

Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) (repealed)

DIRECTIVE 2006/49/EC OF THE EUROPEAN  
PARLIAMENT AND OF THE COUNCIL

of 14 June 2006

on the capital adequacy of investment firms and credit institutions (recast) (repealed)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 47(2) thereof,

Having regard to the proposal from the Commission,

Having regard to the Opinion of the European Economic and Social Committee<sup>(1)</sup>,

Having regard to the Opinion of the European Central Bank<sup>(2)</sup>,

After consulting the Committee of the Regions,

Acting in accordance with the procedure laid down in Article 251 of the Treaty<sup>(3)</sup>,

Whereas:

- (1) Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions<sup>(4)</sup> has been significantly amended on several occasions. Now that new amendments are being made to the said Directive, it is desirable, in order to clarify matters, that it should be recast.
- (2) One of the objectives of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments<sup>(5)</sup> is to allow investment firms authorised by the competent authorities of their home Member State and supervised by the same authorities to establish branches and provide services freely in other Member States. That Directive accordingly provides for the coordination of the rules governing the authorisation and pursuit of the business of investment firms.
- (3) Directive 2004/39/EC does not, however, establish common standards for the own funds of investment firms nor indeed does it establish the amounts of the initial capital of such firms or a common framework for monitoring the risks incurred by them.
- (4) It is appropriate to effect only the essential harmonisation that is necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems; in order to achieve mutual recognition within the framework of the internal financial market, measures should be laid down to coordinate the definition of the own funds of investment firms, the establishment of the amounts of their initial capital and the establishment of a common framework for monitoring the risks incurred by investment firms.

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- (5) Since the objectives of this Directive, namely the establishment of the capital adequacy requirements applying to investment firms and credit institutions, the rules for their calculation and the rules for their prudential supervision, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and the effects of the proposed action, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve its objectives.
- (6) It is appropriate to establish different amounts of initial capital depending on the range of activities that investment firms are authorised to undertake.
- (7) Existing investment firms should be permitted, under certain conditions, to continue their business even if they do not comply with the minimum amount of initial capital fixed for new investment firms.
- (8) Member States should be able to establish rules stricter than those provided for in this Directive.
- (9) The smooth operation of the internal market requires not only legal rules but also close and regular cooperation and significantly enhanced convergence of regulatory and supervisory practices between the competent authorities of the Member States.
- (10) The Commission Communication of 11 May 1999 entitled ‘Implementing the framework for financial markets: Action Plan’ listed a number of goals that need to be achieved in order to complete the internal market in financial services. The Lisbon European Council of 23 and 24 March 2000 set the goal of implementing the action plan by 2005. Recasting of the provisions on own funds is a key element of the action plan.
- (11) Since investment firms face in respect of their trading book business the same risks as credit institutions, it is appropriate for the pertinent provisions of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions<sup>(6)</sup> to apply equally to investment firms.
- (12) The own funds of investment firms or credit institutions (hereinafter referred to collectively as ‘institutions’) can serve to absorb losses which are not matched by a sufficient volume of profits, to ensure the continuity of institutions and to protect investors. The own funds also serve as an important yardstick for the competent authorities, in particular for the assessment of the solvency of institutions and for other prudential purposes. Furthermore, institutions, engage in direct competition with each other in the internal market. Therefore, in order to strengthen the Community financial system and to prevent distortions of competition, it is appropriate to lay down common basic standards for own funds.
- (13) For the purposes of recital (12), it is appropriate for the definition of own funds as laid down in Directive 2006/48/EC to serve as a basis, and to provide for supplementary specific rules which take into account the different scope of market risk related capital requirements.

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- (14) As regards credit institutions, common standards have already been established for the supervision and monitoring of different types of risks by Directive 2000/12/EC.
- (15) In that respect, the provisions on minimum capital requirements should be considered in conjunction with other specific instruments which also harmonise the fundamental techniques of the supervision of institutions.
- (16) It is necessary to develop common standards for market risks incurred by credit institutions and provide a complementary framework for the supervision of the risks incurred by institutions, in particular market risks, and more especially position risks, counterparty/settlement risks and foreign-exchange risks.
- (17) It is necessary to provide for the concept of a ‘trading book’ comprising positions in securities and other financial instruments which are held for trading purposes and which are subject mainly to market risks and exposures relating to certain financial services provided to customers.
- (18) With a view to reducing the administrative burden for institutions with negligible trading-book business in both absolute and relative terms, such institutions should be able to apply Directive 2006/48/EC, rather than the requirements laid down in Annexes I and II to this Directive.
- (19) It is important that monitoring of settlement/delivery risks should take account of the existence of systems offering adequate protection reducing those risks.
- (20) In any case, institutions should comply with this Directive as regards the coverage of the foreign-exchange risks on their overall business. Lower capital requirements should be imposed for positions in closely correlated currencies, whether statistically confirmed or arising out of binding intergovernmental agreements.
- (21) The capital requirements for commodity dealers, including those dealers currently exempt from the requirements of Directive 2004/39/EC, will be reviewed as appropriate in conjunction with the review of that exemption as set out in Article 65(3) of that Directive.
- (22) The goal of liberalisation of gas and electricity markets is both economically and politically important for the Community. With this in mind, the capital requirements and other prudential rules to be applied to firms active in those markets should be proportionate and should not unduly interfere with achievement of the goal of liberalisation. This goal should, in particular, be kept in mind when the reviews referred to in recital 21 are carried out.
- (23) The existence of internal systems for monitoring and controlling interest-rate risks on all business of institutions is a particularly important way of minimising such risks. Consequently, such systems should be supervised by the competent authorities.
- (24) Since Directive 2006/48/EC does not establish common rules for the monitoring and control of large exposures in activities which are principally subject to market risks, it is therefore appropriate to provide for such rules.

- (25) Operational risk is a significant risk faced by institutions and requires coverage by own funds. It is essential to take account of the diversity of institutions in the EU by providing alternative approaches.
- (26) Directive 2006/48/EC states the principle of consolidation. It does not establish common rules for the consolidation of financial institutions which are involved in activities principally subject to market risks.
- (27) In order to ensure adequate solvency of institutions within a group, it is essential that the minimum capital requirements apply on the basis of the consolidated financial situation of the group. In order to ensure that own funds are appropriately distributed within the group and are available to protect investments where needed, the minimum capital requirements should apply to individual institutions within a group, unless this objective can be effectively achieved by other means.
- (28) Directive 2006/48/EC does not apply to groups which include one or more investment firms but no credit institutions. A common framework for the introduction of the supervision of investment firms on a consolidated basis should therefore be provided for.
- (29) Institutions should ensure that they have internal capital which, having regard to the risks to which they are or might be exposed, is adequate in quantity, quality and distribution. Accordingly, institutions should have strategies and processes in place for assessing and maintaining the adequacy of their internal capital.
- (30) Competent authorities should evaluate the adequacy of own funds of institutions, having regard to the risks to which the latter are exposed.
- (31) In order for the internal banking market to operate effectively, the Committee of European Banking Supervisors should contribute to the consistent application of this Directive and to the convergence of supervisory practices throughout the Community, and should report on a yearly basis to the Community Institutions on progress made.
- (32) In order for the internal market to operate with increasing effectiveness it is essential that there should be significantly enhanced convergence in the implementation and application of the provisions of harmonising Community legislation.
- (33) For the same reason, and to ensure that Community institutions which are active in several Member States are not disproportionately burdened as a result of the continued responsibilities of individual Member State competent authorities for authorisation and supervision, it is essential significantly to enhance the cooperation between competent authorities. In this context the role of the consolidating supervisor should be strengthened.
- (34) In order for the internal market to operate with increasing effectiveness and for citizens of the Union to be afforded adequate levels of transparency, it is necessary that competent authorities disclose publicly and in a way which allows for meaningful comparison the manner in which the requirements of this Directive are implemented.

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- (35) In order to strengthen market discipline and stimulate institutions to improve their market strategy, risk control and internal management organisation, appropriate public disclosures by institutions should be provided for.
- (36) The measures necessary for the implementation of this Directive should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission<sup>(7)</sup>.
- (37) In its Resolution of 5 February 2002 on the implementation of financial services legislation<sup>(8)</sup>, the Parliament requested that the Parliament and the Council should have an equal role in supervising the way in which the Commission exercises its executive role in order to reflect the legislative powers of Parliament under Article 251 of the Treaty. In the solemn declaration made before the Parliament the same day, by its President, the Commission supported this request. On 11 December 2002, the Commission proposed amendments to Decision 1999/468/EC and then submitted an amended proposal on 22 April 2004. The Parliament considers that this proposal does not preserve its legislative prerogatives. In the Parliament's view, the Parliament and the Council should have the opportunity of evaluating the conferral of implementing powers on the Commission within a determined period. It is therefore appropriate to limit the period during which the Commission may adopt implementing measures.
- (38) The Parliament should be given a period of three months from the first transmission of draft amendments and implementing measures to allow it to examine them and to give its opinion. However, in urgent and duly justified cases, it should be possible to shorten this period. If, within that period, a resolution is adopted by the Parliament, the Commission should re-examine the draft amendments or measures.
- (39) In order to avoid disruption to markets and to ensure continuity in overall levels of own funds, it is appropriate to provide for specific transitional arrangements.
- (40) This Directive respects fundamental rights and observes the principles recognised in particular by the Charter of Fundamental Rights of the European Union as general principles of Community law.
- (41) The obligation to transpose this Directive into national law should be confined to those provisions that represent a substantive change compared to earlier directives. The obligation to transpose the provisions that remain unchanged exists under the earlier directives.
- (42) This Directive should be without prejudice to the obligations of the Member States relating to the time-limits for transposition into national law of the Directives set out in Part B of Annex VIII,

HAVE ADOPTED THIS DIRECTIVE:

CHAPTER I **U.K.*****Subject matter, scope and definitions****Section 1* **U.K.*****Subject matter and scope****Article 1* **U.K.**

1 This Directive lays down the capital adequacy requirements applying to investment firms and credit institutions, the rules for their calculation and the rules for their prudential supervision. Member States shall apply the requirements of this Directive to investment firms and credit institutions as defined in Article 3.

2 A Member State may impose additional or more stringent requirements on those investment firms and credit institutions that it has authorised.

*Article 2* **U.K.**

1 Subject to Articles 18, 20, 22 to 32, 34 and 39 of this Directive, Articles 68 to 73 of Directive 2006/48/EC shall apply mutatis mutandis to investment firms. In applying Articles 70 to 72 of Directive 2006/48/EC to investment firms, every reference to a parent credit institution in a Member State shall be construed as a reference to a parent investment firm in a Member State and every reference to an EU parent credit institution shall be construed as a reference to an EU parent investment firm.

Where a credit institution has as a parent undertaking a parent investment firm in a Member State, only that parent investment firm shall be subject to requirements on a consolidated basis in accordance with Articles 71 to 73 of Directive 2006/48/EC.

Where an investment firm has as a parent undertaking a parent credit institution in a Member State, only that parent credit institution shall be subject to requirements on a consolidated basis in accordance with Articles 71 to 73 of Directive 2006/48/EC.

Where a financial holding company has as a subsidiary both a credit institution and an investment firm, requirements on the basis of the consolidated financial situation of the financial holding company shall apply to the credit institution.

2 When a group covered by paragraph 1 does not include a credit institution, Directive 2006/48/EC shall apply, subject to the following:

- a every reference to credit institutions shall be construed as a reference to investment firms;
- b in Articles 125 and 140(2) of Directive 2006/48/EC, each reference to other articles of that Directive shall be construed as a reference to Directive 2004/39/EC;
- c for the purposes of Article 39(3) of Directive 2006/48/EC, references to the European Banking Committee shall be construed as references to the Council and the Commission; and
- d by way of derogation from Article 140(1) of Directive 2006/48/EC, where a group does not include a credit institution, the first sentence of that Article shall be replaced by the following: ‘Where an investment firm, a financial holding company or a mixed-activity holding company controls one or more subsidiaries which are insurance companies, the competent authorities and the authorities entrusted with the public task of supervising insurance undertakings shall cooperate closely’.

## Section 2 U.K.

### Definitions

#### Article 3 U.K.

- 1 For the purposes of this Directive the following definitions shall apply:
  - a ‘credit institutions’ means credit institutions as defined in Article 4(1) of Directive 2006/48/EC;
  - b ‘investment firms’ means institutions as defined in Article 4(1)(1) of Directive 2004/39/EC, which are subject to the requirements imposed by that Directive, excluding:
    - (i) credit institutions;
    - (ii) local firms as defined in point (p); and
    - (iii) firms which are only authorised to provide the service of investment advice and/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 themselves in debt with those clients;
  - c ‘institutions’ means credit institutions and investment firms;
  - d ‘recognised third-country investment firms’ means firms meeting the following conditions:
    - (i) firms which, if they were established within the Community, would be covered by the definition of investment firm;
    - (ii) firms which are authorised in a third country; and
    - (iii) firms which are subject to and comply with prudential rules considered by the competent authorities as at least as stringent as those laid down by this Directive;
  - e ‘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;
  - f ‘parent investment firm in a Member State’ means an investment firm which has an institution or financial institution as a subsidiary or which holds a participation in one or both such entities, and which is not itself a subsidiary of another institution authorised in the same Member State or of a financial holding company set up in the same Member State;
  - g ‘EU parent investment firm’ means a parent investment firm in a Member State which is not a subsidiary of another institution authorised in any Member State or of a financial holding company set up in any Member State;
  - h ‘over-the-counter (OTC) derivative instruments’ means the items falling within the list in Annex IV to Directive 2006/48/EC other than those items to which an exposure value of zero is attributed under point 6 of Part 2 of Annex III to that Directive;
  - i ‘regulated market’ means a market as defined in Article 4(1)(14) of Directive 2004/39/EC;
  - j ‘convertible’ means a security which, at the option of the holder, may be exchanged for another security;
  - k ‘warrant’ means a security which gives the holder the right to purchase an underlying asset at a stipulated price until or at the expiry date of the warrant and which may be settled by the delivery of the underlying itself or by cash settlement;

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- l 'stock financing' means positions where physical stock has been sold forward and the cost of funding has been locked in until the date of the forward sale;
- m 'repurchase agreement' and 'reverse repurchase agreement' mean any agreement in which an institution or its counterparty transfers securities or commodities or guaranteed rights relating to title — to securities or commodities where that guarantee is issued by a recognised exchange which holds the rights to the securities or commodities and the agreement does not allow an institution to transfer or pledge a particular security or commodity to more than one counterparty at one time, subject to a commitment to repurchase them — or substituted securities or commodities of the same description — at a specified price on a future date specified, or to be specified, by the transferor, being a repurchase agreement for the institution selling the securities or commodities and a reverse repurchase agreement for the institution buying them;
- n 'securities or commodities lending' and 'securities or commodities borrowing' mean any transaction in which an institution or its counterparty transfers securities or commodities against appropriate collateral, subject to a commitment that the borrower will return equivalent securities or commodities at some future date or when requested to do so by the transferor, that transaction being securities or commodities lending for the institution transferring the securities or commodities and being securities or commodities borrowing for the institution to which they are transferred;
- o 'clearing member' means a member of the exchange or the clearing house which has a direct contractual relationship with the central counterparty (market guarantor);
- p 'local firm' means a firm dealing for its 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 dealing for the accounts of other members of those markets and being guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such a firm is assumed by clearing members of the same markets;
- q 'delta' means the expected change in an option price as a proportion of a small change in the price of the instrument underlying the option;
- r 'own funds' means own funds as defined in Directive 2006/48/EC; and
- s 'capital' means own funds.

For the purposes of applying supervision on a consolidated basis, the term 'investment firm' shall include third-country investment firms.

For the purposes of point (e), financial instruments 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, a rate, an index or the price of another underlying item, and include as a minimum the instruments specified in Section C of Annex I to Directive 2004/39/EC.

2 The terms 'parent undertaking', 'subsidiary undertaking', 'asset management company' and 'financial institution' shall cover undertakings defined in Article 4 of Directive 2006/48/EC.

The terms 'financial holding company', 'parent financial holding company in a Member State', 'EU parent financial holding company' and 'ancillary services undertaking' shall cover undertakings defined in Article 4 of Directive 2006/48/EC, save that every reference to credit institutions shall be read as a reference to institutions.

3 For the purposes of applying Directive 2006/48/EC to groups covered by Article 2(1) which do not include a credit institution, the following definitions shall apply:

- a 'financial holding company' means a financial institution the subsidiary undertakings of which are either exclusively or mainly investment firms or other financial institutions,



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- at least one of which is an investment firm, and which is not a mixed financial holding company within the meaning of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate<sup>(9)</sup>;
- b 'mixed-activity holding company' means a parent undertaking, other than a financial holding company or an investment firm or a mixed financial holding company within the meaning of Directive 2002/87/EC, the subsidiaries of which include at least one investment firm; and
  - c 'competent authorities' means the national authorities which are empowered by law or regulation to supervise investment firms.

## CHAPTER II **U.K.**

### *Initial capital*

#### *Article 4 **U.K.***

For the purposes of this Directive, 'initial capital' shall be comprised of the items referred to in Article 57(a) and (b) of Directive 2006/48/EC.

#### *Article 5 **U.K.***

1 An investment firm that does not deal in any financial instruments for its own account or underwrite issues of financial instruments on a firm commitment basis, but which holds clients' money and/or securities and which offers one or more of the following services, shall have initial capital of EUR 125 000:

- a the reception and transmission of investors' orders for financial instruments;
- b the execution of investors' orders for financial instruments; or
- c the management of individual portfolios of investments in financial instruments.

2 The competent authorities may allow an investment firm which executes investors' orders for financial instruments to hold such instruments for its own account if the following conditions are met:

- 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 firm meets the requirements laid down in Articles 18, 20 and 28; and
- d such positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

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 set out in paragraph 1 or for the purposes of paragraph 3.

3 Member States may reduce the amount referred to in paragraph 1 to EUR 50 000 where a firm is not authorised to hold clients' money or securities, to deal for its own account, or to underwrite issues on a firm commitment basis.

#### *Article 6 **U.K.***

Local firms shall have initial capital of EUR 50 000 insofar as they benefit from the freedom of establishment or to provide services specified in Articles 31 and 32 of Directive 2004/39/EC.

Article 7 **U.K.**

Coverage for the firms referred to in Article 3(1)(b)(iii) shall take one of the following forms:

- (a) initial capital of EUR 50 000;
- (b) professional indemnity insurance covering the whole territory of the Community 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 points (a) or (b).

The amounts referred to in the first sub-paragraph shall be periodically reviewed by the Commission in order to take account of changes in the European Index of Consumer Prices as published by Eurostat, in line with and at the same time as the adjustments made under Article 4(7) of Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation<sup>(10)</sup>.

Article 8 **U.K.**

If a firm as referred to in Article 3(1)(b)(iii) is also registered under Directive 2002/92/EC, it shall comply with Article 4(3) of that Directive and have coverage in one of the following forms:

- (a) initial capital of EUR 25 000;
- (b) professional indemnity insurance covering the whole territory of the Community or some other comparable guarantee against liability arising from professional negligence, 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 points (a) or (b).

Article 9 **U.K.**

All investment firms other than those referred to in Articles 5 to 8 shall have initial capital of EUR 730 000.

Article 10 **U.K.**

1 By way of derogation from Articles 5(1), 5(3), 6 and 9, Member States may continue an authorisation of investment firms and firms covered by Article 6 which was in existence before 31 December 1995, the own funds of which firms or investment firms are less than the initial capital levels specified for them in Articles 5(1), 5(3), 6 and 9.

The own funds of such firms or investment firms shall not fall below the highest reference level calculated after the date of notification contained in Directive 93/6/EEC. That reference level shall be the average daily level of own funds calculated over a six-month period preceding the date of calculation. It shall be calculated every six months in respect of the corresponding preceding period.

2 If control of a firm covered by paragraph 1 is taken by a natural or legal person other than the person who controlled it previously, the own funds of that firm shall attain at least the level specified for them in Articles 5(1), 5(3), 6 and 9, except in the case of a first transfer by

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inheritance made after 31 December 1995, subject to the competent authorities' approval and for a period of not more than 10 years from the date of that transfer.

3 In certain specific circumstances, and with the approval of the competent authorities, in the event of a merger of two or more investment firms and/or firms covered by Article 6, the own funds of the firm produced by the merger need not attain the level specified in Articles 5(1), 5(3), 6 and 9. Nevertheless, during any period when the level specified in Articles 5(1), 5(3), 6 and 9 has not been attained, the own funds of the new firm may not fall below the merged firms' total own funds at the time of the merger.

4 The own funds of investment firms and firms covered by Article 6 may not fall below the level specified in Articles 5(1), 5(3), 6 and 9 and paragraphs 1 and 3 of this Article.

In the event that the own funds of such firms and investment firms fall below that level, the competent authorities may, where the circumstances justify it, allow such firms a limited period in which to rectify their situations or cease their activities.

## CHAPTER III **U.K.**

### *Trading book*

#### *Article 11 **U.K.***

1 The trading book of an institution 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 are either free of any restrictive covenants on their tradability or able to be hedged.

2 Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations. The term 'positions' shall include proprietary positions and positions arising from client servicing and market making.

3 Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the institution to manage the position or portfolio in accordance with Part A of Annex VII.

4 Institutions shall establish and maintain systems and controls to manage their trading book in accordance with Parts B and D of Annex VII.

5 Internal hedges may be included in the trading book, in which case Part C of Annex VII shall apply.

## CHAPTER IV **U.K.**

### *Own funds*

#### *Article 12 **U.K.***

'Original own funds' means the sum of points (a) to (c), less the sum of points (i) to (k) of Article 57 of Directive 2006/48/EC.

The Commission shall, by 1 January 2009, submit an appropriate proposal to the European Parliament and to the Council for amendment of this Chapter.

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### Article 13 **U.K.**

1 Subject to paragraphs 2 to 5 of this Article and Articles 14 to 17, the own funds of investment firms and credit institutions shall be determined in accordance with Directive 2006/48/EC.

In addition, the first subparagraph applies to investment firms which do not have one of the legal forms referred to in Article 1(1) of the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3) of the Treaty on the annual accounts of certain types of companies<sup>(11)</sup>.

2 By way of derogation from paragraph 1, the competent authorities may permit those institutions which are obliged to meet the capital requirements calculated in accordance with Articles 21 and 28 to 32 and Annexes I and III to VI to use, for that purpose only, an alternative determination of own funds. No part of the own funds used for that purpose may be used simultaneously to meet other capital requirements.

Such an alternative determination shall be the sum of the items set out in points (a) to (c) of this subparagraph, minus the item set out in point (d), with the deduction of that last item being left to the discretion of the competent authorities:

- a own funds as defined in Directive 2006/48/EC, excluding only points (l) to (p) of Article 57 of that Directive for those investment firms which are required to deduct item (d) of this paragraph from the total of items (a) to (c);
- b an institution's net trading-book profits net of any foreseeable charges or dividends, less net losses on its other business, provided that none of those amounts has already been included in item (a) of this paragraph as one of the items set out in points (b) or (k) of Article 57 of Directive 2006/48/EC;
- c subordinated loan capital and/or the items referred to in paragraph 5 of this Article, subject to the conditions set out in paragraphs 3 and 4 of this Article and in Article 14; and
- d illiquid assets as specified in Article 15.

3 The subordinated loan capital referred to in point (c) of the second subparagraph of paragraph 2 shall have an initial maturity of at least two years. It shall 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 institution, the debt will become repayable before the agreed repayment date, unless the competent authorities approve the repayment. Neither the principal nor the interest on such subordinated loan capital may be repaid if such repayment would mean that the own funds of the institution in question would then amount to less than 100 % of that institution's overall capital requirements.

In addition, an institution shall notify the competent authorities of all repayments on such subordinated loan capital as soon as its own funds fall below 120 % of its overall capital requirements.

4 The subordinated loan capital referred to in point (c) of the second subparagraph of paragraph 2 may not exceed a maximum of 150 % of the original own funds left to meet the requirements calculated in accordance with Articles 21 and 28 to 32 and Annexes I to VI and may approach that maximum only in particular circumstances acceptable to the competent authorities.

5 The competent authorities may permit institutions to replace the subordinated loan capital referred to in point (c) of the second subparagraph of paragraph 2 with points (d) to (h) of Article 57 of Directive 2006/48/EC.

#### Article 14 **U.K.**

1 The competent authorities may permit investment firms to exceed the ceiling for subordinated loan capital set out in Article 13(4) if they judge it prudentially adequate and provided that the total of such subordinated loan capital and the items referred to in Article 13(5) does not exceed 200 % of the original own funds left to meet the requirements calculated in accordance with Articles 21 and 28 to 32 and Annexes I and III to VI, or 250 % of the same amount where investment firms deduct the item set out in Article 13(2)(d) when calculating own funds.

2 The competent authorities may permit the ceiling for subordinated loan capital set out in Article 13(4) to be exceeded by a credit institution if they judge it prudentially adequate and provided that the total of such subordinated loan capital and points (d) to (h) of Article 57 of Directive 2006/48/EC does not exceed 250 % of the original own funds left to meet the requirements calculated in accordance with Articles 28 to 32 and Annexes I and III to VI to this Directive.

#### Article 15 **U.K.**

Illiquid assets as referred to in point (d) of the second subparagraph of Article 13(2) shall include the following:

- (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, including subordinated claims on, credit or financial institutions which may be included in the own funds of those institutions, unless they have been deducted under points (l) to (p) of Article 57 of Directive 2006/48/EC or under Article 16(d) of this Directive;
- (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, other than those which are available for repayment within 90 days, and also excluding payments in connection with margined futures or options contracts;
- (f) loans and other amounts due, other than those due to be repaid within 90 days; and
- (g) physical stocks, unless they are already subject to capital requirements at least as stringent as those set out in Articles 18 and 20.

For the purposes of point (b), 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, the competent authorities may waive the application of this Article. They may also waive it in respect of those shares which are included in an investment firm's trading book.

#### Article 16 **U.K.**

Investment firms included in a group which has been granted the waiver provided for in Article 22 shall calculate their own funds in accordance with Articles 13 to 15, subject to the following:

- (a) the illiquid assets referred to in Article 13(2)(d) shall be deducted;

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- (b) the exclusion referred to in point (a) of Article 13(2) shall not cover those components of points (l) to (p) of Article 57 of Directive 2006/48/EC which an investment firm holds in respect of undertakings included in the scope of consolidation as defined in Article 2(1) of this Directive;
- (c) the limits referred to in points (a) and (b) of Article 66(1) of Directive 2006/48/EC shall be calculated with reference to the original own funds less the components of points (l) to (p) of Article 57 of that Directive as referred to in point (b) of this Article which are elements of the original own funds of those undertakings; and
- (d) the components of points (l) to (p) of Article 57 of Directive 2006/48/EC referred to in point (c) of this Article shall be deducted from the original own funds rather than from the total of all items as laid down in Article 66(2) of that Directive for the purposes in particular of Articles 13(4), 13(5) and 14 of this Directive.

*Article 17* **U.K.**

1 Where an institution calculates risk-weighted exposure amounts for the purposes of Annex II to this Directive in accordance with Articles 84 to 89 of Directive 2006/48/EC, then for the purposes of the calculation provided for in point 4 of Part 1 of Annex VII to Directive 2006/48/EC, the following shall apply:

- a value adjustments made to take account of the credit quality of the counterparty may be included in the sum of value adjustments and provisions made for the exposures indicated in Annex II; and
- b subject to the approval of the competent authorities, if the credit risk of the counterparty is adequately taken into account in the valuation of a position included in the trading book, the expected loss amount for the counterparty risk exposure shall be zero.

For the purposes of point (a), for such institutions, such value adjustments shall not be included in own funds other than in accordance with the provisions of this paragraph.

2 For the purposes of this Article, Article 153 and 154 of Directive 2006/48/EC shall apply.

CHAPTER V **U.K.**

*Section 1* **U.K.**

***Provisions against risks***

*Article 18* **U.K.**

1 Institutions shall have own funds which are always more than or equal to the sum of the following:

- a the capital requirements, calculated in accordance with the methods and options laid down in Articles 28 to 32 and Annexes I, II and VI and, as appropriate, Annex V, for their trading-book business; and
- b the capital requirements, calculated in accordance with the methods and options laid down in Annexes III and IV and, as appropriate, Annex V, for all of their business activities.

2 By way of derogation from paragraph 1, the competent authorities may allow institutions to calculate the capital requirements for their trading book business in accordance

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with Article 75(a) of Directive 2006/48/EC and points 6, 7, and 9 of Annex II to this Directive, where the size of the trading book business meets the following requirements:

- a the trading-book business of such institutions does not normally exceed 5 % of their total business;
- b their total trading-book positions do not normally exceed EUR 15 million; and
- c the trading-book business of such institutions never exceeds 6 % of their total business and their total trading-book positions never exceed EUR 20 million.

3 In order to calculate the proportion that trading-book business bears to total business for the purposes of points (a) and (c) of paragraph 2, the competent authorities 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 institutions in question, or to a combination of those measures. When the size of on- and off-balance-sheet business is assessed, debt instruments shall be valued at their market prices or their principal values, equities at their market prices and derivatives according to the nominal or market values of the instruments underlying them. Long positions and short positions shall be summed regardless of their signs.

4 If an institution should happen for more than a short period to exceed either or both of the limits imposed in paragraph 2(a) and (b) or either or both of the limits imposed in paragraph 2(c), it shall be required to meet the requirements imposed in paragraph 1(a) in respect of its trading-book business and to notify the competent authority thereof.

#### Article 19 U.K.

1 For the purposes of point 14 of Annex I, subject to the discretion of the national authorities, a 0 % weighting can be assigned to debt securities issued by the entities listed in Table 1 of Annex I, where these debt securities are denominated and funded in domestic currency.

2 By way of derogation from points 13 and 14 of Annex I, Member States may set a specific risk requirement for any bonds falling within points 68 to 70 of Part 1 of Annex VI to Directive 2006/48/EC which shall be equal to the specific risk requirement for a qualifying item with the same residual maturity as such bonds and reduced in accordance with the percentages given in point 71 of Part 1 to Annex VI to that Directive.

3 If, as set out in point 52 of Annex I, a competent authority approves a third country's collective investment undertaking (CIU) as eligible, a competent authority in another Member State may make use of this approval without conducting its own assessment.

#### Article 20 U.K.

1 Subject to paragraphs 2, 3 and 4 of this Article, and Article 34 of this Directive, the requirements in Article 75 of Directive 2006/48/EC shall apply to investment firms.

2 By way of derogation from paragraph 1, competent authorities may allow investment firms that are not authorised to provide the investment services listed in points 3 and 6 of Section A of Annex I to Directive 2004/39/EC to provide own funds which are always more than or equal to the higher of the following:

- a the sum of the capital requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC; and
- b the amount laid down in Article 21 of this Directive.

3 By way of derogation from paragraph 1, competent authorities may allow investment firms which hold initial capital as set out in Article 9, but which fall within the following categories, to provide own funds which are always more than or equal to the sum of the capital

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requirements calculated in accordance with the requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC and the amount laid down in Article 21 of this Directive:

- a) investment firms that deal on 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; and
- b) investment firms:
  - (i) that do not hold client money or securities;
  - (ii) that undertake only dealing on own account;
  - (iii) that have no external customers;
  - (iv) the execution and settlement of whose transactions takes place under the responsibility of a clearing institution and are guaranteed by that clearing institution.

4 Investment firms referred to in paragraphs 2 and 3 shall remain subject to all other provisions regarding operational risk set out in Annex V of Directive 2006/48/EC.

5 Article 21 shall apply only to investment firms to which paragraphs (2) or (3) or Article 46 apply and in the manner specified therein.

*Article 21* **U.K.**

Investment firms shall be required to hold own funds equivalent to one quarter of their preceding year's fixed overheads.

The competent authorities may adjust that requirement in the event of a material change in a firm's business since the preceding year.

Where a firm has not completed a year's business, starting from the day it starts up, the requirement shall be a quarter of the fixed overheads projected in its business plan, unless an adjustment to that plan is required by the competent authorities.

*Section 2* **U.K.**

***Application of requirements on a consolidated basis***

*Article 22* **U.K.**

1 The competent authorities required or mandated to exercise supervision of groups covered by Article 2 on a consolidated basis may waive, on a case-by-case basis, the application of capital requirements on a consolidated basis provided that:

- a) each EU investment firm in such a group uses the calculation of own funds set out in Article 16;
- b) all investment firms in such a group fall within the categories in Article 20(2) and (3);
- c) each EU investment firm in such a group meets the requirements imposed in Articles 18 and 20 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 and;
- d) any financial holding company which is the parent financial holding company in a Member State of any investment firm in such a group holds at least as much capital,



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defined here as the sum of points (a) to (h) of Article 57 of Directive 2006/48/EC, as the sum of the full book value of any holdings, subordinated claims and instruments as referred to in Article 57 of that Directive in investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated, and 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.

Where the criteria in the first subparagraph are met, each EU investment firm shall have in place systems to 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.

2 By way of derogation from paragraph 1, competent authorities may permit financial holding companies which are the parent financial holding company in a Member State of an investment firm in such a group to use a value lower than the value calculated under paragraph 1(d), but no lower than the sum of the requirements imposed in Articles 18 and 20 on an individual basis to investment firms, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated and 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. For the purposes of this paragraph, the capital requirement for investment undertakings of third countries, financial institutions, asset management companies and ancillary services undertakings is a notional capital requirement.

*Article 23* **U.K.**

The competent authorities shall require investment firms in a group which has been granted the waiver provided for in Article 22 to notify them of the risks which could undermine their financial positions, including those associated with the composition and sources of their capital and funding. If the competent authorities then consider that the financial positions of those investment firms is not adequately protected, they shall require them to take measures including, if necessary, limitations on the transfer of capital from such firms to group entities.

Where the competent authorities waive the obligation of supervision on a consolidated basis provided for in Article 22, they shall take other appropriate measures to monitor the risks, namely large exposures, of the whole group, including any undertakings not located in a Member State.

Where the competent authorities waive the application of capital requirements on a consolidated basis provided for in Article 22, the requirements of Article 123 and Chapter 5 of Title V of Directive 2006/48/EC shall apply on an individual basis, and the requirements of Article 124 of that Directive shall apply to the supervision of investment firms on an individual basis.

*Article 24* **U.K.**

1 By way of derogation from Article 2(2), competent authorities may exempt investment firms from the consolidated capital requirement established in that Article, provided that all the investment firms in the group are covered by Article 20(2) and the group does not include credit institutions.

2 Where the requirements of paragraph 1 are met, a parent investment firm in a Member State shall be required to provide own funds at a consolidated level which are always more than or equal to the higher of the following two amounts, calculated on the basis of the parent

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investment firm's consolidated financial position and in compliance with Section 3 of this Chapter:

- a the sum of the capital requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC; and
- b the amount prescribed in Article 21 of this Directive.

3 Where the requirements of paragraph 1 are met, an investment firm controlled by a financial holding company shall be required to provide own funds at a consolidated level which are always more than or equal to the higher of the following two amounts, calculated on the basis of the financial holding company's consolidated financial position and in compliance with Section 3 of this Chapter:

- a the sum of the capital requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC; and
- b the amount prescribed in Article 21 of this Directive.

*Article 25* **U.K.**

By way of derogation from Article 2(2), competent authorities may exempt investment firms from the consolidated capital requirement established in that Article, provided that all the investment firms in the group fall within the investment firms referred to in Article 20(2) and (3), and the group does not include credit institutions.

Where the requirements of the first paragraph are met, a parent investment firm in a Member State shall be required to provide own funds at a consolidated level which are always more than or equal to the sum of the requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC and the amount prescribed in Article 21 of this Directive, calculated on the basis of the parent investment firm's consolidated financial position and in compliance with Section 3 of this Chapter.

Where the requirements of the first paragraph are met, an investment firm controlled by a financial holding company shall be required to provide own funds at a consolidated level which are always more than or equal to the sum of the requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC and the amount prescribed in Article 21 of this Directive, calculated on the basis of the financial holding company's consolidated financial position and in compliance with Section 3 of this Chapter.

*Section 3* **U.K.**

***Calculation of consolidated requirements***

*Article 26* **U.K.**

1 Where the waiver provided for in Article 22 is not exercised, the competent authorities may, for the purpose of calculating the capital requirements set out in Annexes I and V and the exposures to clients set out in Articles 28 to 32 and Annex VI on a consolidated basis, permit positions in the trading book of one institution to offset positions in the trading book of another institution according to the rules set out in Articles 28 to 32 Annexes I, V and VI.

In addition, the competent authorities may allow foreign-exchange positions in one institution to offset foreign-exchange positions in another institution in accordance with the rules set out in Annex III and/or Annex V. They may also allow commodities positions in one institution to offset commodities positions in another institution in accordance with the rules set out in Annex IV and/or Annex V.

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2 The competent authorities may permit offsetting of the trading book and of the foreign-exchange and commodities positions, respectively, of undertakings located in third countries, subject to the simultaneous fulfilment of the following conditions:

- a such undertakings have been authorised in a third country and either satisfy the definition of credit institution set out in Article 4(1) of Directive 2006/48/EC or are recognised third-country investment firms;
- b such undertakings comply, on an individual basis, with capital adequacy rules equivalent to those laid down in this Directive; and
- c no regulations exist in the third countries in question which might significantly affect the transfer of funds within the group.

3 The competent authorities may also allow the offsetting provided for in paragraph 1 between institutions within a group that have been authorised in the Member State in question, provided that:

- a there is a satisfactory allocation of capital within the group; and
- b the regulatory, legal or contractual framework in which the institutions operate is such as to guarantee mutual financial support within the group.

4 Furthermore, the competent authorities may allow the offsetting provided for in paragraph 1 between institutions within a group that fulfil the conditions imposed in paragraph 3 and any institution included in the same group which has been authorised in another Member State provided that that institution is obliged to fulfil the capital requirements imposed in Articles 18, 20 and 28 on an individual basis.

*Article 27* U.K.

1 In the calculation of own funds on a consolidated basis Article 65 of Directive 2006/48/EC shall apply.

2 The competent authorities responsible for exercising supervision on a consolidated basis may recognise the validity of the specific own-funds definitions applicable to the institutions concerned under Chapter IV in the calculation of their consolidated own funds.

*Section 4* U.K.

***Monitoring and control of large exposures***

*Article 28* U.K.

1 Institutions shall monitor and control their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC.

2 By way of derogation from paragraph 1, institutions which calculate the capital requirements for their trading-book business in accordance with Annexes I and II, and, as appropriate, Annex V to this Directive, shall monitor and control their large exposures in accordance with Articles 106 to 118 of Directive 2006/48/EC subject to the amendments laid down in Articles 29 to 32 of this Directive.

3 By 31 December 2007, the Commission shall submit to the European Parliament and to the Council a report on the functioning of this Section, together with any appropriate proposals.

*Article 29* **U.K.**

1 The exposures to individual clients which arise on the trading book shall be calculated by summing the following items:

- a the excess — where positive — of an institution's long positions over its short positions in all the financial instruments issued by the client in question, the net position in each of the different instruments being calculated according to the methods laid down in Annex I;
- 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 Annex II with the client in question, such exposures being calculated in the manner laid down in that Annex, for the calculation of exposure values.

For the purposes of point (b), the net exposure is 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 set out in point 41 of Annex I.

For the purposes of point (b), pending further coordination, the competent authorities shall require institutions to set up systems to monitor and control their 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 in question.

For the purposes of point (c), Articles 84 to 89 of Directive 2006/48/EC shall be excluded from the reference in point 6 of Annex II to this Directive.

2 The exposures to groups of connected clients on the trading book shall be calculated by summing the exposures to individual clients in a group, as calculated in paragraph 1.

*Article 30* **U.K.**

1 The overall exposures to individual clients or groups of connected clients shall be calculated by summing the exposures which arise on the trading book and the exposures which arise on the non-trading book, taking into account Article 112 to 117 of Directive 2006/48/EC.

In order to calculate the exposure which arises on the non-trading book, institutions shall take the exposure arising from assets which are deducted from their own funds by virtue of point (d) of the second subparagraph of Article 13(2) to be zero.

2 Institutions' overall exposures to individual clients and groups of connected clients calculated in accordance with paragraph 4 shall be reported in accordance with Article 110 of Directive 2006/48/EC.

Other than in relation to repurchase transactions, securities or commodities lending or borrowing transactions, the calculation of large exposures to individual clients and groups of connected clients for reporting purposes shall not include the recognition of credit risk mitigation.

3 The sum of the exposures to an individual client or group of connected clients in paragraph 1 shall be limited in accordance with Articles 111 to 117 of Directive 2006/48/EC.

4 By derogation from paragraph 3 competent authorities may allow assets constituting claims and other exposures on recognised third-country investment firms and recognised clearing houses and exchanges in financial instruments to be subject to the same treatment accorded to those on institutions laid out in Articles 113(3)(i), 115(2) and 116 of Directive 2006/48/EC.

### Article 31 **U.K.**

The competent authorities may authorise the limits laid down in Articles 111 to 117 of Directive 2006/48/EC to be exceeded if the following conditions are met:

- (a) the exposure on the non-trading book to the client or group of clients in question does not exceed the limits laid down in Articles 111 to 117 of Directive 2006/48/EC, those limits being calculated with reference to own funds as specified in that Directive, so that the excess arises entirely on the trading book;
- (b) the institution meets an additional capital requirement on the excess in respect of the limits laid down in Article 111(1) and (2) of Directive 2006/48/EC, that additional capital requirement being calculated in accordance with Annex VI to that Directive;
- (c) where 10 days or less has elapsed since the excess occurred, the trading-book exposure to the client or group of connected clients in question shall not exceed 500 % of the institution's own funds;
- (d) any excesses that have persisted for more than 10 days must not, in aggregate, exceed 600 % of the institution's own funds; and
- (e) institutions shall report to the competent authorities every three months all cases where the limits laid down in Article 111(1) and (2) of Directive 2006/48/EC have been exceeded during the preceding three months.

In relation to point (e), in each case in which the limits have been exceeded the amount of the excess and the name of the client concerned shall be reported.

### Article 32 **U.K.**

1 The competent authorities shall establish procedures to prevent institutions from deliberately avoiding the additional capital requirements that they would otherwise incur, on exposures exceeding the limits laid down in Article 111(1) and (2) of Directive 2006/48/EC once those exposures have been maintained for more than 10 days, by means of temporarily transferring the exposures in question to another company, whether within the same group or not, and/or by undertaking artificial transactions to close out the exposure during the 10-day period and create a new exposure.

The competent authorities shall notify the Council and the Commission of those procedures.

Institutions shall maintain systems which ensure that any transfer which has the effect referred to in the first subparagraph is immediately reported to the competent authorities.

2 The competent authorities may permit institutions which are allowed to use the alternative determination of own funds under Article 13(2) to use that determination for the purposes of Articles 30(2), 30(3) and 31 provided that the institutions concerned are required to meet all of the obligations set out in Articles 110 to 117 of Directive 2006/48/EC, in respect of the exposures which arise outside their trading books by using own funds as defined in that Directive.

**Section 5 U.K.*****Valuation of positions for reporting purposes*****Article 33 U.K.**

1 All trading book positions shall be subject to prudent valuation rules as specified in Annex VII, Part B. These rules shall require institutions to ensure that the value applied to each of its trading book positions appropriately reflects the current market value. The former value shall contain an appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of trading book positions.

2 Trading book positions shall be re-valued at least daily.

3 In the absence of readily available market prices, the competent authorities may waive the requirement imposed in paragraphs 1 and 2 and shall require institutions to use alternative methods of valuation provided that those methods are sufficiently prudent and have been approved by competent authorities.

**Section 6 U.K.*****Risk management and capital assessment*****Article 34 U.K.**

Competent authorities shall require that every investment firm, as well as meeting the requirements set out in Article 13 of Directive 2004/39/EC, shall meet the requirements set out in Articles 22 and 123 of Directive 2006/48/EC, subject to the provisions on level of application set out in Articles 68 to 73 of that Directive.

**Section 7 U.K.*****Reporting requirements*****Article 35 U.K.**

1 Member States shall require that investment firms and credit institutions provide the competent authorities of their home Member States with all the information necessary for the assessment of their compliance with the rules adopted in accordance with this Directive. Member States shall also ensure that internal control mechanisms and administrative and accounting procedures of the institutions permit the verification of their compliance with such rules at all times.

2 Investment firms shall report to the competent authorities in the manner specified by the latter at least once every month in the case of firms covered by Article 9, at least once every three months in the case of firms covered by Article 5(1) and at least once every six months in the case of firms covered by Article 5(3).

3 Notwithstanding paragraph 2, investment firms covered by Articles 5(1) and 9 shall be required to provide the information on a consolidated or sub-consolidated basis only once every six months.

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4 Credit institutions shall be obliged to report in the manner specified by the competent authorities as often as they are obliged to report under Directive 2006/48/EC.

5 The competent authorities shall oblige institutions to report to them immediately any case in which their counter parties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

## CHAPTER VI **U.K.**

### *Section 1* **U.K.**

#### **Competent authorities**

##### *Article 36* **U.K.**

1 Member States shall designate the authorities which are competent to carry out the duties provided for in this Directive. They shall inform the Commission thereof, indicating any division of duties.

2 The competent authorities shall be public authorities or bodies officially recognized by national law or by public authorities as part of the supervisory system in operation in the Member State concerned.

3 The competent authorities shall be granted all the powers necessary for the performance of their tasks, and in particular that of overseeing the constitution of trading books.

### *Section 2* **U.K.**

#### **Supervision**

##### *Article 37* **U.K.**

1 Chapter 4 of Title V of Directive 2006/48/EC shall apply mutatis mutandis to the supervision of investment firms in accordance with the following:

- a references to Article 6 of Directive 2006/48/EC shall be construed as references to Article 5 of Directive 2004/39/EC;
- b references to Article 22 and 123 of Directive 2006/48/EC shall be construed as references to Article 34 of this Directive; and
- c references to Articles 44 to 52 of Directive 2006/48/EC shall be construed as references to Articles 54 and 58 of Directive 2004/39/EC.

Where an EU parent financial holding company has as subsidiary both a credit institution and an investment firm, Title V, Chapter 4 of Directive 2006/48/EC shall apply to the supervision of institutions as if references to credit institutions were to institutions.

2 Article 129(2) of Directive 2006/48/EC shall also apply to the recognition of internal models of institutions under Annex V to this Directive where the application is submitted by an EU parent credit institution and its subsidiaries or an EU parent investment firm and its subsidiaries, or jointly by the subsidiaries of an EU parent financial holding company.

The period for the recognition referred to in the first sub-paragraph shall be six months.

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*Article 38* U.K.

1 The competent authorities of the Member States shall cooperate closely in the performance of the duties provided for in this Directive, particularly where investment services are provided on the basis of the freedom to provide services or through the establishment of branches.

The competent authorities shall on request supply one another with all information likely to facilitate the supervision of the capital adequacy of institutions, in particular the verification of their compliance with the rules laid down in this Directive.

2 Any exchange of information between competent authorities which is provided for in this Directive shall be subject to the following obligations of professional secrecy:

- a for investment firms, those imposed in Article 54 and 58 of Directive 2004/39/EC; and
- b for credit institutions, those imposed in Articles 44 to 52 of Directive 2006/48/EC.

CHAPTER VII U.K.

*Disclosure*

*Article 39* U.K.

The requirements set out in Title V, Chapter 5 of Directive 2006/48/EC shall apply to investment firms.

CHAPTER VIII U.K.

*Section 1* U.K.

*Article 40* U.K.

For the purposes of the calculation of minimum capital requirements for counterparty risk under this Directive, and for the calculation of minimum capital requirements for credit risk under Directive 2006/48/EC, and without prejudice to the provisions of Part 2, point 6 of Annex III to that Directive, exposures to recognised third-country investment firms and exposures to recognised clearing houses and exchanges shall be treated as exposures to institutions.

*Section 2* U.K.

*Powers of execution*

*Article 22* U.K.

1 The Commission shall decide on any technical adaptations in the following areas in accordance with the procedure referred to in Article 42(2):

- a clarification of the definitions in Article 3 in order to ensure uniform application of this Directive;
- b clarification of the definitions in Article 3 to take account of developments on financial markets;



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- c adjustment of the amounts of initial capital prescribed in Articles 5 to 9 and the amount referred to in Article 18(2) to take account of developments in the economic and monetary field;
  - d adjustment of the categories of investment firms in Article 20(2) and (3) to take account of developments on financial markets;
  - e clarification of the requirement laid down in Article 21 to ensure uniform application of this Directive;
  - f alignment of terminology on and the framing of definitions in accordance with subsequent acts on institutions and related matters;
  - g adjustment of the technical provisions in Annexes I to VII as a result of developments on financial markets, risk measurement, accounting standards or requirements which take account of Community legislation or which have regard to convergence of supervisory practices; or
  - h technical adaptations to take account of the outcome of the review referred to in Article 65(3) of Directive 2004/39/EC.
- 2 None of the implementing measures enacted may change the essential provisions of this Directive

*Article 42* **U.K.**

1 The Commission shall be assisted by the European Banking Committee established by Commission Decision 2004/10/EC<sup>(12)</sup> of 5 November 2003 (hereinafter referred to as ‘the Committee’).

2 Where reference is made to this paragraph, the procedure laid down in Article 5 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 7(3) and 8 thereof.

The period laid down in Article 5(6) of Decision 1999/468/EC shall be three months.

3 Without prejudice to the implementing measures already adopted, upon expiry of a two-year period following the adoption of this Directive, and by 1 April 2008, the application of the provisions of this Directive requiring the adoption of technical rules, amendments and decisions in accordance with paragraph 2 shall be suspended. Acting on a proposal from the Commission and in accordance with the procedure laid down in Article 251 of the Treaty, the Parliament and the Council may renew those provisions and, to that end, shall review them prior to the expiry of the period or by the date referred to in this paragraph, whichever the earlier.

4 The Committee shall adopt its Rules of Procedure

*Section 3* **U.K.**

***Transitional provisions***

*Article 43* **U.K.**

Article 152(1) to (7) of Directive 2006/48/EC shall apply, in accordance with Article 2 and Chapter V, Sections 2 and 3 of this Directive, to investment firms calculating risk-weighted exposure amounts, for the purposes of Annex II to this Directive, in accordance with Articles 84 to 89 of Directive 2006/48/EC, or using the Advanced Measurement Approach as specified in Article 105 of that Directive for the calculation of their capital requirements for operational risk.

*Article 44* U.K.

Until 31 December 2012, for investment firms the relevant indicator for the trading and sales business line of which represents at least 50 % of the total of relevant indicators for all of their business lines calculated in accordance with Article 20 of this Directive and points 1 to 4 of Part 2 of Annex X to Directive 2006/48/EC, Member States may apply a percentage of 15 % to the business line ‘trading and sales’.

*Article 45* U.K.

1 Competent authorities may permit investment firms to exceed the limits concerning large exposures set out in Article 111 of Directive 2006/48/EC. Investment firms need not include any excesses in their calculation of capital requirements exceeding such limits, as set out in Article 75(b) of that Directive. This discretion is available until 31 December 2010 or the date of entry into force of any modifications consequent to the treatment of large exposures pursuant to Article 119 of Directive 2006/48/EC, whichever is the earlier. For this discretion to be exercised, the following conditions shall be met:

- a the investment firm provides investment services or investment activities related to the financial instruments listed in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC;
- 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 referred to in the introductory part of this paragraph arise in connection with exposures resulting from contracts that are financial instruments as listed in point (a) and relate to commodities or underlyings within the meaning of point 10 of Section C of Annex I to Directive 2004/39/EC (MiFID) and are calculated in accordance with Annexes III and IV of Directive 2006/48/EC, or in connection with exposures resulting from contracts concerning the delivery of commodities or emission allowances; and
- d the investment firm has a documented strategy for managing and, in particular, for controlling and limiting risks arising from the concentration of exposures. The investment firm shall inform the competent authorities of this strategy and all material changes to it without delay. The investment firm shall make appropriate arrangements to ensure a continuous monitoring of the creditworthiness of borrowers, according to their impact on concentration risk. These arrangements shall enable the investment firm to react adequately and sufficiently promptly to any deterioration in that creditworthiness.

2 Where an investment firm exceeds the internal limits set according to the strategy referred to in point (d) of paragraph 1, it shall notify the competent authority without delay of the size and nature of the excess and of the counterparty.

*Article 46* U.K.

By way of derogation from Article 20(1), until 31 December 2011 competent authorities may choose, on a case-by-case basis, not to apply the capital requirements arising from point (d) of Article 75 of Directive 2006/48/EC in respect of investment firms to which Article 20(2) and (3) do not apply, 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.

Instead, the capital requirement in relation to those investment firms shall be at least the lower of:

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- (a) the capital requirements arising from point (d) of Article 75 of Directive 2006/48/EC; and
- b) 12/88 of the higher of the following:
  - (i) the sum of the capital requirements contained in points (a) to (c) of Article 75 of Directive 2006/48/EC; and
  - (ii) the amount laid down in Article 21 of this Directive, notwithstanding Article 20(5).

If point (b) applies, an incremental increase shall be applied on at least an annual basis.

Applying this derogation shall not result in a reduction in the overall level of capital requirements for an investment firm, in comparison to the requirements as at 31 December 2006, unless such a reduction is prudentially justified by a reduction in the size of the investment firm's business.

*Article 47* **U.K.**

Until 31 December 2009 or any earlier date specified by the competent authorities on a case-by-case basis, institutions that have received specific risk model recognition prior to 1 January 2007 in accordance with point 1 of Annex V may, for that existing recognition, treat points 4 and 8 of Annex V to Directive 93/6/EEC as those points stood prior to 1 January 2007.

*Article 48* **U.K.**

1 The provisions on capital requirements as laid down in this Directive and Directive 2006/48/EC 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 points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC and to whom Directive 93/22/EEC<sup>(13)</sup> did not apply on 31 December 2006. This exemption is available until 31 December 2010 or the date of entry into force of any modifications pursuant to paragraphs 2 and 3, whichever is the earlier.

2 As part of the review required by Article 65(3) of Directive 2004/39/EC, the Commission shall, on the basis of public consultations and in the light of discussions with the competent authorities, report to the Parliament and the Council on:

- a an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to the commodity derivatives or derivatives contracts set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC; and
- b the desirability of amending Directive 2004/39/EC to create a further category of investment firm whose main business consists exclusively of the provision of investment services or activities in relation to the financial instruments set out in points 5, 6, 7, 9 and 10 of Section C of Annex I to Directive 2004/39/EC relating to energy supplies (including electricity, coal, gas and oil).

3 On the basis of the report referred to in paragraph 2, the Commission may submit proposals for amendments to this Directive and to Directive 2006/48/EC

#### Section 4 U.K.

#### **Final provisions**

#### Article 49 U.K.

1 Member States shall adopt and publish, by 31 December 2006, the laws, regulations and administrative provisions necessary to comply with Articles 2, 3, 11, 13, 17, 18, 19, 20, 22, 23, 24, 25, 29, 30, 33, 34, 35, 37, 39, 40, 41, 43, 44, 50 and the Annexes I, II, III, V, VII. They shall forthwith communicate to the Commission the text of those provisions and a correlation table between those provisions and this Directive.

They shall apply those provisions from 1 January 2007.

When Member States adopt those measures, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. They shall also include a statement that references in existing laws, regulations and administrative provisions to the directives repealed by this Directive shall be construed as references to this Directive.

2 Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

#### Article 50 U.K.

1 Article 152(8) to (14) of Directive 2006/48/EC shall apply mutatis mutandis for the purposes of this Directive subject to the following provisions which shall apply where the discretion referred to in Article 152(8) of Directive 2006/48/EC is exercised:

- a references in point 7 of Annex II to this Directive to Directive 2006/48/EC shall be read as references to Directive 2000/12/EC as that Directive stood prior to 1 January 2007; and
- b point 4 of Annex II to this Directive shall apply as it stood prior to 1 January 2007.

2 Article 157(3) of Directive 2006/48/EC shall apply mutatis mutandis for the purposes of Articles 18 and 20 of this Directive.

#### Article 51 U.K.

By 1 January 2011, the Commission shall review and report on the application of this Directive and submit its report to the Parliament and the Council together with any appropriate proposals for amendment.

#### Article 52 U.K.

Directive 93/6/EEC, as amended by the Directives listed in Annex VIII, Part A, is repealed, without prejudice to the obligations of the Member States relating to the time-limits for transposition into national law of the Directives set out in Annex VIII, Part B.

References made to the repealed directives shall be construed as being made to this Directive and should be read in accordance with the correspondence table set out in Annex IX.

#### Article 53 U.K.

This Directive shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

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Article 54 **U.K.**

This Directive is addressed to the Member States.

Done at Strasbourg, 14 June 2006.

*For the European Parliament*

*The President*

J. BORRELL FONTELLES

*For the Council*

*The President*

H. WINKLER

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## ANNEX I U.K.

### CALCULATING CAPITAL REQUIREMENTS FOR POSITION RISK

#### GENERAL PROVISIONS

##### Netting

1. The excess of an institution'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 competent authorities shall allow positions in derivative instruments to be treated, as laid down in points 4 to 7, as positions in the underlying (or notional) security or securities. Institutions' holdings of their own debt instruments shall be disregarded in calculating specific risk under point 14.
2. No netting shall be allowed between a convertible and an offsetting position in the instrument underlying it, unless the competent authorities adopt 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, must be converted on a daily basis into the institution's reporting currency at the prevailing spot exchange rate before their aggregation.

Particular 4. Interest#rate futures, forward#rate agreements (FRAs) and forward commitments instruments 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 will 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 point 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 borrowing shall be included in the first category set out in Table 1 in point 14 for purposes of specific risk, and the debt instrument under whichever column is appropriate for it in the same table.

The competent authorities may allow the capital requirement for an exchange#traded future to be equal to the margin required by the exchange if they are 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 Annex or applying the internal models method described in Annex V. The competent authorities may also allow the capital requirement for an OTC derivatives contract of the type referred to in this point cleared by a clearing house recognised by them to be equal to the margin required by the clearing house if they are 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 Annex or applying the internal models method described in Annex V.

For the purposes of this point, ‘long position’ means a position in which an institution 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 Annex. 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 competent authorities or, where that is not available or for OTC-options, that calculated by the institution itself, subject to the competent authorities being satisfied that the model used by the institution is reasonable. **U.K.**

However, the competent authorities may also prescribe that institutions calculate their deltas using a methodology specified by the competent authorities.

Other risks, apart from the delta risk, associated with options shall be safeguarded against. The competent authorities may allow the requirement against a written exchange#traded option to be equal to the margin required by the exchange if they are 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 Annex or applying the internal models method described in Annex V. The competent authorities may also allow the capital requirement for an OTC option cleared by a clearing house recognised by them to be equal to the margin required by the clearing house if they are 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 Annex or applying the internal models method described in Annex V. In addition they 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 point 5.
7. Swaps shall be treated for interest#rate risk purposes on the same basis as on#balance#sheet instruments. Thus, an interest#rate swap under which an institution 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 **U.K.**

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 must be used. For the purpose of calculating the specific risk charge, other than for total return swaps, the maturity of the credit derivative contract is applicable instead of the maturity of the obligation. Positions are determined as follows:

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- (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 Annex VI of Directive 2006/48/EC. It also creates a long position in the specific risk of the reference obligation.
- (ii) A credit default swap does not create a position for general market risk. For the purposes of specific risk, the institution must record a synthetic long position in an obligation of the reference entity, unless the derivative is rated externally and meets the conditions for a qualifying debt 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 must 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 determines 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 point, 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 point, this amount may be taken as the capital requirement for specific risk.

If a first or second-asset to default derivative is externally rated and meets the conditions for a qualifying debt item, then the protection seller need only calculate one specific risk charge reflecting the rating of the derivative.

## B. TREATMENT OF THE PROTECTION BUYER U.K.

For the party who transfers credit risk (the ‘protection buyer’), the positions are determined as the mirror image 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 n<sup>th</sup> to default credit derivatives, protection buyers are allowed to off#set specific risk for n-1 of the underlyings (i.e., the n-1 assets with the lowest specific risk charge).



9. Institutions which mark to market and manage the interest#rate risk on the derivative instruments covered in points 4 to 7 on a discounted#cash#flow basis may use sensitivity models to calculate the positions referred to in those points 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 institution must be approved by the competent authorities. These models should generate positions which have the same sensitivity to interest#rate changes as the underlying cash flows. This sensitivity must be assessed with reference to independent movements in sample rates across the yield curve, with at least one sensitivity point in each of the maturity bands set out in Table 2 of point 20. The positions shall be included in the calculation of capital requirements according to the provisions laid down in points 17 to 32.
10. Institutions which do not use models under point 9 may, with the approval of the competent authorities, treat as fully offsetting any positions in derivative instruments covered in points 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 Annex provided that such securities meet the criteria laid down in Article 11.

#### 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, 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

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positions (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk.

TABLE 1

<b>Categories</b>	<b>Specific risk capital charge</b>
Debt securities issued or guaranteed by central 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 Articles 78 to 83 of Directive 2006/48/EC.	0 %
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 Articles 78 to 83 of Directive 2006/48/EC, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 1 or 2 under the rules for the risk weighting of exposures under Articles 78 to 83 of Directive 2006/48/EC, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under point 28, Part 1 of Annex VI to Directive 2006/48/EC, 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 Articles 78 to 83 of Directive 2006/48/EC. Other qualifying items as defined in point 15.	0,25 % (residual term to final maturity 6 months or less) 1,0 % (residual term to final maturity greater than 6 and up to and including 24 months) 1,6 % (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	8,0 %

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<p>or local authorities or institutions which would qualify for credit quality step 4 or 5 under the rules for the risk weighting of exposures under Articles 78 to 83 of Directive 2006/48/EC, and debt securities issued or guaranteed by institutions which would qualify for credit quality step 3 under the rules for the risk weighting of exposures under point 26 of Part 1 of Annex VI to Directive 2006/48/EC, 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 Articles 78 to 83 of Directive 2006/48/EC. Exposures for which a credit assessment by a nominated ECAI is not available.</p>	
<p>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 institutions which would qualify for credit quality step 6 under the rules for the risk weighting of exposures under Articles 78 to 83 of Directive 2006/48/EC, 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 Articles 78 to 83 of Directive 2006/48/EC.</p>	12,0 %

For institutions which apply the rules for the risk weighting of exposures under Articles 84 to 89 of Directive 2006/48/EC, to qualify for a credit quality step the obligor of the exposure shall have an internal rating with a PD 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 Articles 78 to 83 of that Directive.

Instruments issued by a non-qualifying issuer shall receive a specific risk capital charge of 8 % or 12 % according to Table 1. Competent authorities may require institutions to apply a higher specific risk charge to such instruments and/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 that would be subject to a deduction treatment as set out in Article 66(2) of Directive 2006/48/EC, or risk-weighted at 1,25 % as set out in Part 4 of Annex IX to that Directive, 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 Annex IX to Directive 2006/48/EC.

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15. For the purposes of point 14 qualifying items shall include: **U.K.**
- (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 Title V, Chapter 2, Section 3, Sub#section 1 of Directive 2006/48/EC;
  - (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 (a), under the approach described in Title V, Chapter 2, Section 3, Sub#section 2 of Directive 2006/48/EC;
  - (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 institutions concerned to be sufficiently liquid;
    - (ii) their investment quality is, according to the institution's own discretion, at least equivalent to that of the assets referred to under point (a); and
    - (iii) they are listed on at least one regulated market in a Member State or on a stock exchange in a third country provided that the exchange is recognised by the competent authorities of the relevant Member State;
  - (d) long and short positions in assets issued by institutions subject to the capital adequacy requirements set out in Directive 2006/48/EC which are considered by the institutions concerned to be sufficiently liquid and whose investment quality is, according to the institution's own discretion, at least equivalent to that of the assets referred to under point (a); and
  - (e) securities issued by institutions that 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 institutions set out in Articles 78 to 83 of Directive 2006/48/EC and that are subject to supervisory and regulatory arrangements comparable to those under this Directive.

The manner in which the debt instruments are assessed shall be subject to scrutiny by the competent authorities, which shall overturn the judgment of the institution if they consider that the instruments concerned are subject to too high a degree of specific risk to be qualifying items.

16. The competent authorities shall require the institution to apply the maximum weighting shown in Table 1 to point 14 to instruments that show a particular risk because of the insufficient solvency of the issuer.

#### General risk

- (a) Maturity-based **U.K.**
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 point 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. The institution shall assign its net positions to the appropriate maturity bands in column 2 or 3, as appropriate, in Table 2 in point 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. It 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.
20. The institution 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	0,0	—
	> 1 ≤ 3 months	> 1 ≤ 3 months	0,2	1,0
	> 3 ≤ 6 months	> 3 ≤ 6 months	0,4	1,0
	> 6 ≤ 12 months	> 6 ≤ 12 months	0,7	1,0
Two	> 1 ≤ 2 years	> 1,0 ≤ 1,9 years	1,25	0,9
	> 2 ≤ 3 years	> 1,9 ≤ 2,8 years	1,75	0,8
	> 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	0,7

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> 7 ≤ 10 years	> 5,7 ≤ 7,3 years	3,75	0,65
> 10 ≤ 15 years	> 7,3 ≤ 9,3 years	4,5	0,6
> 15 ≤ 20 years	> 9,3 ≤ 10,6 years	5,25	0,6
> 20 years	> 10,6 ≤ 12,0 years	6,0	0,6
	> 12,0 ≤ 20,0 years	8,0	0,6
	> 20 years	12,5	0,6

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 point 25 as 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 institution may, if it wishes, reverse the order in point 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 points 21, 22 and 23, shall be summed.
25. The institution'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 point 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 **U.K.**
26. The competent authorities may allow institutions 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 points 17 to 25, provided that the institution does so on a consistent basis.

27. Under a system referred to in point 26 the institution 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 institution 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 institution shall then calculate the modified duration of each debt instrument on the basis of the following formula: modified duration = ((duration (D))/(1 + r)), where: U.K.

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

where:

R = yield to maturity (see point 25),

C<sub>t</sub> = cash payment in time t,

M = total maturity (see point 25).

29. The institution 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 ≤ 1,0	1,0
Two	> 1,0 ≤ 3,6	0,85
Three	> 3,6	0,7

30. The institution 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 institution shall calculate its duration-weighted long and its duration-weighted short positions within each zone. The amount of the former which are matched by the latter within each zone shall be the matched duration-weighted position for that zone. U.K.

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

32. The institution'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

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33. The institution shall sum all its net long positions and all its net short positions in accordance with point 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 4 % in order to calculate its capital requirement against specific risk.
35. By derogation from point 34, the competent authorities may allow the capital requirement against specific risk to be 2 % rather than 4 % for those portfolios of equities that an institution holds which meet the following conditions: **U.K.**
- (a) the equities shall not be those of issuers which have issued only traded debt instruments that currently attract an 8 % or 12 % requirement in Table 1 to point 14 or that attract a lower requirement only because they are guaranteed or secured;
- (b) the equities must be adjudged highly liquid by the competent authorities according to objective criteria; and
- (c) no individual position shall comprise more than 5 % of the value of the institution's whole equity portfolio.

For the purpose of point (c), the competent authorities may authorise individual positions of up to 10 % provided that the total of such positions does not exceed 50 % of the portfolio.

#### General risk

36. Its 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 constituent equities. These positions may be treated as underlying positions in the equities in question, and may, subject to the approval of the competent authorities, be netted against opposite positions in the underlying equities themselves.
38. The competent authorities shall ensure that any institution 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; they shall also do this when an institution holds opposite positions in stock-index futures which are not identical in respect of either their maturity or their composition or both.
39. By derogation from points 37 and 38, stock-index futures which are exchange traded and — in the opinion of the competent authorities — 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 point 33, but disregarded in the calculation of the overall gross position in the same point.
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 can be ignored if the stock-index future in question is exchange traded and, in the opinion of the competent authorities, represents a broadly diversified index.

#### UNDERWRITING

41. In the case of the underwriting of debt and equity instruments, the competent authorities may allow an institution to use the following procedure in calculating its capital requirements. Firstly, it 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 %
working day 5:	25 %
after working day 5:	0 %.

‘Working day zero’ shall be the working day on which the institution 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 competent authorities shall ensure that the institution 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 points 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: **U.K.**
- the two legs consist of completely identical instruments; or
  - a long cash position is hedged by a total rate of return swap (or vice versa) and there is an exact match between the reference obligation and the underlying exposure (i.e., the cash position). The maturity of the swap itself may be different from that of the underlying exposure.

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

44. An 80 % offset will 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

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risk, an 80 % specific risk offset will be applied to the side of the transaction 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: **U.K.**
- (a) the position falls under point 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 point 43(a) or point 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 Annex III); or
- (c) the position falls under point 44 but there is an asset mismatch between the cash position and the credit derivative. However, the underlying asset is included in the (deliverable) obligations in the credit derivative documentation.

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 points 43 to 45, a specific risk capital charge will be assessed against both sides of the positions.

Capital charges for CIUs in the trading book

47. The capital requirements for positions in CIUs which meet the conditions specified in Article 11 for a trading book capital treatment shall be calculated in accordance with the methods set out in points 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 general) of 32 %. Without prejudice to the provisions of the fourth paragraph of point 2.1 of Annex III or the sixth paragraph of point 12 of Annex V (commodity risk) taken together with the fourth paragraph of point 2.1 of Annex III, where the modified gold treatment set out in those points 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. Institutions may determine the capital requirement for positions in CIUs which meet the criteria set out in point 51, by the methods set out in points 53 to 56.
50. Unless noted otherwise, no netting is permitted between the underlying investments of a CIU and other positions held by the institution.

#### GENERAL CRITERIA

51. The general eligibility criteria for using the methods in points 53 to 56, for CIUs issued by companies supervised or incorporated within the Community 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 counterparty 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
- (e) there shall be adequate risk assessment of the CIU, by the investing institution.
52. Third country CIUs may be eligible if the requirements in points (a) to (e) of point 51 are met, subject to the approval of the institution's competent authority.

#### SPECIFIC METHODS

53. Where the institution is aware of the underlying investments of the CIU on a daily basis, the institution 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 Annex or, if permission has been granted, in accordance with the methods set out in Annex V. 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 institution, as long as the institution holds a sufficient quantity of units to allow for redemption/creation in exchange for the underlying investments.
54. Institutions may calculate the capital requirements for position risk (general and specific) for positions in CIUs in accordance with the methods set out in this Annex or, if permission has been granted, in accordance with the methods set out in Annex V, 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 institution is not aware of the underlying investments of the CIU on a daily basis, the institution may calculate the capital requirements for position risk (general and specific) in accordance with the methods set out in this Annex, subject to the following conditions:

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- (a) it will be assumed that the CIU first invests to the maximum extent allowed under its mandate in the asset classes attracting 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) institutions 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 point exceed that set out in point 48, the capital requirement shall be capped at that level.
56. Institutions may rely on a third party to calculate and report capital requirements for position risk (general and specific) for positions in CIUs falling under points 53 and 55, in accordance with the methods set out in this Annex, provided that the correctness of the calculation and the report is adequately ensured.

## ANNEX II **U.K.**

### CALCULATING CAPITAL REQUIREMENTS FOR SETTLEMENT AND COUNTERPARTY 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 institution must 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 institution. It must 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 institution shall be required to hold own funds, as set out in Table 2, if:

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- (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
- (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

<b>Transaction Type</b>	<b>Up to first contractual payment or delivery leg</b>	<b>From first contractual payment or delivery leg up to four days after second contractual payment or delivery leg</b>	<b>From 5 business days post second contractual payment or delivery leg until extinction of the transaction</b>
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, institutions using the approach set out in Articles 84 to 89 of Directive 2006/48/EC, may assign PDs to counterparties, for which they have no other non-trading book exposure, on the basis of the counterparty's external rating. Institutions using own estimates of loss given defaults ('LGDs') may apply the LGD set out in point 8 of Part 2 of Annex VII to Directive 2006/48/EC to free delivery exposures treated according to column 3 of Table 2 provided that they apply it to all such exposures. Alternatively, institutions using the approach set out in Articles 84 to 89 of Directive 2006/48/EC may apply the risk weights, as set out in Articles 78 to 83 of that Directive provided that they apply them to all such exposures or may apply a 100 % risk weight to all such exposures. **U.K.**

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

4. In cases of a system wide failure of a settlement or clearing system, competent authorities may waive the capital requirements calculated as set out in points 1 and 2 until the situation is rectified. In this case, the failure of a counterparty to settle a trade shall not be deemed a default for purposes of credit risk.

## COUNTERPARTY CREDIT RISK (CCR)

5. An institution 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;

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- (c) margin lending transactions based on securities or commodities; and
  - (d) long settlement transactions.
6. Subject to the provisions of points 7 to 10, exposure values and risk#weighted exposure amounts for such exposures shall be calculated in accordance with the provisions of Section 3 of Chapter 2 of Title V of Directive 2006/48/EC with references to ‘credit institutions’ in that Section interpreted as references to ‘institutions’, references to ‘parent credit institutions’ interpreted as references to ‘parent institutions’, and with concomitant terms interpreted accordingly.

7. For the purposes of point 6: **U.K.**

Annex IV to Directive 2006/48/EC shall be considered to be amended to include point 8 of Section C of Annex I to Directive 2004/39/EC;

Annex III to Directive 2006/48/EC 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 is multiplied by the following percentages:

- where the reference obligation is one that if it gave rise to a direct exposure of the institution it would be a qualifying item for the purposes of Annex I: 5 %; and
- where the reference obligation is one that if it gave rise to a direct exposure of the institution it would not be a qualifying item for the purposes of Annex I: 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 the insolvency of the entity the exposure of which arising from the swap represents a short position in the underlying, even though the underlying has not defaulted..

Where the credit derivative provides protection in relation to ‘n<sup>th</sup> 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 n<sup>th</sup> lowest credit quality determined by whether it is one that if incurred by the institution would be a qualifying item for the purposes of Annex I.

8. For the purposes of point 6 , in calculating risk#weighted exposure amounts institutions shall not be permitted to use the Financial Collateral Simple Method, set out in points 24 to 29, Part 3 , Annex VIII to Directive 2006/48/EC, for the recognition of the effects of financial collateral.
9. For the purposes of point 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 that 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 recognised as eligible collateral. For the purposes of calculating volatility adjustments where such financial instruments or commodities which are not eligible under Annex VIII of Directive 2006/48/EC are lent, sold or provided, or borrowed, purchased or received by way of collateral or otherwise under such a transaction, and the institution is using the Supervisory volatility adjustments approach under Part 3 of Annex VIII to that Directive, such instruments

and commodities shall be treated in the same way as non-main index equities listed on a recognised exchange. **U.K.**

Where institutions are using the Own Estimates of Volatility adjustments approach under Part 3 of Annex VIII to Directive 2006/48/EC in respect of financial instruments or commodities which are not eligible under Annex VIII of that Directive, volatility adjustments must be calculated for each individual item. Where institutions are using the Internal Models Approach defined in Part 3 of Annex VIII to Directive 2006/48/EC, they may also apply this approach in the trading book.

10. For the purposes of point 6, in relation to the recognition of master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market-driven transactions netting across positions in the trading book and the non-trading book will 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 Title V, Chapter 2, Section 3, Subsection 3 of Directive 2006/48/EC without the application of point 9 of this Annex.
11. Where a credit derivative included in the trading book forms part of an internal hedge and the credit protection is recognised under Directive 2006/48/EC, there shall be deemed not to be counterparty risk arising from the position in the credit derivative.
12. The capital requirement shall be 8 % of the total risk-weighted exposure amounts.

### ANNEX III **U.K.**

#### CALCULATING CAPITAL REQUIREMENTS FOR FOREIGN-EXCHANGE RISK

1. If the sum of an institution's overall net foreign-exchange position and its net gold position, calculated in accordance with the procedure set out in point 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 institution's net open position in each currency (including the reporting currency) and in gold shall be calculated. **U.K.**

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;

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- (d) net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting institution and with the prior consent of the competent authorities, net future income/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
- (f) the market value of other (i.e. non#foreign-currency and non#gold) options.

Any positions which an institution 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 should 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 institution 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. Institutions 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 institution 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 institutions 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 competent authorities shall have the discretion to allow institutions 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 institution's overall net foreign#exchange position.
- 3. By derogation from points 1 and 2 and pending further coordination, the competent authorities may prescribe or allow institutions to use the following procedures for the purposes of this Annex.
  - 3.1. The competent authorities may allow institutions to provide lower capital requirements against positions in closely correlated currencies than those which would result from applying points 1 and 2 to them. The competent authorities 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 competent authorities may allow institutions 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 points 1, 2 and 3.1 that they apply. Institutions 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. **U.K.**

By derogation from the first paragraph, the competent authorities may allow the capital requirement on the matched positions in currencies of Member 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.

#### ANNEX IV **U.K.**

##### 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 Annex III or Annex V, as appropriate, for the purpose of calculating market risk.
3. For the purposes of this Annex, 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 Annex 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, institutions shall also guard against the risk of a shortage of liquidity which may exist in some markets.
6. For the purpose of point 19, the excess of an institution'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. **U.K.**

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The competent authorities shall allow positions in derivative instruments to be treated, as laid down in points 8, 9 and 10, as positions in the underlying commodity.

7. The competent authorities may regard the following positions as positions in the same commodity: **U.K.**
- (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 **U.K.**

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. **U.K.**

The competent authorities may allow the capital requirement for an exchange#traded future to be equal to the margin required by the exchange if they are 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 Annex or applying the internal models method described in Annex V.

The competent authorities may also allow the capital requirement for an OTC commodity derivatives contract of the type referred to in this point cleared by a clearing house recognised by them to be equal to the margin required by the clearing house if they are 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 Annex or applying the internal models method described in Annex V.

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 points 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 point 13. The positions would be long positions if the institution is paying a fixed price and receiving a floating price and short positions if the institution is receiving a fixed price and paying a floating price. **U.K.**

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 Annex. 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 competent authorities or, where none of those is available, or for OTC options, that calculated by the institution itself, subject to the competent authorities being satisfied that the model used by the institution is reasonable. **U.K.**

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However, the competent authorities may also prescribe that institutions calculate their deltas using a methodology specified by the competent authorities.

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

The competent authorities may allow the requirement for a written exchange#traded commodity option to be equal to the margin required by the exchange if they are 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 Annex or applying the internal models method described in Annex V.

The competent authorities may also allow the capital requirement for an OTC commodity option cleared by a clearing house recognised by them to be equal to the margin required by the clearing house if they are 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 Annex or applying the internal models method described in Annex V.

In addition they 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 point 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 Annex.
  - (a) Maturity ladder approach **U.K.**
13. The institution 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 point 7 shall be assigned to the appropriate maturity bands. Physical stocks shall be assigned to the first maturity band. **U.K.**

TABLE 1

Maturity band(1)	Spread rate (in %)(2)
0 ≤ 1 month	1,5
> 1 ≤ 3 months	1,5
> 3 ≤ 6 months	1,5
> 6 ≤ 12 months	1,5
> 1 ≤ 2 years	1,5
> 2 ≤ 3 years	1,5
> 3 years	1,5

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14. Competent authorities may allow positions which are, or are regarded pursuant to point 7 as, positions in the same commodity to be offset and assigned to the appropriate maturity bands on a net basis for the following: **U.K.**
  - (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 institution 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.
17. The institution's capital requirement for each commodity shall be calculated on the basis of the relevant maturity ladder as the sum of the following: **U.K.**
  - (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 point 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 institution's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to point 17.
  - (b) Simplified approach **U.K.**
19. The institution's capital requirement for each commodity shall be calculated as the sum of: **U.K.**
  - (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 institution's overall capital requirement for commodities risk shall be calculated as the sum of the capital requirements calculated for each commodity according to point 19.
  - (c) Extended Maturity ladder approach **U.K.**
21. Competent authorities may authorise institutions to use the minimum spread, carry and outright rates set out in the following table (Table 2) instead of those indicated in

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points 13, 14, 17 and 18 provided that the institutions, in the opinion of their competent authorities: **U.K.**

- (a) undertake significant commodities business;
- (b) have a diversified commodities portfolio; and
- (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 Annex V.

TABLE 2

	<b>Precious metals (except gold)</b>	<b>Base metals</b>	<b>Agricultural products (softs)</b>	<b>Other, including energy products</b>
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

ANNEX V **U.K.**

## USE OF INTERNAL MODELS TO CALCULATE CAPITAL REQUIREMENTS

1. The competent authorities may, subject to the conditions laid down in this Annex, 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 Annexes I, III and IV. Explicit recognition by the competent authorities of the use of models for supervisory capital purposes shall be required in each case.
2. Recognition shall only be given if the competent authority is satisfied that the institution's risk#management system is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met: **U.K.**
  - (a) the internal risk#measurement model is closely integrated into the daily risk#management process of the institution and serves as the basis for reporting risk exposures to senior management of the institution;
  - (b) the institution has a risk control unit that is independent from business trading units and reports directly to senior management. The unit must be responsible for designing and implementing the institution'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 institution'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 institution's overall risk exposure;

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- (d) the institution has sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk#control, audit and back#office areas;
- (e) the institution 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 institution's model has a proven track record of reasonable accuracy in measuring risks;
- (g) the institution 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 institution must conduct, as part of its regular internal auditing process, an independent review of its risk#measurement system.

The review referred to in point (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 institution 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 institution 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;
  - (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 institution 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 institution uses to evaluate back#testing that is conducted to assess the models' accuracy.
3. Institutions 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, institutions 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: **U.K.**

- (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, institutions 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. The institution 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 institution'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. **U.K.**

Competent authorities shall examine the institution's capability to perform back-testing on both actual and hypothetical changes in the portfolio's value. Back-testing on hypothetical changes in the portfolio's value is based on a comparison between the portfolio's end-of-day value and, assuming unchanged positions, its value at the end of the subsequent day. Competent authorities shall require institutions to take appropriate measures to improve their back-testing programme if deemed deficient. Competent authorities may require institutions to perform back-testing on either hypothetical (using changes in portfolio value that would occur were end-of-day positions to remain unchanged), or actual trading (excluding fees, commissions, and net interest income) outcomes, or both.

5. For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions, the competent authorities may recognise the use of an institution's internal model if, in addition to compliance with the conditions in the remainder of this Annex, the internal model meets the following conditions: **U.K.**
- (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 competent authorities allow this 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, that is institutions shall demonstrate that the internal model is sensitive to material idiosyncratic differences between similar but not identical positions; and
  - (f) it captures event risk.

The institution shall also meet the following conditions:

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- where an institution is subject to event risk that is not reflected in its value-at-risk measure, because it is beyond the 10-day holding period and 99 percent confidence interval (low probability and high severity events), the institution shall ensure that the impact of such events is factored in to its internal capital assessment; and
- 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.

Further, as techniques and best practices evolve, institutions shall avail themselves of these advances.

In addition, the institution shall have an approach in place to capture, in the calculation of its capital requirements, the default risk of its trading book positions that is incremental to the default risk captured by the value-at-risk measure as specified in the previous requirements of this point. To avoid double counting, an institution may, when calculating its incremental default risk charge, take into account the extent to which default risk has already been incorporated into the value-at-risk measure, especially for risk positions that could and would be closed within 10 days in the event of adverse market conditions or other indications of deterioration in the credit environment. Where an institution captures its incremental default risk through a surcharge, it shall have in place methodologies for validating the measure.

The institution shall demonstrate that its approach meets soundness standards comparable to the approach set out in Articles 84 to 89 of Directive 2006/48/EC, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality.

An institution that does not capture the incremental default risk through an internally developed approach shall calculate the surcharge through an approach consistent with either the approach set out in Articles 78 to 83 of Directive 2006/48/EC or the approach set out in Articles 84 to 89 of that Directive.

With respect to cash or synthetic securitisation exposures that would be subject to a deduction treatment under the treatment set out in Article 66(2) of Directive 2006/48/EC, or risk-weighted at 1,250 % as set out in Part 4 of Annex IX to that Directive, these positions shall be subject to a capital charge that is no less than set forth under that treatment. Institutions that are dealers in these exposures may apply a different treatment where they can demonstrate to their competent authorities, in addition to trading intent, that a liquid two-way market exists for the securitisation exposures or, in the case of synthetic securitisations that rely solely on credit derivatives, for the securitisation exposures themselves or all their constituent risk components. For the purposes of this section a two-way market is deemed to exist where there are independent good faith offers to buy and sell so that a price reasonably related to the last sales price or current good faith competitive bid and offer quotations can be determined within one day and settled at such a price within a relatively short time conforming to trade custom. For an institution to apply a different treatment, it shall have sufficient market data to ensure that it fully captures the concentrated default risk of these exposures in its internal approach for measuring the incremental default risk in accordance with the standards set out above.

6. Institutions using internal models which are not recognised in accordance with point 4 shall be subject to a separate capital charge for specific risk as calculated according to Annex I.
7. For the purposes of point 9(b), the results of the institution's own calculation shall be scaled up by a multiplication factor of at least 3.



8. The multiplication factor 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. Competent authorities shall require the institutions to calculate overshootings consistently on the basis of back#testing either on actual or on hypothetical 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.

TABLE 1

Number of overshootings	Plus-factor
Fewer than 5	0,0
5	0,4
6	0,5
7	0,65
8	0,75
9	0,85
10 or more	1,0

The competent authorities 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 institution has demonstrated to the satisfaction of the competent authorities 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 competent authorities shall revoke the model's recognition or impose appropriate measures to ensure that the model is improved promptly.

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

9. Each institution must meet a capital requirement expressed as the higher of: **U.K.**
- its previous day's value#at#risk measure according to the parameters specified in this Annex plus, where appropriate, the incremental default risk charge required under point 5; or
  - an average of the daily value#at#risk measures on each of the preceding 60 business days, multiplied by the factor mentioned in point 7, adjusted by the factor referred to in point 8 plus, where appropriate, the incremental default risk charge required under point 5.
10. The calculation of the value#at#risk measure shall be subject to the following minimum standards: **U.K.**
- at least daily calculation of the value#at#risk measure;

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- (b) a 99th percentile, one-tailed confidence interval;
  - (c) a 10-day equivalent holding period;
  - (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) three-monthly data set updates.
11. The competent authorities 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 markets and in particular the following.

#### 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 institution has interest rate sensitive on- or off-balance sheet positions. The institution 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 institution's positions are denominated.

For CIUs the actual foreign exchange positions of the CIU shall be taken into account. Institutions 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 institution 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 point 2.1 of Annex III.

#### Equity risk

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

#### Commodity risk

The risk-measurement system shall use a separate risk factor at least for each commodity in which the institution holds significant positions. The risk-measurement system must 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. It shall also take account of market characteristics, notably delivery dates and the scope provided to traders to close out positions.

13. The competent authorities may allow institutions to use empirical correlations within risk categories and across risk categories if they are satisfied that the institution's system for measuring correlations is sound and implemented with integrity.

## ANNEX VI U.K.

## CALCULATING CAPITAL REQUIREMENTS FOR LARGE EXPOSURES

1. The excess referred to in Article 31(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 Annex I and/or requirements in Annex II, the sum of which equals the amount of the excess referred to in Article 31(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 point 1, on these components.
3. As from 10 days after the excess has occurred, the components of the excess, selected in accordance with point 1, shall be allocated to the appropriate line in column 1 of Table 1 in ascending order of specific#risk requirements in Annex I and/or requirements in Annex II. The additional capital requirement shall be equal to the sum of the specific#risk requirements in Annex I and/or the Annex II requirements on these components, multiplied by the corresponding factor in column 2 of Table 1. U.K.

TABLE 1

<b>Excess over the limits(on the basis of a percentage of own funds)</b>	<b>Factors</b>
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 %

## ANNEX VII U.K.

## TRADING

## PART A U.K.

**Trading Intent**

1. Positions/portfolios held with trading intent shall comply with the following requirements: U.K.
  - (a) there must be a clearly documented trading strategy for the position/instrument or portfolios, approved by senior management, which shall include expected holding horizon;
  - (b) there must be clearly defined policies and procedures for the active management of the position, which shall include the following:

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- (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 institution'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 institution's trading strategy including the monitoring of turnover and stale positions in the institution's trading book.

## PART B U.K.

### Systems and Controls

1. Institutions 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: U.K.
  - (a) documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad#hoc verification procedures; and
  - (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. 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 institution 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 must 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 must be complied with when marking to model: U.K.

- (a) senior management shall be aware of the elements of the trading book which are subject to mark to model and shall understand the materiality of the uncertainty this creates 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 institution 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 point (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 should 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 sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

Valuation adjustments or reserves

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

General standards

9. The competent authorities shall require the following valuation adjustments/reserves 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 institution#related situations e.g. concentrated positions and/or stale positions.
11. Institutions shall consider several factors when determining whether a valuation reserve is necessary for less liquid positions. These 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

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identity of market makers) and the volatility and average of trading volumes, 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 reserves for less liquid positions and on an ongoing basis review their continued suitability.
13. When valuation adjustments/reserves give rise to material losses of the current financial year, these shall be deducted from an institution's original own funds according to point (k) of Article 57 of Directive 2006/48/EC
14. Other profits/losses originating from valuation adjustments/reserves shall be included in the calculation of 'net trading book profits' mentioned in point (b) of Article 13(2) and be added to/deducted from the additional own funds eligible to cover market risk requirements according to such provisions.
15. Valuation adjustments/reserves which exceed those made under the accounting framework to which the institution is subject shall be treated in accordance with point 13 if they give rise to material losses, or point 14 otherwise.

## PART C U.K.

### 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: U.K.
  - (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 must be ensured by adequate procedures.

2. The treatment referred to in point 1 applies without prejudice to the capital requirements applicable to the 'non#trading book leg' of the internal hedge.
3. Notwithstanding points 1 and 2, when an institution 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 institution purchases from an eligible third party protection provider a credit derivative meeting the requirements set out in point 19 of Part 2 of Annex VIII to Directive 2006/48/EC with regard to the non#trading book exposure. 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.

## PART D U.K.

### Inclusion In The Trading Book

1. Institutions shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirements, consistent with the criteria set out in Article 11 and taking into account the institution's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and subject to periodic internal audit.
2. Institutions shall have clearly defined policies and procedures for overall management of the trading book. At a minimum these policies and procedures shall address: U.K.
  - (a) the activities the institution 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 institution 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 institution 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 institution's ability to effect a liquidation or hedge of the position in the short term;
  - (f) the extent to which the institution can, and is required to, actively risk manage the position within its trading operation; and
  - (g) the extent to which the institution may transfer risk or positions between the non#trading and trading books and the criteria for such transfers.
3. Competent authorities may allow institutions to treat positions that are holdings in the trading book as set out in Article 57(1), (m) and (n) of Directive 2006/48/EC as equity or debt instruments, as appropriate, where an institution demonstrates that it is an active market maker in these positions. In this case, the institution shall have adequate systems and controls surrounding the trading of eligible own funds instruments.
4. Term trading-related repo#style transactions that an institution 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 Article 11(2)

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and of Annex VII, Part A, 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 counterparty credit risk charge.

## ANNEX VIII **U.K.**

### REPEALED DIRECTIVES

#### PART A **U.K.**

Repealed(referred to in Article 52) **U.K.**  
directives  
together  
with  
their  
successive  
amendments

Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions

Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions

Directive 98/33/EC of the European Parliament and of the Council of 22 June 1998 amending Article 12 of Council Directive 77/780/EEC on the taking up and pursuit of the business of credit institutions, Articles 2, 5, 6, 7, 8 of and Annexes II and III to Council Directive 89/647/EEC on a solvency ratio for credit institutions and Article 2 of and Annex II to Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions

Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council:

Only Article 26

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC:

Only Article 67

#### PART B **U.K.**

Deadlines(referred to in Article 52) **U.K.**  
for  
transposition

Directive	Deadline for transposition
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Council Directive 93/6/EEC	1.7.1995
Directive 98/31/EC	21.7.2000
Directive 98/33/EC	21.7.2000
Directive 2002/87/EC	11.8.2004
Directive 2004/39/EC	30.4.2006/31.1.2007
Directive 2005/1/EC	13.5.2005

## ANNEX IX U.K.

## CORRELATION TABLE

<b>This Directive</b>	<b>Directive 93/6/EEC</b>	<b>Directive 98/31/EC</b>	<b>Directive 98/33/EC</b>	<b>Directive 2002/87/EC</b>	<b>Directive 2004/39/EC</b>
Article 1(1) first sentence					
Article 1(1) second sentence and (2)	Article 1				
Article 2(1)					
Article 2(2)	Article 7(3)				
Article 3(1) (a)	Article 2(1)				
Article 3(1) (b)	Article 2(2)				Article 67(1)
Article 3(1) (c) to (e)	Article 2(3) to (5)				
Article 3(1)(f) and (g)					
Article 3(1) (h)	Article 2(10)				
Article 3(1)(i)	Article 2(11)		Article 3(1)		
Article 3(1)(j)	Article 2(14)				
Article 3(1) (k) and (l)	Article 2(15) and (16)	Article 1(1) (b)			
Article 3(1) (m)	Article 2(17)	Article 1(1) (c)			
Article 3(1) (n)	Article 2(18)	Article 1(1) (d)			

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Article 3(1) (o) to (q)	Article 2(19) to (21)				
Article 3(1)(r)	Article 2(23)				
Article 3(1) (s)	Article 2(26)				
Article 3(2)	Article 2(7) and (8)				
Article 3(3) (a) and (b)	Article 7(3)			Article 26	
Article 3(3) (c)	Article 7(3)				
Article 4	Article 2(24)				
Article 5	Article 3(1) and (2)				
Article 6	Article 3(4)				Article 67(2)
Article 7	Article 3(4a)				Article 67(3)
Article 8	Article 3(4b)				Article 67(3)
Article 9	Article 3(3)				
Article 10	Article 3(5) to (8)				
Article 11	Article 2(6)				
Article 12 first paragraph	Article 2(25)				
Article 12 second paragraph					
Article 13(1) first sub-paragraph	Annex V(1) first sub-paragraph				
Article 13(1) second sub# paragraph and (2) to (5)	Annex V(1) second sub# paragraph and (2) to (5)	Article 1(7) and Annex 4(a)(b)			
Article 14	Annex V(6) and (7)	Annex 4(c)			
Article 15	Annex V(8)				
Article 16	Annex V(9)				
Article 17					

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Article 18(1) first sub-paragraph	Article 4(1) first sub-paragraph				
Article 18(1) (a) and (b)	Article 4(1)(i) and (ii)	Article 1(2)			
Article 18(2) to (4)	Article 4(6) to (8)				
Article 19(1)					
Article 19(2)	Article 11(2)				
Article 19(3)					
Article 20					
Article 21	Annex IV				
Article 22					
Article 23 first and second paragraph	Article 7(5) and (6)				
Article 23 third paragraph					
Article 24					
Article 25					
Article 26(1)	Article 7(10)	Article 1(4)			
Article 26(2) to (4)	Article 7(11) to (13)				
Article 27	Article 7(14) and (15)				
Article 28(1)	Article 5(1)				
Article 28(2)	Article 5(2)	Article 1(3)			
Article 28(3)					
Article 29(1) (a) to (c) and next two sub-paragraphs	Annex VI(2)				
Article 29(1) last sub-paragraph					
Article 29(2)	Annex VI(3)				
Article 30(1) and (2)	Annex VI(4) and (5)				

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first sub# paragraph					
Article 30(2) second sub# paragraph					
Article 30(3) and (4)	Annex VI(6) and (7)				
Article 31	Annex VI(8) (1), (2) first sentence, (3) to (5)				
Article 32	Annex VI(9) and (10)				
Article 33(1) and (2)					
Article 33(3)	Article 6(2)				
Article 34					
Article 35(1) to (4)	Article 8(1) to (4)				
Article 35(5)	Article 8(5) first sentence	Article 1(5)			
Article 36	Article 9(1) to (3)				
Article 37					
Article 38	Article 9(4)				
Article 39					
Article 40	Article 2(9)				
Article 41(1) (a) to (c)	Article 10 first, second and third indents				
Article 41(1) (d) and (e)					
Article 41(1) (f)	Article 10 fourth indent				
Article 41(1) (g)					
Article 42					
Article 43					
Article 44					
Article 45					

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Article 46	Article 12				
Article 47					
Article 48					
Article 49					
Article 50	Article 15				
Annex I(1) to (4)	Annex I(1) to (4)				
Annex I(4) last paragraph	Article 2(22)				
Annex I(5) to (7)	Annex I(5) to (7)				
Annex I(8)					
Annex I(9) to (11)	Annex I(8) to (10)				
Annex I(12) to (14)	Annex I(12) to (14)				
Annex I(15) and (16)	Article 2(12)				
Annex I(17) to (41)	Annex I(15) to (39)				
Annex I(42) to (56)					
Annex II(1) and (2)	Annex II(1) and (2)				
Annex II(3) to (10)					
Annex III(1)	Annex III(1) first sub-paragraph	Article 1(7) and Annex 3(a)			
Annex III(2)	Annex III(2)				
Annex III(2.1) first to third paragraphs	Annex III(3.1)	Article 1(7) and Annex 3(b)			
Annex III(2.1) fourth paragraph					
Annex III(2.1) fifth paragraph	Annex III(3.2)	Article 1(7) and Annex 3(b)			

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Annex III(2.2), (3), (3.1)	Annex III(4) to (6)	Article 1(7) and Annex 3(c)			
Annex III(3.2)	Annex III(8)				
Annex III(4)	Annex III(11)				
Annex IV(1) to (20)	Annex VII(1) to (20)	Article 1(7) and Annex 5			
Annex IV(21)	Article 11a	Article 1(6)			
Annex V(1) to (12) fourth paragraph	Annex VIII(1) to (13)(ii)	Article 1(7) and Annex 5			
Annex V(12) fifth paragraph					
Annex V(12) sixth paragraph to (13)	Annex VIII(13)(iii) to (14)	Article 1(7) and Annex 5			
Annex VI	Annex VI(8) (2) after the first sentence				
Annex VII					
Annex VIII					
Annex IX					

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- (1) [OJ C 234, 22.9.2005, p. 8.](#)
- (2) [OJ C 52, 2.3.2005, p. 37.](#)
- (3) Opinion of the European Parliament of 28 September 2005 (not yet published in the OJ) and Decision of the Council of 7 June 2006.
- (4) [OJ L 141, 11.6.1993, p. 1.](#) Directive as last amended by Directive 2005/1/EC of the European Parliament and of the Council ([OJ L 79, 24.3.2005, p. 9.](#))
- (5) [OJ L 145, 30.4.2004, p. 1.](#)
- (6) See page 1 of this official Journal
- (7) [OJ L 184, 17.7.1999, p. 23.](#)
- (8) [OJ C 284 E, 21.11.2002, p. 115.](#)
- (9) [OJ L 35, 11.2.2003, p. 1.](#) Directive as amended by Directive 2005/1/EC.
- (10) [OJ L 9, 15.1.2003, p. 3.](#)
- (11) [OJ L 222, 14.8.1978, p. 11.](#) Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council ([OJ L 178, 17.7.2003, p. 16.](#))
- (12) [OJ L 3, 7.1.2004, p. 36.](#)
- (13) Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field ([OJ L 141, 11.6.1993, p. 27.](#)) Directive as last amended by Directive 2002/87/EC.