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ANNEX II

CALCULATING CAPITAL REQUIREMETNS 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:

(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

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

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			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.

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;

(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:

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^{th} 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^{th} 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.

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.

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