

<p style="text-align: center;">LIBA/ISDA PRIORITY TECHNICAL AMENDMENTS 24 MARCH 2005</p>
--

Article 114.3.....	2
Annex VII, Part 4, paragraph 41 & 42	4
Annex VII Part 4 Paragraph 78	5
Annex VIII Part 3 Paragraph 12.....	6
Article 2.1, Article 37.1	7
Annex I Paragraph 8	9
Annex II Paragraph 8.....	13

Article 114.3

3. ...

The credit institution shall satisfy the competent authorities that the stress tests carried out are adequate and appropriate for the assessment of such risks.

In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account under paragraphs 2 and 3 as appropriate, the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of Article 111(1) to (3) shall be reduced accordingly.

Such credit institutions shall include the following in their strategies to address concentration risk:

(a) policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;

(b) policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures (e.g. to a single issuer of securities taken as collateral).

3. ...

The credit institution shall satisfy the competent authorities that the stress tests carried out are adequate and appropriate for the assessment of such risks.

In the event that such a stress test indicates a lower realisable value of collateral taken than would be permitted to be taken into account under paragraphs 2 and 3 as appropriate ***the firm shall take this scenario into account under its pillar 2 capital assessment.*** ~~the value of collateral permitted to be recognised in calculating the value of exposures for the purposes of Article 111(1) to (3) shall be reduced accordingly.~~

Such credit institutions shall include the following in their strategies to address concentration risk:

(a) policies and procedures to address risks arising from maturity mismatches between exposures and any credit protection on those exposures;

(b) policies and procedures to address the situation that a stress test indicates a lower realisable value of collateral than taken into account under paragraphs 2 and 3;

(c) policies and procedures relating to concentration risk arising from the application of credit risk mitigation techniques, and in particular large indirect credit exposures (e.g. to a single issuer of securities taken as collateral).

Justification

We recognise the value of stress testing collateral in the context of a robust risk management of concentration risk, and we agree that it is appropriate that such stress tests should be required. However, we believe that the outcome of the stress test should feed through into the pillar 2 capital assessment, and not the minimum capital charges of pillar 1.

The Commission has not consulted on the impact of the stress tests set out in its proposal. However, if the stress tests were to be applied as the Commission proposes, it is the smaller banks who will be most affected as they may have to reduce their exposures to small business customers.

In the trading book, the stress test, as proposed by the Commission would increase the trading book capital charges. There are alternative and more effective approaches to protecting against concentration risk, notably including a sufficiently broad range of collateral asset types in the pool of eligible collateral agreed upon in the collateral agreement entered into between a firm and its counterparty. A firm's ability to call for additional collateral is determined by the contractual terms of the collateral agreement entered into with its client. These terms do not typically include the ability to increase the amount of margin received based on concentration stress tests performed by one of the parties.

Annex VII, Part 4, paragraph 41 & 42

41. A credit institution shall have in place sound stress testing processes for use in the assessment of its capital adequacy. Stress testing shall involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and assessment of the credit institution's ability to withstand such changes.

42. A credit institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed shall be one chosen by the credit institution, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A credit institution shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of a credit institution's total exposure.

41. A credit institution shall have in place sound stress testing processes for use in the assessment of its capital adequacy. Stress testing shall involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a credit institution's credit exposures and assessment of the credit institution's ability to withstand such changes.

42. A credit institution shall regularly perform a credit risk stress test to assess the effect of certain specific conditions on its total capital requirements for credit risk. The test to be employed shall be one chosen by the credit institution, subject to supervisory review. The test to be employed shall be meaningful and reasonably conservative, considering at least the effect of mild recession scenarios. A credit institution shall assess migration in its ratings under the stress test scenarios. Stressed portfolios shall contain the vast majority of a credit institution's total exposure.

42a. The results of the stress tests carried out under paragraphs 41 and 42 shall be reflected in the requirement set out in Annex XI to this directive.

Justification

It is essential to clarify that the intent of the stress testing requirement is to feed into the wider pillar 2 assessment of overall capital adequacy and is not part of the minimum capital requirements set out in the pillar 1 rules. Firms are already required under Pillar 1 to adopt conservative views and stress internal estimations of PD, LGD and exposure at default, including taking into account an economic downturn (Annex VII, Part 4, paragraphs 19, 49, 54, 63, 74, 87 & 114). The Commission proposal will make all types of obligor and exposure more capital intensive and therefore more expensive and will particularly affect SMEs and small banks.

Annex VII Part 4 Paragraph 78

To the extent that a credit institution does not meet the minimum requirements for collateral set out in Annex VIII any amount expected to be recovered from such collateral shall not be taken into account in its LGD estimates.

To the extent that a credit institution does not meet the minimum requirements for ***LGD estimates take into account the existence of collateral, credit institutions must establish internal requirements for collateral management, legal certainty and risk management that are generally consistent with those*** set out in Annex VIII, ***Part 2*** any amount expected to be recovered from such collateral shall not be taken into account in its LGD estimates.

Justification

The Commission proposal would severely restrict the use of the Advanced IRB approach and would not be in keeping with the Basel Framework; it is super-equivalent to paragraph 470 of the Basel Framework and the suggested changes bring them back in line. The draft proposed by the Commission might imply that if purchased credit risk mitigation does not meet all the requirements throughout Annex VIII, then own-LGD estimates cannot reflect the degree of credit risk mitigation obtained. This is impractical because it will require firms with relatively complex collateralised transactions to distinguish, within the estimated LGD, the cash collected from risk mitigation meeting the requirements and that collected from mitigation that does not meet the requirements. It is also unnecessary because own-LGD estimates must take into consideration any available relevant information, including any instrument that historically can be demonstrated to have an effect on LGD.

Annex VIII Part 3 Paragraph 12

As an alternative to using the Supervisory volatility adjustments approach or the Own Estimates volatility adjustments approach in calculating the fully adjusted exposure value (E*) resulting from the application of an eligible master netting agreement covering repurchase transactions, securities or commodities lending or borrowing transactions, and/or other capital market driven transactions other than derivative transactions, credit institutions may be permitted to use an internal models approach which takes into account correlation effects between security positions subject to the master netting agreement as well as the liquidity of the instruments concerned. Internal models used in this approach shall provide estimates of the potential change in value of the unsecured exposure amount ($\sum E - \sum C$).

As an alternative to using the Supervisory volatility adjustments approach or the Own Estimates volatility adjustments approach in calculating the fully adjusted exposure value (E*), ***credit institutions may be permitted to use an internal models approach for*** ~~resulting from the application of an eligible master netting agreement covering repurchase transactions, securities or commodities lending or borrowing transactions, and/or other capital market driven transactions other than derivative transactions, credit institutions may be permitted to use an internal models approach which~~ ***Internal models must assess potential change in exposure subject to minimum standards set out below and in particular should*** takes into account correlation effects between security positions ~~subject to the master netting agreement as well as,~~ ***as well as*** the liquidity of the instruments concerned. ***Models may reflect netting, but only where such netting is permissible in view of master netting agreements covering the positions.*** ~~Internal models used in this approach shall provide estimates of the potential change in value of the unsecured exposure amount ($\sum E - \sum C$).~~

Justification

The draft proposed by the Commission could imply that internal models can only be used if all transactions are covered by a netting agreement. This interpretation would make the use of internal models redundant. Credit institutions should be allowed to take account of diversification across their market risk positions with a given counterparty regardless of the applicability of netting. Netting and diversification are distinct concepts. The existence of a netting agreement reduces both the current and future exposure to a counterparty. Diversification, which is recognised in internal models, limits future exposure without the need for a netting agreement being in place. We recognise that this amendment may require further attention as a result of the forthcoming Trading Book Review proposals.

CAD

Article 2.1, Article 37.1

Article 2

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

Article 37

1. Where an EU parent financial holding company has as subsidiary both a credit institution and an investment firm, one competent authority responsible for supervision of the credit institution shall be identified to be responsible for consolidated supervision of the entities controlled by that parent.

Article 2

~~1. Where a financial holding company has as subsidiary both a credit institution and an investment firm, requirements on the basis of the consolidated financial situation of the financial holding company shall apply to the credit institution.~~

Article 37

~~1. Where an EU parent financial holding company has as subsidiary both a credit institution and an investment firm, one competent authority responsible for supervision of the credit institution shall be identified to be responsible for consolidated supervision of the entities controlled by that parent.~~

1. If a group has both investment firms and credit institutions, Title V, Chapter 4 of Directive [2000/12/EC] shall apply to the supervision of institutions as if references to credit institutions were institutions.

Justification

The deleted paragraphs would require a consolidated group with a financial holding company parent to be consolidated according to credit institution requirements, irrespective of the overall composition of the financial group. The automatic primacy of the banking regulator neglects the fact that in some groups the overwhelming balance of business will be towards the investment firms. It is inappropriate for this outcome to be applied automatically.

In keeping with the principle of the Financial Conglomerates Directive [2002/87/EC] the regulations for consolidation and the allocation of responsibility for consolidated supervision to the competent authority should reflect the composition of the group on a case by case basis where a financial holding company has both a credit institution and investment firm as subsidiaries.

*Although the proposed deletion above seeks to achieve consistency with the approach set out under Directive 2002/87/EC, we recognise that **further consequential amendments would need to be made both in Directive 93/6/EEC and Directive 2001/12/EC if this general approach were to be agreed.***

Annex I Paragraph 8

8. For credit derivatives, unless specified differently, the notional amount of the credit derivative contract must be used. When calculating the capital requirement for the market risk of the party who assumes the credit risk (the “protection seller”), positions are determined as follows:

A total return swap creates a long position in the general market risk of the reference obligation and a short position in the general market risk of a government bond which is assigned a 0% risk weight under Annex VI of Directive [2000/12/EC]. It also creates a long position in the specific risk of the reference obligation.

A credit default swap does not create a position for general market risk. For the purposes of specific risk, the institution must record a synthetic long position in an obligation of the reference entity. If premium or interest payments are due under the product, these cash flows must be represented as notional positions in a government bond with the appropriate fixed or floating rate.

8.(a) *Treatment of the protection seller*

When calculating the capital requirement for market risk of the party who assumes the credit risk (the “protection seller”) For credit derivatives, unless specified differently, the notional amount of the credit derivative contract must be used. **For the purpose of calculating the specific risk charge, other than for total return swaps, the maturity of the credit derivative contract is applicable instead of the maturity of the obligation.** When calculating the capital requirement for the market risk of the party who assumes the credit risk (the “protection seller”), positions are determined as follows:

(i) A total return swap creates a long position in the general market risk of the reference obligation and a short position in the general market risk of a government bond *with a maturity equivalent to the period until the next interest fixing and* which is assigned a 0% risk weight under Annex VI of Directive [2000/12/EC]. It also creates a long position in the specific risk of the reference obligation.

(ii) A credit default swap does not create a position for general market risk. For the purposes of specific risk, the institution must record a synthetic long position in an obligation of the reference entity, *unless the derivative is rated and meets the conditions for qualifying debt, in which case a long position in the derivative is recorded.* If premium or interest payments are due under the product, these cash flows must be represented as notional positions in a government bonds ~~with the appropriate fixed or floating rate.~~

A credit linked note creates a long position in the general market risk of the note itself, as an interest product. For the purpose of specific risk, a synthetic long position is created in an obligation of the reference entity. In addition, a long position is created in the specific risk of the issuer of the note.

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

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

Where a credit linked note basket product has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note issuer may be recorded instead of the specific risk positions for all reference entities.

A basket product providing proportional protection creates a position in each reference entity for the purposes of specific risk, with the total notional

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

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

~~A second-asset-to-default basket product creates a position for the notional amount in an obligation of each reference entity less one (that with the lowest specific risk capital requirement). If the size of the maximum credit event payment is lower than the capital requirement under the method in the first sentence of this sub-paragraph, this amount may be taken as the capital requirement for specific risk.~~

~~Where a credit linked note basket product has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note issuer may be recorded instead of the specific risk positions for all reference entities.~~

(iv) ***In addition to a long position in the specific risk of the issuer of the note, a basket multiple name credit linked note product providing proportional protection***

amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting determines the specific risk. The maturity of the credit derivative contract is applicable instead of the maturity of the obligation.

~~creates a position in each reference entity for the purposes of specific risk, with the total notional amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting determines the specific risk. The maturity of the credit derivative contract is applicable instead of the maturity of the obligation.~~

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

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

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

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

(b) Treatment of the protection buyer

For the party who transfers credit risk (the “protection buyer”), the positions are determined as the mirror image of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection. In the case of nth to default credit derivatives, protection buyers are allowed to off-set specific risk for n-1 of the underlyings (i.e., the n-1 assets with the lowest specific risk charge).

For the party who transfers credit risk (the “protection buyer”), the positions are determined as the mirror image of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection. In the case of nth to default credit derivatives, protection buyers are allowed to off-set specific risk for n-1 of the underlyings (i.e., the n-1 assets with the lowest specific risk charge).

Justification

Re-ordering is required to clarify the treatment of the main forms of credit derivatives, distinguishing between the capital charge applied to the protection seller and that applied to the protection buyer, as well as between single name and multiple name credit linked notes. In addition, where a credit linked note is externally rated above investment grade, the specific risk charge should reflect the rating of the note. This makes the Directive consistent with the treatment applied in the Accord to first-to-default and second-to-default protection sellers in the banking book (Articles 208 and 210 of the Accord).

Rating agencies, where assigning a rating to a credit linked note, take into account, as appropriate, the creditworthiness of both the reference entity(ies) and the note issuer. Applying a specific risk charge on the note issuer in addition to one on the note would therefore double count the credit risk of the note issuer.

Annex II Paragraph 8

For the purposes of paragraph 5, in the case of repurchase transactions and securities or commodities lending or borrowing transactions, all financial instruments and commodities that are eligible to be included in the trading book may be recognised as eligible collateral. For exposures due to OTC derivative instruments booked in the trading book, commodities that are eligible to be included in the trading book may also be recognised as eligible collateral. For the purposes of calculating volatility adjustments where such financial instruments or commodities are lent, sold or provided, or borrowed, purchased or received by way of collateral, or otherwise under such a transaction such instruments and commodities shall be treated in the same way as non-main index equities listed on a recognised exchange.

For the purposes of paragraph 5, in the case of repurchase transactions and securities or commodities lending or borrowing transactions ***booked in the trading book***, all financial instruments and commodities that are eligible to be included in the trading book may be recognised as eligible collateral. For exposures due to OTC derivative instruments booked in the trading book, commodities that are eligible to be included in the trading book may also be recognised as eligible collateral. For the purposes of calculating volatility adjustments where such financial instruments or commodities ***which are not eligible under Annex VIII of Directive [2000/12/EC]*** are lent, sold or provided, or borrowed, purchased or received by way of collateral, or otherwise under such a transaction, ***and the institution is using the Supervisory volatility adjustments approach under Annex VIII, Part 3 of Directive [2000/12/EC]***, such instruments and commodities shall be treated in the same way as non-main index equities listed on a recognised exchange. ***Where institutions are using the Own estimates of volatility adjustments approach under Annex VIII, Part 3 of Directive [2000/12/EC] in respect of financial instruments or commodities which are not eligible under Annex VIII of Directive [2000/12/EC] volatility adjustments must be calculated for each individual item. Where institutions are using the Internal Models Approach defined at Annex VII, Par 3 of Directive [2000/12/EC], they may also apply this approach in the trading book.***

Justification

The proposed amendment makes the Directive consistent with paragraph 703 of the Basel Framework, which provides firms with the option to apply haircutting methodologies to collateral in the trading book. The ECOFIN supported the inclusion of the own estimates approach, but not the recognition of the Internal Models Approach. Although this area will probably be revisited by the Trading Book Review, it is important that this methodology should be an option available to firms.