THE CENTRAL BANK OF THE BAHAMAS

Consultation Paper on the Calculation of the Capital Charge for Credit Risk – Standardized Approach

Bank Supervision Department

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INTRODUCTION

The Central Bank of The Bahamas ("the Central Bank") is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to the Banks and Trust Companies Regulation Act, 2000, and the Central Bank of The Bahamas Act, 2000. Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

On 26th June, 2004 the Basel Committee on Banking Supervision ("BCBS") released a document entitled ***International Convergence of Capital Measurement and Capital Standards: A Revised Framework***, also known as Basel II (finalised in June 2006). The major objective of Basel II has been to align a bank's regulatory capital more closely with its risks, taking into account the bank's progress in the measurement and management of risk and the opportunities which these provide for strengthened supervision. On April 15th 2005, the Central Bank issued Guidelines for the ***Management of Capital and the Calculation of Capital Adequacy***. These Guidelines outlined the overall framework for assessing the adequacy of a bank's capital, particularly with respect to credit risk associated with the banks' on and off-balance sheet exposures.

PURPOSE

Pillar 1 of the Basel II framework details how banks should calculate their minimum capital requirements to cover credit risk, operational risk and market risk. The purpose of this paper is to seek the views of licensees and the public, regarding the methodology for calculating the capital charge for credit risk. The methodology, entitled ***Credit Risk – The Standardised Approach***, outlines the approach which the Central Bank proposes for licensees to use for measuring credit risk in a standardised manner, supported by external credit assessments.

Consultative Period

To make an informed and impartial decision on this topic, the Central Bank wishes to obtain comments from its licensees and other interested parties. The consultative period will run for thirty (30) days, from 9th October to end on 9th November, 2015. In that regard, we welcome your comments on these proposals.

Questions and/or Comments

You are encouraged to submit any questions and/or comments relative to this consultation paper to the Policy Unit, Bank Supervision Department via postal mail or email.

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Introduction

1. The BCBS provides two alternatives for the implementation of capital charges for credit risk: 1) the Standardized Approach which provides a standardized methodology using the risk ratings assigned by eligible external credit assessment institutions (note that for these purposes the methodology of one institution, Standard & Poor's is being used, however, Moody's Investors Service and Fitch Ratings can equally be used) and 2) the Internal Ratings Based Approach which allows banks to implement their own internal ratings system subject to the approval of national supervisors.

2. In determining credit risk capital charges, the licensee[1] must apply the prescribed risk-weights to both on-balance sheet and off-balance sheet exposures. Exposures are to be risk weighted net of specific provisions. Risk weights will be based on the risk rating assigned by external credit assessment institutions (ECAIs)[2] deemed eligible by the Central Bank. Appendix 1 outlines the criteria the Central Bank will use in recognizing an ECAI as eligible for capital adequacy purposes. It also outlines key issues related to the use of ratings assigned by eligible ECAIs.

Risk Weight Categories

Claims on Sovereigns

3. Claims on sovereigns and their central banks will be risk weighted as follows:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

[1] The term "licensee" generally refers to institutions that are licensed to engage in the business of banking and are supervised by the Central Bank of The Bahamas.
[2] Also called Credit Rating Agencies (CRAs)

4. Using national discretion, the Central Bank will allow a 0% risk weight to be applied to licensees' exposures to The Bahamas Government (or The Central Bank of The Bahamas). Such exposures must be denominated in the domestic currency and funded[3] in the domestic currency.

5. Licensees with exposures (that are funded and denominated in the domestic currency) to other sovereigns (i.e. overseas central governments or central banks) may apply the preferential risk weight assigned to those sovereign exposures by their national supervisors.

6. For claims on sovereigns that are unrated, the Central Bank will recognize the country risk scores assigned by an Export Credit Agencies (ECAs). To qualify, an ECA must publish its risk scores and subscribe to the OECD[4] agreed methodology. Licensees may choose to use the risk scores of ECAs that are recognized by their home supervisor, or the consensus risk scores of ECAs participating in the "Arrangement on Officially Supported Export Credits"[5]. The OECD agreed methodology establishes eight risk score categories associated with minimum export insurance premiums. These ECA risk scores will correspond to the risk weight categories detailed in the table below:

ECA Risk Scores	**0-1**	**2**	**3**	**4-6**	**7**
Risk Weight	0%	20%	50%	100%	150%

7. Licensees should apply a 0% risk weight to claims on the Bank for International Settlements (BIS), the International Monetary Fund (IMF), the European Central Bank and the European Community.

Claims on Non-Central Government Public Sector Entities (PSEs)

8. Using national discretion, claims on domestic PSEs will be assigned a risk weight using the following three criteria:

Domestic PSEs	**Criteria**	**Risk Weight**
Treated as a Sovereign	Claims of domestic PSEs which are guaranteed by central government. The guarantee must be explicit, unconditional, legally enforceable and irrevocable.	0%
Treated as a Bank	Claims of domestic PSEs which are not guaranteed by central government and the PSE does not participate in a	See risk weights for claims on banks

[3] That is, where the bank has corresponding liabilities denominated in that domestic currency.
[4] Organization for Economic Co-operation and Development
[5] The consensus country risk classification is available on the OECD's website (http:/www.oecd.org) in the Export Credit Arrangement web-page of the Trade Directorate.

	competitive market will be assessed an equivalent risk weight as a bank.	
Treated as a Corporate	Claims of domestic PSEs which are not guaranteed by central government and the PSE participates in a competitive market will be assessed an equivalent risk weight as a corporate.	100%

Claims on multilateral development banks (MDBs)

9. Claims on MDBs will generally be risk weighted in accordance with the table below:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	50%	50%	100%	150%	50%

10. Claims on highly rated MDBs that meet the following criteria[6] will receive a risk weight of 0%:
   a) very high quality long term issuer ratings, i.e. the majority of an MDBs external assessments must be AAA;
   b) the MDB's shareholder structure is comprised of a significant proportion of sovereigns with long-term issuer credit assessments of AA- or better, or the majority of the MDB's fund-raising is in the form of paid-in equity/capital and there is little or no leverage;
   c) strong shareholder support demonstrated by the amount of paid-in capital contributed by the shareholders; the amount of further capital the MDBs have the right to call, if required, to repay their liabilities; and continued capital contributions and new pledges from sovereign shareholders;
   d) adequate level of capital and liquidity (a case-by-case approach is necessary in order to assess whether each MDBs capital and liquidity are adequate); and,
   e) strict statutory lending requirements and conservative financial policies, which would include among other conditions a structured approval process, internal creditworthiness and risk concentration limits (per country, sector, and individual exposure and credit category), large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and rigorous assessment of risk and provisioning to loan loss reserve.

11. The following special MDBs are eligible for a risk weight of 0%:
   - International Bank for Reconstruction and Development (IBRD)
   - International Finance Corporation (IFC)
   - Asian Development Bank (ADB)
   - African Development Bank (AfDB)

[6] These criteria are established by the Basel Committee on Banking Supervision.

- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank (IADB)
- European Investment Bank (EIB)
- European Investment Fund (EIF)
- Nordic Investment Bank (NIB)
- Caribbean Development Bank (CDB)
- Islamic Development Bank (IDB)
- Council of Europe Development Bank (CEDB)

Claims on banks

12. No claim on an unrated bank may receive a risk weight lower than a claim on its sovereign of incorporation.

Maturity more than three months

13. Risk weights for all banks incorporated in The Bahamas, will be assigned a risk weight lower than that assigned to claims on the Bahamas Government and will be based on the external credit assessment. However, for claims on banks in countries with sovereigns rated BB+ to B- and on banks in unrated countries, the risk weight of 100% will apply. Accordingly, claims on banks (with a maturity of more than three months) will be risk weighted as follows:

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight for Banks[7]	20%	50%	100%	100%	150%	100%

Maturity less than three months

14. A claim will be treated as a short term claim where it has an original maturity of three (3) months or less. Short term claims on banks that are funded and denominated in **domestic currency** will be assigned a risk weight of 20% (which is one category less favourable than claims on the Government of The Bahamas or the Central Bank).

15. A claim will be treated as a short term claim where it has an original maturity of three (3) months or less. Short term claims on banks that are funded and denominated in **foreign currency** will be assigned a preferential risk weight that is one category less favourable than claims on the sovereign, subject to a floor of 20%.

[7] Using national discretion, the Central Bank is using Option 1 for claims on banks which is based on the credit assessment of sovereigns.

16. Short term claims with (contractual) original maturity under 3 months which are expected to be rolled over (i.e. where the effective maturity is longer than 3 months) will not qualify for the preferential treatment outlined under this part for capital adequacy purposes.

Claims on securities firms

17. Claims on securities firms will be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under the Basel II framework (including, in particular, risk-based capital requirements). Otherwise, such claims will be risk weighted as claims on corporates (see paragraph 18).

NOTE:
These institutions would typically be those joint licensees of the Central Bank and Securities Commission of The Bahamas, that is, within our domestic environment.

Claims on corporates

18. The following claims will be subject to a risk weight of 100% without regard to external ratings:
    i. Claims on corporates (excluding venture capital and private equity investment corporations);
    ii. Claims on insurance companies;
    iii. Claims on securities companies that do not qualify for the treatment for claim on banks (as stated in paragraph 17).

19. No claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation.

20. The Central Bank reserves the right to increase the standard risk weight for unrated claims where it determines that a higher risk weight is warranted by the overall default experience.

21. As part of the supervisory review process (Pillar 2), the Central Bank may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.

Claims included in the regulatory retail portfolios

22. Claims that qualify under the regulatory retail portfolio will receive a 75% risk weight. To qualify under the regulatory retail portfolio the exposure must meet the following criteria:

a. **Orientation Criterion** - The exposure is to an individual person, persons, or small business;

b. **Product Criterion -** The exposure takes the form of any of the following:

   i. Revolving credits and lines of credit (including credit cards and overdrafts);

   ii. Personal term loans and leases (e.g. installment loans, auto loans and leases, student and educational loans, personal finance, etc.); or

   iii. Small business facilities and commitments.

   Securities (such as bonds and equities), whether listed or not, must be excluded from this category. Mortgage loans must also be excluded to the extent that they qualify for treatment as claims secured by residential property.

c. **Granularity Criterion –** the Central Bank must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio. Among other things, the maximum aggregate exposures[8] to any one counterparty should not exceed $100,000.

d. **Low value of individual exposures** – the maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of $100,000. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.

23. Claims that do not satisfy the above criteria will be risk weighted at 100%.

24. In addition, the Central Bank will regularly review the 75% risk weight to ensure that it is not too low based on the default experience for these types of exposures.

25. Past due loans (over 90 days) and claims secured by residential property are **excluded** from the regulatory retail portfolio for risk weighting purposes.

Claims secured by residential property

26. Loans secured by mortgages on residential property (residential mortgage loans) will be risk weighted at 50% provided all the following conditions are met:

    i. The property is or will be occupied by the borrower or is rented; and

    ii. The loan is <u>not</u> past due for more than 90 days.

27. Where a residential mortgage loan does not satisfy the conditions set out at paragraph 26 above, a 100% risk weight should be applied.

[8] Aggregated exposure means gross amount (i.e. not taking any credit risk mitigation into account) of all forms of debt exposures (e.g. loans or commitments) that individually satisfy the three other criteria. In addition, "to one counterparty" means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure on both businesses).

28. The Central Bank will maintain under review the default experience with such claims to determine the continuing appropriateness of the concessionary weighting.

Claims secured by commercial property

29. A risk weight of 100% will be applied to claims secured by commercial real estate.

Past Due Loans

Unsecured Portions of Past Due Loans

30. The unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions, will be risk-weighted as follows:
    - 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan.
    - 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan.
    - 100% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan.

Secured Portions of Past Due Loans

31. Banks should apply the same risk weight on the secured portion of past due loans secured by eligible collateral or guarantees (See Appendix 2 – Eligible Collateral), as if they were not past due, provided the credit risk mitigation criteria continues to be satisfied.

32. Past due loans fully secured by collateral not recognized under the Credit Risk Mitigation framework (see page 16) are to be risk-weighted at 150%.

33. Qualifying residential mortgage loans (discussed at paragraph 26 above) that are past due for more than 90 days will be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight of 50% will be applied.

High Risk Categories

34. A risk weight of 150% will apply to venture capital and private equity investments[9].

[9] A venture capital or private equity investment is deemed to be one which, at the time the investment is made, is: a) in a new or developing company or venture; or b) in a management buy-out or buy-in; or c) made as a means of financing the investee company or venture and accompanied by a right of consultation, or rights to information, or board representation, or management rights; or d) acquired with a view to, or in order to, facilitate a transaction falling within (a) to (c).

Securitizations

35. Securitization tranches that are rated between BB+ and BB- will be risk weighted at 350%. Otherwise, the following will be used to risk weight securitizations:

Credit Assessment	AAA to AA- (A-1/P-1)	A+ to A- (A-2/P-2)	BBB+ to BBB- (A-3/P-3)	BB+ to BB-	B+ and Below	Unrated
Risk Weight	20%	50%	100%	350%	Deduction	Deduction

Investments (Shares and Securities)

36. Domestic Securities such as Public Corporation Bonds will be risk weighted at 20% while other domestic securities will be risk weighted at 100%.
37. Foreign Securities and Other Investments will be risk weighted at 100%.

Other Assets

38. Generally, the standard risk weight for all other assets will be 100%.

39. A 0**%** risk weight will apply to:
    - Cash;
    - Gold Bullion, held in the institution's own vaults or on an allocated basis to the extent backed by bullion liabilities; and,
    - Exposures collateralized by cash deposits.

40. A 20% risk weight will apply to:
    - Cash items in the process of collection

41. A 100% risk weight will apply to:
    - Collective Investment Scheme Exposures;
    - Premises, plant, equipment and other fixed assets;
    - Investments in equity of other entities and holdings of investment funds (including investments in commercial entities) (where there is no deduction from the licensee's capital base);
    - Gold Bullion – other;
    - Silver Bullion; and,
    - All other assets not included elsewhere (such as exposures to individuals, other on-balance sheet assets).

Treatment of Off-Balance Sheet Exposures

42. The categories of off-balance sheet items include guarantees, commitments, and similar contracts whose full notional principal amount may not necessarily be reflected on the balance sheet. A bank's total risk-weighted off-balance sheet credit exposures is calculated as the sum of the risk-weighted amounts of all its market-related (i.e. derivative instruments) and non-market related (i.e. non-derivative instruments) transactions.

43. A two-step approach is used in order to derive the risk-weighted amounts of off-balance sheet items as follows:
    a. The nominal principal amounts of off-balance sheet items are multiplied by the credit conversion factors (CCFs); and
    b. The resulting credit equivalent amounts are multiplied by the risk weights applicable to the counterparty.

    Where the transaction is secured by eligible collateral, guarantee or credit derivative, the credit risk mitigation technique detailed under Credit Risk Mitigation shall be used to reduce the regulatory capital charge of the exposure.

44. Licensees should convert off-balance sheet items into credit exposures equivalents through the use of credit conversion factors (CCFs) as follows:

Off-Balance Sheet Exposure	**Credit Conversion Factor(CCF)**
i. Commitments that are unconditionally cancellable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to the deterioration in a borrower's credit worthiness	**0%**
i. Commitments with an original maturity up to one year. ii. Short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralized by the underlying shipment)[10].	**20%**
i. Commitments with an original maturity exceeding one year, including	**50%**

[10] A 20% CCF will be applied to both issuing and confirming banks

Off-Balance Sheet Exposure	Credit Conversion Factor(CCF)
underwriting commitments and commercial credit lines. ii. Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions). iii. Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).	
i. Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances). ii. Sale and repurchase agreements.[11] iii. Asset sales with recourse where the credit risk remains with the bank[12]. iv. Forward asset purchases, forward deposits and partly-paid shares and securities[13], which represent commitments with certain drawdown. v. Lending of banks' securities or the posting of securities as collateral by banks, including instances where these arise out of repo-style transactions (i.e. repurchase/ reverse repurchase and securities lending/securities borrowing transactions)[14].	**100%**

45. Where there is an undertaking to provide a commitment on an off-balance sheet item, the lower of the two applicable CCFs is to be applied.[15]

[11] A sale and repurchase agreement (repo) is an arrangement whereby a bank sells an instrument to a third party with a commitment to repurchase the asset for an agreed price on demand, or after a stated time, or in the event of a particular contingency. It represents an irrevocable commitment and should be reported as an off-balance sheet item.

[12] These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into).

[13] These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into).

[14] The calculation of the risk weighted assets where the credit converted exposure is secured by eligible collateral is covered under the section "Collateralized Transactions" of the Credit Risk Mitigation Framework.

[15] For example, an irrevocable commitment with an original maturity of 15 months (50% - CCF) to issue a 6 month documentary letter of credit (20% - CCF) would attract the lower of the CCF i.e. the CCF applicable to the documentary letter of credit – 20% CCF.

46. Licensees should categorize off-balance sheet exposures into the following standard items below and determine the appropriate CCF(s) to be applied:

Exposures without CRM

This column is completed for exposures, which do not have any allowable credit risk mitigants. The *Credit Equivalent Exposure* column calculates automatically after inputting the *Principal Amount before CCF*.

Exposures with CRM

This section is completed for exposures which have recognized credit risk mitigants. The *Credit Equivalent Exposure pre-CRM* column calculates automatically after inputting the *Principal Amount before CCF*. However, licensees are required to calculate the *Credit equivalent exposures post-CRM* using the rules outlined under Credit Risk Mitigation. Off-balance sheet netting is not allowed.

Over-the-Counter Derivative (OTC) transactions

47. In calculating a bank's risk-weighted off-balance sheet credit exposures arising from market-related transactions for capital adequacy purposes, the bank should include all market-related transactions held in the banking and trading books which give risk to off-balance sheet credit risk.

48. Market related transactions include the following:

    a. **Interest rate contracts** – these include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and any other instruments of a similar nature;
    b. **Foreign exchange contracts** (including contracts involving gold) – these include cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options purchased, hedge contracts and any other instruments of a similar nature;
    c. **Equity contracts** – these include swaps, forwards, purchased options and similar derivative contracts based on individual equities or equity indices;
    d. **Precious metal contracts** (other than gold) – these include swaps, forwards, purchased options and similar derivative contracts based on precious metals such as silver and platinum;
    e. **Other commodity contracts** (other than precious metals) – these include swaps, forwards, purchased options and similar derivative contracts based on energy contracts, agricultural contracts and any other non-precious metal commodity contracts; and
    f. **Other market-related contracts** – these include any contracts covering other items giving rise to credit risk.

49. To calculate the credit equivalent amount for OTC derivative contracts, the Current Exposure Method is to be applied. Under the Current Exposure Method, a bank would sum:

   a. The current exposure, which is the total replacement cost (obtained by “marking to market”) all of its contracts with positive value; and

   b. An amount for potential future credit exposure, which is derived by applying the CCF, according to the residual maturity, to the notional principal amount or face value of the contracts as specified below:

Conversion factor (%) for an exposure	**Type of Contract**				
Residual maturity	**Interest rate**	**FX and gold**	**Equity**	**Precious metals except gold**	**Other commodities**
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

Notes:

- For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0.5%.
- Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of this matrix are to be treated as "other commodities".
- No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Credit Risk Mitigation

50. Banks may use a number of techniques to mitigate the credit risks to which they are exposed. These techniques include:

   a. Collateralization - exposures may be collateralized by first priority claims, in whole or in part with cash or securities.

b. Netting - licensees may agree to net loans owed to them against deposits from the same counterparty.
c. Guarantees and/or credit derivatives - a loan exposure may be guaranteed by a third party; in addition licensees may buy a credit derivative to offset various forms of credit risk.

51. Where these techniques meet the requirements for legal certainty as set out at paragraph 52 below, the revised approach to credit risk mitigation (CRM) under the Basel II Framework allows a wider range of credit risk mitigants to be recognized for regulatory capital purposes.

Legal Certainty

52. In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met:
    a. all documentation used in collateralized transactions and for documenting on-balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions;
    b. licensees must conduct sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion (in a. above); and
    c. licensees must undertake such further reviews as may be necessary to ensure continuing enforceability of documentation.

General Considerations

53. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks) such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy, consideration of the underlying credit, valuation, policies and procedures, systems, control of roll-off risks and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where the Central Bank is not satisfied that these risks are adequately controlled, it may impose additional capital charges or take other supervisory action pursuant to Pillar 2.

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

55. The effects of CRM will not be double-counted. Therefore, the Central Bank will not grant any additional supervisory recognition of CRM for regulatory capital purposes on claims for which an issue-specific rating is

used that already reflects that CRM. Principal-only ratings will also not be allowed within the framework of CRM.[16]

56. The requirements under Pillar 3 must also be observed for banks to obtain capital relief in respect of any CRM techniques.

Collateralized Transactions

57. A collateralized transaction is one in which:

    a) banks have a credit exposure or potential credit exposure; and

    b) that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty[17] or by a third party on behalf of the counterparty.

58. Where banks take eligible financial collateral (e.g. cash or securities, more specifically defined in Appendix 2), they are allowed to reduce their credit exposure to a counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral.

59. A capital charge will be applied to banks on either side of the collateralized transaction: for example, both repos and reverse repos will be subject to capital charges. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

60. Where a licensee, acting as an agent, arranges a repo-style transaction (i.e. repurchase/reverse repurchase and securities lending/borrowing transactions) between a customer and a third party and provides a guarantee to the customer that the third party will perform on its obligations, then the risk to the bank is the same as if the bank had entered into the transaction as a principal. In such circumstances, a licensee will be required to calculate capital requirements as if it were itself the principal.

61. Under the Basel framework, in calculating regulatory capital for collateralized transactions, licensees are permitted to choose between the "Simple Approach" and the "Comprehensive Approach"[18]. For the purposes of calculating risk-weighted assets, only the Simple Approach will be allowed. In the simple approach, the risk

[16] For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.

[17] In this section "counterparty" is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure or a potential credit exposure. That exposure may, for example, take the form of a loan of cash or securities (where the counterparty would traditionally be called the borrower), of securities posted as collateral, of a commitment or of exposure under an OTC derivatives contract.

[18] The simple approach substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralized portion of the exposure (generally subject to a 20% floor) while the comprehensive approach allows for fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral.

weighting of the collateral instrument, collateralizing or partially collateralizing the exposure is substituted for the risk weighting of the counterparty.

Pre-conditions

62. Prior to banks receiving any capital relief in respect of any form of collateral, the standards below must be met under the Simple Approach:

    a) In addition to the general requirements for legal certainty set out at paragraph 52 above, the legal mechanism by which collateral is pledged or transferred must ensure that banks have the right to liquidate or take legal possession of the collateral, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set forth in the transaction documentation) of the counterparty (and where applicable, of the custodian holding the collateral).
    b) Licensees must take all steps necessary to fulfill those requirements under the law applicable to their interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral.
    c) Where the credit quality of the counterparty and the value of the collateral have a material positive correlation, the collateral instrument will not be eligible for credit risk mitigation purposes. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible.
    d) Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.
    e) Where a custodian holds the collateral, licensees must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

The Simple Approach

Minimum conditions

63. For collateral to be recognized under the simple approach the collateral must be pledged for at least the life of the exposure and it must be marked to market and re-valued with a minimum frequency of six months. Those portions of claims collateralized by the market value of recognized collateral receive the risk weight applicable to the collateral instrument. The risk weight on the collateralized portion will be subject to a floor of 20% (see exceptions outlined below). The uncollateralized portion of a claim will be assigned to the risk weight appropriate to the counterparty.

Exceptions to the Risk Weight Floor of 20%

64. Licensees may apply a 0% risk weight to repo-style transactions that satisfy all of the following criteria and where the counterparty is a core market participant (as defined in paragraph 65).
    a) both the exposure and collateral are cash or a sovereign security or Public Sector Entity (PSE) security qualifying for 0% risk-weight in the standardized approach;
    b) exposure and collateral are both denominated in the same currency;
    c) either the transaction is overnight or else both the exposure and collateral are marked-to-market daily and subject to daily remargining;
    d) in the event of a counterparty's failure to remargin, the bank has the capability to liquidate[19] the collateral no more than 4 business days after the last mark-to market;
    e) the transaction is settled across a settlement system proven for that type of transaction;
    f) the agreement is governed by standard market documentation for repo-style transactions in the securities concerned;
    g) the documentation specifies that in the event of failure of the counterparty to satisfy an obligation to deliver cash or securities or to deliver margin, or other event of default, the transaction is immediately terminable; and
    h) upon any event of default, whether or not the counterparty is insolvent or bankrupt, the bank has an unfettered legally enforceable right to immediately seize and liquidate the collateral for its benefit.

65. Core Market Participants include:
    a) Sovereigns, central banks and PSEs;
    b) Banks and securities firms;
    c) Other financial companies (including insurance companies) eligible for a 20% risk weight in the standardized approach;
    d) Regulated mutual funds that are subject to capital or leverage requirements;
    e) Regulated pension funds; and
    f) Recognized clearing organizations.

    Note: if the counterparty to the transactions discussed at 64 above is not a core market participant, banks may apply a risk weight of 10%.

66. Banks may apply a 0% risk weight to OTC derivative transactions that are subject to daily mark-to-market, collateralized by cash and where there is no currency mismatch.

[19] This does not require the bank to always liquidate the collateral but rather to have the capability to do so within the given time frame.

67. Banks may apply a 10% risk weight to OTC derivative transactions collateralized by sovereign or PSE securities that qualify for a 0% risk weight in the Standardized Approach.

68. Where a transaction is collateralized, a 0% risk weight may be applied where the exposure and the collateral are denominated in the same currency, and either
    a. the collateral is cash on deposit[20]; or
    b. the collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.

Guarantees and Credit Derivatives

69. Where guarantees or credit derivatives are direct, explicit, irrevocable, legally enforceable and unconditional, and the Central Bank is satisfied that licensees fulfill certain minimum operational conditions relating to risk management processes, licensees are permitted to take account of such credit protection in calculating capital requirements.

70. A range of guarantors and protection providers are recognized. A substitution approach will be applied whereby only guarantees issued by or protection provided by entities with a lower risk weight than the counterparty will lead to reduced capital charges since the protected portion of the counterparty exposure is assigned the risk weight of the guarantor or protection provider, whereas the uncovered portion retains the risk weight of the underlying counterparty.

Operational requirements common to both guarantees and credit derivatives

71. A guarantee (counter-guarantee) or credit derivative must:
    a. represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;
    b. be irrevocable; other than where there is non-payment by a protection purchaser of money due in respect of the credit protection contract. There must be no clause in the contract that would allow the protection provider unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure; and
    c. must also be unconditional; there should be no clause in the protection contract outside the direct control of the licensee that could prevent the protection provider from being obligated to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

[20] As defined in a) of Appendix 2 – CRM-Eligible Financial Collateral

Additional operational requirements for guarantees

72. In addition to the legal certainty requirements outlined in paragraph 52 of this paper, in order for a guarantee to be recognized, the following conditions must be satisfied:

    a) On the qualifying default/non-payment of the counterparty, the licensee may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment;
    b) The guarantee is an explicitly documented obligation assumed by the guarantor; and
    c) Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. Where the guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount in accordance with paragraph 81 below.

Additional operational requirements for credit derivatives

73. In order for a credit derivative contract to be recognized, the following conditions must be satisfied:
    a) the credit events specified by the contracting parties must at a minimum cover:
        i. failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);
        ii. bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and
        iii. restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. charge-off, specific provision or other similar debit to the profit and loss account). When restructuring is not specified as a credit event, refer to paragraph 74.
    b) If the credit derivative covers obligations that do not include the underlying obligation, item (g) below governs whether the asset mismatch is permissible;
    c) The credit derivative shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay;
    d) Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. There must be a clearly

specified period for obtaining post-credit event valuations of the underlying obligation. If the reference obligation specified in the credit derivative for purposes of cash settlement is different than the underlying obligation, item (g) below governs whether the asset mismatch is permissible;

e) If the protection purchaser's right/ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld;

f) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event;

g) A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for purposes of determining cash settlement value or the deliverable obligation) is permissible if (1) the reference obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place; and

h) a mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross acceleration clauses are in place.

74. Partial recognition of the credit derivative will be allowed in instances where the restructuring of the underlying obligation is not covered by the credit derivative, but the other operational requirements in paragraph 73 are met. Partial recognition will be permitted:

    a) if the amount of the credit derivative is less than or equal to the amount of the underlying obligation, 60% of the amount of the hedge can be recognized as covered; and

    b) if the amount of the credit derivative is larger than that of the underlying obligation, then the amount of eligible hedge is capped at 60% of the amount of the underlying obligation.

75. Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition.

76. However, the credit protection will not be recognized where banks buy credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting

deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves).

77. Other types of credit derivatives will not be eligible for recognition at this time[21].

Range of Eligible Guarantors (Counter-Guarantors)/Protection Providers

78. Credit protection given by the following entities will be recognized:

    a) sovereign entities[22], PSEs, banks[23] and securities firms with a lower risk weight than the counterparty;

    b) other entities rated A- or better. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor.

Risk Weights

79. The protected portion is assigned the risk weight of the protection provider. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.

80. Materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first loss positions and must be deducted in full from the capital of the bank purchasing the credit protection.

Proportional cover

81. Where the amount guaranteed, or against which credit protection is held, is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, i.e. the bank and the guarantor share losses on a pro-rata basis capital relief will be afforded on a proportional basis. In this instance the protected portion of the exposure will receive the treatment applicable to eligible guarantees/credit derivatives, with the remainder treated as unsecured.

Currency Mismatches

82. Where the credit protection is denominated in a currency different from that in which the exposure is denominated - i.e. there is a currency mismatch - the amount of the exposure deemed to be protected (G_A) will be reduced by the application of a haircut H_{FX}, i.e.

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[21] Cash funded credit linked notes issued by the bank against exposures in the banking book which fulfill the criteria for credit derivatives will be treated as cash collateralized transactions.

[22] These include the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community, as well as those MDBs currently referred to in paragraph 11.

[23] This includes other MDBs.

$$\mathbf{G_A = G \times (1 - H_{FX})}$$

where:

G_A = value of credit protection adjusted for currency mismatch

G = nominal amount of the credit protection

H_{FX} = haircut appropriate for currency mismatch between the credit protection and underlying obligation.

The standard supervisory haircut of 8% will be applied where the exposure and collateral are denominated in different currencies based on a 10-business day holding period (assuming daily marking to - market).

Sovereign Guarantees and Counter-Guarantees

83. As discussed in Paragraph 4, licensee's may apply a lower risk weight to exposures on sovereign (or central bank) where the bank is incorporated and where the exposure is denominated in domestic currency and funded in that currency. This treatment is also extended to portions of claims guaranteed by the sovereign (or central bank), where the guarantee is denominated in the domestic currency and the exposure is funded in that currency. A claim may be covered by a guarantee that is indirectly counter-guaranteed by a sovereign. Such a claim may be treated as covered by a sovereign guarantee provided that:
    a) the sovereign counter-guarantee covers all credit risk elements of the claim;
    b) both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counter-guarantee need not be direct and explicit to the original claim; and
    c) the Central Bank is satisfied that the cover is robust and that no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

Appendix 1-External Credit Rating Institutions (ECAIs)

1. Under the Standardized Approach, banks are able to rely on the credit assessments prepared by ECAIs. For such ratings to be used for capital adequacy purposes, the ECAI must first be recognized as eligible by the Central Bank. An appropriate mapping of the ratings of individual ECAI ratings will also be determined by the Central Bank.

2. Licensees must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Licensees will not be allowed to "cherry-pick" the assessments provided by different ECAIs and to arbitrarily change the use of ECAIs.

The Recognition Process

3. The Central Bank will determine on a continuing basis whether an ECAI meets the criteria (provided below). The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies will also be referenced when determining ECAI eligibility. The assessments of ECAIs may be recognized on a limited basis, e.g. by type of claims or by jurisdiction. The supervisory process for recognizing ECAIs will be made public to avoid unnecessary barriers to entry.

Eligibility Criteria

4. An ECAI must satisfy each of the following six criteria:

Objectivity: The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before recognizing an assessment methodology for any market segment, the Central Bank must be satisfied that at a minimum, rigorous back testing was conducted, covering a period of least one year but preferably three years.

Independence: An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.

International Access/Transparency: Individual assessments must be available to both domestic and foreign institutions with legitimate interests and on equivalent terms. The individual assessments, the key elements underlining the assessments and whether the issuer participated in the assessment process should be publicly available on a non-selective basis, unless they are private assessments. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available.

Disclosure: An ECAI should disclose the following information: its code of conduct; the general nature of its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.

Resources: An ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments.

Credibility: In addition to fulfillment of the above criteria, the extent to which an ECAI's credit assessments are relied upon by independent third parties (investors, insurers, trading partners) is reviewed in judging its credibility. Additionally, credibility is underpinned by the effectiveness of internal procedures aimed at preventing the misuse of confidential information. To be eligible, for recognition, an ECAI does not have to assess firms in more than one country.

The mapping process

5. The Central Bank will assign eligible ECAIs' assessments to the risk weights available under the risk weighting framework outlined in this document, i.e. deciding which assessment categories correspond to which risk weights. The mapping process would be objective and result in a risk weight assignment consistent with that of the level of credit risk reflected in the tables above (for the respective risk weight category). It would cover the full spectrum of risk weights.

6. In conducting the mapping process, the Central Bank will consider factors such as:

    a. the size and scope of the pool of issuers that each ECAI covers,
    b. the range and meaning of the assessments that it assigns, and
    c. the definition of default used by the ECAI.

7. Banks must disclose ECAIs that they use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by the supervisor through the mapping process as

well as the aggregated risk-weighted assets for each risk weight based on the assessments of each eligible ECAI.

Multiple Assessments

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

9. If there are two assessments by ECAIs chosen by a licensee which map into different risk weights, the higher risk weight will be applied.

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

Issuer versus Issue Assessment

11. Where a licensee invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where the claim is an investment in an issue that has not been specifically assessed, the bank can rely on a specific credit assessment of an issued debt or on a credit assessment of the issuer. The following general principles will apply:

    a) Credit Assessment of a specific debt: In circumstances where the borrower has a high quality credit assessment (with a risk weight lower than that which applies to an unrated claim) on a specific debt, and the unassessed claim ranks *pari passu* or senior to claims with the high quality assessment in all respects, then the high quality assessment can also be applied to the unassessed claim. If not, then the high quality credit assessment cannot be used and unassessed claims will receive the risk weight for unrated claims.

    b) Credit Assessment of the issuer: In circumstances where the borrower has a high quality credit assessment, which applies to senior unsecured claims on that issuer; then other unassessed claims of a highly assessed issuer will be treated as unrated. However, If either that issuer or a single issue has a low quality assessment (with a risk weight equal to or higher than that which applies to unrated claims), then an unassessed claim on the same issuer will be assigned the same risk weight as is applicable to the low quality assessment.

    c) Other unassessed claims of a highly assessed issuer will be treated as unrated.

12. Whether licensees intend to rely on an issuer- or an issue-specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure (principal and interest where applicable) that banks have with regard to all payments owed to them.

13. In order to avoid any double counting of credit enhancement factors, no supervisory recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating.

Domestic currency and foreign currency assessments

14. Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, the general rule is that:
    a. foreign currency ratings would be used for exposures in foreign currency; and
    b. domestic currency ratings, if separate, would only be used to risk weight claims denominated in the domestic currency.

Level of Application of the Assessment

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

Unsolicited Ratings

16. Licensees should only use solicited ratings from eligible ECAIs. However, there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Where such behaviour is identified, the Central Bank will consider whether to continue recognizing such ECAIs as eligible for capital adequacy purposes.

Recognized ECAIs

17. The following ECAIs will be recognized for capital adequacy purposes:
    - Moody’s Investors Service;
    - Standard and Poor’s (S&P); and,
    - Fitch Ratings.

18. The ratings of the respective ECAIs are to be mapped as follows:

Short Term Rating

Rating Grade	S&P	Fitch	Moody
1	A-1	F-1	P-1
2	A-2	F-2	P-2
3	A-3	F-3	P-3
4	Other	Other	Other

Long term Rating

Rating Grade	S&P	Fitch	Moody's
1	AAA to AA-	AAA to AA-	Aaa to Aa3
2	A+ to A-	A+ to A-	A1 to A3
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3
4	BB+ to B-	BB+ to B-	Ba1 to B3
5,6	Below B-	Below B-	Below B3
	Unrated	Unrated	Unrated

19. The list of eligible ECAIs will be updated subject to applicants satisfying the eligibility criteria outlined above.

Short Term / Long Terms Assessments

20. For risk-weighting purposes, all short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalized to other short-term claims, except under the following conditions:

    a) The general preferential treatment for short-term claims (discussed at paragraph 14- Maturity less than three months) applies to all claims on banks of up to three months original maturity when there is no specific short-term claim assessment.

    b) When there is a short-term assessment and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. Other short-term claims would benefit from the general preferential treatment.

    c) When a specific short-term assessment for a short term claim on a bank maps into a less favourable (i.e. higher) risk weight, the general short-term preferential treatment for interbank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

21. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates.

22. If a short-term rated facility attracts a 50% risk-weight, unrated short-term claims cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-term, should also receive a 150% risk weight, unless the bank uses recognized credit risk mitigation techniques for such claims.

23. When a short-term assessment is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognizing ECAIs.

24. The table below provides a framework for banks' exposures to specific short-term facilities, such as a particular issuance of commercial paper:

Short Term Ratings		
S&P / Moody's	**Fitch**	**Risk Weight**
A-I /P-I[24]	F1	20%
A2/P-2	F2	50%
A3/P3	F3	100%
Others[25]		150%

[24] The notations follow the methodology used by Standard & Poor's, Moody's Investors Service and Fitch Ratings. The A-1rating of Standard & Poor's includes both A-1+ and A-1- and the F rating of Fitch ratings includes both the modifiers "+" and "-".
[25] This category includes all non-prime and B or C ratings.

Appendix 2 – Eligible Collateral

The following collateral instruments are eligible for recognition:

- Cash (as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure,[26]
- Gold,

Rated debt securities

- Debt securities that have an issue-specific rating agency assessment and is either
  - A claim on a sovereign, multilateral development bank or other international organisation, PSE, bank or corporate that has a rating of 1, 2, or 3 or a risk weight of 0%; or
  - A long term claim on a sovereign that has a rating grade of 1, 2, or 3

Unrated debt securities

- Debt securities that do not have an issue specific rating agency assessment; and that is
  - Issued by another bank; and
  - Listed on a recognized stock exchange; and
  - Classified as senior debt; and
  - Issued by a bank that has other rated issues of the same seniority which have a rating grade of 1, 2 or 3.

Appendix 3 – Statement of Capital Adequacy

Licensees should refer to the ***Statement of Capital Adequacy Form*** alongside these proposals. This Form may be accessed via the link provided, and is divided into the following sections:

i. Capital Composition
ii. On Balance Sheet Items
iii. Off Balance Sheet Items (Non-Derivative)
iv. Off Balance Sheet Items (Derivative)
v. Summary Schedule of Total Eligible Capital
vi. Breakdown of Capital Base
vii. Operational Risk

[26] When cash on deposit, certificates of deposit or comparable instruments issued by the lending bank are held as collateral at a third-party bank in a non-custodial arrangement, if they are openly pledged/assigned to the lending bank and if the pledge/assignment is unconditional and irrevocable, the exposure amount covered by the collateral (after any necessary haircuts for currency risk) will receive the risk weight of the third-party bank.