the position.

44. An 80 % offset shall be applied when the value of two legs always move in the opposite direction and where there is an exact match in terms of the reference obligation, the maturity of both the reference obligation and the credit derivative, and the currency of the underlying exposure. In addition, key features of the credit derivative contract should not cause the price movement of the credit derivative to materially deviate from the price movements of the cash position. To the extent that the transaction transfers risk, an 80 % specific risk offset shall be applied to the side of the transaction

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with the higher capital charge, while the specific risk requirements on the other side shall be zero.

45. Partial allowance shall be given when the value of two legs usually move in the opposite direction. This would be the case in the following situations–

(a) the position falls under paragraph 43(b) but there is an asset mismatch between the reference obligation and the underlying exposure. However, the positions meet the following requirements–

(i) the reference obligation ranks pari passu with or is junior to the underlying obligation; and

(ii) the underlying obligation and reference obligation share the same obligor and have legally enforceable cross default or cross acceleration clauses;

(b) the position falls under paragraph 43(a) or 44 but there is a currency or maturity mismatch between the credit protection and the underlying asset (currency mismatches should be included in the normal reporting foreign exchange risk under Schedule 3); or

(c) the position falls under paragraph 44 but there is an asset mismatch between the cash position and the credit derivative. The underlying asset is included in the (deliverable) obligations in the credit derivative documentation.

In each of those situations, rather than adding the specific risk capital requirements for each side of the transaction, only the higher of the two capital requirements shall apply.

46. In all situations not falling under paragraphs 43 to 45, a specific risk capital charge shall be assessed against both sides of the positions.

**Capital charges for Collective Investment Undertakings in the trading book.**

47. The capital requirements for positions in Collective Investment Undertakings ("CIUs") which meet the conditions specified in regulations 7 for a trading book capital treatment shall be calculated in accordance with the methods set out in paragraphs 48 to 56.

48. Without prejudice to other provisions in this section, positions in CIUs shall be subject to a capital requirement for position risk (specific and

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general) of 32 %. Without prejudice to the provisions of the fourth sub-paragraph of paragraph 2.1 of Schedule 3 or the sixth sub-paragraph of paragraph 12 of Schedule 5 (commodity risk) taken together with the fourth sub-paragraph of paragraph 2.1 of Schedule 3, where the modified gold treatment set out in those paragraphs is used, positions in CIUs shall be subject to a capital requirement for position risk (specific and general) and foreign-exchange risk of no more than 40 %.

49. Investment firms may determine the capital requirement for positions in CIUs which meet the criteria set out in paragraph 51, by the methods set out in paragraphs 53 to 56.

50. Unless noted otherwise, no netting shall be permitted between the underlying investments of a CIU and other positions held by the investment firm.

GENERAL CRITERIA

51. The general eligibility criteria for using the methods in paragraphs 53 to 56, for CIUs issued by companies supervised or incorporated within the EEA are that–

(a) the CIU's prospectus or equivalent document shall include:

(i) the categories of assets the CIU is authorised to invest in;

(ii) if investment limits apply, the relative limits and the methodologies to calculate them;

(iii) if leverage is allowed, the maximum level of leverage; and

(iv) if investment in OTC financial derivatives or repo-style transactions are allowed, a policy to limit counter party risk arising from these transactions;

(b) the business of the CIU shall be reported in half-yearly and annual reports to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period;

(c) the units/shares of the CIU are redeemable in cash, out of the undertaking's assets, on a daily basis at the request of the unit holder;

(d) investments in the CIU shall be segregated from the assets of the CIU manager; and

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(e) there shall be adequate risk assessment of the CIU, by the investing investment firm.

52. Non-EEA CIUs may be eligible if the requirements in paragraphs (a) to (e) of paragraph 51 are met, subject to the approval of the Authority.

SPECIFIC METHODS

53. Where the investment firm is aware of the underlying investments of the CIU on a daily basis, the investment firm may look through to those underlying investments in order to calculate the capital requirements for position risk (general and specific) for those positions in accordance with the methods set out in this Schedule or, if permission has been granted, in accordance with the methods set out in Schedule 5. Under this approach, positions in CIUs shall be treated as positions in the underlying investments of the CIU. Netting is permitted between positions in the underlying investments of the CIU and other positions held by the investment firm, as long as the investment firm holds a sufficient quantity of units to allow for redemption/creation in exchange for the underlying investments.

54. Investment firms may calculate the capital requirements for position risk (general and specific) for positions in CIUs in accordance with the methods set out in this Schedule or, if permission has been granted, in accordance with the methods set out in Schedule 5, to assumed positions representing those necessary to replicate the composition and performance of the externally generated index or fixed basket of equities or debt securities referred to in (a), subject to the following conditions–

(a) the purpose of the CIU's mandate is to replicate the composition and performance of an externally generated index or fixed basket of equities or debt securities; and

(b) a minimum correlation of 0.9 between daily price movements of the CIU and the index or basket of equities or debt securities it tracks can be clearly established over a minimum period of six months. "Correlation" in this context means the correlation coefficient between daily returns on the CIU and the index or basket of equities or debt securities it tracks.

55. Where the investment firm is not aware of the underlying investments of the CIU on a daily basis, the investment firm may calculate the capital requirements for position risk (general and specific) in accordance with the methods set out in this Schedule, subject to the following conditions–

(a) it will be assumed that the CIU first invests to the maximum extent allowed under its mandate in the asset classes attracting

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the highest capital requirement for position risk (general and specific), and then continues making investments in descending order until the maximum total investment limit is reached. The position in the CIU will be treated as a direct holding in the assumed position;

(b) investment firms shall take account of the maximum indirect exposure that they could achieve by taking leveraged positions through the CIU when calculating their capital requirement for position risk, by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the mandate; and

(c) should the capital requirement for position risk (general and specific) according to this paragraph exceed that set out in paragraph 48, the capital requirement shall be capped at that level.

56. Investment firms may rely on a third party to calculate and report capital requirements for position risk (general and specific) for positions in CIUs falling under paragraphs 53 and 55, in accordance with the methods set out in this Schedule, provided that the correctness of the calculation and the report is adequately ensured.

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## SCHEDULE 2

Regulations 9, 13, 14, 24, 25 and 35

### Calculating Capital Requirements for Settlement and Counter Party Credit Risk

SETTLEMENT/DELIVERY RISK

1. In the case of transactions in which debt instruments, equities, foreign currencies and commodities (excluding repurchase and reverse repurchase agreements and securities or commodities lending and securities or commodities borrowing) are unsettled after their due delivery dates, an investment firm shall calculate the price difference to which it is exposed. This is the difference between the agreed settlement price for the debt instrument, equity, foreign currency or commodity in question and its current market value, where the difference could involve a loss for the investment firm. It shall multiply this difference by the appropriate factor in column A of Table 1 in order to calculate its capital requirement.

# Table 1

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

FREE DELIVERIES

2. An investment firm shall be required to hold own funds, as set out in Table 2, if–

(a) it has paid for securities, foreign currencies or commodities before receiving them or it has delivered securities, foreign currencies or commodities before receiving payment for them; and

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(b) in the case of cross-border transactions, one day or more has elapsed since it made that payment or delivery.

**Table 2**
*Capital treatment for free deliveries*

| Transaction Type | Up to first contractual payment or delivery leg | From first contractual payment or delivery leg up to four days after second contractual payment or delivery leg | From 5 business days post second contractual payment or delivery leg until extinction of the transaction |
|---|---|---|---|
| Free delivery | No capital charge | Treat as an exposure | Deduct value transferred plus current positive exposure from own funds |

3. In applying a risk weight to free delivery exposures treated according to column 3 of Table 2, investment firms using the approach set out in regulations 34 to 39 of the FSCACI Regulations, may assign PDs to counter parties, for which they have no other non-trading book exposure, on the basis of the counter party's external rating. Investment firms using own estimates of loss given defaults ('LGDs') may apply the LGD set out in paragraph 8 of Part 2 of Schedule 7 of the FSCACI Regulations to free delivery exposures treated according to column 3 of Table 2 provided that they apply it to all such exposures. Alternatively, investment firms using the approach set out in those regulations may apply the risk weights, as set out in regulations 28 to 33 of those Regulations provided that they apply them to all such exposures or may apply a 100 % risk weight to all such exposures.

If the amount of positive exposure resulting from free delivery transactions is not material, investment firms may apply a risk weight of 100 % to these exposures.

4. In cases of a system wide failure of a settlement or clearing system, the Authority may waive the capital requirements calculated as set out in paragraphs 1 and 2 until the situation is rectified. In this case, the failure of a

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counter party to settle a trade shall not be deemed a default for purposes of credit risk.

COUNTERPARTY CREDIT RISK (CCR)

5. An investment firm shall be required to hold capital against the CCR arising from exposures due to the following–

(a) OTC derivative instruments and credit derivatives;

(b) repurchase agreements, reverse repurchase agreements, securities or commodities lending or borrowing transactions based on securities or commodities included in the trading book;

(c) margin lending transactions based on securities or commodities; and

(d) long settlement transactions.

6. Subject to the provisions of paragraphs 7 to 10, exposure values and risk-weighted exposure amounts for such exposures shall be calculated in accordance with the provisions of Part V of the FSCACI Regulations with references to "credit institutions" in that Part interpreted as references to "investment firms", references to "parent credit institutions" interpreted as references to "parent investment firms", and with concomitant terms interpreted accordingly.

7. For the purposes of paragraph 6–

Schedule 4 of the FSCACI Regulations shall be considered to be amended to include point 8 of Section C of Schedule 1 to Directive 2004/39/EC;

Schedule 3 of the FSCACI Regulations shall be considered to be amended to include, after the footnotes of Table 1, the following text–

"To obtain a figure for potential future credit exposure in the case of total return swap credit derivatives and credit default swap credit derivatives, the nominal amount of the instrument shall be multiplied by the following percentages–

— where the reference obligation is one that if it gave rise to a direct exposure of the investment firm it would be a qualifying item for the purposes of Schedule 1: 5 %; and

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— where the reference obligation is one that if it gave rise to a direct exposure of the investment firm it would not be a qualifying item for the purposes of Schedule 1: 10 %.

However, in the case of a credit default swap, an institution the exposure of which arising from the swap represents a long position in the underlying shall be permitted to use a figure of 0 % for potential future credit exposure, unless the credit default swap is subject to closeout upon insolvency of the entity the exposure of which arising from the swap represents a short position in the underlying, even though the underlying has not defaulted, in which case the figure for potential future credit exposure of the institution shall be limited to the amount of premia which are not yet paid by the entity to the institution.

Where the credit derivative provides protection in relation to 'nth to default' amongst a number of underlying obligations, which of the percentage figures prescribed above is to be applied is determined by the obligation with the nth lowest credit quality determined by whether it is one that if incurred by the investment firm would be a qualifying item for the purposes of Schedule 1.

8. For the purposes of paragraph 6, in calculating risk-weighted exposure amounts investment firms shall not be permitted to use the Financial Collateral Simple Method, set out in paragraphs 24 to 29 of Part 3 of Schedule 8 of the FSCACI Regulations, for the recognition of the effects of financial collateral.

9. For the purposes of paragraph 6, in the case of repurchase transactions and securities or commodities lending or borrowing transactions booked in the trading book, all financial instruments and commodities which are eligible to be included in the trading book may be recognised as eligible collateral. For exposures due to OTC derivative instruments booked in the trading book, commodities that are eligible to be included in the trading book may also be recognized as eligible collateral. For the purposes of calculating volatility adjustments where such financial instruments or commodities which are not eligible under Schedule 8 of the FSCACI Regulations are lent, sold or provided, or borrowed, purchased or received by way of collateral or otherwise under such a transaction, and the investment firm is using the supervisory volatility adjustments approach under Part 3 of Schedule 8 to those Regulations, such instruments and commodities shall be treated in the same way as non-main index equities listed on a recognised exchange.

Where investment firms are using the own estimates of volatility adjustments approach under Part 3 of Schedule 8 of the FSCACI Regulations in respect of financial instruments or commodities which are not eligible under that Schedule, volatility adjustments shall be calculated for each individual item.

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Where investment firms are using the internal models approach defined in that Schedule, they may also apply this approach in the trading book.

10. For the purposes of paragraph 6, in relation to the recognition of master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions or other capital market driven transactions netting across positions in the trading book and the non-trading book shall only be recognised when the netted transactions fulfil the following conditions:

(a) all transactions are marked to market daily; and

(b) any items borrowed, purchased or received under the transactions may be recognised as eligible financial collateral under regulations 40 to 43 of the FSCACI Regulations without the application of paragraph 9 of this Schedule.

11. Where a credit derivative included in the trading book forms part of an internal hedge and the credit protection is recognised under the FSCACI Regulations, no counterparty risk shall be deemed to arise from the position in the credit derivative. Alternatively, an investment firm may consistently include for the purposes of calculating capital requirements for counterparty credit risk all credit derivatives included in the trading book forming part of internal hedges or purchased as protection against a CCR exposure where the credit protection is recognised under those Regulations.

12. The capital requirement shall be 8 % of the total risk-weighted exposure amounts.

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**FINANCIAL SERVICES (CAPITAL ADEQUACY OF INVESTMENT FIRMS) REGULATIONS 2007**

## SCHEDULE 3

Regulations 9, 10, 14, 22 and 35

### Calculating Capital Requirements for Foreign-exchange Risk

1. If the sum of an investment firm's overall net foreign-exchange position and its net gold position, calculated in accordance with the procedure set out in paragraph 2, exceeds 2 % of its total own funds, it shall multiply the sum of its net foreign-exchange position and its net gold position by 8 % in order to calculate its own funds requirement against foreign-exchange risk.

2. A two-stage calculation shall be used for capital requirements for foreign-exchange risk.

2.1. Firstly, the investment firm's net open position in each currency (including the reporting currency) and in gold shall be calculated.

This net open position shall consist of the sum of the following elements (positive or negative)–

(a) the net spot position (i.e. all asset items less all liability items, including accrued interest, in the currency in question or, for gold, the net spot position in gold);

(b) the net forward position (i.e. all amounts to be received less all amounts to be paid under forward exchange and gold transactions, including currency and gold futures and the principal on currency swaps not included in the spot position);

(c) irrevocable guarantees (and similar instruments) that are certain to be called and likely to be irrecoverable;

(d) net future income or expenses not yet accrued but already fully hedged (at the discretion of the reporting investment firm and with the prior consent of the Authority, net future income or expenses not yet entered in accounting records but already fully hedged by forward foreign-exchange transactions may be included here). Such discretion must be exercised on a consistent basis;

(e) the net delta (or delta-based) equivalent of the total book of foreign currency and gold options; and

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(f) the market value of other (i.e. non-foreign-currency and non-gold) options.

Any positions which an investment firm has deliberately taken in order to hedge against the adverse effect of the exchange rate on its capital ratio may be excluded from the calculation of net open currency positions. Such positions shall be of a non-trading or structural nature and their exclusion, and any variation of the terms of their exclusion, shall require the consent of the competent authorities. The same treatment subject to the same conditions as above may be applied to positions which an investment firm has which relate to items that are already deducted in the calculation of own funds.

For the purposes of the calculation referred to in the first paragraph, in respect of CIUs the actual foreign exchange positions of the CIU shall be taken into account. Investment firms may rely on third party reporting of the foreign exchange positions in the CIU, where the correctness of this report is adequately ensured. If an investment firm is not aware of the foreign exchange positions in a CIU, it shall be assumed that the CIU is invested up to the maximum extent allowed under the CIU's mandate in foreign exchange and investment firms shall, for trading book positions, take account of the maximum indirect exposure that they could achieve by taking leveraged positions through the CIU when calculating their capital requirement for foreign exchange risk. This shall be done by proportionally increasing the position in the CIU up to the maximum exposure to the underlying investment items resulting from the investment mandate. The assumed position of the CIU in foreign exchange shall be treated as a separate currency according to the treatment of investments in gold, subject to the modification that, if the direction of the CIU's investment is available, the total long position may be added to the total long open foreign exchange position and the total short position may be added to the total short open foreign exchange position. There would be no netting allowed between such positions prior to the calculation.

The Authority may allow investment firm to use the net present value when calculating the net open position in each currency and in gold.

2.2. Secondly, net short and long positions in each currency other than the reporting currency and the net long or short position in gold shall be converted at spot rates into the reporting currency. They shall then be summed separately to form the total of the net short positions and the total of the net long positions respectively. The higher of these two totals shall be the investment firm's overall net foreign exchange position.

3. Notwithstanding paragraphs 1 and 2 and pending further coordination, the Authority may prescribe or allow investment firms to use the following procedures for the purposes of this Schedule.

3.1. The Authority may allow investment firms to provide lower capital requirements against positions in closely correlated currencies than those which would result from applying paragraphs 1 and 2 to them. The Authority may deem a pair of currencies to be closely correlated only if the likelihood of a loss — calculated on the basis of daily exchange rate data for the preceding three or five years — occurring on equal and opposite positions in such currencies over the following 10 working days, which is 4 % or less of the value of the matched position in question (valued in terms of the reporting currency) has a probability of at least 99 %, when an observation period of three years is used, or 95 %, when an observation period of five years is used. The own-funds requirement on the matched position in two closely correlated currencies shall be 4 % multiplied by the value of the matched position. The capital requirement on unmatched positions in closely correlated currencies, and all positions in other currencies, shall be 8 %, multiplied by the higher of the sum of the net short or the net long positions in those currencies after the removal of matched positions in closely correlated currencies.

3.2. The Authority may allow investment firms to remove positions in any currency which is subject to a legally binding intergovernmental agreement to limit its variation relative to other currencies covered by the same agreement from whichever of the methods described in paragraphs 1, 2 and 3.1 that they apply. Investment firms shall calculate their matched positions in such currencies and subject them to a capital requirement no lower than half of the maximum permissible variation laid down in the intergovernmental agreement in question in respect of the currencies concerned. Unmatched positions in those currencies shall be treated in the same way as other currencies.

Notwithstanding the first paragraph, the Authority may allow the capital requirement on the matched positions in currencies of EEA States participating in the second stage of the economic and monetary union to be 1.6 %, multiplied by the value of such matched positions.

4. Net positions in composite currencies may be broken down into the component currencies according to the quotas in force.

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## SCHEDULE 4

Regulations 9, 10, 14 and 22

### Calculating Capital Requirements for Commodities Risk

1. Each position in commodities or commodity derivatives shall be expressed in terms of the standard unit of measurement. The spot price in each commodity shall be expressed in the reporting currency.

2. Positions in gold or gold derivatives shall be considered as being subject to foreign-exchange risk and treated according to Schedule 3 or 5, as appropriate, for the purpose of calculating market risk.

3. For the purposes of this Schedule, positions which are purely stock financing may be excluded from the commodities risk calculation only.

4. The interest rate and foreign exchange risks not covered by other provisions of this Schedule shall be included in the calculation of general risk for traded debt instruments and in the calculation of foreign exchange risk.

5. When the short position falls due before the long position, investment firms shall also guard against the risk of a shortage of liquidity which may exist in some markets.

6. For the purpose of paragraph 19, the excess of an investment firm's long (short) positions over its short (long) positions in the same commodity and identical commodity futures, options and warrants shall be its net position in each commodity.

The Authority may allow positions in derivative instruments to be treated, as laid down in paragraphs 8, 9 and 10, as positions in the underlying commodity.

7. The Authority may regard the following positions as positions in the same commodity–

(a) positions in different sub-categories of commodities in cases where the sub-categories are deliverable against each other; and

(b) positions in similar commodities if they are close substitutes and if a minimum correlation of 0.9 between price movements can be clearly established over a minimum period of one year.

**Particular instruments.**

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8. Commodity futures and forward commitments to buy or sell individual commodities shall be incorporated in the measurement system as notional amounts in terms of the standard unit of measurement and assigned a maturity with reference to expiry date.

The Authority may allow the capital requirement for an exchange-traded future to be equal to the margin required by the exchange if it is fully satisfied that it provides an accurate measure of the risk associated with the future and that it is at least equal to the capital requirement for a future that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5.

The Authority may also allow the capital requirement for an OTC commodity derivatives contract of the type referred to in this paragraph cleared by a clearing house recognised by it to be equal to the margin required by the clearing house if it is fully satisfied that it provides an accurate measure of the risk associated with the derivatives contract and that it is at least equal to the capital requirement for the contract in question that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5.

9. Commodity swaps where one side of the transaction is a fixed price and the other the current market price shall be incorporated into the maturity ladder approach, as set out in paragraphs 13 to 18, as a series of positions equal to the notional amount of the contract, with one position corresponding with each payment on the swap and slotted into the maturity ladder set out in Table 1 to paragraph 13. The positions shall be long positions if the investment firm is paying a fixed price and receiving a floating price and short positions if the investment firm is receiving a fixed price and paying a floating price.

Commodity swaps where the sides of the transaction are in different commodities are to be reported in the relevant reporting ladder for the maturity ladder approach.

10. Options on commodities or on commodity derivatives shall be treated as if they were positions equal in value to the amount of the underlying to which the option refers, multiplied by its delta for the purposes of this Schedule. The latter positions may be netted off against any offsetting positions in the identical underlying commodity or commodity derivative. The delta used shall be that of the exchange concerned, that calculated by the Authority or, where none of those is available, or for OTC options, that

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calculated by the investment firm itself, subject to the Authority being satisfied that the model used by the investment firm is reasonable.

However, the Authority may also prescribe that investment firms calculate their deltas using a methodology specified by it.

Other risks, apart from the delta risk, associated with commodity options shall be safeguarded against.

The Authority may allow the requirement for a written exchange-traded commodity option to be equal to the margin required by the exchange if it is fully satisfied that it provides an accurate measure of the risk associated with the option and that it is at least equal to the capital requirement against an option that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5.

The Authority may also allow the capital requirement for an OTC commodity option cleared by a clearing house recognised by it to be equal to the margin required by the clearing house if it is fully satisfied that it provides an accurate measure of the risk associated with the option and that it is at least equal to the capital requirement for an OTC option that would result from a calculation made using the method set out in the remainder of this Schedule or applying the internal models method described in Schedule 5.

In addition it may allow the requirement on a bought exchange-traded or OTC commodity option to be the same as that for the commodity underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement for a written OTC option shall be set in relation to the commodity underlying it.

11. Warrants relating to commodities shall be treated in the same way as commodity options referred to in paragraph 10.

12. The transferor of commodities or guaranteed rights relating to title to commodities in a repurchase agreement and the lender of commodities in a commodities lending agreement shall include such commodities in the calculation of its capital requirement under this Schedule.

(a) *Maturity ladder approach*

13. An investment firm shall use a separate maturity ladder in line with Table 1 for each commodity. All positions in that commodity and all positions which are regarded as positions in the same commodity pursuant to

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paragraph 7 shall be assigned to the appropriate maturity bands. Physical stocks shall be assigned to the first maturity band.

***Table 1***

| Maturity band (1) | Spread rate (in %) (2) |
|---|---|
| $0 \leq 1$ month | 1.50 |
| $> 1 \leq 3$ months | 1.50 |
| $> 3 \leq 6$ months | 1.50 |
| $> 6 \leq 12$ months | 1.50 |
| $> 1 \leq 2$ years | 1.50 |
| $> 2 \leq 3$ years | 1.50 |
| $> 3$ years | 1.50 |

14. The Authority may allow positions which are, or are regarded pursuant to paragraph 7 as, positions in the same commodity to be offset and assigned to the appropriate maturity bands on a net basis for the following–

(a) positions in contracts maturing on the same date; and

(b) positions in contracts maturing within 10 days of each other if the contracts are traded on markets which have daily delivery dates.

15. The investment firm shall then calculate the sum of the long positions and the sum of the short positions in each maturity band. The amount of the former (latter) which are matched by the latter (former) in a given maturity band shall be the matched positions in that band, while the residual long or short position shall be the unmatched position for the same band.

16. That part of the unmatched long (short) position for a given maturity band that is matched by the unmatched short (long) position for a maturity band further out shall be the matched position between two maturity bands. That part of the unmatched long or unmatched short position that cannot be thus matched shall be the unmatched position.

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17. The investment firm's capital requirement for each commodity shall be calculated on the basis of the relevant maturity ladder as the sum of the following–

(a) the sum of the matched long and short positions, multiplied by the appropriate spread rate as indicated in the second column of Table 1 to paragraph 13 for each maturity band and by the spot price for the commodity;

(b) the matched position between two maturity bands for each maturity band into which an unmatched position is carried forward, multiplied by 0.6 % (carry rate) and by the spot price for the commodity; and

(c) the residual unmatched positions, multiplied by 15 % (outright rate) and by the spot price for the commodity.

18. The investment firm's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to paragraph 17.

*(b) Simplified approach*

19. An investment firm's capital requirement for each commodity shall be calculated as the sum of–

(a) 15 % of the net position, long or short, multiplied by the spot price for the commodity; and

(b) 3 % of the gross position, long plus short, multiplied by the spot price for the commodity.

20. The investment firm's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to paragraph 19.

*(c) Extended Maturity ladder approach*

21. The Authority may authorise investment firms to use the minimum spread, carry and outright rates set out in the following table (Table 2) instead of those indicated in paragraphs 13, 14, 17 and 18 provided that the investment firms, in the opinion of the Authority–

(a) undertake significant commodities business;

(b) have a diversified commodities portfolio; and

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(c) are not yet in a position to use internal models for the purpose of calculating the capital requirement on commodities risk in accordance with Schedule 5.

***Table 2***

| | Precious metals (except gold) | Base metals | Agricultural products (softs) | Other, including energy products |
|---|---|---|---|---|
| Spread rate ( %) | 1.0 | 1.2 | 1.5 | 1.5 |
| Carry rate ( %) | 0.3 | 0.5 | 0.6 | 0.6 |
| Outright rate ( %) | 8 | 10 | 12 | 15 |

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## SCHEDULE 5

Regulations 9, 10, 14, 22, 24 and 36

### Use of Internal Models to Calculate Requirements

1. The competent authority shall, subject to the conditions laid down in this Schedule, allow institutions to calculate their capital requirements for position risk, foreign-exchange risk and/or commodities risk using their own internal risk-management models instead of or in combination with the methods described in Schedules 1, 3 and 4. Explicit recognition by the competent authority of the use of models for supervisory capital purposes shall be required in each case.

2. Recognition shall only be given if the Authority is satisfied that the investment firm's risk management system is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met–

(a) the internal risk-measurement model is closely integrated into the daily risk-management process of the investment firm and serves as the basis for reporting risk exposures to senior management of the investment firm;

(b) the investment firm has a risk control unit that is independent from business trading units and reports directly to senior management. The unit shall be responsible for designing and implementing the investment firm's risk management system. It shall produce and analyse daily reports on the output of the risk measurement model and on the appropriate measures to be taken in terms of trading limits. The unit shall also conduct the initial and on-going validation of the internal model;

(c) the investment firm's board of directors and senior management are actively involved in the risk control process and the daily reports produced by the risk control unit are reviewed by a level of management with sufficient authority to enforce both reductions of positions taken by individual traders as well as in the investment firm's overall risk exposure;

(d) the investment firm has sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk control, audit and back office areas;

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(e) the investment firm has established procedures for monitoring and ensuring compliance with a documented set of internal policies and controls concerning the overall operation of the risk-measurement system;

(f) the investment firm's model has a proven track record of reasonable accuracy in measuring risks;

(g) the investment firm frequently conducts a rigorous programme of stress testing and the results of these tests are reviewed by senior management and reflected in the policies and limits it sets**.** This process shall particularly address illiquidity of markets in stressed market conditions, concentration risk, one way markets, event and jump-to-default risks, non-linearity of products, deep out-of-the-money positions, positions subject to the gapping of prices and other risks that may not be captured appropriately in the internal models. The shocks applied shall reflect the nature of the portfolios and the time it could take to hedge out or manage risks under severe market conditions; and

(h) the investment firm conducts, as part of its regular internal auditing process, an independent review of its risk measurement system.

The review referred to in paragraph (h) of the first paragraph shall include both the activities of the business trading units and of the independent risk control unit. At least once a year, the investment firm must conduct a review of its overall risk management process.

The review shall consider the following–

(a) the adequacy of the documentation of the risk-management system and process and the organisation of the risk control unit;

(b) the integration of market risk measures into daily risk management and the integrity of the management information system;

(c) the process the investment firm employs for approving risk-pricing models and valuation systems that are used by front and back office personnel;

(d) the scope of market risks captured by the risk-measurement model and the validation of any significant changes in the risk measurement process;

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(e) the accuracy and completeness of position data, the accuracy and appropriateness of volatility and correlation assumptions, and the accuracy of valuation and risk sensitivity calculations;

(f) the verification process the investment firm employs to evaluate the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources; and

(g) the verification process the investment firm uses to evaluate back-testing that is conducted to assess the models' accuracy.

3. Investment firms shall have processes in place to ensure that their internal models have been adequately validated by suitably qualified parties independent of the development process to ensure that they are conceptually sound and adequately capture all material risks. The validation shall be conducted when the internal model is initially developed and when any significant changes are made to the internal model. The validation shall also be conducted on a periodic basis but especially where there have been any significant structural changes in the market or changes to the composition of the portfolio which might lead to the internal model no longer being adequate. As techniques and best practices evolve, investment firms shall avail themselves of these advances. Internal model validation shall not be limited to back-testing, but shall, at a minimum, also include the following–

(a) tests to demonstrate that any assumptions made within the internal model are appropriate and do not underestimate or overestimate the risk;

(b) in addition to the regulatory back-testing programmes, investment firms shall carry out their own internal model validation tests in relation to the risks and structures of their portfolios; and

(c) the use of hypothetical portfolios to ensure that the internal model is able to account for particular structural features that may arise, for example material basis risks and concentration risk.

4. An investment firm shall monitor the accuracy and performance of its model by conducting a back testing programme. The back testing has to provide for each business day a comparison of the one day value-at-risk measure generated by the investment firm's model for the portfolio's end-of-day positions to the one-day change of the portfolio's value by the end of the subsequent business day.

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1. The competent authority shall, subject to the conditions laid down in this Schedule, allow institutions to calculate their capital requirements for position risk, foreign-exchange risk and/or commodities risk using their own internal risk-management models instead of or in combination with the methods described in Schedules 1, 3 and 4. Explicit recognition by the competent authority of the use of models for supervisory capital purposes shall be required in each case.

5. For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions, the competent authority shall recognise the use of an institution's internal model if, in addition to compliance with the conditions in the remainder of this Schedule, the internal model meets the following conditions:

(a) it explains the historical price variation in the portfolio;

(b) it captures concentration in terms of magnitude and changes of composition of the portfolio;

(c) it is robust to an adverse environment;

(d) it is validated through back-testing aimed at assessing whether specific risk is being accurately captured. If the competent authority allow such back-testing to be performed on the basis of relevant sub-portfolios, these must be chosen in a consistent manner;

(e) it captures name-related basis risk, namely institutions shall demonstrate that the internal model is sensitive to material idiosyncratic differences between similar but not identical positions;

(f) it captures event risk.

The institution's internal model shall conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios. In addition, the internal model shall meet minimum data standards. Proxies shall be appropriately conservative and may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio.

An institution may choose to exclude from the calculation of its specific risk capital requirement using an internal model those positions in securitisations or n-th-to-default credit derivatives for which it meets a capital requirement for position risks in accordance with Schedule 1with the exception of those positions that are subject to the approach set out in point 51.

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As techniques and best practices evolve, institutions shall avail themselves of those new techniques and practices.

An institution shall not be required to capture default and migration risks for traded debt instruments in its internal model where it is capturing those risks through the requirements set out in points 5a to 5k.

5a. Institutions subject to point 5 for traded debt instruments shall have an approach in place to capture, in the calculation of their capital requirements, the default and migration risks of its trading book positions that are incremental to the risks captured by the value-at-risk measure as specified in point 5. An institution shall demonstrate that its approach meets soundness standards comparable to the approach set out in regulations 34 to 39 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality.

**Scope**

5b. The approach to capture the incremental default and migration risks shall cover all positions subject to a capital charge for specific interest rate risk but shall not cover securitisation positions and n-th-to-default credit derivatives. Subject to supervisory approval, the institution may choose to consistently include all listed equity positions and derivatives positions based on listed equities for which such inclusion is consistent with how the institution internally measures and manages risk. The approach shall reflect the impact of correlations between default and migration events. The impact of diversification between, on the one hand, default and migration events and, on the other hand, other market risk factors shall not be reflected.

**Parameters**

5c. The approach to capture the incremental risks shall measure losses due to default and internal or external ratings migration at the 99,9 % confidence interval over a capital horizon of 1 year.

Correlation assumptions shall be supported by analysis of objective data in a conceptually sound framework. The approach to capture the incremental risks shall appropriately reflect issuer concentrations. Concentrations that can arise within and across product classes under stressed conditions shall also be reflected. The approach shall be based on the assumption of a constant level of risk over the one-year capital horizon, implying that given individual trading book positions or sets of positions that have experienced default or migration over their liquidity horizon are re-balanced at the end of

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their liquidity horizon to attain the initial level of risk. Alternatively, an institution may choose to consistently use a one-year constant position assumption.

5d. The liquidity horizons shall be set according to the time required to sell the position or to hedge all material relevant price risks in a stressed market, having particular regard to the size of the position. Liquidity horizons shall reflect actual practice and experience during periods of both systematic and idiosyncratic stresses. The liquidity horizon shall be measured under conservative assumptions and shall be sufficiently long that the act of selling or hedging, in itself, would not materially affect the price at which the selling or hedging would be executed.

The determination of the appropriate liquidity horizon for a position or set of positions is subject to a floor of 3 months.

The determination of the appropriate liquidity horizon for a position or set of positions shall take into account an institution's internal policies relating to valuation adjustments and the management of stale positions. When an institution determines liquidity horizons for sets of positions rather than for individual positions, the criteria for defining sets of positions shall be defined in a way that meaningfully reflects differences in liquidity. The liquidity horizons shall be greater for positions that are concentrated, reflecting the longer period needed to liquidate such positions. The liquidity horizon for a securitisation warehouse shall reflect the time to build, sell and securitise the assets, or to hedge the material risk factors, under stressed market conditions.

5e. Hedges may be incorporated into an institution's approach to capture the incremental default and migration risks. Positions may be netted when long and short positions refer to the same financial instrument. Hedging or diversification effects associated with long and short positions involving different instruments or different securities of the same obligor, as well as long and short positions in different issuers, may only be recognised by explicitly modelling gross long and short positions in the different instruments. Institutions shall reflect the impact of material risks that could occur during the interval between the hedge's maturity and the liquidity horizon as well as the potential for significant basis risks in hedging strategies by product, seniority in the capital structure, internal or external rating, maturity, vintage and other differences in the instruments. An institution shall reflect a hedge only to the extent that it can be maintained even as the obligor approaches a credit or other event.

For trading book positions that are hedged via dynamic hedging strategies, a rebalancing of the hedge within the liquidity horizon of the hedged position may be recognised provided that the institution:

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(i) chooses to model rebalancing of the hedge consistently over the relevant set of trading book positions,

(ii) demonstrates that the inclusion of rebalancing results in a better risk measurement, and

(iii) demonstrates that the markets for the instruments serving as hedges are liquid enough to allow for such rebalancing even during periods of stress. Any residual risks resulting from dynamic hedging strategies must be reflected in the capital charge.

5f. The approach to capture the incremental default and migration risks shall reflect the nonlinear impact of options, structured credit derivatives and other positions with material nonlinear behaviour with respect to price changes. The institution shall also have due regard to the amount of model risk inherent in the valuation and estimation of price risks associated with such products.

5g. The approach to capture the incremental default and migration risks shall be based on data that are objective and up-to-date.

**Validation**

5h.As part of the independent review of their risk measurement system and the validation of their internal models as required in this Schedule, institutions shall, with a view to the approach to capture incremental default and migration risks, in particular:

(i) validate that its modelling approach for correlations and price changes is appropriate for its portfolio, including the choice and weights of its systematic risk factors;

(ii) perform a variety of stress tests, including sensitivity analysis and scenario analysis, to assess the qualitative and quantitative reasonableness of the approach, particularly with regard to the treatment of concentrations. Such tests shall not be limited to the range of events experienced historically;

(iii) apply appropriate quantitative validation including relevant internal modelling benchmarks.

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The approach to capture the incremental risks shall be consistent with the institution's internal risk management methodologies for identifying, measuring, and managing trading risks.

**Documentation**

5i. An institution shall document its approach to capturing incremental default and migration risks so that its correlation and other modelling assumptions are transparent to the competent authority.

**Internal approaches based on different parameters**

5j. If the institution uses an approach to capturing incremental default and migration risks that does not comply with all requirements of this point but that is consistent with the institution's internal methodologies for identifying, measuring and managing risks, it shall be able to demonstrate that its approach results in a capital requirement that is at least as high as if it was based on an approach in full compliance with the requirements of this point. The competent authority shall review compliance with the previous sentence at least annually.

**Frequency of calculation**

5k. An institution shall perform the calculations required under its chosen approach to capture the incremental risk at least weekly.

5l. The competent authority shall recognise the use of an internal approach for calculating an additional capital charge instead of a capital charge for the correlation trading portfolio in accordance with point 14a of Schedule 1 of these Regulations provided that all conditions in this point are fulfilled.

Such an internal approach shall adequately capture all price risks at the 99,9 % confidence interval over a capital horizon of 1 year under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality. The institution may incorporate any positions in the approach referred to in this point that are jointly managed with positions of the correlation trading portfolio and may then exclude those positions from the approach required under point 5a.

The amount of the capital charge for all price risks shall not be less than 8 % of the capital charge that would be calculated in accordance with point 14a of Schedule 1 of these Regulations for all positions incorporated in the charge for all price risks.

In particular, the following risks shall be adequately captured:

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(a) the cumulative risk arising from multiple defaults, including the ordering of defaults, in tranched products;

(b) credit spread risk, including the gamma and cross-gamma effects;

(c) volatility of implied correlations, including the cross effect between spreads and correlations;

(d) basis risk, including both:

(i) the basis between the spread of an index and those of its constituent single names, and

(ii) the basis between the implied correlation of an index and that of bespoke portfolios;

(e) recovery rate volatility, as it relates to the propensity for recovery rates to affect tranche prices; and

(f) to the extent the comprehensive risk measure incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing such hedges.

For the purpose of this point, an institution shall have sufficient market data to ensure that it fully captures the salient risks of those exposures in its internal approach in accordance with the standards set out in this point, demonstrates through back testing or other appropriate means that its risk measures can appropriately explain the historical price variation of those products, and is able to separate the positions for which it holds approval in order to incorporate them in the capital charge in accordance with this point from those positions for which it does not hold such approval.

With regard to portfolios subject to this point, the institution shall regularly apply a set of specific, predetermined stress scenarios. Such stress scenarios shall examine the effects of stress to default rates, recovery rates, credit spreads, and correlations on the profit and loss of the correlation trading desk. The institution shall apply such stress scenarios at least weekly and report at least quarterly to the competent authority the results, including comparisons with the institution's capital charge in accordance with this point. Any instances where the stress tests indicate a material shortfall of this capital charge shall be reported to the competent authority in a timely manner. Based on those stress testing results, the competent authority shall consider a supplemental capital charge against the correlation trading portfolio as set out in regulation 83 of the the Financial Services (Capital Adequacy of Credit Institutions) Regulations 2007.

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An institution shall calculate the capital charge to capture all price risks at least on a weekly basis.

6. Institutions using internal models which are not recognised in accordance with point 5 shall be subject to a separate capital charge for specific risk as calculated in accordance with Schedule 1.

7. For the purposes of points 10b(a) and (b), the results of the institution's own calculation shall be scaled up by the multiplication factors (mc) and (ms). Those factors shall be at least 3.

8. For the purposes of points 10b(a) and (b), the multiplication factors (mc) and (ms) shall be increased by a plus-factor of between 0 and 1 in accordance with Table 1, depending on the number of overshootings for the most recent 250 business days as evidenced by the institution's back-testing of the value-at-risk measure as set out in point 10. The competent authority shall require the institutions to calculate overshootings consistently on the basis of back-testing on hypothetical and actual changes in the portfolio's value. An overshooting is a one-day change in the portfolio's value that exceeds the related one-day value-at-risk measure generated by the institution's model. For the purpose of determining the plus-factor the number of overshootings shall be assessed at least quarterly and shall be equal to the higher of the number of overshootings under hypothetical and actual changes in the value of the portfolio.

***Table 1***

| Number of overshootings | Plus-factor |
|---|---|
| Fewer than 5 | 0.00 |
| 5 | 0.40 |
| 6 | 0.50 |
| 7 | 0.65 |
| 8 | 0.75 |
| 9 | 0.85 |
| 10 or more | 1.00 |

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The Authority may, in individual cases and owing to an exceptional situation, waive the requirement to increase the multiplication factor by the 'plus-factor' in accordance with Table 1, if the investment firm has demonstrated to the satisfaction of the Authority that such an increase is unjustified and that the model is basically sound.

If numerous overshootings indicate that the model is not sufficiently accurate, the Authority shall revoke the model's recognition or impose appropriate measures to ensure that the model is improved promptly.

In order to allow Authority to monitor the appropriateness of the plus factor on an ongoing basis, investment firms shall notify it promptly, and in any case no later than within five working days, of overshootings that result form their back-testing programme and that would according to the above table imply an increase of a plus factor.

9. *Deleted*

10. The calculation of the value-at-risk measure shall be subject to the following minimum standards–

(a) at least daily calculation of the value-at-risk measure;

(b) a 99th percentile, one-tailed confidence interval;

(c) a 10-day equivalent holding period (institutions may use value-at-risk numbers calculated according to shorter holding periods scaled up to 10 days by, for example, the square root of time. An institution using that approach shall periodically justify the reasonableness of its approach to the satisfaction of the competent authority);

(d) an effective historical observation period of at least one year except where a shorter observation period is justified by a significant upsurge in price volatility; and

(e) monthly data set updates.

10a. In addition, each institution shall calculate a "stressed value-at-risk" based on the 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of the current portfolio, with value-at-risk model inputs calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the institution's portfolio. The choice of such historical data shall be subject to approval by the competent authority and to annual review by the institution.

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10b. Each institution shall meet, on a daily basis, a capital requirement expressed as the sum of points (a) and (b) and an institution that uses its internal model to calculate the capital requirement for specific position risk shall meet a capital requirement expressed as the sum of points (c) and (d), as follows:

(a) the higher of:

(i) its previous day's value-at-risk number calculated in accordance with point 10 (VaRt-1); and

(ii) an average of the daily value-at-risk measures in accordance with point 10 on each of the preceding sixty business days (VaRavg), multiplied by the multiplication factor (mc);

(b) the higher of:

(i) its latest available stressed-value-at-risk number in accordance with point 10a (sVaRt-1); and

(ii) an average of the stressed value-at-risk numbers calculated in the manner and frequency specified in point 10a during the preceding sixty business days (sVaRavg), multiplied by the multiplication factor (ms);

(c) a capital charge calculated in accordance with Schedule 1 for the position risks of securitisation positions and nth to default credit derivatives in the trading book with the exception of those incorporated in the capital charge in accordance with point 5l;

(d) the higher of the institution's most recent and the institution's 12 weeks average measure of incremental default and migration risk in accordance with point 5a and, where applicable, the higher of the institution's most recent and its 12-week-average measure of all price risks in accordance with point 5l.

10c. Institutions shall also carry out reverse stress tests.

11. The Authority shall require that the model captures accurately all the material price risks of options or option like positions and that any other risks not captured by the model are covered adequately by own funds.

12. The risk-measurement model shall capture a sufficient number of risk factors, depending on the level of activity of the institution in the respective

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markets. Where a risk factor is incorporated into the institution's pricing model but not into the risk-measurement model, the institution shall be able to justify such an omission to the satisfaction of the competent authority. In addition, the risk-measurement model shall capture nonlinearities for options and other products as well as correlation risk and basis risk. Where proxies for risk factors are used they shall show a good track record for the actual position held. In addition, the following shall apply for individual risk types:

**Interest rate risk.**

The risk measurement system shall incorporate a set of risk factors corresponding to the interest rates in each currency in which the investment firm has interest rate sensitive on- or off-balance sheet positions. The investment firm shall model the yield curves using one of the generally accepted approaches. For material exposures to interest rate risk in the major currencies and markets, the yield curve shall be divided into a minimum of six maturity segments, to capture the variations of volatility of rates along the yield curve. The risk measurement system must also capture the risk of less than perfectly correlated movements between different yield curves.

**Foreign-exchange risk.**

The risk measurement system shall incorporate risk factors corresponding to gold and to the individual foreign currencies in which the investment firm's positions are denominated.

For CIUs the actual foreign exchange positions of the CIU shall be taken into account. Investment firms may rely on third party reporting of the foreign exchange position of the CIU, where the correctness of this report is adequately ensured. If an investment firm is not aware of the foreign exchange positions of a CIU, this position should be carved out and treated in accordance with the fourth paragraph of paragraph 2.1 of Schedule 3.

**Equity risk.**

The risk measurement system shall use a separate risk factor at least for each of the equity markets in which the investment firm holds significant positions.

**Commodity risk.**

The risk measurement system shall use a separate risk factor at least for each commodity in which the investment firm holds significant positions. The risk measurement system shall also capture the risk of less than perfectly correlated movements between similar, but not identical, commodities and the exposure to changes in forward prices arising from maturity mismatches.

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It shall also take account of market characteristics, notably delivery dates and the scope provided to traders to close out positions.

13. The Authority may allow investment firms to use empirical correlations within risk categories and across risk categories if it is satisfied that the investment firm's system for measuring correlations is sound and implemented with integrity.

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Regulations 9, 10, 14, 15 and 22

**Calculating Capital Requirements for Large Exposures**

1. The excess referred to in regulation 27(b) shall be calculated by selecting those components of the total trading exposure to the client or group of clients in question which attract the highest specific risk requirements in Schedule 1 or requirements in Schedule 2, the sum of which equals the amount of the excess referred to in regulation 27(a).

2. Where the excess has not persisted for more than 10 days, the additional capital requirement shall be 200 % of the requirements referred to in paragraph 1, on these components.

3. As from 10 days after the excess has occurred, the components of the excess, selected in accordance with paragraph 1, shall be allocated to the appropriate line in column 1 of Table 1 in ascending order of specific risk requirements in Schedule 1 or requirements in Schedule 2. The additional capital requirement shall be equal to the sum of the specific risk requirements in Schedule 1 or the Schedule 2 requirements on these components, multiplied by the corresponding factor in column 2 of Table 1.

***Table 1***

| Excess over the limits (on the basis of a percentage of own funds) | Factors |
|---|---|
| Up to 40 % | 200 % |
| From 40 % to 60 % | 300 % |
| From 60 % to 80 % | 400 % |
| From 80 % to 100 % | 500 % |
| From 100 % to 250 % | 600 % |
| Over 250 % | 900 % |

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## SCHEDULE 7

Regulations 7 and 29.

### Trading

PART A

**Trading Intent.**

1. Positions or portfolios held with trading intent shall comply with the following requirements–

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

(b) there shall be clearly defined policies and procedures for the active management of the position, which shall include the following–

(i) positions entered into on a trading desk;

(ii) position limits are set and monitored for appropriateness;

(iii) dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;

(iv) positions are reported to senior management as an integral part of the investment firm's risk management process; and

(v) positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge ability of the position or its component risks, including the assessment of, the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and

(c) there must be clearly defined policy and procedures to monitor the position against the investment firm's trading strategy including the monitoring of turnover and stale positions in the investment firm's trading book.

PART B

**Systems and Controls.**

1. An investment firm shall establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.

2. Systems and controls shall include at least the following elements–

(a) documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the institution's assumptions of what market participants would use in pricing the position, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures;

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

The reporting line shall ultimately be to a main board executive director.

**Prudent Valuation Methods**

3. Institutions shall mark their positions to market whenever possible. Marking to market is the at least daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers.

4. When marking to market, the more prudent side of bid/offer shall be used unless the investment firm is a significant market maker in the particular type of financial instrument or commodity in question and it can close out at mid market.

5. Where marking to market is not possible, institutions shall conservatively mark to model their positions/portfolios before applying trading book capital treatment. Marking to model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input.

6. The following requirements shall be complied with when marking to model–

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(a) senior management shall be aware of the elements of the trading book or of other fair-valued positions which are subject to mark to model and shall understand the materiality of the uncertainty thereby created in the reporting of the risk/performance of the business;

(b) market inputs shall be sourced, where possible, in line with market prices, and the appropriateness of the market inputs of the particular position being valued and the parameters of the model shall be assessed on a frequent basis;

(c) where available, valuation methodologies which are accepted market practice for particular financial instruments or commodities shall be used;

(d) where the model is developed by the investment firm itself, it shall be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;

(e) there shall be formal change control procedures in place and a secure copy of the model shall be held and periodically used to check valuations;

(f) risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and

(g) the model shall be subject to periodic review to determine the accuracy of its performance (e.g. assessing the continued appropriateness of assumptions, analysis of profit and loss versus risk factors, comparison of actual close out values to model outputs).

For the purposes of paragraph (d), the model shall be developed or approved independently of the front office and shall be independently tested, including validation of the mathematics, assumptions and software implementation.

7. Independent price verification shall be performed in addition to daily marking to market or marking to model. This is the process by which market prices or model inputs are regularly verified for accuracy and independence. While daily marking to market may be performed by dealers, verification of market prices and model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/ trading activity, more frequently). Where independent pricing

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sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

**Valuation adjustments**

8. Institutions shall establish and maintain procedures for considering valuation adjustments.

**General standards**

9. The competent authority shall require the following valuation adjustments to be formally considered: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where relevant, model risk.

*Standards for less liquid positions*

10. Less liquid positions could arise from both market events and investment firm-related situations e.g. concentrated positions and/or stale positions.

11. Institutions shall establish and maintain procedures for calculating an adjustment to the current valuation of less liquid positions. Such adjustments shall where necessary be in addition to any changes to the value of the position required for financial reporting purposes and shall be designed to reflect the illiquidity of the position. Under those procedures, institutions shall consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. Those factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes including trading volumes during periods of market stress, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

12. When using third party valuations or marking to model, institutions shall consider whether to apply a valuation adjustment. In addition, institutions shall consider the need for establishing adjustments for less liquid positions and on an ongoing basis review their continued suitability.

13. With regard to complex products including, but not limited to, securitisation exposures and n-th-to-default credit derivatives, institutions shall explicitly assess the need for valuation adjustments to reflect the model risk associated with using a possibly incorrect valuation methodology and the model risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model.

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PART C

**Internal Hedges.**

1. An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of positions. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in Parts A and B are met. In particular–

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

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

(c) the internal transaction shall be dealt with at market conditions;

(d) the bulk of the market risk that is generated by the internal hedge shall be dynamically managed in the trading book within the authorised limits; and

(e) internal transactions shall be carefully monitored.

Monitoring shall be ensured by adequate procedures.

2. The treatment referred to in paragraph 1 applies without prejudice to the capital requirements applicable to the 'non-trading book leg' of the internal hedge.

3. Notwithstanding paragraphs 1 and 2, when an investment firm hedges a non-trading book credit risk exposure using a credit derivative booked in its trading book (using an internal hedge), the non-trading book exposure is not deemed to be hedged for the purposes of calculating capital requirements unless the investment firm purchases from an eligible third party protection provider a credit derivative meeting the requirements set out in paragraph 19 of Part 2 of Schedule 8 to of the FSCACI Regulations with regard to the non-trading book exposure. Without prejudice to the second sentence of paragraph 11 of Schedule 2, where such third party protection is purchased and is recognised as a hedge of a non-trading book exposure for the purposes of calculating capital requirements, neither the internal nor external credit derivative hedge shall be included in the trading book for the purposes of calculating capital requirements.

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## Inclusion In The Trading Book.

1. An investment firm shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating its capital requirements, consistent with the criteria set out in regulation 7 and taking into account the investment firm's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and subject to periodic internal audit.

2. An investment firm shall have clearly defined policies and procedures for overall management of the trading book. At a minimum these policies and procedures shall address–

(a) the activities the investment firm considers to be trading and as constituting part of the trading book for capital requirement purposes;

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

(c) for positions that are marked-to-model, the extent to which the investment firm can–

(i) identify all material risks of the position;

(ii) hedge all material risks of the position with instruments for which an active, liquid two-way market exists; and

(iii) derive reliable estimates for the key assumptions and parameters used in the model;

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

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

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

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

3. The Authority may allow investment firms to treat positions that are holdings in the trading book as set out in regulation 7(1)(k), (l)(m) and (n) of the FSCACI Regulations as equity or debt instruments, as appropriate, where an investment firm demonstrates that it is an active market maker in these positions. In this case, the investment firm shall have adequate systems and controls surrounding the trading of eligible own funds instruments.

4. Term trading-related repo-style transactions that an investment firm accounts for in its non-trading book may be included in the trading book for capital requirement purposes so long as all such repo-style transactions are included. For this purpose, trading-related repo-style transactions are defined as those that meet the requirements of regulation 7(2) and of Part A of Schedule 7 and both legs are in the form of either cash or securities includable in the trading book. Regardless of where they are booked, all repo-style transactions are subject to a non-trading book counter party credit risk charge.

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