

**KINGDOM OF SAUDI ARABIA**

**Capital Market Authority**

**Prudential Rules**

Issued by the Board of the Capital Market Authority

Pursuant to Resolution No. [       ]

dated [       ] (corresponding to [       ])

based on the Capital Market Law

issued by Royal Decree No. M/30

dated 2/6/1424AH

**English Translation of the Official Arabic Text**

**Arabic is the official language of the Capital Market Authority**

**The current version of these Rules, as may be amended, can be found aton  
the CMA website: [www.cma.org.sa](http://www.cma.org.sa)**

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## **PART 1: INTRODUCTION**

### Chapter 1. Scope, Purpose and Definitions

#### **Article 1:**

- a. The purpose of these Rules is to specify the requirements for the authorised persons' financial prudence.
- b. The authorised persons shall comply with the provisions set forth in these Rules.
- c. These Rules shall be read in conjunction with all Implementing Regulations.
- d. The Authority, if it deems necessary, may impose additional requirements to authorised person' financial prudence.
- e. Definitions:
  - 1) Any reference to the "Capital Market Law" in these Rules shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.
  - 2) Expressions and terms in these Rules have the meaning which they bear in the Capital Market Law and in the Glossary of defined terms used in the Regulations and Rules of the Capital Market Authority, unless otherwise stated in these Rules.
  - 3) For the purpose of implementing these Rules, the following expressions and terms shall have the meaning they bear as follows unless the contrary intention appears:

**Revaluation reserve:** a reserve account considered as a part of an authorised person's Tier-2 capital, that records the surplus created when a revaluation finds that the current value of an asset is higher than its recorded historical cost.

**Internal hedge:** is the position that completely or materially offsets the risk in one or more positions assigned to trading and non-trading activities.

**Exposures:** items reported as assets in the balance sheet, derivatives reported as liabilities or off-balance sheet commitments.

**Large exposures:** an exposure to a counterparty or group of connected counterparties that exceeds 10% of the authorised person's capital base.

**Trading book:** is the accounting book for the positions held with trading intent.

**Commodities:** food, metal, natural resources or other fixed physical substances in which contracts for future delivery are presently or in the future dealt in.

**Tier-1 Capital:** is the most loss-absorbing form of capital, which includes (i) paid-up capital, (ii) audited retained earnings, (iii) share premium, (iv) reserves (other than revaluation reserves), (v) Tier-1 Capital contributions. Tier-1 Capital is the net figure after applicable deductions.

**Tier-2 Capital:** is a less loss-absorbing form of capital compared to Tier-1 Capital. Tier-2 Capital is the net figure after applicable deductions.

**Internal Capital Adequacy Assessment Process"ICAAP":** an internal process in which all the authorised person's risks are identified and assessed, including risks not captured in Pillar 1 of these rules. The process also includes capital planning.

**Capital base:** the capital base is comprised of Tier-1 capital and Tier-2 capital.

**Subordinated loans:** a loan with conditions stating that in the event of liquidation or bankruptcy, the principal of the loan and its interest, shall not be paid until all other creditors have been paid in full.

**Perpetual subordinated loan:** Subordinated loans with no fixed term.

**Fixed-term subordinated loan:** Subordinated loans with a fixed term. This also includes fixed term promissory notes.

**Group of connected counterparties:** two or more natural or legal persons who, unless otherwise shown, constitute a single risk because:

1. One of them, directly or indirectly, has control over the other or others in the group; or
2. They are so interconnected in a way that if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties.

**Financial Group:** a financial group comprises an authorised person and:

1. The authorised person's local and foreign subsidiaries that are regulated by these Rules or by similar rules;
2. Companies with which the authorised person has a joint, or essentially joint, management or exercises a significant influence over; and
3. Private equity investments in which the authorised person owns a majority of the voting rights.

And for the purposes of these Rules, the authorised person's parent bank shall not be included in financial groups.

**Credit risks:** risk of loss resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which authorised persons are exposed.

**Market risk:** risk of loss resulting from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments.

**Positions held with trading intent:** are those positions that are 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.

**Position:** the authorised person's own market position and market position that derive from its activities on behalf of clients or as a market maker.

**Non-trading activities:** the positions that are held for non-trading purposes.

**Risk-weight:** a percentage that describes a risk level of an exposure.

## **PART 2: CAPITAL BASE**

### Chapter 2. The capital base requirement

#### **Article 2:**

An authorised person shall continuously possess a capital base which corresponds to not less than the total of the minimum capital requirements in accordance with Chapter 4 to Chapter 16.

#### **Article 3:**

- a. The Authority may decide that an authorised person's capital base shall be of certain minimum amount, higher than stated in Article 2 of these Rules, where:
  1. The authorised person does not fulfill the requirements in Pillar I, II or III; and
  2. It is unlikely that any other measure is sufficient in order to cause the authorised person to rectify the deficiencies within a reasonable period of time.
  
- b. Paragraph (a) of this Article shall not apply where the violation of these Rules is of such degree that the authorised person's license instead should be suspended or revoked as decided by the Authority.

### Chapter 3. Composition of capital

#### **Article 4:**

The capital base of an authorised person shall comprise the total of:

1. Tier-1 capital calculated according to Chapter 1 of Annex 1 after applying the deductions according to Chapter 3 of Annex 1, plus
2. Tier-2 capital calculated according to Chapter 2 of Annex 1 after applying the deductions according to Chapter 3 of Annex 1.

#### **Article 5:**

Tier-2 capital shall only be allowed up to an amount corresponding to 50% of Tier-1 capital in the calculation of the capital base for an authorised person.

## **PART 3: PILLAR I – MINIMUM CAPITAL REQUIREMENTS**

### Chapter 4. General provisions for the trading book

#### **Article 6:**

The authorised person shall apply the rules regarding trading book exposures when calculating the risk associated with an authorised person's positions or as a market maker in securities which:

1. The authorised person holds with trading intent or in order to hedge other positions in the trading book; or
2. Are not subject to terms and conditions that limit the possibility to trade in them or, if they are subject to such terms and conditions, can be completely hedged.

#### **Article 7:**

Capital is required for trading book exposures which amounts to the total of the capital requirements for:

1. Counterparty risks for trading book exposures;
2. Settlement risks for trading book exposures;
3. Market risk (that is the risk of market price movements) for trading book operations;  
and
4. Foreign exchange risks and commodity risks in the entire operations.

**Article 8:**

The capital requirement for trading book exposures shall be calculated in accordance with Chapter 4 to Chapter 5 and Annex 2, unless otherwise provided in a decision by the Authority pursuant to Article 9 of these Rules.

**Article 9:**

- a. For such trading book exposures as referred to in Article 6 of these Rules, an authorised person may, pursuant to authorization by the Authority, calculate the capital requirement in accordance with the rules for non-trading activities as defined in Chapter 6 to Chapter 8. Authorization shall be granted by the Authority where the total market value of the positions in the trading book and receivables attributable thereto:
- 1) Normally does not exceed 5% of the sum of the authorised person's balance sheet total and total off-balance sheet commitments;
  - 2) Normally does not exceed an amount equivalent to SAR 75 million; and
  - 3) On no occasion exceeds 6% of the sum of the authorised person's balance sheet total and total off-balance sheet commitments, nor exceeds an amount equivalent to SAR 100 million.
- b. Where an authorised person that has been granted authorization pursuant to paragraph (a) of this Article no longer fulfills the requirements for the authorization, such authorised person shall calculate the capital requirement in accordance with Article 8 of these Rules and immediately notify the Authority thereof.

**Article 10:**

When calculating the values that form the basis for the granting of exceptions in accordance with Article 9 of these Rules, all items on the balance sheet that are assigned to the trading book are to be valued at their market value. Items on the balance sheet assigned to non-trading activities are to be valued at their book value. Off-balance sheet items and off-balance sheet commitments are to be valued at their market value. The authorised person's trading book positions shall be aggregated irrespective of whether they are long or short term.

**Article 11:**

- a. Internal hedges can be assigned to the trading book in accordance with the conditions contained in Article 12 of these Rules.
  
- b. The capital requirement for the position assigned to non-trading activities, which is the position to be protected, is not affected by an internal hedge being assigned to the trading book.

**Article 12:**

In order for an internal hedge position to be assigned to the trading book, the following conditions shall be met:

- 1) The position shall be held with trading intent in accordance with Article 6 of these Rules;
- 2) The primary reason for the position must not be to avoid or reduce the capital requirement;
- 3) The position shall have been entered into on market conditions;

- 4) The position shall be valued according to the rules applicable to other trading book exposures; and
- 5) The risk of the position shall be managed and monitored in the same way as other trading book positions and within the set limits.

**Article 13:**

- a. Any positions and exposures not assigned to the trading book according to the provisions set out in Article 6 of these Rules shall be classified as a non-trading activities exposure.
- b. A position in an individual financial instrument or a commodity cannot be assigned to both the trading book and non-trading activities at the same time. However, the same types of financial instruments or commodities may appear in both the trading book and non-trading activities.

**Article 14:**

Receivables and liabilities in the current trading account arising in conjunction with trades in the name of the authorised person but on behalf of a client, that is commission transactions, shall be treated in the context of capital adequacy when calculating the capital requirement in the same way as exposures pursuant to the rules on settlement risks and counterparty risks.

**Article 15:**

- a. The authorised person shall establish a written policy that shows which financial instruments/commodities or portfolios of such financial instruments/commodities are

to be assigned to the trading book and non-trading activities respectively. The written policy shall also indicate in which circumstances internal hedges are permitted.

- b. The intent of the holding of a financial instrument or commodity shall be established by the date of acquisition at the latest. Deviation from the written policy stated in paragraph (a) of this Article is only permitted under the circumstances contained in Article 16 of these Rules.
- c. If the authorised person has an internal audit function, this internal audit function shall regularly review the compliance with the written policy.

**Article 16:**

Transfers of financial instrument or commodity from the trading book to non-trading activities and vice versa shall only occur in exceptional cases and where there is specific cause, in accordance with a written policy established by the authorised person. This written policy shall show how completed transfers are to be documented and which criteria shall be met to allow transfers between the trading book and non-trading activities.

Chapter 5. Management requirements for the trading book

**Article 17:**

An authorised person with a trading book shall comply with the provisions in this Chapter.

**Article 18:**

An authorised person shall have a written trading strategy for positions held with trading intent and have robust and well-documented control processes in place to ensure compliance with the set trading strategy. The authorised person's governing body shall approve the strategy.

**Article 19:**

An authorised person shall have clear procedures for the management of trading book positions. These procedures shall be set out in a written policy, which as a minimum shall include the following:

- 1) Trading limits and procedures for monitoring;
- 2) To what extent dealers have the autonomy to enter into/manage the position within agreed limits and according to the agreed strategy;
- 3) Clearly defined procedures for monitoring risk-taking activities against set trading strategy mentioned in Article (18) of these Rules, including monitoring of turnover and stale positions in the trading book; and
- 4) Procedures for actively monitoring the positions and assessing the marketability or hedgeability of the position.

**Article 20:**

- a. An authorised person shall have procedures and control systems that ensure that the values of trading book positions correspond to their current market values.

- b. If the relevant market provides easily accessible closing prices independent of the authorised person, these shall be used to value positions. This type of valuation is referred to as marking-to-market.
- c. Where the valuation mentioned in paragraph (b) of this Article is not possible, the authorised person may use a mark to model valuation, which is a valuation that is derived from market prices or other market parameters.

**Article 21:**

An authorised person shall specify in its written policy:

- 1) Valuation principles that the authorised person shall apply for the trading book positions;
- 2) From where the market prices and other market parameters that may be needed for the valuation shall be acquired, and when this shall be carried out;
- 3) Controls to verify that the market prices and other market parameters used in the valuation are correct;
- 4) How any adjustments to the market prices and market parameters are carried out; and
- 5) How responsibility for the various steps in the valuation process is distributed within the authorised person.

**Article 22:**

The unit within the authorised person responsible for controlling market prices and other market parameters shall be independent of the position-taking units. Controls of market prices and market parameters shall occur regularly, at least once every month.

## Chapter 6. General provisions for non-trading activities

### **Article 23:**

For positions relating to non-trading activities, capital is required which corresponds to not less than 14% of the authorised person's risk-weighted exposure amounts calculated in accordance with Annex 3.

## Chapter 7. Calculating a risk-weighted exposure amount for non-trading activities

### **Article 24:**

For each exposure, the risk weighted exposure amount shall be calculated by multiplying the exposure amount in accordance with Article 25 of these Rules by the risk weight that applies for that exposure, as set out in Annex 3.

### **Article 25:**

- a. The exposure amount for items on the balance sheet shall be the value net of write offs and specific provisions.
- b. When calculating the capital requirement for risks in non-trading activities, exposures may only be netted in those cases set out in Section 11 to Section 13 of Annex 3. This applies irrespective of what applies to external accounting.
- c. The exposure amount for off-balance sheet commitments shall consist of the nominal amount multiplied by a conversion factor as set out in Chapter 2 of Annex 3.

- d. The exposure amount for counterparty risk in derivatives shall be calculated in accordance with Chapter 3 of Annex 3.
- e. For counterparty risk in derivatives, repurchase transactions, margin lending transactions and securities lending and borrowing transactions, the exposure amount may be set to 0 (zero) if the following requirements are met:
  - 1) The exposures shall be to a central clearing organization;
  - 2) Participants in the clearing organization shall post collateral on a daily basis for the exposure they represent to the clearing organization; and
  - 3) The collateral shall cover both current exposure and any potential future exposure.

**Article 26:**

Each non-trading activities exposure shall be assigned to one of the following exposure classes:

- 1) Exposures to governments and/or central banks;
- 2) Exposures to administrative bodies and non-profit organizations;
- 3) Exposures to authorised persons, banks and foreign equivalents that are subject to capital adequacy rules similar to those applied in the Kingdom;
- 4) Exposures to corporates;
- 5) Retail exposures;
- 6) Past due items;
- 7) High-risk items;
- 8) Exposures to investment funds;

- 9) Exposures to real estate funds;
- 10) Real estate investments; or
- 11) Other items.

**Article 27:**

Sales and repurchase agreements and outright forward purchases shall be assigned to the exposure class that applies to the assets in question and not to the counterparty.

**Article 28:**

Exposures that are deducted from capital base shall, regardless of which exposure class they are assigned to, be assigned a 0% risk weight in calculations of risk-weighted exposure amounts.

**Article 29:**

- a. An authorised person's risk-weighted exposure amounts for exposures to its subsidiaries, regardless of which exposure class they are assigned to, be assigned a risk-weight of 0%, if the following requirements are fulfilled:
  - 1) The counterparty is another authorised person which is fully consolidated in the same financial group as the authorised person;
  - 2) The counterparty is subject to the same risk evaluation, measurement and control procedures as the authorised person; and
  - 3) There are no current or foreseen material practical or legal impediments to the prompt transfer of capital or repayment of liabilities from the counterparty to the authorised person.

- b. The exceptions to the approach provided in paragraph (a) of this Article are equity exposures or exposures in the form of other items that can be included in the issuing authorised person's capital base.

**Article 30:**

When calculating a risk-weighted exposure amount for an exposure, the authorised person may take into account any credit protection in accordance with Chapter 4 of Annex 3.

Chapter 8. Use of credit ratings

**Article 31:**

- a. An authorised person may use credit ratings to determine which credit quality step an exposure corresponds to. To determine this, the authorised person shall use the correspondence tables in Annex 11 and Annex 12 between the credit rating agency's credit ratings and the steps in the credit quality scales determined by the Authority.
- b. An authorised person may only use credit ratings from credit rating agencies that are supervised by the Authority or by an equivalent authority. This applies to credit ratings carried out on the initiative of the credit rating agency itself, and to credit ratings carried out at the behest of borrowers or other interested parties.

**Article 32:**

When determining the risk weight of an exposure, credit ratings shall be used consistently and continuously. Credit ratings may not be used selectively.

**Article 33:**

An authorised person which uses credit ratings for a particular exposure category shall use these credit ratings consistently for all exposures belonging to that category.

**Article 34:**

An authorised person may only use credit ratings that take into account all amounts, that is principal and interest amounts, included in the authorised person's exposure.

**Article 35:**

If two or more credit ratings are available for one exposure and they correspond to different credit quality steps, the step that corresponds to the highest risk weight shall be applied.

**Article 36:**

If a credit rating exists for a specific issuing program or a facility to which the exposure belongs, this credit rating shall be used to determine the exposure's credit quality step.

**Article 37:**

- a. If an credit rating which can be applied directly to a particular exposure is not available but a credit rating exists for a specific issuing program or a facility to which the exposure does not belong, this credit rating shall be used if:
  - 1) It produces a lower credit quality step than would otherwise apply; or
  - 2) It produces a better credit quality step and the relevant exposure is ranked equal to the issuing program, facility or unsecured exposures of the issuer.

- b. Paragraph (a) of this Article applies even if a general credit rating is available for the issuer.

**Article 38:**

Credit ratings for an issuer within a group may not be used as a credit rating for another issuer within the same group.

**Article 39:**

A credit rating for an exposure denominated in the counterparty's domestic currency may not be used to determine the credit quality step for another exposure, to the same counterparty, denominated in another currency.

**Article 40:**

Short-term credit ratings may be used for short-term exposures to authorised persons and corporates. An authorised person may only use a short-term credit rating for the specific exposure to which it refers. The credit rating may not be used to derive the credit quality step of other exposures.

Chapter 9. General provisions regarding operational risks

**Article 41:**

For operational risks, capital is required which is calculated in accordance with any of the approaches stated in Chapter 10 or Chapter 11. However, the capital requirement for operational risks shall correspond to not less than 25% of the authorised person's overhead expenses calculated in accordance with

Chapter 12.

Chapter 10. The basic indicator approach for operational risk

**Article 42:**

The capital requirement for operational risk under the basic indicator approach is equal to 15% of the income indicator calculated in accordance with Annex 4.

Chapter 11. The standardized approach for operational risk

**Article 43:**

After permission from the Authority, an authorised person may calculate the capital requirement for operational risk in accordance with the standardized approach according to Article 44 of these Rules rather than the basic indicator approach.

**Article 44:**

In order to calculate the capital requirement in accordance with the standardized approach, the following requirements must be met.

- 1) The authorised person shall have written policies approved by the governing body for management and assessment of its exposure to operational risks, including extreme events with significant impact on the activities of an authorised person. In addition to stating the authorised person's applied definition of operational risk, the written policies shall state which forms of operational risk are relevant in the operations;

- 2) The authorised person shall have processes for handling its exposure to operational risks;
- 3) The authorised person shall have contingency and business continuity plans in place to ensure its ability to operate on an on-going basis and limit losses in the event of a severe business disruption;
- 4) The authorised person shall have documented risk management for operational risks with a clear allocation of responsibilities. The authorised person shall identify and assess its exposure to operational risks and track relevant data in an organized and structured manner. The risk management shall be regularly subject to an independent review;
- 5) The operational risk management shall be part of the authorised person's risk management process. The risk management outcome shall be an integral part of the monitoring and control of the authorised person's operational risk profile;
- 6) The authorised person shall have an internal reporting structure for operational risks reaching the governing body that provides operational risk reports to relevant authorised person functions. Procedures shall be in place to take appropriate action according to the information in these reports; and
- 7) The authorised person shall have written policies and documented criteria for assigning operations and the income indicator to the appropriate business lines. These written policies and criteria shall be regularly reviewed by an independent review function. The criteria shall be updated regularly and adjusted for new and changing business lines, products and risks. The CEO of the authorised person shall approve that written policy.

**Article 45:**

The authorised person's operations shall be divided into business lines in accordance with Annex 4. The capital requirement for each such line is calculated using the income indicator multiplied by the percentage that applies for each business line in accordance with Annex 4.

Chapter 12. Expenditure-based approach for operational risk

**Article 46:**

- a. When calculating capital requirements for expenditure-based risks, all overhead expenses except extraordinary expenses (such as write-offs) shall be included.
- b. If the authorised person has operated for less than one year, expenditure-based risks shall be calculated as 25% of the overhead expenses set out in the business plan for the first year. Where the operations have changed significantly since the previous year, the Authority may decide to amend the capital requirement.

Chapter 13. General provisions regarding foreign exchange rate risk

**Article 47:**

Capital requirement for foreign exchange rate risk shall be calculated for positions in foreign currency and for positions in gold, in accordance with the provisions set out in Chapter 13 to Chapter 15 and Annex 5.

**Article 48:**

The authorised person shall calculate the capital requirement for foreign exchange rate risk that it is exposed to throughout the business, that is both for positions in the trading book and non-trading activity exposures. The calculation shall cover all assets, liabilities, provisions and off-balance sheet commitments. This calculation shall include gold and every individual currency in which the authorised person has positions except in the reporting currency.

Chapter 14. Valuation and conversion to local currency

**Article 49:**

- a. When calculating capital requirements with regard to foreign exchange rate risk, all assets, liabilities, provisions, positions and off-balance sheet commitments shall be valued at their market value. With regard to non-trading activities or instruments included in capital, if market values do not provide a fair picture, or market values are not available, book values may be used or, if relevant, hedge accounting can be applied when calculating the capital requirement.
- b. Conversion of assets, liabilities, provisions and positions as well as off-balance sheet commitments in currencies other than Saudi Riyal (SAR), shall be carried out using the current spot rates at the time of calculation. The conversion of all positions in foreign currency shall be carried out on the same date.

## Chapter 15. Calculating the capital requirement for foreign exchange rate risk

### **Article 50:**

The authorised person shall use the two-step method provided in Chapter 1 of Annex 5 when calculating capital requirements for foreign exchange rate risks.

### **Article 51:**

- a. The authorised person shall aggregate the absolute values of the following positions:
  - 1) Total net position in foreign currency in accordance with Chapter 1 of Annex 5;
  - 2) The net position in gold in accordance with Chapter 1 of Annex 5; and
  - 3) Currency positions in investment fund units in accordance with Chapter 4 of Annex 5.
- b. The capital requirement for foreign exchange rate risk shall comprise 14% of the sum resulted from the calculation provided in paragraph (a) of this Article.

## Chapter 16. General provisions regarding commodities risk

### **Article 52:**

- a. The authorised person shall calculate the capital requirements for commodities risk according to either the simple method or the maturity-based method for positions in commodities and commodity derivatives throughout the business, that is positions in the trading book and non-trading activities in accordance with this Chapter and Annex 6.

- b. Positions in gold and gold derivatives are exempted from the provisions provided in paragraph (a) of this Article when calculating a capital requirement for commodities risk. Capital requirements for positions in gold and gold derivatives are instead calculated in accordance with Chapter 13 to Chapter 15 and Annex 5. In addition, positions in commodities and commodities derivatives that entail pure stock financing are excepted when calculating capital requirements for commodities risk. Pure stock financing means that stock has been sold forward and the cost of funding has been locked in until the date of the forward sale.
- c. Each position in commodities or commodity derivatives shall be expressed in terms of standard units of measurement (for example barrel, MWh, kg).
- d. Capital requirements for commodities risk shall be calculated on the basis of the authorised person's long and short net positions in each individual commodity. When determining long and short net positions, positions in contracts maturing the same day and contracts maturing within ten days of each other may be netted if they are traded on markets that have daily delivery dates.
- e. In addition to positions in identical commodities, the following positions are also considered to be positions in the same commodity:
  - 1) Positions in different categories of commodity if they can be delivered instead of each other; or
  - 2) Positions in similar commodities, if they are close substitutes and if a minimum correlation of 0.9 between price movements can be clearly established over a minimum period of one year.
- f. The application of this article shall in accordance with Annex 6.

## **PART 4: LARGE EXPOSURES**

### Chapter 17. General provisions for large exposures

#### **Article 53:**

An authorised person shall apply the provisions set out in this Chapter and Annex 7 when determining its large exposures.

#### **Article 54:**

The value of an authorised person's exposures to a single counterparty, or group of connected counterparties, may not exceed 25% of the authorised person's capital base.

#### **Article 55:**

The total value of an authorised person's large exposures may not exceed 800% of the authorised person's capital base.

#### **Article 56:**

The following exposures shall not be included upon calculation of an authorised person's exposures pursuant to Article 54 and Article 55 of these Rules:

- 1) Exposures which, in conjunction with foreign exchange transactions, arise in connection with the normal settlement of a transaction during the two days immediately after payment;

- 2) Exposures which, in conjunction with the purchase or sale of securities or commodities, arise in connection with the normal settlement of a transaction during five working days immediately after the date on which either payment has occurred or the securities or commodities have been delivered;
- 3) Exposures which an authorised person has towards another group undertaking, where the undertakings are the subject of supervision on a consolidated basis which is exercised by a competent authority or equivalent supervision in a third country; and
- 4) Items that are deducted from the authorised person's capital base.

**Article 57:**

- a. An authorised person may estimate the value of the exposures taking into consideration the risk-mitigating effect of credit protection.
- b. Where an authorised person utilizes the possibility of risk-mitigation, that part of the exposure that is covered by collateral shall be treated as an exposure to the issuer of the collateral and not to the counterparty.

**Article 58:**

The value of an authorised person's exposures in the trading book to a counterparty or a group of connected counterparties may, after obtaining an approval from the Authority, exceed the limits stated in Article 54 and Article 55 of these Rules, provided that the authorised person fulfills the special capital requirements and the other conditions set forth in Chapter 5 of Annex 2.

## **PART 5: Minimum Liquidity Requirements**

Chapter 18. General provisions regarding liquidity requirements

### **Article 59:**

An authorised person shall manage its liquidity risks in accordance with the provisions set out in this Chapter and Annex 8.

Chapter 19. Organisational requirements

### **Article 60:**

An authorised person shall have a written policy regarding risk tolerance that is partly based on an explicit quantitative and qualitative approach to the liquidity risk that is appropriate, and tailored to the authorised person's business objectives, strategic direction and general risk preference. The governing body of the authorised person shall take decisions on risk tolerance.

### **Article 61:**

An authorised person shall have strategies, policies and instructions as set out in Annex 8, as to manage liquidity risk in accordance with the risk tolerance pursuant to Article 60 of these Rules and to ensure that the authorised person maintains sufficient liquidity.

### **Article 62:**

The authorised person's CEO shall monitor and regularly report on its liquidity risk management and the liquidity development to the authorised person's governing body.

**Article 63:**

- a. The governing body of the authorised person shall at least annually review and approve the strategies, policies and instructions set out in Annex 8 relating to the authorised person's liquidity risk management.
- b. The governing body shall ensure that the authorised person's senior management handles liquidity risk in accordance with its risk tolerance.

**Article 64:**

- a. Strategies, policies and instructions on the management of liquidity risk provided in Article 61 of these Rules shall ensure that the authorised person monitors and meets future liquidity needs for normal day-to-day management as well as at temporary and protracted emergencies. They shall also provide guidance on responsibility of work, measurement methods, limits, monitoring and reporting. The guidelines and instructions refer to the authorised person as a whole, including any branches and, where appropriate, coordination between them.
- b. An authorised person that is a part of a financial group shall consider the strategies, policies and instructions that apply to the group in setting their own strategies, policies and instructions.

**Article 65:**

The strategies, policies and instructions mentioned in Article 61 of these Rules shall be communicated to all relevant staff in the authorised person.

**Article 66:**

- a. Each authorised person shall have a central function for independent oversight of liquidity risk (liquidity risk control) that report directly to the CEO or a member of the

authorised person's governing body which is not responsible for position-taking business units.

- b. The central liquidity risk control function must have good working knowledge of financial instruments, liquidity risks and methods of governance and oversight of liquidity risk. If the authorised person has a central risk control, then the function for liquidity risk management can be part of it.
- c. If an authorised person is part of a financial group, the central function for liquidity risk control could be placed in the parent company.
- d. The central liquidity risk control function is responsible for the on-going reporting and analysis of the authorised person's and, where appropriate, the group's liquidity risk.
- e. If an authorised person has an internal function for liquidity risk control within a position-taking unit the internal function shall report to the central liquidity risk control function or the central risk control function, if any.
- f. An authorised person that is a part of a financial group shall adjust its liquidity risk control to the common group liquidity risk control function.

**Article 67:**

- a. An authorised person shall regularly review and perform independent evaluation of the following:
  - 1) its governance and oversight of liquidity risk;
  - 2) the liquidity risk management to identify weaknesses or problems with the procedures, methods and systems for calculating and reporting of liquidity risk;
  - 3) the established policies and procedures to ensure that they are followed and that the processes meet the set goals; and
  - 4) whether it has an appropriate organization for their liquidity management.

- b. The function for independent review shall report directly to the authorised person's governing body. If the authorised person has an internal audit function, the independent audit shall be conducted by it.

## **PART 6: PILLAR II – ASSESSMENT OF ALL RISKS**

### Chapter 20.ICAAP

#### **Article 68:**

- a. Authorised persons shall have in place ICAAP pursuant to Annex 9. Authorised persons shall ensure that their ICAAP consists of five main features:
  - 1) Governing body oversight;
  - 2) Sound capital assessment;
  - 3) Comprehensive assessment of risks;
  - 4) Monitoring and reporting; and
  - 5) Internal control review.
- b. The ICAAP shall be reviewed and revised annually by the authorised person's governing body. The CEO shall have the responsibility over the ICAAP and ensure that the ICAAP is an integrated part of the business environment.
- c. The ICAAP shall be proportionate to the nature, scale and complexity of the activities of the authorised persons concerned.
- d. Authorised persons shall at least annually conduct a comprehensive review and investigation according to the ICAAP. The annual investigation shall lead to a yearly report submitted to the Authority.

## **PART 7: PILLAR III – DISCLOSURE AND REPORTING**

### Chapter 21.Disclosure

#### **Article 69:**

- a. The disclosure obligations in this Chapter and Chapter 22 shall be in addition to any notification requirements that an authorised person has under the Authorised Persons Regulations.
- b. Where stated in these Rules that an authorised person shall submit information to the Authority or disclose information to the public, and the authorised person is part of a financial group, then the authorised person is obligated to disclose in addition to its own information the group's information.

#### **Article 70:**

- a. The information referred to in Annex 10 shall be disclosed at least once a year and shall, where applicable, include the financial status on the balance sheet date of the authorised person's annual report or, where applicable, the consolidated accounts for the financial group.
- b. The information referred to in Annex 10 shall be disclosed as quickly as possible, although, where applicable, no later than in conjunction with the public disclosure of the annual report.

**Article 71:**

Authorised persons must have a website on which they shall publish the information stipulated in Annex 10. Listed authorised persons must also include that information in their annual report.

Chapter 22.Reporting

**Article 72:**

An authorised person shall submit their financial statements to the Authority.

**Article 73:**

An authorised person shall submit information regarding the calculation of capital base, minimum capital requirements and large exposures in accordance with the capital adequacy model.

**Article 74:**

The information in Article 72 and Article 73 of these Rules shall be submitted to the Authority within 10 days after the end of the month for the monthly statements, and within 60 days after the fiscal year end for the annual statements.

**Article 75:**

An authorised person shall keep and preserve all financial and non-financial records and documents in accordance with the relevant provisions provided in the Authorised Persons Regulations.

**Article 76:**

- a. Annual audited financial statements shall be prepared in accordance with the Saudi Organization for Certified Public Accountants (SOCPA) accounting standards or, after obtaining an approval from the Authority, internationally accepted accounting standards, and audited by an external audit firm who is a member of SOCPA.
- b. The external audit firm shall report whether, from its test examinations and after making due inquiry, the authorised person's minimum capital computations have been correctly computed and have been maintained in compliance with these Rules.

**Article 77:**

An authorised person shall report all deviations from these Rules to the Authority. Simultaneously the authorised person shall submit a plan to rectify these deviations.

## **PART 8: FINANCIAL GROUPS**

### Chapter 23. General provisions regarding financial groups

#### **Article 78:**

With respect to a financial group, responsibility for fulfillment of the requirements on a consolidated basis shall be borne by the authorised person that is not an affiliate of another authorised person.

### Chapter 24. Consolidated accounts

#### **Article 79:**

The responsible authorised person pursuant to Article 80 of these Rules shall ensure that the financial group as a whole fulfills the requirements set forth in:

- 1) Chapter 2 and Chapter 3 and Chapter 19 and associated annex regarding capital base;
- 2) Chapter 4 to Chapter 15 and associated annexes regarding capital requirements;
- 3) Chapter 17 and associated annex regarding large exposures requirements; and
- 4) Chapter 18 and Chapter 19 and associated annexes regarding liquidity risk requirements.

#### **Article 80:**

Consolidated accounts shall be prepared for a financial group by applying relevant rules applicable to the preparation of consolidated balance sheets and consolidated income

statements. Upon preparation of the accounts, the authorised person shall consolidate all the companies that are a part of its financial group, in full.

**Article 81:**

- a. The Authority may decide that any company that is a part of the authorised person's financial group or an undertaking participation by the authorised person shall be excluded from the consolidated accounts mentioned in Article 80 of these Rules.
- b. The authorised person may submit an application to the Authority to exclude any company that is a part of its financial group or any undertaking in which a participation is held from the consolidated accounts mentioned in Article 80 of these Rules, where:
  - 1) The undertaking is situated in a country that there are legal obstacles to the transfer of necessary information;
  - 2) The undertaking is of negligible significance in light of the purpose of the supervision; or
  - 3) A compilation of the financial position of the company that is a part of the authorised person's financial group would be inappropriate or misleading in light of the purpose of the supervision.

**Article 82:**

An authorised person's profit and loss statement, balance sheet and off-balance sheet commitments may, if there are special grounds and with the permission of the Authority, be included in the consolidated accounts on the basis of financial statements referring to another point in time than the reporting date.

**Article 83:**

When producing the consolidated accounts, all parts of the authorised person's financial group shall be fully consolidated. The Authority can allow account consolidation by another method where special grounds exist.

**Article 84:**

An authorised person shall, on the dates and for the accounting periods determined by the Authority for each individual case, provide the Authority with the following consolidated information:

- 1) Information about the financial group's consolidated financial position;
- 2) Information about the purchase and sale of assets between the authorised person and any company that is a part of its financial group;
- 3) Information about the receivables and liabilities between the authorised person and any company that is a part of its financial group;
- 4) Information about agreements between the authorised person and any company that is a part of its financial group (for example cooperation or guarantee agreements); and
- 5) Information about commitments and any contingent liability between the authorised person and any company that is a part of its financial group (for example letters of guarantee or intent).

## Chapter 25.Foreign undertakings

### **Article 85:**

- a. When calculating the financial group's capital requirements, the authorised person may treat a foreign company that is a part of its financial group in accordance with this Chapter, after receiving permission from the Authority.
- b. The capital requirement for the authorised person's exposures in the foreign company that is a part of its financial group may be calculated in accordance with the rules of the country in which the foreign company has its registered office if that country's rules are equivalent to these Rules.
- c. Netting shall not occur for long and short positions in the same financial instrument issued by an issuer outside the financial group and which are held by different companies within the same financial group. The netting is allowed, however, if a position belongs to the trading book in all of the relevant countries. If this method is utilized to include a foreign company that is a part of the authorised person's financial group, it shall be used consistently.

### **Article 86:**

When calculating capital, the instruments which are included in the capital of the foreign company that is a part of the authorised person's financial group may only be included in the capital of the financial group if these instruments fulfill the conditions applying to Tier-1 capital or Tier-2 capital in accordance with Annex 1.

## Chapter 26. Systems and Controls

### **Article 87:**

In discharging its duties pertaining to systems and controls requirements as set out in the Authorised Persons Regulations, an authorised person shall have regard to the provisions of these Rules.

## **PART 9: CLOSING PROVISIONS**

Chapter 27: Publication and Entry into Force

### **Article 88:**

These Rules shall be effective upon the date of their publication.

## **Annex 1: CAPITAL BASE**

### Chapter 1. Tier-1 capital

#### *Section 1*

Tier-1 capital shall include the following:

1. Paid-up capital;
2. Audited retained earnings;
3. Share premium;
4. Reserves (other than revaluation reserves); and
5. Tier-1 capital contributions.

#### *Section 2*

- a. Unconditional Tier-1 capital contributions shall be included as Tier-1 capital.
- b. Conditional Tier-1 capital contributions shall only be included as Tier-1 capital if their conditions state that the governing body decides on the repayment of the contributions.
- c. In order for an authorised person to include a Tier-1 capital contribution as Tier-1 capital, the contribution must have been paid in to the authorised person.

#### *Section 3*

- a. Profit generated in the current financial year by an authorised person or financial group may be included in the capital of the authorised person or financial group as Tier-1 capital, if the authorised person's external auditors have verified the profit for

both the individual authorised person and the financial group. Profit refers to profit after estimated taxes and zakat.

- b. External auditor's verification of profit means that the authorised person's external auditors have examined the accounts that form the basis of the capital adequacy report for the authorised person or financial group.

#### ***Section 4***

An authorised person or financial group that later reports a smaller profit than what was most recently verified shall only include the smaller profit in the Tier-1 capital.

#### ***Section 5***

If financial liabilities that are not held for trading intent or are not the subject of an effective and documented fair value hedge are reported at fair value, accumulated value change which can be assigned to changes in own creditworthiness shall not affect the size of capital.

#### ***Section 6***

When calculating capital base, Tier-1 capital contribution instruments may represent a maximum of 15% of the authorised person's Tier-1 capital after the reductions of Tier-1 capital in accordance with these Rules.

#### ***Section 7***

Interest payment for Tier-1 capital contribution instruments shall only be made if there are distributable funds available in the authorised person. Interest conditions for the Tier-1 capital contribution instrument shall not be cumulative.

### ***Section 8***

Tier-1 capital contribution instruments may not contain conditions stipulating that the interest can be raised after a period (step-up).

### ***Section 9***

The terms of the Tier-1 capital contribution instrument shall state that the contribution has subordinated terms of payment. A Tier-1 capital contribution can be considered equal with other Tier-1 capital instruments in terms of subordination, but it shall be subordinated to all other borrowings or deposits.

### ***Section 10***

- a. The terms of the Tier-1 capital contribution instrument shall state that the contribution is unsecured and in principle open term (perpetual).
- b. For Tier-1 capital contribution to be considered open term, the interest rate may not be unreasonably high at the beginning of the term of the loan only to then fall drastically (step-down).
- c. An instrument structure with a high interest rate at the beginning of the term of the instrument and a large decline in the interest rate later can be seen as a form of hidden amortisation.

### ***Section 11***

Tier-1 capital contribution should be limited to the actual amount of funds the authorised person has received regardless of if the instrument was issued at a discount or a premium.

## ***Section 12***

- a. The terms of the Tier-1 capital contribution instrument shall state that the investor has the right to repayment only if the authorised person has been declared bankrupt and on obtaining an approval from the Authority. Such approval may be given at the earliest five years after the contribution has been taken up or issued.
- b. The Authority, where it deems necessary and in accordance with paragraph (d) of this Section, may permit the Tier-1 capital contribution to be repaid or repurchased less than five years after the contribution was taken up or issued.
- c. When applying for permission for the repayment or repurchase of a Tier-1 capital contribution mentioned in paragraph (b) of this Section, the authorised person shall describe how the repayment or repurchase will affect the authorised person's capital adequacy. In addition, the authorised person shall specify which short-term changes it expects to the capital requirement and capital.
- d. The Authority may give its permission mentioned in paragraph (b) of this Section if the authorised person's capital adequacy ratio is deemed satisfactory in the long-term, even after the Tier-1 capital contribution has been repaid or repurchased. Otherwise, permission cannot be given unless the Tier-1 capital contribution is replaced by at least an equal amount of capital of the same or higher quality. A new Tier-1 capital contribution may not have better preferential rights than the contribution that is to be repaid or repurchased.

## ***Section 13***

The Authority may give permission to an authorised person to repurchase a portion of an issued Tier-1 capital contribution intended for resale as part of securities-related operations. An authorised person that has received permission shall deduct the portion of the contribution

repurchased from the Tier-1 capital. When later selling the repurchased Tier-1 capital contribution notes, a corresponding amount may again be included in the Tier-1 capital.

#### *Section 14*

The terms of the Tier-1 capital contribution instrument shall state that the Tier-1 capital contribution, including accrued and unpaid interest can be appropriated to cover losses, so the authorised person can, by doing so, continue its activities without having to go into liquidation.

#### *Section 15*

- a. An authorised person that has drawn up a balance sheet for liquidation purposes and finds that it is thereby liable to go into liquidation may appropriate all or part of a Tier-1 capital contribution, including accrued interest amounts, in order to restore Tier-1 capital to a level equal to the paid-up capital. The authorised person shall in the first instance appropriate the Tier-1 capital contribution and its accrued interest. Accrued interest amount shall be entered as liabilities before they can be appropriated.
- b. The Annual (or Extraordinary) General Meeting, or where not relevant the meeting of the shareholders, shall decide whether the Tier-1 capital contribution and accrued interest entered as liabilities shall be appropriated. Such decision may, however, only be implemented after the auditors have examined the balance sheet and the Authority has given its permission.
- c. The appropriation mentioned in paragraph (b) of this Section shall be irrevocable and final. Provisions regarding the right of contribution providers to future payment shall

only cover cases in which the restoration of the appropriated amount can be made from distributable profits in accordance with an adopted balance sheet.

- d. Interest shall at any time be charged only on the remaining portion of the Tier-1 capital contribution that has not been appropriated.

## Chapter 2. Tier-2 capital

### *Section 16*

Tier-2 capital may include perpetual subordinated loans and term subordinated loans with an original term to maturity of not less than five years.

### *Section 17*

An authorised person may include cumulative preference shares in Tier-2 capital on obtaining the permission of the Authority. In the application for permission, the authorised person shall report on the rules in the authorised person's articles of association regarding how the accumulation shall occur.

### *Section 18*

- a. Revaluation reserves shall be included in Tier-2 capital.
- b. Unrealised accumulated value changes to loans and receivables or other interest-bearing financial instruments, classified as available-for-sale financial assets, may not affect the amount of Tier-2 capital other than for value changes reported as write downs or reversed write-downs in the profit and loss statement.

***Section 19***

A revaluation reserve that has been formed in conjunction with the write-up of a fixed asset may, on obtaining permission from the Authority, be included in Tier-2 capital. In the application for permission, the authorised person shall report on the circumstances that served as the basis for the establishment of the reserve.

***Section 20***

Unrealised accumulated profit from investment property and tangible non-current assets at fair value shall be included in Tier-2 capital.

***Section 21***

A perpetual subordinated loan is allowed to contain conditions establishing how interest shall be determined during the entire term of the loan.

***Section 22***

The perpetual subordinated loan may not contain conditions stipulating that the interest can be raised after a period (step-up).

***Section 23***

- a. The terms of the perpetual subordinated loan shall state that the authorised person shall be able to defer payment of the interest on the loan, when:
  1. The authorised person reports a negative operating income; or
  2. The governing body has decided not to pay a dividend.

- b. The interest on the deferred amount of interest may at the most be 300 basis points above the interest that otherwise applies to the loan.

#### ***Section 24***

The terms of the perpetual subordinated loan agreement shall state that the loan has subordinated terms of payment. A perpetual subordinated loan can be considered equal to other perpetual subordinated loans in terms of subordination, but must rank lower than fixed-term subordinated loans.

#### ***Section 25***

- a. It shall be stated in the contract terms for a perpetual subordinated loan that the loan is unsecured and that it in principle has an open term.
- b. For a perpetual subordinated loan to be considered open term, the interest rate may not be unreasonably high at the beginning of the term of the loan only to then decline drastically (step-down). A credit agreement structure with a high interest rate at the beginning of the term of the loan and a large decline in the interest rate later can be seen as a form of hidden amortisation of the loan.

#### ***Section 26***

A perpetual subordinated loan shall be limited to the actual amount of funds the authorised person has received regardless if the perpetual subordinated loan was issued at a discount or a premium.

### ***Section 27***

- a. The terms of the perpetual subordinated loan agreement shall state that the investor has the right to repayment only if the authorised person has been declared bankrupt and on obtaining an approval from the Authority. Such approval may be given at the earliest five years after the loan has been issued.
- b. The Authority, where it deems necessary and in accordance with paragraph (d) of this Section, may permit the perpetual subordinated loan to be repaid or repurchased less than five years after the loan was issued.
- c. When applying for permission for the repayment or repurchase of a perpetual subordinated loan mentioned in paragraph (b) of this Section, the authorised person shall describe how the repayment or repurchase will affect the authorised person's capital adequacy. In addition, the authorised person shall specify which short-term changes it expects to the capital requirement and capital.
- d. The Authority may give its permission mentioned in paragraph (b) of this Section if the authorised person's capital adequacy ratio is deemed satisfactory in the long-term, even after the perpetual subordinated loan has been repaid or repurchased. Otherwise, permission cannot be given unless the perpetual subordinated loan is replaced by at least an equal amount of capital of the same or higher quality. A new perpetual subordinated loan may not have better preferential rights than the loan that is to be repaid or repurchased.

### ***Section 28***

The Authority may give permission to an authorised person to repurchase a portion of an issued perpetual subordinated loan intended for resale as part of securities-related operations.

An authorised person that has received permission shall deduct that portion of the loan

repurchased from the Tier-2 capital. When later selling the repurchased perpetual subordinated loan notes, a corresponding amount may again be included in the Tier-2 capital.

### ***Section 29***

The terms of the perpetual subordinated loan agreement shall state that the perpetual subordinated loan, including accrued and unpaid interest, can be appropriated to cover losses so that the authorised person can, by doing so, continue its activities without having to enter into liquidation.

### ***Section 30***

- a. An authorised person that has drawn up a balance sheet for liquidation purposes and finds that it is thereby liable to go into liquidation may appropriate all or part of a perpetual subordinated loan, including accrued interest, in order to restore shareholders' equity to a level equal to the registered share capital. The authorised person shall in the first instance appropriate any Tier-1 capital contributions and their accrued interest. Accrued interest amounts shall be entered as liabilities before they can be appropriated.
- b. The Annual (or Extraordinary) General Meeting, or where not relevant the meeting of the shareholders, shall decide whether the perpetual subordinated loan and accrued interest entered as liabilities shall be appropriated. Such a decision may, however, only be implemented after the auditors have examined the balance sheet and the Authority has given its permission.
- c. The appropriation mentioned in paragraph (b) of this Section shall be irrevocable and final. Provisions regarding the right of contribution providers to future payment shall

only cover cases in which the restoration of the appropriated amount can be made from distributable profits in accordance with an adopted balance sheet.

- d. Interest shall at any time be charged only on the portion of the perpetual subordinated loan that has not been appropriated.
- e. The payment of interest, may, like the repayment of the appropriated amount, only be made from distributable profits. With regard to perpetual subordinated loans, the interest on the amount of interest calculated on the fictitious debt may not exceed by more than three percentage points the interest that otherwise applies to the loan.
- f. When the Annual (or Extraordinary) General Meeting, or where not relevant the meeting of the shareholders, decides to appropriate all or part of the perpetual subordinated loan, including accrued interest, in order to restore shareholders' equity, the General Meeting, or where not relevant the meeting of the shareholders, may also decide to enter a provision into the articles of association with the following content:  
“The authorised person may not pay dividends or make other repayment to shareholders unless the following conditions are met:
  - 1. the appropriated amount of the perpetual subordinated loan, including appropriated interest, has been re-entered as a liability; and
  - 2. the authorised person has entered as a liability and paid an amount corresponding to the interest which – if appropriation for covering losses has not taken place – should have accrued and been paid on the loan”.

***Section 31***

That indicated in Section 32 to Section 41 of this Annex regarding fixed-term subordinated loans with subordinated terms of payment also applies to other similar fixed-term promissory notes with subordinated terms of payment.

***Section 32***

Fixed-term subordinated loans may be included in Tier-2 capital if the loans are paid in cash and no collateral is posted for the loans.

***Section 33***

The terms of the fixed-term subordinated loan agreement shall state that the loan has subordinated terms of payment. It shall also state that the loan has preferential rights over perpetual subordinated loans and Tier-1 capital contributions.

***Section 34***

For a fixed-term subordinated loan to be included in Tier-2 capital, the period from the issue date of the loan to the date at which the authorised person may terminate the loan for early repayment shall be at least five years. If an authorised person has issued a fixed-term subordinated loan with the right to terminate the loan for early repayment, the date of this right (the call date) must form the basis for the calculation of the loan's effective term. However, this does not apply if agreed early repayment is conditional on the Authority's permission.

### ***Section 35***

Fixed-term subordinated loans with a residual term less than five years may be included in Tier-2 capital up to a maximum of 20% of the notional value for each full year remaining until the maturity date.

### ***Section 36***

The terms of the fixed-term subordinated loan agreement shall state that the investor has the right to repayment before the agreed maturity date only if the authorised person has been declared bankrupt or has entered liquidation.

### ***Section 37***

- a. When notifying or applying for permission for the early repayment or repurchase of a fixed-term subordinated loan, the authorised person shall describe how the repayment or repurchase will affect the authorised person's capital adequacy. In addition, in both cases, the authorised person shall specify which short-term changes it expects to the capital requirement and capital.
- b. A condition for the repayment or repurchase is that the Authority judges the authorised person's capital adequacy ratio to be satisfactory in the long-term, even after the loan has been repaid or repurchased. Otherwise, repayment or repurchase may not take place unless the loan is replaced by at least a corresponding amount of capital of the same or higher quality. A new fixed-term subordinated loan may not have better preferential rights than the loan that is to be redeemed.

### ***Section 38***

The Authority can give permission to an authorised person to repurchase a portion of an issued fixed-term subordinated loan intended for resale as part of securities-related operations. An authorised person that has received permission shall deduct the portion of the loan that was repurchased from the Tier-2 capital. When later selling the repurchased subordinated loan notes, a corresponding amount may again be included in the Tier-2 capital.

### ***Section 39***

If a fixed-term subordinated loan is extended, the entire loan shall be considered to be a new loan. The residual term shall, after the extension be at least five years in order for the loan, after the extension, to be included in the Tier-2 capital.

### ***Section 40***

20% of amounts that shall be amortised on a fixed-term subordinated loan may be included in Tier-2 capital for each full year remaining until the amortisation date. A loan with several amortisations may therefore be included on the same conditions as if the corresponding amount had been taken up by several loans maturing on the respective amortisation dates.

### ***Section 41***

Fixed-term subordinated loans, issued at a discount or premium, may, when issued, be included in Tier-2 capital to a maximum of the amount that the authorised person or borrower received at that time.

***Section 42***

An authorised person shall deduct losses in accordance with the annual accounts from the Tier-1 capital even if the authorised person's external auditors have not yet verified the losses.

***Section 43***

A deduction shall be made from the verified profit for the current financial year of an authorised person or financial group for as much of the annual cash dividend, or other similar allocations of these funds, bearing upon the current financial year for the period up to the relevant calculation date.

***Section 44***

Losses arising from price adjustments or provisions to valuation reserves shall be deducted from the Tier-1 capital.

***Section 45***

Goodwill and intangible non-current assets shall be deducted from Tier-1 capital.

Shortfalls/negative goodwill shall not be offset against surpluses/goodwill.

***Section 46***

Deferred zakat or taxes assets (where applicable) reported on the balance sheet shall be deducted from Tier-1 capital.

***Section 47***

Acquired own shares included in the authorised person's trading book shall be deducted from Tier-1 capital.

#### ***Section 48***

Subordinated loans, Tier-1 capital contributions and other subordinated promissory notes may be included in capital only to the amounts placed in the market. This means that that portion of the issued subordinated loan or Tier-1 capital contribution not placed in the market, or which the authorised person has redeemed or repurchased – and where the authorised person has booked as an asset its own subordinated loan notes or other own debt instruments related to the loan or contribution – shall be deducted from the original or Tier-2 capital when calculating capital.

#### ***Section 49***

- a. If an authorised person owns equity in companies/establishments in a securities business or otherwise, whether based in the Kingdom or outside the Kingdom, which in turn owns another authorised person, this authorised person is covered by the capital requirement for the financial group, but not the company/establishment.
- b. When making a deduction of the authorised person's contribution for both the authorised person and the financial group, this contribution is reduced by the amount that corresponds to the portion of the authorised person's book value for shares in the insurance company or equivalent foreign company, foreign reinsurance company or the insurance holding company, which refers to the other authorised person.
- c. With regard to the financial group, in such cases the reported goodwill referring to that authorised person is deducted from the Tier-1 capital.

#### ***Section 50***

- a. The authorised person shall, in the manner stated in Section 51 of this Annex, deduct from the Tier-1 capital and Tier-2 capital the book value of the shares or other risk bearing capital (contribution) in an authorised person, a bank, an insurance company

or equivalent foreign subsidiary. Such a deduction shall be made where the authorised person's holdings exceeds 10% of the undertaking's capital.

- b. Deductions shall not be made for contributions that relate to undertakings covered by the same consolidated accounts as the authorised person through complete consolidation or through a proportional consolidation.

***Section 51***

- a. Of the total amount deducted pursuant to Section 50 of this Annex, 50% shall be deducted from the Tier-1 capital and the remaining 50% from Tier-2 capital.
- b. Where the amount to be deducted from Tier-2 capital exceeds Tier-2 capital, the excess amount shall be deducted from Tier-1 capital.

***Section 52***

- a. Deductions from Tier-1 capital related to unsettled exposures shall be made according to Section 70 of Annex 2.
- b. Deductions from capital base shall be made for items for which an authorised person utilises the possibility set out in Article 56 of these Rules.

## **Annex 2: TRADING BOOK**

### Chapter 1. Interest rate risks

#### *Section 1*

- a. Interest rate risks shall be calculated for positions in interest rate linked financial instruments included in an authorised person's trading book. Calculating capital requirements for specific and general risk may be carried out on the authorised person's net positions in interest rate linked financial instruments. Net position refers to the difference between a long and a short position in financial instruments of the same type and issued by the same issuer. Same issuer refers to the same legal entity.
- b. Financial instruments issued by different issuers may be treated in the same way as instruments issued by the same issuer on the condition that a clearing organisation can confirm that bonds issued by these issuers are fully deliverable against one another.
- c. In the case of cheapest-to-deliver futures or forwards an authorised person may net a short notional position in the cheapest to deliver security, arising from a short future or forward where the seller has a choice of which debt security it may use to settle its obligations, against a long position in any deliverable security. This exception is only applicable where the authorised person has sold the future or forward and netting is not allowed where the authorised person has bought a cheapest-to-deliver future or forward.
- d. Financial instruments are considered to be of the same type if they are denominated in the same currency and their coupons and maturities are the same. An authorised

person may not net positions in financial instruments that are denominated in different currencies. The financial instruments shall also afford equal rights if the issuer enters liquidation.

*Section 2*

- a. A long (purchased) position in a future, synthetic future, forward or option shall be treated as:
  1. A notional long position in the underlying security (or the cheapest to deliver (taking into account the conversion factor) where the contract can be satisfied by delivery of one from a range of securities); and
  2. A notional short position in a zero coupon zero-specific-risk security with a maturity equal to the expiry date of the future or forward.
  
- b. A short (sold) position in a future, synthetic future, forward or option is treated as:
  1. A notional short position in the underlying security (or the cheapest to deliver (taking into account the conversion factor) where the contract can be satisfied by delivery of one from a range of securities); and
  2. A notional long position in a zero coupon zero-specific-risk security with a maturity equal to the expiry date of the future, synthetic future or forward.
  
- c. Long and short positions deriving from an option shall be delta-weighted in accordance with Section 9 of this Annex.

- d. A zero coupon bond deriving from the partition of derivatives into a long and a short position shall in this context be considered to be issued by a government which qualifies for credit quality step 1, alternatively to have a risk weight of 0% in non-trading activities.
- e. Netting long and short positions in zero coupon bonds shall be carried out in accordance with Section 1 of this Annex.
- f. The positions which arise from the partitioning into long and short positions shall be included in the calculation of specific and general risk unless otherwise set out in Section 3 to Section 31 of this Annex.

### ***Section 3***

- a. The calculation of capital requirements for the specific risk of the underlying security shall be based on the issuer of the underlying security.
- b. The capital requirement for specific risk in the zero coupon zero-specific-risk security, irrespective of whether it is long or short position, shall be calculated in accordance with Section 33 of this Annex.
- c. With regard to forwards with a constructed underlying instrument and several deliverable bonds, the underlying instrument shall be made up of the bond that is cheapest to deliver.

### ***Section 4***

- a. Forwards based on an index of interest rate linked financial instruments (including delta-weighted equivalents of options based on an index consisting of interest rate

linked financial instruments) shall be treated as combined long and short positions in the same way as other derivatives. A long or short position in such an index may be split up among the instruments included in the index. These instruments may be netted against opposite positions in the same financial instrument to that extent that the instrument is included in the index. Forwards based on an index consisting of interest rate linked financial instruments not split up among the instruments included in the index shall be treated as individual financial instruments.

- b. The calculation of specific risk for both the underlying financial instrument and the zero coupon bond shall be carried out in accordance with Section 2 to Section 3 of this Annex.

#### ***Section 5***

- a. A long (sold) position in a forward rate agreements shall be treated as a combination of a long position in a zero coupon bond with a maturity date corresponding to the settlement date for the forward rate agreements contract plus the number of days which correspond to the maturity of the contract and a short position in a zero coupon bond which expires on the settlement date.
- b. A short (purchased) position in forward rate agreements shall similarly be treated as a short position in a zero coupon bond with a maturity date corresponding to the settlement date coupon for the contract plus the number of days which correspond to the maturity of the contract and a long position in a zero coupon bond which matures on the settlement date.
- c. The amount due for the zero coupon bond with a maturity date corresponding to the settlement date for the contract plus the number of days corresponding to its maturity shall be comprised of the contract's notional amount plus the agreed amount of

interest. The amount due for the zero coupon bond which matures on the settlement date of the contract shall be comprised of the contract's notional amount.

- d. These zero coupon bonds shall be considered to be issued by a government which qualifies for credit quality step 1, alternatively to have a risk weight of 0% in non-trading activities. Netting long and short positions in zero coupon bonds shall be carried out in accordance with Section 1 of this Annex.
- e. The capital requirement for specific risk in both long and short zero coupon bonds may be calculated in accordance with Section 33 of this Annex.

#### ***Section 6***

- a. An interest rate swap shall be considered to be a combination of a short and a long position. For example, an interest rate swap designed to give its holder variable interest or while paying fixed interest is treated as a combination of a long position in a financial instrument with a variable interest rate maturing on the next interest rate adjustment date and a short position in a financial instrument with a fixed interest rate and the same maturity that applies to the swap.
- b. A currency swap shall be considered a combination of a short and a long position in each currency.
- c. A currency swap in which the holder pays and receives a variable interest rate in different currencies shall be treated as a combination of a long and a short position in financial instruments with a variable interest rate maturing on the next interest rate adjustment date.
- d. Capital requirements for specific risk in both long and short positions may be calculated in accordance with Section 33 of this Annex.

### *Section 7*

- a. A currency forward shall be considered to be a combination of a long and a short position in a zero coupon bond in each currency.
- b. The zero coupon bonds shall be considered to be issued by a government which qualifies for credit quality step 1, alternatively to have a risk weight of 0% in non-trading activities.
- c. Netting long and short positions in zero coupon bonds shall be carried out in accordance with Section 1 of this Annex.
- d. Capital requirements for specific risk in both long and short positions in zero coupon bonds may be calculated in accordance with Section 33 of this Annex.

### *Section 8*

- a. The transferring party in a repurchase transaction (repo) based on financial instruments assigned to the trading book shall be considered to have a short position in a zero coupon bond maturing when the contract expires. The capital requirement for specific risk for the short position may be calculated in accordance with Section 33 of this Annex. The receiving party in a repurchase transaction (reversed repo) shall be considered to have a long position in a zero coupon bond maturing when the contract expires.
- b. The capital requirement for the specific risk for the long position may be calculated in accordance with Section 33 of this Annex. Real repurchase transactions (repos and reversed repos) in which the settlement date for the repurchase/re-selling is three working days or less after the trade day are excepted from the treatment set out in this Section.

## *Section 9*

- a. Options based on interest rates, interest rate swaps or other similar interest rate linked financial instruments shall be treated as a combination of long and short positions in the same way as other derivatives. Both positions shall be converted into delta-weighted positions by multiplying the underlying instrument's market value by the option's delta value. The delta-weighted positions may be netted against any offsetting positions in the same type of underlying financial instruments.
- b. If the exchange which lists the options does not publish the delta values of the options, or if they are over the counter options, the authorised person shall calculate the delta values of its options.
- c. When calculating capital requirements for specific risk for bought and sold options, the underlying debt instruments shall be treated on the basis of the issuer of the instrument.
- d. Calculation of capital requirements for specific risk of the zero coupon bonds arising from options in interest rate swaps or currency swaps (swaptions) and interest rate options (e.g. caps and floors) may be calculated in accordance with Section 33 of this Annex.
- e. A bought option does not need to be converted to a delta-weighted position and included in the calculation of specific risk as set out in Section 31 to Section 39 of this Annex or general risk as set out in Section 44 to Section 45 of this Annex. The capital requirement for such a position may instead be set at equal to the market value of the option. Netting against an offset position in the underlying instrument cannot be carried out in this case. An authorised person shall have systems in place and apply protective measures such that account is taken of other risks associated with options trading, such as:

1. The sensitivity of the delta value to price changes in the underlying financial instrument (gamma); and
2. The sensitivity of the option price to changes in maturity (theta); and
3. The sensitivity of the option price to changes in standard deviation (vega); and
4. The sensitivity of the option price to changes in the risk-free interest rate (rho).

#### ***Section 10***

- a. Warrants entailing rights to the purchase or other acquisition of financial instruments which can be assigned to an on-going or future new bond issue shall be treated in the same way as the financial instruments in the issue. This type of position may be netted against corresponding positions in the opposite direction.
- b. Warrants entailing rights to the purchase or other acquisition of previously issued financial instruments, shall be treated in the same way as options. Warrants entailing rights other than those contained in the first and second paragraphs shall be treated in the same way as options.

#### ***Section 11***

Unless otherwise specified, calculating capital requirements for specific and general risk shall be based on the notional amount of the credit derivative.

#### ***Section 12***

Credit derivatives are of the same type if they are denominated in the same currency and have the same maturity at the same time as the reference assets are issued by the same legal entity, afford equal rights if the issuer enters into liquidation and have the same coupon and maturity. In addition, for credit derivatives that are designed so that the risk seller receives payment

only in the case of a credit event, the selection of credit event and contractual calculation models for establishing payment shall be identical.

### ***Section 13***

If the risk seller has the right to terminate the credit derivative prematurely and this right is associated with an increase (step-up) in the cost of the derivative, the date of this right shall form the basis of determining the maturity of the credit derivative.

### ***Section 14***

Calculation of capital requirements for general and specific risk may be carried out on the authorised person's net positions in credit derivatives. Net position refers to the difference between a long and a short position in credit derivatives of the same kind.

### ***Section 15***

When calculating capital requirements for general risk the positions in credit derivatives may not be netted against positions in underlying assets.

### ***Section 16***

The position on which the capital requirement for specific risk shall be based shall be determined in accordance with Section 17 to Section 22 of this Annex. When calculating the capital requirement for specific risk, positions in credit derivatives may be netted against other positions in credit derivatives or positions in other assets in accordance with Section 17 of this Annex. A reduced capital requirement for specific risk may also be granted in accordance with Section 18 to Section 22 of this Annex when the authorised person has credit derivatives that protect other credit derivatives or underlying assets.

### *Section 17*

An authorised person which holds a position in a total return swap may net a long/short position in the reference asset against a short/long position in a protected asset on condition that the reference asset and the protected asset are identical in all respects. However, the maturity of the swap does not need to coincide with the maturity of the protected asset.

### *Section 18*

- a. An authorised person may treat positions in credit derivatives and positions in underlying assets in accordance with that set out in paragraph (b) of this Section if the following conditions are met:
  1. The market value of both positions shall always move in opposite directions;
  2. The conditions associated with the credit derivative shall not be designed so that there can be reason to believe that the market value of the credit derivative has changed to a different extent than that of the market value of the underlying asset;
  3. The reference asset and the underlying asset shall be identical;
  4. The maturity of the credit derivative shall coincide with the maturity of the underlying asset; and
  5. The credit derivative and the underlying asset shall be denominated in the same currency.
  
- b. If the conditions in paragraph (a) of this Section have been met, the authorised person only needs to calculate capital requirements for the position which gives rise to the highest capital requirement for specific risk. The size of the position is determined by

multiplying the market value by 20%. Capital requirements for specific risk for the other position do not need to be calculated.

### ***Section 19***

- a. An authorised person may treat total return swaps and positions in underlying assets in accordance with that set out in the paragraph (b) of this Section if the following conditions are met:
  1. The underlying asset and reference asset shall be issued by the same company;
  2. The reference asset shall be ranked equal or junior to the protected asset in the event of bankruptcy; and
  3. There are cross clauses in place between the reference asset and the protected asset which mean that if the borrower defaults (e.g. suspends payments) on other loans, this will also be treated as a default on the reference asset.
  
- b. If the conditions mentioned in paragraph (a) of this Section have been met, the authorised person need only calculate capital requirements for specific risk for either the credit derivative or the underlying asset. In this case the authorised person shall only calculate capital requirements for the position which gives rise to the highest capital requirement for specific risk.

### ***Section 20***

An authorised person may calculate the capital requirement for specific risk in accordance with Section 19 of this Annex, if the positions fulfill the requirements set out in points 1 until 3 of paragraph (a) in Section 18 of this Annex, .

### ***Section 21***

The capital requirement for specific risk for short and long positions in credit derivatives which fulfill the requirements for being of the same type as set out in Section 12 of this Annex, apart from the requirement of having the same maturity and being denominated in the same currency, may be calculated in accordance with paragraph (b) of Section 19 of this Annex..

### ***Section 22***

An authorised person may calculate the capital requirement for the specific risk in accordance with Section 19 of this Annex, if the positions fulfill the requirements set out in Section 18 of this Annex, apart from the requirement that the reference asset and the underlying asset be identical. However, the underlying asset shall be deliverable in accordance with the conditions of the credit derivative.

### ***Section 23***

- a. A position in a credit default swap shall, when calculating specific risk, be treated as a synthetic position in the reference asset. However, the reference asset shall be considered to have a maturity corresponding to the maturity of the credit derivative. It shall be assumed that the risk seller holds a short position in the reference asset and the risk purchaser a long position. If the credit event payment is defined as a fixed amount, the size of the position corresponds to the amount received should a credit event occur. If the payment is defined as a notional amount reduced by the recovery value, or alternatively the payment of a notional amount in exchange for a physical delivery of the reference asset, the size of the position corresponds to the notional amount of the reference asset.

- b. If the risk seller, through a credit default swap, has an obligation to pay interest or a periodic premium to the risk purchaser, both parties in the contract shall take this payment into account when calculating the capital requirements for general risk. It shall be assumed that the risk seller holds a short position in a bond issued by a government and the risk purchaser a long position.

*Section 24*

- a. A position in a credit-linked note shall be treated as a combination of a bond and a credit default swap. The risk seller shall treat a position in a credit-linked note as:
  - 1. A short position corresponding to a notional amount in the bond issued by the risk seller that gives rise to the capital requirement for general risk based on the bond's coupon or interest; and
  - 2. A short position in the reference asset for which capital requirement for specific risk shall be calculated (the reference asset shall however be considered to have a maturity equal to that of the credit derivative).
  
- b. The risk purchaser shall treat a position in a credit-linked note as:
  - 1. A long position corresponding to a notional amount in the bond issued by the risk seller which gives rise to the capital requirement for specific risk based on the issuer of the bond and general risk based on the bond's coupon or interest; and
  - 2. A long position in the reference asset for which capital requirement for specific risk shall be calculated (the reference asset shall however be considered to have a maturity equal to that of the credit derivative).

- c. The provisions of this Section do not need to be applied to a credit linked note which has an credit rating from a credit rating agency and which meets the requirements for risk weight assignment in accordance with Section 33 to Section 37 of this Annex.

#### ***Section 25***

- a. The risk seller shall treat a position in a total return swap as a short position corresponding to a notional amount in the reference asset for which the capital requirement for specific and general risk shall be calculated. The risk purchaser shall treat a position in a total return swap as a long position corresponding to a notional amount in the reference asset for which capital requirement for specific and general risk is to be calculated.
- b. Where the derivative contract includes interest or premium payments, the derivative contract shall be considered a short or alternatively long position in a bond issued by a government which has a risk weight of 0% in non-trading activities. The bond's maturity shall be the period until the next interest or premium payment. The position shall be included in the calculation of the capital requirement for general risk.

#### ***Section 26***

Credit derivatives tied to a basket of assets shall be treated in accordance with Section 23 to Section 25 of this Annex unless otherwise stated in Section 27 to Section 29 of this Annex.

#### ***Section 27***

A credit derivative which refers to more than one asset and where the design of the derivative is such that it becomes due for payment when the first default occurs among the assets in the basket shall, when calculating the specific risk, be treated as if the authorised person held

positions in all of the reference assets. Each position shall be considered to have a notional amount which corresponds to the notional amounts of the credit derivative. However, a cap for the capital requirement for specific risk in the reference assets is set that equals to the maximum amount which can be paid out during the contract.

### ***Section 28***

When calculating specific risk, a credit derivative which refers to more than one asset and is designed such that it becomes due for payment when the second default occurs among the assets in the basket shall be treated as if the authorised person held positions in all of the assets in the basket except for the asset which gives rise to the lowest capital requirement for specific risk. Each position shall be considered to have a notional amount which corresponds to the notional amounts of the credit derivative. However, a cap for the capital requirement for specific risk in the reference assets is set that equals the maximum amount which can be paid out during the contract.

### ***Section 29***

With regard to a credit linked note which refers to more than one asset and where the yield of these assets is transferred in accordance with their proportion in the basket (green bottle structure), the authorised person shall be considered to be exposed to all the assets in the basket. The proportion of each asset in the basket determines the size of the exposures. If several debt instruments for a particular reference asset are deliverable, the authorised person shall base the calculation of the specific risk on the debt instrument which gives rise to the highest capital requirement.

### ***Section 30***

An authorised person shall calculate capital requirements for specific and general interest rate risk separately for each individual currency in which the authorised person has positions. Positions in foreign currency shall be converted before the capital requirement is calculated.

### ***Section 31***

An authorised person's holdings in their own debt instruments shall be disregarded when calculating capital requirement for the specific risk.

### ***Section 32***

The capital requirement for the specific risk is calculated in two steps. The net position in each financial instrument is first multiplied by the weights set out in Section 33 to Section 39 of this Annex. The absolute values of the calculated in this way are then totalled to determine the total capital requirement for specific risk. If the authorised person judges that a financial instrument has a higher risk than that indicated in Section 33 to Section 39 of this Annex, the authorised person shall assign the financial instrument a weight of 21%.

### ***Section 33***

Net positions in the following financial instruments shall have a weight of 0% if they qualify for credit quality step 1:

1. Financial instruments issued or guaranteed by governments; and
2. Financial instruments issued by central banks.

**Section 34**

- a. Net positions in the following financial instruments shall have a weight that varies depending on the remaining maturity of the instrument in accordance with Table 1 below:

**Table 1**

$\leq 6$ months	$> 6 \leq 24$ months	$> 24$ months
0.5%	1.8%	2.8%

- b. The remaining maturity of the instrument refers to the time until the instrument matures. The following financial instruments shall have a weight in accordance to Table 1 above:

1. Financial instruments issued or guaranteed by governments that would qualify for credit quality steps 2 or 3;
2. Financial instruments issued by central banks that would qualify for credit quality steps 2 or 3;
3. Financial instruments issued or guaranteed by authorised persons or foreign equivalents that would qualify for credit quality steps 1 or 2; and
4. Financial instruments issued or guaranteed by companies that would qualify for credit quality steps 1 or 2.

### ***Section 35***

Financial instruments which do not have a credit rating from a credit rating agency may be assigned a weight in accordance with Section 34 of this Annex if the following conditions are met:

1. The authorised person considers the financial instrument to have high liquidity;
2. The authorised person considers the financial instrument to have a creditworthiness corresponding to the creditworthiness of the financial instruments set out in Section 34 of this Annex; and
3. The financial instrument shall be traded on the Exchange, on obtaining the permission of the Authority, on a regulated market outside the Kingdom.

### ***Section 36***

Financial instruments issued by a foreign financial institution maybe assigned a weight in accordance with Section 34 of this Annex if the following conditions are met:

1. The issuer of the financial instrument must be subject to capital adequacy rules similar to the applied rules in the Kingdom; and
2. The authorised person has determined that the financial instrument has high liquidity; and
3. The authorised person considers the financial instrument to have a creditworthiness corresponding to the creditworthiness of the financial instruments set out in Section 34 of this Annex.

### ***Section 37***

Financial instruments issued by companies conducting activities similar to that of authorised persons may be assigned a weight in accordance with Section 34 of this Annex if the following conditions have been met:

1. The authorised person considers the financial instrument to have a creditworthiness corresponding to credit quality step 2; and
2. The company shall be subject to regulations equivalent to the rules applied in the Kingdom.

### ***Section 38***

Net positions in the following financial instruments shall have a weight of 14%:

1. Financial instruments issued or guaranteed by governments that would qualify for credit quality steps 4 or 5;
2. Financial instruments issued by central banks that would qualify for credit quality steps 4 or 5;
3. Financial instruments issued or guaranteed by authorised persons that would qualify for credit quality steps 3-5;
4. Financial instruments issued or guaranteed by companies that would qualify for credit quality steps 3 or 4; and
5. Financial instruments which have no credit rating from a credit rating agency.

### ***Section 39***

Net positions in the following financial instruments shall have a weight of 21%:

1. Financial instruments issued or guaranteed by governments that would qualify for credit quality step 6;
2. Financial instruments issued by central banks that would qualify for credit quality step 6;
3. Financial instruments issued by authorised persons that would qualify for credit quality step 6; and
4. Financial instruments issued or guaranteed by companies that would qualify for credit quality steps 5 or 6.

### ***Section 40***

- a. The method, either maturity-based or duration-based, selected by the authorised person to calculate the capital requirement for general interest rate risk shall be applied consistently for all interest rate linked financial instruments. The calculation methods may not be replaced without the permission of the Authority.
- b. If the maturity-based or duration-based method selected by an authorised person for calculating the capital requirement proves difficult to apply for certain types of interest rate linked financial instruments, the authorised person may, after obtaining the permission of the Authority, use the other method for this type of financial instrument, on condition that this model is applied consistently. Authorised persons applying for such permission shall justify the application of the other method.

#### *Section 41*

- a. In addition to the conditions applying to netting under Section 1 of this Annex, when calculating general interest rate risk, authorised persons may net positions in derivatives in accordance with Section 3 to Section 7 of this Annex and against offsetting positions in derivatives in accordance with Section 9 and Section 10 of this Annex, if all conditions below are met:
1. The positions are denominated in the same currency;
  2. The reference interest rates (for floating rate positions) or coupons (for fixed rate positions) do not deviate by more than 0.15 percentage points (fifteen basis points);  
and
  3. The remaining maturity or time until the next interest rate adjustment date corresponds to the following:
    - a) if there is less than one month until maturity/interest rate adjustment, the same day;
    - b) if there is between one month and one year until the maturity/interest rate adjustment, the difference may not exceed seven days; and
    - c) if there is more than one year until the maturity/interest rate adjustment, the difference may not exceed 30 days.
- b. The net positions obtained shall be included when calculating the capital requirement for the general interest rate risk in accordance with Section 44 or Section 45 of this Annex.

#### ***Section 42***

Authorised persons which mark-to-market and calculate the interest rate risk of derivatives in accordance with Section 3 to Section 7 of this Annex and Section 9 and Section 10 of this Annex on the basis of the present value of future cash flows may, on obtaining the Authority's permission, use a sensitivity model to calculate the positions. Positions obtained in this way shall be included when calculating the capital requirement for general interest rate risk according to the maturity-based method or duration-based method in accordance with Section 44 or Section 45 of this Annex.

#### ***Section 43***

- a. A sensitivity model shall be used to calculate the present value of all future cash flows that the different instruments give rise to using selected zero-coupon rates. The present value of each cash flow shall then be distributed among the maturity bands set out in Section 44 of this Annex. Within each maturity band, short and long positions may be netted so that there is only one position, long or short, per maturity band. These positions shall then be multiplied by the weight for that maturity band.
- b. Alternatively to what has been mentioned in paragraph (a) of this Section, the interest rate risk, that is the sensitivity of the present values of the cash flows to changes in the zero-coupon interest rates, may be calculated directly. The interest rate risk shall be assessed taking into account independent movements in interest rates along the yield curve/zero coupon curve with at least one sensitivity point for each of the maturity bands set out in Section 44 of this Annex and the assumptions about the size of interest rate changes made according to the maturity based method or the duration-based method. The interest rate risks shall then be distributed among the maturity

bands set out in Section 44 of this Annex or the zones set out in Section 45 of this Annex.

- c. The model shall be well documented, be used continuously and the authorised person shall be able to justify the use of the proposed model to the Authority. An authorised person's application for permission to apply a sensitivity model shall contain information about the model's algorithms, underlying assumptions, a justification and explanation of the selection of the zero coupon method and a description of the information technology system and control procedures.

#### ***Section 44***

When the maturity ladder approach is used to calculate the capital requirement for the general interest rate risk, the subsequent eight steps shall be followed:

Step 1. The authorised person shall assign net positions, both long and short, in each individual interest rate linked financial instrument to one of the maturity bands in Table 2. The factors that determine which maturity band is applied to each financial instrument are the remaining maturity and whether the interest rate according to the coupon is 3% or more. With regard to instruments with variable interest rates, remaining maturity refers to the time remaining until the next interest rate adjustment date.

**Table 2**

Zone	Maturity band	Remaining maturity		Weight (%)
		Coupon with 3% interest or more	Coupon with less than 3% interest	
One	1	$0 \leq 1$ month	$0 \leq 1$ month	0.00
	2	$> 1 \leq 3$ months	$> 1 \leq 3$ months	0.20
	3	$> 3 \leq 6$ months	$> 3 \leq 6$ months	0.40
	4	$> 6 \leq 12$ months	$> 6 \leq 12$ months	0.70
Two	5	$> 1 \leq 2$ years	$> 1.0 \leq 1.9$ years	1.25
	6	$> 2 \leq 3$ years	$> 1.9 \leq 2.8$ years	1.75
	7	$> 3 \leq 4$ years	$> 2.8 \leq 3.6$ years	2.25
Three	8	$> 4 \leq 5$ years	$> 3.6 \leq 4.3$ years	2.75
	9	$> 5 \leq 7$ years	$> 4.3 \leq 5.7$ years	3.25
	10	$> 7 \leq 10$ years	$> 5.7 \leq 7.3$ years	3.75
	11	$> 10 \leq 15$ years	$> 7.3 \leq 9.3$ years	4.50
	12	$> 15 \leq 20$ years	$> 9.3 \leq 10.6$ years	5.25
	13	$> 20$ years	$> 10.6 \leq 12$ years	6.00
	14		$> 12 \leq 20$ years	8.00
	15		$> 20$ years	12.50

Step 2. The authorised person's net position in each individual financial instrument shall be multiplied by the weight that applies to the net position's maturity band. Long and short net positions shall be weighted separately.

Step 3. The weighted long and short net positions are then aggregated individually within each maturity band. The portion of the sum of the weighted long net positions corresponding to the sum of the weighted short net positions, or vice versa, within each maturity band, is the matched position within the maturity band. The difference between both sums is the unmatched position within the same maturity band.

Step 4. All weighted long and short unmatched net positions are aggregated separately within each zone. The sum of weighted long and the sum of the weighted short unmatched positions are then matched within each zone. The matched positions resulting from this matching are

sum 2 for zone 1, sum 3 for zone 2 and sum 4 for zone 3. Sum 2 is weighted by 70%, sum 3 by 52.5% and sum 4 by 52.5%.

Step 5. The remaining unmatched positions, long or short, within each zone after matching in accordance with step 4 shall then be matched between the zones as follows.

First the long (short) unmatched position in zone 1 is matched with the short (long) unmatched position in zone 2. The resulting matched position is sum 5. The remaining long (short) unmatched position in zone 2 is then matched with the short (long) unmatched position in zone 3. The resulting matched position is sum 6. Both sums are weighted by 70%. In the matching process described in the previous paragraph, an authorised person may instead first match zones 2 and 3 and then zones 1 and 2.

Step 6. The remaining long (short) unmatched position in zone 1 is then matched with the remaining short (long) unmatched position in zone 3. The resulting matched position is sum 7. This sum is weighted by 250%.

Step 7. All unmatched positions remaining after the maturity bands and zones are matched are aggregated and are sum 8. This sum is weighted by 175%.

Step 8. The weighted sums obtained in steps 3–7 are aggregated and provide the capital requirement for general interest rate risk for interest rate linked financial instruments. Matching of positions and calculation of the capital requirement shall be carried out separately for each individual currency.

### *Section 45*

When the duration-based method is used to calculate the capital requirement for general interest rate risk, the subsequent eight steps shall be followed.

Step 1. With regard to each individual interest rate linked financial instrument with a fixed interest rate, the yield to maturity of the instrument is calculated based on the market value. The yield is calculated in the same way for each individual interest rate linked financial instrument with a variable interest rate but with the assumption that the principal of the instrument falls due on the next interest rate adjustment date.

Step 2. With regard to each interest rate linked financial instrument, the modified duration is calculated on the basis of the yield calculated in step 1. The modified duration shall be calculated using the following formula.

$$\text{Modified duration} = \frac{\text{Duration}}{(1 + r)}$$

$$\text{Duration} = \frac{\sum_{t=1}^m \frac{tC_t}{(1+r)^t}}{\sum_{t=1}^m \frac{C_t}{(1+r)^t}}$$

r = return to maturity as a percentage

C<sub>t</sub> = payment at time t

t = time to payment (years)

m = time to maturity (years)

Step 3. Each individual net position is assigned to the zone which, according to Table 3, can be applied to each financial instrument. The division into zones is based on the modified duration of the individual financial instrument.

**Table 3**

Zone	Modified Duration (years)	Assumed change in interest (percentage points)
One	$> 0 \leq 1.0$	1.00
Two	$> 1.0 \leq 3.6$	0.85
Three	$> 3.6$	0.70

Step 4. The authorised person shall calculate the duration-weighted net position of each individual financial instrument by multiplying the instrument’s market value by the modified duration and the assumed change in interest rate. The duration-weighted long net positions and duration-weighted short net positions are then aggregated separately within each zone.

The portion of the sum of the weighted long net positions corresponding to the sum of the weighted short net positions, or vice versa, within each zone, comprises the matched position within the zone. The difference between the weighted sums comprises the unmatched position within the zone.

The matched position comprises sum 1 for zone 1, sum 2 for zone 2 and sum 3 for zone 3. All sums are weighted by 3.5%.

Step 5. The remaining unmatched duration-weighted positions within each zone after matching in accordance with step 4 shall then be matched between the zones as follows.

First the long (short) unmatched duration-weighted position in zone 1 is matched with the short (long) unmatched duration-weighted position in zone 2. The resulting matched position is sum 4. The remaining long (short) unmatched position in zone 2 is then matched with the short (long) unmatched position in zone 3. The resulting matched position is sum 5. Both sums are weighted by 70%. In the matching process described in the previous paragraph, an authorised person may instead first match zones 2 and 3 and then zones 1 and 2.

Step 6. The remaining duration-weighted long (short) unmatched position in zone 1 is then matched with the remaining duration-weighted short (long) unmatched position in zone 3. The resulting matched position is sum 6. This sum is weighted by 250%.

Step 7. All remaining unmatched positions after the matching process within and between the zones are aggregated and become sum 7. This sum is weighted by 175%.

Step 8. The weighted sums obtained in steps 4–7 are aggregated and provide the capital requirement for general interest rate risk for interest rate linked financial instruments. Matching of positions and calculation of capital requirements shall be carried out separately for each individual currency.

## Chapter 2. Equity price risks

### *Section 46*

- a. Equity price risks shall be calculated for positions in equity and equity linked financial instruments included in an authorised person's trading book. Capital requirements for

equity price risks shall be calculated based on both the authorised person's gross and net position as they are defined in Section 54 to Section 55 of this Annex.

- b. Netting of the authorised person's long and short positions in equity and equity linked financial instruments may be carried out if they are issued by the same legal entity. Long and short positions in equity and equity linked financial instruments which belong to different classes may be netted against each other only if they have equal order of priority, dividend rights or rights in a future issue, and the difference between the equities' voting rights of a share of any class may not exceed ten times that of a share of another class.
- c. With regard to netting financial instruments and any underlying instruments, e.g. depository receipt, the underlying instruments shall be issued in the same currency.
- d. Positions in derivatives shall first be treated as positions in underlying financial instruments in accordance with Section 47 of this Annex.

***Section 47***

- a. Forwards and options shall be treated as combined long and short positions.
- b. A long (purchased) position in a forward or an option shall be treated as a combination of:
  - 1. A long position comprised of underlying financial instruments in the contract; and
  - 2. A short position corresponding to a zero coupon bond, for which the forward price for forwards or the exercise price of options consists of the amount due of the bond, and has a maturity date on the delivery date or exercise date for the contract.
- c.

- d. A short (sold) position in a forward or an option shall be treated as a combination of:
1. A short position comprised of underlying financial instruments in the contract; and
  2. A long position corresponding to a zero coupon bond, for which the forward price for forwards or the exercise price of options consists of the amount due of the bond, and has a maturity date on the delivery date or exercise date for the contract. Long and short positions deriving from an option shall be delta-weighted in accordance with Section 50 of this Annex.
- e. A zero coupon bond deriving from the partition of derivatives into a long and a short position shall be considered to be issued by a government which qualifies for credit quality step 1, alternatively to have a risk weight of 0%, in non-trading activities. When calculating specific and general risk, the zero coupon bond shall be considered to be an interest rate linked financial instrument and be treated in accordance with articles Section 1 to Section 45 of this Annex. The positions which arise from the partitioning into long and short positions shall be included in the calculation of specific and general risk unless otherwise set out in Section 48 to Section 55 of this Annex.

#### ***Section 48***

- a. Calculating capital requirements for specific risk for zero coupon bonds deriving from equity forwards may be carried out in accordance with Section 33. An underlying financial instrument shall be included when calculating the authorised person's gross position for specific risk, irrespective of whether the position is long or short.

- b. When calculating capital requirements for general risk, the zero coupon bond shall, irrespective of whether the position is long or short, be included when calculating matched and unmatched positions in interest rate linked financial instruments in accordance with Section 44 to Section 45 of this Annex. An underlying financial instrument shall be included when calculating the authorised person's net position for general risk, irrespective of whether the position is long or short.

***Section 49***

- a. Equity index forwards (including delta-weighted equivalents to options on equity index forwards and equity indexes) shall be treated as combined long and short positions in the same way that applies to other derivatives. A long or short position in such an index may be divided among the shares included in the index. These may be netted against opposite positions in the same share to the extent that the share is included in the index. Equity index forwards not divided among the shares included in the index shall be treated as individual shares.
- b. Calculating capital requirement for specific risk in zero coupon bonds may be carried out in accordance with Section 33 of this Annex.
- c. Forwards or options traded on regulated markets and based on a broadly diversified index or its equivalent may be assigned a capital requirement of 0% for specific risk.
- d. When calculating capital requirements for general risk, the zero coupon bond shall, irrespective of whether the position is long or short, be included when calculating matched and unmatched positions in interest rate linked financial instruments in accordance with Section 44 to Section 45 of this Annex.

## *Section 50*

- a. Options based on equity or equity indexes shall be treated as combined long and short positions in the same way as other derivatives. Both positions shall be converted into delta-weighted positions by multiplying the underlying instrument's market value by the option's delta value. The delta-weighted positions may be netted against any offsetting positions in the same type of underlying financial instrument. If the exchange that lists the options does not publish the delta values of the options, or if they are over the counter options, the authorised person shall calculate the delta values of its options.
- b. When calculating the capital requirement for specific risk for bought and sold options, the underlying debt instruments shall be included in the calculation of the authorised person's gross position. Calculating the capital requirement for specific risk in zero coupon bonds may be carried out in accordance with Section 33 of this Annex.
- c. When calculating the capital requirement for general risk for bought and sold options, the underlying debt instruments shall be included in the calculation of the authorised person's net position. The zero coupon bond shall be included when calculating matched and unmatched positions in interest rate linked financial instruments, in accordance with Section 44 or Section 45 of this Annex, irrespective of whether the position is long or short.
- d. A bought option does not need to be converted to a delta-weighted position and included in the calculation of specific risk as set out in Section 54 of this Annex or general risk as set out in Section 55 of this Annex. The capital requirement for such an option may instead be set equal to the market value of the option. Netting against an offset position in the underlying instrument cannot be carried out in this case.

- e. An authorised person shall have systems in place and apply protective measures such that sufficient account is taken of other risks associated with options trading, such as:
1. The sensitivity of the delta value to price changes in the underlying financial instrument (gamma);
  2. The sensitivity of the option price to changes in maturity (theta);
  3. The sensitivity of the option price to changes in standard deviation (vega); and
  4. The sensitivity of the option price to changes in the risk-free interest rate (rho).

### ***Section 51***

Warrants entailing rights to the purchase or other acquisition of financial instruments, which can be assigned to an on-going or future new share issue, shall be treated in the same way as the financial instruments in the issue. Such a position may be netted against corresponding positions in the opposite direction.

Warrants entailing rights to the purchase or other acquisition of previously issued financial instruments shall be treated in the same way as options. Warrants entailing rights other than those contained in the first and second paragraphs shall be treated in the same way as options.

### ***Section 52***

- a. A convertible debt instrument shall be treated as if the conversion to the underlying instrument has taken place if the intent is that such a conversion shall take place, or if the current market conditions are such that the conversion may be expected to take place. Such a position shall be delta-weighted and may be netted against a short position in an equivalent underlying financial instrument. A convertible debt

instrument that is not treated as if the conversion to the underlying instrument has taken place shall be treated as a debt instrument. Such a position may be netted against a short position in an equivalent underlying financial instrument. The capital requirement for such a position shall be calculated according to the rules for calculating capital requirements for interest rate linked financial instruments, pursuant to Chapter 1.

- b. Alternatively to what has been mentioned in paragraph (a) of this Section, a convertible debt instrument may be treated as a combination of the above alternatives. The portion corresponding to the underlying instrument is comprised of a subscription right or a subscription option and shall be treated in the same way as options. The portion corresponding to the debt instrument is comprised of the discounted present value of the portion of the debt instrument in the convertible debt. Such a position may be netted against a short position in an equivalent underlying financial instrument. The capital requirement for such a position shall be calculated according to the rules for calculating a capital requirement for equity linked financial instruments and interest rate linked financial instruments, as prescribed in this Chapter.

### ***Section 53***

An authorised person shall calculate capital requirements for specific and general equity risk separately for each individual currency in which the authorised person has positions. Positions in foreign currency shall be converted before the capital requirement is calculated. With regard to depository receipt, the underlying instruments shall be assigned to the currency in which the instrument was issued.

#### ***Section 54***

- a. The capital requirement for specific risk shall be set at 4% of the authorised person's gross position.
- b. In exceptional cases the capital requirement for specific risk may be reduced to 2% of the authorised person's gross position for share portfolios that fulfill the following conditions:
  1. Based on an objective evaluation the shares shall be considered to have a high liquidity;
  2. Shares issued by the same issuer may not exceed 5% of the value of the share portfolio, or 10% if the total sum of such individual positions does not exceed 50% of the share portfolio; and
  3. The shares may not be issued by an issuer whose interest rate linked financial instruments receive a capital requirement of 14% or 21% in accordance with Section 38 to Section 39 of this Annex.
- c. Gross position refers to the sum of all of the authorised person's net positions in financial instruments irrespective of whether they are long or short.

#### ***Section 55***

- a. The capital requirement for general risk shall be set to 14% of the authorised person's net position.
- b. Net position refers to the difference between the sum of the authorised person's long net positions in financial instruments and the sum of the authorised person's short net positions in financial instruments.

## Chapter 3. Risks related to investment funds

### *Section 56*

The capital requirement for general and specific risk for positions in investment funds shall, unless otherwise stated, be calculated by the market value of the position multiplied by 32%.

### *Section 57*

Positions in investment funds may be treated in accordance with Section 58 to Section 60 of this Annex if they either satisfy the requirement of the Investment Funds Regulations, or meet the following criteria:

- 1) The investment fund is managed by a company subject to supervision by a competent supervisory authority;
- 2) The investment fund's terms and conditions and/or information brochure or equivalent documentation includes:
  - a) the categories of assets in which the investment fund is authorised to invest;
  - b) how any investment limits on the investment fund shall be calculated;
  - c) the investment fund's rules for limiting counterparty risk in repurchase transactions and over the counter derivatives if the investment fund has the right to make such transactions; and
  - d) how comprehensive the leverage may be if the investment fund has the right to use leverage in investments;
- 3) Information about the investment fund's activities and assets, liabilities and revenue shall be reported at least every six months;

- 4) It shall be possible for investment fund units to be redeemed in cash on a daily basis at the request of the unitholder;
- 5) The positions in the investment fund shall be separate from the investment fund manager's positions; and
- 6) The authorised person shall have evaluated the risks of investing in the investment fund.

***Section 58***

Where an authorised person is aware of all positions included in the investment fund, they may be treated as if they were held directly by the authorised person. The netting of such positions against other positions held by the authorised person may be carried out. A condition for this is that the authorised person has a sufficient amount of investment fund units for these to be converted into holdings in the financial instruments which are part of the investment fund.

***Section 59***

If an investment fund replicates an index, an authorised person may treat the holding in the investment fund as if it had positions in the securities included in the index or basket. However, the following conditions shall be met.

- 1) The investment fund shall aim to replicate an index or basket of securities; and
- 2) The correlation coefficient between the daily price of the investment fund units and the daily price of the index or basket shall be at least 0.9. The correlation coefficient shall be calculated on the basis of a minimum of six months.

**Section 60**

- a. If an authorised person is not aware on a day-to-day basis of the positions included in the investment fund, the authorised person may treat holdings in the investment fund as follows:
- 1) The authorised person shall assume that the investment fund is investing to the maximum extent allowed under the relevant law, rules, or the investment fund's terms and conditions in the asset classes attracting the highest capital requirement for specific and general risk. The authorised person shall then assume that the investment fund is investing to the maximum extent allowed in the asset classes attracting successively lower capital requirement for specific and general risk. When calculating specific and general risk, the authorised person shall be considered to hold positions in all of these asset classes; and
  - 2) The authorised person shall take account of the maximum indirect exposure that it could achieve by taking leveraged positions through the investment fund when calculating its position risk, by proportionally increasing the position in the investment fund up to the maximum exposure to the underlying investment items resulting from the investment mandate.
- b. Where an authorised person applies the method mentioned in paragraph (a) of this Section, the capital requirement for the position in the investment fund shall not be more than the market value of the position multiplied by 32%.

## Chapter 4.Underwriting

### *Section 61*

- a. An authorised person that guarantees or offer to purchase previously issued equity and/or interest bearing financial instruments shall calculate the capital requirement following the same principles which would apply if the financial instruments were part of the authorised person's trading book.
- b. If an authorised person only guarantees a subscriber will pay cash for an issue or offer for subscribed financial instruments on the settlement date, that is payment guarantee, the guarantee is not covered by the provisions regarding the capital requirements for risks in the trading book. The capital requirement for such a guarantee shall instead be calculated in accordance with the capital requirements for non-trading activities pursuant to Chapter 6 to Chapter 7 of Part 3 and Annex 3.

### *Section 62*

- a. An alternative method that an authorised person may use on obtaining the permission of the Authority allows the authorised person to deduct the portions of the issue or offer subscribed or underwritten by a third party pursuant to a formal agreement from the portion of the issue or offer underwritten by the authorised person. In order for an issue or offer to be considered subscribed or underwritten by a third party, the written contract shall contain the third party's unconditional liability for the issue or offer.
- b. After the deduction in accordance with the above paragraph, the authorised person may reduce the positions by the reduction factors in Table 4 below.

**Table 4**

Working Day	Reduction Factor
0	100%
1	90%
2-3	75%
4	50%
5	25%
after working day 5	0%

Working day “0” in Table 4 above means the day on which the authorised person becomes unconditionally obliged to accept a certain quantity of the financial instrument at a price determined in advance. This refers to the first day after the end of the subscription period or another, earlier date when it is clear how large a portion of the issue or offer has not been subscribed and shall therefore be underwritten by the authorised person.

- c. When the authorised person’s positions have been determined, the authorised person shall calculate the capital requirement for the underwritten and reduced positions in accordance with the rules which apply to calculating a capital requirement for the holding of such financial instruments.

## Chapter 5.Excess exposure

### *Section 63*

- a. With regard to excess exposures pursuant to Article 58 of these Rules, special additional capital requirement applies to the capital requirements normally calculated for the authorised person’s portfolio. When calculating the additional capital

requirement, the excess exposure shall be comprised of the individual exposures in the trading book that have the highest capital requirement for specific risk and/or counterparty and settlement risk.

- b. The additional capital requirement is 200% of the sum of the capital requirements that apply to the individual exposures included in the excess exposure, if ten days or less have passed since an excess exposure has arisen.
- c. If an excess exposure has existed for longer than ten days, the exposures included in the excess exposure shall be entered into Table 5 below. The excess exposures shall be slotted into the respective bands starting with those trading book exposures which have the lowest capital requirements for specific risk under the market risk capital requirement or the lowest capital requirements under the counterparty risk capital component and taking those with the highest capital requirements last.
- d. The limits in the first column of Table 5 below refer to the proportion of capital of the aggregated exposure. Only the exposures included in the excess exposure are to be entered into the table.

**Table 5**

Excess Exposure	Factor
Up to 40%	200%
40–60%	300%
60–80%	400%
80–100%	500%
100–250%	600%
over 250%	900%

- e. The additional capital requirement for the excess exposure is the lowest of:
  - 1. The sum of the capital requirements which, in accordance with this Chapter, apply to the individual exposures after these have been multiplied by the percentages set out in the table; and
  - 2. 100% of the exposure.

## Chapter 6. Settlement risks

### *Section 64*

- a. The capital requirements for settlement risks shall be calculated for positions that are included in the trading book of an authorised person. Repos, reverse repos, securities borrowing and securities lending are exempted from this provision.
- b. When calculating the capital requirement for settlement risks, account must be taken of the risk of losses to the authorised person for a transaction that is not completed on the due settlement date. Either the purchaser or seller is assigned the capital requirement in an individual transaction.

### *Section 65*

- a. With regard to transactions in interest, equity, currency and commodity-linked financial instruments as well as commodities which are not settled on the due settlement date, the authorised person shall calculate the loss, that is the negative difference in price which the authorised person risks suffering, without regard to potential positive differences in price. Netting of positive and negative differences in

price in different transactions may not occur. The negative difference in price is made up of the difference between the agreed price of the financial instrument or commodity and the current market value on the calculation date.

- b. If a financial instrument or commodity is purchased, a negative price difference arises if the current market value of the instrument or commodity exceeds the agreed price. If a financial instrument or commodity is sold, a negative price difference arises if the agreed price exceeds the current market value of the instrument or commodity.
- c. The capital requirement is calculated by multiplying the absolute value of the negative price difference by the capital requirement factor in accordance with Table 6 below.

**Table 6**

Number of working days after due settlement date	Capital requirement (%)
0-3	0
4-5	100
6 or more	175

Chapter 7. Counterparty risks

**Section 66**

- a. An authorised person shall calculate a risk-weighted exposure amount for counterparty risk in:
  - 1. Transactions in which the counterparty has not fulfilled its delivery/payment liability;
  - 2. Over the counter derivatives and other derivatives giving rise to credit exposure;

3. Repos, reverse repos, securities lending or borrowing transactions; and
  4. Margin lending transactions based on securities or commodities.
- b. Calculating a risk-weighted exposure amount shall be carried out in accordance with Chapter 6 to Chapter 7 of Part 3 and Annex 3.

***Section 67***

An authorised person shall apply the provisions set out in Section 68 to Section 70 of this Annex if the authorised person has paid for securities, foreign currency or commodities before receiving them, or if the authorised person has delivered securities, foreign currency or commodities before receiving payment for them.

***Section 68***

An authorised person shall, as of the due settlement date and up to and including the fourth day after the settlement date, treat that component of the transaction which the counterparty has not fulfilled as an exposure, for which the authorised person shall calculate a risk-weighted amount. With regard to cross-border transactions an exposure shall not be considered to arise before the day after the due settlement date.

***Section 69***

If the exposures set out in Section 67 and Section 68 of this Annex are insignificant in relation to the total exposure of the authorised person, the authorised person may apply a risk weight of 100%. This may be done on condition that this method is applied for all such exposures.

### ***Section 70***

As of the fifth day after the due settlement date and until the transaction terminates, the authorised person shall deduct the value of what has been delivered to the counterparty from Tier-1 capital. If the transaction has a positive price difference, this value shall also be deducted from Tier-1 capital.

### ***Section 71***

- a. When calculating potential risk change, the credit derivative shall be assigned a risk factor of 10%. If the reference asset is an asset that may be assigned a risk weight for specific risk in accordance with Section 33 to Section 34 of this Annex, the risk factor may be 5%.
- b. If the credit derivative is a credit default swap, the authorised person may use a risk factor of 0% if the following requirements have been met:
  1. Through the credit default swap the authorised person shall have a long position in the underlying asset, which is the authorised person has purchased risk; and
  2. The credit default swap agreement may not contain provisions which entail that the derivative closes in the event of insolvency of the party with a short position in the underlying asset.
- c. When a credit derivative is designed so that it becomes due for payment when the  $n^{\text{th}}$  default occurs in a basket of assets, the authorised person shall base the calculation on the asset in the basket that has the  $n^{\text{th}}$  worst credit quality to determine the risk factor. If this asset is an asset that may be assigned a risk weight for specific risk in

accordance with Section 33 or Section 34 of this Annex, the risk factor shall be 5%.  
Otherwise the risk factor shall be 10%.

***Section 72***

- a. Collateral that meets the conditions in Section 85 to Section 8 of Annex 3 are eligible collateral.
- b. Financial instruments and commodities assigned to the trading book are eligible as collateral if these are also included in repurchase transactions or in securities lending or borrowing transactions which are also assigned to the trading book.
- c. If the authorised person uses the prescribed volatility adjustments in accordance with Section 10 to Section 11 of Annex 3, eligible collateral shall be adjusted for volatility in accordance with the category “Other eligible collateral”.

***Section 73***

Authorised persons which, in accordance with Section 11 to Section 13 of Annex 3, take account of netting agreements when calculating a risk-weighted exposure amount, shall take the following into consideration with regard to repurchase transactions, securities lending or other capital market driven transactions. With regard to this type of transaction, netting between transactions that are on the trading book and non-trading activities, respectively, may only take place when the following conditions have been met:

1. All transactions shall be marked to market daily; and
2. All financial instruments or commodities borrowed, purchased or received as part of the transactions shall be recognisable collateral in accordance with the provisions in Section 85 to Section 8 of Annex 3.

## **Annex 3: NON-TRADING ACTIVITIES**

### Chapter 1. Exposure classes and risk weights

#### ***Section 1***

Where a credit rating is used to determine the risk weight of the exposure, the risk weight shall be assigned based on the exposure's credit quality step in accordance with the rules for using credit ratings as set out in Chapter 8 of Part 3.

#### ***Section 2***

Exposures to governments or central banks for which a credit rating is available shall be assigned a risk-weight according to one of the credit quality steps set out in Table 7 below.

**Table 7**

Credit quality step	1	2	3	4	5	6
Risk weight	0%	20%	50%	100%	100%	150%

#### ***Section 3***

Exposures to governments or central banks for which a credit rating is not available shall be assigned a risk-weight of 100%.

#### ***Section 4***

An authorised person shall apply a risk-weight of 0% for exposures to SAMA regardless of what is stated in Section 2 and Section 3.

### *Section 5*

Exposures to administrative bodies (including public sector entities) and non-commercial companies shall be assigned a risk-weight of 100%.

### *Section 6*

- a. Where exposures to public sector entities are treated by the Authority as exposures to governments and central banks, such exposures may be assigned the same risk weight as governments and central banks.
- b. Where the Authority treats exposures to public sector entities as exposures to authorised persons, such exposures may, with the permission of the Authority, be assigned the same risk weight as exposures to authorised persons.

### *Section 7*

Exposures to authorised persons, banks and foreign equivalents in countries where credit ratings for the government are available may be assigned a risk-weight according to one of the credit quality steps set out in Table 8 below. Otherwise, a risk-weight of 150% shall be used for exposures to authorised persons, banks and foreign equivalents.

**Table 8**

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	100%	150%

**Section 8**

Exposures to authorised persons, banks and foreign equivalents in countries where credit ratings for the government are not available shall be assigned a risk-weight of 150%.

**Section 9**

Exposures to authorised persons, banks and foreign equivalents with an original maturity of three months or less and for which a credit rating for the specific exposure is available maybe assigned a risk-weight according to one of the credit quality steps set out in Table 9 below.

**Table 9**

Credit quality step	1	2	3	4	5	6
Risk weight	20%	20%	20%	50%	50%	150%

**Section 10**

Investments in equity or other instruments issued by other authorised persons or banks or foreign equivalents that may be included in capital, as set out in Section 1 of Annex 1 shall be assigned a risk-weight of 150%.

**Section 11**

Exposures to corporates for which a credit rating is available maybe assigned a risk weight in accordance with Table 10. Otherwise, a risk-weight of 150% shall be used for exposures to corporates.

**Table 10**

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

***Section 12***

Retail exposures refer to exposures to natural persons and shall be assigned a risk-weight of 100%.

***Section 13***

- a. Past due item shall refer to an exposure where, interest or principal are more than 90 days past due, calculated from the original agreed payment date.
- b. The unsecured part of any item that is past due shall be assigned the following risk weight:
  1. 150% if specific provisions are less than 20% of the unsecured part of the exposure gross of specific provisions; and
  2. 100% if specific provisions are more than 20% of the unsecured part of the exposure gross of specific provisions.

***Section 14***

Exposures associated with particularly high risks such as investments in venture capital companies and other private equity investments (including private equity funds) shall be assigned a risk weight of 150%. Non-securities business shall also be assigned a risk weight of 150%.

**Section 15**

With the exception of past due items, high-risk exposures assigned a 150% risk weight, and for which specific provisions have been established shall be assigned the following risk weight:

1. 100% if specific provisions are at least 20% of the exposure value, gross of specific provisions; and
2. 50% if specific provisions are at least 50% of the exposure value, gross of specific provisions.

**Section 16**

Exposures to investment funds for which a credit rating is available shall be assigned a risk-weight according to one of the credit quality steps set out in Table 11 below.

**Table 11**

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

**Section 17**

Exposures to investment funds for which a credit rating is not available shall be assigned a risk weight of 100%.

### ***Section 18***

Where the authorised person is aware of all of the underlying exposures of an investment fund, exposures to an investment fund may be assigned a risk weight as if the underlying exposures were owned directly by the authorised person.

### ***Section 19***

If the authorised person is not aware of the underlying exposures of an investment fund, the authorised person may calculate an average risk weight for the investment fund. This assumes that the investment fund first invests, to the maximum extent allowed under its mandate in the exposure classes attracting the highest risk weights, and then continues making investments in descending order in the remaining exposure classes.

### ***Section 20***

An authorised person may rely on a third party to calculate a risk weight for the investment fund in accordance with the methods set out in Section 18 and Section 19 of this Annex, provided the correctness of the calculation may be adequately ensured.

### ***Section 21***

To assign a risk weight for an investment fund in accordance with Section 18 to Section 20 of this Annex, the following criteria shall be met:

1. The investment fund is administered by an authorised person or a foreign equivalent subject to supervision of a competent authority; and
2. The investment fund's information brochure or equivalent document includes:

- a) the categories of assets in which the investment fund is authorised to invest; and
  - b) clarification of whether investment limits apply, that is the threshold values and the methods to calculate them; and
3. The business of the investment fund shall be reported on at least an annual basis to enable an assessment of the assets, liabilities, income and operations.

***Section 22***

Exposures to real estate funds shall be assigned a risk-weight of 714%.

***Section 23***

Real estate investments shall be assigned a risk-weight of 714%.

***Section 24***

Items referred to in Section 25 to Section 30 of this Annex shall be classified in the exposure class “Other items”.

***Section 25***

Tangible assets shall be assigned a risk weight of 714%.

***Section 26***

Deferred expenditures and accrued income for which an authorised person is unable to determine the counterparty, or if it would be unreasonably burdensome for the authorised person to determine the counterparty, shall be assigned a risk weight of 714%.

***Section 27***

Holdings of equity and other participations shall be assigned a risk weight of 714%.

***Section 28***

Cash in hand and equivalent items shall be assigned a risk weight of 0%.

***Section 29***

Gold bullion held in own vaults or at an assigned location to the extent the authorised person has bullion liabilities shall be assigned a 0% risk weight.

***Section 30***

Exposures in any other form of items for which rules regarding risk-weighted amounts are not provided in Section 25 to Section 29 of this Annex shall be assigned a risk weight of 714%.

Chapter 2. Calculating exposure amounts for off-balance sheet items

***Section 31***

All off-balance sheet commitments shall be multiplied by a conversion factor.

***Section 32***

A conversion factor of 100% applies to the following commitments:

1. Guarantees having the character of credit substitutes and other similar commitments, such as guarantees issued by authorised persons to a central clearing institution which

entail that the authorised person shall upon request pay a maximum amount to the clearing institution pursuant to the guarantee as an issuer in the clearing system;

2. Repurchase transaction:

- a) In a repurchase agreement the transferring party shall calculate the capital requirement for counterparty risk with regard to the transferred asset; and
- b) An authorised person which is the seller at the spot phase of an optional repurchase agreement and which is obliged at a later date to repurchase a previously sold asset shall, for the agreed exercise price, be assigned the risk weight applying to the underlying asset in the transaction;

3. Securities lending and other similar commitments:

- a) The risk weight for lent assets is based on which party is the counterparty; and
- b) The risk weight for collateral for borrowed assets is based on which party is the counterparty;

4. Commitment to provide margin lending facilities; and

5. Commitments to make payments and other similar commitments:

- a) Commitments such as the unpaid portion of shares and other securities that sellers upon request may require to be settled and other full risk items; and
- b) Where an authorised person on the settlement date receives from the seller a delivery commitment instead of the purchased security, the capital requirement is calculated

from the delivery commitment. The delivery commitment shall be assigned a risk weight based on the issuer of the commitment.

### ***Section 33***

A conversion factor of 50% applies to the following commitments:

1. Other guarantees:
  - a) Warranties and indemnities e.g. tender, performance, customs and tax;
  - b) A guarantee issued by an “authorised person” on behalf of a third authorised person which entails that the “authorised person” shall be responsible for the fulfilment of the authorised person’s obligations to the stock market clearing house; and
  - c) Guarantees for commercial paper programs or other domestic borrowing programs with an original maturity of more than one year; and
2. Guarantees for borrowing facilities:
  - a) Commitments in the form of Note Issuance Facilities (NIFs) and Revolving Underwriting Facilities (RUFs).

### ***Section 34***

A conversion factor of 20% applies to guarantees for commercial paper programs or other domestic borrowing programs with an original maturity of at the most one year.

### ***Section 35***

A conversion factor of 0% applies to guarantees for commercial paper programs or other domestic borrowing programs that may be unconditionally cancelled at any time without notice.

## Chapter 3. Calculating the non-trading book exposure amount for derivatives

### ***Section 36***

- a. An authorised person shall apply either the marking-to-market or risk approach for calculating exposure amounts for counterparty risk in derivatives.
- b. Within a financial group, the marking-to-market and risk approaches may be combined.  
An individual legal entity shall only use one approach.

### ***Section 37***

Derivatives based on different types of indices shall be classified as interest rate, equity, commodity or exchange rate derivatives depending on the relevant type of index in each individual case.

### ***Section 38***

An authorised person that purchases credit protection through credit derivatives for an exposure that is not assigned to the trading book or for an exposure to counterparty risk may set the exposure amount for the credit derivative to zero (0).

### ***Section 39***

An authorised person may take netting agreements into account when establishing exposure amounts in accordance with the provisions in Section 11 to Section 13 of this Annex.

### ***Section 40***

The exposure amount under the marking-to-market Approach is the sum of the current replacement cost on the balance sheet date according to Section 41 of this Annex and the amount of possible risk change according to Section 42 of this Annex. For interest rate swaps where both legs are denominated in the same currency and are based on floating rates, the exposure amount shall only constitute replacement cost.

### ***Section 41***

Current replacement cost for an existing contract refers to the cost which the authorised person would incur for acquiring an equivalent new contract on the balance sheet date. Where the contract is of a type regularly traded on the market, replacement cost may be set at current market value. Where current market prices are not available, the contract's present value shall be calculated using current market interest rates and exchange rates. The calculation shall be based on current quotations that are professionally assessed to be correct for the currencies and maturities of the contract. For contracts with negative market value, the replacement cost shall be deemed to be zero.

### ***Section 42***

Amount for possible risk change refers to an amount which expresses the possibility that the replacement cost increases during the residual term of the contract calculated from the balance sheet date. Possible risk change is calculated for each contract (even for contracts that have a

negative market value on the balance sheet date) by multiplying the contract's notional principal amount by a risk factor as set out in Table 12 below.

**Table 12**

Residual maturity	Interest rate contracts	Contracts concerning foreign exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities except precious metals and gold
≤ 1 year	0%	1%	6%	7%	10%
> 1 ≤ 5 years	0.5%	5%	8%	7%	12%
> 5 years	1.5%	7.5%	10%	8%	15%

Contracts which do not fall within one of the five categories specified in the table shall be treated as contracts concerning commodities except precious metals. For contracts where outstanding exposures are settled periodically so that the market value of the contract is reset to zero on each such occasion, the residual maturity shall be equal to the time until the next reset date.

***Section 43***

Notional principal refers to the amount in the reporting currency which the original contract covers. When determining a contract's notional amount where the reporting currency is not included at any stage, the value shall be calculated in accordance with the applicable spot rates at the time of calculation. The notional amount shall be the higher of the two values obtained as a result of the translation to the reporting currency. The authorised person shall ensure that the notional amounts that may be used are relevant for the risk the contract entails.

**Section 44**

Authorised persons which have received permission from the Authority to calculate commodities risk in accordance with Section 7 of Annex 6 may use the risk factors presented in Table 13 instead of those presented in Table 12.

**Table 13**

Residual maturity	Contracts concerning precious metals except gold	Contracts concerning base metals	Contracts concerning agricultural products	Contracts concerning other commodities (incl. energy)
≤ 1 year	2.0%	2.5%	3.0%	4.0%
> 1 ≤ 5 years	5.0%	4.0%	5.0%	6.0%
> 5 years	7.5%	8.0%	9.0%	10%

**Section 45**

A risk approach may only be used for derivatives.

**Section 46**

- a. An exposure amount under the risk approach shall be calculated separately for each netting set taking into account any collateral as follows:

Exposure amount =

$$\beta * \max \left( CMV - CMC; \sum_j \left| \sum_i RPT_{ij} - \sum_i RPC_{ij} \right| * CCRM_j \right)$$

where

$CMV$  = the current market value of all transactions within the netting set with a counterparty gross of collateral, where

$$CMV = \sum_i CMV_i$$

$CMV_i$  = the current market value for the transaction  $i$ ,

$CMC$  = the current market value of the collateral assigned to the netting set, where

$$CMC = \sum_l CMC_l$$

$CMC_l$  = the current market value of collateral  $l$ ,

$i$  = refers to the transaction,

$l$  = refers to the collateral,

$j$  = refers to hedging set category

These hedging sets correspond to risk factors for which risk positions of opposite sign may be offset to yield a net risk position on which the exposure measure is then based.

$RPT_{ij}$  = Risk position from transaction i with respect to hedging set j,

$RPC_{ij}$  = Risk position from collateral l with respect to hedging set j,

$CCRM_j$  = Multiplier set out in Section 59 for counterparty credit risk with respect to hedging set j, and

$\beta = 1.4$ .

- b. Collateral that is recognisable with the approach clarified in paragraph (a) of this Section is limited to the collateral that is eligible under Annex 3 and commodities assigned to the trading book.

#### ***Section 47***

For a credit default swap, the risk position consists of the notional value of the reference debt instrument multiplied by the remaining maturity of the credit default swap.

#### ***Section 48***

For options or other similar instruments (e.g. swaptions), the risk position consists of the delta equivalent market value of the underlying financial instrument for the transaction except in the case of an underlying debt instrument. Where the underlying instrument is a debt instrument or a payment leg, the risk position consists of the delta equivalent market value of the financial instrument or payment leg multiplied by the modified duration for the debt instrument or the payment leg.

#### ***Section 49***

- a. For other derivatives the risk position is the market value of the underlying financial instrument (also commodities) converted to SAR. For debt instruments and payment legs, however, the risk position is the market value of the outstanding gross payments (including notional amounts), converted to SAR and multiplied by the modified duration of the debt instrument or payment leg, respectively.
- b. Where the underlying financial instruments are equity (also equity index) or commodities, these shall be allocated a risk position for the respective equity (or equity index) or commodity and an interest rate risk position for the payment leg. If the payment leg is expressed in foreign currency the currency shall also be allocated a risk position.
- c. Where the underlying instrument is a debt instrument, one interest rate risk position shall be allocated for the debt instrument and another for the payment leg. Where payment shall take place against payment (including foreign currency forwards), an interest rate risk position is allocated for each payment leg. Where the underlying debt instrument is expressed in foreign currency, a risk position is allocated for the foreign currency. Where a payment leg is expressed in foreign currency, this is also allocated a risk position for the currency concerned. The exposure amount assigned to an interest basis swap is zero.

#### ***Section 50***

For the determination of risk positions, collateral received from a counterparty shall be treated as a long position that is due today whereas collateral posted shall be treated as a short position that is due today.

### ***Section 51***

For payment legs with a remaining maturity of less than a year, the authorised person shall disregard the interest rate risk. For transactions that consist of two payment legs denominated in the same currency, for example interest rate swaps, the authorised person may treat the transaction as a single transaction.

### ***Section 52***

An authorised person shall use the following formulae to determine the amount and sign of its risk position:

1. For all other instruments than debt instruments: market value, or

$$\text{delta equivalent market value} = P_{ref} \frac{\partial V}{\partial p}$$

where

$P_{ref}$  = the price of the underlying instrument, expressed in the reference currency,

$V$  = the option price for an option or the value of the underlying instrument for other transactions, and

$p$  = the price of the underlying instrument expressed in the same currency as  $V$ .

2. For the debt instrument and payment legs for all transactions: market value multiplied by the modified duration, or delta equivalent market value multiplied by the modified duration

$$\frac{\partial V}{\partial r}$$

where

V = the option price for an option or the value of the underlying instrument or payment leg for other derivatives, and

r = interest rate.

If V is expressed in another currency than the reference currency the derivative shall be converted to the reference currency.

### ***Section 53***

Sections from 53 to 58 of this Annex contain provisions for the hedging sets. For the calculation of the exposure amount, risk positions shall be grouped in hedging sets. The net risk position shall be calculated for each hedging set, that is the absolute value of the sum of the resulting risk positions. The net risk position is calculated in Section 46 of this Annex by the following.

$$\left| \sum_i RPT_{ij} - \sum_l RPC_{lj} \right|$$

### ***Section 54***

For interest rate risk positions from payment legs, money deposits received from the counterparty as collateral as well as underlying debt instruments, which in accordance with

Section 33 to Section 37 of Annex 2, shall be assigned a capital requirement of a maximum of 1.6%, there are three hedging sets set out in Table 14. The hedging amount shall be calculated for each separate currency.

Table 14

	Government referenced interest rates
Maturity	$\leq 1$ year
Maturity	$> 1 \leq 5$ years
Maturity	$> 5$ years

**Section 55**

For interest rate risk positions from payment legs or underlying debt instruments with interest rates linked to a reference interest rate that represents a general market interest level, the remaining maturity is equivalent to the time interval up to the next adjustment of the interest rate. In all other cases the maturity is the remaining life of the underlying debt instrument or, in the case of a payment leg, the remaining life of the transaction.

**Section 56**

There is one hedging set for each issuer of a reference debt instrument underlying a credit default swap.

**Section 57**

- a. In the case of interest rate risk positions from money deposits that are posted with a counterparty as collateral, when that counterparty has no outstanding debt obligations with low specific risk and from underlying debt instruments, which according to Section 38 to Section 39 of Annex 2 shall be assigned a capital requirement of over

1.6%, there is a hedging set for each issuer. When a payment leg emulates such a debt instrument, there is also a hedging set for each issuer.

- b. Authorised persons may assign risk positions arising from debt instruments of a certain issuer or from reference debt instruments of the same issuer that are emulated by payment legs or that underlie a credit default swap to the same hedging set.

***Section 58***

- a. Underlying financial instruments other than debt instruments shall be assigned to the same hedging sets only if they are identical or similar instruments. In all other cases, they shall be assigned to separate hedging sets.
- b. The similarity of instruments is established as follows:
  - 1. For equities, similar instruments are those of the same issuer. An equity index is treated as a separate issuer; and
  - 2. For precious metals, similar instruments are those of the same metal. A precious metal index is treated as a separate precious metal; and
  - 3. For electric power, similar instruments are electricity supply rights and obligations that refer to the same peak and off-peak load interval over 24 hours; and
  - 4. For commodities, similar instruments are those of the same commodity. A commodity index is treated as a separate index.

**Section 59**

- a. Multipliers for counterparty credit risk (CCRM) for the different hedging set categories shall be assigned in accordance with Table 15 below:

**Table 15**

	Hedging set categories	CCRM
1.	Interest rates	0.2%
2.	Interest rates for risk positions from a reference debt instrument that underlies a credit default swap and which, in accordance with Section 33 to Section 37 of Annex 2, shall be assigned a capital requirement of a maximum of 1.6%	0.3%
3.	Interest rates for risk positions from a debt instrument or reference instrument and which in accordance with Section 38-Section 39 of Annex 2, shall be assigned a capital requirement of over 1.6%.	0.6%
4.	Exchange rates	2.5%
5.	Electric power	4.0%
6.	Gold	5.0%
7.	Equity	7.0%
8.	Precious metals (except gold)	8.5%
9.	Other commodities (except precious metal, gold and electric power)	10.0%
10.	Underlying financial instruments of derivate contracts that are not in any of the above categories	10.0%

- b. The underlying instruments of derivatives according to point 10 in Table 10 shall be assigned to separate individual hedging sets for each category of underlying financial instrument.

**Section 60**

For transactions with options where an authorised person cannot establish a delta value or modified duration, the authorised person may instead use the marking-to-market approach to

determine the exposure amount. In this case netting may not be taken into account, that is the exposure amount shall be determined as if there was a netting set which only contains the individual transaction.

#### Chapter 4. Credit protection

##### *Section 61*

An authorised person intending to utilize the effect of credit protection when calculating a risk-weighted exposure amount shall apply Chapter 4 to Chapter 8.

##### *Section 62*

An authorised person may only consider the effect of recognisable protection. Protection is recognisable if the form is eligible and if the authorised person meets the specific requirements related to the management of each respective form of protection.

##### *Section 63*

Where an individual exposure has more than one type of recognisable credit protection the authorised person shall distribute the exposure among the different types of credit protection. A risk-weighted exposure amount shall be calculated separately for each component.

## Chapter 5. Guarantees and credit derivatives

### *Section 64*

Guarantees and credit derivative are recognisable if they are eligible in accordance with Section 65 of this Annex and the authorised person meets the management requirements set out in Section 75 of this Annex.

### *Section 65*

Guarantees and credit derivative are eligible as credit protection if they are issued by an eligible protection provider in accordance with Section 66 of this Annex and meet the conditions pursuant to Section 67 to Section 74 of this Annex.

### *Section 66*

Eligible issuers of guarantees and credit derivatives are issuers whose commitments are assigned to one of the following exposure classes:

1. Exposures to governments and central banks; or
2. Exposures to public sector entities treated as governments and central banks or authorised persons; or
3. Exposures to authorised persons.

In addition to what has been mentioned in paragraph (a) of this Section, companies with a credit rating corresponding to credit quality step 2 or better are deemed to be eligible issuers of guarantees and credit derivative.

***Section 67***

In order for a guarantee or a credit derivative to provide eligible protection, the following requirements shall be met:

1. The protection is direct;
2. The protection applies to clearly defined and identifiable claims; and
3. The protection agreement is legally enforceable in all relevant jurisdictions.

***Section 68***

a. The protection agreement may not contain conditions outside the control of the authorised person that entail that:

1. The issuer of the guarantee or credit derivative has a unilateral right to revoke the protection;
2. The cost of the protection increases due to the deteriorating quality of the protected asset;
3. The issuer of the guarantee or credit derivative is not obliged to pay out in a timely manner in the event the obligor fails to make payments due; or
4. It is possible for the issuer of the guarantee or credit derivative to reduce the maturity of the guarantee or credit derivative.

b. The following shall also apply to the agreement referred to in paragraph (a) of this Section:

1. Protection in the form of guarantees shall meet the conditions set out in Section 66 of this Annex; and

2. Protection in the form of credit derivatives must meet the conditions in Section 67 to Section 70 of this Annex.

***Section 69***

- a. In the event of a failure to pay, the authorised person shall have the right to, without undue delay, make a claim for payment against the protection issuer, without first being required to make a claim against the obligor.
- b. This requirement mentioned in paragraph (a) of this Section does not need to be met for counter-guarantees or guarantees issued by credit guarantee associations or guarantors, on condition that one of the following conditions have been met:
  1. The terms of the contract give the authorised person the right to, without undue delay, receive a provisional payment corresponding to a reliable estimate of the amount constituting the guaranteed portion of the authorised person's expected financial loss, including losses arising from the non-payment of interest and other amounts for which the borrower is obligated to make; or
  2. The authorised person can demonstrate that the loss-protecting effects, including losses resulting from non-payment of amounts for which the borrower is liable, justify the above. Guarantees which protect exposures using collateral in residential real estate are also eligible where the period before the authorised person can demand payment from the issuer is up to 24 months.

***Section 70***

- a. The following types of credit derivatives are eligible:
  1. Credit default swaps;

2. Total return swaps; and
  3. Credit linked note for the amount paid in.
- b. Financial instruments composed of or financially equivalent to these types of credit derivatives are also eligible.
- c. A total return swap is not eligible if the authorised person books the net payments from this credit derivative as income but does not take up a corresponding reduction in the value of the asset which the credit derivative protects as a cost.

*Section 71*

- a. Events that mean that the credit derivative becomes due for payment (credit events) shall at least include:
1. The obligor defaults on amounts due;
  2. The obligor stops payments or applies for bankruptcy; and
  3. A grace period for the obligor in which to pay instalments and interest due or any other change to the terms of payment, in a manner that results in a financial loss for the authorised person.
- b. Where in accordance with the underlying debt instrument, the obligor can obtain a grace period regarding the payment of amounts due, the definition of the credit event pursuant to the above, point 1, must take account of this. Where the credit event does not include that set out in the first paragraph, point 3, the credit derivative may still be taken into account, although the protected amount shall be reduced in accordance with Section 79 of this Annex.

- c. It shall be clearly defined which parties are responsible for deciding if a credit event has occurred. This decision may not rest solely with the protection issuer. The protection purchaser shall have both the right and possibility to inform the protection issuer if a credit event occurs.

### *Section 72*

For credit derivatives with cash settlement, the authorised person shall have procedures for reliably estimating losses. A period shall be set during which the authorised person may obtain post-credit event assessments of the reference exposure. If the cash settlement is conditional on the protection purchaser's transfer of the reference exposure to the issuer of the protection, the contract shall provide that any required permission between the parties to such a transfer may not unduly delay the transfer.

### *Section 73*

Even if the reference exposure of a credit derivative does not exactly correspond to the exposure that the authorised person wishes to protect, the credit derivative is eligible if the following conditions are met:

1. The reference exposure refers to the same counterparty;
2. The reference exposure is ranked equal to or junior to the protected asset in the event of bankruptcy; and
3. There are cross clauses in place between the reference asset and the protected asset that mean that if the borrower defaults (e.g. stops payments) on other loans the borrower has taken, this will be treated as a default on the reference asset as well.

#### ***Section 74***

Where the authorised person creates an internal hedge using a credit derivative, such that it hedges the credit risk of an exposure in non-trading activities with a credit derivative in the trading book, the credit risk transferred to the trading book shall be transferred to a third party as set out in Section 66 of this Annex for the protection to be eligible.

#### ***Section 75***

An authorised person shall have set guidelines regarding the use of guarantees and credit derivatives related to the authorised person's overall risk management strategy. The authorised person shall have procedures and systems for following up and managing potential concentrations of credit risk arising as a result of this protection.

#### ***Section 76***

When a recognisable credit derivative or guarantee is available for an exposure, the obligor's risk weight may be replaced by the protection issuer's risk weight for the protected amount. When an authorised person has a guarantee or credit derivative for off-balance sheet commitments, the effect of these shall be included before the authorised person applies the relevant conversion factor.

#### ***Section 77***

- a. Protected amount refers to the maximum amount that the protection provider has undertaken to pay, reduced by the adjustments specified in this paragraph.
- b. Where the protection does not cover all types of payment that can arise from the exposure, the protected amount shall be adjusted in order to take account of this.  
Where the protection is denominated in a currency other than that of the direct

exposure, the protected amount shall be reduced by the exchange rate volatility adjustment factor ( $H_{fx}$ ) that shall be determined in accordance with Section 10 to Section 11 of this Annex.

***Section 78***

Where a credit derivative pursuant to the terms of the contract cannot be redeemed because the obligor received a grace period to pay instalments due and interest due or other changes to the terms of payment that result in a financial loss, in cases in which the protection does not exceed the exposure amount, the protected amount shall be reduced by 40%. If the protection exceeds the exposure amount, the protected amount shall not exceed 60% of the exposure amount.

***Section 79***

- a. Where a credit derivative covers several exposures and the credit derivative is designed so that it becomes due for payment when the first exposure occurs, the authorised person may only include protection for the exposure which in the absence of protection would give rise to the lowest risk weighted exposure amounts, provided that the protection at least covers the exposure.
- b. Where a credit derivative covers several exposures and the credit derivative is designed so that it becomes due for payment when the  $n^{\text{th}}$  default occurs, the authorised person may apply the method specified in the first paragraph, appropriately tailored, provided that either another protection has been obtained for default 1 to n-1 or that n-1 default has already occurred.

### ***Section 80***

Where there is a maturity mismatch, that is when the residual maturity of the credit protection is less than that of the protected exposure, the credit protection may not be taken into account when calculating risk-weighted exposure amounts if the residual maturity of the credit protection is less than three months or if the original term is less than one year.

### ***Section 81***

The residual maturity of the protected exposure refers to the time until the obligor must have fulfilled its obligations. However, the residual maturity shall be subject to a maximum of five years.

### ***Section 82***

- a. The residual maturity of the credit protection shall be the time to the earliest point of time at which the protection expires or may be terminated. Where the protection seller has the option to terminate the agreement the residual maturity of the protection shall be considered to be the time to the earliest date at which that option may be exercised.
- b. Where the credit protection buyer has the right to terminate the agreement, and the original agreement terms contain a positive incentive for the buyer to terminate the protection before contractual maturity, the residual maturity of the protection shall be considered to be the time to the earliest date at which this option may be exercised.
- c. The residual maturity shall be reduced by the amount of the grace period for credit derivatives that become repayable without consideration for the possibility that the protected asset may be subject to a grace period before default is considered to have occurred.

***Section 83***

Where there is a maturity mismatch the protected amount shall be reduced by multiplying it by the result of following expression:

$$(t-0.25)/(T-0.25),$$

where

T is the residual maturity of the protected exposure, though a maximum of five years,

t is the residual maturity of the credit protection, though a maximum of T.

***Section 84***

Recognisable credit linked notes issued by the authorised person may be treated as cash collateral in accordance with the requirements set out in Section 85 to Section 8 of this Annex.

Chapter 6. Financial collateral

***Section 85***

Collateral is recognisable if it is eligible as set out in Section 86 to Section 8 of this Annex and the authorised person fulfills the management requirements in accordance with Section 8 to Section of this Annex.

## *Section 86*

The following financial collaterals are eligible:

1. Cash deposited with the authorised person and cash equivalent instruments issued by and deposited with the authorised person;
2. Debt instruments:
  - a. Assigned to exposures to governments and central banks that have a credit rating or a credit rating by an export credit agency corresponding to credit quality steps 4 or better;
  - b. Issued by foreign authorities and comparable associations or public sector entities which may be treated as exposures to their government; or
  - c. Issued by an authorised person or other legal entity or have a credit rating corresponding to credit quality step 3 or better for the relevant type of counterparty;
  - d. Issued by foreign authorities or comparable associations with a credit rating corresponding to credit quality step 3 or better;
  - e. Issued by public sector entities with the same risk-weight as exposures to authorised persons and with a credit rating corresponding to credit quality step 3 or better; or
  - f. Which have a credit rating corresponding to credit quality 3 or better for short-term exposures;
  - g. Issued by authorised persons and corresponding foreign companies which do not have a credit rating are still eligible provided that the following conditions are met:

- i. They are traded on a regulated market; and
  - ii. They are not subordinated; and
  - iii. Where there are other debt instruments issued by the same counterparty with the same seniority for which there is a credit rating, all of these profit-bearing securities' credit ratings shall correspond to credit quality 3 or better; and
  - iv. The authorised person has no information to suggest that that the liquidity of the debt instrument is insufficient; and
3. Equity and convertibles included in one of the indexes set out in Annex 13; and
4. Gold.

***Section 87***

- a. Investment fund units are eligible if the following conditions are met:
  1. The price of units in investment funds is updated and made public daily; and
  2. The terms and conditions of the investment fund only allow the investment fund to invest in the securities specified in Section 86 of this Annex.
- b. What has been mentioned in paragraph (a) of this Section does not prevent the investment fund from using derivatives to hedge investments in such securities.

### ***Section 88***

- a. The creditworthiness of the counterparty and the value of the collateral may not have a material positive correlation.
- b. Securities issued by the counterparty or by other companies within the same group as the counterparty are not recognisable. However, foreign debt instruments issued by the counterparty are recognisable if they have been used as collateral under a repurchase transaction and if the bonds meet the condition set out above.

### ***Section 89***

The agreement regarding the grant of collateral shall be legally binding in all relevant jurisdictions. Where a third party holds the collateral, the authorised person shall take all necessary steps to ensure that the third party segregates the collateral from its own assets.

### ***Section 90***

The forms of the grant of collateral shall be documented, including the procedures for timely liquidation of collateral. The authorised person shall have written policies that regulate the type and volumes of assets that it accepts as collateral.

### ***Section 91***

An authorised person shall have well-functioning procedures and processes for verifying the risks arising due to the utilization of the collateral, including:

1. Risk of failed or reduced credit protection, for example the risk that the authorised person cannot immediately freely dispose of or liquidate the collateral;
2. The risk of incorrect valuations; and

3. Concentration risk arising from the utilization of financial collateral, and its effect on the authorised person's collective risk profile.

***Section 92***

An authorised person shall perform a new mark-to-market of collateral when there is reason to believe that a material change has occurred with a minimum frequency of six months.

***Section 93***

Where there is a maturity mismatch, that is when the residual maturity of the financial collaterals is less than that of the protected exposure, the authorised person shall take into account Section 9 or Section 10 of this Annex when calculating risk-weighted exposure amounts.

***Section 94***

An authorised person may disregard maturity mismatches if the following requirements are met:

1. The protected exposure and the collateral are valued daily;
2. The collateral agreement specifies that the collateral shall be delivered without undue delay if a collateral deficit has arisen; and
3. Where the financial collateral consists of debt instruments, the collateral agreement shall imply that if the collateral expires the funds shall be paid into an account at the authorised person which the counterparty cannot utilize without the permission of the authorised person.

***Section 95***

The residual maturity of the protected exposure refers to the time until the obligor must have fulfilled its obligations. However, maturity shall never be longer than five years.

***Section 96***

Subject to this Chapter, the residual maturity of the credit protection shall be the time to the earliest date at which the protection expires or can be terminated.

***Section 97***

When determining risk-weighted exposure amounts the authorised person may use recognisable financial collateral by using either the simple method pursuant to Section 9 to Section 10 of this Annex or the comprehensive method pursuant to Section 10 to Section 10 of this Annex.

***Section 98***

If the authorised person applies the simple method, the residual maturity of the protection must be at least as long as the residual maturity of the exposure, otherwise the credit protection may not be considered when calculating risk-weighted exposure amounts.

***Section 99***

- a. When an exposure has recognisable financial collateral, the risk weight of the counterparty may be replaced by the risk weight of the collateral instrument for the portion that the collateral covers. However, the new risk weight for the portion of the exposure covered by the collateral shall be at least 20%, except when applying Section 10 to Section 10 of this Annex.

- b. When the authorised person has financial collateral for off-balance sheet commitments, the effect of these shall be used before the authorised person applies the relevant conversion factor. The remainder of the exposure shall be assigned the risk weight that would be assigned to an unsecured exposure to the counterparty.

#### ***Section 100***

The value of the financial collateral shall be the market value. A 0% risk weight shall be assigned to the collateralized portion of an exposure arising from transactions. If the counterparty to the transaction is not a counterparty in accordance with point 8 of Section 10 of this Annex, the portion shall be assigned a 10% risk weight.

#### ***Section 101***

- a. Derivatives subject to daily marking-to-market and collateralized by cash deposited with the authorised person or cash equivalent instruments and where there is no currency mismatch, shall be assigned, to the extent of the collateralization, a 0% risk weight.
- b. Derivatives collateralized by debt instruments issued by governments or central banks assigned a 0% risk weight shall be assigned a 10% risk weight.
- c. Debt instruments issued by foreign authorities and comparable associations must be treated in the same way as exposures to their government.

#### ***Section 102***

Where the exposure and the collateral are denominated in the same currency a 0% risk weight may be assigned to that exposure if one of the following conditions is met:

1. The collateral is cash on deposit with the authorised person or a cash assimilated instrument; or
2. The collateral is in the form of debt instruments issued by governments or central banks assigned a 0% risk weight and the collateral's market value has been discounted by 20%.

***Section 103***

- a. Under the financial collateral comprehensive method, the authorised person shall calculate volatility-adjusted amounts to be applied to the exposure amount and the collateral to determine the extent to which the collateral is considered to cover the exposure.
- b.  $E_{unsec}$  is the portion of the exposure not considered protected by the collateral and is calculated as follows:

$$E_{unsec} = \max\{0, (E_{VA} - C_{VA})\}$$

$$E_{VA} = E^* \times (1 + H_E)$$

$$C_{VA} = C \times (1 - H_C - H_{fx})$$

C is the market value of the collateral.

$E^*$  is an adjusted exposure amount where off-balance sheet commitments are included, that is conversion factors are not taken into account.

$E_{VA}$  and  $C_{VA}$  are the volatility-adjusted amounts of the exposure and collateral respectively. Where there is a maturity mismatch,  $C_{VA}$  shall be adjusted in accordance with Section 10 of this Annex.

$H_E$  and  $H_C$  are factors for the volatility adjustment of the amounts of the exposure and collateral, respectively, with regard to changes in market prices. Both  $H_E$  and  $H_C$  will henceforth be called H.

$H_{fx}$  is a factor for volatility adjustment with regard to changes in exchange rates.

- c. When determining the volatility adjustment factors, the authorised person may use the prescribed volatility adjustments according to Section 10 to Section 11 of this Annex.

#### ***Section 104***

- a. Where there is a maturity mismatch, the value of the collateral shall be reduced according to the following formula:

$$C_{VAM} = C_{VA} \times (t-0.25)/(T-0.25)$$

where

$C_{VAM}$  is  $C_{VA}$  adjusted for the maturity mismatch,

$C_{VA}$  is the value of the credit protection in accordance with Section 10,

T is the residual maturity of the protected exposure, though a maximum of five years,

t is the residual maturity of the credit protection, though a maximum of T.

$C_{VAM}$  replaces  $C_{VA}$  when calculating  $E_{unsec}$  pursuant to Section 10.

- b. The credit protection may not be taken into account if either the residual maturity of the credit protection is less than three months or if the original maturity of the credit protection is less than one year.

#### ***Section 105***

Where several different financial collateral are recognisable for an exposure, the volatility adjustment factor shall be a weighted average of the factors applying to each individual collateral. The portion of the aggregated market value that each individual collateral represents is used as the weight.

#### ***Section 106***

The volatility adjustment may be set to 0% if the following conditions are met:

1. The exposure and its collateral are debt instruments issued by governments and central banks and assigned a 0% risk weight;
2. The exposure and its collateral are denominated in the same currency;
3. The maturity of the transaction is a maximum of one day, alternatively that the marking-to-market for both the exposure and collateral is set daily and that the mark-to-market margin is set daily;

4. The authorised person judges that the time between the last market valuation and liquidation of the collateral has not exceeded four business days in situations where the counterparty fails to discharge its obligation to set a mark-to-market margin;
5. The transaction is cleared and settled in a clearing and settlement system suitable for this type of transaction;
6. The agreement governing the transaction is a standard market agreement for repurchase transactions and securities lending transactions;
7. Pursuant to the agreement mentioned in point 6 of this Section, the transaction may be terminated immediately if the counterparty fails to satisfy its obligation to deliver cash or securities or to provide collateral or if the counterparty in any other way fails to discharge its obligations; and
8. The counterparty is one of the following:
  - a) governments and central banks assigned a 0% risk weight;
  - b) Other authorised persons, banks or insurance companies assigned a risk weight that does not exceed 20%;
  - c) Investment fund companies or equivalent foreign companies that are obligated under law to meet capital adequacy standards; or
  - d) Clearing organisations.

### ***Section 107***

Volatility adjustments for changes in market prices do not need to be made for cash deposited with the authorised person and cash assimilated instruments deposited with and issued by the authorised person. Volatility adjustments for changes in market prices do not need to be made for cash lent by the authorised person.

**Section 108**

The values of *H* in Section 1 to Section 11 of this Annex apply to collateral and exposures for which mark-to-market revaluations are conducted daily. If marking-to-market is less frequent, the values for *H* shall be adjusted upwards in accordance with Section 11 of this Annex.

**Section 109**

The debt instruments referred to in point 2 (a-b) of Section 86 of this Annex issued by counterparties shall be adjusted for volatility in accordance with Table 16 below.

**Table 16**

H in %		Liquidation period		
Credit quality step	Residual maturity in years	20 days	10 days	5 days
1	≤ 1 year	0.707	0.5	0.354
1	> 1 ≤ 5 years	2.828	2	1.414
1	> 5 years	5.657	4	2.828
2-3	≤ 1 year	1.414	1	0.707
2-3	> 1 ≤ 5 years	4.243	3	2.121
2-3	> 5 years	8.485	6	4.243
4		21.213	15	10.607
Debt instruments with a credit rating for short-term exposures				
1		0.707	0.5	0.354
2-3		1.414	1§	0.707

**Section 110**

The debt instruments referred to in point 2 (c-e) of Section 86 of this Annex issued by counterparties shall be adjusted for volatility, Irrespective of the issuer, based on credit quality steps 2–3 in accordance with Table 17 below.

**Table 17**

H in %		Liquidation period		
Credit quality step	Residual maturity in years	20 days	10 days	5 days
1	≤ 1 year	1.414	1	0.707
1	> 1 ≤ 5 years	5.657	4	2.828
1	> 5 years	11.314	8	5.657
2-3	≤ 1 year	2.828	2	1.414
2-3	> 1 ≤ 5 years	8.485	6	4.243
2-3	> 5 years	16.971	12	8.485
Debt instruments with a credit rating for short-term exposures				
1		1.414	1	0.707
2-3		2.828	2	1.414

**Section 111**

Other types of exposures or recognisable financial collateral shall be adjusted for volatility in accordance with Table 18 below.

**Table 18**

H in %	Liquidation period		
Type of exposure or collateral	20 days	10 days	5 days
Shares included in one of the eligible indexes specified in Annex 13	21.213	15	10.607
Other eligible collateral	35.355	25	17.678
Gold	21.213	15	10.607

**Section 112**

For volatility adjustment of units in investment funds which are recognisable collateral, a weighted average *H* is calculated for the assets in which the investment fund has invested.

When adjustments are being made, the liquidation period for each transaction type must be applied. If the assets are not known to the authorised person, the authorised person shall use the maximum value of H that would apply to one of the assets permitted in accordance with terms and conditions of this investment fund.

**Section 113**

The factor for volatility adjustment for changes in exchange rates,  $H_{fx}$ , is expressed as a percentage in Table 19 and applies to collateral and exposures which are subject to daily mark-to-market.

**Table 19**

Liquidation period		
20 days	10 days	5 days
11.314	8	5.657

**Section 114**

- a. With regard to over the counter derivatives, volatility adjustments for changes in exchange rates shall be carried out if the collateral currency is different from the settlement currency.
- b. With regard to over the counter derivatives for which the authorised person has recognisable netting agreements, volatility adjustments for currency fluctuations shall be applied if there is a mismatch between the collateral currency and the settlement currency. Only a single volatility adjustment shall be applied even if the netting agreement includes transactions in multiple currencies.

### ***Section 115***

The liquidation period used to determine  $H$  and  $H_{fx}$ , respectively, is the following:

1. Five business days for securities loans and for repurchase transactions that do not include the transfer of commodities or commodities or guaranteed rights relating to title to commodities;
2. Ten business days for capital market-driven transactions other than those indicated in point 1; or
3. 20 business days for other exposures.

### ***Section 116***

If the authorised person does not mark-to-market its collateral and exposures daily,  $H$  and  $H_{fx}$ , which are defined in Section 1 to Section 11 of this Annex, shall be adjusted upwards according to the following formula.

$$H_A = H_M \sqrt{\{N_R + (T_M - 1)\} / T_M}$$

$H_A$  is the factor for the final volatility adjustment after adjustment for the frequency of the market valuation carried out by the authorised person. It is this value that is used in the calculation in Section 10 of this Annex.

$H_M$  refers to the volatility adjustment that is specified in Section 1 to Section 11 of this Annex.

$N_R$  refers to the number of business days between each valuation.

$T_M$  is the liquidation period for the relevant security in accordance with Section 11 of this Annex.

## Chapter 7. Netting agreements

### *Section 117*

Bilateral netting agreements are recognisable if they are eligible under Section 11 to Section 12 of this Annex and the authorised person fulfills the requirements for managing them as contained in Section 12 to Section 12 of this Annex.

### *Section 118*

- a. The eligible netting agreement shall be legally binding in all relevant jurisdictions. The agreement shall provide that the party which has not defaulted pursuant to the terms of the contract may terminate all contracts covered by the agreement without delay when a credit event occurs. Credit events shall include the insolvency or bankruptcy of the counterparty.
- b. The eligible netting agreement shall create a single obligation covering all receivables and liabilities contained in the agreement and covered by netting, so that, if the authorised person or counterparty do not fulfill their payment obligations, are declared bankrupt, go into liquidation, become the subject of public composition proceedings or start any other insolvency proceedings, the liability of the counterparty is only for the net sum of the receivables and liabilities.

- c. The eligible netting agreement may not contain conditions that would permit a non-defaulting party to make limited payments only, or no payments at all, to the defaulting party, even if the defaulter is a net creditor.

***Section 119***

An authorised person shall have written and reasoned legal opinions in its possession that demonstrate that the agreed netting would, in all probability, be recognised by the relevant courts and administrative authorities in the relevant jurisdictions. The legal opinions shall show that even if a netting agreement is terminated as a result of an event such as those set out in Section 11 of this Annex, a legal review by the relevant courts and administrative authorities would, in all probability, find the authorised person's receivables and liabilities limited to the net sum of the positive and negative market values of all the contracts included in the agreement and covered by netting, or limited to the net sum of all the receivables and liabilities covered by netting. The evaluation of the outcome of the legal review must be based on:

1. Governing law in the jurisdiction in which the parties have their respective registered offices and, if the commitments of the counterparty or authorised person were entered into through a foreign branch office, governing law in the jurisdiction in which the branch office is situated, pursuant to that set out in Section 1 of this Annex;
2. Governing law which pursuant to the agreement regulates the individual contracts and receivables and liabilities covered by the agreement; and
3. Governing law regulating every contract or agreement necessary to effect the netting agreement.

***Section 120***

- a. In cases where the parties have entered into a netting agreement in which several foreign branch offices are included, the legal opinions indicated in Section 1 of this Annex shall be requested from all the jurisdictions in which the branch offices are situated.
- b. If it is not possible to obtain a legal opinion pursuant to Section 1 of this Annex for one of the branch offices, this branch office can still be included in the agreement on condition that a legal opinion is available that finds that the netting agreement will not be declared null and void in its entirety merely for the reason that such agreements do not have any legal standing for the contracts and receivables and liabilities entered into with such a branch office. Agreements that include branch offices situated within the jurisdiction where the netting agreement is not legally binding may not be considered.

***Section 121***

A legal opinion pursuant to Section 1 of this Annex shall include the following:

1. A judgment that states that the netting agreement and the contracts and receivables and liabilities covered by the agreement do not breach laws, regulations or court judgments in the relevant jurisdictions;
2. Reference to existing netting agreements and a reference to the netting provisions contained in each such agreement; and
3. A judgment that states that the netting agreement will in all probability be deemed legally binding in the situations specified in Section 11 of this Annex in the relevant

jurisdictions, if action is taken by an administrator, liquidator, receiver or the equivalent in other jurisdictions.

***Section 122***

The legal opinion pursuant to Section 1 of this Annex shall be issued by an external, independent licensed lawyer/law firm with considerable experience in the field. The opinion can be either given directly to the authorised person or to the organization behind the netting agreement that the authorised person has utilized. The opinion can also be a common legal opinion for a specific netting agreement for several authorised persons together or an organization representing the authorised person. The opinion can be drawn up for different types of netting agreement.

***Section 123***

- a. Before a netting agreement can influence the calculation of a risk-weighted amount for the first time, the authorised person shall notify the Authority that a legally binding netting agreement exists.
  
- b. The authorised person shall certify to the Authority in writing that:
  1. All conditions pursuant to Section 11 of this Annex are met; and
  2. The authorised person has legal opinions pursuant to Section 1 to Section 12 of this Annex; and
  3. The authorised person has the necessary technical systems or manual procedures for calculating counterparty exposures as a net amount instead of a gross amount; and

4. The authorised person has the necessary technical systems or manual procedures for calculating the risk arising when the counterparty's contracts or liabilities cease.

#### ***Section 124***

An authorised person is responsible for documenting each individual netting agreement and legal opinion. Netting agreements and legal opinions must be kept well arranged.

#### ***Section 125***

An authorised person shall continuously verify that:

1. Its netting agreements have legal standing with respect to the relevant counterparties, contracts, receivables and liabilities and jurisdictions, with regard to amendments to law; and
2. The conclusions of the legal opinions obtained are legally valid and no older than one year. If a legal opinion is older than one year, the authorised person shall request a new legal opinion stating that the conclusions of the previous opinion still apply.

#### ***Section 126***

If an authorised person learns that the competent authorities in a counterparty's homeland do not consider a netting agreement to have legal standing in accordance with existing law in that country, the netting agreement may not be considered. This applies irrespective of the legal opinions obtained.

***Section 127***

If a legal opinion issued in accordance with Section 1 of this Annex is missing a piece of significant information regarding the sustainability of a netting agreement, the authorised person must assess whether an eligible netting agreement exists. If the authorised person judges the requirements have not been met, the exposure amount may not be adjusted.

***Section 128***

Authorised persons that treat financial collateral according to the comprehensive method may take eligible netting agreements into account when calculating the exposure for capital market driven transactions, such as repurchase transactions and securities lending or borrowing transactions in accordance with either the prescribed method pursuant to Section 13 and Section 13 of this Annex.

***Section 129***

To qualify for recognition under the netting agreement, the collateral received should be eligible in accordance with Section 86 of this Annex.

***Section 130***

The management requirements shall be met for the assets covered by the netting agreement.

***Section 131***

For the repurchase transactions, securities lending or borrowing transactions and other capital market-driven transactions covered by a recognisable netting agreement, a net amount, E\*, shall replace the individual exposure amounts for these transactions.

$$E^* = \max \{0, \Sigma E - \Sigma C + \Sigma T_{\text{net}} \times H_T + \Sigma E_{\text{fx}} \times H_{\text{fx}}\}$$

$E^*$  therefore cannot be a negative amount.

$E$  is the exposure amount for each separate exposure without regard to credit protection.

$C$  is the market value of the assets that the authorised person has borrowed, purchased or received as collateral under the netting agreement.

$T_{\text{net}}$  is the amount of the net position (whether positive or negative) of each asset type. Asset type refers to securities which have been issued by the same legal entity, have the same issue date, the same terms of contract and liquidation period in accordance with Section 11.

$H_T$  is the volatility adjustment factor for changes in market value,  $H$ , for each asset and is calculated in accordance with Section 10 to Section 11 of this Annex.

$E_{\text{fx}}$  is the amount of the net position (whether positive or negative) in each currency that is not the settlement currency.

$H_{\text{fx}}$  is the volatility adjustment factor for changes in foreign exchange rates and shall be calculated in accordance with Section 11 of this Annex.

### ***Section 132***

An authorised person may adjust the exposure amount in line with Section 13 to Section 13 of this Annex in order to take account of recognisable netting agreements for derivatives.

### *Section 133*

When calculating the sum of the current replacement cost for contracts with a specific counterparty, the authorised person may reduce it by the sum of the negative market values for contracts that the authorised person has with the same counterparty.

### *Section 134*

- a. For derivatives covered by a recognisable netting agreement, the amount for potential change in risk is calculated in accordance with the following formula.

$$PCE_{\text{red}} = 0.4 * PCE_{\text{gross}} + 0.6 * NGR * PCE_{\text{gross}}$$

where

$PCE_{\text{red}}$  = the reduced amount for potential future credit exposure for all contracts with a specific counterparty included in a netting agreement.

$PCE_{\text{gross}}$  = the sum of the figures for potential change in risk for all contracts with a specific counterparty included in a netting agreement and calculated by multiplying their notional value with a risk factor in accordance with Table 12.

NGR = “net-gross ratio”: the ratio between the net replacement cost for all contracts included in a netting agreement with a given counterparty (numerator) and the gross replacement cost for all contracts included in a netting agreement with that counterparty (denominator).

- b. If netting leads to a net debt when calculating the net replacement cost, the net replacement cost shall be set at zero in the above formula.  $PCE_{red}$  may therefore never be less than  $0.4 * PCE_{gross}$ .

***Section 135***

- a. An authorised person may adjust the exposure amount in accordance with Section 13 of this Annex to take account of recognisable netting agreements for other receivables and liabilities in the balance sheet.
- b. Recognisable netting agreements for other liabilities and receivables are limited to mutual cash receivables between the authorised person and the authorised person's counterparty that constitute loans or deposits with the authorised person.

***Section 136***

With regard to receivables covered by the netting agreement, a net amount,  $E_{unsec}$ , may replace the individual exposure amounts when determining a risk-weighted exposure amount.

$$E_{unsec} = \max\{0, (\Sigma E - \Sigma C_{VA})\}$$

$$C_{VA} = C \times (1 - H_{fx})$$

E is the net book value of the receivables.

C is the net book value of the liabilities.

$C_{VA}$  is the volatility-adjusted amount of the liabilities.

$H_{fx}$  is a factor for volatility adjustment with regard to changes in exchange rates.

## Chapter 8. Other credit protection

### *Section 137*

Life insurance policies pledged or assigned to the authorised person can be recognisable collateral if the conditions in Section 13 to Section 1 of this Annex are met.

### *Section 138*

The insurance provider meets the criteria for an eligible issuer pursuant to Section 66 of this Annex.

### *Section 139*

- a. For the purposes of Section 13 of this Annex, the following conditions shall be met:
  1. The insurance provider shall have been notified of the pledge or assignment. The insurance provider may not make any payments under the terms of the pledged or assigned insurance contract without the permission of the authorised person;
  2. The insurance must have a declared surrender value that cannot be reduced;
  3. The authorised person must have the right to cancel the insurance and obtain the surrender value without undue delay if the counterparty defaults;
  4. The authorised person shall be given information by the insurance provider concerning any premiums unpaid by the policyholder; and

5. The agreement regarding the grant of collateral shall be legally binding in all relevant jurisdictions.

b. In addition to what has been mentioned in paragraph (a) of this Section, the credit protection must be valid throughout the entire underlying exposure's maturity.

***Section 140***

Recognisable life insurance policies shall be considered to be a guarantee issued by the insurance provider. The protected amount shall consist of the surrender value of the insurance policy and adjusted in accordance with Section 64 to Section 84 of this Annex where applicable.

***Section 141***

Cash on deposit with another authorised person (third party), or cash equivalent instruments held by a third party, in a non-custodial arrangement can be considered to be recognisable collateral if the following conditions have been met:

1. The borrower's claim against the third party authorised person is pledged or assigned to the authorised person;
2. The third party shall have been notified of the pledge or assignment;
3. It may not be possible for the third party to make payments to any party other than the authorised person without the permission of the latter;
4. The pledge or assignment shall be unconditional and irrevocable; and
5. The agreement regarding the grant of collateral shall be legally binding in all relevant jurisdictions. Collateral pursuant to the above shall be treated as a guarantee issued by a third party.

## **Annex 4: OPERATIONAL RISK**

### Chapter 1. The basic indicator approach

#### *Section 1*

- a. The income indicator consists of the average operating income of the three most recent financial years in accordance with Section 2 of this Annex. Where an authorised person terminates a large portion of its operations and as a consequence the income indicator no longer provides a fair view of its operating income, the authorised person may, after receiving permission from the Authority, during a transition period, calculate the capital requirement for operational risk based on a different indicator.
- b. Where the operating income is negative or zero for any of the three financial years referred in paragraph (a) of this Section, these years shall not be included when calculating the income indicator. The income indicator shall be calculated as the operating income sum of the positive financial years divided by the number of positive financial years. If any of the three most recent financial years was shortened or extended, the operating income shall be recalculated to a twelve-month basis using simple proportions.
- c. Where an authorised person has been in business for less than one year, the income indicator shall correspond to the operating income given in the authorised person's business plan for the first year.

*Section 2*

- a. Operating income is calculated as the balance of the following items:
  1. Profit receivable income;
  2. Dividends received;
  3. Commissions receivable;
  4. Net income on financial transactions; and
  5. Other operating income.
  
- b. The operating income shall be calculated before deductions for provisions and operating expenses. Operating expenses shall include fees paid for outsourced services rendered by third parties that are not included in the authorised person's financial group. Expenditure for outsourced services rendered by third parties may be deducted from operating income if they were paid to a company subject to the supervision of the Authority.
  
- c. The following items shall not be taken into account when calculating operating income:
  1. Dividends from companies in the authorised person's financial group; and
  2. Realized profits/losses from the sale of assets in non-trading activities

## Chapter 2. The standardized approach

### *Section 3*

- a. The income indicator for each business line shall be calculated as an average of the operating income for the last three financial years. Operating income is calculated in accordance with Section 2 of this Annex. Where the operating income is negative for any of the three financial years in question, the operating income for each business line during the year in question shall be set as zero when calculating the income indicator. Where the operating income for a certain business line is negative, though the operating income for the entire year is not negative, the negative figure may be used.
- b. Where an authorised person terminates a large portion of its operations and as a consequence the income indicator no longer provides a fair view of its operating income, the authorised person may apply for permission to calculate, during a transition period, the capital requirement for operational risk based on a different indicator. If any of the three most recent financial years was shortened or extended, the operating income shall be recalculated to a twelve-month basis using simple proportions.
- c. Where an authorised person has been in business for less than one year, the income indicator shall correspond to the operating income given in the authorised person's business plan for the first year.

### *Section 4*

Under the standardized approach, the capital requirement for operational risk is the sum of the capital requirements calculated across the business lines.

## ***Section 5***

The following conditions apply for the division of operations into business lines:

1. All of an authorised person's operations shall be consistently assigned to one of the five business lines;
2. An operation that cannot be assigned to a specific business line but which represents an ancillary function to an activity shall be allocated to the same business line to which that activity is assigned. Where the ancillary function supports more than one business line, the division shall be made on objective criteria;
3. If an activity or an ancillary function for an activity cannot be assigned to a specific business line in accordance with point 2 above, the activity shall be assigned to the business line with the highest percentage; and
4. The authorised person shall decide how to allocate income between business lines. Costs generated in one business line that can be attributed to another line may be reassigned to the business line to which they pertain, for example by using internal pricing between two business lines.

## ***Section 6***

Table 20 below presents the business lines, the corresponding licenses and the percentages for calculating the capital requirement.

**Table 20**

Business Line	Risk charge	License
Corporate Finance	18%	Arranging
Research and Advisory	18%	Advising
Trading and Sales	18%	Dealing
Custody	15%	Custody
Asset Management	12%	Managing

## **Annex 5: FOREIGN EXCHANGE RATE RISK**

### Chapter 1. The two-step method

#### *Section 1*

When using the two-step method, the calculation of the authorised person's total net position (long or short) in foreign currency is carried out in two steps. In addition, the net position in gold is calculated. Positions in the reporting currency shall not be included in the calculations.

#### *Step 1. Net position in individual currency and in gold*

- a. First, the authorised person's open net position, long or short, in each currency and in gold, in which the authorised person has positions, is calculated. The net position in each currency and in gold is calculated as the net of the positive and negative items respectively, in accordance with the following:
  - 1) The net spot position, that is all asset items less all liability items and provisions, including accrued income/expenses and deferred expenses/income, or, for gold, the net spot position in gold;
  - 2) The net forward position, that is all outstanding amounts less all liabilities in currency and gold forwards transactions and the principal on currency swaps not included in the net spot position;
  - 3) Irrevocable guarantees and similar instruments that is certain to be called and for which repayment most likely will not take place;
  - 4) Net future income/expenditure not yet accrued but already fully hedged (application shall be carried out consistently over time);

- 5) The net delta corresponding to the total holding in foreign currency and gold options;
  - 6) The market value of other derivatives based on financial instruments in foreign currency or gold;
  - 7) Other off-balance sheet commitments; and
  - 8) The net position (long or short) in each currency and in gold shall be converted into SAR in accordance with Article 49 of these Rules.
- b. If an authorised person conducts activities abroad through a company that is a part of its financial group or through participating undertakings, profits shall continuously be taken into account when calculating the position (after deductions for taxes in accordance with applicable national tax rates for that company or the participating undertaking) in the relevant currency.

*Step 2. Total net position in foreign currency*

After completing Step 1, the converted long net positions in currency shall be aggregated. The sum of the short net positions in currency shall be calculated in the same way. The higher of these sums shall be the authorised person's total net foreign currency position.

Chapter 2. Calculating the capital requirement

*Section 2*

- a. With regard to matched positions in closely correlated currencies, a capital requirement corresponding to 7% of the value of the matched position may be applied.

A pair of currencies are only to be treated as closely correlated if the likelihood of a loss — calculated on the basis of daily exchange rate data for the preceding three or five years — occurring on equal and opposite positions in such currencies over the following 10 working days, which is 4 % or less of the value of the matched position in question (valued in terms of the reporting currency) has a probability of at least 99 %, when an observation period of three years is used, or 95 %, when an observation period of five years is used.

- b. In addition to what has mentioned in paragraph (a) of this Section, a lower capital requirement may be applied for currencies covered by legally binding exchange rate agreements between governments. The capital requirement for matched positions in such currencies shall comprise of half of the maximum permitted exchange rate fluctuation variation set by the governments in question for the currencies. Unmatched positions in those currencies shall be treated in the same way as other currencies.
- c. The capital requirement on unmatched positions in closely correlated currencies, and all positions in other currencies, shall be 14 %, multiplied by the higher of the sum of the net short or the net long positions in those currencies after the removal of matched positions in closely correlated currencies.

## Chapter 3.Options

### *Section 3*

- a. Options based on currencies shall be treated as combined long and short positions. Both positions shall be converted into delta-weighted positions by multiplying the notional amounts in each currency by the option's delta value. The net delta in a

currency is calculated as the net of the delta-weighted short and long positions in that currency in accordance with Section 1 of this Annex.

- b. If the exchange which lists the options does not publish the delta values of the options, or if they are over the counter options, the authorised person shall calculate the delta values of its options.
- c. An authorised person shall have systems in place and apply protective measures that take sufficient account of other risks associated with options trading, such as:
  1. The sensitivity of the delta value to price changes in the underlying financial instrument (gamma);
  2. The sensitivity of the option price to changes in maturity (theta);
  3. The sensitivity of the option price to changes in standard deviation (vega), and
  4. The sensitivity of the option price to changes in the risk-free interest rates (rho) in both countries.

## Chapter 4. Investment funds

### *Section 4*

If the authorised person is aware of all currency positions included in the investment fund, these shall be included in the calculation of the net position and total net position in accordance with Article 50 of these Rules. The netting of such currency positions against other currency positions may be carried out in accordance with Chapter 1 of Annex 5.

### *Section 5*

If the authorised person is not aware of all of the currency positions included in the investment fund, the authorised person shall use the following method:

1. The authorised person shall assume that the investment fund's currency position is the maximum currency exposure that it can have by law and under investment fund's terms conditions;
2. The authorised person shall then take into consideration whether the investment fund uses derivatives to leverage investments by increasing the currency position in accordance with point 1 of this Section proportionally to the leverage; and
3. The currency position calculated in this way shall be treated as a separate currency and may not be netted against another currency.

### *Section 6*

The fund manager may calculate the currency positions in the investment fund, provided that the authorised person ensures that the manager can carry out the calculations in accordance with that set out in this Chapter. The netting of such currency positions against other currency positions may be carried out in accordance with the rules in Article 50 of these Rules.

## Chapter 5.Composite currencies

### *Section 7*

Net positions in composite currencies or baskets of currencies may be distributed across the component currencies following the quotas of these currencies in force. Alternatively, such

currencies may be treated as one currency. Authorised persons shall apply either of these methods consistently over time.

## Chapter 6. Collateral in a third country's currency

### *Section 8*

If a claim denominated in foreign currency is classified as doubtful according to the Authority's Regulations and Rules on financial reporting and the collateral for such a claim is denominated in a third country's currency, the calculation of the position shall be based on the currency in which the collateral is denominated. The calculation of positions with regard to current claims shall be based on the lending currency.

## Chapter 7. Exceptions

### *Section 9*

If an authorised person has hedged the exchange rate for a result or forecast result in another authorised person within the same financial group, the authorised person may take into consideration both the exchange rate hedge and the other authorised person's result or forecast result when calculating the net position. However this applies only to results or forecast results in the current financial year.

### *Section 10*

- a. Any positions which an authorised person has deliberately taken to hedge against the adverse effect of the exchange rate on its capital adequacy ratio may, on obtaining the

Authority's permission, be excluded from the calculation of net open currency positions. Such positions shall not be positions held with trading intent, but long term positions used to hedge structural foreign exchange rate risks. Every change in the conditions for excluding such positions requires the permission of the Authority.

- b. In addition to what has been mentioned in paragraph (a) of this Section, on obtaining the permission of the Authority, such structural positions comprised of units/equity in companies that are a part of the authorised person's financial group and/or in which the authorised person has a participating undertaking and which shall be deducted from the capital may be excepted. In order for the structural positions to be excepted from the calculation of the open net position, they must be treated consistently.

## **Annex 6: COMMODITIES RISK**

### Chapter 1. Calculating positions and netting long and short positions

#### *Section 1*

- a. Forwards and options shall be treated as combined long and short positions.
- b. A long (purchased) position in a forward or option shall be treated as a combination of:
  1. A long position made up of underlying commodities or financial instruments in the contract; and
  2. A short position corresponding to a zero coupon bond for which the forward price for forwards or the exercise price of options comprises the amount due of the bond and has a maturity date on the delivery date or exercise date for the contract.
- c. A short (sold) position in a forward or option shall be treated as a combination of:
  1. A short position comprised of underlying financial instruments in the contract; and
  2. A long position corresponding to a zero coupon bond, for which the forward price for forwards or the exercise price of options comprises the amount due of the bond and has a maturity date on the delivery date or exercise date for the contract.

- d. Long and short positions deriving from an option shall be delta-weighted in accordance with Section 4 of this Annex.
- e. A zero coupon bond deriving from the partition of derivatives into a long and a short position shall be considered to be issued by a government which qualifies for credit quality step 1, or is assigned a risk weight of 0% in non-trading activities.
- f. When calculating specific and general risk, the zero coupon bond shall be considered to be an interest rate linked financial instrument and treated in accordance with Annex

### ***Section 2***

Commodity forwards and forward commitments to buy or sell individual commodities shall be incorporated into the maturity ladder approach as notional amounts in terms of the standard units of measurement and assigned a maturity corresponding to the period until the maturity date.

### ***Section 3***

- a. Commodity swaps where one leg of the transaction is a fixed price and the other leg the current market price shall be incorporated into the maturity ladder approach as a series of positions equal to the notional amount of the contract, with each position corresponding to each payment in the swap and slotted into the maturity ladder in accordance with this. The positions are long if an authorised person pays a fixed price and receives a floating price and short if the authorised person receives a fixed price and pays a floating price.
- b. Each leg of a commodity swap where the legs of the transaction are in different commodities shall be placed in the relevant category of commodities in the maturity ladder approach.

#### *Section 4*

- a. Options based on commodities or commodity derivatives shall be treated as combined long and short positions in the same way that applies to other derivatives. Both positions shall be converted into delta-weighted positions by multiplying the underlying asset's market value by the option's delta value. The delta-weighted positions may be netted against any offsetting positions in the same underlying commodities.
- b. If the exchange that lists the options does not publish the delta values of the options, or if they are over the counter options, the authorised person shall calculate the delta value of its options.
- c. An authorised person shall have systems in place and apply protective measures that take sufficient account of other risks associated with options trading, such as:
  1. The sensitivity of the delta value to price changes in the underlying financial instrument (gamma);
  2. The sensitivity of the option price to changes in maturity (theta);
  3. The sensitivity of the option price to changes in standard deviation (vega); and
  4. The sensitivity of the option price to changes in the risk-free interest rate (rho).

#### *Section 5*

To the extent permitted by the Authority, authorised persons that transfer or guarantee the title of commodities in a repurchase agreement and lend commodities in a commodities lending agreement shall include such positions when calculating the capital requirement for commodities risk.

## Chapter 2. The maturity-based method

### *Section 6*

When the maturity-based method is used to calculate the capital requirement for commodities risk, the steps below shall be followed for each individual commodity.

Step 1. All positions in a commodity and positions which, in accordance with Article 52 of these Rules, are considered positions in the same commodity shall be expressed in terms of the standard units of measurement (barrel, kWh, kg, etc.).

Step 2. Long and short net positions in a commodity are calculated in accordance with that prescribed in paragraph (d) of Article 52 of these Rules.

Step 3. The long and short net positions in the commodity are multiplied by the spot price and placed in the relevant maturity band in the Table 21. Physical stocks of commodities shall be assigned to the first maturity band.

**Table 21**

Maturity band
$0 \leq 1$ month
$> 1 \leq 3$ months
$> 3 \leq 6$ months
$> 6 \leq 12$ months
$> 1 < 2$ years
$> 2 \leq 3$ years
$> 3$ years

Step 4. Long and short net positions within each maturity band shall be aggregated.

Step 5. Matched long and short positions within a maturity band comprise the matched position within a maturity band. The matched long and short positions in each maturity band are aggregated and multiplied by the spread rate of 2.6%.

Step 6. Unmatched long or short positions in each maturity band comprise the unmatched position within a maturity band. Unmatched long (or short) positions within a maturity band may be moved to a higher maturity band in order to match short (or long) positions in those maturity bands. The portion of an unmatched position within a maturity band moved in order to match positions in a higher maturity band comprises the matched position between two maturity bands. This position is multiplied by a carry rate of 1.1% for each maturity band the position is moved forward. The matched position arising in the higher maturity band due to an opposing position being moved from a lower maturity band is treated in the same way as matched long and short positions in step 5.

Step 7. Remaining long or short positions which cannot be matched within a maturity band or between two maturity bands comprise the unmatched position. This position is multiplied by an outright rate of 26%. The authorised person's total capital requirement for commodities risk is calculated by aggregating the capital requirements calculated in steps 5, 6 and 7 for each individual commodity.

### **Section 7**

- a. Authorised persons may, after receiving permission from the Authority, use the values of the spread rate, carry rate and outright rate set out in Table 22 below instead of those set out in Section 6 of this Annex.

**Table 22**

	Precious metals (except gold)	Base metals	Agricultural products	Other (incl. energy)
Spread rate (%)	1.0	1.2	1.5	1.5
Carry rate (%)	0.3	0.5	0.6	0.6
Outright rate (%)	8.0	10.0	12.0	15.0

- b. In order to obtain the permission from the Authority referred to in paragraph (a) of this Section, the authorised person must:
1. Conduct extensive trading in commodities;
  2. Have a diversified commodities portfolio; and
  3. Have sound procedures, methods and systems for measuring and monitoring commodities risk.

### Chapter 3. The simple method

### **Section 8**

When the simple method is used to calculate the capital requirement for an authorised person's commodities risk, the following steps shall be applied to each individual commodity.

Step 1. The authorised person's net position in the commodity shall be calculated in terms of the standard units of measurement (barrel, MWh, kg, etc.). The net position in each commodity equals the difference between an authorised person's long and short net positions in the commodity. Long and short net positions in a commodity are calculated in accordance with that prescribed in paragraph (d) of Article 52 of these Rules,

Step 2. 26% of the net position is multiplied by the spot price.

Step 3. The authorised person's gross position in the commodity shall be calculated in terms of the standard units of measurement (barrel, MWh, kg, etc.). The gross position is calculated as the sum of an authorised person's long and short net positions in the commodity.

Step 4. 5% of the gross position is multiplied by the spot price. The authorised person's total capital requirement for commodities risk is calculated by aggregating the capital requirements calculated in steps 2 and 4 for each individual commodity.

## **Annex 7: LARGE EXPOSURES**

### Chapter 1. Management requirements

#### ***Section 1***

An authorised person shall have sound administrative and accounting procedures and adequate internal control procedures for the purpose of identifying and recording all large exposures in order to be able to monitor them using the authorised person's own exposure strategy.

#### ***Section 2***

- a. When an exposure to a client is protected by a third party through a recognisable guarantee or credit derivative, except credit linked notes, the exposure may be treated as if it referred to the third party rather than the client.
- b. If the risk weight for an exposure, when calculating a risk-weighted exposure amount in accordance with the rules for non-trading activities, is determined on the basis of the protection provider, this provider shall be considered as the counterparty also when calculating large exposures.

### Chapter 2. Determining exposure amounts in non-trading activities

#### ***Section 3***

- a. When determining large exposures, the exposure amount shall be the following:
  1. On-balance sheet items shall be taken at the net accounting value;

2. Off-balance sheet commitments shall consist of the nominal amount;
  3. Derivatives shall be calculated in accordance with paragraph (d) of Article 25 of these Rules; and
  4. Repurchase transactions, margin lending transactions and securities lending or borrowing transactions may be handled in accordance with paragraph (e) of Article 25 of these Rules.
- b. The authorised person may, when calculating its exposure amounts, take into account any netting agreements for these exposures.

### Chapter 3. Determining exposure amounts in the trading book

#### *Section 4*

An authorised person shall calculate exposure to individual clients by aggregating the following items:

1. The sum, if it is positive, of the net positions in interest and equity linked financial instruments issued by the client. The net position in each instrument is calculated in accordance with the methods set out in Section 1 to Section 29 of Annex 2 and Section 46 to Section 52 of Annex 2;
2. Net positions arising due to underwriting commitments in conjunction with issues, reduced by the reduction factors set out in Section of Annex 2; and
3. Exposures in activities exposed to settlement and counterparty risks are calculated in accordance with Section to Section of Annex 2. Exposures arising from transactions

not settled on the due settlement date shall not be multiplied by the factors set out in Section 65 of Annex 2. Transactions that are assigned a capital requirement of zero in accordance with Section 65 of Annex 2 maybe excepted when determining large exposures.

*Section 5*

After a calculation in accordance with Section 4 of this Annex, exposures with regard to individual counterparties shall be aggregated to the group of connected counterparties to which the individual counterparty belongs.

*Section 6*

Exposures in the form of units in investment funds shall be reported as an exposure to the investment fund. The holdings in various investment funds do not need to be aggregated if they are administered by the same investment fund manager.

## **Annex 8: LIQUIDITY RISK**

### Chapter 1. Identification and measurement of liquidity risk

#### *Section 1*

- a. An authorised person shall identify and measure their exposure to liquidity risk and its funding needs within and between business lines and currencies.
- b. An authorised person that is a part of a financial group shall pay particular attention to, and document, the various legal and operational limitations to freely transfer cash and securities between companies that are part of its financial group.

#### *Section 2*

An authorised person shall calculate the cost of liquidity and take the costs into account in pricing and performance measurement. The cost of liquidity shall reflect the authorised person's current cost of refinancing, for the relevant maturities, and the cost that this entails for the authorised person to keep a liquidity reserve in accordance with Section 15 of this Annex.

#### *Section 3*

An authorised person shall use several customized risk measures and ratios to calculate the liquidity risk in a comprehensive manner. The authorised person must have a forward looking perspective on liquidity risk and assess the balance sheet structure, cash flows, liquidity positions and risks of off-balance. Risk measures and ratios shall identify vulnerabilities in normal operations and during periods of stress. Measurement procedures shall, where appropriate, distinguish between liquidity risks in different currencies.

#### ***Section 4***

- a. An authorised person shall calculate the cash flows expected to arise when all assets, liabilities and off balance sheet items are settled. Cash flows will be allocated to the different time intervals in which they are normally expected to occur. Cash inflows from assets in the liquidity reserve in accordance with Section 15 of this Annex shall be attributed to the time interval in which the asset at the earliest can be converted into cash.
- b. The authorised person shall in the cash flow calculation use daily intervals. If, having regard to the authorised person's size of business, it is not appropriate and reasonable to use the daily time intervals, the authorised person shall use at least seven time intervals: one day, more than one day up to one week, more than a week up to a month, more than one month up to three months; more than three months up to six months, more than six months up to a year, more than a year.
- c. The time interval referred to in paragraph (b) of this Section shall be mutually exclusive and collectively exhaustive (MECE principle).
- d. A financial group shall always use the daily time intervals in the cash flow calculation.
- e. For each time interval, the authorised person must calculate the net cash flow as the sum of expected cash outflows less the sum of expected cash inflows. The authorised person will then accumulate net cash flow over all time intervals to show how long it has a positive cash flow.

#### ***Section 5***

- a. An authorised person shall, when calculating expected cash flows, distinguish contracted cash flows with fixed payment dates from such cash flows for which the payment dates and the size of payments is controlled by the authorised person's own

decisions, customer behaviour or market trends. In cases where customer behaviour or market trend is the basis for the calculation of expected cash flows, the calculation shall be based on empirical observations.

- b. The authorised person shall ensure that the methods and assumptions used to calculate the expected cash flows are relevant.

### *Section 6*

An authorised person shall also measure its structural liquidity risk. The authorised person shall calculate and over time, follow the appropriate ratios from the balance sheet in order to highlight the financial structure and specific elements of the authorised person's liquidity risk.

### *Section 7*

- a. An authorised person shall be well prepared to manage their liquidity under conditions that deviate from normal conditions. The authorised person shall carry out regular stress tests to identify and measure liquidity risk under different scenarios and make sure that the authorised person's current exposure to liquidity risk is consistent with the established risk tolerance.
- b. The authorised person shall develop appropriate scenarios based on their current risk profile. The scenarios shall be based on varying degrees of stress and duration and cover both the idiosyncratic as well as market related problems. Problems shall be illustrated both individually and in combination with each other. The stress tests shall take into account the evolution of liquidity and the need for intraday liquidity for time critical payments.

### ***Section 8***

- a. The authorised person shall design its stress tests based on its own and customers' risk exposure and the focus and complexity. The authorised person shall conduct market-wide stress tests based on assumptions about the erosion of market values of certain assets and a general deterioration in the conditions of market financing.
- b. The authorised person shall regularly review the assumptions underlying the stress test scenarios used, to ensure that they are relevant.

### ***Section 9***

An authorised person shall use the results of stress tests to adjust their strategies, policies and positions. The results of stress tests shall be coordinated with the authorised person's risk tolerance.

### ***Section 10***

An authorised person that is apart of a financial group shall consider its role and position in the group for the purposes of Section 7 to Section 9 of this Annex.

## **Chapter 2. Liquidity risk management**

### ***Section 11***

An authorised person's long-term plan for the authorised person to meet its payment obligations (liquidity policy) shall include:

1. How liquidity management shall be organized;

2. How the assets and liabilities are put together;
3. The distribution of various maturities and currencies;
4. Transfer of liquidity among different countries;
5. The use of borrowing instruments;
6. Possession of realizable assets; and
7. Preparedness for uneven intraday cash flows.

### ***Section 12***

- a. An authorised person shall in a long term plan for its future financing (financing strategy) seek to ensure that there is a sufficient degree of diversification of funding sources with regard to the appropriate number and type of counterparties, type of financial instruments, secured and unsecured borrowings, maturities, currencies and geographic markets.
- b. The authorised person will attend its chosen funding markets and ensure that they have a strong relationship with its funders to promote effective diversification of its sources of funding. The authorised person shall identify the key factors that affect the ability to raise financing and closely monitor these factors to ensure that the estimated financing ability is still valid under various possible circumstances.

### ***Section 13***

An authorised person shall manage their intraday liquidity positions and associated risks so that it can meet its payment and settlement obligations in various currencies and in different payment systems. The authorised person shall meet its commitments on time, both during normal times or emergency and shall specifically identify and prioritize the most critical obligations. The authorised person must also take account of such obligations that may arise in its role as a custodian.

#### ***Section 14***

- a. An authorised person shall manage their collateral and oversee those of its subsidiaries with respect to jurisdiction and currency exposure. The authorised person must differentiate between assets that are utilized as collateral and other assets.
- b. An authorised person shall continuously learn about the requirements in regard to securities that could be used as collateral in central banks to have access to intraday credit, repos and monetary policy loans, including loans in lending facilities. The authorised person will also learn about the securities eligible as collateral for major counterparties and financiers of secured borrowing in the private market. A market value of securities shall be adjusted using an appropriate haircut.
- c. The authorised person must follow the location of the available securities to ensure that these securities may be used to provide liquidity.

#### ***Section 15***

- a. An authorised person shall keep a separate pool of high quality liquid assets that can be used to secure the authorised person's short-term ability to pay for loss or reduced access to commonly available sources. The assets of the liquidity reserve may not be utilized as collateral. The size of the liquidity reserve shall be such that it is possible for an authorised person to withstand a severe liquidity strain, without having to change its business model.
- b. The liquidity reserve referred to in paragraph (a) of this Section shall consist of such assets that liquidity can be created in a short time at predictable values. The liquidity reserve shall consist of assets that are both liquid in private markets and that allows financing with central banks.

- c. An authorised person shall satisfy itself that there are no barriers to using reserve funds for short term financing.
- d. An authorised person shall, in determining the size and location of its financial group's liquidity reserve, take into account the degree to which companies that are part of its financial group shall be self-sufficient in liquidity and the extent of liquidity support to these compines.
- e. An authorised person with liquidity risk in different currencies shall where possible, allocate the liquidity in relevant currencies in order to avoid potential interference in the swap markets.

#### ***Section 16***

An authorised person shall evaluate what other measures might create liquidity in a near future without that the authorised person needs to change its business model.

#### ***Section 17***

- a. An authorised person shall set limits to control its exposure to liquidity risk. The limits shall be reviewed periodically and adjusted as circumstances or the governing body's risk tolerance change. The choice of the limits imposed by the authorised person shall be selected according to the methods it uses to measure liquidity risk and is therefore a consequence of the nature, scope and complexity.
- b. The authorised person shall under normal circumstances use the exposure limits in the current management of liquidity within and across business units and legal entities. Such a limit structure must also ensure that the authorised person can continue to act during times of market stress, business stress and a combination thereof.

- c. An authorised person shall have a procedure for the allocation of limits referred to in paragraph (a) of this Section. A decision scheme shall include details of how, by whom and to who limit excesses are reported and documented. It must also clarify whether and under what conditions limits can be redistributed and the steps to be taken for breaches of limits.

### ***Section 18***

An authorised person shall identify and use internal authorised person-specific indicators of liquidity risk and, where possible, market-related indicators that provides early warning of negative trends and increased risk.

### ***Section 19***

- a. An authorised person shall have a contingency plan for liquidity crises.
- b. The contingency plan for liquidity crises shall contain clear instructions for how it shall respond to crisis situations involving different time horizons (options) to overcome liquidity shortage. The plan shall outline the measures to deal with various crises and contain definitions for events that trigger the application of any of the various policy options. The contingency plan shall be periodically tested and updated on the basis of such results of stress tests.

### ***Section 20***

An authorised person that is a part of a financial group shall consider its role and position in the group for the purposes of Section 19 of this Annex.

## **Annex 9: INTERNAL CAPITAL ASSESSMENT**

### Chapter 1. Internal Capital Adequacy Assessment Process (ICAAP)

#### *Section 1*

The purpose of Pillar II is to ensure that authorised persons have sufficient capital to support all material risks to which their business exposes them. It shall therefore reinforce the link between the risks and the capital, so that the authorised person's risk management strategy, approaches and systems are integrated with its capital planning. Authorised persons are expected to develop and use sound risk management techniques in monitoring and measuring all their risks.

#### *Section 2*

- a. Each authorised person is responsible for its ICAAP, and for setting internal capital targets that are consistent with its risk profile and operating environment. The ICAAP should be tailored to the authorised person's circumstances and needs, and it should use the inputs and definitions that the authorised person normally uses for internal purposes.
- b. The authorised person should be able to demonstrate how the ICAAP meets supervisory requirements. Authorised persons retain full responsibility for their ICAAP regardless of the degree of outsourcing, as outsourcing does not relieve authorised persons from the need to ensure that their ICAAP fully reflects their specific situation and individual risk profile.

### ***Section 3***

- a. The responsibility for initiating and designing the ICAAP rests with the executive management. The governing body should approve the conceptual design (at a minimum, the scope, general methodology and objectives) of the ICAAP.
- b. The executive management is responsible for integrating capital planning and capital management into the authorised person's overall risk management culture and approach. They should ensure that capital planning and management policies and procedures are communicated, implemented and supported by sufficient authority and resources.
- c. The authorised person's ICAAP (that is the methodologies, assumptions and procedures) and capital policy should be formally documented and written, and it should be reviewed and approved by the governing body.

### ***Section 4***

The ICAAP should form an integral part of authorised persons' management processes so as to enable the governing body to assess, on an on-going basis, the risks that are inherent in their activities and material to the authorised person. This could range from using the ICAAP to allocate capital to business units or to having it play a role in the individual business decision process.

### ***Section 5***

- a. The authorised person shall ensure that risks are covered adequately and that capital coverage reflects the actual risk profile of the authorised person. This review should take place at least annually.

- b. The ICAAP and its review process should be subject to independent internal review. Any changes in the authorised person's strategic focus, business plan, operating environment or other factors that materially affect assumptions or methodologies used in the ICAAP should initiate appropriate adjustments to the ICAAP. New risks that occur in the business of the authorised person should be identified and incorporated into the ICAAP.

### ***Section 6***

- a. The adequacy of an authorised person's capital is a function of its risk profile. The authorised person should set capital targets that are consistent with their risk profile and operating environment.
- b. Authorised persons may take other considerations into account in deciding how much capital to hold, such as external rating goals, market reputation and strategic goals. However, the authorised person in this case shall be able to explain to the Authority how those considerations have influenced its decisions concerning the amount of capital to hold.
- c. The focus of the ICAAP for less readily quantifiable risks should be more on qualitative assessment, risk management and mitigation. The authorised person should clearly establish for which risks a quantitative measure is warranted, and for which risks a qualitative measure is the correct risk mitigation tool.
- d. Authorised persons that take a Pillar I approach as the starting point for their ICAAP may also consider developing a fully risk-based approach.

### ***Section 7***

- a. The ICAAP should capture all the material risks to which the authorised person is exposed, albeit that there is no standard categorisation of risk types and definition of

materiality. The authorised person may use its own terminology and definitions, albeit that it should be able to explain these in detail to the Authority, including the methods used, the coverage of all material risks and how its approach relates to its obligations under Pillar I.

b. The ICAAP should cover the following:

1. Pillar I risks, including major differences between the treatment of Pillar I risks in the calculation of capital base requirements and their treatment under the ICAAP;
2. Pillar II risks, such as concentration risk, liquidity risk, reputation and strategic risk. Some of these risks are less likely to lend themselves to quantitative approaches, in which cases authorised persons are expected to employ more qualitative methods of assessment and mitigation; and
3. Risk factors external to the authorised person. These include risks that may arise from the regulatory, economic or business environment and which are not included in the risks mentioned in 1 and 2 above.

### *Section 8*

- a. The ICAAP should take into account the authorised person's strategic plans and how they relate to macro-economic factors. The authorised person should develop an internal strategy for maintaining capital levels that can incorporate factors such as business growth expectations, future sources and uses of funds and dividend policy.
- b. The authorised person should have an explicit, approved capital plan, which states the authorised person's objectives and the time horizon for achieving those objectives, and in broad terms the capital planning process and the responsibilities for that process. The plan should state the following:

1. How the authorised person will comply with capital requirements in the future;
  2. Any relevant limits related to capital; and
  3. A general contingency plan for dealing with divergences and unexpected events (for example, raising additional capital, restricting business, or using risk mitigation techniques).
- c. Authorised persons should conduct appropriate stress tests which take into account, for example, the risks specific to the jurisdiction(s) in which they operate and the particular stage of the business cycle. Authorised persons should analyse the impact that new legislation, the actions of competitors or other factors may have on their performance, in order to determine what changes in the environment they could sustain.

### ***Section 9***

The ICAAP should produce a reasonable overall capital number and assessment. The authorised person should be able to explain to the Authority the similarities and differences between its ICAAP (which should cover all material risks) and its capital base requirements under Pillar I.

## Chapter 2.Strategies on how to reach and maintain capital targets

### *Section 10*

The ICAAP shall take into account the authorised person's strategic plans and how they relate to macroeconomic factors. The authorised person shall develop an internal strategy for maintaining capital levels that can incorporate factors such as business growth expectations, future sources and uses of funds and dividend policy.

### *Section 11*

In designing an ICAAP, the authorised person must address core issues and define its general strategic conditions based on its fundamental attitude toward risk and risk management. The result of this process is the authorised person's risk strategy, which shall be documented in writing. The scope and level of detail of this strategy depend on the size, complexity and risk levels of the specific authorised person, but a concise strategic outline shall be preferred over an excessively long description.

### *Section 12*

Every authorised person is characterized by a fundamental attitude toward risk and risk management. This basic attitude manifests itself in the authorised person's risk policy principles, its risk appetite, its (current and planned) risk structure as well as the structure and positioning of risk management within the authorised person. These elements already exist in every authorised person, for example, in the existing organization or in the instruments used for risk management.

## Chapter 3. Self-assessment and stress testing

### *Section 13*

- a. Authorised persons shall, if possible, conduct appropriate stress tests and self-assessment which take into account, for example, the risks specific to the jurisdiction(s) in which they operate and the particular stage of the business cycle. Authorised persons shall analyse the impact that new legislation, the actions of competitors or other factors may have on their performance, in order to determine what changes in the environment they could sustain.
- b. The stressed scenarios shall be developed by the authorised persons, reflecting the risk factors that affect their specific business. However, the Authority also has the right to develop generic stressed scenarios that the authorised persons must assess its risks according to.

## **Annex 10: DISCLOSURE**

Chapter 1. Disclosure regarding authorised person and financial group

### ***Section 1***

An authorised person shall, when it discloses information in accordance with these Rules, state its full name and authorised person license number.

### ***Section 2***

If an authorised person is part of a financial group, the authorised person shall describe the organisational structure of the financial group.

### ***Section 3***

An authorised person shall describe its objective and guidelines for risk management for each individual risk category. The information shall include:

1. Strategies and processes for risk management;
2. How the risk management and compliance function is organised and structured;
3. The scope and nature of risk reporting and measurement systems; and
4. The guidelines for hedging and mitigating risk and the strategies and procedures the authorised person has to monitor the continuing effectiveness of hedges and mitigations of risks.

## Chapter 2. Disclosure regarding capital base

### *Section 4*

An authorised person shall disclose a summary of the terms and conditions that apply to all capital items and components thereof.

### *Section 5*

- a. An authorised person shall disclose the amount of the capital base pursuant to Article 4 of these Rules with separate disclosure of all capital base items and deductions.
- b. The authorised person shall also submit information about the deductions made from Tier-1 capital and Tier-2 capital so as not to exceed the threshold values set out in these Rules. The authorised person shall also submit information concerning total eligible capital base, net of deductions and threshold values, in accordance with these Rules.

### *Section 6*

An authorised person shall disclose all current or foreseen material or legal impediments to the prompt transfer of capital or repayment of liabilities between the authorised person and its subsidiaries.

## Chapter 3. Disclosure regarding capital requirements

### *Section 7*

An authorised person shall state whether the requirements for the minimum level for capital are fulfilled and report its strategies and methods for valuing and maintaining capital requirement in accordance with these Rules.

### *Section 8*

An authorised person shall summarize its strategy and approach for assessing the adequacy of its internal capital to support current and future activities.

### *Section 9*

An authorised person shall disclose information regarding the capital requirement for:

1. Risks in the trading book;
2. Risks in non-trading activities;
3. Operational risk;
4. Foreign exchange rate risk; and
5. Commodity risk.

## Chapter 4. Disclosure regarding non-trading activities

### *Section 10*

An authorised person shall submit the following information concerning its credit risk exposures:

1. The definitions in accordance with the external accounts of past due claims and impaired liabilities; and
2. Information concerning the approaches adopted to determine impairments and specific provisions.

### ***Section 11***

An authorised person shall disclose the total amount of all exposures, in accordance with the applicable accounting regulations, after offsets but without taking into account the effects of credit risk mitigation, and the average amount of the exposures over the period broken down by different types of exposure classes.

### ***Section 12***

An authorised person shall disclose information broken down by significant industries and counterparty type, concerning:

1. Impaired exposures and past due exposures, provided separately;
2. Impairments and specific provisions; and
3. Charges for impairments and specific provisions during the last financial year.

### ***Section 13***

- a. A report for changes in impairments and specific provisions for impaired exposures shall be submitted separately. This information shall include:
  1. Opening balances;
  2. The amounts impaired or reversed during the report period;

3. The amounts set aside or reversed for estimated probable losses on exposures during the report period, any other adjustments including those determined by exchange rate differences, business combinations, acquisitions and disposals of subsidiaries and transfers between provisions; and
  4. Closing balances.
- b. Specific provisions and recoveries recorded directly to the income statement shall be stated separately.

#### ***Section 14***

Where credit risk protection is utilised to decrease the capital requirement, the authorised person shall disclose the following:

1. The policies and processes for, and indication of the extent to which it makes use of, on and off-balance sheet netting;
2. The policies and processes for collateral valuation and management;
3. A description of the most important types of collateral accepted by the authorised person;
4. Information on the most important types of guarantor and credit derivative counterparties and their creditworthiness; and
5. Information about market or credit risk concentrations within the credit risk mitigation taken.

#### ***Section 15***

- a. An authorised person shall, separately for each exposure class, indicate the total exposure amount that is covered by eligible collateral.

- b. The exposure amount shall, where relevant, be calculated after netting on and off-balance sheet as well as after application of volatility adjustments.

***Section 16***

- a. An authorised person shall indicate the total exposure value that is covered by guarantees or credit derivatives separately for each exposure class.
- b. The exposure amount shall, where relevant, be calculated after netting on and off-balance sheet as well as after application of volatility adjustments.

***Section 17***

Each authorised person shall submit information concerning all exposure classes. The information shall include the following:

1. Names of the credit rating agencies used and the reasons for any changes;
2. The exposure classes for which each credit rating agency are used;
3. A description of the process used to transfer the issuer and to issue credit ratings onto non-trading activities items;
4. The mapping between the credit rating from each credit rating agency with the credit quality steps in regards to non-trading activities. This information need not be disclosed if the authorised person uses ratings from rating agencies mentioned in Annex 11 and Annex 12; and
5. Exposure amounts before and after credit risk protection associated with each credit quality step in regards to non-trading activities, as well as the exposure amounts that are deducted from capital.

## Chapter 5. Disclosure regarding liquidity risk

### *Section 18*

An authorised person shall regularly publish such information as in Section 19 and Section 20, of this Annex which means that market participants can assess the authorised person's ability to manage liquidity risk and its liquidity position on an informed manner.

### *Section 19*

An authorised person shall describe in the public information both the strategy and guidelines for its liquidity risk management, and how the function of liquidity risk management is organized. In addition, the scope and nature of risk reporting and risk measurement systems involved. The authorised person will also describe the stress tests conducted and how the authorised person's contingency plan is designed.

### *Section 20*

An authorised person shall disclose quantitative information on their liquidity positions, making it possible for market participants to get an idea of its liquidity risk. The authorised person shall at least provide information on the size and composition of its liquidity reserves, the size and distribution of funding sources and the values of the various risk measures and ratios, which are periodically reported to the Authority. The authorised person shall provide sufficient qualitative information on the use of ratios and risk measures so that market participants can understand them.

## Chapter 6. Disclosure regarding counterparty risk

### *Section 21*

An authorised person shall provide a description of:

1. The methodology used to assign internal capital and credit limits for counterparty risk exposures;
2. The policies for securing collateral and establishing credit reserves; and
3. The policies for the authorised person's wrong-way risk exposures.

### *Section 22*

An authorised person shall also provide a description of the methodology used to calculate the risk exposure amount for counterparty risk.

### *Section 23*

Information concerning counterparty risk shall include:

1. The impact of the amount of collateral the authorised person would have to provide following a downgrade in the authorised person's credit rating;
2. The notional value of credit derivative hedges;
3. The gross positive fair value of contract;
4. Netting benefits;
5. Netted current credit exposure;
6. Held collateral; and
7. Net derivative credit exposures.

#### ***Section 24***

An authorised person shall provide information concerning its credit derivative transactions (notional values). The information shall be divided among transactions that are used in own credit portfolios and intermediation activities to assist client needs. The authorised person shall furthermore provide information about the distribution of the type of credit derivative products used, broken down further by protection bought and sold within each product group.

#### Chapter 7. Disclosure regarding operational risk

#### ***Section 25***

An authorised person shall disclose which method that is used to calculate the capital requirements for operational risk.

#### Chapter 8. Periodic disclosure

#### ***Section 26***

Periodic disclosure information shall as a minimum include the following information concerning capital:

1. The amount of Tier-1 capital;
2. The amount of Tier-2 capital;
3. The amount of an alternative determination of capital;
4. Deductions and threshold values in accordance with these Rules; and
5. Total capital, net after deductions and threshold values in accordance with these Rules.

*Section 27*

Periodic disclosure information shall as a minimum include the following information about the capital requirement:

1. The capital requirement for non-trading activities;
2. The capital requirement for risks in the trading book;
3. The capital requirement for operational risk;
4. The capital requirement for foreign exchange risk;
5. The capital requirement for commodities risk; and
6. The total minimum capital requirement.

## Annex 11: Long-term mapping

Credit quality Step	Assessment			
	S & P	Fitch	Moody's	Capital Intelligence
1	AAA to AA-	AAA to AA-	Aaa to Aa3	AAA
2	A+ to A-	A+ to A-	A1 to A3	AA to A
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	BBB
4	BB+ to BB-	BB+ to BB-	Ba1 to Ba3	BB
5	B+ to B-	B+ to B-	B1 to B3	B
6	CCC+ and below	CCC+ and below	Caa1 and below	C and below

## Annex 12: Short-term mapping

Credit quality step	Assessment			
	S & P	Fitch	Moody's	Capital Intelligence
1	A-1+, A-1	F1+, F1	P-1	A1
2	A-2	F2	P-2	A2
3	A-3	F3	P-3	A3
4	Below A-3	Below F3	Not Prime	Below A3

### Annex 13: Liquid indexes

<b>Country</b>	<b>Index</b>
Australia	All Ords
Belgium	BEL 20
Denmark	OMXC20
Finland	OMXH25
France	CAC 40
Hong Kong	Hang Seng
Italy	MIB 30
Japan	Nikkei 225
Canada	TSE 35
Netherlands	EOE25
Norway	OBX
Switzerland	SMI
Spain	IBEX 35
United Kingdom	FTSE 100
United Kingdom	FTSE Mid 250
Sweden	OMXSB
Germany	DAX
USA	S&P 500
Austria	ATX