EUROPEAN COMMISSION
Internal Market DG

REVIEW OF CAPITAL REQUIREMENTS FOR BANKS AND INVESTMENT FIRMS

COMMISSION SERVICES THIRD CONSULTATION PAPER

WORKING DOCUMENT

1 July 2003

Contents of Working Document

Please note that where numbered provisions are indicated to be 'blank' this is due simply to the structural approach adopted in developing the legislative instrument. Unless otherwise indicated, there is no substantive significance to this.

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WORKING DOCUMENT - PART ONE

Draft proposed risk-based capital requirements

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’ shall mean credit institutions and investment firms;

(2) ‘financial institutions’ shall mean financial institutions as defined in Article 1(5) of Directive 2000/12/EC;

(3) 'credit institution' shall mean a credit institution within the meaning of Article 1(1) of Directive 2000/12/EC;

(4) 'investment firm' shall mean an investment firm within the meaning of Article 1(2) of Directive 93/22/EEC, excluding local firms as defined in Article 2(20) of Directive 93/6/EEEC and firms which only receive and transmit orders from investors without holding money or securities belonging to their clients and which for that reason may not at any time place themselves in debit with their clients; and for the purpose of applying supervision on a consolidated basis shall include undertakings referred to in Article 2(4) of Directive 93/6/EEC

(5) 'asset management company' shall mean a management company within the meaning of Article 1a(2) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as amended, an undertaking the registered office of which is outside the Community and which would require authorisation in accordance with Article 5(1) of that Directive if it had its registered office within the Community, a management company other than the aforementioned and other than an investment firm, whose principal activity is discretionary and non-discretionary asset management, on a client-by-client or collective basis;

(7) ‘ancillary services undertaking’ shall mean an undertaking the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more institutions

(8) 'insurance undertaking' shall mean an insurance undertaking within the meaning of Article 6 of Directive 73/239/EEC, Article 6 of Directive 79/267/EEC or Article 1(b) of Directive 98/78/EC;

(9) 'reinsurance undertaking' shall mean a reinsurance undertaking within the meaning of Article 1(c) of Directive 98/78/EC;

(10) 'insurance holding company' shall mean a parent undertaking, the main business of which is to acquire and hold participations in subsidiary undertakings, where those subsidiary undertakings are exclusively or mainly insurance undertakings, reinsurance undertakings, or non-member-country insurance undertakings, at least

one of such subsidiary undertakings being an insurance undertaking, and which is not a mixed financial holding company within the meaning of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate;

[(11)-(13) Blank]

(14) 'group' shall mean a group of undertakings, which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC;

(15) ‘subgroup’ shall mean any group as defined in point 14 of this Article which can be identified within a larger group as defined in point 14 of this Article;

(16) ‘group of institutions’ shall mean any group of undertakings which comprise at least two entities such as defined in points 1 or 2 or 5 of this Article of which at least one is an institution such as defined in point 1 of this Article;

(17) "close links" shall mean a situation in which two or more natural or legal persons are linked by:

(a) "participation", which shall mean the ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking; or

(b) "control", which shall mean the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1(1) and 1(2) of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings.

A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons;

(18) ‘subgroup of institutions’ shall mean any group of institutions as defined in point 14 of this Article which can be identified within a larger group of institutions as defined in point 14 of this Article;

(19) ‘parent undertaking’ shall mean a parent undertaking within the meaning of Article 1 of Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts as amended and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;

(20) ‘subsidiary undertaking’ shall mean a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC as amended and any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence; all subsidiary undertakings of subsidiary undertakings shall also be considered as subsidiary undertakings of the parent undertaking

(21) ‘financial holding company’ shall mean a financial institution, the subsidiary undertakings of which are either exclusively or mainly institutions or financial institutions, at least one of such subsidiaries being an institution, and which is not a mixed financial holding company within the meaning of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate[1];

(22) ‘participation’ shall mean a participation within the meaning of the first sentence of Article 17 of Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies as amended, or the direct or indirect ownership of 20 % or more of the voting rights or capital of an undertaking;

(23) 'parent undertaking institution' shall mean a parent undertaking as defined in point 19 of this article which is also an institution as defined in point 1 of this article; [(24-25) Blank]

[(24-25) Blank]

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

(26A) ‘Covered bonds’, shall mean bonds as defined in Article 22(4) of Directive 85/6111/EEC and collateralised by the following eligible assets:

- Exposures to sovereigns, central banks, multilateral development banks, international organisations, administrative bodies, non-commercial undertakings, regional governments and local authorities that qualify for the credit quality assessment step 1 under the standardised approach,

- exposures to institutions that qualify for the credit quality assessment step 1 under the standardised approach. The total exposure shall not exceed 5% of the nominal amount of outstanding covered bonds of the institution.

- loans secured by residential real estate where only liens that are combined with any prior liens within 80% of the market value of the pledged property.

- loans secured by commercial real estate where only liens that are combined with any prior liens within 60% of the market value of the pledged property. The competent authorities may recognise instruments as eligible where the LTV ratio of 60% is exceeded up to a maximum level of 70% if they are satisfied that there is an adequate level of overcollateralisation. In this case, the market value or, in the absence of a market value, the fair value of the total assets pledged as collateral for the covered bonds must exceed the nominal amount outstanding on the covered bond by at least

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8%, and the bondholders' claim must meet the legal certainty requirements set out in Section III. The bondholders' claim must take priority over all other claims on the collateral.

(27) 'eligible ECAI' means an external credit assessment institution that has been recognised as 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;

(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.

[(33)-(45) Blank]

(46) 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 (in the case of retail exposures institutions may apply this definition at an obligation level) 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. In the case of Retail and PSE exposures the competent authorities of the Member States shall set a number of days past due as specified in Annex D-5, paragraph 42. [Note. See also Article 146(1)]

The elements to be taken as indications of unlikeliness to pay are enumerated in Annex D-5, paragraph 43.

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

(48) 'PD' shall mean the probability of default of a counterparty over one year.

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

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

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

(52) ‘EAD’ shall mean the expected gross exposure of a facility upon default of the counterparty.

(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) and (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, Article 2 (17) and (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 by virtue of which the credit risk associated with a credit risk exposure or pool of credit risk exposures is tranched and

(a) payments in the transaction or scheme depend upon the performance of the credit exposure or pool of credit exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

(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.

In the context of a synthetic securitisation the retained exposure of the originating institution to the pool of assets securitised shall be deemed to represent a position or positions in the securitisation.

Securitisation positions include exposures to a securitisation arising from interest rate or currency derivative contracts. [Valuation to be in accordance with valuation rule prescribed under 'Thickness of exposure' paragraph in F7.]

(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) 'Credit enhancement' means contractual arrangement by which the credit quality of a position in a securitisation is improved in relation to what it would be if the enhancement was not provided. Credit enhancement includes the enhancement provided by more junior tranches in the scheme or other types of credit protection.

(91) Special purpose entity ('SPE'). A corporation trust or other entity, other than an institution, organised for a narrow and well-defined objective, in this case the

carrying on of a securitisation or securitisations, the activities of which are limited to those appropriate to accomplish [that objective], and the structure of which is intended to isolate the SPE and the credit risk of the originator from each other.

[(91)-(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.

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 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.

   [Subject to the rrespective of the amount of the capital requirement referred to in (a) to (e) the own-funds requirement for investment firms with limited licence falling under the categories mentioned in Annex H-1 shall never be less than the amount prescribed in Annex IV of Directive 93/6/EEC.]

Note: the above paragraph represents the text that would be introduced to implement the 'potential way forward' discussed in Section 14 of the CP3 Explanatory Document.

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.]

Concerning Article 5, see discussion in Section 3 of the CP3 Explanatory Document

[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 of institutions 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 subgroup of institutions 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 of institutions 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 to the institution which is the parent undertaking within a sub-group of institutions, Member States competent authorities may apply capital requirements to such an institution on an individual basis in accordance with provisions laid down in this Directive or in Directive 2000/12/EC except that the book value of any holdings, subordinated claims, and instruments referred to in Article 35 of Directive 2000/12/EC held in respect of institutions, financial institutions, asset management companies and ancillary services undertakings which would

otherwise be consolidated in accordance with the provisions of Articles 52 to 56 of Directive 2000/12/EC is deducted in full from the capital of that institution.

4. Institutions to which paragraph 3 of this Article applies must deduct, for the calculation of their individual capital requirements referred to in that same paragraph, the items referred to in points 12 to 16 of Article 34(2) of Directive 2000/12/EC which are held in institutions, financial institutions, asset management companies, and ancillary services undertakings, as well as in insurance undertaking, reinsurance undertakings, and insurance holding companies, except for the following:

   – where shares in another institution, financial institution, asset management company and ancillary services undertakings, as well as insurance or reinsurance undertaking or insurance holding company are held temporarily for the purposes of a financial assistance operation designed to reorganise and save that entity, the competent authority may waive the provisions on deductions referred to in points 12 to 16 of Article 34(2) of Directive 2000/12/EC.

   – as an alternative to the deduction of the items referred to in points 15 and 16 of Article 34(2) of Directive 2000/12/EC, Member States may allow their institutions to apply *mutatis mutandis* methods 1, 2, or 3 of Annex I to Directive 2002/87/EC. Method 1 (Accounting consolidation) shall only be applied if the competent authority is confident about the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The method chosen shall be applied in a consistent manner over time.

Article 19

Ancillary services undertakings

When capital requirements apply on a consolidated or sub-consolidated basis in accordance with Articles 17 or 18 of this Directive, ancillary 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 of institutions or within a group of institutions

1. Competent authorities may provide that, for the calculation of individual capital requirements, the parent undertaking institution within a sub-group of institutions 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 institutions, financial institutions, asset management companies and ancillary services undertakings 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 institutions, financial institutions, asset management companies and ancillary services undertakings 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 provided that:

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

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

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

   (d) no investment firm within the group of institutions 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 of institutions holds clients' money or securities.

   (f) the funds of the group of institutions 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 of institutions 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 services undertakings in accordance with Articles 52 to 56 of Directive 2000/12/EC;

   (h) financial institutions and ancillary 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 of institutions has in place systems to monitor and control the sources of capital and funding of all other financial holding company, financial institutions and ancillary services undertakings within the group.

[Articles 22-24 Blank]

Title II – Minimum Capital Requirements

Chapter 1 – Credit Risk

Article 25

Methodology to be adopted

To determine the total amount of risk weighted assets for the purposes of 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 methodologies prescribed in Section 2. Where an institution is permitted to use the methodologies prescribed in Section 2, it shall not use the methodology prescribed in Section 1 except insofar as permitted by the provisions of Section 2.

SECTION I – STANDARDISED APPROACH

Subsection 1 - Determination of risk weighted assets

Article 26

Exposure values for asset and off-balance sheet items

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 item its relevant value determined according to Annex C-3 shall be taken as the exposure value of the item.

3. Without any prejudice to the provisions of paragraph 1 and 2, if an eligible funded credit risk protection exists for an item according to the provisions of Section 3 of this Chapter and that effect of that protection is calculated using the Financial Collateral Comprehensive method, the exposure value applicable to that item shall be modified according to the provision of that Section.

Article 27

Classes of items

1. With the exception of items representing securitisation positions as described in Section IV of this Chapter, every asset and off-balance sheet items shall be assigned to one of the following classes:

   (i) items constituting claims on central governments 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;

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

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

(x) past due items;

(xi) items constituting covered bonds

(xii) items constituting securitised exposures

(xiii) items constitution securitisation positions

(xiv) items belonging to regulatory high-risk categories

(xv) other items;

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

- The exposure must be either to an individual person or persons, or to a small business;
- The exposure must take the form of any of the following: revolving credits and lines of credit such as credit cards and overdrafts, personal term loans and leases, instalment loans, mortgage loans, auto loans and leases, student and educational loans, personal finance and small business facilities and commitments;
- Competent authorities must be satisfied that the exposures included in the regulatory retail portfolio are such that the portfolio is sufficiently granular to substantially reduce its risks.
- The aggregated claim to any group of counterparties that can be considered as a single beneficiary, including any past due claim, must not exceed an absolute threshold of EUR 1 million or such other amount reflecting the effects of inflation as may be prescribed in Annex C.

Securities are not eligible for the regulatory retail portfolio.

Article 28

Risk weights

1. As specified in Annex C-1, asset and off-balance sheet items belonging to one of the classes (i) to (xiii) specified in Article 27 are, unless deducted from own funds, 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 the first indent of the previous paragraph, credit quality can be determined:

   - from the credit assessments of nominated External Credit Assessment Institutions (ECAIs) by the use of a credit quality assessment scale with 6 steps;

   - from the credit assessments of recognised Export Credit Agencies (ECAs) or from appropriate consensus risk scores of ECAs participating in appropriate arrangements " by the use of a credit quality scale with 7 steps as shown in Annex C-1.

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

Article 29

Determination of risk-weighted asset amounts

1. Any asset and off-balance sheet item exposure value shall be multiplied by the applicable risk weight as determined by the provision of Article 28 and Annex C-1 to produce its risk weighted asset amount.

2. Notwithstanding the provisions of paragraph 1, if an eligible unfunded credit risk protection exists for an item according to the provisions of Section III of this Chapter or an eligible funded credit protection the effect of which is calculated using the Financial Collateral Simple method or using a guarantee treatment, the percentage risk weight applicable to that item may be determined according to the provisions of that Section.

Subsection 2 – ECAIs credit assessments

Article 30

Use of eligible 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 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 must use them in a continuous and consistent way over time.

4 An institution can only use ECAIs credit assessments that take into account all amounts both in principal and in interest owed to it.

Article 31

Solicited and unsolicited credit assessments

1. Institutions shall use solicited credit assessments produced by eligible ECAIs. 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 a 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 shall 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, this 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 no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the claim does not belong, then:

- if the use of the existing credit assessment would determine for the unrated item 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 for the unrated item 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.

4. The provisions of paragraph 1, 2 and 3 of this Article do not prevent competent authorities from exercising their discretion regarding the treatment of all claims on institutions in accordance with one of the two methodologies described in paragraphs 6.3 and 6.4 of Annex C-1.

5. The provisions of paragraph 1, 2 and 3 of this Article are not to prevent the application of the provisions on covered bonds contained in paragraph 13 of Annex C-1.

6. Credit assessments for issuers within a corporate group cannot be used as credit assessment of another issuer within the same corporate group.

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 for any other item.

3. Notwithstanding 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 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 paragraph 1, 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, competent authorities may allow the credit assessment on the obligor’s domestic currency item to be used for risk weighting purposes.

Subsection 3 – Recognition of external credit assessment institutions and mapping of external credit assessment institutions credit assessments

Article 36

Recognition of eligible external credit assessment institutions

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

2. An external credit assessment institution may be recognised as eligible by the competent authorities for one or more of the item classes specified in Article 27.

3. Competent authorities shall ensure that the list of recognised external credit assessment institutions shall be publicly available.

4. Competent authorities shall make the process for recognising external credit assessment institutions public.

Article 37

Minimum principles for external credit assessment institutions methodology

Competent authorities will recognise an external credit assessment institution as eligible only if they are satisfied with the way in which the methodology followed by that external credit assessment institution 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 external credit assessment institutions credit assessments

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

1. Credibility and market acceptance

2. Transparency and disclosure

Article 39

Optional mutual recognition of external credit assessment institutions by Member States

When an external credit assessment institution has been recognised as eligible by the competent authorities of a Member State, the competent authorities of other Member

States may recognise as eligible that external credit assessment institution as eligible on that basis.

Article 40

Mapping

1. Competent authorities are responsible for mapping external credit assessment institutions credit assessments into the steps of the credit quality assessment scale specified in Article 28, paragraph 2, first indent.

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 Annex C-2.

4. When the competent authorities of a Member State have established the mapping of an external credit assessment institution's credit assessments, the competent authorities of other Member States may recognise that mapping.

[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 minimum 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 permission by the competent authorities of the use of the IRB Approach for supervisory capital purposes shall be required in the case of each institution.

2. Permission shall only be given if the competent authority is satisfied that the institutions risk-management system is conceptually sound and implemented with integrity and that, in particular, the following qualitative standards are met:

   - Internal ratings and default and loss estimates play an essential role in the credit approval, risk management, internal capital allocations, and corporate governance functions of the institution. Where institutions use different estimates for minimum regulatory capital and internal purposes it shall be documented and their reasonableness shall be demonstrated to the competent authority.

   - The institution has a credit risk control unit that is independent from the personal and management functions responsible for originating exposures and that reports directly to senior management. The unit shall be responsible for the design or selection, implementation, operation and performance of the institution's internal rating system and further areas set out in Annex D-5, paragraph 39. It shall produce and analyse daily reports on the output of the risk-measurement model and on the appropriate measures to be taken in terms of trading limits;

   - Institutions using the IRB Approach shall collect and store all relevant data to provide effective support to its internal credit risk measurement and management process. At a minimum, institutions shall store the data enumerated in Annex D-5, paragraphs 31-33. Institutions shall also collect and store data on aspects of their internal ratings as required under Title IV.

   - The institution meets the applicable minimum requirements in Annex D-5 at the outset and on an ongoing basis.

3. 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 in Section III of this Chapter.

4. Where an institution ceases to be in compliance with the requirements laid down in this Section, 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 47

Asset Classes

1. Exposures shall be categorised into seven asset classes - corporates, institutions, sovereigns, retail, equity, securitisation positions, and fixed assets - based on the exposure definitions set out in this Article. Exposures shall be categorised as corporate exposures if they do not fall within any of the other specified exposure classes.:

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

3. 'Sovereign exposure' shall mean a debt obligation of, and off-balance sheet exposures to 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.

4. 'Exposure to an institution' shall mean a debt obligation of, and off-balance sheet exposures to 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.

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 exposure is to an individual and secured by a residential structure with one living unit or a small number of living units (with the limit set at discretion of Competent authorities) or a small number of living units in a condominium or co-operative residential property.

   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 a small business borrower on a consolidated basis is less than € 1 million or such other amount reflecting the effects of inflation as may be prescribed in Annex D. 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 exposures, 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 identify separately three sub-asset classes: (a) exposures secured by residential mortgages as defined above, (b) qualifying revolving retail exposures, as defined in Annex D-1 and (c) all other retail exposures.

8. Within the corporate asset class, institutions shall identify separately 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 possesses all the following characteristics, either in legal form or by economic substance:

- the exposure 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 obligation, apart from the income that it receives from the asset(s) being financed;
- the terms of the obligation 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 obligation 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

Requirements for internal ratings systems

1. 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.

2. The requirements laid down 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.

Article 49

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 requirements in this Article. For the retail asset class this requirement applies on a basis of the three sub-asset classes. During the roll-out period no capital relief shall be 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 may remain on the Slotting Criteria Approach for one or more of its SL product lines, and move to the Foundation or Advanced IRB Approach for other product lines within the corporate asset class, subject to approval of the competent authorities.

3. 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 53.

4. 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.

5. 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.

6. 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 50

Combined use of methodologies

Institutions applying the IRB Approach for other asset classes can apply the Standardised Approach permanently for exposures to institutions and sovereign exposures, if they have a limited number of counterparties in these asset classes, subject to approval of the competent authorities.

Article 51

Exposures to corporates, institutions and sovereigns

1. Institutions shall estimate PDs from long run averages of one-year realised default rates for borrowers in a grade. The PD estimates shall meet the minimum requirements laid down in Annex D-5, Section 5.

2. For purchased corporate receivables which meet the criteria as set out in Annex D-1, paragraph 16 and hold permission from the competent authority to treat them on a pooled basis, institutions shall estimate EL of the pool(s). The EL estimates shall meet the minimum requirements laid down in Annex D-5, Section 5.

3. Institutions shall estimate EL for dilution risk of purchased corporate receivables. Depending on which Approach an institution applies estimates shall be derived on an individual receivables basis or on a pooled basis. The EL estimates shall meet the minimum requirements laid down in Annex D-5, Section 5. If institutions can demonstrate to the competent authorities that dilution risk is immaterial, it need not be recognised.

4. Institutions applying the Foundation IRB Approach shall use supervisory estimates of LGD and EAD , and recognise maturity as laid down in Annex D-3, paragraph 9. If required by competent authorities institutions shall recognise effective maturity as laid down in Annex D-3, paragraph 10.

5. Institutions applying the Advanced IRB Approach shall estimate a long run average LGD for each facility, estimate internal credit conversion factors (CFF) across different product types, and recognise effective maturity. LGDs shall be measured as the loss given default as a percentage of exposure at default. The LGD and CCF estimates shall meet the minimum requirements laid down in Annex D-5, Section 5.

6. The risk weighted asset amounts for exposures to corporates, institutions and sovereigns shall be calculated according to the methods laid down in Annex D-2, paragraph 1.

7. In the Foundation Approach, in the case of unfunded credit protection or funded protection to which a guarantee treatment is applied, risk weighted asset amounts shall be calculated in accordance with the provisions of Section III.

8. The risk weighted asset amounts for dilution risk of purchased corporate receivables shall be calculated according to the methods laid down in Annex D-2, paragraph 1.

9. For SL exposures the same rules as for corporate exposures shall apply. If an institution cannot demonstrate to the satisfaction of its competent authorities that their PD estimates for SL exposures meet the minimum requirements laid down in Annex D-5, Section 5 it shall use the Slotting Criteria Approach. Under the Slotting Criteria Approach institutions shall map their internal rating grades of these exposures to the supervisory risk weight categories laid down in Annex D-2, paragraph 2 - 3, based upon the slotting criteria provided in Annex D-7. Institutions shall demonstrate that the mapping process has resulted in an alignment of grades which is consistent with the preponderance of the characteristics in the respective supervisory risk weight category.

Article 52

Retail exposures

1. Institutions shall estimate PDs from long-run averages of one year default rates for exposures by a pool, long run average LGDs for each facility, and internal credit conversion factors (CFF) across different product types. The estimates shall meet the minimum requirements laid down in Annex D-5, Section 5. The risk parameters shall be estimated for each pool of retail exposures separately. Where an institution purchases retail receivables it shall also comply with the minimum operational requirements as laid down in Annex D-5, paragraphs 85-93.

2. Institutions shall estimate EL for dilution risk of purchased retail receivables pools subject to the minimum operational requirements as laid down in Annex D-5, paragraphs 85-93. If institutions can demonstrate to the competent authorities that dilution risk is immaterial, it need not be recognised.

3. The risk weighted asset amounts for retail exposures shall be calculated for every retail sub-asset class separately according to the methods laid down in Annex D-2, paragraphs 4-6. For purchased receivables belonging unambiguously to one of the sub-asset classes, the risk-weight functions for this sub-asset class shall apply. For hybrid pools containing mixtures of sub-asset classes where purchasing institutions cannot separate the exposures by sub-asset class, the risk weight function producing the highest capital requirements for those exposures shall apply.

4. The risk weighted asset amounts for dilution risk for purchased retail receivables shall be calculated according to the methods laid down in Annex D-2, paragraph 1.

Article 53

Equity exposures

5. EAD for equity exposures shall be determined as laid down in Annex D-4, paragraph 15.

6. Risk weighted asset amounts for equity exposures shall be calculated using one of the following approaches subject to approval of the competent authorities:

   a. The simple risk weight approach

   b. The internal model approach subject to the minimum requirements laid down in Annex D-5, paragraphs 102-112

   c. The PD/LGD approach

   Subject to approval of the competent authorities, an institution can employ different approaches to different portfolios where the institution itself uses different approaches internally. The competent authorities can require the use of any of these approaches based on the individual circumstances of an institution. Where an institution is permitted to use different approaches, the institution shall demonstrate to the competent authorities that the choice is made consistently and is not determined by regulatory arbitrage considerations.

7. Under the PD/LGD Approach institutions shall estimate PDs from long run averages of one-year realised default rates for borrowers in a grade PDs. The PD estimates shall meet the minimum requirements laid down in Annex D-5, Section 5 Institutions shall rely on supervisory estimates of LGD and use the maturity adjustment as laid down in Annex D-3, paragraph 23. The risk weighted asset amounts shall be calculated according to the methods laid down in Annex D-2, paragraph 1.

   In the case of unfunded credit protection or funded protection to which a guarantee treatment is applied, risk weighted asset amounts shall be calculated in accordance with the provisions of Section III.

   Under the Simple Risk Weight Approach, institutions shall use for the calculation of risk weighted assets the methods as laid down in Annex D-2, paragraphs 7-8 and 15. In the case of unfunded credit protection or funded protection to which a guarantee treatment is applied, risk weighted asset amounts shall be calculated in accordance with the provisions of Section III.

Under the Internal Models Approach, institutions shall use for the calculation of risk weighted asset amounts the methods as laid down in Annex D-2, paragraphs 13-14. [

Article 54

Securitised exposures and securitisation Positions

Risk weighted asset amounts for items which are either securitised exposures or securitisation positions shall be calculated in accordance with the provisions of Section IV.

Article 55

Fixed Assets

Risk weighted assets amounts for fixed assets should be calculated in accordance with the method laid down in Annex D-2 paragraph 16.

[Articles 56-65 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

(a) exposures the capital requirements in relation to which are determined under the Standardised Approach; and

(b) exposures the capital requirements in relation to which are determined under the IRB Foundation Approach, other than items the capital requirements in respect of which are determined under [the Specialised Lending Slotting Criteria Approach].

Article 67

Central 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 the right to liquidate or retain the assets from which the protection derives in a timely manner 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

Calculation of the effects of CRM

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.

Compliance with Title IV requirements

Placeholder for text making the availability of capital relief subject to compliance with the requirements of Title IV.

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

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, subject to the exception that where there is no specific IRB treatment for the underlying asset type an investing institution with approval to use the IRB approach for any exposure class shall use the IRB approach for its positions in the securitisation.

Article 82

Recognition of risk transfer by originators

Without prejudice to the minimum capital requirements imposed on the institution in respect of its securitisation positions, if any, in the securitisation, an originating institution may be permitted – to the extent prescribed in Annex F-2 or F-3 - to exclude from its minimum capital requirements calculations the credit risk exposures which are the subject of the securitisation, only where significant credit risk associated with those exposures has been transferred from the institution in accordance with the terms of Annex F-2 or F-3 as appropriate.

In the case of a failure to transfer significant credit risk the originating institution will not be required to hold capital against its positions in the securitisation in question.

Article 83

Eligibility of external credit assessment institutions for securitisation risk weighting purposes

A. Use of external credit assessment institutions' credit assessments for the determination of the risk weighted amounts of securitisation positions under the Standardised Approach and the Ratings Based Method of the IRB Approach.

1. An institution may nominate one or more external credit assessment institutions recognised by the competent authorities as eligible under paragraphs B below for the purposes of this Section - a 'nominated external credit assessment institution'. The relevant credit assessments of a nominated external credit assessment institution shall be used for the determination of the risk weighted amount of a securitisation position to the extent and in the manner prescribed in Annex F

2. For the purposes of this Section 'relevant credit assessment' means a credit assessment of a tranche of a securitisation which meets the requirements prescribed under Annex F-4 in relation to the public availability of the assessment and the aspects which it takes into account.

3. An institution using the relevant credit assessments of a nominated external credit assessment institution for the purposes of determining the risk weighted amounts of securitisation positions, must do so in a continuous and consistent manner as elaborated in Annex F-4.

4. If two or more relevant credit assessments are available from nominated external credit assessment institutions the mode of use shall be as prescribed in Annex F-4.

B. Recognition of external credit assessment institutions for the purposes of this Section

1. Competent authorities shall recognise an external credit assessment institution as eligible for the purposes of this Section only if

(i) they are satisfied that the methodology followed by the external credit assessment institution in the formulation of its credit assessments complies with the principles prescribed in Article 37 as elaborated in Annex C; and

(ii) they are satisfied that the external credit assessment institution's relevant credit assessments comply with the principles of credibility and market acceptance as elaborated in Annex F-4.

2. When an external credit assessment institution has been recognised as eligible for the purposes of this Section by the competent authorities of one Member State, the competent authorities of other Member States may recognise the external credit assessment institution as eligible for the purposes of this Section on the basis of the assessment performed by the competent authorities of the first Member State.

C. Mapping of relevant credit assessments

1. Competent authorities are responsible for mapping the relevant credit assessments of external credit assessment institutions recognised as eligible for the purposes of this Section into the steps of the credit quality assessment scales specified in Annex F-5 and F-6.

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 scales.

3. In order to differentiate between the relative degrees of risk expressed by each relevant credit assessment, competent authorities shall consider quantitative and qualitative factors as specified in Annex F-4.

4. When the competent authority of one Member State has established the mapping of an external credit assessment institution's relevant 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.

Article 84

Calculation of risk weighted asset amounts

1. As prescribed in Annex F, the risk weighted amount of a securitisation position shall be calculated having regard to

(a) the level of credit risk or potential credit risk associated with the securitisation position;

(b) the approach to the calculation of risk weighted amounts used by the institution;

(c) the difficulties in identifying with an appropriate level of certainty the risk associated with securitisation positions and the need to ensure sufficient levels of capital in such context;

(d) the need to prevent, insofar as possible, securitisation being used as a means of circumventing the capital requirements established under this Directive – so that any reduction in minimum capital requirements resulting from the securitisation of credit exposures should reflect a sufficiently certain reduction in the risk to which the institution is exposed.

2. The risk weighted amounts of securitisation positions shall be calculated as follows:

(a) For on-balance sheet securitisation positions the amount of the position shall be multiplied by a risk weight determined in accordance with the appropriate methodology as prescribed in Annex F-5 and F-6;

(b) For off-balance sheet securitisation positions the amount of the position shall be multiplied by a conversion factor as specified in Annex F-5 and F-6 and then by a risk weight determined in accordance with the appropriate methodology as prescribed in Annex F-5 and F-6;

(c) Credit protection acquired in respect of a securitisation position shall, subject to the eligibility and other requirements prescribed in Section III of this Chapter, be recognised as specified in Annex F.

Article 85

Capitalised assets

Originating institutions will be required to deduct the amount of any capitalised assets from original own funds.

Capitalised assets means any capitalised future income that is recorded as an on-balance sheet asset and has been recognised in regulatory capital.

Article 86

Revolving securitisations with early amortisation provisions

As prescribed in Annex F, originating institutions shall be required to hold capital against the risk, arising from revolving securitisations with early amortisation provisions, that the levels of credit risk to which it is exposed may increase following the operation of the early amortisation provisions.

Article 87

Implicit Recourse

An originating or sponsoring institution shall not provide support to the securitisation beyond its contractual obligations with a view to reducing potential or actual losses to investors.

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 88-95 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 with trading intent or in order to hedge other elements of the trading book, 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 in compliance with the requirements prescribed 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 systems and controls sufficient to provide valuation estimates that 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. This should notably cover:

– 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 102A

Internal hedges

In the case of internal hedges capital requirements shall be calculated in accordance with the terms of Annex G-5A

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

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 (that with the lowest specific risk capital requirement). 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) . If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection. In the case of *n*th to default credit derivatives protection buyers are allowed to off-set specific risk for *n-1* of the underlyings (i.e., the *n-1* assets with the lowest specific risk charge).

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 3.

5 Annex II (settlement and counterparty risk) [will be modified or repealed – to reflect the outcome of the issue discussed in Section 12 of CP3 Explanatory Document].

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.

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, section 4.

Article 110

Advanced measurement approaches

Competent authorities may authorise institutions to use advanced measurement approaches based on their own internal risk measurement system 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.

The internal risk measurement system must be consistent with the scope of operational risk defined in Article 106 and with the loss event types defined in Annex H-8.

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 different methodologies

Competent authorities may allow institutions to use a combination of the Basic indicator approach, the Standardised approach and Advanced measurement approaches under the conditions laid down in Annex H-5.

[*Article 112*

Specific provisions on operational risk for investment firms with limited licence

1. Subject to the competent authorities' discretion, investment firms with limited licence falling under the categories mentioned in Annex H-1 may be exempted from the individual capital requirement for operational risk established in Article 107 provided that these firms are required to provide own funds which are at all times more than or equal to the higher of the following two requirements:

   (a) the sum of the capital requirements mentioned in Article 3, letters a-d (credit and market risk), and

   (b) the amount prescribed in Annex IV of Directive 93/6/EEC (EBR).

2. These firms shall remain subject to all the other provisions regarding operational risk envisaged in the present Directive.

3. Subject to the competent authorities' discretion, investment firms with limited licence falling under the categories mentioned in Annex H-1 may be exempted from the consolidated capital requirement for operational risk established in Article 107 provided that all the investment firms in the group fall under the categories mentioned

in Annex H-1, and the group does not include credit institutions. When this occurs, the parent investment firm shall be required to provide consolidated own funds which are at all times more than or equal to the higher of the following two consolidated requirements:

(a) the sum of the capital requirements mentioned in Article 3, letters a-d (credit and market risk)

(b) the amount prescribed in Annex IV of Directive 93/6/EEC (EBR).

Article 113

Expenditure based Requirement

Subject to the competent authorities' discretion, the capital requirement established in Article 3, paragraph 1, second sub-paragraph (EBR), can be waived for investment firms that are authorised to use Advanced Measurement Approaches to calculate the capital requirement for operational risk according to Article 110. For these firms the capital charge for operational risk shall remain cumulative with the other capital requirements imposed in Article 3, paragraph 1.]

Note: the above draft Articles 112 and 113 represent the text that would be introduced to implement the 'potential way forward' discussed in Section 14 of the CP3 Explanatory Document.

Article 114

Reports by Member States

The competent authorities of each Member State shall regularly provide the Commission with information concerning the implementation of Articles 112 and 113.

[Article 115 Blank]

Title III – Supervisory Review Process

CHAPTER 1 – CONTROL ENVIRONMENT

Article 116

Assessment process

1. Competent authorities shall require each institution to have a sound, effective and complete process for assessing that it holds, on an ongoing basis, internal capital quantitatively and qualitatively adequate to cover the risks inherent in its activities.

2. The process referred to under paragraph 1 shall include the following components:
   (a) policies and procedures to identify, measure, and report the risks inherent in the institution's activities. At a minimum, the risks referred to under Annex I, Sections 2 to 9 shall be addressed, where applicable. Appropriate processes shall be developed to estimate the risks which cannot be measured precisely;
   (b) a process to relate the institution's internal capital to its risks;
   (c) a process to state the institution's goals in terms of adequate internal capital, taking account of the institution’s strategies and business plan;
   (d) a process of internal controls, reviews and audit.

3. Competent authorities shall require each institution to assess the adequacy of its internal capital pursuant to paragraph 1 having regard to the following factors:
   (a) appropriateness of the methodologies and requirements laid down under Title II to cover the institution's exposure to the risks contemplated under that Title;
   (b) exposure to risks not incorporated in the framework of Title II;
   (c) foreseeable effects on the institution of external factors, including the macroeconomic environment and the status of the business cycle.

4. The process referred to under paragraph 1 shall be comprehensive and ensure a full and timely coverage of the risks incurred by every part of an institution's organisation, as well as the risks related to outsourced functions.

5. Competent authorities shall require institutions to review their assessment process to correct any deficiencies promptly. The frequency of reviews shall be prudently determined by institutions in consideration of the risks involved and the frequency and nature of changes occurring in their operating environment.

Article 117

Management and coverage of risks

1. Competent authorities shall require institutions to lay down strategies for the management of the risks they incur. These strategies shall include limits to risk taking.

2. Competent authorities shall also require institutions to lay down a strategy for maintaining the adequacy of their risk coverage pursuant to Article 116.1 taking into account the objectives of their business plans.

[Articles 118-125 blank]

CHAPTER 2 – COMPETENT AUTHORITIES' EVALUATION PROCESS, INTERVENTION AND TRANSPARENCY

Article 126

Evaluation Process

(1) Competent authorities shall apply a process to each institution to review and evaluate on a systematic and consistent basis:

(a) the institution's exposure to risks referred to under Article 116.2(a);

(b) the adequacy and reliability of the assessment process in relation to the requirements laid down under Articles 116 and 117 and Annex I;

(c) the quantitative and qualitative adequacy of the institution's own funds and internal capital;

(d) the institution's ongoing compliance with the requirements and standards laid down in Titles II and IV for the use of specific techniques and access to advanced calculation methodologies;

(e) the institution's compliance with the other requirements laid down under this Directive.

(2) Competent authorities shall determine for each institution the frequency, intensity and scope of the evaluation process referred to under paragraph 1 having regard to systemic importance, nature, scale and complexity of the activities of the institution concerned.

(3) Competent authorities shall review the results of the evaluation process referred to under paragraph 1 at least annually and consider the need to carry out the evaluation process on an institution, or to review the most recent one, as soon as they get any new information which may significantly impact on that institution.

(4) Based on the analysis and results of the evaluation process, the competent authorities shall assess whether any weaknesses or inadequacies are identified or can be anticipated at the institution concerned.

Article 127

Competent authorities' powers

(1) Member States shall empower the competent authorities to require any institution to take a range of prudential measures based on the analysis and results of the evaluation process referred to under Article 126.

(2) At a minimum, the prudential measures referred to under paragraph 1 shall include the obligation to hold own funds in excess of the minimum level laid down under Article 3 and those listed in Annex J, Section 2.

(3) Member States shall empower the competent authorities 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.

Article 128

Prudential measures and intervention

(1) Competent authorities shall require from any institution appropriate prudential measures at an early stage with the objective of preventing the adequacy of own funds of that institution from falling below the minimum levels necessary to support its risk and control characteristics.

(2) A specific own funds adequacy requirement shall be imposed by the competent authorities at least on those institutions whose inadequacy in the level of own funds in relation to the exposure to risk and the effectiveness of the control environment is unlikely to be rectified within an appropriate timeframe solely through the application of other prudential measures.

(3) Competent authorities shall consider requiring the more prescriptive prudential measures if the institution concerned does not timely and effectively comply with the required measures.

(4) 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.

(5) Competent authorities shall monitor the adequacy of the own funds held by institutions in respect of individual securitisation transactions. This shall be aimed at ensuring that institutions hold appropriate own funds in respect of securitisation transactions having regard to the economic substance of the transaction and the risks arising. Aspects to be considered in determining whether additional own funds are required to be held include those prescribed in Annex J, Section 4.

Article 129

Transparency and accountability

(1) The general criteria and methodologies used by the competent authorities in the evaluation process referred to under Article 126 shall be publicly available.

(2) At a minimum, the analysis and results of the evaluation process shall be communicated by the competent authorities to the institutions which are required to take prudential measures pursuant to Article 128.

(3) Requirements to hold an amount of own funds higher than that prescribed in Article 3 shall not be published.

Title IV – Market Discipline

Article 136

Disclosure requirements

1. For the purposes of this Directive, competent authorities shall require the entities set forth in Article 137 to publicly disclose the information laid down in Annex L-2, subject to the provisions laid down in Article 138.

2. Competent authorities shall also require the entities set forth in Article 137 to adopt a formal policy to comply with the disclosure requirements set forth in paragraph 1 and have policies for assessing the appropriateness of their disclosures, including validation and frequency of them.

3. Recognition by the competent authorities under Title II of the instruments and methodologies referred to in Annex L-3 shall be subject to the public disclosure by the entities set forth in Article 137 of the information laid down in that Annex.

Article 137

Entities subject to disclosure requirements

1. For the purposes of this Directive, competent authorities shall require the institutions not included within a group to disclose the information laid down in Article 136 on an individual basis.

2. Competent authorities shall require the parent undertakings within a group to disclose the information laid down in Article 136 on a consolidated basis.

3. Competent authorities shall also require the parent undertakings within a group to disclose any 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 may partially or completely exempt the entities set out in paragraphs 1 and 2 from the disclosure requirements set forth in Article 136 if those entities are included within equivalent disclosures provided at a group level by a parent undertaking established outside the EU.

Article 138

Derogations to the disclosure requirements

1. Notwithstanding Article 136, competent authorities shall permit the entities set forth in Article 137 not to make one or more disclosures listed in Annex L-2 if the entity concerned considers that the information provided by such disclosures

would not be material in the light of the criterion set forth in Annex L-1, paragraph 1.

2. Notwithstanding Article 136, competent authorities shall also permit the entities set forth in Article 137 not to publish one or more items of information included in the disclosures listed in Annexes L-2 and L-3 if the entity concerned considers that those items would include proprietary or confidential information in the light of the criteria set forth in Annex L-1, paragraphs 2 and 3.

3. In the exceptional cases referred to under paragraph 2, the entity concerned shall state in its disclosures the fact that, and the reason why, the specific items of information are not disclosed, and publish more general information about the subject matter of the disclosure requirement.

Article 139

Frequency of disclosures

1. Competent authorities shall require the entities set forth in Article 137 to publish the disclosures required under Article 136 on an annual basis at a minimum.

2. Competent authorities shall also require the entities set forth in Article 137 to determine whether a frequency higher than that laid down in paragraph 1 is necessary in the light of the criteria set out in Annex L-1, paragraph 4.

Article 140

Medium and location of disclosures

Competent authorities shall permit the entities set forth in Article 137 to determine the appropriate medium and location to effectively comply with the disclosure requirements set forth in Article 136. Equivalent disclosures made by those entities under accounting, listing or other requirements may be relied upon for compliance with Article 136, subject to the criteria laid down in Annex L-1, paragraph 5.

Article 141

Competent authorities overriding powers

Notwithstanding the Articles 138 to 140, Member States shall empower competent authorities to require the entities set forth in Article 137:

(a) to make one or more disclosures among those referred to in Annexes L-2 and L-3;

(b) to publish one or more disclosures more frequently than annually, and

(c) to use specific media and locations for disclosures.

[Articles 142-145 Blank]

Title V – Powers of Execution

Article 142

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 143-145 – Blank]

Title VI – Transitional and Final Provisions

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 shall abide by under the definition of default set out in Article 1, paragraph 46 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 shall fall within 90 days and the figure, the 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:

   - 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 institutions shall 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 an institution shall demonstrate it has been using a rating system that was broadly in line with the minimum requirements articulated in this Directive for at least three years prior to qualification.

   - The applicable aforementioned transitional arrangements also apply to the PD/LGD Approach to equity.

   Under these transitional arrangements 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.

3. Until 31 December 2009 LGDs for retail exposures secured by residential properties cannot be set below 10% for any sub-segment of exposures to which

the formula in Annex D-2, paragraph 4 is applied. The 10% LGD floor shall not apply to exposures that are subject to/benefit from sovereign guarantees.

4. Institutions adopting the Foundation and/or Advanced IRB Approach shall calculate their minimum regulatory capital requirements for this Directive in parallel with the Directive 2000/12 for 2007 and 2008. During 2007, for these institutions capital requirements resulting from the IRB treatment shall be subject to a floor of 90% of the institution's capital requirements that would result under Directive 2000/12. During 2008 the floor shall be 80%.

5. 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 the exceeding part of the holding shall not be subject to the exemption. Nor shall 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 shall be subject to the capital requirements of the Standardised Approach.