

# GUIDANCE NOTE FOR DEPOSIT TAKERS

## Quarterly Prudential Returns

**May 2009**

(updated March 2011 and January 2012)



Financial Supervision Commission Barrantee Oaseirys

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## **CHAPTER 1**

### **GENERAL GUIDANCE NOTES**

#### **SECTION 1 – INTRODUCTION**

The Isle of Man reporting forms are primarily required for supervisory purposes although certain industry statistics may be collated from them.

Attention is drawn to Rule 5.16 of the Financial Services Rule Book (“the Rule Book”) which requires that the external auditors of the bank select and verify one set of the reporting forms (other than a set that coincides with the deposit taker’s annual reporting date (hereinafter referred to as bank or banks year-end) which has been submitted to the Commission during the relevant accounting period, to the accounting books and records of the bank.

#### **SECTION 2 – THE REPORTING FORMS**

##### **Banks incorporated in the Isle of Man**

Banks incorporated in the Isle of Man are normally required to complete:-

- (i) Form SR-1A – Balance Sheet Assets, Liabilities and Off Balance Sheet items
- (ii) Form SR-1B – Credit Risk
- (iii) Form SR-1C – Operational Risk
- (iv) Form SR-2A – Capital, Current Period’s Profit and Loss, Provisions and Non-performing Assets
- (v) Form SR-2B – Large Exposures Reporting
- (vi) Form SR-2C – Risk Asset Ratio and Memorandum Items
- (vii) Form SR-3A – Liquidity Risk
- (viii) Form SR-3B – Interest Rate Risk
- (ix) Form SR-4 – Market Risk (FX and gold, commodities) and Settlement Risk

If insufficient space is provided within a particular section of the electronic reporting forms, an appendix should be submitted to the Commission in electronic or hard copy format. The template forms are shown on the Commission’s website.

##### **Banks not incorporated in the Isle of Man (“branches”)**

Branches are normally required to complete:-

- (i) Form SR-1A – Balance Sheet Assets, Liabilities and Off Balance Sheet items
- (ii) Form SR-2A – Current Period’s Profit and Loss, Provisions and Non-performing Assets (i.e. excludes capital section)
- (iii) Form SR-2B – Large Exposures Reporting
- (iv) Form SR-2C – Memorandum Items (i.e. excludes Risk Asset Ratio)
- (v) Form SR-3A – Liquidity Risk

If insufficient space is provided within a particular section of the electronic reporting forms, an appendix should be submitted to the Commission in electronic or hard copy format. The template forms are shown on the Commission’s website.

### **SECTION 3 – SUBMISSION AND ENQUIRIES**

Reporting forms should be prepared based on the information as at either the last working day, or the last calendar day, of March, June, September and December.

In addition, if the bank's financial year-end falls on a date other than one of the above days, a further set of reporting forms should be prepared as at the close of business on the last day in the financial year.

The reporting forms should be submitted in electronic format. The Isle of Man resident officers are responsible for the completeness and accuracy of the reporting forms, but the electronic signing may be undertaken by another employee of the bank, as approved by the Commission. The reporting forms should be submitted within one month of the reporting date to which they relate.

Banks are reminded of the importance of submitting all reporting forms within the prescribed time scales and of informing the Commission, in advance, of any difficulty they may have in meeting a deadline.

Incomplete, inaccurate, misleading, or late submission of reporting forms is often an indication of weak management information, or poor accounting systems. Thus, such occurrences could lead to the Commission requesting that Reporting Accountants be appointed to provide an explanation.

Enquiries regarding the completion of the reporting forms should be addressed to Banking Supervision at:

Financial Supervision Commission  
P O Box 58  
Finch Hill House  
Bucks Road  
Douglas  
Isle of Man  
IM99 1DT

Tel: +44 (0) 1624 689300  
Fax: +44 (0) 1624 689398

### **SECTION 4 – GENERAL**

#### **4.1 *The bank / reporting bank***

This is normally the entity that has been issued with a class 1 licence under the Financial Services Act 2008. It includes branches in this context.

#### **4.2 *Currency convention, rounding, and sign convention***

The forms must be completed in sterling. Sterling denominated business is separated from other currencies in some sections of the reporting forms. Other currency business must be reported as a sterling equivalent figure calculated using the middle market spot rate in the London market at the close of business on the

reporting date, or as close to that time as a bank's system will allow. For transactions, the rate ruling at the time of the transaction should be used.

Banks that account in a currency other than sterling should convert to sterling.

Figures reported should be to the nearest thousand pounds sterling (but omitting the "£'000s" - e.g. £5,678,123 should be reported as 5678). Rounding should conform to the following convention: £1,001 to £1,499 round down to £1000 (i.e. report as 1), £1,500 to £1,999 round up to £2,000 (i.e. report as 2). Decimal points must not be used. The cells are formatted not to show decimal places and do not recognise decimal points.

Where a nil balance is recorded do not enter anything in the relevant cell.

The software automatically calculates the figures reported in some cells of the reporting forms. Generally, figures should be reported using a positive sign convention unless otherwise stated in the specific notes for completion of each form.

#### 4.3 ***Consolidated returns***

Consolidated returns (in relation to banks incorporated in the Isle of Man, and in addition to solo returns that must be submitted) will normally be required in the following circumstances:-

- Where the bank has provided substantial finance (other than share capital) for subsidiary companies or where it carries on a significant part of its business through subsidiary companies;
- Where the bank has a material subsidiary that is a licensed bank in the Isle of Man or elsewhere; or
- Where the bank has a material subsidiary that conducts financial services business in the Isle of Man or elsewhere.

The requirements should be discussed and agreed with the Commission in advance.

#### 4.4 ***Transactions to be reported***

The reporting forms should relate to all transactions where the bank has acted as principal in a non-fiduciary capacity (i.e. where the transactions pass through, and are recorded in, the accounting records of the bank). See also item 4.5 below.

#### 4.5 ***Fiduciary Deposits***

Where the bank acts in a fiduciary capacity (i.e. placing funds with another institution in its own name on behalf of a customer) it should not show the transaction in its balance sheet but in row E of Memorandum Items in Form SR-2C.

#### 4.6 ***Relationship to audited financial statements***

The reporting forms sometimes require items to be treated in a way that differs from the bank's practice for preparing its financial statements.

#### 4.7 ***Netting***

Debit balances should not be set-off against credit balances unless a legally enforceable specific netting agreement is in place between the bank and its counterparty or customer.

*Note: A current tax asset and current tax liability should only be offset by a bank where it has a legally enforceable right to set off the amounts and it intends to settle them on a net basis. If the amounts are not settled on a net basis then they should be settled simultaneously. For the purpose of credit risk, a current tax asset (whether or not arising from netting) may be reported in portfolio A or L of form SR-1B as appropriate.*

*Deferred tax assets and liabilities should similarly only be offset where the bank has a legally enforceable right to set off current tax assets against current tax liabilities and the deferred tax assets and liabilities have arisen on income taxes levied by the same taxation authority. In addition, the amounts should be in relation to the same taxable entity, or where they have arisen in respect of different taxable entities there should be the right to settle the amounts on a net basis or simultaneously. For the purpose of credit risk, a current tax asset (whether or not arising from netting) may be reported in portfolio A or L of form SR-1B as appropriate.*

#### 4.8 ***Risk weightings***

The risk weightings used in Form SR-1B for banks incorporated in the Isle of Man are based on the principles outlined in the Basel Committee on Banking Supervision paper titled International Convergence of Capital Measurement and Capital Standards - comprehensive version- June 2006 (effectively known as "Basel II"). ***For branches the risk-weighting framework for capital adequacy does not apply.***

#### 4.9 ***Accounting standards***

The bank shall prepare the reporting forms based on UK GAAP or International Financial Reporting Standards ("IFRS"), unless otherwise agreed with the Commission. The forms take into account both standards but in places regulatory requirements and descriptions differ from statutory accounting requirements and terminology, primarily in relation to forms SR-1A and SR-2A.

#### 4.10 ***Defined benefit occupational pension schemes***

The following definitions are used for the purposes of reporting the capital treatment for defined benefit occupational pension schemes:

*Defined benefit occupational pension scheme*

This is an occupational pension scheme that is not defined as being a *defined contribution occupational pension scheme*

*Defined contribution occupational pension scheme*

This is an occupational pension scheme into which the bank, as employer, pays regular fixed contributions and will have no legal or constructive obligation to pay further contributions if the scheme does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

*Defined benefit asset*

This is the excess of the value of the assets in a *defined benefit occupational pension scheme* over the present value of the scheme liabilities, to the extent that the bank, as employer, in accordance with the accounting principles applicable to it, should recognise that excess as an asset in its balance sheet.

*Defined benefit liability*

This is the shortfall of the value of the assets in a *defined benefit occupational pension scheme* below the present value of the scheme liabilities, to the extent that the bank, as employer, in accordance with the accounting principles applicable to it, should recognise that shortfall as a liability in its balance sheet.

*Deficit reduction amount*

In respect of a *defined benefit occupational pension scheme* this is the sum, determined by the bank in conjunction with the scheme's actuaries or trustees (or both) of the additional funding (net of tax) that will be required to be paid into the scheme by the bank over the following 5 year period for the purpose of reducing the bank's *defined benefit liability*.

## **SECTION 5 – PARTIES CONNECTED TO THE BANK**

The definitions below of parties connected to the bank may not necessarily concur with those applied by the bank's auditors under current accounting standards. Disclosure in the annual audited financial statements should continue to be guided by current accounting standards. Reference to the Rule Book and the Financial Services Act 2008 ("the Act") is provided where applicable.

### **5.1 *Subsidiary company (as defined in the Act)***

A subsidiary company is defined in the Act with reference to the Companies Act 1974.

### **5.2 *Associated company (as defined in the Rule Book)***

An associated company is a company (not being a subsidiary of the bank) in which:

- (i) The bank holds more than 20% of the equity shares, or

- (ii) The bank is able to exercise a significant influence and the interest in the company is effectively that of a partner in a joint venture or consortium, or the bank has a long-term and substantial interest in the company.

*Significant influence* (this is not defined in the Rule Book) over a company essentially involves participation in the financial and operating policy decisions of that company, (including dividend policy), but not necessarily control of those policies. Representation on the board of directors is indicative of such participation, but will neither necessarily give conclusive evidence of it nor be the only method by which the bank may participate in policy decisions.

Where the interest of the bank is not effectively that of a partner in a joint venture or consortium but nevertheless amounts to 20 per cent or more of the equity voting rights of a company, it will be presumed that the bank has the ability to exercise significant influence over that company unless it can clearly be demonstrated otherwise. For example, there may exist one or more other large shareholdings that prevent the exercise of such influence.

### 5.3 ***Directors, controllers, senior management, key persons and their associates (as defined in the Act and Rule Book as applicable)***

*A director means* any person who occupies the position of a director by whatever name called and anyone who appears to the Commission to hold a position analogous to that of a director.

*A controller means -*

- (i) A managing director of the bank or of another institution of which it is a subsidiary, or in the case of a partnership, a partner; or
- (ii) A chief executive of the bank or of another institution of which it is a subsidiary; or
- (iii) A person in accordance with whose directions or instructions the directors of the bank or of another institution of which it is a subsidiary, (or any of them), are accustomed to act; or
- (iv) A person who either alone or with any associate, or associates, is entitled to exercise, or control the exercise of, 15% or more of the voting power at any general meeting of the bank or of another institution of which it is a subsidiary.

*Senior management means* – the chief executive of the bank in the Isle of Man, the Isle of Man resident directors and the Isle of Man resident officers (as defined in the Rule Book).

*A chief executive means* - a person who is employed by the bank and who either alone or jointly with others is or will be responsible under the immediate authority of the directors for the conduct of the business of the bank.

*A key person means* – such a person as defined in the Act

*Associates* (as defined in the Act where applicable): When determining exposures to directors, controllers senior management and key persons (each being referred

to as an “individual”), any exposure to the persons or bodies described below should normally be aggregated with actual exposures to the individuals:

- (i) A spouse, mother, father, brother, sister child or stepchild of the relevant individual; or
- (ii) A business partner or employee of the individual; or
- (iii) A trust in respect of which the individual has a beneficial interest; or
- (iv) A company in which the individual is also a director; or
- (v) Any company in which the individual is a shareholder, and together with any other associates, holds 20% or more of the equity; or
- (vi) Any other person whose business or domestic relationship with the individual or his associate might reasonably be expected to give rise to a community of interest between them which may involve a conflict of interest in dealings with third parties.

#### 5.4 ***Non-group companies, trusts and other bodies***

*Non-group companies with which directors and controllers are associated:*

A director/controller (including an alternate director) of the bank is deemed to be associated with another company in the following circumstances:

- (i) He/she holds the office of a director (or alternate director) with that company, or
- (ii) As a result of a loan granted by, or financial interest taken by, the bank to, or in, that company, or
- (iii) By virtue of a professional interest unconnected with the bank, or
- (iv) He/she and/or his/her associates, as defined above, together hold 20% or more of the equity share capital of that company.

For the purposes of this item only, include as a director, an employee of the bank who is not a director of the bank but who is appointed by the bank to be a director of another company.

*Trusts and other bodies* in which a director or controller of the bank has a significant influence should be treated as a party connected to the bank. Where the bank is not sure as to whether or not its director or controller can exercise significant influence, the liability/exposure should not be reported as connected.

#### 5.5 ***Group companies (in addition to the definition of “group” in the Rule Book)***

A company is considered to be a group company if:-

- (i) It is a subsidiary of the bank, or of another group or associated company; or
- (ii) It is an associated company of the bank, or of another group company; or
- (iii) It is the ultimate parent company of the bank; or
- (iv) It is a company directly, or indirectly, owned by the ultimate parent company.

## **SECTION 6 - CLOSELY RELATED CUSTOMERS AND COUNTERPARTIES (DEFINED IN THE RULE BOOK)**

A group of closely related customers / counterparties exists where individual customers / counterparties are related in such a way that the financial soundness of any of them may affect the financial soundness of the other or others and as such they constitute a single risk (*as defined in the Rule Book*).

*The following is not defined in the Rule Book and is additional guidance:*

In such cases the exposure to these individuals should be aggregated and reported as a single exposure to "a group of closely related customers / counterparties". For these purposes, such a group also exists where the financial soundness of individual customers / counterparties may be adversely affected by the same event.

It is not possible to give a comprehensive list of the different types of relationship between individual customers / counterparties which it might be reasonable to consider as giving rise to a common risk and therefore which constitute for these purposes a group of related customers / counterparties. The following list is therefore indicative and not comprehensive:

- (i) Group companies, (as defined in 5.5 above but excluding the references to the bank);
- (ii) Companies whose ultimate owner (whether in whole or in significant part) is the same individual or individuals and which do not have a formal group structure;
- (iii) Counterparties linked by cross guarantees;
- (iv) Two individuals who have borrowed for a common purpose, (e.g. business partners);
- (v) An individual and a company controlled by that individual;
- (vi) Exposures secured by the same company or individual.

Where there is doubt in a particular case as to whether a number of individual persons constitute a group of related customers / counterparties or, notwithstanding that a relationship as identified above exists, it is considered that the customers / counterparties do not share a "common risk", the circumstances should be discussed with the Commission to determine how the exposure(s) should be reported. Exposures to a number of public sector bodies, or local authorities, are deemed not to constitute a single exposure to "a group of closely related customers / counterparties".

## **SECTION 7 – LARGE EXPOSURES (AS DEFINED IN THE RULE BOOK)**

### **7.1 *Exposure (as defined in the Rule Book)***

An exposure means a claim on an individual counterparty, or group of closely related counterparties.

An exposure should be calculated as the gross amount of risk (subject to the provisions in rules 8.37(2) and 8.37(2A)) from:

- (i) Claims including actual and potential claims which would arise from the drawing down in full of undrawn advised facilities (revocable or irrevocable, conditional or unconditional) which the bank has committed itself to provide, and claims which the bank has committed itself to purchase or underwrite, or
- (ii) Contingent liabilities arising in the normal course of business, and those contingent liabilities which would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional which the bank has committed itself to provide), or
- (iii) Assets, including assets which the bank has committed itself to purchase or underwrite, whose value depends wholly or mainly on a counterparty performing its obligations, or whose value otherwise depends on that counterparty's financial soundness but which do not represent a claim on the counterparty.

## **7.2 Customer / Counterparty (as defined in the Rule Book)**

A customer or counterparty means any person on whom a bank has a claim, whether directly or indirectly.

## **7.3 Large Exposures Capital Base ("LECB") (as defined in the Rule Book)**

This is interpreted in accordance with the Rule Book. In addition to this, if there is any material alteration in the LECB during the year resulting from a change to tier 1 or tier 2 capital (e.g. through the payment of a dividend, interim profits verified by the auditor, an injection of subordinated debt or repayment of capital), the revised figure should also be agreed with the Commission.

A pro-forma for the calculation of LECB is provided in the **Commission's Guidance Note** on Large Exposures.

Adjusted capital base is calculated as described in form SR-2A and is also broadly defined in the Rule Book.

## **SECTION 8 – VERIFICATION OF INTERIM PROFITS BY EXTERNAL AUDITORS**

Verification by the external auditors should, in normal circumstances, include at least the following:

- (i) The auditors should satisfy themselves that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records
- (ii) The auditors should review the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the bank in drawing up its annual financial statements
- (iii) The auditors should perform analytical procedures on the results to date, including comparisons of the actual performance to date with budget and with the results of the prior period(s)
- (iv) The auditors should discuss with management the overall performance and financial position of the bank

- (v) The auditors should obtain adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and provisioning for bad and doubtful debts have been properly taken into account in arriving at the interim profits, and
- (vi) The auditors should follow up problem areas of which they are already aware in the course of auditing the financial statements.

A full scope audit is not required. However, the auditors should indicate in their report where the scope of work differs materially from that set out above.

The auditors should submit an opinion to the bank on whether the interim profits are fairly stated. This should be submitted to the Commission.

A pro forma for use by auditors is attached in **Appendix 1**.

*Note:* a bank should report its capital adequacy position as at the reporting date. Therefore, with regard to profits to be included in Tier 1 capital, profits may be included for which auditors' verification has been completed before the reporting date. In some cases verification of profit may be completed after the reporting date but before submission of the reporting forms. In these cases the capital position reported should also include the audited profit.

## **SECTION 9 – CREDIT INSTITUTIONS**

Where the term "credit institution" is used in the guidance, this means another bank or building society. In other parts of the guidance, the term "bank" can also be deemed to include "building society".

## CHAPTER 2

### GUIDANCE NOTES – FORM SR-1A

#### SECTION 1 - GENERAL

The general principles underlying these notes are outlined in **Chapter 1**.

The bank should report balance sheet assets, liabilities and off balance sheet items by column according to:

- Sterling denominated assets, liabilities and off balance sheet items; and
- All other currency denominated assets, liabilities and off balance sheet items.

Assets, liabilities and off balance sheet items should be further categorised by row according to the tables below. To the right of the input area, applicable portfolio reference numbers are quoted for each row in respect of credit reporting (applicable to incorporated banks only).

The designation of an asset as marketable means:

- Prices are regularly quoted for the asset;
- The asset is regularly traded;
- The asset is readily sold, including by repo, either on an exchange, or in a deep and liquid market, for payment in cash; and
- Settlement is made according to a prescribed timetable, rather than a negotiated timetable.

“Past due” assets are reported in F.5, rather than according to the normal classification. Assets must be classified as “Past due” after 90 days have passed since a payment is missed.

Generally, assets should be reported net of specific provisions (impairment).

#### SECTION 2 – COMPLETION NOTES

##### **Assets**

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>	<b>Credit</b>
<b>A</b>			
A.1	Notes and coins	Notes and coins held by the bank.	F

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>	<b>Credit</b>
A.2	Cash items in the course of collection	The amount of cheques, drafts and other items drawn on other banks that will be paid for the account of the bank immediately upon presentation and that are in the process of collection.	F
A.3	Gold	Gold held by the bank.	F
	<b>SUBTOTAL</b>	<b>Total for "A: Cash", calculated by the sheet as the sum of A.1 to A.3.</b>	
<b>B</b>			
B.1	Loans to Parent	Loans to parent banks of the reporting bank.	D
B.2	Loans to fellow banking subsidiaries	Loans to banks in the same group as the reporting bank. A company is considered to be in the same group as the reporting bank if it is a subsidiary of the ultimate parent of the reporting bank.	D
B.3	Loans to other banks - 1 year or less to maturity	Loans to all other banks that are one year or less to maturity at the reporting date.	D
B.4	Loans to other banks - greater than 1 year to maturity	Loans to all other banks which are greater than one year to maturity at the reporting date.	D
	<b>SUBTOTAL</b>	<b>Total for "B: Loans to Banks", calculated by the sheet as the sum of B.1 to B.4.</b>	
<b>C</b>			
C.1	Government debt	Holdings of Government debt issues that are marketable.	A
C.2	PSE debt	Holdings of PSE debt issues that are marketable.	B
<b>C.3</b>	<b>CDs, CP and FRNs of less than 1 year to maturity</b>		
C.3.1	Parent issued	Marketable holdings of CDs, CP and FRNs of less than 1 year to maturity that are issued by parent banks of the reporting bank.	D
C.3.2	Other group - bank issued	Marketable holdings of CDs, CP and FRNs of less than 1 year to maturity that are issued by banks in the same group as the reporting bank.	D

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>	<b>Credit</b>
C.3.3	Other banks	Marketable holdings of CDs, CP and FRNs of less than 1 year to maturity that are issued by other banks.	D
C.3.4	All marketable CP	All holdings of marketable CP issued by corporates.	C
<b>C.4</b>	<b>Other Marketable Bank Debt</b>		
C.4.1	Parent issued	Marketable holdings of debt not covered by C.3.1 issued by parent banks of the reporting bank.	D
C.4.2	Other group - bank issued	Marketable holdings of debt not covered by C.3.2 issued by banks in the same group as the reporting bank.	D
C.4.3	Other Banks	Marketable holdings of debt not covered by C.3.3 issued by other banks.	D

<b>C.5</b>	<b>Other Marketable Assets</b>		
C.5.1	Other Marketable debt - Group non-banking entities	Marketable holdings of debt issued by non banking companies in the same group as the reporting bank.	C
C.5.2	Other Marketable debt - Corporate	Marketable holdings of debt issued by other non banking companies.	C
C.5.3	Other Marketable debt - Securitisation exposures - non equity	Marketable holdings of securitisation tranches, other than equity tranches.	E
C.5.4	Other Marketable debt - Sovereign	Other marketable holdings of debt issued by sovereigns.	A

C.5.5	Other Marketable PSE Debt	Other marketable holdings of debt issued by PSEs.	B
C.5.6	Marketable Bank equity holdings	Marketable holdings of capital instruments, including equity, issued by banks.  <i>Note that this feeds item "C.3: Holdings of Banks' Capital Instruments" in form SR-2A, capital section, for incorporated banks.</i>	K
C.5.7	Marketable Corporate equity holdings	Marketable holdings of equity issued by non-banking companies.	L
C.5.8	Marketable Securitisation exposures - equity tranche holdings	Marketable holdings of the equity tranches of securitisations.  <i>Note that this feeds item "C.4: Securitisations – Equity Tranches" in form SR-2A, capital section, for incorporated banks.</i>	K
	<b>SUBTOTAL</b>	<b>Total for "C: Marketable Assets", calculated by the sheet as the sum of C.1, C.2, C.3.1 to C.3.4, C.4.1 to C.4.3 and C.5.1 to C.5.8.</b>	

<b>D</b>	<b>Loans and Advances</b>		
D.1	Group non-banking entities	Loans/advances to non banking companies in the same group as the reporting bank.	C
D.2	Sovereigns	Loans/advances to sovereign governments and central banks.	A
D.3	PSEs	Loans/advances to public sector entities.	B
D.4	Corporate lending	All loans/advances to companies other than those qualifying for reporting elsewhere.	C
D.5	Retail lending	Loans/advances to individuals and small businesses.	G
D.6	Residential mortgages	Loans/advances secured by charges over residential property.	H
D.7	Capital connected lending	Loans/advances of a capital nature.  <i>Note that this feeds item "C.2: Capital connected lending" in form SR-2A, capital section, for incorporated banks.</i>	K
	<b>SUBTOTAL</b>	<b>Total for "D: Loans and Advances", calculated by the sheet as the sum of D.1 to D.7.</b>	
<b>E</b>	<b>Investments</b>		

E.1	Non marketable sovereign debt	Non marketable holdings of debt issued by sovereigns.	A
E.2	Non marketable PSE debt	Non marketable holdings of debt issued by PSEs.	B
E.3	Non marketable debt - parental	Non marketable holdings of debt issued by parent banks of the reporting bank.	D
E.4	Non marketable debt - other group bank	Non marketable holdings of debt issued by banks in the same group as the reporting bank.	D
E.5	Non marketable debt - other bank issued	Non marketable holdings of debt issued by other banks.	D
E.6	Non marketable debt - group non-banking entities	Non marketable holdings of debt issued by non banking companies in the same group as the reporting bank.	C
E.7	Non marketable debt - corporate	Non marketable holdings of debt issued by other non banking companies.	C
E.8	Non marketable securitisation exposures - non capital	Non marketable holdings of securitisation tranches, other than equity tranches.	E

E.9	Investments requiring deduction	<p>Significant (minority and/or majority) investments in commercial entities; those which exceed materiality levels should be deducted from banks' capital. Materiality levels are:</p> <p>(a) 15% of the bank's capital for individual investments in commercial entities; and</p> <p>(b) 60% of the bank's capital for the aggregate of such investments.</p> <p>The amount to be deducted will be that portion of the investment that exceeds the materiality level. The amount below this level should be categorised as normal.</p> <p><i>Also report here any other assets for which the treatment agreed with the Commission is to deduct the nominal from capital. Note that this feeds item "C.7: Other" in form SR-2A, capital section, for incorporated banks.</i></p>	K
E.10	Capital investments in subsidiaries and other associated companies	<p>Investments in subsidiary and associated companies. Such companies include:</p> <p>(a) The reporting bank's ultimate parent;</p> <p>(b) All subsidiaries of that ultimate parent;</p> <p>(c) All companies with whom the reporting bank has entered into a joint venture, together with the joint venture itself and any subsidiaries of it;</p> <p>(d) All companies where the reporting bank is a significant shareholder and holds over 20% of that company's share capital; and</p> <p>(e) All companies where the reporting bank exercises management control.</p> <p><i>Note that this feeds item "C.1: Investment in Subsidiaries" in form SR-2A, capital section, for incorporated banks.</i></p>	K
E.11	Capital investments in other banks	<p>Holdings of capital instruments issued by banks and other regulated financial services businesses.</p> <p><i>Note that this feeds item "C.3: Holdings of Banks' Capital Instruments" in form SR-2A, capital section, for incorporated banks.</i></p>	K
E.12	Equity - corporate	<p>Marketable holdings of capital instruments, including equity, issued by non-banking companies.</p>	L

E.13	Securitisation exposures - equity tranches	Marketable holdings of the equity tranches of securitisations.  <i>Note that this feeds item "C.4: Securitisations – Equity Tranches" in form SR-2A, capital section, for incorporated banks.</i>	K
	<b>SUBTOTAL</b>	<b>Total for "E: Investments", calculated by the sheet as the sum of E.1 to E.13.</b>	
<b>F</b>	<b>Other Financial</b>		
F.1	Items in suspense	All items in suspense.	L
F.2	Settlement Balances	All settlement balances due to the bank.	L
F.3	Debtors and Prepayments	Debtors and prepayments.	L
F.4	Operating leases	Capitalised assets relating to operational leases.	L
F.5	All past due assets	All past due assets here (more than 90 days).	J
	<b>SUBTOTAL</b>	<b>Total for "F: Other Financial", calculated by the sheet as the sum of F.1 to F.5.</b>	
<b>G</b>	<b>Other</b>		
G.1	Premises owned and occupied by the reporting bank	The reporting bank's own premises should be included along with any property being developed for occupation. Also report here property owned by the reporting bank that is occupied by employees.	L
G.2	Other land and property owned by the reporting bank	Any other land and property owned by the reporting bank.	L
G.3	Plant, equipment, leasehold premises, and motor vehicles	All other tangible fixed assets of the reporting bank.	L
G.4	Intangible assets including goodwill	All intangible fixed assets of the reporting bank, including goodwill.  <i>Note that this feeds item "A.7.1: Goodwill and other intangible assets" in form SR-2A, capital section, as a deduction from Tier 1 Capital, for incorporated banks</i>	K
	<b>SUBTOTAL</b>	<b>Total for "G: Other", calculated by the sheet as the sum of G.1 to G.4.</b>	

	<b>TOTAL ASSETS</b>	<b>Total of amounts reported above, calculated by the sheet as the sum of the subtotals A to G.</b>	
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### Liabilities

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
<b>A</b>	<b>Deposits due to:</b>	
A.1	Parent / Holding Company or Group	Deposits from all companies of which the reporting bank is a subsidiary. The reporting bank is deemed to be a subsidiary of such a company if either: <ul style="list-style-type: none"> <li>(a) The company is a shareholder of the reporting bank and controls the composition of its board of directors;</li> <li>(b) The company holds more than one half in nominal value of the reporting bank's equity share capital; or</li> <li>(c) The reporting bank is a subsidiary of any other subsidiary of the company.</li> </ul>
A.2	Associated Banking Companies	Deposits from regulated banks that are associated companies of the reporting bank. For the purpose of reporting this item in the return, this comprises: <ul style="list-style-type: none"> <li>(a) All companies with whom the reporting bank has entered into a joint venture, together with the joint venture itself and any subsidiaries;</li> <li>(b) All companies where the reporting bank holds over 20% of that company's share capital; and</li> <li>(c) All companies where the reporting bank exercises management control.</li> </ul>
A.3	Fellow Subsidiaries	Deposits from companies in the same group as the reporting bank. A company is considered to be in the same group as the reporting bank if it is a subsidiary of the ultimate parent of the reporting bank.
A.4	Other Deposit Takers	All deposits from banks and other deposit taking institutions, such as building societies.
A.5	Retail Accounts	Deposits taken and held in accounts for named individuals.
A.6	Corporate / Trust / Fiduciary	Deposits from corporates, trusts and deposits received on a fiduciary basis (as recipient bank).

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
A.7	All Other Depositors	All deposits not falling within categories A.1 to A.6.
	<b>SUBTOTAL</b>	<b>Calculated by the sheet, being the sum of A.1 to A.7.</b>
<b>B</b>	<b>CDs and Other Debt</b>	
B.1	Certificates of deposit issued	CDs issued by the reporting bank.
B.2	Promissory notes, bills and other short term paper issued	All other short term paper (less than one year) issued by the reporting bank.
B.3	Non - Capital term debt issued	All other debt issued by the reporting bank, excepting only where the debt is eligible for inclusion as regulatory capital.
	<b>SUBTOTAL</b>	<b>Calculated by the sheet, being the sum of B.1 to B.3.</b>
<b>C</b>	<b>Creditors &amp; Accruals etc</b>	
C.1	Interest payable	Interest accrued but not paid.
C.2	Creditors and accruals	Amounts owed to all creditors of the reporting bank, except in relation to items to be reported in C.7 or C.8.
C.3	Current taxation	Taxation accrued for the current year but not paid.
C.4	Other taxation	All other amounts accrued for taxation but not paid.
C.5	Settlement balances	Settlement amounts due to be paid.
C.6	Items in suspense	All amounts payable in suspense.
C.7	Provisions	Any provisions that are treated as liabilities (excluding general/collective provisions, which are included in portfolio D below).
C.8	Dividends payable	Dividends proposed/declared by the bank not yet paid which are recognised as liabilities.
C.9	Other liabilities	Any liability item not falling within one of the other above categories.
	<b>SUBTOTAL</b>	<b>Calculated by the sheet, being the sum of C.1 to C.9.</b>
<b>D</b>	<b>Capital (<i>for incorporated banks</i>)</b>	

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
D.1	Tier 1 capital items, before deductions	All tier 1 capital items before deductions ( <i>total to match amount reported in form SR-2A, capital section, line A.6</i> ).
D.2	Tier 2 capital items, before deductions	All tier 2 capital items before deductions ( <i>total to match amount reported in form SR-2A, capital section, line B.7</i> ).
D.3	Capital items falling outside of regulatory capital	Any items that are accounted for as capital, but that do not meet the Commission's definition of regulatory capital.
	<b>SUBTOTAL</b>	<b>Calculated by the sheet, being the sum of D.1 to D.3.</b>
<b>D</b>	<b>Capital (for branches)</b>	
D.1	Retained profits	Profits retained in the branch.
D.2	General / collective provisions	General/collective provisions made in respect of lending.
D.3	Capital issued by the branch	Instruments issued by the branch that are components of regulatory capital for the legal entity.
D.4	Capital items – other working capital	Any other working capital.
	<b>SUBTOTAL</b>	<b>Calculated by the sheet, being the sum of D.1 to D.4.</b>
	<b>TOTAL LIABILITIES</b>	<b>Total of amounts reported above, calculated by the sheet as the sum of the subtotals A to D.</b>

## Off balance sheet items

Item	Nature of Item	Guidance
<b>A</b>	<b>Off Balance Sheet Commitments</b>	
A.1	Direct Credit Substitutes	<p>Direct credit substitutes almost always relate to the financial wellbeing of a third party. In this case, the risk of loss to the reporting bank from the transaction is equivalent to a direct claim on that party, i.e. the risk of loss depends on the creditworthiness of the third party.</p> <p><i>Note that the total for this feeds item M.1 “amount” in form SR-1B for incorporated banks.</i></p>
A.2	Transaction Related Contingencies	<p>Transaction related contingents relate to the ongoing trading activities of a counterparty, where the risk of loss to the reporting bank depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. They are essentially guarantees that support particular financial obligations, rather than supporting customers’ general financial obligations.</p> <p><i>Note that the total for this feeds item M.2 “amount” in form SR-1B for incorporated banks.</i></p>
A.3	Trade Related Contingencies	<p>These comprise short-term, self liquidating trade related items, such as documentary letters of credit issued by the reporting bank, which are, or are to be, collateralised by the underlying shipment, i.e. where the credit provides for the reporting bank to retain title to the underlying shipment.</p> <p><i>Note that the total for this feeds item M.3 “amount” in form SR-1B for incorporated banks.</i></p> <p><i>Note: Such items should be weighted (for risk weighting purposes) according to the counterparty on whose behalf the credit is issued whether or not the terms and conditions of the credit have yet to be complied with.</i></p>

Item	Nature of Item	Guidance
A.4	Asset sales with recourse	<p>Asset sales with recourse (where the credit risk remains with the bank) fall into the weighting category determined by the asset and not the counterparty with whom the transaction has been entered into.</p> <p>Put options written where the holder of the asset is entitled to put the asset back to the reporting bank, e.g. if the credit quality deteriorates, should be reported here, as should put options written by the reporting bank attached to marketable instruments or other physical assets.</p> <p><i>Note that the total for this feeds item M.4 "amount" in form SR-1B for incorporated banks.</i></p>
A.5	Forward asset purchases	<p>Include commitments for loans and other balance sheet items with committed drawdown. Exclude foreign currency spot deposits with value dates one or two working days after trade date.</p> <p><i>Note that the total for this feeds item M.5 "amount" in form SR-1B for incorporated banks.</i></p>
A.6	Partly paid up shares and securities	<p>The unpaid part should only be included if there is a specific date for the call on that part of the shares and securities held.</p> <p><i>Note that the total for this feeds item M.6 "amount" in form SR-1B for incorporated banks.</i></p>
A.7	Forward deposits placed	<p>These comprise commitments to place deposits in the future.</p> <p>Where the reporting bank has instead contracted to receive the deposit, failure to deliver by the counterparty will result in an unanticipated change in its interest rate exposure and may involve a replacement cost. Such exposures should therefore be treated as interest rate contracts (see B.1).</p> <p><i>Note that the total for this feeds item M.7 "amount" in form SR-1B for incorporated banks.</i></p>
A.8	Note Issuance and Revolving Underwriting Facilities	<p>Note issuance facilities and revolving underwriting facilities should include the total amounts of the reporting bank's underwriting obligations of any maturity. Where the facility has been drawn down by the borrower and the notes are held by anyone other than the reporting bank, the underwriting obligation should continue to be reported at the full nominal amount.</p> <p><i>Note that the total for this feeds item M.8 "amount" in form SR-1B for incorporated banks.</i></p>

Item	Nature of Item	Guidance
A.9 and A.10	Other commitments split into those with original maturity of less than 1 year (A.9) and 1 year or over (A.10)	<p>The bank is regarded as having a commitment from the date the customer is advised of the facility (e.g. the date of the letter advising the customer), regardless of whether the commitment is revocable or irrevocable, conditional or unconditional and in particular whether or not the facility contains a “material adverse change” clause. Facilities subject to annual review should only be classified within A.9, rather than A.10, if the bank is confident there is no client expectation of automatic renewal.</p> <p><i>Note that the totals for these feed items M.9a and M.9b “amount” in form SR-1B for incorporated banks.</i></p>
A.11	Commitments that are unconditionally cancellable without prior notice	<p>Commitments (including the undrawn portion of any binding arrangements which obligate the reporting bank to provide funds at some future date) that are unconditionally cancellable without prior notice other than for “force majeure” reason, or that effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness. This also includes any revolving or undated/open-ended commitments, (e.g. overdrafts or unused credit card lines) provided that they can be unconditionally cancelled at any time and are subject to credit review at least annually. Facilities should only be classified here, rather than in A.9/10, if the bank is confident that the client is aware of both the review process and has confirmed that the facility may be withdrawn at any time.</p> <p><i>Note that the total for this feeds item M.9c “amount” in form SR-1B for incorporated banks.</i></p>
<b>A</b>	<b>SUBTOTAL</b>	<b>Subtotal of amounts reported in “A: Off-balance sheet commitments”, calculated by the sheet as the sum of A.1 to A.11.</b>

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
<b>B</b>	<b>OTC Contracts</b>	
B.1	Interest rate contracts	Report the total nominal of all OTC contracts, sub-categorised by type, excluding only netted amounts that qualify for inclusion in C.1.
B.2	Foreign exchange and gold contracts	
B.3	Equity contracts	
B.4	Other precious metal contracts	
B.5	Other commodity contracts	
<b>B</b>	<b>SUBTOTAL</b>	<b>Subtotal of amounts reported in “B: OTC contracts”, calculated by the sheet as the sum of B.1 to B.5.</b>
<b>C</b>	<b>Netted Exposures</b>	
C.1	Netted Exposures	Report the netted amount where OTC derivative transactions are covered by a valid bilateral netting agreement.
<b>C</b>	<b>SUBTOTAL</b>	<b>Subtotal of amounts reported in “C: Netted Exposures”, calculated by the sheet as being equal to C.1</b>
	<b>Total Off-Balance Sheet Items</b>	<b>Total reported above, calculated by the sheet as the sum of subtotals A to C.</b>

## CHAPTER 3

### GUIDANCE – FORM SR-1B

#### (FOR BANKS INCORPORATED IN THE ISLE OF MAN ADOPTING THE SIMPLIFIED STANDARDISED APPROACH TO CREDIT RISK)

##### SECTION 1 – GLOSSARY

The following abbreviations are used within this chapter:-

CIS	-	Collective Investment Scheme
CRM	-	Credit Risk Mitigation
CCF	-	Credit Conversion Factor
CEA	-	Credit Equivalent Amount
ECA	-	Export Credit Agency
LTV	-	Loan-To-Value
MDB	-	Multilateral Development Bank
OTC	-	Over-The-Counter
RWA	-	Risk-Weighted Amount
SSA	-	Simplified Standardised Approach to credit risk

##### SECTION 2 – INTRODUCTION AND OVERVIEW

Every bank that uses the simplified standardised approach to calculate its credit risk capital requirement will be required to complete form SR-1B. The return covers the bank's balance sheet assets and off-balance sheet exposures in its banking book, including OTC derivative contracts.

###### Definitions and clarifications

**Amounts:** should be reported net of specific provisions for all balance sheet assets and off-balance sheet exposures other than OTC derivative transactions. Specific provisions for OTC derivative transactions should be deducted from the credit equivalent amount.

**Amount after CRM:** means the reported amount, adjusted for the capital effect of recognised CRM techniques. The latter refers to techniques the bank may use to mitigate credit risk and hence reduce the capital requirement of a credit exposure. Three types of CRM techniques are recognised for this purpose:

- Collateral;
- Guarantees; and
- Credit derivatives.

In order to be recognised, a CRM technique should satisfy the relevant operational requirements and conditions set out in **Annex F to this chapter**.

Double counting of exposures arising from the same contract or transaction should be avoided. For example, only the undrawn portion of a loan commitment should be reported

as an off-balance sheet exposure; the actual amount which has been lent will be reported as a balance sheet asset in the relevant portfolio. Trade-related contingencies such as shipping guarantees for which the exposures have already been reported as letters of credit issued or loans against import bills are not required to be reported as trade-related contingencies. In certain cases, credit exposures arising from derivative contracts may already be reflected, in part, on the balance sheet. For example, the reporting bank may have recorded current credit exposures to counterparties (i.e. mark-to-market values) under foreign exchange and interest rate related contracts on the balance sheet, typically as either sundry debtors or sundry creditors. To avoid double counting, such exposures should be excluded from the balance sheet assets and treated as off-balance sheet exposures for the purposes of this return.

Accruals on a claim should be classified and weighted in the same way as the claim. Accruals that cannot be so classified, e.g. due to systems constraints, should be categorised within “Other, including prepayments and debtors” within Portfolio L.

### **SECTION 3 - PORTFOLIO CLASSIFICATION AND RISK WEIGHTS: BALANCE SHEET ASSETS**

#### Portfolio classification

Within the module, the balance sheet is organised as follows:

- Portfolio A - Sovereigns
- Portfolio B - Public sector entities (PSEs)
- Portfolio C - Corporates
- Portfolio D - Banks
- Portfolio E – Securitisation exposures
- Portfolio F - Cash and similar items
- Portfolio G - Retail
- Portfolio H – Residential mortgages
- Portfolio J – Past due exposures
- Portfolio K – Capital deductions
- Portfolio L – Other balance sheet exposures

Each Portfolio is mutually exclusive and each asset should be reported in only one Portfolio. For instance, any asset which is past due should only be reported in Portfolio J and not elsewhere.

#### Collective investment schemes

Exposures to collective investment schemes should be categorised as equity, except that:

- Exposures to a fixed income fund should be categorised within “Other” in Portfolio L;
- Investments in venture capital and private equity schemes should be categorised within “High Risk Assets” in Portfolio L.

## Determination of risk weights

The risk weight for an asset in Portfolios A, B and D is generally determined from the consensus risk scores of ECAs participating in the “OECD Arrangement on Officially Supported Export Credits”. The consensus country risk classification is available on the OECD’s website ([www.oecd.org](http://www.oecd.org)).

Each of these three consensus ECA country score based Portfolios has its own risk-weighting framework. **Annex A** sets out how, for each Portfolio, different country scores are mapped to risk weights.

The following subsections explain how assets in each Portfolio are risk-weighted and, where applicable, the relevant principles for reporting assets under the Portfolio.

### Portfolio A: Claims on sovereigns

Item	Description of Item	Guidance														
A.1	Claims on Isle of Man Government	Claims on the Isle of Man Government are risk-weighted at 0%. For the difference between a sovereign claim and a claim on a public sector entity refer to <b>Annex B</b> .														
A.2	Claims on other sovereigns	Claims on the other Crown Dependencies and UK Governments are risk weighted at 0%. All claims on other sovereigns should be weighted in accordance with the consensus ECA country score as follows:														
		<table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3</th> <th>4 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>0%</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Country Score	0-1	2	3	4 - 6	7	Unrated	Risk Weight	0%	20%	50%	100%	150%	100%
		Country Score	0-1	2	3	4 - 6	7	Unrated								
		Risk Weight	0%	20%	50%	100%	150%	100%								
Despite the above, where an equivalent regulator* exercises its discretion to permit banks in its jurisdiction to allocate a lower risk weight to claims on that jurisdiction’s sovereign denominated in the domestic currency of that jurisdiction and funded in that currency, the same lower risk-weight may be allocated to such claims.																
For the difference between a sovereign claim and a claim on a public sector entity refer to <b>Annex B</b> .																
A.3	Claims on Multilateral Development Banks	All claims on multilateral development banks (“MDB”s) are risk weighted at 0%. <b>Annex C</b> contains a list of eligible MDBs.														

\* An “equivalent regulator” for the purposes of this document is one that is considered by the Commission to regulate banks under a Basel II regime in a manner that is broadly equivalent to the Commission’s regulation. For example, the Commission considers the other Crown Dependency Commissions and the Financial Services Authority to be equivalent regulators. The Commission has not published a list of regulators that it deems to be equivalent; the Commission will only assess regulators where a bank requests it.

Portfolio B: Claims on public sector entities (PSEs)

Item	Description of Item	Guidance												
B.1	Claims on Isle of Man PSEs	Includes all exposures to non-central Isle of Man Government PSEs, unless they may be treated as a sovereign claim as explained in <b>Annex B</b> , in which case the claim can be reported in portfolio A. Claims on these exposures are risk-weighted at 20%.												
B.2	Claims on other PSEs	Claims on other Crown Dependency and UK PSEs are risk weighted at 20%. All claims on other PSEs should be weighted in accordance with the consensus ECA country score as follows:												
		<table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Country Score	0-1	2	3 - 6	7	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Country Score	0-1	2	3 - 6	7	Unrated							
		Risk Weight	20%	50%	100%	150%	100%							
If claims on a foreign PSE are regarded as claims on the sovereign, for the purposes of capital adequacy calculation by an equivalent regulator of the jurisdiction in which the PSE is established, then such a claim may instead be disclosed in Portfolio A at the risk weight applicable to that sovereign.														

Portfolio C: Claims on corporates

Item	Description of Item	Guidance
C	Claims on Corporates	All claims on Corporates should be weighted at 100%.

Portfolio D: Claims on banks

Claims on banks arising from bank guarantees received should be split from all other claims. All claims are then further divided into those with original effective maturity of 3 months or less from drawdown and those longer than 3 months from drawdown.

Item	Description of Item	Guidance												
D.1.1	Claims on banks, except guarantees: Maturity more than 3 months	Claims on banks should be weighted in accordance with the consensus ECA country score of the country in which they are incorporated, as follows:												
		<table border="1"> <thead> <tr> <th>Country Score</th> <th>0-1</th> <th>2</th> <th>3 - 6</th> <th>7</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Country Score	0-1	2	3 - 6	7	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Country Score	0-1	2	3 - 6	7	Unrated							
Risk Weight	20%	50%	100%	150%	100%									
D.1.2	Claims on banks, except guarantees: Maturity less than 3 months	Sterling denominated short-term claims on banks incorporated in the Isle of Man, Jersey, Guernsey and the UK are risk weighted at 20%. Where an equivalent regulator exercises a similar discretion to allocate a lower risk weight to short term claims on that jurisdiction's sovereign denominated in the domestic currency of that jurisdiction, the same lower risk-weight may be allocated to such claims.												
D.2	Claims secured by guarantees from banks	Claims guaranteed by banks should be shown separately in this section using the mappings for a direct claim on the bank giving the guarantee (as above). The relevant maturity is that of the underlying claim. Note that such claims are shown in the "Amount after CRM" column, in accordance with <b>Section 4</b> .												

Portfolio E: Securitisations

Item	Description of Item	Guidance
E	Securitisation	The risk weight for securitisation exposures is 100%. For first loss positions acquired, deduction from capital will be required – disclose in Portfolio K.5.

Portfolio F: Cash and similar items

Item	Description of Item	Guidance
F.1	Notes and coins	Notes and coins are allocated a risk weight of 0%.
F.2	Cash items in the course of collection	Cash items in the course of collection refer to the amount of cheques, drafts and other items drawn on other banks that will be paid for the account of the bank immediately upon presentation and that are in the process of collection. Such items are allocated a risk weight of 20%.
F.3	Gold	Gold has a risk weight of 0%. However, the net position in gold is subject to a market risk charge, which for the standardised approach broadly equates to a 100% weight for the net position.
F.4	Claims fully collateralised by cash deposits	<p>The bank should report here claims collateralised by cash deposits (<b>see Section 4</b>). Claims secured by cash deposits should be recorded under the column headed "Amount after CRM". These are then allocated a risk weight of 0%.</p> <p>When a cash deposit is held as collateral at a third-party bank in a non custodial arrangement, the bank should treat the cash deposit as a claim on that third-party bank and report it within Portfolio D.2.</p>

Portfolio G: Retail exposures

Item	Description of Item	Guidance
G.1	Claims in "Regulatory Retail Portfolio"	Claims that qualify for this Portfolio are allocated a risk weight of 75%. To apply the risk weight of 75% to claims on small businesses or individuals, the bank must satisfy the relevant criteria set out in <b>Annex H</b> . Claims that are not past due but do not satisfy the criteria for inclusion as regulatory retail exposures should be reported in Portfolio G.2.
G.2	Claims falling outside the "Regulatory Retail Portfolio"	Claims on small businesses or individuals other than those qualifying for inclusion in Portfolio G.1. Such claims are allocated a risk weight of 100%.

Portfolio H: Residential mortgages

Item	Description of Item and Risk Weighting	Guidance
H.1	Residential Mortgages: 35%	Residential Mortgages that meet all the criteria set out in <b>Annex H</b> are assigned a weighting of 35% for that portion below 80% LTV.
H.2	Residential Mortgages: 50%	<p>Residential Mortgages that meet all the criteria set out in <b>Annex H</b> except for either:</p> <ul style="list-style-type: none"> <li>• Mortgages for which the bank's systems do not hold adequate LTV information; or</li> <li>• Mortgages in jurisdictions other than those where the local regulator is deemed equivalent, has adopted Basel II, has evaluated the local market and deemed a weight of 35% to be appropriate.</li> </ul> <p>Those mortgages in the above two categories are assigned a risk weighting of 50%.</p>
H.3	Residential Mortgages: 75%	Residential Mortgages that meet all the criteria set out in <b>Annex H</b> are assigned a weighting of 75% for that portion above 80% LTV.
H.4	Residential Mortgages: 100%	Residential Mortgages that do not meet the criteria set out in <b>Annex H</b> , other than those that qualify for inclusion in H.2, are assigned a risk weight of 100%.

Portfolio J: Past due exposures

For the purpose of defining the secured portion of a past due loan, eligible collateral and guarantees will be treated in line with the credit risk mitigation process detailed in **Section 4**.

Item	Description of Item	Guidance
J.1	Secured	<p>The secured part of any past due exposure i.e. that part that meets the terms for eligible CRM, as set out in <b>Section 4</b>, should be reported here. The risk weight is unaffected providing the terms of the CRM remain fulfilled.</p> <p>The exception is the case of qualifying residential mortgage loans. When such loans are past due for more than 90 days, they must be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50%.</p>
J.2	Unsecured	<p>The unsecured portion of any loan that is past due for more than 90 days, net of specific provisions, including partial write-offs, will be risk-weighted as follows:</p> <ul style="list-style-type: none"><li>• <i>150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan;</i></li><li>• <i>100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan but less than 50%;</i></li><li>• <i>50% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan.</i></li></ul>

## Portfolio K: Capital deductions

These items require full deduction from capital and therefore do not contribute to RWA.

<b>Item</b>	<b>Description of Item</b>	<b>Guidance</b>
K.1	Investment in Subsidiaries	All investments in subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies. Associated companies are those with whom the bank has entered into joint ventures or where the bank owns a material shareholding. A shareholding that exceeds 20% would ordinarily be considered material.
K.2	Capital connected lending	All lending of a capital nature to subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies.
K.3	Holdings of financial services business' capital instruments	All investments in other financial service business' capital instruments not captured above.
K.4	Goodwill and other intangible fixed assets	All intangible assets should be deducted from capital, including goodwill.
K.5	Securitisations - equity tranches	Includes all first loss tranches.
K.6	Other	All items that require a full deduction as a result of specific or general guidance and that do not fall within Portfolios K.1 to K.5.

Portfolio L: Other balance sheet exposures

Item	Description of Item and Risk Weighting	Guidance
L.1	Tangible fixed assets 100%	Premises, plant and equipment, other fixed assets for own use, and other interests in realty. Included are investments in land, premises, plant and equipment and all other fixed assets of the reporting bank which are held for its own use, including any fixed asset held by the bank as lessee under a finance lease. Other interest in land which is not occupied or used in the operation of the bank's business should also be reported here.
L.2	Equity 100%	Investments in equity of other entities and holdings of collective investment schemes. Included are investments in commercial entities, other than those where a deduction from capital base is required. Collective investment schemes should be included unless they invest in high risk assets, in which case they are categorised as such, or they are fixed income (only debt investments, not equity) in which case they are categorised within L.4.
L.3	High Risk Assets 150%	Investments in venture capital and private equity, including investments in collective investment schemes holding such investments, are weighted at 150%.
L.4	Other, including prepayments and debtors 0-150%	Accrued interest, prepayments and debtors should be classified here and weighted according to the underlying counterparty. Unallocated amounts, including unallocated interest, should be weighted at 100%. This includes unrestricted fixed income collective investment schemes (see L.2 above).

## **SECTION 4 - CREDIT RISK MITIGATION AND ASSOCIATED CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: BALANCE SHEET ASSETS**

### Introduction

For each balance sheet asset, the RWA is calculated by multiplying its “Amount after CRM” by an appropriate risk weight determined by the type of exposure, as set out in **Section 3**.

Where an asset is not covered by any recognised CRM techniques (**see Section 2 and Annex F**), the amounts reported under the columns headed “Amount” and “Amount after CRM” will be the same. Where an asset is covered wholly or partially by recognised CRM techniques (**see Section 2 and Annex F**), the amount reported under the column of “Amount after CRM” should be adjusted to reflect the CRM effect.

**Annex G** contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

### CRM treatment

The first step is to identify the Portfolio to which the underlying claim belongs, based on the instructions set out in **Section 3**, then report the whole principal of the claim under the column of “Amount” in that Portfolio, classified according to the risk weight applicable to that claim.

The “Amount” is divided into two portions: the portion covered by credit protection and the remaining uncovered portion.

- For guarantees and credit derivatives, the value of credit protection to be recorded is their nominal value. However, where the credit protection is denominated in a currency different from that of the underlying obligation, the covered portion should be reduced by a haircut for the currency mismatch of 10%;
- For collateral, the value of credit protection to be recorded is its market value subject to a minimum revaluation frequency of 6 months for performing assets, and 3 months for past due assets (if this is not achieved then no value can be recognised);
- Where the collateral involves cash deposits, certificates of deposit, cash funded credit-linked notes, or other comparable instruments which are held at a third-party bank in a non-custodial arrangement and unconditionally and irrevocably pledged or assigned to the reporting bank, the collateral will be allocated the same risk weight as that of the third-party bank.

The covered and uncovered portions are reported according to the following:

- Where the asset covered by CRM is not past due, report the amount of the covered portion in the Portfolio to which the credit protection belongs, under the column of “Amount after CRM”, classified according to the risk weight applicable to the credit protection (subject to a 20% floor, which can be reduced in situations set out in **Annex D**);

- Where the asset covered by CRM is past due, the amount of the covered portion should be included in Portfolio J - Past Due Exposures and reported under the column of “Amount after CRM” in accordance with the risk weight applicable to the credit protection.

In both cases, the RWA of the covered portion is then calculated by multiplying the amount of the covered portion by the risk weight attributed to the credit protection in accordance with **Section 3**.

However, where the credit protection takes the form of a credit derivative contract with the following features, there are certain additional guidelines the bank should follow in determining the extent of credit protection:

*Where the contract is a first-to-default credit derivative contract, the bank may recognise regulatory capital relief for the asset within the basket with the lowest risk weight, provided that the amount of that asset is less than or equal to the notional amount of the credit derivative. The bank may substitute the risk weight of the protection seller for the risk weight of that asset.*

*Where the contract is a second-to-default credit derivative contract, the reporting bank may substitute the risk weight of the protection seller for the risk weight of the reference entity with the second lowest risk weight in the basket of reference entities specified in the contract, but only if:*

- The bank has, as a protection buyer, entered into a first-to-default credit derivative contract relating to the same basket of reference entities; or
- A reference entity in the basket has defaulted.

Lastly, report the amount of the remaining uncovered portion in the Portfolio to which the underlying claim belongs, under the column of “Amount after CRM”, classified according to the risk weight of the underlying claim. The reported RWA of the uncovered portion will then be calculated by multiplying the amount of the uncovered portion by the risk weight of the claim.

### ***Credit protection by means of credit-linked notes***

For credit-linked notes, where the bank issues such a note to cover the credit risk of an underlying asset, the maximum amount of protection is the amount of the funds received from issuing that note. The protected amount should be treated as a claim collateralised by cash deposits in Portfolio F, while the remaining unprotected amount, if any, should be treated as a credit exposure to the underlying asset.

Where the bank holds a credit-linked note, it acquires credit exposure on two fronts, to the reference entity of the note and also to the note issuer. This balance sheet asset should be weighted according to the higher of the risk weight of the reference entity or the risk weight of the note issuer and reported accordingly in the relevant Portfolio. The amount of exposure is the book value of the note.

**SECTION 5 - PORTFOLIO CLASSIFICATION, DETERMINATION OF CREDIT CONVERSION FACTORS AND RISK WEIGHTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES**

Categorisation and determination of CCFs

The bank should categorise off-balance sheet exposures into the following standard items and report:

- The amount (which is automatically generated from form SR-1A); and
- The amount after allowing for credit risk mitigation and applying CCF, categorised by risk weight.

<b>Item</b>	<b>Description of Item</b>	<b>Guidance</b>	<b>CCF</b>
M.1	Direct credit substitutes	Direct credit substitutes almost always relate to the financial wellbeing of a third party. In this case the risk of loss to the bank from the transaction is equivalent to a direct claim on that party, i.e. the risk of loss depends on the creditworthiness of the third party.	100%
M.2	Transaction related contingencies	Transaction related contingents relate to the ongoing trading activities of a counterparty where the risk of loss to the bank depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. They are essentially guarantees that support particular financial obligations rather than supporting customers' general financial obligations.	50%
M.3	Trade-related contingencies	These comprise short-term, self liquidating trade-related items, such as documentary letters of credit issued by the bank, which are, or are to be, collateralised by the underlying shipment, i.e. where the credit provides for the bank to retain title to the underlying shipment. Such items should be risk weighted according to the counterparty on whose behalf the credit is issued whether or not the terms and conditions of the credit have yet to be complied with.	20%

Item	Description of Item	Guidance	CCF
M.4	Asset sales with recourse	<p>Asset sales with recourse (where the credit risk remains with the bank) fall into the risk weighting category determined by the asset and not the counterparty with whom the transaction has been entered into.</p> <p>Put options written where the holder of the asset is entitled to put the asset back to the reporting bank, e.g. if the credit quality deteriorates, should be reported here, as should put options written by the reporting bank attached to marketable instruments or other physical assets.</p>	100%
M.5	Forward asset purchases	The risk weight should be determined by the asset to be purchased, not the counterparty with whom the contract has been entered into. Include commitments for loans and other balance sheet items with committed drawdown. Exclude foreign currency spot deposits with value dates one or two working days after trade date.	100%
M.6	Partly paid-up shares and securities	The unpaid part should only be included if there is a specific date for the call on that part of the shares and securities held.	100%
M.7	Forward deposits placed	<p>These include a commitment to place a forward deposit.</p> <p>Where the bank has instead contracted to receive the deposit, failure to deliver by the counterparty will result in an unanticipated change in its interest rate exposure and may involve a replacement cost. Its exposure should therefore be treated as an interest rate contract (<b>see Section 7</b>).</p>	100%
M.8	Note issuance and revolving underwriting facilities	Note issuance facilities and revolving underwriting facilities should include the total amounts of the bank's underwriting obligations of any maturity. Where the facility has been drawn down by the borrower and the notes are held by anyone other than the bank, the underwriting obligation should continue to be reported at the full nominal amount.	50%
M.9a	Other commitments with original maturity of less than 1 year	The bank is regarded as having a commitment from the date the customer is advised of the facility (e.g. the date of the letter advising the customer), regardless of whether the commitment is revocable or	20%

Item	Description of Item	Guidance	CCF
M.9b	Other commitments with original maturity of 1 year and over	irrevocable, conditional or unconditional and in particular whether or not the facility contains a “material adverse change” clause. Facilities subject to annual review should only be classified within M.9a if the bank is confident there is no client expectation of automatic renewal/continuation.	50%
M.9c	Commitments that are unconditionally cancellable without prior notice	<p>Commitments (including the undrawn portion of any binding arrangements which obligate the bank to provide funds at some future date) that are unconditionally cancellable without prior notice by it other than for “force majeure” reason, or that effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness.</p> <p>Retail credit lines may be considered as unconditionally cancellable if the terms permit the bank to cancel them to the full extent allowable under consumer protection and related legislation.</p> <p>Where a bank has entered into a so called “uncommitted facility” and it is apparent that the facility is commercially (if not legally) committed, consideration should be given to applying a capital charge to such a facility under Pillar 2 (the ICAAP) which might be equivalent to the charge that would be applicable if there was a legally enforceable commitment.</p>	0%

## Determination of risk weights for off-balance sheet items excluding OTC Derivatives

Except for the following, the applicable risk weight for an off-balance sheet item is determined by reference to the risk weight allocated to the counterparty of the exposure, in accordance with the relevant instructions under **Section 3**. The exceptions are:

- “Direct credit substitutes”;
- “Asset sales with recourse”;
- “Forward asset purchases”;
- “Partly paid-up shares and securities”; and
- Exposures arising from the selling of credit derivative contracts booked in the reporting bank’s banking book reported as “Direct credit substitutes”.

For these, the applicable risk weight to an exposure should be:

*In the case of “Direct credit substitutes”, “Asset sales with recourse” and “Forward asset purchases”, the risk weight is determined by reference to the risk weight allocated to the underlying asset;*

*In the case of “Partly paid-up shares and securities”, use the risk weight for the equities in question (usually 100%); and*

*In the case of exposures arising from the selling of credit derivative contracts booked in the reporting bank’s banking book reported as “Direct credit substitutes”, the risk weight is normally determined by reference to the risk weight of the relevant reference entity. However:*

- Where a credit derivative contract sold is a first-to-default credit derivative contract, the bank should report as per the aggregate risk weights of the reference entities in the basket, subject to a maximum of 1000%.
- Where a credit derivative contract sold is a second-to-default credit derivative contract, the bank should aggregate the risk weights of the reference entities in the basket, but excluding that reference entity to which the lowest risk weight would be allocated, subject to a maximum of 1000%.
- Where a credit derivative contract sold provides credit protection proportionately to a basket of reference entities, in ratios set out in the credit derivative contract, the bank should calculate the risk weight of its exposure under the credit derivative contract by taking a weighted average of the risk weights attributable to the reference entities in the basket. For the purpose of reporting in form SR-1B M.1, the weighted average risk weight should be entered as a round number (e.g. if the average weighting was 25.64% the amount should be entered in the form as 26).

## **SECTION 6 - CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES**

### Introduction

For each off-balance sheet exposure, the bank is required to identify the relevant risk weight for the counterparty by reference to what this would be for a balance sheet exposure to the same counterparty.

Where an exposure is not covered by any recognised CRM techniques the process for calculating the capital requirement is:

- Firstly, enter the “Amount” (this is automated within the form software), which is converted into a “Credit Equivalent Amount” by multiplying it by the applicable CCF;
- Secondly, the “Credit Equivalent Amount” is classified by the applicable risk weighting, which is then used to calculate the RWA.

Where an exposure is covered fully or partially by recognised CRM techniques, the capital treatment is similar to that of balance sheet assets set out in **Section 4**, except that, in calculating the RWA, the “Credit Equivalent Amount” (“CEA”) is used instead of the “Amount”.

**Annex G** contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

### CRM treatment by substitution of risk weights

Report the amount of the exposure in the row “Amount”, classified according to **Section 5**.

Divide the amount into two portions: the portion covered by credit protection and the remaining uncovered portion (the value of the credit protection for different types of CRM techniques being determined in the same way as when the techniques are used to cover balance sheet assets – **see Section 4**).

Multiply both portions by the CCF applicable to the exposure to create two CEAs (the total of which must equate to the CEA given by the sheet).

Classify the CEA of the uncovered portion according to the risk weight of the exposure and the CEA of the covered portion according to the risk weight of the collateral (subject to a 20% floor which can be reduced in the situations set out in **Annex D**) or, for a guarantee or credit derivative, the credit protection provider. These inputs will then be used by the module to arrive at the risk weighted amount by multiplying each CEA by the appropriate weight.

## **SECTION 7 - PORTFOLIO CLASSIFICATION: OFF-BALANCE SHEET EXPOSURES: OTC DERIVATIVES**

### OTC contracts summary

For OTC contracts, all information and calculation is performed within the relevant schedule. The OTC form is a summary of the results of the individual schedules.

<b>Item</b>	<b>Description of Item</b>	<b>Guidance</b>
N.1	Interest rate contracts	Summary, automatically completed from the data input in Schedule N.1
N.2	Foreign exchange and gold contracts	Summary, automatically completed from the data input in Schedule N.2
N.3	Equity contracts	Summary, automatically completed from the data input in Schedule N.3
N.4	Other precious metal contracts	Summary, automatically completed from the data input in Schedule N.4
N.5	Other commodity contracts	Summary, automatically completed from the data input in Schedule N.5

### OTC contract Schedules

*OTC N.1:* The following derivative contracts may be excluded from the calculation of RWA:

- Exchange rate contracts (except those which are based on gold) with an original maturity of 14 calendar days or less; or
- Forward exchange rate contracts arising from swap deposit arrangements. Under such contracts, the money deposited by the customer remains under the control of the bank at all times during the transaction and the bank will be in a position to ensure that the customer does not default on the settlement of the forward contract.

### Categorisation and add-on factors for OTC derivative contracts

The add-on factors, used to determine the Credit Equivalent Amount applicable to OTC derivative transactions, are set out in the following table according to their residual maturities:

	Interest Rate	FX and Gold	Equities	Precious Metals (except Gold)	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over 1 year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

For contracts structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity should be set equal to the time until the next reset date. In the

case of interest rate contracts that meet these criteria, and the remaining time to final maturity of the contracts is more than one year, the add-on factor is subject to a floor of 0.5%.

Forwards, swaps, purchased options and similar derivative contracts other than those contracts the value of which is derived from the value of exchange rate, gold, interest rate, equity, or precious metal, should have applied the add-on factors applicable to "Other Commodities".

## **SECTION 8 - CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - OTC DERIVATIVES**

The reporting bank should use the replacement cost method to risk weight credit exposures to counterparties under OTC derivatives. OTC derivative transactions should be reported in Schedules N.1 to N.5. Where OTC derivative transactions are covered by a valid bilateral netting agreement, the bank may report the netted amount under item P in the OTC Summary page.

Report the “Amount” outstanding, being the total nominal value of all relevant OTC contracts classified according to type, maturity and the risk weighting of the counterparty. Insert the sum of any and all positive mark-to-market valuations relating to these contracts in the column headed “Positive Mark-to-Market”, which is the replacement cost (obtained by “marking to market”) of every contract with a positive value (where a contract has a negative value, it should be taken as zero), or where contracts are covered by a valid bilateral netting agreement, the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the bilateral netting agreement, if positive.

The “Credit Equivalent Amount” will then be the sum of:

- The “Positive Mark-to-Market”; and
- The “Add-on Amount”, which is derived by multiplying the “Amount” of each contract by the appropriate “add-on factor” for that classification (as set out in **Section 7**).

Single currency floating/floating (basis) interest rate swaps should be classified as being less than 1 year to maturity and hence attract an add-on of 0%; the “Credit Equivalent Amount” is simply the positive mark-to-market.

In the absence of CRM, report the “Credit Equivalent Amount” in the column headed “Amount after CRM”. Allowance for specific provisions can be made by deducting these from the “Credit Equivalent Amount”. Note that the sheet will provide an unadjusted “Credit Equivalent Amount” that should be used if there are no provisions. This would then be multiplied by the applicable risk weight to calculate the RWA.

Where the (net) exposure to the counterparty is protected fully or partially by recognised CRM techniques, the capital treatment is similar to that of balance sheet assets explained in **Section 4**, albeit in calculating the RWA, the “Credit Equivalent Amount” is used instead of the “Amount”.

**Annex G** to this chapter contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures.

### **CRM treatment**

Report the amount of the underlying transaction under the column “Amount”.

Convert the “Amount” into a “Credit Equivalent Amount” as set out above. Specific provisions should be deducted from the “Credit Equivalent Amount”.

Divide the “Credit Equivalent Amount” into two portions: the portion covered by credit protection and the remaining uncovered portion.

In the “After CRM”, column classify the “Credit Equivalent Amount” of the uncovered portion according to the applicable risk weight of the exposure and the “Credit Equivalent Amount” of the covered portion according to the applicable risk weight of the collateral (subject to a floor of 20% which can be reduced in the situations set out in **Annex D**) or credit protection provider. Each amount will be multiplied by the appropriate risk weight to arrive at the risk-weighted amount.

## **SECTION 9 - CREDIT RISK MITIGATION – SPECIFIC ISSUES**

### **Multiple credit risk mitigation**

An exposure covered by two or more different CRM techniques (e.g. with both collateral and guarantee partially covering the claim) should be accounted for by dividing the exposure into portions covered by each type of CRM technique. The calculation of the RWA of each portion will be done separately according to the reporting of each portion. Where there is an overlap of coverage between the CRM techniques, the bank may select, in respect of the overlapped portion, the CRM technique that will result in the lowest RWA for the exposure.

An exposure covered by two or more CRM techniques that are of the same form but have different maturities should likewise be divided into different portions according to the maturities. The RWA of each portion should then be calculated separately.

Where an exposure is in the form of a general banking facility consisting of several types of credit line, the reporting bank may determine how any CRM techniques available under the facility should be allocated to individual claims under each line.

### **Maturity mismatches**

Where the residual maturity of the CRM is less than that of the underlying credit exposure, a maturity mismatch occurs. Maturity mismatches will not be allowed; no CRM will be recognised in such cases.

## **ANNEX A - ECA RATINGS**

### **Export Credit Agencies (“ECA”s)**

Under the simplified standardised approach, banks do not use External Credit Assessment Institutions’ ratings for determining risk weights associated with sovereign, central bank and other bank exposures. Instead, banks must use the consensus risk scores of ECAs participating in the “OECD Arrangement on Officially Supported Export Credits”. The consensus country risk classification is available on the OECD’s website ([www.oecd.org](http://www.oecd.org)). The mapping of the score to risk weights is shown below:-

<b>Country Score</b>	<b>Sovereigns</b>	<b>Banks and securities firms</b>	<b>PSEs</b>
0-1	0%	20%	20%
2	20%	50%	50%
3	50%	100%	100%
4-6	100%	100%	100%
7	150%	150%	150%

## **ANNEX B – CLASSIFICATION BETWEEN SOVEREIGN AND PSE EXPOSURES**

### **Zero weighted exposures to the Isle of Man Government, United Kingdom Government and the States of Jersey and Guernsey**

The Commission has exercised its national discretion such that claims on (and guaranteed by) the Isle of Man Government denominated in sterling, and funded in sterling attract a risk weighting of zero. In cases where the Isle of Man Government, through Treasury, has provided a letter of comfort rather than a formal guarantee, the Commission may also allow such claims to be risk weighted at zero but a bank should seek clarification in such circumstances.

Similarly, claims on (and guaranteed by) the United Kingdom Government and the States of Jersey and Guernsey denominated in sterling and funded in sterling also attract a risk weighting of zero. In essence, the Isle of Man Government and States of Jersey and Guernsey are treated as “sovereigns” for the purpose of credit risk reporting.

### **Claims on non central government PSEs**

Generally, such claims are risk weighted in accordance with portfolio B of form SR-1B (i.e. a floor of 20%). However, there are cases where it may be appropriate to treat a claim on PSE as being a claim on a sovereign which could attract a lower risk weighting. Matters which should be considered in determining whether a claim can be treated as to a sovereign include the following:-

- The extent of guarantees provided by the central government (and in the case of the Isle of Man Government, letters of comfort);
- For PSEs (often regional governments and local authorities) that have revenue raising powers the claim may be treated as a claim on the sovereign / central government if the PSE has specific revenue raising powers and have specific institutional arrangement the effect of which is to reduce their risks of default;
- For PSEs (administrative bodies responsible to central governments, regional governments or local authorities, and other non commercial undertakings) that do not have revenue raising powers or do not have special constitutional arrangements (or guarantees), it is unlikely the claim will be treated as a claim on the sovereign / central government. Further, if strict lending rules apply to these entities and a declaration of bankruptcy is not possible because of their special public status, it may be appropriate to treat these claims in the same manner as claims on banks.

## **ANNEX C - MULTILATERAL DEVELOPMENT BANKS (“MDBs”)**

List of institutions that shall be considered as MDBs:

- European Investment Bank
- European Bank for Reconstruction and Development
- Council of Europe Development Bank
- European Investment Fund
- International Bank for Reconstruction and Development
- International Finance Corporation
- Inter-American Development Bank
- African Development Bank
- Asian Development Bank
- Caribbean Development Bank
- Nordic Investment Bank
- Islamic Development Bank

## **ANNEX D - EXCEPTIONS TO THE RISK WEIGHT FLOOR OF 20% FOR COLLATERAL**

### Introduction

In general, a bank should not allocate a risk weight of less than 20% to collateral that is recognised under the “simple” approach except to those set out below.

### Repo-style transactions

A risk weight of 0% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in **Annex E**.

A risk weight of 10% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in **Annex E** *excluding those relating to core market participants*.

### OTC Derivative Transactions

A risk weight of 0% can be allocated to the collateralised portion of an OTC derivative transaction provided that:

- The transaction is marked-to-market daily and collateralised by cash provided to the bank, and
- The settlement currency of the transaction is the same currency as the cash provided as collateral.

A risk weight of 10% can be allocated to the collateralised portion of an OTC derivative transaction when the transaction is collateralised by debt securities issued by a sovereign or a sovereign foreign public sector entity qualifying for a risk weight of 0% in accordance with **Section 3 and Annex B**.

### Other Transactions

A 0% risk weight can be allocated to the collateralised portion of a transaction if both the transaction and the collateral are denominated in the same currency, and either:

- The collateral is cash on deposit with the bank; or
- The collateral is in the form of debt securities issued by a sovereign or a sovereign foreign public sector entity eligible for a risk weight of 0% in accordance with **Section 3 and Annex B**, and the current market value of which has been discounted by 20%.

A 0% risk weight can be allocated to recognised collateral in the form of gold bullion held by the bank.

## **ANNEX E - CRITERIA FOR PREFERENTIAL TREATMENT OF REPO-STYLE TRANSACTIONS**

### Introduction

Other than those covered by a valid bilateral netting agreement, the reporting bank should adopt the “economic substance” approach for capital treatment of repo-style transactions and report them as balance sheet assets as described below.

### Repos of securities

Where the reporting bank has sold securities under repo agreements, the securities sold should continue to be treated as assets with capital requirement provided for the credit risk to the securities:

- Reverse repos of securities - where the bank has acquired securities under reverse repo agreements, the transaction should be treated as a collateralised lending to the counterparty, providing the securities acquired meet the relevant criteria for recognising collateral. The capital requirement should then be provided for the credit risk to the counterparty, taking into account the CRM effect of the collateral;
- Securities lending - the treatment is similar to that of repo transactions. This means that the securities lent should continue to remain as an asset on the balance sheet of the bank, with the capital requirement being derived from the credit risk of the securities; and
- Securities borrowing - the treatment depends on whether the collateral provided is cash or other securities:
  - Where the collateral provided is cash, it should be treated as a collateralised lending to the counterparty, providing the securities received meet the relevant criteria for recognising collateral, as set out in **Annex F**. The capital requirement should then be derived from the credit risk to the counterparty, taking into account the CRM effect of the collateral;
  - Where the collateral provided is not cash but securities, the securities borrowed should be reported as assets on the balance sheet of the bank.

For securities lending or borrowing where the contractual agreement is made between the securities borrower/lender and the custodian (e.g. Clearstream Banking or Euroclear Bank) and the securities borrower/lender has no knowledge as from/to whom the security is borrowed / lent, the custodian becomes the “counterparty” of the stock borrower/lender.

The Commission will allow a preferential risk-weighting treatment for qualified repo-style transactions which satisfy all the requirements below. Under the “comprehensive” approach for collateral (which is not available under the SSA for credit risk in any case), these qualified transactions are not required to be subject to any haircuts.

## Requirements to be satisfied

- The counterparty should be a core market participant. The Commission recognises the following entities as core market participants:
  - Sovereigns, central banks and PSEs;
  - Banks and securities firms;
  - Other financial companies (including insurance companies) eligible for a 20% risk weight in the standardised approach;
  - Regulated mutual funds that are subject to capital or leverage requirements;
  - Regulated pension funds; and
  - Recognised clearing organisations.
- Both the exposure and the collateral are cash or securities issued by sovereigns or PSEs treated as sovereigns which qualify for a risk weight of 0%.
- Both the exposure and the collateral are denominated in the same currency.
- Either the transaction is overnight or both the exposure and the collateral are subject to daily mark-to-market and daily re-margining.
- In the case of a counterparty's failure to re-margin, the time between the last mark-to-market before the failure to re-margin and the liquidation of the collateral is no more than four business days.
- The transaction is settled across a settlement system proven for that type of transaction.
- Standard market documentation in the securities concerned is used for the agreement covering the repo-style transactions.
- The documentation of the transaction should specify that the transaction is immediately terminable if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults.
- Upon any event of default, regardless of whether the counterparty is insolvent or bankrupt, the bank should have an unfettered and legally enforceable right to immediately seize and liquidate the collateral for its benefit.

## **ANNEX F - REQUIREMENTS FOR RECOGNITION OF COLLATERAL**

### Introduction

Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised by first priority claims, in whole or in part with cash or securities, a loan exposure may be guaranteed by a third party, or a bank may buy a credit derivative to offset various forms of credit risk. Additionally, banks may agree to set-off loans owed to them against deposits from the same counterparty.

Where these techniques meet the requirements for legal certainty as described below, the revised approach to CRM allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than was permitted under the 1988 Accord.

### General remarks

No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

The effects of CRM should not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.

While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including:

- Strategy;
- Consideration of the underlying credit;
- Valuation;
- Policies and procedures;
- Systems;
- Control of roll-off risks; and
- Management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.

Where these risks are not adequately controlled, supervisors may impose additional capital charges or take other supervisory actions, as outlined in Pillar 2 of Basel II.

### Legal certainty

In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met:

- All documentation used in collateralised transactions, and for documenting balance sheet netting, guarantees and credit derivatives, must be binding on all parties and legally enforceable in all relevant jurisdictions; and
- Banks must have conducted sufficient legal review to verify this, have a well-founded legal basis to reach this conclusion and undertake such further review as necessary to ensure continuing enforceability.

In addition to the general requirements for legal certainty set out above, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, banks must take all steps necessary to fulfil those requirements under the law applicable to the bank's interest in the collateral to obtain and maintain an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set-off.

In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible.

Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

## ANNEX G - ILLUSTRATIONS ON REPORTING OF CREDIT RISK MITIGATION TECHNIQUES

### Balance sheet example: Collateralised loan

The reporting bank provides a 5-year term loan of £5,000,000 to an unrated corporate. The loan is secured by debt securities issued by a bank and denominated in Euro. The bank is incorporated in a country with a consensus ECA country score of “1” and the debt securities have a remaining maturity of 7 years. They are subject to daily revaluation and presently have a market value in GBP equivalent amount of £5,200,000.

Considerations:

- A loan to an unrated corporate is subject to a risk weight of 100%.
- A bank incorporated in a country with a consensus ECA country score of “1” is mapped to a risk weight of 20%.
- As the market value of the collateral debt securities is £5,200,000, the loan is fully secured.
- RWA of the loan: 5,000,000 x 20% = £1,000,000.

Reporting illustration: balance sheet example:

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
...	...	...	...	...	...
<b>C</b>	<b>Claims on Corporates</b>				
C.1	Risk Weight 20%	0	0	20	0
C.2	Risk Weight 50%	0	0	50	0
C.3	Risk Weight 100%	5,000	0	100	0
C.4	Risk Weight 150%	0	0	150	0
	<b>SUBTOTAL</b>	<b>5,000</b>	<b>0</b>		<b>0</b>

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
<b>D</b>	<b>Claims on Banks</b>				
<b>D.1</b>	<b>Claims on Banks, except guarantees</b>				
D.1.1	Maturity more than 3 Months				
D.1.1.1	Risk Weight 20%	0	5,000	20	1,000
D.1.1.2	Risk Weight 50%	0	0	50	0
D.1.1.3	Risk Weight 100%	0	0	100	0
D.1.1.4	Risk Weight 150%	0	0	150	0
...	...	...	...	...	...
	<b>SUBTOTAL</b>	<b>0</b>	<b>5,000</b>		<b>1,000</b>

### Off-balance sheet example: Collateralised loan commitment

If it were the case that the corporate borrower in the above example had not yet drawn down the loan facility, the transaction would be recorded as a commitment in the book of the reporting bank. Assuming that the rest of the deal was unaltered – same collateral etc

– and that the commitment cannot be cancelled unconditionally, the capital requirement of the transaction under the two approaches would be calculated as follows:

Considerations:

- The commitment for a 5-year term loan attracts a CCF of 50% as it cannot be cancelled unconditionally. The credit equivalent amount of this secured commitment is therefore calculated as: £5,000,000 x 50% = £2,500,000.
- As the amount committed is £5,000,000 and the market value of the collateral debt securities is £5,200,000 the commitment is considered fully secured.
- A 20% risk weight for the collateral debt securities is applied to calculate the RWA of this secured transaction: £2,500,000 x 20% = £500,000.

Item	M.6	M.7	M.8	M.9a	M.9b
<b>Nature of Item</b>	<b>Partly paid up shares and securities</b>	<b>Forward deposits placed</b>	<b>Note Issuance and revolving Underwriting Facilities</b>	<b>Other commitments with original maturity of less than 1 year</b>	<b>Other commitments with original maturity of 1 year and over</b>
<b>Amount</b>	0	0	0	0	5,000
<b>Credit Conversion Factor</b>	100	100	50	20	50
<b>Credit Equivalent Amount</b>	0	0	0	0	2,500
<b>After CRM:</b>					
Risk Weight 0%	0	0	0	0	0
Risk Weight 20%	0	0	0	0	2,500
Risk Weight 35%	0	0	0	0	0
Risk Weight 50%	0	0	0	0	0
Risk Weight 75%	0	0	0	0	0
Risk Weight 100%	0	0	0	0	0
Risk Weight 150%	0	0	0	0	0
<b>Risk Weighted Amount</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>500</b>
<b>Items requiring Capital Deduction</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

Reporting illustration: off-balance sheet example:

### OTC derivative transaction example

The reporting bank has a £100,000,000 interest rate contract with a four-year residual maturity. The other counterparty to the contract is an unrated corporate. Pledged as collateral for the contract is an £800,000 bond issued by a bank incorporated in a country with a consensus ECA country score of “2”, which has more than five years to go to maturity. This is a capital market transaction subject to daily re-margining and there are no foreign exchange mismatches between the interest rate contract and the collateral. The mark-to-market value of the interest rate contract is £1,000,000 and the add-on is 0.5%, giving an “Add-on amount” of £500,000.

Considerations:

- Credit equivalent amount of the interest rate contract is the sum of the positive mark-to-market and the “Add-on amount” (i.e. £1,000,000 + £500,000 = £1,500,000).
- The unrated corporate attracts a 100% risk weight.
- The £800,000 bank bond attracts a 50% risk weight.

- RWA of secured portion: £800k x 50% = £400k.
- RWA of unsecured portion: £700k x 100% = £700k.
- Total RWA (secured + unsecured): £400k + £700k = £1,100k.

Reporting illustration: OTC schedule:

#### N.1 Interest rate contracts

	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-on Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
	100,000	1,000			500	1,500	1,500		1,100

#### N.1 Schedule

No.	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-on Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
...	...	...	...	...	...	...	...	...	...
6	0	0	1 - 5 years	0.50%	0	0	0	0%	0
7	0	0	1 - 5 years	0.50%	0	0	0	20%	0
8	0	0	1 - 5 years	0.50%	0	0	800	50%	400
9	100,000	1,000	1 - 5 years	0.50%	500	1,500	700	100%	700
10	0	0	1 - 5 years	0.50%	0	0	0	150%	0
...	...	...	...	...	...	...	...	...	...

Reporting illustration: OTC summary page (assuming no other OTC contracts – automatically populated with summary information from the Schedules):

#### N Off-Balance Sheet - OTCs

Item	N.1	N.2	N.3	N.4	N.5
Nature of Item	Interest rate contracts	Foreign exchange and gold contracts	Equity contracts	Other precious metal contracts	Other commodity contracts
Amount	100,000	0	0	0	0
Positive Mark-to-Market	1,000	0	0	0	0
Add-on Amount	500	0	0	0	0
Credit Equivalent Amount	1,500	0	0	0	0
After CRM:					
Risk Weight 0%	0	0	0	0	0
Risk Weight 20%	0	0	0	0	0
Risk Weight 50%	800	0	0	0	0
Risk Weight 100%	700	0	0	0	0
Risk Weight 150%	0	0	0	0	0
<b>Risk Weighted Amount</b>	<b>1,100</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

## **ANNEX H - CRITERIA FOR CLASSIFICATION AS A RETAIL EXPOSURE AND / OR AS A RESIDENTIAL MORTGAGE**

### Retail Exposures

To be included in the “Regulatory Retail Portfolio”, claims must meet the following four criteria:

- Orientation criterion: The exposure is to an individual person or persons or to a small business (less than £2m turnover and balance sheet footings).
- Product criterion: The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g. instalment loans, auto loans and leases, student and educational loans, personal finance) and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property (see below).
- Granularity criterion: The Commission must be satisfied that the “Regulatory Retail Portfolio” is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. Accordingly, in defining what constitutes a significant number of *retail exposures* (for diversification) a reporting bank need only satisfy itself that the number of *retail exposures* is sufficiently large to diversify away idiosyncratic risk<sup>1</sup>. This assessment will be subject to supervisory review and part of a reporting bank’s *SREP*. The Commission requires each bank to set out its criteria and may, where necessary, require changes to be made if the bank is to be allowed to utilise the 75% risk weight.
- Low value of individual exposures. The maximum aggregated retail exposure to one counterparty cannot exceed an absolute threshold of £750,000.

### Residential mortgages

The Commission has set the following criteria:

- The property or properties must be for residential purposes only;
- The security may be indirect – an example of this would be where the security held comprised shares where the share ownership conferred ownership of a property e.g. share transfer ownership;
- The lending may either be directly to an individual or to a special purpose entity\*;
- If the lending is to a special purpose entity the bank must:-

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<sup>1</sup> Also known as unsystematic risk this is the risk of price change due to the unique and uncorrelated circumstances of an asset or firm as opposed to a market movement.

- Ensure that the repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral. For personal investment companies this should include having recourse to the beneficial owner in the event of default;
  - Ensure that the mortgage or charge is enforceable in all jurisdictions which are relevant at the time of conclusion of the credit agreement and properly file such charges on a timely basis;
  - Ensure that the arrangements reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled);
  - Ensure that the protection agreement and legal process underpinning it enable the bank to realise the value of protection within a reasonable timeframe; and
  - Consider whether any additional risks arise from the arrangements that should be addressed under Pillar 2 of Basel II.
- The properties must be either occupied by the borrower or rented, normally to individuals (although renting to corporate tenants is allowed if the property is used only for residential purposes). In the case of property being rented, a property (or property portfolio) should not comprise more than 10 rental units / properties;
  - For claims secured by residential properties with loan-to-value ratios of up to 80% (i.e. considered as fully secured) a risk weight of 35% will apply. For higher LTVs a risk weight of 75% will apply on that portion above 80% LTV;
  - If a bank does not hold information regarding LTVs for individual exposures, a risk weighting of 50% will apply to the whole of those exposures;
  - LTVs should be assessed on a regular basis, making use of relevant indices and market information where appropriate. The LTV used for the purpose of the allocation of risk weightings (35% / 75%) is that which is determined by an independent valuer (a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process) on an individual exposure basis.

\* A special purpose entity may be in the form of a personal investment company or a trust.

## CHAPTER 4

### GUIDANCE – FORM SR-1B

#### (FOR BANKS INCORPORATED IN THE ISLE OF MAN ADOPTING THE STANDARDISED APPROACH TO CREDIT RISK)

##### SECTION 1 – GLOSSARY

The following abbreviations are used within this chapter:-

CIS	-	Collective Investment Scheme
CRM	-	Credit Risk Mitigation
CCF	-	Credit Conversion Factor
CEA	-	Credit Equivalent Amount
ECA	-	Export Credit Agency
ECAI	-	External Credit Assessment Institution
LTV	-	Loan-To-Value
MDB	-	Multilateral Development Bank
OTC	-	Over-The-Counter
RWA	-	Risk-Weighted Amount
SAC	-	Standardised Approach to Credit risk

##### SECTION 2 – INTRODUCTION AND OVERVIEW

Every bank that uses the standardised approach to calculate its credit risk capital requirement will be required to complete form SR-1B. The return covers the bank's balance sheet assets and off-balance sheet exposures in its banking book, including OTC derivative contracts.

##### Definitions and clarifications

**Amounts:** should be reported net of specific provisions for all balance sheet assets and off-balance sheet exposures other than OTC derivative transactions. Specific provisions for OTC derivative transactions should be deducted from the credit equivalent amount.

**Amount after CRM:** means the reported amount, adjusted for the capital effect of recognised CRM techniques. The latter refers to techniques the bank may use to mitigate credit risk and hence reduce the capital requirement of a credit exposure. Four types of CRM techniques are recognised for this purpose:

- Collateral;
- Netting;
- Guarantees; and
- Credit derivatives.

In order to be recognised, a CRM technique should satisfy the relevant operational requirements and conditions set out in **Annex G to this chapter**.

Under the standardised approach, there are two methods that can be used for recognising the impact of collateral. Banks must choose between the “simple” and “comprehensive” approaches and use that chosen method exclusively.

Netting, guarantees and credit derivatives are always handled using the same approach, being the “comprehensive” approach for netting and the “simple” approach for guarantees and credit derivatives.

Double counting of exposures arising from the same contract or transaction should be avoided. For example, only the un-drawn portion of a loan commitment should be reported as an off-balance sheet exposure; the actual amount which has been lent will be reported as a balance sheet asset in the relevant portfolio. Trade-related contingencies such as shipping guarantees for which the exposures have already been reported as letters of credit issued or loans against import bills are not required to be reported as trade-related contingencies. In certain cases, credit exposures arising from derivative contracts may already be reflected, in part, on the balance sheet. For example, the bank may have recorded current credit exposures to counterparties (i.e. mark-to-market values) under foreign exchange and interest rate related contracts on the balance sheet, typically as either sundry debtors or sundry creditors. To avoid double counting, such exposures should be excluded from the balance sheet assets and treated as off-balance sheet exposures for the purposes of this return.

Accruals on a claim should be classified and weighted in the same way as the claim. Accruals that cannot be so classified, e.g. due to systems constraints, should be categorised within “Other, including prepayments and debtors” in Portfolio L.

### **SECTION 3 - PORTFOLIO CLASSIFICATION AND RISK WEIGHTS: BALANCE SHEET ASSETS**

#### Portfolio classification

Within the form, the balance sheet is organised as follows:

- Portfolio A - Sovereigns
- Portfolio B - Public sector entities (PSEs)
- Portfolio C - Corporates
- Portfolio D - Banks
- Portfolio E – Securitisation exposures
- Portfolio F - Cash and similar items
- Portfolio G - Retail
- Portfolio H – Residential mortgages
- Portfolio J – Past due exposures
- Portfolio K – Capital deductions
- Portfolio L – Other balance sheet exposures

Each Portfolio is mutually exclusive and each asset should be reported in only one Portfolio. For instance, any asset which is past due should only be reported in Portfolio J and not elsewhere.

## Collective investment schemes

Exposures to collective investment schemes should be categorised as equity, except that:

- Exposures to a fixed income fund with a rating from an eligible ECAI should be weighted in accordance with **Table 5** and categorised as:
  - Corporate if the CIS can invest in corporate as well as bank, PSE and sovereign debt;
  - Bank if it can invest in bank as well as PSE and sovereign debt;
  - PSE if it can invest in only PSE and sovereign debt; or
  - Sovereign if restricted to only sovereign debt.
- If the scheme is rated but does not fit within these rules it should be categorised within “Other” in Portfolio L.
- Investments in venture capital and private equity schemes should be categorised within “High Risk Assets” in Portfolio L.

## Determination of risk weights

The risk weight for an asset in Portfolios A to E is generally determined from its credit assessment by an ECAI. These are perhaps more commonly known as rating agencies, and the Commission allows banks to use the results of several, these being Moody’s, Standard and Poor’s and Fitch (**see Annex A to this chapter**).

Each of these 5 ECAI ratings-based Portfolios has its own risk-weighting framework. **Tables 1 to 6 in Section 9** set out how, for each Portfolio, different sets of ratings used by different ECAs are mapped to risk weights. They also provide specific risk weights for unrated assets in each Portfolio and separate scales for risk-weighting paper issued by banks and corporates that has issue-specific ratings. **Annex A** to this chapter sets out a number of general principles that banks should follow for the selection of the appropriate rating for risk-weighting an asset.

The term “issuer rating” means, for all ECAI ratings-based Portfolios, a current long-term rating assigned by a recognised ECAI to an obligor and the term “issue-specific rating” means:

- For Portfolios A&B (i.e. claims on Sovereigns and Public Sector Entities): a current long-term rating specifically assigned to a particular debt obligation, and
- For Portfolios C, D and E (i.e. claims on Corporates, Banks, and Securitisation exposures): either a current long-term or a current short-term rating specifically assigned to a particular debt obligation.

The term “current” in relation to an ECAI issuer rating or ECAI issue-specific rating, means the ECAI which assigned the credit assessment rating concerned has not suspended or withdrawn the rating and, in the case of issue-specific rating, the issue concerned is still outstanding.

The following sections explain how assets in each Portfolio are risk-weighted and, where applicable, the relevant principles for reporting assets under the Portfolio.

Portfolio A: Claims on sovereigns

Item	Description of Item	Guidance														
A.1	Claims on Isle of Man Government	Claims on the Isle of Man Government are risk-weighted at 0%. For the difference between a sovereign claim and a claim on a public sector entity refer to <b>Annex B</b> .														
A.2	Claims on other sovereigns	Claims on the other Crown Dependencies and UK Governments are risk weighted at 0%. All claims on other sovereigns should be weighted in accordance with <i>Table 1</i> . This assigns risk weights based on ratings assigned by eligible ECAs. The generic mapping is as follows:														
		<table border="1"> <thead> <tr> <th>Credit Assessment</th> <th>AAA to AA-</th> <th>A+ to A-</th> <th>BBB+ to BBB-</th> <th>BB+ to B-</th> <th>Below B-</th> <th>Unrated</th> </tr> </thead> <tbody> <tr> <td>Risk Weight</td> <td>0%</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </tbody> </table>	Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated	Risk Weight	0%	20%	50%	100%	150%	100%
		Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated								
		Risk Weight	0%	20%	50%	100%	150%	100%								
Despite the above, where an equivalent regulator* exercises its discretion to permit banks in its jurisdiction to allocate a lower risk weight to claims on that jurisdiction's sovereign denominated in the domestic currency of that jurisdiction and funded in that currency, the same lower risk-weight may be allocated to such claims.																
For the difference between a sovereign claim and a claim on a public sector entity refer to <b>Annex B</b> .																
A.3	Claims on Multilateral Development Banks	All claims on multilateral development banks ("MDB"s) are risk weighted at 0%. <b>Annex C</b> contains a list of eligible MDBs.														

\* An "equivalent regulator" for the purposes of this document is one that is considered by the Commission to regulate banks under a Basel II regime in a manner that is broadly equivalent to the Commission's regulation. For example, the Commission considers the other relevant Crown Dependency Commissions and the Financial Services Authority to be equivalent regulators. The Commission has not published a list; the Commission will only assess regulators where a bank requests it.

Portfolio B: Claims on public sector entities (PSEs)

Item	Description of Item	Guidance												
B.1	Claims on Isle of Man PSEs	Includes all exposures to non-central Isle of Man Government PSEs, unless they may be treated as a sovereign claim as explained in <b>Annex B</b> , in which case the claim can be reported in portfolio A. Claims on these exposures are risk-weighted at 20%.												
B.2	Claims on other PSEs	Claims on other Crown Dependency and UK PSEs are risk weighted at 20%. All claims on other PSEs should be weighted in accordance with <i>Table 1</i> . This assigns risk weights based on the rating of the sovereign in which the PSE is established. The generic mapping is as follows:												
		<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to AA-</td> <td>A+ to A-</td> <td>BBB+ to B-</td> <td>Below B-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </table>	Credit Assessment	AAA to AA-	A+ to A-	BBB+ to B-	Below B-	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Credit Assessment	AAA to AA-	A+ to A-	BBB+ to B-	Below B-	Unrated							
		Risk Weight	20%	50%	100%	150%	100%							
<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to AA-</td> <td>A+ to A-</td> <td>BBB+ to B-</td> <td>Below B-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </table>	Credit Assessment	AAA to AA-	A+ to A-	BBB+ to B-	Below B-	Unrated	Risk Weight	20%	50%	100%	150%	100%		
Credit Assessment	AAA to AA-	A+ to A-	BBB+ to B-	Below B-	Unrated									
Risk Weight	20%	50%	100%	150%	100%									
If claims on a foreign PSE are regarded as claims on the sovereign, for the purposes of capital adequacy calculation by an equivalent regulator of the jurisdiction in which the PSE is established, then such a claim may instead be disclosed in Portfolio A at the risk weight applicable to that sovereign.														

Portfolio C: Claims on corporates

Item	Description of Item	Guidance												
C	Claims on Corporates	Claims on Corporates should be weighted in accordance with <i>Table 1</i> . This assigns risk weights based on the rating of the legal entity concerned. The generic mapping is as follows:												
		<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to AA-</td> <td>A+ to A-</td> <td>BBB+ to BB-</td> <td>Below BB-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </table>	Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated	Risk Weight	20%	50%	100%	150%	100%
		Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated							
		Risk Weight	20%	50%	100%	150%	100%							
<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to AA-</td> <td>A+ to A-</td> <td>BBB+ to BB-</td> <td>Below BB-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>100%</td> </tr> </table>	Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated	Risk Weight	20%	50%	100%	150%	100%		
Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated									
Risk Weight	20%	50%	100%	150%	100%									
Short-term claims with an issue specific rating should be weighted in accordance with that rating, as detailed in <i>Table 2</i> .														

Portfolio D: Claims on banks

Claims on banks arising from bank guarantees received should be split from all other claims. All claims are then further divided into those with original maturity of 3 months or less from drawdown and those longer than 3 months from drawdown.

Item	Description of Item	Guidance												
D.1.1	Claims on Banks, except guarantees: Maturity more than 3 Months	Claims should be weighted in accordance with the relevant column in <i>Table 1</i> . This assigns risk weights based on the rating of the legal entity concerned. The generic mapping is as follows:												
		<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to AA-</td> <td>A+ to BBB-</td> <td>BB+ to B-</td> <td>Below B-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> <td>50%</td> </tr> </table>	Credit Assessment	AAA to AA-	A+ to BBB-	BB+ to B-	Below B-	Unrated	Risk Weight	20%	50%	100%	150%	50%
		Credit Assessment	AAA to AA-	A+ to BBB-	BB+ to B-	Below B-	Unrated							
Risk Weight	20%	50%	100%	150%	50%									
D.1.2	Claims on Banks, except guarantees: Maturity less than 3 Months	Short term claims should be weighted in accordance with the relevant column in <i>Table 1</i> . This assigns risk weights based on the rating of the legal entity concerned. The generic mapping is as follows:												
		<table border="1"> <tr> <td>Credit Assessment</td> <td>AAA to BBB-</td> <td>BB+ to B-</td> <td>Below B-</td> <td>Unrated</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>150%</td> <td>20%</td> </tr> </table>	Credit Assessment	AAA to BBB-	BB+ to B-	Below B-	Unrated	Risk Weight	20%	50%	150%	20%		
		Credit Assessment	AAA to BBB-	BB+ to B-	Below B-	Unrated								
		Risk Weight	20%	50%	150%	20%								
		Where a debt instrument has a specific short term rating the claim should be weighted in accordance with <i>Table 2</i> . The generic mapping is as follows:												
		<table border="1"> <tr> <td>Credit Assessment</td> <td>A-1</td> <td>A-2</td> <td>A-3</td> <td>Below A-3</td> </tr> <tr> <td>Risk Weight</td> <td>20%</td> <td>50%</td> <td>100%</td> <td>150%</td> </tr> </table>	Credit Assessment	A-1	A-2	A-3	Below A-3	Risk Weight	20%	50%	100%	150%		
Credit Assessment	A-1	A-2	A-3	Below A-3										
Risk Weight	20%	50%	100%	150%										
D.2	Claims secured by guarantees from Banks	Claims guaranteed by banks should be shown separately in this section using the mappings for a direct claim on the bank giving the guarantee (as above). The relevant maturity is that of the underlying claim. Note that such claims are shown in the "Amount after CRM" column, in accordance with <b>Section 4</b> .												

Portfolio E: Securitisations

Item	Description of Item	Guidance					
E	Securitisation	Claims on Securitisations should be weighted in accordance with <i>Table 3</i> . This assigns risk weights based on the rating of the legal entity concerned. The generic mapping is as follows:					
		Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB- and Unrated
		Risk Weight	20%	50%	150%	350%	Deduct from capital – disclose in Portfolio K.5
		Where an issue has a specific short term rating, it should be weighted in accordance with <i>Table 4</i> . The generic mapping is as follows:					
		Credit Assessment	A-1	A-2	A-3	Below A-3	
		Risk Weight	20%	50%	100%	Deduct from capital – disclose in Portfolio K.5	

Portfolio F: Cash and similar items

Item	Description of Item	Guidance
F.1	Notes and coins	Notes and coins are allocated a risk weight of 0%.
F.2	Cash items in the course of collection	Cash items in the course of collection refer to the amount of cheques, drafts and other items drawn on other banks that will be paid for the account of the bank immediately upon presentation and that are in the process of collection. Such items are allocated a risk weight of 20%.
F.3	Gold	Gold has a risk weight of 0%. However, the net position in gold is subject to a market risk charge, which for the standardised approach broadly equates to a 100% weight for the net position.
F.4	Claims fully collateralised by cash deposits	<p>The bank should report here claims collateralised by cash deposits if it has adopted the simple approach for the CRM treatment of collateral (<b>see Section 4</b>). Claims secured by cash deposits should be recorded under the column headed “Amount after CRM”. These are then allocated a risk weight of 0%.</p> <p>When a cash deposit is held as collateral at a third-party bank in a non custodial arrangement, the institution should treat the cash deposit as a claim on that third-party bank and report it within Portfolio D.2.</p>

Portfolio G: Retail exposures

Item	Description of Item	Guidance
G.1	Claims in “Regulatory Retail Portfolio”	Claims that qualify for this Portfolio are allocated a risk weight of 75%. To apply the risk weight of 75% to claims on small businesses or individuals, the bank must satisfy the relevant criteria set out in <b>Annex J</b> . Claims that are not past due but do not satisfy the criteria for inclusion as regulatory retail exposures should be reported in Portfolio G.2.
G.2	Claims falling outside the “Regulatory Retail Portfolio”	Claims on small businesses or individuals other than those qualifying for inclusion in Portfolio G.1. Such claims are allocated a risk weighting of 100%.

Portfolio H: Residential mortgages

Item	Description of Item and Risk Weighting	Guidance
H.1	Residential Mortgages: 35%	Residential Mortgages that meet all the criteria set out in <b>Annex J</b> are assigned a weighting of 35% for that portion below 80% LTV.
H.2	Residential Mortgages: 50%	Residential Mortgages that meet all the criteria set out in <b>Annex J</b> except for either: <ul style="list-style-type: none"> <li>• Mortgages for which the bank’s systems do not hold adequate LTV information; or</li> <li>• Mortgages in jurisdictions other than those where the local regulator is deemed equivalent, has adopted Basel II, has evaluated the local market and deemed a weight of 35% to be appropriate.</li> </ul> Those mortgages in the above two categories are assigned a risk weighting of 50%.
H.3	Residential Mortgages: 75%	Residential Mortgages that meet all the criteria set out in <b>Annex J</b> are assigned a weighting of 75% for that portion above 80% LTV.
H.4	Residential Mortgages: 100%	Residential Mortgages that do not meet the criteria set out in <b>Annex J</b> , other than those that qualify for inclusion in H.2, are assigned a risk weight of 100%.

Portfolio J: Past due exposures

For the purpose of defining the secured portion of a past due loan, eligible collateral and guarantees will be treated in line with the credit risk mitigation process detailed in **Section 4**.

Item	Description of Item	Guidance
J.1	Secured	<p>The secured part of any past due exposure i.e. that part that meets the terms for eligible CRM, as set out in <b>Section 4</b>, should be reported here. The weight is unaffected providing the terms of the CRM remain fulfilled.</p> <p>The exception is the case of qualifying residential mortgage loans. When such loans are past due for more than 90 days, they must be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50%.</p>
J.2	Unsecured	<p>The unsecured portion of any loan that is past due for more than 90 days, net of specific provisions, including partial write-offs, will be risk-weighted as follows:</p> <ul style="list-style-type: none"> <li>• <i>150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan;</i></li> <li>• <i>100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan but less than 50%;</i></li> <li>• <i>50% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan.</i></li> </ul>

Portfolio K: Capital deductions

These items require full deduction from capital and therefore do not contribute to RWA.

Item	Description of Item	Guidance
K.1	Investment in Subsidiaries	All investments in subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies. Associated companies are those with whom the bank has entered into joint ventures or where the bank owns a material shareholding. A shareholding that exceeds 20% would ordinarily be considered material.
K.2	Capital connected lending	All lending of a capital nature to subsidiaries of the bank, fellow group subsidiaries, joint ventures and associated companies.
K.3	Holdings of financial services business' capital instruments	All investments in other financial service business' capital instruments not captured above.
K.4	Goodwill and other intangible fixed assets	All intangible assets should be deducted from capital, including goodwill.
K.5	Securitisations - equity tranches	Includes all first loss tranches. Also includes tranches rated below BB-, including those with short term ratings of lower than A-3 (or equivalent - see <i>Tables 3 &amp; 4</i> ).
K.6	Other	All items that require a full deduction as a result of specific or general guidance and that do not fall within Portfolios K.1 to K.5.

Portfolio L: Other balance sheet exposures

<b>Item</b>	<b>Description of Item and Risk Weighting</b>	<b>Guidance</b>
L.1	Tangible fixed assets 100%	Premises, plant and equipment, other fixed assets for own use, and other interests in realty. Included are investments in land, premises, plant and equipment and all other fixed assets of the reporting institution which are held for its own use, including any fixed asset held by the institution as lessee under a finance lease. Other interest in land which is not occupied or used in the operation of the bank's business should also be reported here.
L.2	Equity 100%	Investments in equity of other entities and holdings of collective investment schemes. Included are investments in commercial entities, other than those where a deduction from capital base is required. Collective investment schemes should be included unless they invest in high risk assets, in which case they are categorised as such, or they are fixed income (only debt investments, not equity) in which case they are categorised within L.4.
L.3	High Risk Assets 150%	Investments in venture capital and private equity, including investments in collective investment schemes holding such investments, are weighted at 150%.
L.4	Other, including prepayments and debtors 0-150%	Accrued interest, prepayments and debtors should be classified here and weighted according to the underlying counterparty. Unallocated amounts, including unallocated interest, should be weighted at 100%. This includes unrestricted fixed income collective investment schemes (see L.2 above).

## **SECTION 4 - CREDIT RISK MITIGATION AND ASSOCIATED CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: BALANCE SHEET ASSETS**

### Introduction

For each balance sheet asset, the RWA is calculated by multiplying its “Amount after CRM” by an appropriate risk weight determined by the type of exposure, as set out in **Section 3**.

Where an asset is not covered by any recognised CRM techniques (**see Section 2 and Annex G**), the amounts reported under the columns headed “Amount” and “Amount after CRM” will be the same. Where an asset is covered wholly or partially by recognised CRM techniques (**see Section 2 and Annex G**), the amount reported under the column of “Amount after CRM” should be adjusted to reflect the CRM effect.

The reporting arrangement for exposures covered by CRM techniques depends on the types of techniques used. In particular, an institution must choose between using the “simple” or “comprehensive” treatments for collateral.

**Annex H** contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures based on the “simple” approach and the “comprehensive” approach of the credit risk mitigation framework.

### CRM treatment by substitution of risk weights

This method should be used for collateral under the “simple” approach and - in all cases - for the recognition of the impact of guarantees and credit derivatives.

The first step is to identify the Portfolio to which the underlying claim belongs, based on the instructions set out in **Section 3**, then report the whole principal of the claim under the column of “Amount” in that Portfolio, classified according to the risk weight applicable to that claim.

The “Amount” is divided into two portions: the portion covered by credit protection and the remaining uncovered portion.

- For guarantees and credit derivatives, the value of credit protection to be recorded is their nominal value. However, where the credit protection is denominated in a currency different from that of the underlying obligation, the covered portion should be reduced by a haircut for the currency mismatch of 10%;
- For collateral, the value of credit protection to be recorded is its market value subject to a minimum revaluation frequency of 6 months for performing assets, and 3 months for past due assets (if this is not achieved then no value can be recognised);
- Where the collateral involves cash deposits, certificates of deposit, cash funded credit-linked notes, or other comparable instruments which are held at a third-party bank in a non-custodial arrangement and unconditionally and irrevocably pledged or assigned to the reporting institution, the collateral will be allocated the same risk weight as that of the third-party bank.

The covered and uncovered portions are reported according to the following:

- Where the asset covered by CRM is not past due, report the amount of the covered portion in the Portfolio to which the credit protection belongs, under the column of “Amount after CRM”, classified according to the risk weight applicable to the credit protection (subject to a 20% floor, which can be reduced in situations set out in **Annex D**);
- Where the asset covered by CRM is past due, the amount of the covered portion should be included in Portfolio J - Past Due Exposures and reported under the column of “Amount after CRM” in accordance with the risk weight applicable to the credit protection.

In both cases, the RWA of the covered portion is then calculated by multiplying the amount of the covered portion by the risk weight attributed to the credit protection in accordance with **Section 3**.

However, where the credit protection takes the form of a credit derivative contract with the following features, there are certain additional guidelines the bank should follow in determining the extent of credit protection:

*Where the contract is a first-to-default credit derivative contract, the bank may recognise regulatory capital relief for the asset within the basket with the lowest risk weight, provided that the principal amount of that asset is less than or equal to the notional amount of the credit derivative. The institution may substitute the risk weight of the protection seller for the risk weight of that asset.*

*Where the contract is a second-to-default credit derivative contract, the reporting institution may substitute the risk weight of the protection seller for the risk weight of the reference entity with the second lowest risk weight in the basket of reference entities specified in the contract, but only if:*

- The bank has, as a protection buyer, entered into a first-to-default credit derivative contract relating to the same basket of reference entities; or
- A reference entity in the basket has defaulted.

Lastly, report the amount of the remaining uncovered portion in the Portfolio to which the underlying claim belongs, under the column of “Amount after CRM”, classified according to the risk weight of the underlying claim. The reported RWA of the uncovered portion will then be calculated by multiplying the amount of the uncovered portion by the risk weight of the claim.

#### CRM treatment by reduction of principal of an exposure

This method should be used for the comprehensive approach for collateral, balance sheet netting, and the netting of multiple repo-style transactions with one counterparty.

### ***Comprehensive approach for collateral***

Report the whole principal of the underlying claim under the column headed “Amount” in the Portfolio to which the underlying claim belongs, classified according to the risk weight applicable to that claim.

Report the net amount (i.e. A\*) under the column headed “Amount after CRM” in the same Portfolio of the underlying claim, still classified according to the risk weight of that claim. This is arrived at by subtracting the value of collateral from the Amount of the claim, with the application of haircuts to both the “Amount” of the claim and the value of collateral based on the formula set out below:-

$$A^* = \text{Max} \{0, [A \times (1 + He) - C \times (1 - Hc - Hfx)]\}$$

**where:**

A\* = “Amount after CRM”

A = “Amount”

He = Haircut appropriate to the claim

C = Value of the collateral before adjustment required by the comprehensive approach

Hc = Haircut appropriate to the collateral

Hfx = Haircut appropriate to currency mismatch between the claim and the collateral

**Annex F** sets out the standard supervisory haircuts and the required adjustments for transactions with assumptions on holding-periods and frequencies of re-margining / revaluation that are different from those underlying the standard supervisory haircuts.

The reported RWA will then be calculated by multiplying A\* by the risk weight of the underlying claim.

### ***Balance sheet netting***

Report the principal of the asset under the column headed “Amount” in the Portfolio to which the asset belongs, classified according to the risk weight applicable to that asset.

Report the principal of the asset net of the book value of the related liability under the column headed “Amount after CRM” in the same Portfolio, still classified according to the risk weight of the asset. Where the asset is denominated in a currency different from that of the liability, the book value of the liability should be reduced by a haircut for the currency mismatch.

$$\text{“Amount after CRM”} = \text{Max} \{0, \text{asset} - \text{liability} \times (1 - Hfx)\}$$

**where:**

Hfx = Haircut appropriate to currency mismatch between the asset and the liability (see Annex F).

The reported RWA will then be calculated by multiplying the “Amount after CRM” by the risk weight of the asset.

### ***Netting of multiple repo-style transactions with one counterparty***

The bank must use the comprehensive approach for collateral if it intends to recognise the CRM effect of a valid bilateral netting agreement under which certain repo-style transactions are entered into with the same counterparty. The bank should compare the aggregate value of financial assets sold/lent/provided as collateral with the value of financial collateral acquired/borrowed/received as collateral taking into account haircuts based on the following formula. Where the “Counterparty exposure after netting” calculated in accordance with the formula is greater than zero, the bank has a net exposure to the counterparty, for which capital requirement should be provided:-

$$E^* = \text{Max} \{0, [(\sum(E) - \sum(C)) + \sum(Es \times Hs) + \sum(Efx \times Hfx)]\}$$

**where:**

**E\* = Counterparty exposure after netting**

**E = Value of financial assets sold/lent/provided as collateral**

**C = Value of financial collateral acquired/borrowed/received as collateral by the bank**

**Es= Absolute value of the net position in the same securities**

**Hs= Haircut appropriate to the net position in the same securities (i.e. Es)**

**Efx = Absolute value of the net position in a currency different from the settlement currency**

**Hfx = Haircut appropriate for currency mismatch**

The reporting arrangement for a net counterparty exposure in repo-style transactions covered by a valid bilateral netting agreement is as follows:

- Identify the Portfolio to which the counterparty belongs and the risk weight applicable to the counterparty;
- Report the gross amount (i.e. aggregate amount of all outward legs) of all the repo-style transactions subject to the netting agreement under the column of “Amount” and the “Counterparty exposure after netting” under the column of “Amount after CRM”, classified according to the risk weight of the counterparty;
- The reported RWA will then be calculated by multiplying the “Counterparty exposure after netting” by the risk weight applicable to the counterparty.

### ***Credit protection by means of credit-linked notes***

For credit-linked notes, where the bank issues such a note to cover the credit risk of an underlying asset, the maximum amount of protection is the amount of the funds received from issuing that note. The protected amount should be treated as a claim collateralised by cash deposits in Portfolio F, while the remaining unprotected amount, if any, should be treated as a credit exposure to the underlying asset.

Where the bank holds a credit-linked note, it acquires credit exposure on two fronts, to the reference entity of the note and also to the note issuer. This balance sheet asset should be weighted according to the higher of the risk weight of the reference entity or the risk weight of the note issuer and reported accordingly in the relevant Portfolio. The amount of exposure is the book value of the note.

**SECTION 5 - PORTFOLIO CLASSIFICATION, DETERMINATION OF CREDIT CONVERSION FACTORS AND RISK WEIGHTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES**

Categorisation and determination of CCF

The bank should categorise off-balance sheet exposures into the following standard items and report:

- The amount (which is automatically generated from form SR-1A); and
- The amount after allowing for credit risk mitigation and applying CCF, categorised by risk weight.

<b>Item</b>	<b>Description of Item</b>	<b>Guidance</b>	<b>CCF</b>
M.1	Direct credit substitutes	Direct credit substitutes almost always relate to the financial wellbeing of a third party. In this case the risk of loss to the reporting institution from the transaction is equivalent to a direct claim on that party, ie the risk of loss depends on the creditworthiness of the third party.	100%
M.2	Transaction related contingencies	Transaction related contingents relate to the ongoing trading activities of a counterparty where the risk of loss to the bank depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. They are essentially guarantees that support particular financial obligations rather than supporting customers' general financial obligations.	50%
M.3	Trade-related contingencies	These comprise short-term, self liquidating trade-related items, such as documentary letters of credit issued by the bank, which are, or are to be, collateralised by the underlying shipment, ie where the credit provides for the bank to retain title to the underlying shipment. Such items should be weighted according to the counterparty on whose behalf the credit is issued whether or not the terms and conditions of the credit have yet to be complied with.	20%

Item	Description of Item	Guidance	CCF
M.4	Asset sales with recourse	<p>Asset sales with recourse (where the credit risk remains with the bank) fall into the weighting category determined by the asset and not the counterparty with whom the transaction has been entered into.</p> <p>Put options written where the holder of the asset is entitled to put the asset back to the reporting bank, e.g. if the credit quality deteriorates, should be reported here, as should put options written by the reporting bank attached to marketable instruments or other physical assets.</p>	100%
M.5	Forward asset purchases	The weight should be determined by the asset to be purchased, not the counterparty with whom the contract has been entered into. Include commitments for loans and other balance sheet items with committed drawdown. Exclude foreign currency spot deposits with value dates one or two working days after trade date.	100%
M.6	Partly paid-up shares and securities	The unpaid part should only be included if there is a specific date for the call on that part of the shares and securities held.	100%
M.7	Forward deposits placed	These include a commitment to place a forward deposit. Where the bank has instead contracted to receive the deposit, failure to deliver by the counterparty will result in an unanticipated change in its interest rate exposure and may involve a replacement cost. Its exposure should therefore be treated as an interest rate contract ( <b>see Section 7</b> ).	100%
M.8	Note issuance and revolving underwriting facilities	Note issuance facilities and revolving underwriting facilities should include the total amounts of the bank's underwriting obligations of any maturity. Where the facility has been drawn down by the borrower and the notes are held by anyone other than the bank, the underwriting obligation should continue to be reported at the full nominal amount.	50%
M.9a	Other commitments with original maturity of less than 1 year	The bank is regarded as having a commitment from the date the customer is advised of the facility (e.g. the date of the letter advising the customer), regardless of whether the commitment is revocable or	20%

Item	Description of Item	Guidance	CCF
M.9b	Other commitments with original maturity of 1 year and over	irrevocable, conditional or unconditional and in particular whether or not the facility contains a “material adverse change” clause. Facilities subject to annual review should only be classified within M.9a if the bank is confident there is no client expectation of automatic renewal.	50%
M.9c	Commitments that are unconditionally cancellable without prior notice	<p>Commitments (including the undrawn portion of any binding arrangements which obligate the bank to provide funds at some future date) that are unconditionally cancellable without prior notice by it other than for “force majeure” reason, or that effectively provide for automatic cancellation due to deterioration in a borrower’s creditworthiness.</p> <p>Retail credit lines may be considered as unconditionally cancellable if the terms permit the bank to cancel them to the full extent allowable under consumer protection and related legislation.</p> <p>Where a bank has entered into a so called “uncommitted facility” and it is apparent that the facility is commercially (if not legally) committed, consideration should be given to applying a capital charge to such a facility under Pillar 2 (the ICAAP) which might be equivalent to the charge that would be applicable if there was a legally enforceable commitment.</p>	0%

## Determination of risk weights for off-balance sheet items excluding OTC Derivatives

Except for the following, the applicable risk weight for an off-balance sheet item is determined by reference to the risk weight allocated to the counterparty of the exposure, in accordance with the relevant instructions under **Section 3**. The exceptions are:

- “Direct credit substitutes”;
- “Asset sales with recourse”;
- “Forward asset purchases”;
- “Partly paid-up shares and securities”; and
- Exposures arising from the selling of credit derivative contracts booked in the reporting institution’s banking book reported as “Direct credit substitutes”.

For these, the applicable risk weight to an exposure should be:

*In the case of “Direct credit substitutes”, “Asset sales with recourse” and “Forward asset purchases”, the risk weight is determined by reference to the risk weight allocated to the underlying assets;*

*In the case of “Partly paid-up shares and securities”, use the risk weight for the equities in question (usually 100%); and*

*In the case of exposures arising from the selling of credit derivative contracts booked in the reporting bank’s banking book reported as “Direct credit substitutes”, the risk weight is normally determined by reference to the risk weight of the relevant reference entity. However:*

- Where a credit derivative contract sold is a first-to-default credit derivative contract:
  - If it has a current rating assigned to it by an ECAI, the bank should apply the risk weight attributed to the rating using the securitisation mapping (Tables 3 & 4); or
  - If it does not have a current rating assigned to it by an ECAI, the bank should report as per the aggregate risk weights of the reference entities in the basket, subject to a maximum of 1000%.
- Where a credit derivative contract sold is a second-to-default credit derivative contract:
  - If it has a current rating assigned to it by an ECAI, the bank should apply the risk weight attributed to the rating using the securitisation mapping (Tables 3 & 4); or
  - If it does not have a current rating assigned to it by an ECAI, the bank should aggregate the risk weights of the reference entities in the basket, but excluding that reference entity to which the lowest risk weight would be allocated, subject to a maximum of 1000%.

- Where a credit derivative contract sold provides credit protection proportionately to a basket of reference entities, in ratios set out in the credit derivative contract, the institution should calculate the risk weight of its exposure under the credit derivative contract by taking a weighted average of the risk weights attributable to the reference entities in the basket. For the purpose of reporting in form SR-1B M.1, the weighted average risk weight should be entered as a round number (e.g. if the average weighting was 25.64% the amount should be entered in the form as 26).

## **SECTION 6 - CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - EXCLUDING OTC DERIVATIVES**

### Introduction

For each off-balance sheet exposure, the bank is required to identify the relevant risk weight for the counterparty by reference to what this would be for a balance sheet exposure to the same counterparty.

Where an exposure is not covered by any recognised CRM techniques the process for calculating the capital requirement is:

- Firstly, enter the “Amount” (this is automated within the form software), which is converted into a “Credit Equivalent Amount” by multiplying it by the applicable CCF;
- Secondly, the “Credit Equivalent Amount” is classified by the applicable risk weighting, which is then used to calculate the RWA.

Where an exposure is covered fully or partially by recognised CRM techniques, the capital treatment is similar to that of balance sheet assets set out in **Section 4**, except that, in calculating the RWA, the “Credit Equivalent Amount” (“**CEA**”) is used instead of the “Amount”. The calculation will depend on the type of CRM techniques used.

**Annex H** contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures based on both the “simple” approach and the “comprehensive” approach of the Basel II credit risk mitigation framework.

### CRM treatment by substitution of risk weights

This method should be used for collateral under the “simple” approach, and in all cases for the recognition of the impact of guarantees and credit derivatives.

Report the amount of the exposure in the row “Amount”, classified according to **Section 5**.

Divide the amount into two portions: the portion covered by credit protection and the remaining uncovered portion (the value of the credit protection for different types of CRM techniques being determined in the same way as when the techniques are used to cover balance sheet assets – **see Section 4**).

Multiply both portions by the CCF applicable to the exposure to create two CEAs (the total of which must equate to the CEA given by the sheet).

Classify the CEA of the uncovered portion according to the risk weight of the exposure and the CEA of the covered portion according to the risk weight of the collateral (subject to a 20% floor which can be reduced in the situations set out in **Annex D**) or, for a guarantee or credit derivative, the credit protection provider. These inputs will then be used by the module to arrive at the risk weighted amount by multiplying each CEA by the appropriate weight.

### CRM treatment by reduction of amount of an exposure

This method should be used for the comprehensive approach for collateral.

Report the “Amount”, classified according to **Section 5**.

Calculate the “Credit Equivalent Amount after CRM” and multiply it by the applicable CCF based on the following formula:

$$CEA^* = \max \{0, [A \times (1 + He) - C \times (1 - Hc - Hfx)]\} \times CCF$$

where:

CEA\* = “Credit Equivalent Amount after CRM”

A = “Amount”

He = Haircut appropriate for the exposure

C = Value of the collateral

Hc = Haircut appropriate to the collateral

Hfx = Haircut appropriate for currency mismatch between the exposure and the collateral

CCF = Credit conversion factor applicable to the exposure

Classify the “Credit Equivalent Amount after CRM” according to the risk weighting of the counterparty. This will then be used by the module to calculate the “Risk-weighted Amount”.

**SECTION 7 PORTFOLIO CLASSIFICATION: OFF-BALANCE SHEET EXPOSURES: OTC DERIVATIVES**

OTC contracts summary

For OTC contracts, all information and calculation is performed within the relevant schedule. The OTC form is a summary of the results of the individual schedules.

<b>Item</b>	<b>Description of Item</b>	<b>Guidance</b>
N.1	Interest rate contracts	Summary, automatically completed from the data input in Schedule N.1
N.2	Foreign exchange and gold contracts	Summary, automatically completed from the data input in Schedule N.2
N.3	Equity contracts	Summary, automatically completed from the data input in Schedule N.3
N.4	Other precious metal contracts	Summary, automatically completed from the data input in Schedule N.4
N.5	Other commodity contracts	Summary, automatically completed from the data input in Schedule N.5

OTC contract Schedules

*OTC N.1:* The following derivative contracts may be excluded from the calculation of RWA:

- Exchange rate contracts (except those which are based on gold) with an original maturity of 14 calendar days or less; or
- Forward exchange rate contracts arising from swap deposit arrangements. Under such contracts, the money deposited by the customer remains under the control of the bank at all times during the transaction and the institution will be in a position to ensure that the customer does not default on the settlement of the forward contract.

Categorisation and add-on factors for OTC derivative contracts

The add-on factors used to determine the Credit Equivalent Amount applicable to OTC derivative transactions are set out in the following table according to their residual maturities:

	Interest Rate	FX and Gold	Equities	Precious Metals (except Gold)	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over 1 year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

For contracts structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity should be set equal to the time until the next reset date. In the case of interest rate contracts that meet these criteria, and the remaining time to final maturity of the contracts is more than one year, the add-on factor is subject to a floor of 0.5%.

Forwards, swaps, purchased options and similar derivative contracts other than those contracts the value of which is derived from the value of exchange rate, gold, interest rate, equity, or precious metal, should have applied the add-on factors applicable to "Other Commodities".

## **SECTION 8 - CREDIT RISK MITIGATION AND THE CALCULATION AND REPORTING OF RISK-WEIGHTED AMOUNTS: OFF-BALANCE SHEET EXPOSURES - OTC DERIVATIVES**

The bank should use the replacement cost method to risk weight credit exposures to counterparties under OTC derivatives. OTC derivative transactions should be reported in Schedules N.1 to N.5. Where OTC derivative transactions are covered by a valid bilateral netting agreement, the bank may report the netted amount under item P in the OTC Summary page.

Report the “Amount” outstanding, being the total nominal value of all relevant OTC contracts classified according to type, maturity and the risk weighting of the counterparty. Insert the sum of any and all positive mark-to-market valuations relating to these contracts in the column headed “Positive Mark-to-Market”, which is the replacement cost (obtained by “marking to market”) of every contract with a positive value (where a contract has a negative value, it should be taken as zero), or where contracts are covered by a valid bilateral netting agreement, the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the bilateral netting agreement, if positive.

The “Credit Equivalent Amount” will then be the sum of:

- The “Positive Mark-to-Market”; and
- The “Add-on Amount”, which is derived by multiplying the “Amount” of each contract by the appropriate “add-on factor” for that classification (as set out in **Section 7**).

Single currency floating/floating (basis) interest rate swaps should be classified as being less than 1 year to maturity and hence attract an add-on of 0%; the “Credit Equivalent Amount” is simply the positive mark-to-market.

In the absence of CRM, report the “Credit Equivalent Amount” in the column headed “Amount after CRM”. Allowance for specific provisions can be made by deducting these from the “Credit Equivalent Amount”. This would then be multiplied by the applicable risk weight to calculate the RWA.

Where the (net) exposure to the counterparty is protected fully or partially by recognised CRM techniques the capital treatment is similar to that of balance sheet assets explained in **Section 4**, albeit in calculating the RWA, the “Credit Equivalent Amount” is used instead of the “Amount”. The calculation will depend on the type of CRM techniques used, as described in the following two sections.

**Annex H** contains a number of examples to illustrate the capital treatment and reporting arrangement of collateralised exposures based on the “simple” approach and the “comprehensive” approach of the credit risk mitigation framework.

### **CRM treatment by substitution of risk weights**

This method should be used for collateral under the “simple” approach, and in all cases for the recognition of the impact of guarantees and credit derivatives.

Report the amount of the underlying transaction under the column "Amount".

Convert the "Amount" into a "Credit Equivalent Amount" as set out above. Specific provisions should be deducted from the "Credit Equivalent Amount". Note that the sheet will provide an unadjusted "Credit Equivalent Amount" that should be used if there are no provisions.

Divide the "Credit Equivalent Amount" into two portions: the portion covered by credit protection and the remaining uncovered portion.

In the "After CRM", column classify the "Credit Equivalent Amount" of the uncovered portion according to the applicable risk weight of the exposure and the "Credit Equivalent Amount" of the covered portion according to the applicable risk weight of the collateral (subject to a floor of 20% which can be reduced in the situations set out in **Annex D**) or credit protection provider. Each amount will be multiplied by the appropriate risk weight to arrive at the risk-weighted amount.

CRM treatment by reduction of amount of an exposure

This method should be used for the "comprehensive" approach for collateral.

Report the principal of the underlying transaction under the column "Amount".

Convert the "Amount" into a "Credit Equivalent Amount" as set out above. Specific provisions should be deducted from the "Credit Equivalent Amount".

Calculate the "Credit Equivalent Amount after CRM" according to the following formula:

**CEA\*** = Max {0, [CEA - C x (1 - Hc - Hfx)]}

**where:**

**CEA\*** = "Credit Equivalent Amount after CRM"

**CEA** = "Credit Equivalent Amount" (i.e. sum of "Positive Mark-to-Market" and "Add-on Amount", net of specific provisions)

**C** = Value of the collateral

**Hc** = Haircut appropriate to the collateral

**Hfx** = Haircut appropriate for currency mismatch between the settlement currency and the collateral currency

In the "After CRM" column enter the "Credit Equivalent Amount after CRM" classified by the risk weight of the counterparty. This is then used to calculate the "Risk-weighted Amount".

## **SECTION 9 CREDIT RISK MITIGATION – SPECIFIC ISSUES**

### **Multiple credit risk mitigation**

An exposure covered by two or more different CRM techniques (e.g. with both collateral and guarantee partially covering the claim) should be accounted for by dividing the exposure into portions covered by each type of CRM technique. The calculation of the RWA of each portion will be done separately according to the reporting of each portion. Where there is an overlap of coverage between the CRM techniques, the bank may select, in respect of the overlapped portion, the CRM technique that will result in the lowest RWA for the exposure.

An exposure covered by two or more CRM techniques that are of the same form but have different maturities should likewise be divided into different portions according to the maturities. The RWA of each portion should then be calculated separately.

Where an exposure is in the form of a general banking facility consisting of several types of credit line, the bank may determine how any CRM techniques available under the facility should be allocated to individual claims under each line.

### **Maturity mismatches**

Where the residual maturity of the CRM is less than that of the underlying credit exposure, a maturity mismatch occurs. Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognised for capital purposes. In other cases where there is a maturity mismatch, partial recognition is given to the CRM for regulatory capital purposes as detailed below. Under the “simple” approach for collateral, maturity mismatches will not be allowed.

For the “comprehensive” approach, the value of the credit protection should be adjusted based on the following formula:

$$Pa = P \times (t - 0.25) / (T - 0.25)$$

**where:**

**Pa = Value of credit protection adjusted for maturity mismatch**

**P = Value of credit protection adjusted for haircuts for price volatility of collateral and currency mismatch**

**T = The lower of 5 years and the residual maturity of the underlying exposure, expressed in years**

**t = The lower of T and the residual maturity of the credit protection, expressed in years**

## Tables

**Table 1 – Mapping of ECAs’ credit assessments to risk weightings: Long-term mapping**

Standard and Poor’s (“S&P”) assessments	Fitch’s assessments	Moody’s assessments	Corporate	Banks and securities firms		Sovereign	PSE (Sovereign rating based)
				Maturity > 3 months	Maturity 3 months or less		
AAA to AA-	AAA to AA-	Aaa to Aa3	20%	20%	20%	0%	20%
A+ to A-	A+ to A-	A1 to A3	50%	50%	20%	20%	50%
BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	100%	50%	20%	50%	100%
BB+ to BB-	BB+ to BB-	Ba1 to Ba3	100%	100%	50%	100%	100%
B+ to B-	B+ to B-	B1 to B3	150%	100%	50%	100%	100%
CCC+ and below	CCC+ and below	Caa1 and below	150%	150%	150%	150%	150%

**Table 2 – Mapping of ECAs’ credit assessments to risk weightings: Short-term mapping (Banks and Corporates)**

S&P assessments	Fitch’s assessments	Moody’s assessments	Risk weight
A-1+, A-1	F1+, F1	P-1	20%
A-2	F2	P-2	50%
A-3	F3	P-3	100%
All short-term ratings below A-3	Below F3	Not prime (NP)	150%

**Table 3 – Securitisation - Mapping of ECAs' credit assessments to risk weightings: Long term mapping**

<b>S&amp;P assessments</b>	<b>Fitch's assessments</b>	<b>Moody's assessments</b>	<b>Risk weight</b>
AAA to AA-	AAA to AA-	Aaa to Aa3	20%
A+ to A-	A+ to A-	A1 to A3	50%
BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	100%
BB+ to BB-	BB+ to BB-	Ba1 to Ba3	350%
B+ and below	B+ and below	B1 and below	Capital deduction

**Table 4 – Securitisation - Mapping of ECAs' credit assessments to risk weightings: Short term mapping**

<b>S&amp;P assessments</b>	<b>Fitch's assessments</b>	<b>Moody's assessments</b>	<b>Risk weight</b>
A-1+, A-1	F1+, F1	P-1	20%
A-2	F2	P-2	50%
A-3	F3	P-3	100%
All short-term ratings below A-3	Below F3	Not prime (NP)	Capital deduction

**Table 5 – Collective investment undertakings - mapping of ECAs' credit assessments to risk weightings**

<b>S&amp;P assessments (principal stability fund ratings)</b>	<b>S&amp;P assessments (fund credit quality ratings)</b>	<b>Fitch's assessments</b>	<b>Moody's assessments</b>	<b>Risk weight</b>
AAm to AA-m	AAAf to AA-f	AAA to AA-	Aaa to Aa3	20%
A+m to A-m	A+f to A-f	A+ to A-	A1 to A3	50%
BBB+m to BBB-m	BBB+f to BBB-f	BBB+ to BBB-	Baa1 to Baa3	100%
BB+m to BB-m	BB+f to BB-f	BB+ to BB-	Ba1 to Ba3	100%
B+m to B-m	B+f to B-f	B+ to B-	B1 to B3	150%
CCC+m and below	CCC+f and below	CCC+ and below	Caa1 and below	150%

**Table 6 – Mapping consensus risk scores from participating ECAs to risk weightings**

<b>Country Score</b>	<b>Sovereign</b>
0-1	0%
2	20%
3	50%
4-6	100%
7	150%

## **ANNEX A - ECAI RATINGS AND MAPPING**

### **Recognition of External Credit Assessment Institutions (ECAIs)**

The ECAIs recognised are:

- Fitch Ratings;
- Standard & Poor's Ratings Services; and,
- Moody's Investors Service.

### **Mapping of ECAIs' ratings to risk weights for capital adequacy purposes**

The mapping of the recognised ECAIs' ratings to risk weights is shown in *Tables 1&2* for the standardised approach, and in *Tables 3&4* for securitisations under the standardised approach. *Table 5* shows the mapping of ECAIs' ratings to risk weights in respect of collective investment undertakings.

Banks must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purpose. Banks will not be allowed to "cherry-pick" the assessments provided by different ECAIs, and must disclose the ECAIs that they intend to use for the risk weighting of their assets by type of claim as per the mapping process in *Tables 1, 2, 3, 4 and 5*. Further guidance is provided below.

### ***Guidelines applicable to banks with respect to the nomination of ECAIs***

For the purpose of applying ECAI ratings to derive risk-weights for exposures under the relevant portfolios, a bank should satisfy the following four steps:

- Nominate one or more ECAI(s) whose assigned ratings will be used by the bank for deriving risk weights for exposures in each of the external ratings-based Portfolios, provided that the nominated ECAI(s) can provide a reasonable coverage of the bank's exposures within the Portfolios in terms of the types of counterparties and different geographical regions covered by the ECAI(s);
- Notify the Commission of its nominated ECAI(s) and the application of the ratings of such ECAI(s) on each of the bank's external ratings-based Portfolios;
- Use the ratings of the nominated ECAI(s) within each of the external ratings-based Portfolios consistently, and seek the consent of the Commission on any subsequent changes to such ECAI(s) and the application of its/their ratings; and
- Treat a relevant exposure or the person to whom the bank has a relevant exposure as "unrated" for risk weighting purposes if that exposure or that person does not have a solicited rating assigned to it by any ECAI chosen by the bank.

The above requirements are to ensure that a bank applies the ratings of its nominated ECAI(s) consistently and avoid any possible cherry picking of ratings provided by different ECAIs.

In determining its nominated ECAI(s), a bank should pay special attention to the criterion of “reasonable coverage”. Where a bank has significant exposures within the external ratings-based Portfolios to a particular type/set of counterparties or a particular country that is not rated by the bank’s nominated ECAI(s) but ratings are available from other ECAI(s) recognised by the Commission, the bank should include such ECAI as a nominated ECAI to comply with the “reasonable coverage” requirement.

### ***Multiple assessments***

If there is only one assessment by a nominated ECAI chosen by a bank for a particular claim, that assessment should be used to determine the risk weight of the claim.

If there are two assessments by nominated ECAs chosen by a bank that map into different risk weights, the higher risk weight will be applied.

If there are three assessments with different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights will be applied.

### ***Level of application of assessments***

External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

### ***Issue versus issuer assessment***

Where a bank invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where a bank’s claim is not an investment in a specific assessed issue the following principles apply:

- In circumstances where the borrower has a specific assessment for an issued debt, but the bank’s claim is not an investment in this particular debt, a high quality credit assessment (that being one which maps into a risk weight lower than that which applies to an unrated claim) on that specific debt may only be applied to the bank’s un-assessed claim if this claim ranks *pari passu* or senior to the claim with an assessment in all respects. If not, the credit assessment cannot be used and the un-assessed claim will receive the risk weight for unrated claims; and
- In circumstances where the borrower has an issuer assessment, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a high quality issuer assessment. Other un-assessed claims of a highly (mapping into a risk weight equal to or higher than that which applies to unrated claims), assessed issuer will be treated as unrated. If either the issuer or a single issue has a low quality assessment (mapping into a risk weight lower than that which applies to unrated claims), an un-

assessed claim on the same counterparty will be assigned the same risk weight as is applicable to the low quality assessment.

Where a bank intends to rely on an issuer or an issue specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure a bank has with regard to all amounts owed to it.

### ***Short-term / long-term assessments***

For risk weighting purposes, short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims, except under the conditions that follow in relation to short-term inter-bank claims of the standardised approach to credit risk, which the Commission has applied:

- The general preferential treatment for short-term claims, as defined under paragraphs 62 and 64 of Basel II, applies to all claims on banks of up to three months original maturity when there is no specific short-term assessment (i.e. apply the long-term ratings and associated risk weights as defined in *Table 1&3* for short-term claims);
- Where there is a short-term assessment, and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only; and
- Where a specific short-term assessment for a short-term claim on a bank maps into a less favourable (i.e. higher) risk weight, the general preferential treatment for inter-bank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

Short-term ratings cannot be used to support a risk weight for an unrated long-term claim, and may only be used for short-term claims against banks, corporate entities and securitisations. The mapping process for short-term claims is shown in *Tables 2&4*.

### ***Collective investment undertakings (“CIU”s)***

The mapping for CIUs is the same as the mapping for long-term fundamental credit ratings. Fitch and Moody’s use the same rating scale for their “Managed Funds Credit Quality Ratings” as for their fundamental credit ratings, while Standard & Poor’s uses a slightly different rating scales for “Principal Stability Fund” ratings and for “Fund Credit Quality Ratings”, the rating scales are identical in terms of number of rating categories.

Credit assessments in relation to exposures in the form of CIUs are to be applied purely for fixed income CIUs within the standardised approach. The mapping of ECAIs’ ratings to risk weights is shown in *Table 5*.

### Export Credit Agencies (“ECA”s)

Basel II (para 55) allows supervisors to recognise the country risk scores assigned by ECAs in respect of the risk weighting of sovereign and central bank exposures. This is in addition to banks being able to use ECAs for such exposures. The Commission Group exercised this National Discretion, stating that banks can only use the consensus risk scores of ECAs participating in the “OECD Arrangement on Officially Supported Export Credits”. The consensus country risk classification is available on the OECD’s website ([www.oecd.org](http://www.oecd.org)). The mapping of the score to risk weights is shown in *Table 6*. Banks wishing to use the consensus risk scores of ECAs must use these consistently.

## **ANNEX B – CLASSIFICATION BETWEEN SOVEREIGN AND PSE EXPOSURES**

### **Zero weighted exposures to the Isle of Man Government, United Kingdom Government and the States of Jersey and Guernsey**

The Commission has exercised its national discretion such that claims on (and guaranteed by) the Isle of Man Government denominated in sterling, and funded in sterling attract a risk weighting of zero. In cases where the Isle of Man Government, through Treasury, has provided a letter of comfort rather than a formal guarantee, the Commission may also allow such claims to be risk weighted at zero but a bank should seek clarification in such circumstances.

Similarly, claims on (and guaranteed by) the United Kingdom Government and the States of Jersey and Guernsey denominated in sterling and funded in sterling also attract a risk weighting of zero. In essence, the Isle of Man Government and States of Jersey and Guernsey are treated as “sovereigns” for the purpose of credit risk reporting.

### **Claims on non central government PSEs**

Generally, such claims are risk weighted in accordance with portfolio B of form SR-1B (i.e. a floor of 20%). However, there are cases where it may be appropriate to treat a claim on PSE as being a claim on a sovereign which could attract a lower risk weighting. Matters which should be considered in determining whether a claim can be treated as to a sovereign include the following:-

- The extent of guarantees provided by the central government (and in the case of the Isle of Man Government, letters of comfort);
- For PSEs (often regional governments and local authorities) that have revenue raising powers the claim may be treated as a claim on the sovereign / central government if the PSE has specific revenue raising powers and have specific institutional arrangement the effect of which is to reduce their risks of default;
- For PSEs (administrative bodies responsible to central governments, regional governments or local authorities, and other non commercial undertakings) that do not have revenue raising powers or do not have special constitutional arrangements (or guarantees), it is unlikely the claim will be treated as a claim on the sovereign / central government. Further, if strict lending rules apply to these entities and a declaration of bankruptcy is not possible because of their special public status, it may be appropriate to treat these claims in the same manner as claims on banks.

## **ANNEX C - MULTILATERAL DEVELOPMENT BANKS (MDBs)**

List of institutions that shall be considered as MDBs:

- European Investment Bank
- European Bank for Reconstruction and Development
- Council of Europe Development Bank
- European Investment Fund
- International Bank for Reconstruction and Development
- International Finance Corporation
- Inter-American Development Bank
- African Development Bank
- Asian Development Bank
- Caribbean Development Bank
- Nordic Investment Bank
- Islamic Development Bank

## **ANNEX D - EXCEPTIONS TO THE RISK WEIGHT FLOOR OF 20% UNDER THE SIMPLE APPROACH FOR COLLATERAL**

### Introduction

In general, a bank should not allocate a risk weight of less than 20% to collateral that is recognised under the “simple” approach except those set out below.

### Repo-style Transactions

A risk weight of 0% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in **Annex E**.

A risk weight of 10% can be allocated to repo-style transactions that are treated as collateralised lending and satisfy all requirements set out in **Annex E excluding those relating to core market participants**.

### OTC Derivative Transactions

A risk weight of 0% can be allocated to the collateralised portion of an OTC derivative transaction provided that:

- The transaction is marked-to-market daily and collateralised by cash provided to the institution, and
- The settlement currency of the transaction is the same currency as the cash provided as collateral.

A risk weight of 10% can be allocated to the collateralised portion of an OTC derivative transaction when the transaction is collateralised by debt securities issued by a sovereign or a sovereign foreign public sector entity qualifying for a risk weight of 0% in accordance with **Section 3 and Annex B**.

### Other Transactions

A 0% risk weight can be allocated to the collateralised portion of a transaction if both the transaction and the collateral are denominated in the same currency, and either:

- The collateral is cash on deposit with the bank; or
- The collateral is in the form of debt securities issued by a sovereign or a sovereign foreign public sector entity eligible for a risk weight of 0% in accordance with **Section 3 and Annex B**, and the current market value of which has been discounted by 20%.

A 0% risk weight can be allocated to recognised collateral in the form of gold bullion held by the bank.

## **ANNEX E - CRITERIA FOR PREFERENTIAL TREATMENT OF REPO-STYLE TRANSACTIONS**

### Introduction

Other than those covered by a valid bilateral netting agreement, the bank should adopt the “economic substance” approach for capital treatment of repo-style transactions and report them as balance sheet assets as described below.

### Repos of securities

Where the bank has sold securities under repo agreements, the securities sold should continue to be treated as assets with capital requirement provided for the credit risk to the securities:

- Reverse repos of securities - where the bank has acquired securities under reverse repo agreements, the transaction should be treated as a collateralised lending to the counterparty, providing the securities acquired meet the relevant criteria for recognising collateral. The capital requirement should then be provided for the credit risk to the counterparty, taking into account the CRM effect of the collateral;
- Securities lending - the treatment is similar to that of repo transactions. This means that the securities lent should continue to remain as an asset on the balance sheet of the bank, with the capital requirement being derived from the credit risk of the securities; and
- Securities borrowing - the treatment depends on whether the collateral provided is cash or other securities:
  - Where the collateral provided is cash, it should be treated as a collateralised lending to the counterparty, providing the securities received meet the relevant criteria for recognising collateral, as set out in **Annex G**. The capital requirement should then be derived from the credit risk to the counterparty, taking into account the CRM effect of the collateral;
  - Where the collateral provided is not cash but securities, the securities borrowed should be reported as assets on the balance sheet of the bank.

For securities lending or borrowing where the contractual agreement is made between the securities borrower/lender and the custodian (e.g. Clearstream Banking or Euroclear Bank) and the securities borrower/lender has no knowledge as from/to whom the security is borrowed/lent, the custodian becomes the “counterparty” of the stock borrower/lender.

The Commission will allow a preferential risk-weighting treatment for qualified repo-style transactions which satisfy all the requirements below. Under the

“comprehensive” approach for collateral, these qualified transactions are not required to be subject to any haircuts.

#### Requirements to be satisfied

- The counterparty should be a core market participant. The Commission recognises the following entities as core market participants:
  - Sovereigns, central banks and PSEs;
  - Banks and securities firms;
  - Other financial companies (including insurance companies) eligible for a 20% risk weight in the standardised approach;
  - Regulated mutual funds that are subject to capital or leverage requirements;
  - Regulated pension funds; and
  - Recognised clearing organisations
- Both the exposure and the collateral are cash or securities issued by sovereigns or PSEs treated as sovereigns which qualify for a risk weight of 0%.
- Both the exposure and the collateral are denominated in the same currency.
- Either the transaction is overnight or both the exposure and the collateral are subject to daily mark-to-market and daily re-margining.
- In the case of a counterparty’s failure to re-margin, the time between the last mark-to-market before the failure to re-margin and the liquidation of the collateral is no more than four business days.
- The transaction is settled across a settlement system proven for that type of transaction.
- Standard market documentation in the securities concerned is used for the agreement covering the repo-style transactions.
- The documentation of the transaction should specify that the transaction is immediately terminable if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults
- Upon any event of default, regardless of whether the counterparty is insolvent or bankrupt, the bank should have an unfettered and legally enforceable right to immediately seize and liquidate the collateral for its benefit.

## **ANNEX F - STANDARD SUPERVISORY HAIRCUTS FOR THE COMPREHENSIVE APPROACH FOR COLLATERAL**

### Introduction

Banks applying the “comprehensive” approach for collateralised transactions are required to use standard supervisory haircuts provided in the table below to adjust the price volatility of both the underlying exposure and/or the collateral. These haircuts assume daily marking-to-market, daily re-margining and a 10-business-day holding period. (Figures below are in percentages.)

### Table of Supervisory Haircuts

<b>Issue rating for debt securities</b>	<b>Residual Maturity</b>	<b>Sovereigns</b>	<b>Other issuers</b>
AAA to AA-	=<1 year	0.5	1
	>1 year, =< 5 years	2	4
	> 5 years	4	8
A+ to BBB- and unrated bank securities	=<1 year	1	2
	>1 year, =< 5 years	3	6
	> 5 years	6	12
BB+ to BB-	All	15	Not Allowed
Main index equities (including convertible bonds) and Gold		15	
Other equities (including convertible bonds) listed on a recognised exchange		25	
UCITS/Mutual funds		Highest haircut applicable to any security in which the fund can invest	
Cash in the same currency		0	

Haircuts for sovereigns should be applied to MDBs and PSEs treated as sovereigns by an equivalent regulator.

### Guidance on use of haircuts

For transactions in which a bank lends to a counterparty instruments that are not included in the above table (e.g. non-investment grade corporate debt securities), the haircut to be applied to the exposure should be equivalent to the haircut for equity traded on a recognised exchange that is not part of a main index (i.e. 25%).

In cases where the underlying exposure and collateral are denominated in different currencies, a standard supervisory haircut for currency risk (**Hfx**) of 8% should be imposed to further reduce the value of collateral. This haircut is also based on daily mark-to-market and a 10-business-day holding period.

When applying the appropriate haircuts to the underlying exposure and collateral, institutions should distinguish the transaction between three types:

- Repo-style transactions;
- Other capital market transactions (i.e. OTC derivative transactions, and margin lending); and
- Secured lending.

The appropriate haircut to be used for each of these types of transactions depends on the frequency of re-margining or revaluation and the assumed minimum holding period for the type of transaction. Providing the transactions are subject to daily revaluation or re-margining, the assumed minimum holding period of these three types of transactions are as follows:

Type of Transactions	Minimum Holding Period	Condition
Repo-style transactions	5 business days	Daily re-margining
Other capital market transactions	10 business days	Daily re-margining
Secured lending	20 business days	Daily revaluation

Providing the requirements set out at **Annex E** are satisfied, a repo-style transaction treated as a collateralised loan to a core market participant will not be subject to any haircuts.

Where a transaction has a minimum holding period different from 10 business days or is not re-margined or re-valued daily as assumed in the standard supervisory haircuts, banks are required to scale up or down the standard haircuts (**He**, **Hc** and **Hfx**) by the following formula when applying them to calculate the RWA of a transaction:

$$H = H10 \times \text{Square root of } ((NR+(TM-1))/10)$$

**where:**

**H = Haircut after adjustment for differences in holding period and revaluation frequency**

**H10 = Standard supervisory haircuts based on a minimum holding period of 10 business days**

**NR = Actual number of days between re-margining or revaluation of collateral**

**TM = Minimum holding period for particular types of transaction (i.e. 5 business days for repo-style transactions or 20 business days for secured lending)**

In the case of repo-style transactions, haircuts for price volatility of the instruments involved in the transactions could be lowered to 0% if the criteria specified in **Annex E** are satisfied.

## **ANNEX G - REQUIREMENTS FOR RECOGNITION OF COLLATERAL**

### Introduction

Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised by first priority claims, in whole or in part with cash or securities, a loan exposure may be guaranteed by a third party, or a bank may buy a credit derivative to offset various forms of credit risk. Additionally, banks may agree to set-off loans owed to them against deposits from the same counterparty.

Where these techniques meet the requirements for legal certainty as described in below, the revised approach to CRM allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than is permitted under the 1988 Accord.

### General remarks

The framework is applicable to the banking book exposures in the standardised approach. The comprehensive approach for the treatment of collateral will also be applied to calculate the counterparty risk charges for OTC derivatives and repo-style transactions booked in the trading book.

No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.

While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including:

- Strategy;
- Consideration of the underlying credit;
- Valuation;
- Policies and procedures;
- Systems;
- Control of roll-off risks; and
- Management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.

Where these risks are not adequately controlled, supervisors may impose additional capital charges or take other supervisory actions, as outlined in Pillar 2.

## Legal certainty

In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met:

- All documentation used in collateralised transactions, and for documenting balance sheet netting, guarantees and credit derivatives, must be binding on all parties and legally enforceable in all relevant jurisdictions; and
- Banks must have conducted sufficient legal review to verify this, have a well-founded legal basis to reach this conclusion and undertake such further review as necessary to ensure continuing enforceability.

In addition to the general requirements for legal certainty set out above, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, banks must take all steps necessary to fulfil those requirements under the law applicable to the bank's interest in the collateral to obtain and maintain an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set-off.

In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible.

Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

## ANNEX H - ILLUSTRATIONS ON REPORTING OF CREDIT RISK MITIGATION TECHNIQUES

### Balance sheet example: Collateralised loan

The reporting bank provides a 5-year term loan of £5,000,000 to an unrated corporate. The loan is secured by debt securities issued by a bank and denominated in Euro. The debt securities are rated AA by Standard & Poor's and have a remaining maturity of 7 years. They are subject to daily revaluation and presently have a market value in GBP equivalent amount of £5,200,000.

### ***Collateralised loan – “simple” approach***

Considerations:

- A loan to an unrated corporate is subject to a risk weight of 100%.
- An external credit assessment of “AA” for a bank by Standard & Poor's is mapped to a risk weight of 20%.
- As the market value of the collateral debt securities is £5,200,000, the loan is fully secured.
- RWA of the loan:  $5,000,000 \times 20\% = \text{£}1,000,000$ .

Reporting illustration: “simple” approach to CRM, balance sheet example:

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
...	...	...	...	...	...
<b>C</b>	<b>Claims on Corporates</b>				
C.1	Risk Weight 20%	0	0	20	0
C.2	Risk Weight 50%	0	0	50	0
C.3	Risk Weight 100%	5,000	0	100	0
C.4	Risk Weight 150%	0	0	150	0
	<b>SUBTOTAL</b>	<b>5,000</b>	<b>0</b>		<b>0</b>

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
<b>D</b>	<b>Claims on Banks</b>				
<b>D.1</b>	<b>Claims on Banks, except guarantees</b>				
D.1.1	Maturity more than 3 Months				
D.1.1.1	Risk Weight 20%	0	5,000	20	1,000
D.1.1.2	Risk Weight 50%	0	0	50	0
D.1.1.3	Risk Weight 100%	0	0	100	0
D.1.1.4	Risk Weight 150%	0	0	150	0
...	...	...	...	...	...
	<b>SUBTOTAL</b>	<b>0</b>	<b>5,000</b>		<b>1,000</b>

## **Collateralised loan – “comprehensive” approach**

Considerations:

- The standard supervisory haircut for debt securities rated AA for banks is 8%.
- The standard supervisory haircut for a currency mismatch between the underlying claim and collateral is also 8%.
- As the standard supervisory haircuts assume only a 10-day holding period, the 8% haircuts for both the collateral and the currency mismatch have to be scaled up to a 20-day minimum holding period assumed for a secured lending transaction (see Appendix E) using the following formula:

$$H = H10 \times \text{Square root of } ((NR+(TM-1))/10)$$

where:

**H = Haircut after adjustment for differences in holding period and revaluation frequency**

**H10 = Standard supervisory haircuts which assume a minimum 10-day holding period = 8% in this case.**

**NR= Actual number of days between revaluation (= 1 day in this case).**

**TM = Minimum holding period for the type of transaction (which is different from a holding period of 10 days) = 20 days in this case.**

- The adjusted haircuts for the collateral and the currency mismatch in this example are therefore:

$$H = 8\% \times \text{Square root of } ((1+(20-1))/10) = 11\% \text{ (rounded to the nearest percentage point).}$$

- The exposure after CRM is calculated as:

$$A^* = \max \{0, [A \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \text{ where:}$$

**A\* = Amount after CRM**

**A = Amount = £5,000,000 in this case.**

**H<sub>e</sub> = Haircut appropriate to the claim; H<sub>e</sub> = 0 in this case as the lending involves only cash so no haircut is required for the loan exposure.**

**C = Value of the collateral = £5,200,000 in this case.**

**H<sub>c</sub> = Haircut appropriate to the collateral = 11% in this case.**

**H<sub>fx</sub> = Haircut appropriate to currency mismatch between the claim and the collateral (= 11% in this case).**

- Hence:

$$\begin{aligned} A^* &= \text{Max } \{0, [£5,000,000 \times (1 + 0\%) - £5,200,000 \times (1 - 11\% - 11\%)]\} \\ &= \text{Max } (0, £5,000,000 - £4,056,000) \\ &= £944,000. \end{aligned}$$

- The RWA of the transaction is calculated by multiplying the exposure after CRM (£944k) with the risk weight of the unrated corporate (100%), which equals £944k.

Reporting illustration: “comprehensive” approach to CRM, balance sheet example:

Item	Nature of Item	Amount	Amount after CRM	Risk Weight	Risk Weighted Amount
...	...	...	...	...	...
<b>C</b>	<b>Claims on Corporates</b>				
C.1	Risk Weight 20%	0	0	20	0
C.2	Risk Weight 50%	0	0	50	0
C.3	Risk Weight 100%	5,000	944	100	944
C.4	Risk Weight 150%	0	0	150	0
	<b>SUBTOTAL</b>	<b>5,000</b>	<b>944</b>		<b>944</b>

#### Off-balance sheet example: Collateralised loan commitment

If it were the case that the corporate borrower in the above example had not yet drawn down the loan facility, the transaction would be recorded as a commitment in the book of the reporting bank. Assuming that the rest of the deal was unaltered – same collateral etc – and that the commitment cannot be cancelled unconditionally, the capital requirement of the transaction under the two approaches would be calculated as follows:

#### ***Collateralised loan commitment – “simple” approach***

Considerations:

- The commitment for a 5-year term loan attracts a CCF of 50% as it cannot be cancelled unconditionally. The credit equivalent amount of this secured commitment is therefore calculated as: £5,000,000 x 50% = £2,500,000.
- As the amount committed is £5,000,000 and the market value of the collateral debt securities is £5,200,000 the commitment is considered fully secured.
- A 20% risk weight for the collateral debt securities is applied to calculate the RWA of this secured transaction: £2,500,000 x 20% = £500,000.

Reporting illustration: “simple” approach, off-balance sheet:

Item	M.6	M.7	M.8	M.9a	M.9b
Nature of Item	Partly paid up shares and securities	Forward deposits placed	Note Issuance and revolving Underwriting Facilities	Other commitments with original maturity of less than 1 year	Other commitments with original maturity of 1 year and over
Amount	0	0	0	0	5,000
Credit Conversion Factor	100	100	50	20	50
Credit Equivalent Amount	0	0	0	0	2,500
<b>After CRM:</b>					
Risk Weight 0%	0	0	0	0	0
Risk Weight 20%	0	0	0	0	2,500
Risk Weight 35%	0	0	0	0	0
Risk Weight 50%	0	0	0	0	0
Risk Weight 75%	0	0	0	0	0
Risk Weight 100%	0	0	0	0	0
Risk Weight 150%	0	0	0	0	0
<b>Risk Weighted Amount</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>500</b>
<b>Items requiring Capital Deduction</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

### ***Collateralised loan commitment – “comprehensive” approach***

Considerations:

- The standard supervisory haircuts (**Hc/Hfx**) for both the debt securities collateral and the currency mismatch between the underlying exposure and the collateral are scaled up from 8% to 11% (as shown in paragraph G.3.1 in the earlier example).

- The credit equivalent amount after CRM is derived from the formula

$$CEA^* = \max \{0, [A \times (1 + He) - C \times (1 - Hc - Hfx)]\} \times CCF$$

where:

**CEA\*** = Credit Equivalent Amount after CRM

**A** = Amount = £5,000,000 in this case.

**He** = Haircut appropriate for the exposure = 0% in this case as the commitment is cash.

**C** = Value of the collateral = £5,200,000 in this case.

**Hc** = Haircut appropriate to the collateral = 11% in this case.

**Hfx** = Haircut appropriate for currency mismatch between the exposure and the collateral = 11% in this case.

**CCF** = Credit conversion factor applicable to the exposure = 50% in this case.

- Hence:

$$\begin{aligned}
 CEA^* &= \text{Max} \{0, [\text{£}5,000,000 \times (1 + 0\%) - \text{£}5,200,000 \times (1 - 11\% - 11\%)]\} \times 50\% \\
 &= \text{Max} \{0, [\text{£}5,000,000 - \text{£}4,096,000]\} \times 50\% \\
 &= \text{£}472,000 \text{ (half the balance sheet example due to the impact of the CCF).}
 \end{aligned}$$

- As the credit equivalent amount after CRM is £472k and the risk weight for an unrated corporate is 100%, the RWA of this secured commitment is £472k.

Reporting illustration: “comprehensive” approach, off-balance sheet:

Item	M.6	M.7	M.8	M.9a	M.9b
Nature of Item	Partly paid up shares and securities	Forward deposits placed	Note Issuance and revolving Underwriting Facilities	Other commitments with original maturity of less than 1 year	Other commitments with original maturity of 1 year and over
<b>Amount</b>	0	0	0	0	5,000
<b>Credit Conversion Factor</b>	100	100	50	20	50
<b>Credit Equivalent Amount</b>	0	0	0	0	2,500
<b>After CRM:</b>					
...	...	...	...	...	...
Risk Weight 100%	0	0	0	0	472
Risk Weight 150%	0	0	0	0	0
<b>Risk Weighted Amount</b>	0	0	0	0	472
<b>Items requiring Capital Deduction</b>	0	0	0	0	0

### OTC derivative transaction example

The reporting bank has a £100,000,000 interest rate contract with a four-year residual maturity. The other counterparty to the contract is an unrated corporate. Pledged as collateral for the contract is a £800,000 corporate bond with an “A1” Moody’s rating, that has more than five years to go to maturity. This is a capital market transaction subject to daily re-margining and there are no foreign exchange mismatches between the interest rate contract and the collateral. The mark-to-market value is £1,000,000 and the add-on is 0.5%, giving an “Add-on amount” of £500,000.

### **OTC derivative transactions example – “simple” approach**

Considerations:

- Credit equivalent amount of the interest rate contract is the sum of the positive mark-to-market and the “Add-on amount” (i.e. £1,000,000 + £500,000 = £1,500,000).
- The unrated corporate attracts a 100% risk weight.
- The £800,000 corporate bond attracts a 50% risk weight.
- RWA of secured portion: £800k x 50% = £400k.
- RWA of unsecured portion: £700k x 100% = £700k.
- Total RWA (secured + unsecured): £400k + £700k = £1,100k.

## OTC derivative transaction – “comprehensive” approach

Considerations:

- As this is a capital market transaction, there is no need to scale up the haircut applicable to the corporate bond as collateral, being 12% for an A1 rated bond with 5 years to go until maturity.
- The adjusted exposure of the transaction is calculated based on the formula:

- $$CEA^* = \max \{0, [CEA - C \times (1 - Hc - Hfx)]\}$$

where:

**CEA\*** = credit equivalent amount after CRM

**CEA** = credit equivalent amount (i.e. sum of the positive mark-to-market and the “Add-on amount”) = £1,500,000 in this case.

**C** = value of the collateral = £800,000 in this case.

**Hc** = haircut appropriate to the collateral = 12% in this case.

**Hfx** = haircut appropriate for currency mismatch between the settlement currency and the collateral currency = 0% in this case.

- Hence:

$$\begin{aligned} CEA^* &= \text{Max} \{0, [\text{£}1,500,000 - \text{£}800,000 \times (1 - 12\% - 0\%)]\} \\ &= \text{Max} (0, \text{£}1,500,000 - \text{£}704,000) \\ &= \text{£}796,000 \end{aligned}$$

- The RWA is calculated at: £796,000 x 100% = £796,000.

Reporting illustration: “comprehensive” approach to CRM, OTC Schedule:

N.1 Interest rate contracts									
	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-On Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
	100,000	1,000			500	1,500	796		796
N.1 Schedule									
No.	Amount	Positive Mark-to-Market	Time to Maturity	Add-on %	Add-On Amount	Credit Equivalent Amount	After CRM	Weight	Risk Weighted Amount
1			< 1 year	0.00%	0	0		0%	0
2			< 1 year	0.00%	0	0		20%	0
3			< 1 year	0.00%	0	0		50%	0
4			< 1 year	0.00%	0	0		100%	0
5			< 1 year	0.00%	0	0		150%	0
6			1 - 5 years	0.50%	0	0		0%	0
7			1 - 5 years	0.50%	0	0		20%	0
8			1 - 5 years	0.50%	0	0		50%	0
9	100,000	1,000	1 - 5 years	0.50%	500	1,500	796	100%	796
10			1 - 5 years	0.50%	0	0		150%	0

## **ANNEX J - CRITERIA FOR CLASSIFICATION AS A RETAIL EXPOSURE AND / OR AS A RESIDENTIAL MORTGAGE**

### Retail Exposures

To be included in the “Regulatory Retail Portfolio”, claims must meet the following four criteria:

- Orientation criterion: The exposure is to an individual person or persons or to a small business (less than £2m turnover and balance sheet footings).
- Product criterion: The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g. instalment loans, auto loans and leases, student and educational loans, personal finance) and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property (see below).
- Granularity criterion: The Commission must be satisfied that the “Regulatory Retail Portfolio” is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. Accordingly, in defining what constitutes a significant number of *retail exposures* (for diversification) a reporting bank need only satisfy itself that the number of *retail exposures* is sufficiently large to diversify away idiosyncratic risk<sup>2</sup>. This assessment will be subject to supervisory review and part of a reporting bank’s *SREP*. The Commission requires each bank to set out its criteria and may, where necessary, require changes to be made if the bank is to be allowed to utilise the 75% risk weight.
- Low value of individual exposures. The maximum aggregated retail exposure to one counterparty cannot exceed an absolute threshold of £750,000.

### Residential mortgages

The Commission has set the following criteria:

- The property or properties must be for residential purposes only;
- The security may be indirect – an example of this would be where the security held comprised shares where the share ownership conferred ownership of a property e.g. share transfer ownership;

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<sup>2</sup> Also known as unsystematic risk this is the risk of price change due to the unique and uncorrelated circumstances of an asset or firm as opposed to a market movement.

- The lending may either be directly to an individual or to a special purpose entity\*;
- If the lending is to a special purpose entity the bank must:-
  - Ensure that the repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral. For personal investment companies this should include having recourse to the beneficial owner in the event of default;
  - Ensure that the mortgage or charge is enforceable in all jurisdictions which are relevant at the time of conclusion of the credit agreement and properly file such charges on a timely basis;
  - Ensure that the arrangements reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled);
  - Ensure that the protection agreement and legal process underpinning it enable the bank to realise the value of protection within a reasonable timeframe; and
  - Consider whether any additional risks arise from the arrangements that should be addressed under Pillar 2 of Basel II.
- The properties must be either occupied by the borrower or rented, normally to individuals (although renting to corporate tenants is allowed if the property is used only for residential purposes). In the case of property being rented, a property (or property portfolio) should not comprise more than 10 rental units / properties;
- For claims secured by residential properties with loan-to-value ratios of up to 80% (i.e. considered as fully secured) a risk weight of 35% will apply. For higher LTVs a risk weight of 75% will apply on that portion above 80% LTV;
- If a bank does not hold information regarding LTVs for individual exposures, a risk weighting of 50% will apply to the whole of those exposures;
- LTVs should be assessed on a regular basis, making use of relevant indices and market information where appropriate. The LTV used for the purpose of the allocation of risk weightings (35% / 75%) is that which is determined by an independent valuer (a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process) on an individual exposure basis.

\* A special purpose entity may be in the form of a personal investment company or a trust.

## **CHAPTER 5**

### **GUIDANCE NOTES – FORM SR-1C**

#### **SECTION 1 - INTRODUCTION**

There are four approaches to calculating the operational risk capital requirement within Basel II. The Basic Indicator Approach (“BIA”) and Standardised Approach to Operational Risk (“SAO”) are considered appropriate for all Isle of Man incorporated banks. The Alternative Standardised Approach (“ASA”) may be appropriate, dependent upon a bank’s risk profile.

Each of these three approaches has an associated reporting form that must be used to derive the operational risk capital requirement, a calculation based on income data from the past three years. These three approaches are contained within the form SR-1C. Banks using any of these approaches should only complete the part of form SR-1C that is relevant to the approach agreed between the bank and the Commission.

Where a bank has been approved to use the fourth approach, the Advanced Measurement Approach (“AMA”), it will be required to complete a different reporting form which will be agreed between the bank and the Commission.

#### **SECTION 2 – DEFINITION OF YEAR OF OPERATION**

Under the BIA and SAO, the bank’s capital charge for operational risk is calculated using gross income data from the last three years.

The ASA also offers the option of calculating the capital charge through using the average volume of loans and advances (“loans and advances” hereafter are simply referred to as “advances”) for each of those years. Year one is the last completed accounting year, years two and three are the two immediately preceding accounting years.

The Risk Weighted Assets (“RWA”) “equivalent amount” is derived by multiplying the capital charge by 12.5, as established in Basel II. This is combined with the RWA derived for credit risk and other risks to arrive at the total RWA of the bank.

A bank should treat any partial year of operation of six months or more as a full year. Any partial year of operation of less than six months should be disregarded. If any partial year is counted as a full year, the gross income of that partial year should be annualised. Under the ASA, the mean average of the amount of advances outstanding at the end of each full calendar quarter within that partial year should be taken as the average level of advances for that year.

An illustration of calculating the gross income and advances in the retail and commercial banking business lines for partial and full years of operation is shown in ***Annex A to this chapter***.

## **SECTION 3 – GUIDANCE ON FORM COMPLETION**

### **General layout**

There are three different reporting forms (see above), covering:

- Basic Indicator Approach;
- Standardised Approach; and
- Alternative Standardised Approach.

The bank will have agreed with the Commission which approach it will use. A completed example of each form is included in ***Annex B to this chapter***.

Section A of each form asks if this approach is the agreed approach. This section should be completed by entering “YES” in the form for the agreed approach, and “NO” in the forms for the other two approaches. The forms where “NO” has been indicated should be left blank.

### **Basic Indicator Approach (“BIA”)**

The capital charge for operational risk under the BIA is calculated as 15% (denoted “Alpha”) of the average gross income over the past three years, ignoring those years where income was not positive.

#### **Section B: Gross Income comprising:**

<b>Item</b>	<b>Item Name</b>	<b>Definition</b>
B.1	Net Interest Income	Interest Income net of Interest Expense, for each of the three preceding years, gross of any provisions (e.g. for unpaid interest).
B.2	Net Non-Interest Income	Net non-interest income for each of the three preceding years. Note that this is gross of operating expenses (including fees paid to outsourcing service providers) and should exclude realised profits/losses from the sale of securities in the banking book and extraordinary or irregular items as well as income derived from insurance.

#### **Section C: BIA Calculation**

“Average Income” is calculated as the sum of the two items, shown in section B, for each year where the said sum was positive, divided by the number of those years.

## Section D: BIA Requirement

The capital charge for the BIA is calculated as 15% of Average Income. The RWA equivalent for the BIA is calculated by multiplying the capital charge by 12.5.

## **Standardised Approach to Operational Risk (“SAO”)**

The SAO requires the bank to allocate income by business line for each of the previous three years. Multiplying these income amounts by the appropriate scaling factor for that business line (denoted “Beta”) gives the capital charge for each of these lines. Adding together the capital charges of each line gives the total charge for a year. Beta varies from 12% to 18%, as specified in Basel II. The RWA equivalent is derived from the average of these yearly capital charges, ignoring those where the capital charge derived is not positive.

## Section B: Income

Item	Item Name	Bet	Definition
B.1	Corporate Finance	18%	<ul style="list-style-type: none"><li>▪ Net fees and commission earned.</li></ul>
B.2	Trading & Sales	18%	<ul style="list-style-type: none"><li>▪ Profits/losses on instruments held for trading purposes, net of funding costs.</li><li>▪ Fees from wholesale broking.</li></ul>
B.3	Retail Banking	12%	<ul style="list-style-type: none"><li>▪ Net interest income on advances to retail customers and small businesses treated as retail.</li><li>▪ Fees related to retail activities.</li><li>▪ Net income from swaps and derivatives held to hedge the retail banking book.</li><li>▪ Income on purchased retail receivables.</li></ul>
B.4	Commercial Banking	15%	<ul style="list-style-type: none"><li>▪ Net interest income on advances to corporate, bank and sovereign customers.</li><li>▪ Income on purchased corporate receivables.</li><li>▪ Fees related to commercial banking activities including commitments, guarantees and bills of exchange.</li><li>▪ Net income on securities held in the banking book.</li><li>▪ Profits/losses on swaps and derivatives held to hedge the commercial banking book.</li></ul>
B.5	Payment & Settlement	18%	<ul style="list-style-type: none"><li>▪ Net fees/commissions earned.</li><li>▪ Fees for provision of payments/settlement facilities for wholesale counterparties.</li></ul>
B.6	Agency Services	15%	<ul style="list-style-type: none"><li>▪ Net fees and commission earned.</li></ul>

B.7	Asset Management	12%	▪ Net fees and commission earned.
B.8	Retail Brokerage	12%	▪ Net fees and commission earned.

All income of the bank must be allocated to a business line in accordance with the principles and guidance of business line mapping shown in ***Annex C to this chapter***.

### Section C: Capital Charge

The capital charge for each year is derived by:

- Multiplying the income reported in Section B by the appropriate Beta for each business line to get the charge for that line; and
- Adding together the eight capital charges thus calculated for the business lines.

In any given year, positive capital charges for any individual lines may be offset by negative capital charges for other business lines in that year without limit. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the numerator for that year will be zero.

### Section D: “SAO Requirement”

The capital charge for the SAO is calculated as the sum of the three yearly capital charges, where positive, divided by the number of those years. The “RWA equivalent” for the SAO is calculated by multiplying this capital charge by 12.5.

### **Alternative Standardised Approach (“ASA”)**

The ASA is an available option within Basel II. It uses an alternative proxy for operational risk in respect of both retail and corporate lending. Total retail and corporate advances (not risk weighted and gross of provisions) are multiplied by a fixed factor 0.035 (i.e. 3.5%) which has been calculated by the Basel Committee (denoted “m”).

The capital charge is then calculated by applying a scale factor, Beta, of 15% to this amount, then adding a sum equivalent to 18% of all other income.

### Section B: “Retail/Commercial Lending – Volume”

Enter average retail and commercial lending balances based on quarter end balances of the relevant year.

### Section C: Income

Item	Item Name	Bet	Definition
C.1	Retail /Commercial Lending	15%	3.5% of the average volume reported in Section B above, as an alternative proxy for operational risk from these two business lines.
C.2	All Other income	18%	Gross income from all business lines except retail and commercial lending as per the SAO definitions

All income of the bank must be allocated to a business line in accordance with the principles and guidance of business line mapping shown in ***Annex D to this chapter***.

### Section D: Capital Charge

The capital charge for each year is derived by:

- Multiplying the income reported in Section C by the appropriate “Beta” for each business line to get the charge for that line; and
- Adding together both capital charges thus calculated for the business lines.

A negative capital charge for “All other income” can offset that derived for Retail/Commercial lending. However, where the aggregate capital charge within a given year is negative, then the input to the numerator for that year will be zero.

### Section E: “ASA Requirement”

The capital charge for the ASA is calculated as the sum of the three yearly capital charges, where positive, divided by the number of those years. The “RWA equivalent” for the ASA is calculated by multiplying this capital charge by 12.5.

## **ANNEX A – EXAMPLES OF FULL AND PARTIAL YEAR TREATMENTS**

### **Example 1: Three or more full years**

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations prior to 1/1/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: derived in equivalent fashion to “Last Year”.

“2 years prior” would be 2006.

### **Example 2: One full year plus one year of more than six months duration**

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/4/2007; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: annualise this partial year’s gross income; in this case by dividing by nine (number of months of operation) and multiplying by twelve, and, only for the ASA, report the average of advances reported at end Q2, Q3 and Q4 2007.

“2 years prior” would be 2006: report zero for gross income and, for the ASA only, report zero advances. The calculation disregards these figures.

### **Example 3: Two full years plus one year of less than 6 months duration**

If a bank:

- Had an accounting year that matched the calendar year;
- Had commenced operations on 1/9/2006; and
- Wished to report for Q4 2008, or any of the first three quarters in 2009, then:

“Last Year” would be 2008: report full year’s gross income and, for the ASA only, report the average of advances as reported at end Q1, Q2, Q3 and Q4 2008.

“1 year prior” would be 2007: derived in equivalent fashion to “Last Year”.

“2 years prior” would be 2006: report zero for gross income and, for the ASA only, report zero advances. The calculation disregards these figures.

## **ANNEX B – COMPLETION EXAMPLES**

### Introduction

The example data given in the tables below has been used to complete the form overleaf for illustrative purposes.

*Whilst the form has been completed for all three options in reality the form would only be completed for the option that the bank had agreed, with the form left blank for the other options.*

### **Gross Income**

	<b>2008</b>		<b>2007</b>		<b>2006</b>	
<b>Business Line</b>	<b>Net Interest Income</b>	<b>Net Non-Interest Income</b>	<b>Net Interest Income</b>	<b>Net Non-Interest Income</b>	<b>Net Interest Income</b>	<b>Net Non-Interest Income</b>
<b>Corporate Finance</b>	0	1,200	0	1,100	0	1,000
<b>Trading &amp; Sales</b>	0	2,000	0	-1,000	0	0
<b>Retail Banking</b>	5,000	-1,000	5,500	-1,000	6,000	-1,000
<b>Commercial Banking</b>	1,000	-2,000	-1,000	-3,000	0	0
<b>Payment &amp; Settlement</b>	0	300	0	150	0	200
<b>Agency Services</b>	0	55	0	45	0	50
<b>Asset Management</b>	0	1000	0	-500	0	0
<b>Retail Brokerage</b>	0	1500	0	-500	0	0

### **Loans and Advances**

<b>Business Line</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
Retail	80,000	90,000	100,000
Commercial	80,000	40,000	0

## Completed Form

### 3.1 BASIC INDICATOR APPROACH ("BIA")

Item	Nature of Item	Value
A	BIA as agreed approach?	YES

Item	Nature of Item	Last year	1 year prior	2 years prior
<b>B</b>	<b>Income</b>			
B.1	Net Interest Income	6,000	4,500	6,000
B.2	Net Non-Interest Income	3,055	(4,705)	250
<b>TOTAL</b>		<b>9,055</b>	<b>(205)</b>	<b>6,250</b>

Item	Nature of Item	Value
<b>C</b>	<b>BIA Calculation</b>	
C.1	Average Income, where positive	7,653
C.2	Alpha	15%

Item	Nature of Item	Capital Charge	RWA Equivalent
<b>D</b>	<b>BIA Requirement</b>	<b>1,148</b>	<b>14,348</b>

### 3.2 STANDARDISED APPROACH TO OPERATIONAL RISK ("SAO")

Item	Nature of Item	Value
A	SAO as agreed approach?	YES

Item	Nature of Item	Last year	1 year prior	2 years prior
<b>B</b>	<b>Income</b>			
B.1	Corporate Finance	1,200	1,100	1,000
B.2	Trading and sales	2,000	(1,000)	0
B.3	Retail banking	4,000	4,500	5,000
B.4	Commercial banking	(1,000)	(4,000)	0
B.5	Payment and settlement	300	150	200
B.6	Agency services	55	45	50
B.7	Asset management	1,000	(500)	0
B.8	Retail Brokerage	1,500	(500)	0
<b>TOTAL</b>		<b>9,055</b>	<b>(205)</b>	<b>6,250</b>

Item	Nature of Item	Beta	Last year	1 year prior	2 years prior
<b>C</b>	<b>Capital Charge</b>				
C.1	Corporate Finance	18%	216	198	180
C.2	Trading and sales	18%	360	(180)	0
C.3	Retail banking	12%	480	540	600
C.4	Commercial banking	15%	(150)	(600)	0
C.5	Payment and settlement	18%	54	27	36
C.6	Agency services	15%	8	7	8
C.7	Asset management	12%	120	(60)	0
C.8	Retail Brokerage	12%	180	(60)	0
<b>TOTAL</b>			<b>1,268</b>	<b>0</b>	<b>824</b>

Item	Nature of Item	Capital Charge	RWA Equivalent
<b>D</b>	<b>SAO Requirement</b>	<b>1,046</b>	<b>13,073</b>

### 3.3 ALTERNATIVE STANDARDISED APPROACH ("ASA")

Item	Nature of Item	Value
A	ASA as agreed approach?	YES

Item	Nature of Item	Last year	1 year prior	2 years prior
B	Retail/Commercial Lending - Volume	160,000	130,000	100,000

Item	Nature of Item	Proxy based Percentage	Last year	1 year prior	2 years prior
<b>C</b>	<b>Income</b>				
C.1	Retail/Commercial Lending	3.50%	5,600	4,550	3,500
C.2	All other income		6,055	(705)	1,250
<b>TOTAL</b>			<b>11,655</b>	<b>3,845</b>	<b>4,750</b>

Item	Nature of Item	Beta	Last year	1 year prior	2 years prior
<b>D</b>	<b>Capital Charge</b>				
D.1	Retail/Commercial Lending	15%	840	683	525
D.2	All other income	18%	1,090	(127)	225
<b>TOTAL</b>			<b>1,930</b>	<b>556</b>	<b>750</b>

Item	Nature of Item	Capital Charge	RWA Equivalent
<b>E</b>	<b>ASA Requirement</b>	<b>1,079</b>	<b>13,481</b>

**ANNEX C - PRINCIPLES AND GUIDANCE FOR BUSINESS LINE MAPPING UNDER THE STANDARDISED APPROACH**

**Summary of Business Lines, Activity Groups and Income Definitions**

<b>Business Line</b>	<b>Major Business Segments</b>	<b>Activity Groups</b>	<b>Charge as % of gross income</b>	<b>Gross income definition</b>
<b>Corporate Finance</b>	Corporate Finance	Mergers and Acquisitions, Underwriting, Privatisations, Securitisation, Research, Debt (Government / High Yield), Equity, Syndications, IPO, Secondary Private Placements	18	Net fees / commissions earned in each business line.
	Municipal/Government Finance			
	Merchant Banking			
	Advisory Services			
<b>Trading &amp; Sales</b>	Sales	Fixed income, equity, foreign exchange, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage	18	Profits / losses on instruments held for trading purposes, net of funding cost.  Fees from wholesale broking.
	Market Making			
	Proprietary Positions			
	Treasury			
<b>Retail Banking</b>	Retail Banking	Retail lending and deposits, banking services, trust and estates	12	Net interest income on loans and advances to retail customers and small businesses treated as retail.
	Private Banking	Private lending and deposits, banking services, trusts and estates, investment advice		Fees related to traditional retail activities.

	Card Services	Merchant / Commercial / Corporate cards, private labels and retail		<p>Net income from swaps and derivatives held to hedge the retail banking book.</p> <p>Income on purchased retail receivables.</p>
<b>Commercial Banking</b>	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lends, guarantees, bills of exchange	15	<p>Net interest income on loans and advances to corporate, inter-bank and sovereign customers.</p> <p>Income on purchased corporate receivables.</p> <p>Fees related to traditional commercial banking activities including commitments, guarantees, bills of exchange.</p> <p>Net interest income on securities held in the banking book.</p> <p>Profits/losses on swaps and derivatives held to hedge the commercial banking book.</p>
<b>Payment &amp; Settlement</b>	External Clients	Payments and collections, fund transfer, clearing and settlement	18	<p>Net fees / commissions earned.</p> <p>Fees to cover provision of payments / settlement facilities for wholesale counterparties.</p>

<b>Agency Services</b>	Custody	Escrow, Depository receipts, Securities lending (customers), Corporate actions	15	Net fees / commissions earned in each business.
	Corporate Agency	Issuer and paying agents, Agency services		
	Corporate Trust			
<b>Asset Management</b>	Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open, private equity	12	Net fees / commissions earned in each business.
	Non-Discretionary Fund Management	Pooled, segregated, retail, institution, closed, open		
<b>Retail Brokerage</b>	Retail Brokerage	Execution and full service	12	Net fees / commissions earned in each business.

## **Principles and Guidance for Business Line Mapping under the Standardised Approach - continued**

(a) All activities must be mapped into the eight business lines in a mutually exclusive and jointly exhaustive manner. All income must be allocated to one of the business lines.

(b) Any banking or non-banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criterion must be consistently adopted and the reasoning behind adopting that criterion recorded by the bank.

(c) When mapping gross income, if an activity cannot be mapped into a particular business line then the business line yielding the highest capital charge must be used. The same business line will apply to any associated ancillary activity.

(d) Banks may use internal pricing methods to allocate gross income between business lines provided that total gross income for the bank (as would be recorded under the Basic Indicator Approach) still equals the sum of gross income for the eight business lines.

(e) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e. credit and market risk. Any deviations from this principle must be clearly explained and documented.

(f) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly record any exceptions or overrides.

(g) Processes must be in place to define the mapping of any new activities or products.

(h) Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).

(i) The mapping process to business lines must be subject to independent review.

## Supplementary Business Line Mapping Guidance

There are a variety of valid approaches that banks can use to map their activities to the eight business lines, provided the approach used meets the business line mapping principles (above). Nevertheless, the Commission is aware that some banks would welcome further guidance. The following is therefore an example of one possible approach that could be used by a bank to map its **gross income**:

**Gross income for retail banking** consists of net interest income on loans and advances to retail customers (which includes private banking customers) and SMEs treated as retail, plus fees related to traditional retail activities, net income from swaps and derivatives held to hedge the retail banking book, and income on purchased retail receivables. To calculate net interest income for retail banking, a bank takes the interest earned on its loans and advances to retail customers less the average cost of funding of the loans (from whatever source - retail or other deposits).

**Similarly, gross income for commercial banking** consists of the net interest income on loans and advances to corporate (plus SMEs treated as corporate), interbank (including placements with other group or parent banks) and sovereign customers and income on purchased corporate receivables, plus fees related to traditional commercial banking activities including commitments, guarantees, bills of exchange, net income (e.g. from coupons and dividends) on securities held in the banking book, and profits/losses on swaps and derivatives held to hedge the commercial banking book. Again, the calculation of net interest income is based on interest earned on loans and advances to corporate, interbank and sovereign customers less the average cost of funding for these loans (from whatever source).

**For trading and sales**, gross income consists of profits/losses on instruments held for trading purposes (i.e. in the mark-to-market book), net of funding cost, plus fees from wholesale broking.

**For the other five business lines**, gross income consists primarily of the net fees/commissions earned in each of these businesses. **Payment and settlement** consists of fees to cover provision of payment/settlement facilities for wholesale counterparties. **Asset management** is management of assets on behalf of others.

## **ANNEX D – PRINCIPLES AND GUIDANCE FOR BUSINESS LINE MAPPING UNDER THE ALTERNATIVE STANDARDISED APPROACH**

### **Principles for Business Line Mapping**

- (a) All activities must be mapped into the two aggregated business lines (retail and commercial banking together, and the six other together) in a mutually exclusive and jointly exhaustive manner. All income must be allocated to one of the business lines.
- (b) Any banking or non-banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criterion must be consistently adopted and the reasoning behind adopting that criterion recorded by the bank.
- (c) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e. credit and market risk. Any deviations from this principle must be clearly explained and documented.
- (d) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly record any exceptions or overrides.
- (e) Processes must be in place to define the mapping of any new activities or products.
- (f) Senior management is responsible for the mapping policy (which is subject to the approval by the board of directors).
- (g) The mapping process to business lines must be subject to independent review.

### **Supplementary Business Line Mapping Guidance**

There are a variety of valid approaches that banks can use to map their activities to the aggregated business lines, provided the approach used meets the business line mapping principles (above). Nevertheless, the Commission is aware that some banks would welcome further guidance. The following is therefore an example of one possible approach that could be used by a bank to map its **total loans and advances** (for retail and commercial banking aggregated), and **gross income** for the other six business lines (aggregated):

**Total loans and advances in the retail banking** business line consist of the total drawn amounts (gross of provisions) in the following credit portfolios: retail (including private banking), SMEs treated as retail, and purchased retail receivables. For **commercial banking**, total loans and advances consist of the drawn amounts (gross of provisions) in the following credit portfolios: corporate, sovereign, interbank (including placements with other group, or parent, banks), specialised lending, SMEs treated as corporate and purchased corporate receivables. The book value of securities held in the banking book should also be included.

In respect of the other six business lines, which are based on gross income, in order to disaggregate them from income derived from retail and commercial banking the following may help:

**For trading and sales**, gross income consists of profits/losses on instruments held for trading purposes (i.e. in the mark-to-market banking book), net of funding cost, plus fees from wholesale broking.

**For the other five business lines**, gross income consists primarily of the net fees/commissions earned in each of these business activities. **Payment and settlement** consists of fees to cover provision of payment/settlement facilities for wholesale counterparties. **Asset management** is management of assets on behalf of others.

## **ANNEX E - QUALIFYING CRITERIA FOR ALL BANKS WISHING TO USE THE STANDARDISED APPROACH**

(a) In order to qualify for use of the Standardised Approach, a bank must satisfy the Commission that, as a minimum:

- Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- It has an operational risk management system that is conceptually sound and is implemented with integrity; and
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

(b) The Commission will have the right to insist on a period of initial monitoring of a bank's Standardised Approach before it is used for regulatory capital purposes.

(c) A bank must develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping are set out in **Annex C** above

The Commission also recommends that banks which are not considered to be internationally active banks should nevertheless have due regard to the additional qualifying criteria stated below. The Commission will consider the additional criteria, taking into account the nature of a bank's activities, when assessing whether a bank may qualify to adopt the Standardised Approach.

### **Additional qualifying criteria for internationally active banks<sup>3</sup>**

An internationally active bank wishing to use the Standardised Approach must meet the following additional criteria:

(a) The bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm's operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

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<sup>3</sup> "Internationally active bank" means banks operating in more than one jurisdiction or with clients from outside their place of incorporation. This will include almost all banks in the Isle of Man.

(b) As part of the bank's internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by business line. Its operational risk assessment system must be closely integrated into the risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the banks operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(c) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(d) The bank's operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(e) The bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(f) The bank's operational risk assessment system (including the internal validation processes) must be subject to regular review by external specialists, auditors, and/or supervisors.

## **ANNEX F - QUALIFYING CRITERIA FOR ALL BANKS WISHING TO USE THE ASA**

(a) In order to qualify for use of the ASA, a bank must satisfy the Commission that, at a minimum:

- Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- It has an operational risk management system that is conceptually sound and is implemented with integrity; and
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

(b) The Commission will have the right to insist on a period of initial monitoring of a bank's ASA before it is used for regulatory capital purposes.

(c) A bank must develop specific policies and have documented criteria for separately identifying its aggregate mapping of its retail and commercial (loans) business lines from the gross income derived from the six other aggregated business lines book. The criteria must be reviewed and adjusted for new or changing business activities as appropriate. The principles for business line mapping relevant to the ASA are described in **Annex D** above.

The Commission also recommends that banks which are not considered to be internationally active banks should nevertheless have due regard to the additional qualifying criteria stated below. The Commission will consider the additional criteria, taking into account the nature of a bank's activities, when assessing whether a bank may qualify to adopt the ASA.

### **Additional qualifying criteria for internationally active banks<sup>4</sup>**

An internationally active bank using the ASA must meet the following additional criteria:

(a) The bank must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm's operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

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<sup>4</sup> "Internationally active bank" means banks operating in more than one jurisdiction or with clients from outside their place of incorporation. This will include almost all banks in the Isle of Man.

(b) As part of the bank's internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by business line. Its operational risk assessment system must be closely integrated into the risk management processes of the bank. Its output must be an integral part of the process of monitoring and controlling the bank's operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(c) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(d) The bank's operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(e) The bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(f) The bank's operational risk assessment system (including the internal validation processes) must be subject to regular review by external auditors, specialists and/or supervisors.

## **CHAPTER 6**

### **GUIDANCE NOTES – FORM SR-2A**

#### **SECTION 1 – CAPITAL (INCORPORATED BANKS ONLY)**

##### **Types of capital**

For supervisory purposes, capital is split into three categories: Tier 1, Tier 2 and Tier 3. These categories reflect the varying quality of capital that different instruments provide.

Tier 1 capital is a bank's highest quality capital. Tier 1 may be issued or internally generated capital:

- Issued capital includes ordinary shares and preference shares;
- Internally generated capital arises from accruing profit to reserves or by capitalising dividends.

Further guidance on Tier 1 capital can be found in ***Annex A to this chapter.***

Tier 2 capital can be split between perpetual (sometimes referred to by other regulators as Upper Tier 2) and dated instruments. Perpetual Tier 2 capital includes:

- Issued: hybrid capital instruments e.g. perpetual subordinated debt that is able to absorb losses and cumulative preference shares. To qualify as perpetual Tier 2 capital these instruments should be cumulative i.e. dividend or interest payments may not be cancelled, but may be deferred;
- Internally generated: includes general/collective provisions and certain revaluation reserves.

Dated Tier 2 capital (i.e. it has a maturity date), should have a minimum maturity of over five years and interest should be paid as it falls due. It normally takes the form of term subordinated debt. Such debt is classed as a lower form of capital because its loss absorbency features only come into effect in the event of insolvency, and in general there is less funding flexibility, since a deferral of an interest payment can be an event of default. The maximum extent to which dated Tier 2 capital can be relied upon is limited to 50% of Tier 1 capital.

In order to avoid a sudden diminution in the amount of capital available to a bank, Tier 2 dated capital should be amortised on a straight-line basis in its final five years to maturity. Where a bank has an option to repay Tier 2 dated capital early, the Commission does not normally assume early repayment for the purposes of

amortisation, unless failure to exercise the option incurs a significant increase in the interest paid on the debt (a “step-up”).

Tier 3 capital is comprised principally of subordinated debt that has a minimum original maturity of two years, but that does not qualify for inclusion in Tier 2 (i.e. original maturity does not exceed 5 years). It may only be used to support market risk in the trading book and is therefore only applicable to banks that have such a book. The Commission has not included tier 3 capital in the prudential forms as this is not considered necessary at present based on incorporated banks’ activities in the Isle of Man.

### Detailed guidance

Item	Description	Guidance
<b>A</b>	<b>Tier 1 Capital</b>	
A.1	Ordinary shares / Common Stock	Ordinary shares, i.e. allotted, called up and fully paid share capital. This should be recorded net of any of its own shares that a bank holds. “Fully paid” means the proceeds of the issue have been received by the bank and are available to absorb losses.
A.2	Perpetual non-cumulative preferred stock	Perpetual non-cumulative preference shares, including such shares redeemable both at the option of the issuer and with the Commission’s prior consent; and such shares that are convertible into ordinary shares.
<b>A.3</b>	<b>Reserves:</b>	
A.3.1	Share Premium Account	Share premium relating to A.1.
A.3.2	Disclosed Prior Year Reserves	Reserves disclosed in the audited year-end accounts less any dividends paid out of such reserves.
A.3.3	FX Translation Differences	Impact of exchange rate movements on reserves held on currencies other than sterling.
A.3.4	Current Year's profit verified by external auditor	Report profits only where they have been certified by the external auditor. This remains the case for year-end accounts – profits may only be included if either the audit is complete and signed off or a separate certification is supplied.
	<b>Total reserves</b>	<b>Calculated by the sheet, being the sum of A.3.1 to A.3.4.</b>
A.4	Current Year Losses	Always report current year losses (as a negative figure).

Item	Description	Guidance
A.5	Minority Interests in Tier 1	Minority interests arise when a company owns a subsidiary via a majority shareholding. The company's consolidated accounts usually include all of the assets of the subsidiary so it would be misleading to include only that part of the subsidiary's share capital and reserves that is owned by the company. The capital subscribed by the minority shareholders is therefore included in the consolidated capital base.
<b>A.6</b>	<b>Total</b>	<b>Calculated by the sheet as the sum of A.1, A.2, Total reserves, A.4 and A.5.</b>
<b>A.7</b>	<b>Less: (adjustments to capital)</b>	
A.7.1	Goodwill and other intangible assets	All goodwill and other intangible fixed assets should be shown here and deducted from Tier 1 capital. <i>This is automated from SR-1A line G.4.</i>
A.7.2	Securitisations - gains on sale	Banks must deduct from Tier 1 capital any increase in reserves resulting from a current securitisation transaction, such as that associated with expected future margin income resulting in a gain on sale.
	<b>Total deductions:</b>	<b>Calculated by the sheet, being the sum of A.7.1 and A.7.2.</b>
	<b>TOTAL</b>	<b>Calculated by the sheet, being A.6 less Total deductions.</b>

Item	Description	Guidance
<b>B</b>	<b>Tier 2 Capital</b>	
B.1	Fixed Asset Revaluation Reserve	Reserves arising from the revaluation of tangible fixed assets, or fixed asset investments, are reserves created when such assets are re-valued to bring them in line with replacement costs. Valuations must be from an independent professional valuer.
B.2	Reserves/fair value gains of securities not held for trading	The Commission does not recognise reserves relating to available-for-sale instruments as being eligible for inclusion in capital (for balance sheet reporting in SR-1A these should be shown in the capital section row D.3 for incorporated banks). However, gains arising from items accounted for at "fair value through profit and loss" but which are not held for trading should be reported here. Examples could include derivatives in the banking book.

Item	Description	Guidance
B.3	General/Collective Provisions	<p>Provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses that subsequently materialise and therefore qualify for inclusion within Tier 2 capital. Provisions ascribed to the identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. However, general provisions/general loan-loss reserves eligible for inclusion in Tier 2 capital will be limited to a maximum of 1.25 percentage points of credit risk, risk weighted assets – the excess will be deducted automatically in B.8.1.</p>
B.4	Hybrid Debt/Equity instruments	<p>This heading includes a range of instruments which combine characteristics of equity capital and of debt. They should meet the following requirements:</p> <ul style="list-style-type: none"> <li>• They are unsecured, subordinated and fully paid-up;</li> <li>• They are not redeemable without the prior consent of the Commission;</li> <li>• They are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);</li> <li>• Although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with cumulative preference shares) where the profitability of the bank would not support payment.</li> </ul> <p>Cumulative preference shares, which have these characteristics, would be eligible for inclusion in this category, as would perpetual subordinated debt. Debt capital instruments which do not meet these criteria may be eligible for inclusion in item B.5.</p>

Item	Description	Guidance										
B.5	Subordinated term debt	<p>Report unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares.</p> <p>Also report here perpetual unsecured subordinated debt capital instruments and preference shares which do not meet the criteria for inclusion in item B.4.</p> <p>During the last five years to maturity, a cumulative discount (or amortisation) factor of 20% per year must be applied to reflect the diminishing value of these instruments as a continuing source of support (see B.8.2).</p> <p>Unlike instruments included in item B.4, these instruments are not normally available to participate in the losses of a bank which continues trading. For this reason these instruments will be limited to a maximum of 50% of Tier 1 capital (any excess will be calculated automatically and shown as a deduction in B.8.3).</p>										
B.6	Minority interests in Tier 2	In a similar fashion to A.5, report here minority interests that by their nature fall within Tier 2 capital – for example, reserves attributable to minority shareholders.										
<b>B.7</b>	<b>Total</b>	<b>Calculated by the sheet, being the sum of B.1 to B.6.</b>										
<b>B.8</b>	<b>Less: (adjustments to capital)</b>											
B.8.1	Excess General Provisions	<b>Calculated by the sheet, being the amount by which General Provisions (B.3) exceed total credit risk RWA (refer form SR-2C risk asset ratio section)</b>										
B.8.2	Amortisation on Tier 2 subordinated debt	<p>Report the total of all discounts required for the amortisation of term debt (see B.5) in accordance with the following table (arranged by residual maturity):</p> <table border="1" data-bbox="594 1446 1459 1816"> <tbody> <tr> <td data-bbox="594 1446 932 1499">Over 4 years.</td> <td data-bbox="932 1446 1459 1499">0% of nominal.</td> </tr> <tr> <td data-bbox="594 1499 932 1593">3 years plus to 4 years.</td> <td data-bbox="932 1499 1459 1593">20% of nominal.</td> </tr> <tr> <td data-bbox="594 1593 932 1688">2 years plus to 3 years.</td> <td data-bbox="932 1593 1459 1688">40% of nominal.</td> </tr> <tr> <td data-bbox="594 1688 932 1782">1 year plus to 2 years.</td> <td data-bbox="932 1688 1459 1782">60% of nominal.</td> </tr> <tr> <td data-bbox="594 1782 932 1816">Less than 1 year.</td> <td data-bbox="932 1782 1459 1816">80% of nominal.</td> </tr> </tbody> </table>	Over 4 years.	0% of nominal.	3 years plus to 4 years.	20% of nominal.	2 years plus to 3 years.	40% of nominal.	1 year plus to 2 years.	60% of nominal.	Less than 1 year.	80% of nominal.
Over 4 years.	0% of nominal.											
3 years plus to 4 years.	20% of nominal.											
2 years plus to 3 years.	40% of nominal.											
1 year plus to 2 years.	60% of nominal.											
Less than 1 year.	80% of nominal.											

Item	Description	Guidance
B.8.3	Excess Tier 2 subordinated debt	Calculated by the sheet, being the amount by which Subordinated Debt after amortisation (B.5 minus B.8.2) exceeds 50% of Tier 1 Capital (Table A Total).
B.8.4	Excess Tier 2	Calculated by the sheet, being the amount by which Tier 2 capital after all other deductions (B.7 minus B.8.1, B.8.2 and B.8.3) exceeds Tier 1 Capital (Table A Total)
	<b>Total deductions:</b>	Calculated by the sheet, being the sum of B.8.1 to B.8.4.
	<b>TOTAL</b>	Calculated by the sheet, being B.7 less total deductions.

Item	Description	Guidance
<b>C</b>	<b>Deductions from Capital</b>	
C.1	Investment in Subsidiaries	<p><b>Derived automatically from Item E.10 in form SR-1A Balance Sheet Assets.</b></p> <p>Investments in subsidiary and associated companies. Such companies include:</p> <ul style="list-style-type: none"> <li>(d) The reporting bank's ultimate parent;</li> <li>(e) All subsidiaries of that ultimate parent;</li> <li>(f) All companies with whom the reporting bank has entered into a joint venture, together with the joint venture itself and any subsidiaries of it;</li> <li>(g) All companies where the reporting bank is a significant shareholder and holds over 20% of that company's share capital; and</li> <li>(h) All companies where the reporting bank exercises management control.</li> </ul>
C.2	Capital connected lending	<p><b>Derived automatically from Item D.7 in form SR-1A Balance Sheet Assets.</b></p> <p>Lending of a capital nature to subsidiary and associated companies other than that reported in C.1.</p>
C.3	Holdings of Banks' Capital Instruments	<p><b>Derived automatically from Items C.5.6 and E.11 in form SR-1A Balance Sheet Assets.</b></p> <p>Holdings of capital instruments issued by banks and other regulated financial services businesses.</p>

<b>Item</b>	<b>Description</b>	<b>Guidance</b>
C.4	Securitisations - Equity Tranches	<b>Derived automatically from Items C.5.8 and E.13 in form SR-1A <i>Balance Sheet Assets</i>.</b>  Holdings of equity tranches of securitisations.
C.5	Off balance sheet items of a capital nature	Deductions required regarding off-balance sheet items, as set out further in the appropriate credit risk forms (SR-1B).
C.6	IRB deductions, including deductions for excess expected losses	Report here the total deductions required regarding excess expected losses compared to provisions and other IRB deductions, as set out further in the appropriate (AIRB/FIRB) credit risk module.
C.7	Other	<b>Derived automatically from Item E.9 in form SR-1A <i>Balance Sheet Assets</i>.</b>  Significant (minority and/or majority) investments in commercial entities (those which exceed materiality levels) should be deducted from banks' capital. Materiality levels are: <ul style="list-style-type: none"> <li>(i) 15% of the bank's capital for individual investments in commercial entities; and</li> <li>(j) 60% of the bank's capital for the aggregate of such investments.</li> </ul> The amount to be deducted will be that portion of the investment that exceeds the materiality level.
	<b>TOTAL</b>	<b>Calculated by the sheet, being the sum of C.1 to C.7.</b>

<b>Item</b>	<b>Description</b>	<b>Guidance</b>
<b>D</b>	<b>Capital after deductions</b>	
D.1.1	Tier 1 Capital	<b>Calculated by the sheet, being the total from Table A.</b>
D.1.2	Deductions pro rata	<b>Calculated by the sheet from the total of capital deductions (from Table C) minus the amount deducted from Tier 2 capital (D.2.2).</b>
<b>D.1</b>	<b>Net Tier 1 capital</b>	<b>Calculated by the sheet, being D.1.1 minus D.1.2.</b>

<b>Item</b>	<b>Description</b>	<b>Guidance</b>
D.2.1	Tier 2 Capital	<b>Calculated by the sheet, being the total from Table B.</b>
D.2.2	Deductions pro rata	<b>Calculated by the sheet, being the total of capital deductions (from Table C) divided by 2, limited to ensure that this deduction does not exceed the amount of Tier 2 capital (D.2.1).</b>
<b>D.2</b>	<b>Net Tier 2 capital</b>	<b>Calculated by the sheet, being D.2.1 minus D.2.2.</b>
	<b>ADJUSTED CAPITAL BASE (Tiers 1&amp;2)</b>	<b>Calculated by the sheet, being D.1 plus D.2.</b>

*NOTE:* Adjustments in respect of a *defined benefit occupational pension scheme* are to be applied as follows:

- (a) Any *defined benefit asset* included in reserves for accounting purposes must be excluded for capital purposes from section A.3. For form SR-1A these reserves should be shown D.3 “capital items falling outside of regulatory capital”.
- (b) A bank may substitute for its *defined benefit liability* included in reserves its *deficit reduction amount*. Any difference between the *defined benefit liability* and the *deficit reduction amount* should not be included in regulatory capital. For form SR-1A any such difference is to be reported under D.3 “capital items falling outside of regulatory capital”, together with any part of (a) above, as it is not eligible for capital.

Definitions of the terms in italics are provided in the **Chapter 1 section 4.10**.

## **SECTION 2 – PROFIT AND LOSS ACCOUNT**

The *Profit & Loss* should be completed to detail a bank’s profit and loss account (which may be referred to as the income statement) for the current financial year up to the reporting date.

In “A: Income”, a positive figure should be input for an amount that gives rise to a profit and a negative item for a loss. The sole exception to this is A.1.1.2 where the absolute amount of the interest expense should be entered.

In “B: Operating Expenses” and “C: Profit or Loss”, for “B.2.2: Bad debts”, “C.2: Extraordinary Items”, “C.3: Taxation” and “C.5: Dividends”, the assumption is that all these items are expenses and hence a positive figure should be entered for an amount that gives rise to a loss and a negative figure for a profit.

### **Detailed guidance**

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
<b>A</b>	<b>Income</b>	
<b>A.1</b>	<b>Banking Income</b>	
A.1.1.1	Interest Income	Include under these headings both interest actually received and paid and interest receivable and payable that has accrued but has not yet been received or paid. Amounts accrued should be based on the latest date to which these calculations were made; thus for a bank which accrues profits on a daily basis, accruals should include amounts up to and including the reporting date. Also include under this heading income accrued in respect of the amortisation of discounts (and premiums) on the purchase of fixed maturity investments which are not held for dealing (e.g. Treasury Bills).
A.1.1.2	Interest Expense (enter absolute value)	
<b>A.1.1</b>	<b>Net Interest Income</b>	<b>Calculated by the sheet as the amount reported as interest income minus the amount reported as interest expense.</b>
A.1.2	Profit/loss on foreign exchange dealing and currency positions	Report the net income derived from revaluations of foreign exchange positions and, if identifiable, fees and commissions relating to foreign exchange business.

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
A.1.3	Profit/loss on investments held for dealing	Report the net income derived from investments (excluding revaluation profits or losses) other than those arising from the sale of investments in subsidiary or associated companies, trade investments or the amortisation of premiums or discounts on the purchase of fixed maturity investments that are not held for dealing.
A.1.4	Net Income from banking fees, charges and commissions	Income from banking fees and commissions. Include charges made for services provided by the bank, e.g. for the provision of current account facilities, corporate advice, investment management services, guarantees and indemnities, commission on the sale of insurance or travellers cheques etc, but not those disclosed separately in A.1.2 or A.2.
A.1.5	Increase / decrease in book value of investments	Report the net gains derived from the revaluation of investments other than those arising from the revaluation of investments in subsidiary or associated companies, trade investments or the amortisation of premiums or discounts on the purchase of fixed maturity investments that are not held for dealing.
<b>A.1</b>	<b>Total Banking Income</b>	<b>Calculated by the sheet as the sum of items A.1.1 to A.1.5.</b>
<b>A.2</b>	<b>Non Banking Income</b>	
A.2.1	Investment management fees	All fees/commissions received by the bank for portfolio management services, (both for discretionary and non-discretionary portfolios). Include only fees/commissions agreed with the customer for the management of portfolios.
A.2.2	Trust and company administration fees	All fees received by the bank for administering companies on behalf of clients/trusts, including those charged for the provision of registered office, directors, company secretary, etc.
A.2.3	Trustee/Custodian fees	All fees received by the bank for acting as a Trustee or Custodian.
A.2.4	Fund management fees	All fees received by the bank for acting in any role in relation to the management of a fund.

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
A.2.5	Investment dealing profits and commissions	All commissions and profits received/earned in investment transactions with, or on behalf of, clients. Include commission/profits from investment dealing transactions undertaken by the bank where it acts as principal but buys/sells on a matched (or virtually matched) basis to clients. (For example, where the bank purchases a block of shares/investments from a broker and then sells these on to its own investment clients).
A.2.6	Other	Any other income from customers.
<b>A.2</b>	<b>Total Non Banking Income</b>	<b>Calculated by the sheet as the sum of items A.2.1 to A.2.6.</b>
<b>A.3</b>	<b>Dividends and other income</b>	
A.3.1	Dividends/share of profits (or losses) from subsidiaries and associated companies (report a loss as a negative)	Banks reporting on an unconsolidated basis should include only the dividends received from other group companies. Those reporting on a consolidated basis should include the share of profits from associated companies where equity accounting is used.
A.3.2	Other Income	All other income not included elsewhere.
<b>A.3</b>	<b>Dividends and other income</b>	<b>Calculated by the sheet as the sum of items A.3.1 to A.3.2.</b>
<b>A</b>	<b>Total Income</b>	<b>Calculated by the sheet as the sum of items A.1, A.2 and A.3.</b>
<b>B</b>	<b>Expenses</b>	
<b>B.1</b>	<b>Operating Expenses</b>	
B.1.1	Staff Costs	Include salary costs, employer's social security contributions, the employer's contribution to any pension scheme and the costs of staff benefits paid on a per capita basis such as private medical insurance, staff travel concessions etc. General staff benefits, such as subsidised restaurants, would fall outside this category and be included in line B.1.6.
B.1.2	Occupancy	Include rates, rent, buildings' insurance, lighting, heating, maintenance costs and depreciation.

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
B.1.3	Audit and Legal fees	Include all Audit and Legal fee expenses.
B.1.4	Directors Remuneration	Include <b>all</b> costs relating to both Executive and Non Executive Directors.
B.1.5	Group Management / Administration Charge	Include in this heading general management charges paid to the Parent or Group that are not specifically allocated under any other heading.
B.1.6	Other	Any other operating expenses not separately classified in B.1.1 to B.1.5 above.
<b>B.1</b>	<b>Total Operating Expenses</b>	<b>Calculated by the sheet as the sum of items B.1.1 to B.1.6.</b>
<b>B.2</b>	<b>Other Expenses</b>	
B.2.1	Interest paid and payable on subordinated debt	Report interest on loan stock which qualifies for inclusion as tier 2 capital.
B.2.2	Net charge/credit for specific/individual and general/collective bad debt provisions	Enter here the net charge for specific and general bad debt provisions.
B.2.3	Other expenses	Any other non operating expenses not separately shown in B.2.1 and B.2.2.
<b>B.2</b>	<b>Total Other Expenses</b>	<b>Calculated by the sheet as the sum of items B.2.1, B.2.2 and B.2.3.</b>
<b>B</b>	<b>Total Expenses</b>	<b>Calculated by the sheet as the sum of items B.1 and B.2.</b>
<b>C</b>	<b>Profit or Loss</b>	
<b>C.1</b>	<b>Profit / Loss before taxation, extraordinary items and dividends</b>	<b>Calculated by the sheet as item A less item B.</b>
C.2	Extraordinary items	Extraordinary items should be reported net of attributable taxation. Enter net extraordinary income as a negative figure, and net extraordinary costs as a positive figure.

Item	Nature of Item	Guidance
C.3	Taxation	For reports covering less than a year, the taxation charge should be estimated by applying a reasonable estimate of the bank's effective tax rate applicable for the year in question.
<b>C.4</b>	<b>Profit / loss after taxation and extraordinary items</b>	<b>Calculated by the sheet as being item C.1 minus items C.2 and C.3.</b>
C.5	Dividends	Report only dividends declared that have been paid out of current year profits. All other dividends should be deducted directly from disclosed reserves.
<b>C</b>	<b>Profits / loss retained</b>	<b>Calculated by the sheet as C.4 minus C.5.</b>

## **SECTION 3 - PROVISIONS AND NON-PERFORMING ASSETS**

### **Detailed guidance**

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
<b>A</b>	<b>Provisions against bad and doubtful debts</b>	
A.1	Gross value of loans against which specific/individual provisions made	Report the total gross value, before the deductions of provisions (impairment), of loans against which specific/individual provisions have been made.
A.2	Amounts written off in the period – specific/individual provisions only	<p>Report amounts written off in the current accounting period. Where a debt has been identified as bad in the current accounting period and wholly, or partially, written off, the amount written off should be included here.</p> <p>Where a debt has been identified as bad and a specific/individual provision has been made prior to the beginning of the current accounting period, and the debt has been written off in this current accounting period, the amount written off should also be included here.</p>
A.3	Recoveries of amounts previously written off – specific/individual provisions only	Report all amounts recovered from loans previously written off.
<b>B</b>	<b>Non performing assets and loans</b> ( <i>Note: this item is not concerned with recoverability of those loans and assets – just whether interest is overdue or outstanding on those loans/assets after the elapse of the time period</i> ).	
B.1	Loans and other assets – 60 days past due	Report the value of loans and other assets (e.g. bonds and securities) on which the interest due has not been received at the reporting date. Report those loans/assets overdue for more than 60 days up to those overdue for 89 days.

<b>Item</b>	<b>Nature of Item</b>	<b>Guidance</b>
B.2	Loans and other assets – 90 days past due	Report the value of loans and other assets (e.g. bonds and securities) on which the interest due has not been received at the reporting date. Report those loans/assets overdue for more than 90 days.

## **ANNEX A – TIER 1 CAPITAL**

- A.1 The only capital instruments that may be eligible for Tier 1 capital are those described in paragraphs A.2 and A.3 below.
- A.2 Ordinary shares, i.e. allotted, called up and fully paid share capital.
- This should be net of any of its own shares that a bank holds.
  - “Fully paid” means that the proceeds of the issue have been received by the bank and are available to absorb losses.
- A.3 Perpetual non-cumulative preference shares, including such shares redeemable with the Commission’s prior consent and such shares convertible into ordinary shares.
- A.4 Ordinary share capital is the strongest form of capital in terms of insulating depositors from credit risk. This is because:
- There is statutory subordination. Shareholders are the last to be paid in the event of the liquidation of a bank;
  - Dividends are discretionary and non-cumulative - they can only be paid when the bank has sufficient distributable reserves;
  - Ordinary share capital absorbs losses while the bank is still trading: A bank can have negative reserves, as long as these do not exceed the book value of the shares issued; and
  - It is undated.

## **CHAPTER 7**

### **GUIDANCE NOTES – FORM SR-2B**

#### **SECTION 1 - GENERAL**

These notes generally set out the minimum information to be reported in respect of a bank's large exposures to customers / counterparties.

Exposures to the following categories of customers / counterparties should be reported separately:-

- (i) Non-credit institutions
- (ii) Credit institutions

Reference should be made to Chapter 1, sections 5, 6 and 7 for the following definitions:-

- (i) Exposure;
- (ii) Customers / Counterparties (including those related to each other and those connected to the bank); and
- (iii) Large Exposures Capital Base ("LECB").

The Commission may, however, require additional information to be provided by the bank either regularly or in respect of certain reporting dates only. Such additional information will be agreed with the Commission, in writing, with the bank concerned.

Exposures should be reported in descending order of size.

Exposures at the reporting date should be reported. Where the maximum exposure to the same customer / counterparty during the period since the previous reporting date has exceeded that at the reporting date the former should also be reported, unless it is the result of converting an exposure denominated, wholly or partly, in foreign currency into sterling (at a different exchange rate from that applied at the reporting date), arises from valuing a marketable security at a higher price, or unless otherwise agreed by the Commission.

An exposure which is less than 10% of the bank's LECB at the reporting date but which has exceeded 10% of the bank's LECB since the previous reporting date should also be reported, unless otherwise agreed, in writing, by the Commission.

Exposures are defined gross of specific/individual provisions made for bad and doubtful debts and eligible collateral for the purpose of reporting to the Commission. Such provisions should however be reported in column 4 and details of the security in column 10.

**SECTION 2 – ANALYSIS OF ALL EXPOSURES TO NON-CREDIT INSTITUTIONS OF 10% OR ABOVE OF LARGE EXPOSURES CAPITAL BASE (“LECB”)**

**Banks incorporated in the Isle of Man**

Report all exposures that exceed 10% (unless the Financial Supervision Commission has determined a lower percentage) of the bank's LECB. The latest agreed LECB figure should be entered in the appropriate box on the form.

**Branches**

Report the ten largest exposures only.

**General**

Exposures to a group of closely related customers / counterparties should be reported as one exposure for the purpose of this form.

1. ***Customer / Counterparty Name***

Report the name of the customer / counterparty.

2. ***State if customer / counterparty is connected to the bank***

If the borrower is connected to the bank then report Y. If not, report N.

3. ***Exposure as at reporting date***

Report the amount of the facility being utilised (whether drawn down or guaranteed), as at the reporting date, gross of specific / individual provisions and collateral.

4. ***Specific/individual bad debt provision (if any)***

Report the amount of any such provisions made specifically/individually against each exposure.

5. ***Maturity date(s)***

Report the maturity date in the format DD.MM.YY or “various” (see below).

A security with optional redemption dates, which are exercisable by the holder, should be classified according to the first optional redemption date. Where there are several maturity dates due to (for example) a number of

individual exposures making up the total closely related exposure; "various" may be inserted here.

6. ***Currency***

Report the currency in which the exposure is denominated. Where the exposure, or group of closely related exposures, is denominated in more than one currency, "various" may be inserted here.

7. ***Reported on Form SR-1 under item(s)***

Report the relevant item number(s) on Form SR-1A under which the exposure(s) is/are included. Note that entries should be made in the electronic reporting software in the format "X.Y" only (i.e. A.3).

8. ***Facility limit***

Report the amount of the aggregated facility limit.

9. ***Maximum exposure in the quarter***

Report the maximum amount of the exposure since the last supervisory return was submitted if larger than the figure in column 8.

10. ***Nature of security***

Report the type of security taken against the loan (e.g. cash, securities, property, guarantee from parent bank etc). If no security is taken then enter "none".

11. ***Date large exposure card submitted (this does not apply to branches)***

Report the date that the most recently updated large exposure card was submitted to the Commission, in the format DD.MM.YY.

Banks are asked to note that a large exposure card must be provided for each exposure listed in section 1 and that these large exposure cards must be updated as necessary and in any event at least annually.

**SECTION 3 – ANALYSIS OF EXPOSURES TO CREDIT INSTITUTIONS**

**Banks incorporated in the Isle of Man**

Report all exposures that exceed 10% (unless the Financial Supervision Commission has determined a lower percentage) of the bank's LECB. The latest agreed LECB figure should be entered in the appropriate box on the form.

## **Branches**

Report the ten largest exposures only.

## **General**

Exposures in the form of investment, (including those in the form of equities or subordinated loans stocks), in another credit institution should be reported here regardless of the maturity of the security.

Exposures to groups of closely related counterparties should be reported as one exposure. Exposures to individual counterparties within the bank's group should be separately identified only if they are equal to or greater than 2% of total assets.

1. ***Name of credit institution***

Report the name of the credit institution counterparty.

2. ***Reported on Form SR-1A under item(s)***

Report the relevant item number(s) on Form SR-1A under which the exposure(s) is/are included. Note that entries should be made in the electronic reporting software in the format "X.Y" only (i.e. A.3).

3. ***Maturity date(s)***

Report the maturity date in the format DD.MM.YY or "various" (see below).

A security with optional redemption dates, which are exercisable by the holder, should be classified according to the first optional redemption date. Where there are several maturity dates due to (for example) a number of individual exposures making up the total closely related exposure; "various" may be inserted here.

4. ***Limit***

Report the maximum amount that may be put at risk with the particular credit institution, by the bank.

5. ***Current amount***

Report the amount at risk as at the reporting date.

## CHAPTER 8

### GUIDANCE NOTES – FORM SR-2C

#### SECTION 1 - RISK ASSET RATIO CALCULATION (INCORPORATED BANKS ONLY)

The *Risk Asset Ratio* is intended to allow the Commission to assess whether a bank has adequate financial resources to meet the risks that it is exposed to. This sheet derives the total risk weighted asset requirement from the output of the appropriate forms for credit (SR-1B), operational (SR-1C) and market risk and settlement risk (SR-4). It then compares this requirement against the capital derived in form SR-2A, capital section to arrive at a Risk Asset Ratio (“RAR”). The Commission has established that a bank’s minimum risk asset ratio must be maintained at all times at or above 8%, or such other higher ratio as has been prescribed.

#### Detailed guidance

Item	Description	Guidance
<b>A</b>	<b>Credit Risk</b>	
A.1	Credit Risk - RWA Equivalent: SSA	If the bank uses SSA for credit risk then record the total RWA reported for the bank, as calculated by form SR-1B.
A.2	Credit Risk - RWA Equivalent: SAC	If the bank uses SAC for credit risk then record the total RWA reported for the bank, as calculated by form SR-1B.
A.3	Credit Risk - RWA Equivalent: FIRB	If the bank uses FIRB for credit risk then record the total RWA calculated for the bank using that approach.
A.4	Credit Risk - RWA Equivalent: AIRB	If the bank uses AIRB for credit risk then record the total RWA calculated for the bank using that approach.
	<b>TOTAL CREDIT RISK RWA</b>	<b>Calculated by the sheet, being the sum of A.1 to A.4 (for banks using the SSA or SAC this will equal the amount reported under that approach only)</b>
<b>B</b>	<b>Operational Risk</b>	
B.1	Operational Risk - RWA Equivalent: BIA	If the bank uses BIA for operational risk then record the total RWA equivalent reported for the bank, as calculated by form SR-1C. <b><i>This line will be automatically generated from SR-1C.</i></b>

<b>Item</b>	<b>Description</b>	<b>Guidance</b>
B.2	Operational Risk - RWA Equivalent: SAO	If the bank uses SAO for operational risk then record the total RWA equivalent reported for the bank, as calculated by form SR-1C. <b><i>This line will be automatically generated from SR-1C.</i></b>
B.3	Operational Risk - RWA Equivalent: ASA	If the bank uses ASA for operational risk then record the total RWA equivalent reported for the bank, as calculated by form SR-1C. <b><i>This line will be automatically generated from SR-1C.</i></b>
B.4	Operational Risk - RWA Equivalent: AMA	If the bank uses AMA for operational risk then record the total RWA equivalent calculated for the bank using that approach.
	<b>TOTAL OPERATIONAL RISK RWA</b>	<b>Calculated by the sheet, being the sum of B.1 to B.4 (normally equivalent to only one of the above lines).</b>
<b>C</b>	<b>Market Risk in the Banking Book</b>	
C.1	Market Risk - RWA Equivalent - SAM: FX & Gold	If the bank uses SAM for market risk then record the total RWA equivalent reported for these exposures, as calculated by form SR-4 in the section on "Foreign Currency Exposure". <b><i>This line will be automatically generated from SR-4.</i></b>
C.2	Market Risk - RWA Equivalent - SAM: Commodities	If the bank uses SAM for market risk then record the total RWA equivalent reported for commodities, as calculated by form SR-4 in the section on "Commodity Risk". <b><i>This line will be automatically generated from SR-4.</i></b>
	<b>TOTAL BANKING BOOK MARKET RISK RWA</b>	<b>Calculated by the sheet, being the sum of C.1 and C.2.</b>
<b>D</b>	<b>TOTAL SETTLEMENT RISK RWA</b>	If the bank uses SAM for market risk then record the total RWA equivalent reported for these exposures, as calculated by form SR-4 in the section on "Settlement Risk". <b><i>This line will be automatically generated from SR-4.</i></b>
<b>E</b>	<b>Eligible Capital</b>	
E.1	Adjusted Capital Base (Tiers 1&2)	<b>Calculated by the sheet, from form SR-2A capital section.</b>
	<b>TOTAL ELIGIBLE CAPITAL</b>	<b>Calculated by the sheet as being E.1.</b>

Item	Description	Guidance
<b>F</b>	<b>TOTAL RISK WEIGHTED ASSETS (Pillar 1)</b>	<b>Calculated by the sheet, being the sum of the totals of A to D above.</b>
<b>G</b>	<b>Risk Asset Ratio and Surplus Capital</b>	
G.1	Actual Risk Asset Ratio	<b>Calculated by the sheet, being the amount of eligible capital (E) divided by the Pillar 1 RWA (F).</b>
G.2	Agreed Minimum Risk Asset Ratio	The minimum RAR required for the bank, as established by the Commission as a result of the Pillar 2 assessment of the bank. The figure should be entered as a number only (e.g. if the prescribed minimum is 9% it should be entered as "9").
G.3	Eligible Capital required to support Pillar 1 risks	<b>Calculated by the sheet, being 8% of the total risk weighted assets reported in F above.</b>
G.4	Eligible Capital required to support Pillar 2 risks	<b>Calculated by the sheet, being the agreed minimum RAR reported in G.2 multiplied by the total risk weighted assets reported in F, less the amount reported in G.3 covering pillar 1 risks.</b>
G.5	Surplus Eligible Capital	<b>Calculated by the sheet being the amount shown in E less the capital amounts reported in G.3 and G.4.</b>

## **SECTION 2 - MEMORANDUM ITEMS**

For the definitions of parties connected to the bank refer to **chapter 1, section 5**.

### **Detailed guidance**

Item	Description	Guidance
<b>A</b>	<b>Amounts due to parties connected to the bank</b>	
A.1	Other group companies – credit institutions	All liabilities, not merely deposit liabilities, due to parties connected to the bank in the four categories provided in the form.
A.2	Other group companies - other	Amounts due to individual directors, controllers

<b>Item</b>	<b>Description</b>	<b>Guidance</b>
A.3	Directors, controllers and their associates	and their associates need not be reported here provided the amount does not exceed £50,000.
A.4	Non-group companies, trusts and other bodies with which the directors and controllers are associated	The bank must state where the balances are reported in form SR-1A, the amount drawn (on balance sheet) and any limit that may apply. <i>Note that entries should be made in the electronic reporting software in the format "X.Y" only (i.e. A.3).</i>
	<b>SUB-TOTAL</b>	<b>Calculated by the sheet, being the sum of A.1 to A.4</b>
<b>B</b>	<b>Amounts due from parties connected to the bank</b>	
B.1	Other group companies – credit institutions	Report all such exposures due from parties connected to the bank in the four categories provided in the form.
B.2	Other group companies - other	Amounts due from individual directors, controllers and their associates need not be reported here provided the amount does not exceed £50,000.
B.3	Directors, controllers and their associates	
B.4	Non-group companies, trusts and other bodies with which the directors and controllers are associated	The bank must state where the balances are reported in form SR-1A, the amount drawn (on balance sheet) and any limit that may apply. <i>Note that entries should be made in the electronic reporting software in the format "X.Y" only (i.e. A.3).</i>
	<b>SUB-TOTAL</b>	<b>Calculated by the sheet, being the sum of B.1 to B.4</b>
<b>C</b>	<b>Investments</b>	
C.1	Quoted investments: market valuation	The total market value of all investments listed under a Recognised Stock Exchange included within Form SR-1A.  Amounts must be classified between sterling balances and non-sterling balances.

Item	Description	Guidance
C.2	Unquoted investments: Directors' valuation	<p>The total value of all unquoted investments included within Form SR-1A for which directors' valuations apply. A revaluation by directors of such investments is not required on each reporting date, but it must be undertaken at least once a year. The latest valuation for statutory or management accounting purposes should be shown unless substantial impairment of that value is known to have occurred.</p> <p>Amounts must be classified between sterling balances and non-sterling balances.</p>
<b>D</b>	<b>Encumbered Assets</b>	<p>The total of any assets not freely available to meet the claims of the generality of creditors in a liquidation of the bank because they are subject to charge, pledge or other restriction. This will include items given as security in connection with the bank's participation in a payments/settlements system (such as Euroclear). Assets pledged in excess of the actual liability to individual systems at the reporting date should not be reported. This line will also include assets given as security for the bank's other liabilities (e.g. property which has been mortgaged and hire purchase agreements pledged as collateral). Assets reported should exclude any element of unearned finance charges.</p> <p>Amounts must be classified between sterling balances and non-sterling balances.</p>
<b>E</b>	<b>Fiduciary Deposits</b>	<p>The total of deposits received by the bank that are placed or relent at the depositor's risk or under arrangements by which they are not regarded as liabilities of the bank.</p> <p>Amounts must be classified between sterling balances and non-sterling balances.</p> <p><i>See also chapter 1, section 4.5.</i></p>

Item	Description	Guidance
<b>F</b>	<b>Number of staff employed</b>	<p>The number of staff employed by the bank, taking into account the following:</p> <p>(i) An employee is regarded as full time if the hours he/she works for the bank, in an average week, are thirty or more, (excluding overtime). Such staff should thus be reported in the full time column. All other employees should be considered to be part time for the purposes of this return and reported in the part time column.</p> <p>(ii) Employee includes a director of the bank where that director is an executive, (rather than non-executive), director.</p>
<b>G</b>	<b>Number of accounts as at the reporting date</b>	<p>Report only deposit accounts with a credit balance when completing this section (i.e. do not include overdrawn accounts). Figures should be classified between sterling denominated accounts and those of other currencies (combined).</p>
<b>H</b>	<b>Deposits / loans received from other Isle of Man credit institutions</b>	<p>All deposits/loans made to the bank by Isle of Man offices of other institutions holding a class 1 licence issued under the Financial Services Act 2008, which will include deposits / loans made to the bank by Isle of Man offices of UK building societies.</p> <p>Amounts must be classified between sterling balances and non-sterling balances.</p>

## **CHAPTER 9**

### **GUIDANCE NOTES – FORM SR-3A**

#### **SECTION 1 - GENERAL**

The purpose of this return is to assess a bank's liquidity profile, taking into account liquid assets, products containing embedded and prepayment options, and behavioural adjustments to the retail deposit base.

Assets and deposit liabilities should be reported on a residual maturity basis throughout the return, but the bank may, at its option, also report interest due to be paid and received and additional cash flows such as dividend payments, large plant purchases etc on a cash-flow basis. All foreign exchange flows should be separately reported in the FX cash inflows and outflows columns (see notes 13 and 27).

Assets and liabilities are recorded on a maturity ladder and, where appropriate, behavioural adjustments are applied prior to the final mismatch position being calculated.

A "worst-case" basis is used to determine the timing of flows from assets and liabilities, with assets being recorded at the latest maturity and liabilities at the earliest. This approach allows a bank's liquidity to be assessed in the circumstances of depositors withdrawing their funds and lenders being unwilling to renew their facilities. However, the Commission recognises that some banks may maintain liquidity through holding highly liquid instruments such as government securities, certificates of deposit, floating rate notes, and bills of exchange. It is also recognised that the cash flows produced by some liabilities may bear little resemblance to their contractual maturity. For example, customer demand deposits are not normally withdrawn the next day and can remain with the same bank for several years. Banks may therefore apply to the Commission for agreement to apply behavioural adjustments to such deposit liabilities.

In general, banks are required to maintain appropriate levels of liquidity in each individual currency. It is recognised that the liquidity of the forward foreign exchange market is such that banks should experience little difficulty in executing foreign exchange swap deals to fund assets in a currency where the bank is short of liquidity from liabilities in a currency where the bank has an excess of liquidity. The Commission will therefore allow banks to report all currencies on a net basis but would not expect interest arbitrage to form a major part of their liquidity strategy. The Commission may therefore require the bank to report in specified individual currencies.

For the purposes of this report "sight less than eight days" means the 1<sup>st</sup> to 7<sup>th</sup> day inclusive of the month following the reporting date. "8 days less than month"

means the 8<sup>th</sup> day of the month following the reporting date up to and including the last day of the same month. Beyond this, references to “month or months” mean calendar month or months. All monetary balances should be reported in sterling.

## **SECTION 2 – COMPLETION NOTES - LIQUIDITY**

### **Assets**

1. Report deposits placed with, and CDs issued by, group entities according to contractual maturity date. CDs issued by group institutions do not qualify for behavioural adjustment unless the instruments are highly liquid and able to be independently sold in the secondary market. Banks must obtain the agreement of the Commission if it is intended to apply behavioural adjustments to such assets.
2. Report deposits with credit institutions on either a notice or fixed term basis. Do not include certificates of deposit, floating rate notes or deposits or other instruments that incorporate embedded options.
3. Report deposits with, or other instruments issued by, credit institutions (including group) that incorporate embedded derivatives or early repayment options. Assets should be reported by contractual maturity. In order to qualify for behavioural adjustment, the bank must clearly show that it has the sole right to exercise an option for repayment prior to final maturity. The prior agreement of the Commission must be sought before making such adjustments.
4. Report certificates of deposit, bills of exchange and floating rate notes by contractual maturity. Bills of exchange should be included at book value. These instruments qualify for behavioural adjustment to the sight to less than 8 days maturity band subject to the following discounts:

Under 1 year to maturity:	5%
1 to 5 years to maturity or floating rate:	10%

5. Report bonds issued by credit institutions (including group) that incorporate embedded derivatives or early repayment options according to final maturity. To qualify for any behavioural adjustment, the bank must have the sole right to exercise an option for repayment prior to final maturity, or that there is a liquid secondary market for the instrument. The prior agreement of the Commission must be sought before making such adjustments.
6. Report bonds / securities issued by central governments / central banks, and multilateral development banks which would receive (unsecured) a

0% risk weighting under the standardised approach, according to contractual maturity. Such bonds may be subject to a behavioural adjustment to the sight to less than 8 days maturity band subject to the following discounts:

Under 1 year to maturity or floating rate	3%
1 to 5 years to maturity	7%
Over 5 years to maturity	16%

7. Report bonds / securities issued by other governments and central banks which are not risk weighted at 0% according to contractual maturity (unless otherwise agreed with the Commission).
8. Report all other investments according to contractual maturity date with the exception of designated money market funds which can be reported as sight assets with the prior agreement of the Commission (refer to the liquidity risk management guidance note for more details). Equities and other undated marketable assets should be included in the over 1, less than 3 month maturity band. Behavioural adjustments may be appropriate in respect of main index equities. Commercial paper should be entered according to contractual maturity, but behavioural adjustments may be appropriate. The prior agreement of the Commission must be sought for such adjustments.
9. Loans should be reported according to final contractual maturity date. Overdrafts should be entered in the over 1, less than 3 month maturity band.
10. Mortgages should be reported according to final maturity date.
11. Report all other on balance sheet assets according to their maturity date. The treatment of undated assets of material value should be agreed with the Commission.
12. For each maturity band, this is the sum of the figures reported under notes 1 to 11 above. It is system generated. The total of this line (i.e. total assets) should equal total assets as reported in SR-1A.
13. Report foreign exchange purchases according to settlement date.
14. Report any un-drawn committed standby facilities granted to the bank by third party credit institutions. Facilities granted by group should not be included without prior discussion and agreement with the Commission. Such facilities should be unconditional unless otherwise agreed with the Commission.

15. **Completion of this row is optional.** Report known inflows.
16. Report all behavioural adjustments that have been agreed with the Commission. Behavioural adjustments out of the reported maturity band should be shown as a negative entry, and the corresponding adjustment should be shown as a positive entry in the appropriate maturity band. The sum of the entries of each of these rows should therefore amount to zero.
- Use a separate row for each adjustment.
- The prior agreement of the Commission must be sought for behavioural adjustments on any assets other than those specified in the notes above.
17. For each maturity band this is the sum of the figures reported under notes 12 to 16. It is system generated.

## **Liabilities**

18. Report all retail call or notice deposits. Do not include deposits from credit institutions, or any deposit accepted via a professional person or body that has a fiduciary responsibility for the funds (e.g. international life companies or trust companies).
19. Report all other call or notice deposits.
20. Report all retail fixed term deposits. Do not include deposits from credit institutions, or any deposit accepted via a professional person or body that has a fiduciary responsibility for the funds (e.g. international life companies or trust companies), or deposits or deposit bonds issued by the bank that incorporate embedded derivatives or offer the client an early repayment facility.
21. Report all other fixed term deposits other than deposits or deposit bonds issued that incorporate embedded derivatives or offer the client an early repayment facility.
22. Report all structured deposits, deposits or deposit bonds issued that incorporate embedded options or offer the customer the option to obtain repayment in part or in full prior to final maturity. For the latter, report on a "worst case" basis (i.e. the earliest date upon which the client can obtain repayment). If the bank sells a five year product that allows clients to withdraw 20% on the principal annually on 1<sup>st</sup> March, the 31<sup>st</sup> March return would show 20% of the deposit under 6 to 12 months, 40% under 1 to 3 years and 40% under 3 – 5 years.

23. For each maturity band this is the sum of the figures reported in lines 18 to 22. It is system generated.
24. Report total capital and reserves as reported as over 5 years. Subordinated loans and other eligible debt should be entered under contractual maturity.
25. Report all other on balance sheet liabilities according to maturity date.
26. For each maturity band this is the sum of the figures reported in lines 23 to 25. It is system generated. The total of this line (i.e. total liabilities) should equal total liabilities as reporting in SR-1A.
27. Report foreign exchange sales according to settlement date.
28. Where the bank is aware that committed lending facilities to customers are to be drawn down, classify these facilities according to draw down date. Where the date of draw down is unknown, include 35% of the total amount in the sight < 8 days maturity band. The balance may be omitted.
29. **Completion of this row is optional.** Report known future outflows.
30. Report behavioural adjustments on liabilities that have been previously agreed with the Commission. If for example, the Commission has agreed that a bank may factor a certain percentage of its retail sight < 8 days deposits to the over 1 month to less than 3 month maturity band, the adjustment should appear as a negative figure in the sight < eight days column, and a positive in the over 1 month to less than 3 months column. The total of each of these rows should therefore amount to zero.
31. For each maturity band this is the sum of the figures reported in lines 26 to 30. It is system generated.
32. For each maturity band this is the total adjusted assets calculated under line 17, less the total adjusted liabilities calculated under line 31. It is system generated.
33. For each maturity band this is the mismatch position calculated from line 32 on a cumulative basis (i.e. from sight). It is system generated.
34. For each maturity band this is line 33 compared to the total of line 23. It is system generated.

### **SECTION 3 - COMPLETION NOTES – ANALYSIS OF THE TEN LARGEST DEPOSITORS**

The ten largest deposits should be reported, aggregating multiple deposits from one customer.

**Customer / counterparty name** – state the name of the customer / counterparty.

**Amount** – report the total amount of the deposit.

**Maturity Date(s)** – report the maturity date of the deposit in the format DD.MM.YY. If there is more than one deposit state “various”.

**Currency** – state the currency that the deposit is denominated in. If there is more than one currency state “various”.

### **SECTION 4 - COMPLETION NOTES – ANALYSIS OF NON-CREDIT INSTITUTION DEPOSITS**

In completing this section the residence of a deposit with, or loans to, the bank should be classified according to the address to which the bank corresponds if no better classification is available. The geographical classifications in the form are not tight and it will be necessary for the bank to exercise its own judgement as to which category a particular deposit should be classified in.

The heading “Isle of Man” has been sub divided into two sections as follows:

**Individuals** – report deposits with, or loans to, the bank from individuals in the same manner as for the classification of deposits in SR-1A line A.5 of liabilities.

**Other** – report deposits with, or loans to, the bank from all other parties, excluding those from other credit institutions.

## **CHAPTER 10**

### **GUIDANCE NOTES – FORM SR-3B**

#### **SECTION 1 - GENERAL**

The purpose of this return is to enable the Commission to determine the degree of interest rate risk assumed by the bank, and to calculate the amount of capital that may be required to support the risk.

Simple maturity / re-pricing schedules can be used to generate simple indicators of the interest rate risk sensitivity, of both earnings and economic value, to changing interest rates. The approach is typically referred to as “gap analysis”. Interest rate sensitive liabilities in each time band are subtracted from the corresponding interest rate sensitive assets to produce a re-pricing gap for that time band. This gap is multiplied by an assumed change in interest rates to yield an approximation of the change in net interest income that would result from such a movement. In this regard the Commission uses a 200 basis point shock methodology.

A negative, or liability sensitive, gap occurs when liabilities exceed assets (including off balance sheet positions) in a given time band, which means that an increase in market interest rates could cause a decline in net interest income. A positive, or asset sensitive, gap implies that the bank’s net interest income could decline as a result of a decrease in the level of interest rates.

All banks are required to report interest rate mismatch positions classified in specific maturity bands according to their residual maturity or re-pricing date.

Maturity dates and interest rate re-pricing dates should be determined on a worst case basis, with assets being recorded at their latest maturity and deposit liabilities at their earliest. Due regard should also be taken of products that allow the customer to withdraw all, or a proportion of, their deposit prior to final maturity.

For the purpose of measuring interest rate risk, long positions in one currency cannot be offset against short positions in another currency. A separate return should be made for each currency that represents in excess of 25% of the bank’s deposit liabilities. Other currencies should be calculated individually and aggregated. The total should be entered under “other currencies”. Currencies that constitute less than 5% of total deposit liabilities may be ignored. The Commission reserves the right to request reports for individual foreign currencies at its discretion.

Where derivatives are used to hedge interest rate risk, they should be regarded as synthetic assets or liabilities for reporting purposes. Thus, in a case where the

bank has hedged a one year fixed rate asset against one month floating rate, it should report the hedging transaction as a liability in the 6-12 month band, and an asset in the up to 1 month band in the lines entitled "other interest rate contracts". Refer lines 12 and 22.

For the purposes of this report references to "month or months" mean calendar month or months.

## **SECTION 2 – COMPLETION NOTES**

### **Assets**

Non-interest bearing assets (which may include interest accrued as at the reporting date) should be reported in the band titled "non-interest bearing" in the appropriate asset category of the form. Such assets are outside of the interest rate gap shock analysis.

1. Report deposits with other banks according to the next contractual re-pricing date or maturity / repayment date.
2. Report according to the earliest date that the bank has the ability to obtain repayment of the asset. Where early repayment is at the option of the borrower, or relates to a specific market event (eg. FTSE 100 closing higher than a specified level), the asset should be reported according to contractual maturity date.
3. Report all liquid assets (e.g. CDs, FRNs, and bills of exchange purchased) according to the next interest re-pricing date or contractual maturity / repayment date.
4. Report bonds and other instruments according to the earliest date that, under the terms and conditions of the issue, the bank has the ability to obtain repayment of the asset.
5. Report all other investments by contractual maturity / repayment or next interest rate re-pricing date.
6. Overdrafts should be reported in the sight < one month maturity band. Loans should be reported by the earliest date at which the bank has the ability to obtain repayment or vary the interest rate.
7. Variable mortgages should be reported in the sight < one month maturity band. Floating rate mortgages should be reported according to the next interest rate re-pricing date.

8. Fixed rate mortgages should be reported according to the end of the fixed period.
9. Report all other assets according to contractual maturity / repayment or interest rate re-pricing date. The treatment of undated assets of material value should be agreed with the Commission.
10. For each maturity band this is the sum of the figures reported in lines 1 to 9. It is system generated.
11. Report forward foreign exchange purchases according to settlement date.
12. Report all notional amounts receivable under interest rate related contracts.
13. Report other derivative contract amounts receivable by payment date.
14. For each maturity band this is the sum of the figures reported in lines 10 to 13. It is system generated.

## **Liabilities**

Non-interest bearing liabilities (which may include interest accrued as at the reporting date) should be reported in the band titled “non-interest bearing” in the appropriate liability category of the form. Such liabilities are outside of the interest rate gap shock analysis.

15. Report total demand and notice accounts according to the maturity band in which the interest rate payable on the deposit can be changed or varied by the bank. Current accounts should be reported in the sight < one month band, one-month notice accounts in the 1 < 3 month band etc. *(NB: if the bank's procedure is to vary interest rates without giving notice to the customer, and the rate change takes immediate effect, the deposit should be reported as a sight liability)*. Where a product allows a proportion of the deposit to be withdrawn without penalty prior to the notice period, this proportion should be reported in the sight < one month maturity band. This may give rise to one deposit being split and reported over two or more maturity bands.
16. Report fixed term deposits according to contractual maturity / repayment.

17. Report all deposit bonds issued by the bank according to the next re-pricing or repayment date. Do not include bonds issued that incorporate embedded derivatives, or bonds that grant the customer the right to withdraw funds prior to final maturity.
18. Report any structured deposits, deposits and deposit bonds issued that incorporate embedded derivatives, or bonds that grant the customer the right to withdraw funds prior to final maturity, in the maturity band that represents the earliest date the customer can obtain repayment. This may give rise to one deposit being split and reported over two or more maturity bands.
19. Report all other liabilities. For capital and reserves, shareholders' equity should normally be reported as "non interest bearing". Variable and floating rate debt should be entered by next interest rate re-pricing date.
20. For each maturity band this is the sum of the figures reported in lines 15 to 19. It is system generated.
21. Report forward foreign exchange sales by settlement date.
22. Report all notional amounts payable under interest rate related contracts.
23. Report other derivative contract amounts payable by settlement date.
24. For each maturity band this is the sum of the figures reported in lines 20 to 23. It is system generated.
25. For each maturity band this is the total assets (line 14) less the total liabilities (line 24), including off balance sheet. It is system generated.
26. These percentages are pre-set, to represent a 200 basis points shock.
27. For each maturity band this is the figure in line 25 multiplied by the percentage in line 26. It is system generated.
28. The amount at risk is the sum of the weighted positions and is system generated for sterling and specified currencies. It is the aggregate for all other currencies that are reported.

29. Bring forward the amount at risk from the sterling report (this is automated).
- 30–32 Bring forward the amount at risk from each specified currency report (this is automated).
- 33 Report the aggregate of all other currencies that constitute in excess of 5% of total deposit liabilities (this is automated).
- 34 This is a system generated line, being the sum of the amounts at risk as reported under lines 29 to 33. The Commission will be particularly attentive to the sufficiency of capital of banks where the loss is more than 20% of the sum of the tier 1 and tier 2 capital as a result of an interest rate shock of 200 basis points or its equivalent.

## **CHAPTER 11**

### **GUIDANCE NOTES – FORM SR-4**

#### **SECTION 1 - GLOSSARY OF TERMS**

The following abbreviations are used:

DvP	Delivery versus Payment
SAM	Standardised Approach to Market Risk

#### **SECTION 2 - OVERVIEW**

The market risks (in the banking book) that generate a capital requirement are:

- Foreign exchange risk; and
- Commodities risk.

These forms and guidance also cover settlement risk, the risks that arise through failed DvP transactions and free delivery transactions.

The rules set out relate to the completion of standardised reporting forms. These are:-

- Section 2 – FX & Gold
- Section 3 – Commodities
- Section 4 – Settlement Risk

Where material positions are permitted by the bank's risk limit structure, related capital requirements should be calculated daily. Settlement risk should be calculated daily for all banks that may have failed trades.

#### **SECTION 3 – SAM - FX AND GOLD**

##### **Introduction**

The risks arising from foreign currency and gold exposures are similar, and hence the form addresses both. In both cases, the bank is allowed to offset current and future exposures to arrive at a net figure.

##### **Foreign Exchange Positions**

Do not report any position for the accounting currency of your bank; the return calculates a balancing item corresponding to the effective position in this

currency. For most banks this means that row A.1 (pounds sterling) should be blank.

The major currencies should be reported separately, namely Pounds Sterling (“GBP”), US Dollars (“USD”), Euros (“EUR”), Swiss Francs (“CHF”) and Japanese Yen (“JPY”). Other currencies should be split into two groups according to whether the bank is long or short, as follows:

- Other – Long Currencies: group together currencies where the net overall position in each individual currency is positive;
- Other – Short Currencies: group together currencies where the net overall position in each individual currency is negative.

Note that the “net overall position” is the sum of all balance sheet assets less balance sheet liabilities plus / minus net forward purchases / sales. All input figures should correspond to the gross, and absolute, amount.

Table A: Foreign Currency Positions

Item	Description		Completion Notes	
A.1 to A.7	Spot	Balance Sheet Assets	Total balance sheet assets denominated in the foreign currency or group of currencies.	
		Balance Sheet Liabilities	Total balance sheet liabilities denominated in the foreign currency or group of currencies.	
		Net	<b>A calculated field, being equal to “Balance Sheet Assets” less “Balance Sheet Liabilities” and representing the net spot position.</b>	
	Forward	Gross Purchases	All forward purchases of the foreign currency or group of currencies.	
		Gross Sales	All forward sales of the foreign currency or group of currencies.	
		Net	<b>A calculated field, being equal to the “Gross Purchases” less “Gross Sales” and representing the net forward position.</b>	
	Overall	<b>A calculated field, being the sum of the net spot position and the net forward position. A negative value here indicates a short position; a positive value indicates a long position.</b>		
	A.8	Balancing Item		<b>A calculated field, being the position required to make the overall total of net long and short positions in all currencies together to be zero.</b>

A	Aggregate Net Long Open Positions	<b>A calculated field being the sum of all the long positions including the entry for the “balancing item” if it is a positive. This aggregate of net long open positions, which will be positive or zero, is included in the capital charge and risk weighted assets calculation.</b>
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### Gold Positions

Report any position for gold. The net overall position in gold is the sum of all balance sheet gold assets less balance sheet gold liabilities plus / minus net forward purchases / sales of gold. All input figures should correspond to the gross, and absolute, amount.

Table B: Gold Positions

Item	Description		Completion Notes
B	Spot	Balance Sheet Assets	Total balance sheet gold assets.
		Balance Sheet Liabilities	Total balance sheet gold liabilities.
		Net	<b>A calculated field, being equal to “Balance Sheet Assets” less “Balance Sheet Liabilities” and representing the net spot position.</b>
	Forward	Gross Purchases	All forward purchases of gold.
		Gross Sales	All forward sales of gold.
		Net	<b>A calculated field, being equal to the “Gross Purchases” less “Gross Sales” and representing the net forward position.</b>
	Overall	<b>A calculated field, being the sum of the net spot position and the net forward position. A negative value here indicates a short position; a positive value indicates a long position.</b>	

### Capital Requirement and Risk Weighted Assets Equivalent

Item C calculates the capital charge, being 8% of the sum of the “aggregate net long position” from Table A and 8% of the absolute value for the net open position in gold from Table B. Item D calculates the equivalent Risk Weighted Asset figure, being 12.5 times the charge computed in Item C.

## **SECTION 4 – SAM - COMMODITY RISK**

### **Introduction**

All commodity positions should be reported using this part of the form except gold, which is treated as a currency and reported within “FX and Gold” – see Section 2 above. The bank is allowed to offset current and future exposures to arrive at a net position, and the capital charge is made up of elements for the net and gross positions.

### **Reporting and calculation of capital charge**

The groupings are:

- A.1: Precious metals (excluding gold)
- A.2: Base metals
- A.3: Energy contracts
- A.4: Other contracts

All figures input should correspond to the gross, and absolute, amount.

Table A: Commodity Positions

<b>Item</b>	<b>Description</b>	<b>Completion Notes</b>
A.1 to A.4	Gross Long	All long positions of each commodity group.
	Gross Short	All short positions of each commodity group.
	Net Open Position	<b>A calculated field, being equal to “Gross Long” less “Gross Short”.</b>
	Simplified Approach	<b>A calculated field, being equal to 15% of the absolute value of the “Net Open Position” plus 3% of “Gross Long” plus 3% of “Gross Short”.</b>
A (Total)	Gross Long	<b>A calculated field, being the sum of the “Gross Long” positions entered for all commodity groups (A.1 to A.4).</b>
	Gross Short	<b>A calculated field, being the sum of the “Gross Short” positions entered for all commodity groups (A.1 to A.4).</b>
	Net Open Position	<b>A calculated field, being the sum of the absolute values derived for the “Net Open Position” for all commodity groups (A.1 to A.4).</b>
	Simplified Approach	<b>A calculated field, being equal to 15% of the “Net Open Position” plus 3% of “Gross Long” plus 3% of “Gross Short” for all commodity groups (A.1 to A.4).</b>

## **Risk Weighted Assets Equivalent**

Item B calculates the equivalent Risk Weighted Assets figure, being 12.5 times the total charge computed in Item A.

## **SECTION 5 – SETTLEMENT RISK**

### **Introduction**

Settlement risk arises through failed DvP trades and for all non DvP trades (free deliveries).

### **Failed DvP trades**

Whether or not a transaction involving the delivery of an instrument against the receipt attracts a counterparty risk charge during its life, a capital charge should apply in cases of unsettled transactions where delivery of the instrument is due to take place against the receipt of cash, but which will remain unsettled five business days after the due settlement date<sup>5</sup>.

In principle, banks' systems should be set up in such a manner that, where a deal attracts a counterparty risk charge, this charge continues to apply when settlement is due but has not been completed. Banks are expected to adopt this for all such transactions.

No capital charges in respect of settlement risk on spot and forward foreign exchange transactions of any type are considered necessary.

### **Treatment**

Unsettled transactions should attract a capital cost based upon the difference between the amount due and the current market value of the instrument, if this has a potential loss. The capital requirement should be this potential loss multiplied by the factor in the table below.

This applies only to trades where a loss may arise for the bank if the trade fails to settle. Failed trades must be reported once the date is more than four days after the agreed settlement date. The capital requirement for such transactions is not multiplied by the counterparty risk weight.

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<sup>5</sup> As an example of where this is applicable, if Bank A sells shares in Company C to Bank B and Bank A fails to deliver on time, Bank B should hold capital for counterparty risk on Bank A in addition to capital for specific risk on Company C. This is because if the price moves in Bank B's favour, then the risk is that Bank A will not deliver and Bank B will have to pay a higher price to replace the purchase.

Table A: Factors for failed DvP transactions

Number of working days after due settlement date	Item	Factor
5 – 15	A.1	8%
16 - 30	A.2	50%
31 - 45	A.3	75%
46 or more	A.4	100%

The figures that must be reported are:

Item	Description	Completion Notes
A.1 to A.4	Number of Trades	Report number of failed trades, by time-band.
	Nominal of Trades	Report total amount receivable on the trades, by time-band.
	Loss if trade fails	Calculate the mark to market loss of each trade and report the sum of these, ignoring gains.
	Capital Charge	The capital charge is calculated by the sheet, being the factor multiplied by the “Loss if trade fails”.

### Risk Weighted Asset Equivalent

Item B calculates the total capital charge from Table A and the equivalent Risk Weighted Asset figure, being 12.5 times this charge.

### **Free Deliveries**

A free delivery occurs when a bank has paid away (or received) its side of a transaction and has yet to receive (or pay away) the securities / cash concerned. For free deliveries, an immediate exposure arises where a bank has settled its side of the transaction but has yet to receive the counter-value. The bank that has made the delivery will be deemed to have a claim on the other party for the amount of the cash or equivalent to the current market value of the securities, whichever is still outstanding<sup>6</sup>.

The capital requirement for free deliveries should be calculated as:-

- Four working days or less past settlement date: the risk weighted amount should be the counterparty claim multiplied by the counterparty risk weight;
- More than four working days past settlement date: the counterparty claim should be deducted from capital, however for the purposes of reporting the

<sup>6</sup> For example, if Bank A sells shares in Company C to Bank B and if Bank B pays for the shares immediately and Bank A is to deliver at some future date, Bank B should hold capital for the counterparty risk on Bank A in addition to capital for the risk relating to holding Company C shares. This is because Bank B is exposed for the whole amount of the value of the shares to Bank A until delivery takes place.

capital charge is converted to a risk weighted asset equivalent figure which gives approximately the same result.

For clarity, this treatment should also be applied to exchange traded contracts involving physical delivery. No capital charges in respect of delivery risk on spot and forward foreign exchange transactions are considered necessary.

Where the transaction is effected across a national border, the Commission considers that there is a window of one working day before the exposure should be included in the return.

Table C: Free delivery transactions

Item	Description	Completion Notes
C.1.1 to C1.5: 4 days or less	Number of Trades	Number of trades four days or less past settlement, by counterparty weight.
	Mark-to-market receivable	Receivable mark-to-market amounts, by counterparty weight.
	Counterparty Weight	Transactions should be recorded in accordance with the credit risk weight for the counterparty under the credit risk approach used by the bank.
	Risk Weighted Assets	<b>A calculated field, being equal to the “mark-to-market receivable” multiplied by the “Counterparty Weight”.</b>
C.2: More than 4 days	Number of Trades	Number of trades more than four days past settlement.
	Mark-to-market receivable	Receivable mark-to-market amounts.
	Capital Charge	Equal to the Mark-to-market receivable.
	Risk Weighted Assets	<b>A calculated field, being equal to the “Capital Charge” multiplied by 12.5.</b>

Risk Weighted Asset Equivalent

Item D calculates the total Risk Weighted Asset figures from Table C.

**Summary of Settlement Risk**

Item E calculates the total equivalent Risk Weighted Asset figures from Item B for DvP failed transactions and Item D for all free delivery transactions.

## APPENDIX 1

### AUDIT REPORT ON VERIFICATION OF INTERIM PROFITS

The Board of Directors  
[name and address of bank]  
[date]

Dear Sirs

#### **[name of bank] – Report on interim profits for inclusion in tier 1 capital**

In accordance with your letter of instruction dated [date], a copy of which is attached, we have reviewed [name of bank's] current year interim profits, for the period [date to date] as reported on form SR-2A dated [date], a copy of which is attached for identification. Our review, which did not constitute an audit, has been carried out having regard to the conditions set out in chapter 1 section 8, and chapter 6 line A.3.4 of this Guidance Note.

On the basis of the results of our review, nothing came to our attention to indicate that:

- (a) the interim profits as reported on form SR-2A have not been calculated on the basis of accounting policies adopted by the bank in preparing its latest statutory accounts for the year to [date] except for [list changes arising from accounting standards – there is no need to quantify their impact];
- (b) the accounting policies adopted by the bank differ in any material respects from those required by the Commission under Rule 2.10 of the Financial Services Rule Book;
- (c) the interim profits amounting to £[amount] as so reported are not reasonably stated.

Yours faithfully

[name of firm]