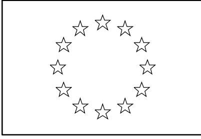

EUROPEAN COMMISSION
Internal Market DG

WORKING DOCUMENT OF THE COMMISSION SERVICES ON CAPITAL REQUIREMENTS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

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Title I – Definitions, General Provisions on Capital Adequacy and Scope of Consolidation

CHAPTER 1 – DEFINITIONS

Article 1

For the purposes of the present Directive

(1) 'institutions' means institutions as defined in point 3 of Article 2 of Directive 93/6/EEC;

(2) 'financial institutions' means financial institutions as defined in point 5 of Article 1 of Directive 2000/12/EC;

[(3)-(15) Blank]

(16) 'group' means two or more natural or legal persons between whom there are close links and which comprise at least two entities such as defined in points 1 and 2 of this Article of which at least one is an institution such as defined in point 1 of this Article;

(17) 'close links' means close links within the meaning of point 26 of Article 1 of Directive 2000/12/EC, as well as :

(a) a situation in which in the opinion of the competent authorities one or more persons effectively exercise a dominant influence over another person;

(b) a situation in which persons are linked by a participation within the meaning of Article 17, first sentence, of Council Directive 78/660/EEC;

(c) or a situation in which persons are linked by a relationship within the meaning of Article 12 (1) of Directive 83/349/EEC;

(18) 'subgroup' means any group as defined in point 16 of this Article which can be identified within a larger group as defined in point 16 of Directive 2000/12/EC;

(19) 'parent undertaking' means parent undertaking as defined in point 12 of Directive 2000/12/EC;

(20) 'subsidiary' means subsidiary as defined in point 13 of Article 1 of Directive 2000/12/EC;

(21) 'financial holding company' means financial holding company within the meaning of point 3 of Article 7 of Directive 93/6/EEC or of point 21 of Article 1 of Directive 2000/12/EC;

(23) 'participation' means participation as defined in point 9 of Article 1 of Directive 2000/12/EC;

(24) 'ancillary banking services undertaking' shall mean ancillary banking services undertaking as defined in point 23 of Article 1 of Directive 2000/12/EC;

[(25) Blank]

(26) ‘public sector entities’ means non-commercial administrative bodies responsible to sovereigns, regional governments or local authorities, or authorities which, in the view of the competent authorities exercise the same responsibilities as regional and local authorities;

(27) ‘eligible ECAI’ means an external credit assessment institution that has been declared eligible for regulatory purposes by the national competent authorities;

(28) ‘nominated ECAI’ means an eligible ECAI that a particular institution has chosen to make use of for the determination of its regulatory capital requirements;

(29) ‘rated item’ means an asset or an off-balance sheet item, constituting a claim on an obligor, to which a credit assessment has been attributed as:

(a) an nominated ECAI has issued a credit assessment for the specific issuing program or facility (issue specific rating) to which the claim belongs, or

(b) an nominated ECAI has issued a credit assessment for some other issue by the obligor which can be attributed to the claim according to the provisions of Article 33.2, or

(c) an nominated ECAI has issued a general credit assessment of the obligor which can be attributed to the claim according to the provisions of Article 33.3.

(30) ‘unrated item’ means any asset or off-balance sheet item which does not qualify as rated item.

(31) ‘unsolicited credit assessment’ means any credit assessment of an asset, of an off-balance sheet item, or of an entity by an eligible ECAI not commissioned by the entity to which the item refers.

(32) For the purposes of the Standardised Approach to credit risk minimum capital requirements, ‘corporate item’ means an asset or an off-balance sheet item which corresponds to an exposure to a body or persons authorised by law to act as one person having distinct rights and liabilities.

[(33)-(45) Blank]

(46) ‘PD’ shall mean the probability of default of a counterparty over one year.

(47) ‘LGD’ shall mean the loss incurred on a facility at default of a counterparty relative to the amount outstanding at default.

(48) For the purposes of the Internal Ratings Based Approach to credit risk minimum capital requirements ‘loss’ shall mean economic loss including discount effects, and direct and indirect costs associated with collecting on the instrument in the determination of loss.

(49) ‘Dilution risk’ shall mean the possibility that the receivable amount is reduced through cash or non-cash credits to the receivables obligor.

(50) 'EL' shall mean the expected loss on a facility from a potential default of a counterparty or dilution relative to EAD over one year.

(51) 'EAD' shall mean the expected gross exposure of a facility upon default of the counterparty.

(52) For the purposes of the Internal Ratings Based Approach to credit risk minimum capital requirements a 'default' shall be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place:

- The institution considers that the obligor is unlikely to pay its credit obligations to the institution in full, without recourse by the institution to actions such as realising security (if held).

- The obligor is past due more than 90 days on any material credit obligation to the institution. Overdrafts shall be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

The elements to be taken as indications of unlikeliness to pay are enumerated in Annex D-5, paragraph 53.

(53) 'Publicly traded equity holding' shall mean any equity exposure traded on a recognised exchange.

(54) 'Foundation Approach' shall mean that institutions use supervisory estimates of LGDs, EADs, and, unless otherwise required by competent authorities, are not required to take into account the effective maturity of its facilities

(55) 'Advanced Approach' shall mean that institutions use own estimates of LGDs and/or EADs and are required to take into account the effective maturity of its facilities.

[(56)-(65) Blank]

(66) 'Credit risk mitigation' means any technique used by an institution to reduce the credit risk associated with an exposure which it continues to hold.

(67) 'Credit protection' means the protection against credit risk provided by a technique of credit risk mitigation.

(68) 'Funded credit protection' refers to credit risk mitigation where the mitigation of the credit risk on the exposure of an institution derives from the right of the institution, in the event of the default of the counterparty or on the occurrence of other specified credit events relating to the counterparty, to liquidate, obtain transfer or appropriation of and/or retain certain assets or amounts, or to reduce the amount of the exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the institution.

(69) 'Unfunded credit protection' refers to credit risk mitigation where the mitigation of the credit risk on the exposure of an institution derives from the undertaking of a third party to pay an amount in the event of the default of the borrower or on the occurrence of other specified events.

(70) ‘Repurchase transaction’ means any transaction governed by an agreement falling within the definition of ‘repurchase agreement’ or ‘reverse repurchase agreement’ as defined in Directive 93/6/EEC (CAD), Article 2 (17) & (18).

(71) ‘Securities or commodities lending or borrowing transaction’ means any transaction falling within the definition of ‘securities or commodities lending’ or ‘securities or commodities borrowing’ as defined in Directive 93/6/EEC (CAD), Article 2 (17) & (18) as amended.

(72) ‘Cash assimilated instrument’ means ‘a certificate of deposit or other similar instrument issued by the lending institution’

(73) ‘Recognised exchange’ shall have the meaning set out in Directive 2000/12, Article 1(27).

[(74)-(80) Blank]

(81) ‘Securitisation’ means a transaction or scheme (other than one falling within the definition of ‘specialised lending’) by virtue of which the credit risk associated with a credit risk exposure or pool of credit risk exposures is tranched and payments in the transaction or scheme depend upon the credit exposure or pool of credit exposures.

(82) ‘Traditional Securitisation’ means a securitisation which involves economic transfer of credit exposure(s) to a Special Purpose Entity which issues securities. This must be accomplished by legally isolating the underlying exposure(s) from the originating institution or through sub-participation. Payments to investors are not derived from an obligation of the originating institution.

(83) ‘Synthetic securitisation’ means a securitisation the tranching in which is achieved by the use of credit derivatives and/or guarantees. The pool of credit exposures is not removed from the originator’s balance sheet.

(84) ‘Tranche’ means a contractually established segment of the credit risk associated with a credit risk exposure or number of credit risk exposures, a position in which, without taking account of credit protection provided by third parties directly to the holders of positions in the segment, entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, again without taking account of credit protection provided by third parties directly to the holders of positions in the segment.

(85) ‘Securitisation position’ means an exposure to a securitisation. Where there is an exposure to different tranches in a securitisation, the exposure to each tranche shall be considered a separate securitisation position. The providers of credit protection to securitisation positions will be considered to hold positions in the securitisation.

(86) ‘Originator’ means an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the credit risk exposure being securitised; or which purchases a third party’s credit risk exposures onto its balance sheet and then securitises them.

(87) ‘Sponsor’ means an institution other than an originating institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases credit exposures from third party entities.

(88) 'Investor in a securitisation' means an entity, other than an originating or sponsoring institution, having a securitisation position.

(89) 'Servicer' means an entity that manages the underlying credit exposures of a securitisation on a day-to-day basis in terms of collection of principal and interest.

[(90)-(95) Blank]

(96) 'Trading book'. The trading book of an institution shall consist of all positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely.

(97) 'Trading intent'. Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and include proprietary positions, positions arising from client servicing (e.g. matched principal broking) and market making.

(98) A 'trading book hedge' is a position that materially or entirely offsets the component risk elements of another trading book position or a set of positions.

(99) 'Financial instrument'. A financial instrument is any contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party. Financial instruments include both primary financial instruments or cash instruments, and derivative financial instruments the value of which is derived from the price of an underlying financial instrument or a rate or an index or the price of an underlying other item.

(100) A 'financial asset' is any asset that is cash, the contractual right to receive cash or another financial asset from another party ; or the contractual right to exchange instruments with another party on potentially favourable terms, or an equity instrument of another party.

(101) A 'financial liability' is the contractual obligation to deliver cash or another financial asset to another party or to exchange instruments with another party under conditions that are potentially unfavourable.

(102) An 'equity instrument' is any contract that evidences a residual interest in the assets of a party after deducting all of its liabilities.

(103) 'Qualifying debt items' shall mean:

a) long and short positions in assets qualifying for a 20% or less risk weighting under the Standardised Approach or the Internal Ratings Based Approach to credit risk minimum capital requirements

b) in addition, an institution may, subject to its own discretion, consider as qualifying debt items long and short positions in debt instruments that are:

- considered by the institution concerned to be sufficiently liquid and, because of the solvency of the issuer, subject to a degree of default risk which is comparable to or lower than that of the assets referred to under a) above; and

- listed on at least one regulated market in a Member State or on a stock exchange in a third country provided that that exchange is

recognised by the competent authorities of the relevant Member State.

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

c) pending further co-ordination, and subject to the competent authorities discretion, instruments that are:

- considered by the competent authorities to be sufficiently liquid and

- because of the solvency of the issuer, subject to a degree of default risk which is comparable to or lower than that of the assets referred to under a) above.

  The default risk associated with such instruments must have been evaluated at such level by at least two credit-rating agencies recognised by the competent authorities or by at least one such credit rating agency so long as they are not rated below such a level by any other credit-rating agency recognised by the competent authorities.

  The competent authorities may, however, waive this condition if they judge it inappropriate in the light of, for example, the characteristics of the market, the issuer, the issue, or some combination of those characteristics.

The competent authorities shall require the institutions to apply the maximum weighting shown in Table 1 in Annex G-4 to instruments that show a particular risk because of the insufficient solvency of the issuer or liquidity.

The competent authorities of each Member State shall regularly provide the Council and the Commission with information concerning the methods used to evaluate the qualifying items, in particular the methods used to assess the degree of liquidity of the issue and the solvency of the issuer.

CHAPTER 2 - GENERAL PROVISIONS ON CAPITAL ADEQUACY

Article 2

Capital Adequacy

Member States shall require that, pursuant to the provisions of this Directive, institutions

(a) hold at all times own funds which are adequate having regard to the overall risk profile of the institution;

(b) implement and apply a sound control environment, including appropriate risk management and reporting, and an adequate capital adequacy assessment process; and

(c) disclose information regarding the scope of application of this Directive, their own funds and capital adequacy, and their risk exposure and assessment;

and that, pursuant to the provisions of this Directive, competent authorities

(d) review and evaluate the compliance of institutions with the provisions of this Directive; and,

(e) adopt, as appropriate, relevant measures in relation to the specific risk profile, level of own funds, control environment and capital adequacy assessment process of institutions.

Article 3

Minimum Level of Own Funds

1. Without prejudice to the obligation of an institution to comply with requirements imposed by the other provisions of this Title or by or under the provisions of Title III, Member States shall require institutions to provide own funds which are at all times more than or equal to the sum of the following capital requirements:

   a. for credit risk, 8 per cent of the total amount of its risk weighted assets calculated in accordance with Title II, Chapter 1 of this Directive;

   b. for position risk and, insofar as the limits laid down under Directive 2000/12/EC Article 49 are authorised to be exceeded, for large exposures exceeding such limits, the capital requirements determined in accordance with Annex I and VI and, as appropriate, Annex VIII of Directive 93/6/EEC, for their trading book business;

   c. for settlement and counter-party risk, the capital requirements determined according to Article 102;

   d. for foreign-exchange risk and for commodities risk for all of their business activities, the capital requirements determined in accordance with Annex III and VII and, as appropriate, Annex VIII of Directive 93/6/EEC;

   e. for operational risk, the capital requirements determined in accordance with Title II, Chapter 3 of this Directive.

   Irrespective of the amount of the capital requirement referred to in (a) to (e) the own-funds requirement for investment firms in respect of these risks shall never be less than the amount prescribed in Annex IV of Directive 93/6/EEC.

2. Notwithstanding paragraph 1, Member States may allow institutions to determine the capital requirements for position, settlement and counterparty risk according to capital requirements for credit risk determined in accordance with paragraph 1(a) above rather than in accordance with paragraphs (1)(b) and (c) above where the trading book business of the institution is determined, in accordance with the provisions of Annex A, to be small both in absolute terms and as a proportion of the total business of the institution.

Article 4

Frequency of reporting

Placeholder

Article 5

Prescribed methodologies

1. In assessing the adequacy of their own funds having regard to their overall risk profile, institutions must assess the own funds for each of the risks covered by Article 3 in an amount which is not less than the minimum requirements imposed by the provisions of Title II in respect of each of those risks. For these purposes, such risks do not include risks associated with the monitoring, measurement, management and control of the risks covered by Article 3.

2. In carrying out their responsibilities under Title III competent authorities shall not interpret the concept of capital adequacy in a manner inconsistent with the previous paragraph.

[Articles 6-15 Blank]

Chapter 3 – Scope of Consolidation

Article 16

Individual Capital Requirements

1. The capital requirements prescribed in this Directive shall apply to all institutions on an individual basis in accordance with the methods laid down in this Directive.

Article 17

Consolidated Capital Requirements

1. Without prejudice to the provisions contained in Article 16 of this Directive, the parent undertaking institution within a group shall be subject to capital requirements on a consolidated basis in accordance with the methods laid down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC.

2. Without prejudice to the provisions contained in Article 16 of this Directive, institutions whose parent undertaking is a financial holding company shall be subject to capital requirements applied on the basis of the consolidated financial situation of that financial holding company in accordance with the methods laid down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC.

Article 18

Sub-consolidated Capital Requirements

1. Without prejudice to the provisions contained in Article 16 of this Directive, the parent undertaking institution within any sub-group shall be subject to capital requirements on a sub-consolidated basis in accordance with the methods laid

down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC when not all institutions within the sub-group are authorised and supervised by the competent authorities of the same Member State.

2. Without prejudice to the provisions contained in Article 16 of the present Directive, competent authorities may impose the application of capital requirements on a sub-consolidated basis to the parent undertaking institution within any sub-group when such requirements are considered to be relevant for the purposes of supervision.

3. In the cases in which paragraph 1 of this Article applies, as an alternative to the application of capital requirements on a sub-consolidated basis on the institution which is the parent undertaking within a sub-group, Member States competent authorities may apply capital requirements to such an institution on an individual basis provided that the full book value of any holdings, subordinated claims, and instruments referred to in Article 35 of Directive 2000/12/EC in institutions, financial institutions and ancillary banking services undertakings is deducted from the capital of that institution in accordance with the provisions of Articles 52 to 56 of Directive 2000/12/EC.

4. Institutions to which the previous paragraph applies must deduct, for the calculation of their individual capital requirements, their holdings in other institutions, financial holding companies, financial institutions and ancillary banking services undertakings which would be included in the sub-consolidation in accordance with the provisions of Articles 52 to 56 of Directive 2000/12/EC.

Article 19

Ancillary banking services undertakings

When parent undertaking institutions are subject to capital requirements on a consolidated or sub-consolidated basis in accordance with Articles 17 or 18 of this Directive, ancillary banking services undertakings shall be included in the consolidation or in the sub-consolidation.

Article 20

Individual capital requirements for parent undertaking institutions within a sub-group or within a group

1. Competent authorities may provide that, for the calculation of individual capital requirements, the parent undertaking institution within a sub-group subject to capital requirements on a sub-consolidated basis need not deduct from their own funds and in accordance with the methods laid down in Articles 34 to 39 of Directive 2000/12/EC their holdings in other institutions or financial institutions which are included in the sub-consolidation.

2. Competent authorities may provide that, for the calculation of individual capital requirements, the parent undertaking institution within a group subject to capital requirements on a consolidated basis need not deduct from their own funds and

in accordance with the methods laid down in Articles 34 to 39 of Directive 2000/12/EC their holdings in other institutions or financial institutions which are included in the consolidation

Article 21

Exemption from consolidated capital requirements for Investment Firms groups

1. The competent authorities may waive, on a case by case basis, the application of capital requirements on a consolidated basis for the parent undertaking investment firm within a group provided that:

   (a) all institutions within the group are investment firms;

   (b) all institutions within the group use the definition of own funds given in paragraph 9 of Annex V of Directive 93/6/EEC;

   (c) all institutions within the group are authorised and supervised by the competent authorities of the same Member State;

   (d) no investment firm within the group is authorised to provide the services listed in point 2 and in point 4 of Section A of the Annex of Directive 93/22/EEC when provided on a firm commitment basis;

   (e) no investment firm within the group holds clients' money or securities, deals for its own accounts, or underwrites issues on a firm commitment basis.

   (f) the funds of the group comply with the capital requirements applied on a consolidated basis to the parent undertaking within the group;

   (g) any financial holding company within the group holds as much capital as the full book value of any holdings, subordinated claims, and instruments referred to in Article 35 of Directive 2000/12/EC in investment firms, financial institutions and ancillary banking services undertakings in accordance with Articles 52 to 56 of Directive 2000/12/EC;

   (h) financial institutions and ancillary banking services undertakings hold letter of credits for an amount equal to or greater than the capital required to fulfil the capital requirements as provided for in paragraph 1 of Article 16 of this Directive.

2. In cases where paragraph 1 of this Article applies, each institution within the group have in place systems to monitor and control the sources of capital and funding of all other financial holding company, financial institutions and ancillary banking services undertakings within the group.

[Articles 22-24 Blank]

Title II – Minimum Capital Requirements

Chapter 1 – Credit Risk

Article 25

Methodology to be adopted

In determining the total amount of risk weighted assets for the purposes calculating the minimum amount of own funds to be provided for credit risk under Article 3, institutions shall use the methodology prescribed in Section 1 of this Chapter, except insofar as they are permitted by competent authorities to use the methodology prescribed in Section 2 in accordance with the provisions of that Section.

SECTION I – STANDARDISED APPROACH

Subsection 1 - Determination of risk weights

Article 26

Determination of risk-weighted asset amounts

1. Any asset and off-balance sheet item exposure value shall be multiplied by the applicable percentage risk weight to produce its risk weighted asset amount.

2. Notwithstanding the provisions contained in paragraph 1, if an eligible unfunded credit risk protection exists for an item according to the provisions contained in the Section III of this Chapter, the percentage risk weight applicable to that item may be determined according to the provisions of the Section III of this Chapter.

Article 27

Asset and off-balance sheet items exposure values

1. The valuation of asset and off-balance-sheet items shall be effected according to Directive 86/635/EEC.

2. For any asset item its balance-sheet value and for any off-balance sheet items its relevant value shall be taken as the exposure value of the item. Notwithstanding this provision, if an eligible funded credit risk protection exists for an item according to the provisions contained in the Section III of this Chapter, the exposure value applicable to that item shall be modified according to the provision of that Section.

3. In the case of any off-balance-sheet item listed in Annex II of Directive 2000/12/EC, the result of the following procedure shall be considered its relevant value. The off-balance sheet item will first be allocated to one of the risk groupings set out in Annex II of Directive 2000/12/EC. It will then be considered as relevant value the following percentage of its value: 100% if it is a full-risk

item, 50% if it is a medium-risk item, 20% if it is a medium/low-risk item, 0% if it is a low-risk item.

4. In the case of any off-balance-sheet item listed in Annex IV of Directive 2000/12/EC, its relevant value shall be determined by means of one of the two methods set out in Annex III of Directive 2000/12/EC.

5. Notwithstanding the provisions of paragraph 4 , contracts traded on recognised exchanges, and foreign-exchange contracts (except contracts concerning gold) with an original maturity of 14 calendar days or less are exempt from the application of the methods set out in Annex III of Directive 2000/12/EC, and will be attributed a relevant value of zero.

6. Until 31 December 2006 the competent authorities of Member States may exempt from the application of the methods set out in Annex III of Directive 2000/12/EC and attribute a relevant value of zero to over-the-counter (OTC) contracts cleared by a clearing house where the latter acts as the legal counterparty and all participants fully collateralise on a daily basis the exposure they present to the clearing house, thereby providing a protection covering both the current exposure and the potential future exposure.

   The posted collateral must:

   - qualify for a 0% risk weight, or
   - be cash deposits placed with the lending institution, or
   - be certificates of deposit or similar instruments issued by and lodged with the latter.

   The competent authority must be satisfied that the risk of a build-up of the clearing house's exposures beyond the market value of posted collateral is eliminated.

   Member States shall inform the Commission of the use they make of this option.

   [Note. The treatment of OTC contracts cleared by clearing houses as prescribed on a transitional basis under Directive 2000/12/EC Article 43(2)(3) and the similar treatment prescribed under CAD Annex III, paragraph 5 will be considered in view of the scheduled expiry date.]

Article 28

Classes of items

1. Every asset and off-balance sheet items shall be assigned to one of the following classes:

   - according to the nature of the borrower:

   (i) items constituting claims on sovereigns and central banks;

   (ii) items constituting claims on regional governments and local authorities;

(iii) items constituting claims on administrative bodies and non-commercial undertakings;

(iv) items constituting claims on multilateral development banks;

(v) items constituting claims on international organisations;

(vi) items constituting claims on institutions;

(vii) items constituting claims on corporates;

- according to the nature of the transaction:

(viii) items constituting claims of the regulatory retail portfolio;

(ix) items constituting claims fully secured on real property;

(x) items belonging to regulatory high-risk categories;

(xi) items constituting securitisation positions;

(xii) other items;

2. Risk weights for securitisation positions shall be determined in accordance with the provisions of Section IV of this Chapter.

3. To be included in the regulatory retail portfolio, claims must meet the following criteria:

The exposure is to an individual person or persons or to a small business;

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.

The aggregate retails exposure to one counterparty does not exceed 0.2% of the overall regulatory retail portfolio.

The aggregated retail exposure to one counterparty does not exceed an absolute threshold of EUR 1 million.

Securities are not eligible for the regulatory retail portfolio.

Mortgages can not be included in the regulatory retail portfolio when they are treated as claims fully secured on real property.

Article 29

Risk weights

1. As specified in the provisions of Annex C-1, asset and off-balance sheet items are risk weighted by means of:

- risk weights that can be 0%, 20%, 50%, 100% and 150% depending on their credit quality;

  or

- fixed risk weights.

2. For the purposes of first indent of the previous paragraph, credit quality can be determined:

   - from the credit assessments of nominated ECAIs by the use of a credit quality assessment scale with 6 steps, where 1 indicates the highest credit quality and 6 the lowest credit quality;

   - from the credit assessments of recognised ECAs by the use of a credit quality assessment scale with 7 steps, where 1 indicates the highest credit quality and 7 the lowest credit quality.Notwithstanding the provisions of this Section and of Annex C-1, competent authorities may fix higher risk weights when they deem it necessary.

Subsection 2 – ECAIs credit assessments

Article 30

Use of ECAIs credit assessments for the determination of applicable risk weights

1. An institution may nominate one or more eligible ECAIs to be used for the determination of risk weights applicable to asset and off-balance sheet items.

2. An institution which decides to use the credit assessments produced by an eligible ECAI or ECAIs for a certain class of items must use those credit assessments consistently for all items belonging to that class.

3. An institution which decides to use the credit assessments produced by an eligible ECAI or ECAIs must use them in a continuous and consistent way over time.

Article 31

Solicited and unsolicited credit assessments

1. Institutions shall use solicited credit assessments produced by eligible ECAIs. However, competent authorities may allow institutions to use the unsolicited credit assessments produced by an eligible ECAI.

2. Competent authorities shall not permit institutions to use the unsolicited credit assessments produced by an eligible ECAI when the ECAI uses them to obtain inappropriate advantages in the relationship with assessed parties.

3. If competent authorities identify that unsolicited credit assessments produced by an ECAI are used to obtain inappropriate advantages in the relationship with assessed parties, competent authorities must:

(a) stop permitting institutions to use unsolicited credit assessments produced by that ECAI;

(b) evaluate whether to continue recognising the eligibility of that ECAI.

Article 32

Multiple credit assessments

1. If only one credit assessment is available from an nominated ECAI for a rated item, that credit assessment shall be used to determine the risk weight for that item.

2. If two credit assessments are available from nominated ECAIs and the two correspond to different risk weights for a rated item, the higher risk weight will be applied.

3. If more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest risk weights shall be referred to. If the two lowest risk weights are different, the higher risk weight shall be applied. If the two lowest risk weights are the same, that risk weight shall be applied.

Article 33

Issuer and issue credit assessment

1. Without any prejudice to the provisions of Article 32, in the case where a credit assessment exists for a specific issuing program or facility to which the item constituting the claim belongs, the credit assessment shall be used to determine the risk weight applicable to that item.

2. Without any prejudice to the provisions of Article 32, in the case that a credit assessment exists for a specific issuing program or facility to which the item constituting the claim does not belong, and for which no directly applicable credit assessment exists:

- if the use of the existing credit assessment would determine the application to the unrated item of a risk weight which is lower than that otherwise applicable, the credit assessment on the specific issuing program or facility will only be used to determine the risk weight of the item if the item ranks *pari passu* or senior in all respects to the specific issuing program or facility;

- if the use of the existing credit assessment would determine the application to the unrated item of a risk weight which is higher than that otherwise applicable, the credit assessment on the specific issuing program or facility will be used to determine the risk weight of the unrated item.

3. Without any prejudice to the provisions of Article 32, in the case that a general credit assessment exists for the issuer of a specific issuing program or facility to

which the item constituting the claim belongs, and for which no directly applicable credit assessment exists:

- if the use of the existing issuer credit assessment would determine the application to the unrated facility of a risk weight which is lower than that otherwise applicable, the credit assessment on the issuer will only be used to determine the risk weight of the facility if the item ranks *pari passu* or senior in all respects to senior unsecured claims of that issuer.

- if the use of the existing issuer credit assessment would determine the application to the unrated facility of a risk weight which is higher than that otherwise applicable, the credit assessment on the issuer of the item will be used to determine the risk weight of the unrated facility.

Article 34

Long-term and short-term credit assessments

1. Short-term credit assessments may only be used for short-term asset and off-balance sheet items constituting claims on institutions and corporates.

2. Any short-term credit assessment shall only apply to the item the short-term credit assessment refers to, and it shall not be used to derive risk weights applicable to any other item.

3. Notwithstanding the provision of paragraph 2, if a short-term rated facility receives a 150% risk weight, then all unrated unsecured claims on that obligor whether short-term or long-term shall also receive a 150% risk weight.

4. Notwithstanding the provision of paragraph 2, if a short-term rated facility attracts a 50% risk-weight, no unrated short-term claim shall attract a risk weight lower than 100%.

5. When a short-term credit assessment is to be used, the nominated ECAI producing the short-term credit assessment needs to meet all the eligibility criteria for being recognised as an eligible ECAI, as specified in Article 37 and 38, in terms of its short-term credit assessments.

Article 35

Domestic and foreign currency items

1. A credit assessment that refers to an item denominated in the obligor's domestic currency cannot be used to derive a risk weight for another claim on that same obligor that is denominated in a foreign currency.

2. Notwithstanding the provision of paragraph 1 , competent authorities may, when an exposure arises through a bank's sub-participation in a loan that has been extended by a Multilateral Development Bank whose preferred creditor status is recognised in the market and transferred to the sub-participants, allow that the

credit assessment on the obligor's domestic currency item be used for risk weighting purposes instead of his foreign currency credit assessment.

Subsection 3 – Recognition of ECAIs and mapping of ECAIs credit assessments

Article 36

Recognition of eligible External Credit Assessment Institutions

1. The credit assessment eligible to determine the risk weight of an item must be awarded by an external credit assessment institution (ECAI) that has been recognised as eligible by the competent authorities.

2. An ECAI may be recognised as eligible by the competent authorities for one or more of the item classes specified in Article 28.

3. Competent authorities shall ensure that the list of recognised ECAIs shall be publicly available.

4. Competent authorities shall make the process for recognising ECAIs public.

Article 37

Minimum principles for ECAIs methodology

Competent authorities will recognise an ECAI as eligible only if they are satisfied with the way in which the methodology followed by that ECAI in the formulation of its credit assessments complies with the following principles:

1. Objectivity

2. Independence

3. Ongoing review

4. Transparency and disclosure

Article 38

Minimum principles for ECAIs credit assessments

Competent authorities will recognise an ECAI as eligible only if they are satisfied of the way in which the ECAI's credit assessments comply with the following principles:

1. Credibility and market acceptance

2. Transparency and disclosure

Article 39

Optional mutual recognition of ECAIs by Member States

When an ECAI has been recognised as eligible by one Member State, other Member States may recognise as eligible that ECAI on the basis of the assessment performed by the first Member State.

Article 40

Mapping

1. Competent authorities are responsible for mapping ECAIs credit assessments into the steps of the credit quality assessment scale specified in Article 29.

2. The mapping process shall be objective and consistent and it shall take account of the full spectrum of steps of the credit quality assessment scale.

3. In order to differentiate between the relative degrees of risk expressed by each credit assessment, competent authorities shall consider quantitative and qualitative factors as specified in the provisions of Annex C-2.

4. When the competent authority of one Member State has established the mapping of an ECAI's credit assessments, the competent authorities of other Member States may recognise that mapping on the basis of the assessment performed by the competent authority of the former Member State.

[Articles 41-45 Blank]

SECTION II – INTERNAL RATINGS BASED APPROACH

Article 46

Use of the IRB Approach

1. The competent authorities may, subject to the conditions set out in this Section, allow institutions to calculate their capital requirements for credit risk using the Internal Ratings Based Approach (IRB Approach) instead of the methods described in Section I of this Chapter. Explicit recognition by the competent authorities of the use of the IRB Approach for supervisory capital purposes shall be required.

2. If institutions use the Foundation Approach the rules set out in this Section shall be read in conjunction with and subject to the rules set out Section III of this Chapter.

Article 47

Asset Classes

1. Exposures shall be categorised into five asset classes: corporates, institutions, sovereigns, retail, and equity, based on the exposure definitions set out in this Article.. Exposures shall be categorised as corporate exposures if they do not meet one of the four other definitions set out below:

2. 'Corporate exposure' shall mean a debt obligation of a corporation, partnership, or proprietorship and any off-balance sheet exposure to such an entity.

3. 'Sovereign exposure' shall mean a debt obligation of, and any off-balance sheet exposure to, such an entity a sovereign, its central bank, regional governments and local authorities claims on which are treated as claims on sovereigns under the Standardised Approach, Multilateral Development Banks (MDB) and International Organisations claims on which receive a 0% risk weight under the Standardised Approach proprietorship.

4. 'Exposure to an institution' shall mean a debt obligation of, and any off-balance sheet exposure to, such an entity an institution, regional governments and local authorities claims on which are not treated as claims on sovereigns under the Standardised Approach, PSEs claims on which are treated as claims on institutions under the Standardised Approach, and Multilateral Development Banks (MDB) claims on which do not receive a 0% risk weight under the Standardised Approach proprietorship.

5. 'Retail exposure'. An exposure shall be considered 'retail' if it meets the criteria (a) and (b) below:

   (a) Nature of borrower or low value of individual exposures

   - The exposure is to an individual. Competent authorities may establish exposure thresholds for the retail portfolio;

     or

   - The exposure is a residential mortgage loan – provided that the credit is extended to an individual who owns the property and occupies or lets it. Competent authorities may set limits on the maximum number of housing units per counterpart. Loans secured by a single or small number of condominium or co-operative housing units in a single building or complex also fall within the scope of the residential mortgage category.

   - Exposures to small businesses are eligible for retail treatment provided the institution meets the requirements of the SME use test as defined in Annex D-1 and the total exposure of the institution to an individual small business is less than € 1 million. Small business exposures extended through or guaranteed by an individual and exposures to individuals for business use are also eligible for retail treatment provided they meet these requirements.

(b) Large number of exposures

The exposure shall be one of a large pool of loans, which are managed on a pooled basis. Competent authorities may set a minimum number of exposures within a pool for exposures in that pool to be treated as retail.

6. 'Equity' exposure. An instrument shall be categorised as 'equity' exposure if it meets all the following requirements:

- It is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or by the liquidation of the issuer;
- It does not embody an obligation on the part of the issuer; and
- It conveys a residual claim on the assets or income of the issuer.

Any of the instruments enumerated in Annex D-1, paragraph 10 shall be categorised as an equity exposure.

7. Within the retail asset class, institutions shall separately identify three sub-asset classes: (a) exposures secured by residential mortgages as defined above, (b) qualifying revolving exposures, as defined in Annex D-1 and (c) all other retail exposures.

8. Within the corporate asset class, institutions shall separately identify five sub-classes of specialised lending (project finance, object finance, commodities finance, income producing real estate and high-volatility commercial real estate as defined in Annex D-1). Such lending posses all the following characteristics, either in legal form or by economic substance:

- the loan is to an entity which was created specifically to finance and/or operate physical assets;
- the borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the loan, apart from the income that it receives from the asset(s) being financed;
- the terms of the loan give the lender a substantial degree of control over the asset(s) and the income that it generate; and
- as a result of the preceding factors, the primary source of repayment of the loan is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.

9. Institutions shall demonstrate to competent authorities that their methodology for assigning exposures to different asset classes and sub-asset classes is appropriate and consistent over time.

Article 48

Availability of Approaches

1. For exposures to corporates, institutions and sovereigns the Foundation and Advanced Approaches are available.

2. For retail exposures only the Advanced Approach is available.

3. For equity exposures which are treated under the PD/LGD approach only the Foundation Approach is available.

Article 49

Requirements for internal ratings systems

1. If institutions use the IRB Approach, internal ratings and default and loss estimates shall play an essential role in its credit approval, risk management, internal capital allocations, and corporate governance functions.

2. Rating and risk estimation systems and processes shall provide for a meaningful assessment of borrower and transaction characteristics, a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk. Furthermore, these systems and processes shall be consistent with internal use of these estimates.

3. The requirements prescribed in this Section shall apply to all asset classes unless noted otherwise. The standards related to the process of assigning exposures to borrower or facility grades (and the related oversight, validation, etc.) apply equally to the process of assigning retail exposures and eligible purchased receivables to pools of homogenous exposures, unless noted otherwise.

4. Where an institution ceases to be in compliance with the requirements prescribed in this Article, the institution shall present a plan for a timely return to compliance to the competent authority or the institution shall demonstrate that the effect of non-compliance is immaterial.

Article 50

Roll out of Internal Ratings Based Approach

1. Institutions shall adopt the IRB Approach across its whole group. With the approval of the competent authorities institutions can adopt a roll-out plan as specified in Annex D-1 for a phased roll-out subject to the paragraphs below. For the retail asset class this requirement applies on a basis of the three sub-asset classes. During the roll-out period, national competent authorities shall ensure that no capital relief is granted for intra-group transactions which are designed to reduce a group's aggregate capital charge by transferring credit risk among entities on the Standardised Approach, foundation and advanced IRB Approaches.

2. Institutions applying the IRB Approach for other asset classes can apply the Standardised Approach permanently for exposures to institutions and sovereign exposures, subject to approval of the competent authorities.

3. Institutions may remain on the foundation IRB Approach for one or more of its SL product lines, and move to the Advanced Approach for other product lines within the corporate asset class, subject to approval of the competent authorities.

4. Institutions moving to the IRB Approach for any of the other asset classes shall at the same time apply the treatment of equity exposures as specified in Article 51.

5. This Section applies for the calculation of minimum capital requirements for all exposures in respect of which an institution adopts the IRB Approach other than securitisation positions. For securitisation positions, risk weighted assets shall be calculated in accordance with Section IV of this Chapter.

6. Exposures in non-significant business units as well as asset classes that are immaterial in terms of size and perceived risk profile can be exempt from the IRB treatment, subject to the approval of the competent authorities. Exposures excluded from the IRB treatment shall be risk weighted according to the rules prescribed in Section I of this Chapter, with the national competent authority determining whether an institution should hold more capital under the supervisory review process for such positions.

7. A voluntary return to the Standardised or Foundation Approach shall be permitted only in extraordinary circumstances and shall be approved by the competent authority.

Article 51

Methodologies

Note:	Work is ongoing to develop Strand 1 text for methodological requirements related to IRB. The aim is to develop principles, rules and requirements governing and constraining the implementing and technical provisions prescribed in Annex D-2 to D-6.For the moment, an indication of the issues to be dealt with and related Annex provisions are indicated below.

A1 Exposures To Corporates, Institutions And Sovereigns

- Estimation of PDs for internal borrower grades - Annex D-5, paragraphs 58-59.
- Estimation of EL for purchased corporate receivables treated on a pooled basis - Annex D-5, paragraphs 86-94.
- Estimation of EL for dilution risk of purchased corporate receivables - Annex D-5, paragraphs 86-94.
- Use of supervisory estimates:

- Ø LGD, Annex D-3 - paragraph 5;
- Ø EAD - Annex D-4, paragraphs 1-12;
- Ø recognition of maturity - Annex D-3, paragraphs 8/9.

- Internal estimates under the Advanced Approach:
  - Ø LGD, Annex D-3 - paragraph 6;
  - Ø EAD - Annex D-4, paragraphs 1-8, 13-14;
  - Ø recognition of effective maturity - Annex D-3, paragraph 9.
- Risk weighted assets for exposures to corporates, institutions and sovereigns - Annex D-2, paragraph 1.
- Risk weighted assets for dilution risk of purchased corporate receivables - Annex D-2, paragraph 1.

A2 SPECIALISED LENDING EXPOSURES

- Supervisory slotting approach for SL exposures (Project finance, Income Producing Real Estate, Object Finance, Commodities Finance):
  - Ø supervisory risk weight categories - Annex D-2, paragraph 2;
  - Ø slotting criteria - Annex D-7.
- Slotting of high-volatility commercial real estate exposures:
  - Ø supervisory risk weight categories - Annex D-2, paragraph 3;
  - Ø slotting criteria - Annex D-7.

B RETAIL EXPOSURES

- Estimation of PD, LGD and EAD - Annex D-4, paragraphs 1-8, 13-14; Annex D-5, paragraphs 58-75. For purchased retail receivables the institution shall also comply with further minimum operational requirements - Annex D-5, paragraphs 86-94.
- Estimation of EL for dilution risk of purchased retail receivables pools - Annex D-5, paragraphs 86-94.
- Risk weighted assets for retail exposures (retail sub-asset classes) - Annex D-2, paragraphs 4-6.
- Risk weighted assets for dilution risk for purchased retail receivables - Annex D-2, paragraph 1.

C Equity Exposures

- EAD for equity - Annex D-4, paragraphs 15-16.
- PD/LGD approach:
  - Ø estimation of PD for internal borrower grades - Annex D-5, paragraphs 58-59;
  - Ø use of supervisory LGDs - Annex D-3, paragraph 20;
  - Ø EAD – Annex D-4, paragraphs 15-16;
  - Ø recognition of maturity - Annex D-3, paragraph 20;
  - Ø Risk weighted assets - Annex D-2, paragraph 1.
- Simple risk weight approach, risk weighted assets - Annex D-2, paragraphs 8-10.
- Internal models approach, risk weighted assets - Annex D-2, paragraph 11, Annex D-5, paragraphs 101-112.

[Articles 52-65 Blank]

SECTION III – CREDIT RISK MITIGATION UNDER THE STANDARDISED APPROACH AND THE IRB FOUNDATION APPROACH

Article 66

Scope

The provisions of this Section apply to credit risk mitigation in relation to exposures, the capital requirements in relation to which are determined under the Standardised Approach or the IRB Foundation Approach.

Article 67

Overarching Principle

Credit risk mitigation may be recognised by competent authorities and regulatory capital relief given where reduction in the level of credit risk on the exposure as a result of the credit risk mitigation is sufficiently certain. The minimum conditions for such certainty are set out in this Section.

The benefits of such recognition will be limited to that element of the exposure which is deemed, in accordance with the rules for valuation of the exposure and the credit protection set out in this Directive, to be covered by the credit protection. The capital charge for any uncovered element will be determined on the basis of the credit risk weight of the underlying exposure determined according to the credit risk approach being used to calculate the regulatory capital requirements of the lending institution in relation to exposures of the relevant category.

No exposure in respect of which credit risk mitigation is obtained will receive a higher credit risk capital requirement than an otherwise identical claim in respect of which there is no credit risk mitigation.

Article 68

Regulatory Recognition

In order for credit risk mitigation to satisfy the requirement of certainty contained in Article 1, the following requirements must be complied with.

1. Eligibility

Funded protection

In the case of funded credit protection, to be eligible for recognition the assets relied upon by the institution for protection must be sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the (level of) credit protection achieved, having regard to the credit risk approach being used to calculate the regulatory capital requirements of the lending institution and to the degree of capital relief allowed. The types of assets which meet these criteria are set out in Annex E-1.

Unfunded protection

In the case of unfunded protection, to be eligible for recognition the party giving the undertaking must be sufficiently creditworthy, to provide appropriate certainty as to the (level of) credit protection achieved (including appropriate certainty in relation to likelihood of payment under the credit protection agreement in the event of default of the counterparty or on the occurrence of other specified credit events), having regard to the credit risk approach being used to calculate the regulatory capital requirements of the lending institution and to the degree of capital relief allowed. The types of protection providers which meet these criteria are set out in Annex E-1.

Only those types of credit derivatives set out in Annex E-1 are eligible for recognition.

2. Minimum requirements

(a) Legal certainty

In accordance with the requirements set out in Annex E-2, the mechanism used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by the lending institution must be such as to result in credit protection arrangements which are legally robust and effective and enforceable in all relevant jurisdictions.

Without prejudice to the foregoing, in respect of funded protection, the legal mechanism by which protection is given must ensure that the lender has clear rights over the assets from which the protection derives and may in a timely manner liquidate or retain them in the event of the default, insolvency or bankruptcy (or otherwise-defined credit event set out in the transaction documentation) of the obligor and where applicable of the custodian holding the collateral.

(b) Operational requirements

In accordance with the requirements set out in Annex E-2, the lending institution must take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

(c) Further requirements

Funded protection

In order for capital relief to be given, the degree of correlation between the value of the assets relied upon for protection and the credit quality of the borrower must not be of an undue level as prescribed in Annex E-2.

Unfunded protection

In order for capital relief to be given, the nature of the undertaking must be such as to provide appropriate certainty of protection as set out in Annex E-2.

Article 69

Capital Treatment

Regulatory capital relief may be given in respect of an exposure having regard to the degree of credit risk mitigation achieved.

Valuation

In accordance with the detailed rules set out in Annex E-3, in considering the degree of credit risk mitigation achieved the realisable value and potential changes in such value of any asset or amount lent or transferred or relied upon for credit protection purposes shall be taken into account.

Double counting

The effects of credit risk mitigation will not be double counted. Therefore, no additional supervisory recognition of credit risk mitigation for regulatory capital purposes may be granted on exposures in respect of which such credit risk mitigation is reflected in the capital charge to be imposed without taking into account the provisions of this Section.

Maturity mismatch

A maturity mismatch occurs when the residual maturity of the credit risk mitigation is less than that of the underlying exposure. The maturity of both the underlying exposure and the credit protection shall be gauged conservatively subject to the terms of Annex E-4. Maturity mismatched credit risk mitigation may be taken into account in calculating regulatory capital requirements subject to the conditions set out in Annex E-4 and in accordance with the formula for adjustment of the capital relief set out there.

The capital treatment

The capital treatment that may be applied where credit risk mitigation is recognised in accordance with this Section is set out at Annex E-3, E-5 and E-6.

Article 70

Monitoring of Credit Exposures

Notwithstanding the existence of credit risk mitigation techniques that have attracted regulatory capital relief, institutions shall continue to undertake full credit risk assessment of the underlying exposure and be in a position to demonstrate the fulfilment of this requirement to the competent authorities.

[Articles 71-80 Blank]

SECTION IV – ASSET SECURITISATION

Note: Work is ongoing to develop Strand 1 text for Asset Securitisation. This will contain the principles and rules governing and constraining the implementing and technical provisions to be prescribed in the Annex. For the moment, the Articles set out below are included to indicate the future configuration of this section.

Article 81

Approach to be used

Where an institution uses the IRB Approach for the exposure class of which the exposures being securitised are part, then it shall use the IRB Approach in relation to the securitisation of the assets. In all other cases it shall use the Standardised Approach.

Article 82

Recognition of risk transfer by originators

An originating institution must meet the criteria set out in Annex F-2 for traditional securitisations and Annex F-3 for synthetic securitisations in order to receive recognition of risk transference to the extent indicated in those sections of Annex F. Failure to meet these criteria results in the originators capital requirements being calculated on the basis that no risk transference has taken place.

Non-recognition of risk-transference by the originator does not affect the capital treatment for investors prescribed below.

Article 83

Eligibility of ECAIs for securitisation risk weighting purposes

In order to assign risk weights based on the credit assessments of eligible external credit assessment institutions, the operational requirements as set out in Annex F-4 must be met.

Competent authorities are responsible, in accordance with the provisions of Annex F-4, for mapping the credit assessment of external credit assessment institutions into the steps of the credit quality assessment scales specified in Annex F-5 for the calculation of capital requirements under the Standardised Approach and in Annex F-6 for the calculation of capital charges under the IRB Approach using the Ratings Based Approach.

Article 84

Capital Treatment

An institution having a securitisation position and using the Standardised Approach must hold capital in accordance with Annex F-5.

An institution having a securitisation position and using the IRB Approach must hold capital in accordance with Annex F-6.

Article 85

Implicit Recourse

The provision of implicit recourse by an originating institution or a sponsoring institution will result in the treatment set out in Annex F-7.

[Articles 86-95 Blank]

Chapter 2 – Market Risks

Article 96

Trading intent and prudent valuation

To be eligible for trading book capital treatment, a position or a portfolio must be held for trading intent and be subject to frequent and accurate valuation.

Trading intent shall be evidenced based on the strategies, policies and procedures set up by the institution to manage the position/portfolio. These are listed in Annex G-1.

Regulation on prudent valuation shall apply to all positions in the trading book, based on the requirements set out in Annex G-2. This notably covers: (i) systems and controls; (ii) valuation methodologies; (iii) valuation adjustments and reserves.

Article 97

Systems and controls

Institutions shall establish and maintain adequate systems and controls sufficient to give management and competent authorities the confidence that their valuation estimates are prudent and reliable. These systems shall be integrated with other risk management systems within the organisation and comply with the prudential requirements listed in Annex G-2, section A.

Article 98

Valuation methodologies

(i) Marking to market

Institutions shall evaluate their positions using mark to market as much as possible.

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

When marking to market, the more prudent side of bid/offer shall be used unless the institution is a significant market maker in a particular position type and it can close out at mid-market.

(ii) Marking to model

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

When marking to model, institutions must demonstrate compliance with the prudential requirements specified in Annex G-2, section B. In this case, an extra degree of conservatism is appropriate.

Article 99

Valuation adjustments or reserves

Institutions shall establish and maintain procedures for considering valuation adjustments/reserves. These shall be compliant with the prudential requirements set out in Annex G-2, section C.

Competent authorities expect institutions using third-party valuations to consider whether valuation adjustments are necessary. Such considerations are also necessary when marking to model. In addition, competent authorities will require institutions to consider the need for establishing reserves for less liquid positions and on an ongoing basis review their continued appropriateness.

Valuation adjustments shall impact regulatory capital based on the criteria set out in Annex G-2, section D.

Article 100

Collective-investment undertakings (CIU)

Positions in units of collective-investment undertakings are eligible for trading book capital treatment subject to the conditions specified in Article 96 (trading intent and prudent valuation). Capital requirements shall be calculated according to Annex G-3.

Article 101

Specific risk

Institutions shall calculate their capital requirement for specific risk in the trading book according to Annex G-4.

Article 102

Settlement / counterparty risk

An institution shall be required to hold capital against settlement/counterparty risk separate from the capital charge for general market risk and specific risk for the following positions:

– Exposures due to unsettled transactions and free deliveries;

– exposures due to over-the-counter (OTC) derivative instruments included in the trading book;

– exposures due to repurchase agreements and securities and commodities lending which are based on securities and commodities included in the trading book;

– exposures due to reverse repurchase agreements and securities-borrowing and commodities-borrowing transactions which meet the conditions on trading intent and prudent valuation for being held in the trading book; and

– exposures in the form of fees, commission, interest, dividends and margin on exchange-traded derivatives which are directly related to the items included in the trading book;

The capital requirement shall be calculated according to the Standardised Approach or the Internal Ratings Based Approach, subject, where appropriate, to the specific rules envisaged in Annex G-5.

Article 103

Amendments to Directive 93/6/EEC (CAD)

Directive 93/6/EEC is amended as follows:

1 In Article 2, the following definitions are repealed:

n. 5 – financial instruments;

n.6 – trading book;

n. 12 – qualifying items;

2 Article 4 is replaced by Article 3 of this Directive.

3 Article 6 (valuation of positions for reporting purposes) is repealed.

4 Annex I is amended as follows:

[Memo: Paragraph 1 to be amended to allow for netting of long and short positions in CIUs]

The following paragraph 7 bis is added after paragraph 7 [the following text is work in progress]:

7 bis. For credit derivatives**,** unless specified differently the notional amount of the credit derivative contract must be entered. 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 C-1, section 1. 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 security 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. In order to calculate 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.

When calculating the specific risk charge, a first-asset-to-default basket creates a position for the notional amount in an obligation of each reference entity. If a capital deduction equal to the size of the maximum credit event payment is lower than the total capital requirement under the above-mentioned method, this amount may be deducted from the capital.

When calculating the specific risk charge, a second-asset-to-default basket product creates a position for the notional amount in an obligation of each reference entity less one (choice of the institution). If a capital deduction equal to the size of the maximum credit event payment is lower than the total capital requirement under the above-mentioned method, this amount may be deducted from the capital. If 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.

For the party who transfers credit risk (the 'protection buyer') the positions are determined as the mirror image of the position of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer) and a first- or second-asset-to-default basket product (which entails only a short position in one reference entity at choice of the institution; for the second-asset-to-default basket product the reference entity entailing the highest capital charge is excluded with respect to this choice). 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 order to calculate the specific risk charge for a basket product providing proportional protection, a position whose size is in accordance with the proportionality of the notional amount recorded in the contract must be entered in an obligation of each reference entity. When 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.

Paragraph 11 (CIUs) is repealed;

Paragraph 14 is repealed. References to this paragraph shall be read as references to Annex G-4, paragraph 1.

Paragraphs 32 and 33 are repealed. References to these paragraphs shall be read as references to Annex G-4, paragraph 2.

5 Annex II (settlement and counterparty risk) is repealed.

6 In Annex V (own funds), paragraph 2 shall be amended by the deletion of 'II' from the third line.

7 In Annex VI (large exposures), paragraph 2 is amended by the replacement of sub-paragraph (iii) with the following.

> (iii) the exposures due to the transactions, agreements and contracts referred to in Article 102 of Directive [new Capital Requirements Directive] to the client or group of clients in question, such exposures being calculated in the manner laid down in that Annex, without application of the weightings for counter-party risk.

8 Paragraphs 8 sub-paragraphs 1 and 2 of Annex VI are replaced by the following:

> (a) the exposure on the non-trading book to the client or group of clients in question does not exceed the limits laid down in Article 49 of Directive 2000/12/EC, calculated with reference to own funds as defined in Title V, Chapter 2, Section 1 of Directive 2000/12/EC, so that the excess arises entirely on the trading book;
>
> (b) the firm meets an additional capital requirement on the excess in respect of the limits laid down in Article 49 (1) and (2) of Directive 2000/12/EC. This shall be calculated by selecting those components of the total trading exposure to the client or group of clients in question which attract the highest specific-risk requirements in Annex G-4 and/or requirements in Article 102 of Directive [new Capital Requirements Directive], the sum of which equals the amount of the excess referred to in (a); where the excess has not persisted for more than 10 days, the additional capital requirement shall be 200 % of the requirements referred to in the previous sentence, on these components.
>
> As from 10 days after the excess has occurred, the components of the excess, selected in accordance with the above criteria, shall be allocated to the appropriate line in column 1 of the table below in ascending order of specific-risk requirements Annex G-4 and/or requirements in Article 102 of Directive [new Capital Requirements Directive]. The institution shall then meet an additional capital requirement equal to the sum of the specific-risk requirements in Annex G-4 and/or Article 102 requirements on these components multiplied by the corresponding factor in column 2;
>
> [Table remains the same]

9 The following paragraph is inserted after paragraph 8 of Annex VI:

> 8 bis. Pending further co-ordination on the treatment of large exposures, competent authorities can establish that the exposures referred to in paragraph 2, point (iii) above be excluded from the treatment envisaged in paragraph 8 above (additional capital requirements) provided that such exposures are, as a general rule, subject to the treatment envisaged for large exposures under Article 49 of Directive 2000/12/EC and paragraph 8

(a) above. Exposures over limits shall in this case not be allowed, unless under the approval of the competent authorities on a case-by-case basis, and provided that exposures are of a temporary nature. When this happens, such exposures shall be computed in the calculation of the capital requirements envisaged in paragraph 8 (b) above.

[Articles 104-105 - Blank]

Chapter 3 – Operational risk

Article 106

Scope

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.

Article 107

Capital requirement

The competent authorities shall require institutions to hold capital against operational risk. This capital will have to be calculated in accordance with the methodologies set out in Articles 108 to 111, and subject to the provisions of Articles 112 and 113.

Article 108

Basic indicator approach

The capital requirement for operational risk under the basic indicator approach will be set as a certain percentage of a relevant income indicator. The parameters for the basic indicator approach are defined in Annex H-2.

At the request of institutions, competent authorities may grant a capital alleviation to reflect the impact of insurance against operational risk. Operational risk insurance shall meet the general eligibility criteria laid down in H-6. The specific conditions under which capital alleviation may be granted under the basic indicator approach are laid down in Annex H-2.

Article 109

Standardised approach

The Standardised Approach requires institutions to divide their activities in a number of business lines.

For each business line, a proxy indicator for operational risk is identified.

For each business line, institutions will calculate a capital requirement for operational risk by multiplying the relevant proxy indicator by a certain risk factor reflecting the risk of operational losses.

The capital requirement for operational risk under the Standardised Approach will be the simple sum of the capital requirements for operational risk across all individual business lines.

The parameters for the Standardised Approach are laid down in Annex H-3.

To be eligible for the Standardised Approach, institutions must satisfy their competent authorities that they meet the qualifying criteria set out in Annex H-3.

At the request of institutions, competent authorities may grant a capital alleviation to reflect the impact of insurance against operational risk. Operational risk insurance shall meet the general eligibility criteria laid down in Annex H-6. The specific conditions under which capital alleviation may be granted under the Standardised Approach are laid down in Annex H-3.

Article 110

Advanced measurement approaches

Competent authorities may authorise institutions to use advanced measurement approaches based on their own risk management models to calculate the capital requirement for operational risk. Explicit recognition by the competent authorities of the use of models for supervisory capital purpose shall be required in each case.

To be eligible for advanced measurement approaches, institutions must satisfy their competent authorities that they meet the qualitative and quantitative standards set out in Annex H-4.

Institutions will be allowed to recognise the impact of insurance against operational risk under advanced measurement approaches. The specific conditions under which capital alleviation may be granted under advanced measurement approaches are laid down in Annex H-4.

Article 111

Combination of basic indicator/Standardised Approach and advanced measurement approaches

Competent authorities may allow institutions to use a combination of the basic indicator/Standardised Approach and advanced measurement approaches.

The conditions for combining the basic indicator/Standardised Approach and advanced measurement approaches are laid down in Annex H-5.

Article 112

Specific provisions on operational risk for investment firms with limited licence

Member States may apply the capital requirements for operational risk specified in Articles 108-109 subject to the modifications indicated in Annex H-2, paragraph 4 and Annex H-3, paragraph 4.1, respectively under the basic indicator approach and the Standardised Approach, to institutions that meet all the following criteria:

- They are allowed to provide only the following investment services covered under sections A and B of Annex I to the Investment Services Directive 93/22/EEC.:

(1) reception and transmission, of orders from clients in relation to one or more financial instruments or connected foreign exchange services

(2) execution of orders on behalf of clients in relation to one or more financial instruments or connected foreign exchange services

(3) investment advice

(4) placing or other activities undertaken in agreement with the issuer of the instrument to assist the distribution of or subscription to public or private offers of financial instruments, when these activities do not imply firm commitment or subscription on the part of the institution

(5) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings

(6) investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments

- They are fully compliant with the provisions specified in Title III, Chapter 1 and with the risk management standards on operational risk arising from the provision of investment services listed in Annex H-7, section A on an ongoing basis;

- They are not allowed to come into possession of money or instruments belonging to clients to which they provide their services. This situation is deemed to occur when the arrangements specified in Annex H-7, section B are adopted and applied on an ongoing basis.

Article 113

Provisions on operational risk arising from specific activities

For institutions other than those mentioned under Article 112, Member States may, in respect of the investment services indicated below, apply the capital requirements for operational risk specified in Article 109 subject to the modifications indicated in Annex H-3, paragraph 4.2, under the Basic Indicator Approach and the Standardised Approach, provided that all the following criteria are met:

- The investment services referred to in the previous paragraph are the following services covered under Sections A and C of the Annex to the Investment Services Directive 93/22/EEC:

(1) reception and transmission, of orders from clients in relation to one or more financial instruments or connected foreign exchange services

(2) execution of orders on behalf of clients in relation to one or more financial instruments or connected foreign exchange services

(3) investment advice

(4) placing or other activities undertaken in agreement with the issuer of the instrument to assist the distribution of or subscription to public or private offers of financial instruments when these activities do not imply firm commitment or subscription on the part of the institution

(5) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings

(6) investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments

(7) managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments.

and the activity mentioned under Article 1, paragraph 2 of Directive 85/611/EEC (UCITS Directive as amended) [collective asset management];

- institutions are fully compliant with the provisions specified in Title III, Chapter 1 and with the risk management standards on operational risk arising from the provision of investment services listed in Annex H-7, section A and C on an ongoing basis.

Article 114

Further developments

No later than …. the Commission shall present a report to the European Parliament and the Council on the application of this capital requirement, accompanied when necessary by proposals for its revision.

[Article 115 Blank]

Title III – Supervisory Review Process

CHAPTER 1 – INSTITUTIONS' CONTROL ENVIRONMENT AND CAPITAL ADEQUACY ASSESSMENT PROCESS

Article 116

Institutions' control environment

1. Member States shall require institutions to conduct their activities within strategic objectives and corporate values established by the governing bodies. These objectives and values shall be communicated throughout the institutions.

2. Member States shall require the institutions' governing bodies to establish clear and transparent lines of responsibility and accountability structures throughout their organisation.

3. Member States shall require the members of institutions' governing bodies to have a thorough understanding of their role in the implementation and functioning of the control environment and exercise appropriate oversight of the institution's activities and functions.

4. To ensure adequacy, integrity and efficiency of the control environment and capital adequacy assessment process referred to in Article 118, institutions shall be required to implement and apply appropriate review processes, in compliance with the minimum requirements laid down in Annex I-2, section 3.

Article 117

Institutions' risk management and reporting

1. Member States shall require institutions' governing bodies to approve strategies for all the risks generated by the institutions' activity. These strategies shall reflect the institutions' tolerance for risks and understanding of the specific characteristics of each risk category.

2. Institutions' governing bodies shall be responsible for implementing the strategies and for developing written policies and procedures for identifying, measuring, monitoring and controlling all risks incurred by institutions.

3. Institutions' strategies, policies and procedures shall be subject to regular reviews and shall be communicated throughout the organisation to ensure that staff at all levels understand their responsibility in respect of risk management and control.

4. Institutions shall be required to establish independent, ongoing controls over the risks incurred. This system shall ensure controls of risk management processes, verification and enforcement of compliance with policies and procedures as well as limits. This system shall ensure that risk exposures and the results of reviews and controls are reported directly to institutions' governing bodies in a timely manner.

5. Member States shall ensure that groups integrate their risk monitoring and reporting systems well into their structures, so that risks can be measured, monitored and controlled on a consolidated level.

Article 118

Institutions' capital adequacy assessment process

1. Member States shall require institutions' governing bodies to implement and apply a capital adequacy assessment process proportionate to the nature, scale and complexity of their activities, designed to identify, measure and report risks, and to ensure on an ongoing basis the quantitative and qualitative adequacy of own funds in relation to the overall risk profile and control environment.

2. Without prejudice to the provisions of Articles 3 and 5, the capital adequacy assessment process shall be the basis for institutions to set their capital adequacy with respect to risk and to lay down a strategy for maintaining their capital adequacy taking account of the impact of their business strategy on risk profile and capital adequacy.

3. Institutions shall be required to assess their capital adequacy and their vulnerability to loss under normal and stressful conditions, including the breakdown of key strategic assumptions, and consider those results when establishing and reviewing capital adequacy.

4. Institutions shall be required to regularly operate the assessment process. The frequency of monitoring different activities shall be prudently determined by institutions taking into account the risks involved and the frequency and nature of changes occurring in the operating environment.

[Articles 119-125 Blank]

CHAPTER 2 – COMPETENT AUTHORITIES' EVALUATION PROCESS, CORRECTIVE ACTION AND TRANSPARENCY

Article 126

Evaluation process

1. Competent authorities shall review and evaluate the adequacy and reliability of the institutions' control environment, risk management and reporting, and capital adequacy assessment process in relation to the institutions' risk profile and quality of management, having regard to the requirements set forth in Chapter 1 above and in Annexes I-1 and I-2. Institutions' compliance with the requirements and standards laid down in this Directive for the use of specific techniques and access to advanced calculation methodologies shall also be reviewed.

2. The analysis and results of the evaluation process referred to in paragraph 1 shall be the basis for the competent authorities to assess the quantitative and qualitative adequacy of each institution's own funds and to determine any necessary improvement to the institutions' own funds, control environment, risk management and reporting, and capital adequacy assessment process.

3. Competent authorities shall apply the evaluation process to all institutions on a systematic and consistent basis and the results of the process shall be reviewed periodically. Competent authorities shall determine for each institution the frequency, intensity and scope of the process and review having regard to factors

such as institutions' systemic importance, nature and scale of business, organisational complexity and elements which might impact on the institutions' risk profile.

4. Notwithstanding paragraph 3 above, competent authorities shall consider the need to carry out the evaluation process as soon as they get any new information which may significantly impact on an institution's capital adequacy, risk profile and control environment.

Article 127

Prudential measures

1. Member States shall provide their competent authorities with powers to take a range of prudential measures against institutions. As a minimum, these measures shall include to require institutions to hold an amount of own funds higher than that laid down in Article 3 and the measures listed in Annex J-2, paragraph 1.

2. Competent authorities shall be allowed to enforce their powers in such a way as to achieve an appropriate treatment by institutions of all risks, including non-measurable ones, and compliance with qualitative requirements.

3. Based on the analysis and results of the evaluation process referred to in Article 126, competent authorities shall exercise their powers under paragraph 1 as a minimum to correct or mitigate weaknesses or inadequacies detected in the factors listed in Annex J-2, paragraph 2.

4. Competent authorities shall also impose prudential measures as early as possible on institutions whose level of own funds is assessed to be inadequate in relation to the institutions' risk profile, control environment, risk management and reporting, and capital adequacy assessment process. A specific or additional capital adequacy requirement shall be imposed by competent authorities at least on those institutions whose inadequacy in the level of own funds is unlikely to be rectified within an appropriate timeframe solely through the application of other prudential measures.

5. In the event of an institution's failure to comply with the requirements prescribed in Article 3 or by competent authorities under this Article, Member States shall ensure that the institution in question takes appropriate steps to achieve compliance with those requirements as quickly as possible.

Article 128

Transparency and accountability

1. The general criteria and methodologies used by the competent authorities in the review process shall be publicly available.

2. The analysis and results of the evaluation process shall be communicated by the competent authorities as a minimum to the institutions against which prudential measures are adopted pursuant to Article 127, paragraphs 3 and 4. Requirements to hold an amount of own funds higher than that prescribed in Article 3 shall not be published.

Note that Title III text in relation to CRM residual risk, securitisation and stress-tests aspects remains under development and has not yet been incorporated.

[Articles 129-135 Blank]

Title IV – Market Discipline

Article 136

Entities subject to disclosure requirements

1. For the purposes of this Directive, Member States shall require institutions not included within a group to publicly disclose on an individual basis the information laid down in Article 138 and in Annexes L-2 and L-3.

2. Member States shall require parent undertakings within a group to publicly disclose the information laid down in Article 138 and in Annexes L-2 and L-3 on a consolidated basis.

3. Parent undertakings within a group shall also be required to disclose the information specifically indicated in Annexes L-2 and L-3 with regard to their significant subsidiary institutions, on an individual basis, and significant sub-groups subject to capital requirements pursuant to Article 18, on a sub-consolidated basis.

4. Competent authorities shall be empowered to partially or completely exempt the entities set out in paragraphs 1 and 2 above from disclosure requirements if those entities are included within equivalent disclosures provided at a group level by their parent undertaking established outside the EU.

Article 137

General criteria on disclosure requirements

1. Notwithstanding Article 136, Member States shall permit the entities subject to disclosure requirements not to make one or more disclosures listed in Annexes L-2 and L-3 if the information provided by such disclosures would either not be material or include proprietary or confidential information in the light of the criteria set forth in Annex L-1, paragraphs 1 and 2.

2. If in exceptional cases one or more disclosures are not made on the basis that compliance would involve the disclosure of proprietary or confidential

information, the entities set forth in Article 136 shall state the fact that they have not complied with the requirement, the reasons therefor and disclose more general information about the subject matter of the requirement.

3. Notwithstanding the derogation set out in paragraph 1, competent authorities shall be empowered to require the entities set forth in Article 136 to make any disclosures among those referred to in Annex L-2 and L-3.

4. Member States shall require the entities set forth in Article 136 to publish disclosures on an annual basis as a minimum and to assess whether a higher frequency is necessary in the light of the criteria set out in Annex L-1, paragraph 3. Competent authorities shall be empowered to require the entities set forth in Article 136 to publish one or more disclosures more frequently than the minimum requirement laid down above.

5. Member States shall require the entities set forth in Article 136 to determine the appropriate medium and location to effectively comply with the disclosure requirements set forth in this Directive. Equivalent disclosures made under accounting or listing requirements shall be eligible for compliance with this Directive. Competent authorities shall be empowered to require specific solutions from the entities subject to disclosure requirements.

Article 138

Disclosures on risk management and disclosure policy

1. The entities set forth in Article 136 shall be required to disclose their risk management objectives and arrangements for each separate category of risk they incur.

2. The entities set forth in Article 136 shall be required to adopt a formal disclosure policy to comply with the disclosure requirements set forth in this Directive and have arrangements for assessing the appropriateness of their disclosures, including validation and frequency of them.

[Articles 139-140 Blank]

Title V – Powers of Execution

Article 141

Powers conferred to the Commission

1. The Commission shall adopt, in accordance with the procedure laid down in paragraph 2, implementing measures and technical adaptations to be made to this Directive in the following areas:

[Provision to be completed to reflect proposal that the implementing measures and technical provisions comprising the Annexes should be capable of amendment by comitology.]

2. The Commission shall be assisted by

[Provision to be completed.]

3. When a reference is made to this paragraph, the regulatory procedure laid down in

[Provision to be completed.]

[Articles 142-145 – Blank]

TITLE VI -Transitional Provisions

Article 146

Internal Ratings Based Approach

1. Until 31 December 2011, for corporate exposures the competent authorities of the Member States may set the number of days past due that all institutions in its jurisdiction must abide by under the definition of default for lending to such counterparts situated within this Member State up to a figure of 180 days if local conditions make it appropriate.
This paragraph shall not prevent competent authorities of a Member State, which applies a lower past due figure for such exposures in its territory, from allowing higher figures for lending to counterparts situated in the territories of other Member States that allow higher figures. The specific number must fall within 90 days and the figure, other Member States have set for lending to such counterparts within its territory.
Member States shall inform the Commission of the use they make of this paragraph.

2. Until 31 December 2009 the competent authorities may relax the following minimum requirements: Nevertheless institutions are required to have a minimum of two years of data at the 31 December 2006. This requirement will increase by one year for each of three years up to the 31 December 2009.

- For corporate, institutions and sovereign exposures under the Foundation Approach the requirement that regardless of the data source institutions shall use at least five years of data to estimate the probability of default (PD).

- For retail exposures the requirement that regardless of the data source banks must use at least five years of data to estimate loss characteristics (EAD, and either expected loss (EL) or PD and LGD).

- For corporate, institutions, sovereign and retail exposures the requirement is that a bank must demonstrate it has been using a rating system that was broadly in line with the minimum requirements articulated in this document for at least three years prior to qualification.

3. Institutions adopting the Foundation and/or Advanced IRB Approach shall calculate their minimum regulatory capital requirements in parallel for the Current Accord for two years following the date of implementation of the Directive. During the first year, capital requirements resulting from the IRB treatment will be subject to a floor of 90% of the institution's capital requirements that would result under the Current Accord. During the second year there will be a floor of 80%.

4. Until 31 December 2016, the competent authorities of the Member States may exempt from the IRB treatment particular equity investments held at the time of application of this Directive. The exempted position is measured as the number of shares as of that date and any additional arising directly as a result of owning those holdings, as long as they do not increase the proportional share of ownership in a portfolio company. If an acquisition increases the proportional share of ownership in a specific holding (e.g., due to a change of ownership initiated by the investing company subsequent to the publication of the accord) the exceeding part of the holding will not be subject to the exemption. Nor will the exemption apply to holdings that were originally subject to the exemption, but have been sold and then bought back. Equity holdings covered by these transitional provisions will be subject to the capital requirements of the Standardised Approach.