PRUDENTIAL STANDARD FOR CAPITAL MEASUREMENT: BASEL II/III DEFINITION OF CAPITAL AND PILLAR I FRAMEWORK FOR FINANCIAL INSTITUTIONS LICENSED UNDER THE BANKING ACT, 2015

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EASTERN CARIBBEAN CENTRAL BANK

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List of Acronyms

ABCP	Asset-backed commercial paper
ABS	Asset-backed securities
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BIA	Basic Indicator Approach
CAR	Capital adequacy ratio
CCoB	Capital Conservation Buffer
CCF	Credit conversion factor
CCR	Counterparty credit risk
CET1	Common Equity Tier 1
CariCRIS	Caribbean Information and Credit Rating Services Limited
CRA	Credit Rating Agencies
CRM	Credit risk mitigation
DTA	Deferred tax assets
DTL	Deferred tax liabilities
ECAI	External credit assessment institution
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ECPCGC	Eastern Caribbean Partial Credit Guarantee Scheme
FX	Foreign currency
IOSCO	International Organisation of Securities Commissions
IFRS	International Financial Reporting Standards
LFI	Licensed Financial Institution
MBS	Mortgage-backed securities
MSR	Mortgage Servicing Rights
PSE	Public sector entity
RW	Risk weights

RWA	Risk-weighted assets
SFT	Securities Financing Transaction
S&P	Standard and Poor's
SPE	Special purpose entity
SPV	Special purpose vehicle

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This Prudential Standard (Standard) is issued by the Eastern Caribbean Central Bank (Central Bank/ECCB), in exercise of the powers conferred on it by section 184 of the Banking Act, 2015[1] (hereinafter referred to as the Act).

1 COMMENCEMENT

This Standard shall come into effect on **3 day of January 2024**.

2 INTERPRETATION

This section of the Standard employs the interpretation established in the Act. However, the following terms are defined for the purpose of this Standard:

(a) **An affiliate** of a licensed financial institution (LFI/licensee) is defined in section 2 of the Act[2]. and includes any company that controls, or is controlled by, or is under common control with, the LFI. Control of a company is defined as (1) ownership, control, or holding with power to vote 20.0 per cent or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.

(b) **A Banking Group** is a group that engages predominantly in banking activities and, in some countries, a banking group may be registered as an LFI. A banking group, through consolidation, includes all majority-owned or controlled banking entities, and other relevant financial activities (both regulated and unregulated).

(c) **Banking Book** includes all financial instruments that are not held in the Trading book. Thus, it includes securities held to maturity or at fair value to other comprehensive income (aimed to generate earnings from a cash flow by selling assets occasionally, but not with a significant turnover), as well as the traditional banking activity items, such as loans and commitments.

[1] Anguilla Banking Act No 6 of 2015 (183), as amended
[2] Anguilla Banking Act No 6 of 2015 (1), as amended

(d) **The Capital Conservation Buffer** (CCoB) is a capital buffer of 2.5 per cent of a LFI's total risk weighted assets. The CCoB is comprised of Common Equity Tier 1 (CET1) capital, and is established above the regulatory minimum capital requirement. The CCoB is designed to ensure that LFIs build up capital buffers outside periods of stress which can be drawn down as losses are incurred. [3]

(e) **Going-Concern Capital** is capital against which losses can be written off while the bank continues to operate.

(f) **Gone-Concern Capital** is capital that would not absorb losses until such time as an LFI is wound up, or the capital is otherwise written off or converted to ordinary shares.

(g) **Holding Company** is as defined in section 2 of the Act.[4]

(h) **Indirect Holdings** are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding. Indirect holdings arise when a bank invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that financial institution.

(a) **Intangible Assets** are non-monetary assets which are without physical substance and identifiable (either being separable or arising from contractual or other legal rights). They include, but are not limited to, copyright, goodwill, licences, trademarks, patents, intellectual property and capitalised information technology software costs.

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[3] For additional information on the CCoB, (including how it is built over time and when it can be used), please see the documents '*The capital buffers in Basel III - Executive Summary* ' which can be accessed at https://www.bis.org/fsi/fsisummaries/b3_capital.htm#:~:text=The%20capital%20conservation%20buffer%20was,of%20total%20risk%2Dweighted%20assets and '*Risk-based Capital Requirements: Capital Buffers Above the Regulatory Minimum*' accessible at https://www.bis.org/basel_framework/chapter/RBC/30.htm?inforce=20191215#paragraph_RBC_30_20191215_30_4

[4] Banking Act of Anguilla, No 6 of 2015 (1), as amended

(b) **Licensed Financial Institution** is as defined in section 2 of the Act[5]. However, any reference to LFIs also includes reference to an LFI's holding company in respect of all the entities in the banking group on a consolidated basis.

(c) **The Long Position** of the holder or buyer of a security or other instrument, is a position that is expected to appreciate in value when market prices increase.

(d) **Mortgage Servicing Rights** refer to a contractual agreement in which the right to service an existing mortgage is sold by the original lender to another party who, for a fee, performs the various functions involved with servicing mortgages.

(e) **Total Qualifying /Eligible Capital** is the sum of Tier 1 capital and Tier 2 capital.

(f) **Maturity** means the original maturity date of the exposure. Time to maturity means how much time is remaining before the exposure reaches the original date of maturity.

(g) **Net Long Positions** are the gross long positions net of short positions in the same underlying exposures, where the maturity of the short positions either match the maturity of the long positions, or have residual maturities of at least one year. They include netting positions in physical instruments and derivatives over the same underlying exposure (including those associated with looking through holdings of index securities).

(h) **Operating Entity** is an entity set up to conduct business with clients, with the intention of earning a profit in its own right.

(i) **Related Entity** can include a parent company, a sister company, a subsidiary or any other affiliates. A holding company is a related entity.

(j) **A Short Position** is a position whereby an investor incurs rights and obligations that mirror the characteristics of another counterparty's asset position, or a position that appreciates in value when the underlying market price decreases.

(k) **A synthetic holding** arises when a bank invests in an instrument where the value

[5] Banking Act of Anguilla, No 6 of 2015 (1), as amended

of the instrument is directly linked to the value of the capital of an unconsolidated bank, financial or insurance entity.

(l) **Standardised Approach to Credit Risk** is a methodology to calculate the capital requirements for credit risk in a consistent manner. LFIs are required to assign risk weights to credit risk exposures based on factors like exposure type, external credit ratings, specific provisions and loans to value ratios. It also specifies the treatment for credit risk mitigation and securitisation.

(m) **Trading Book** consists of positions in financial instruments and commodities held either with the intention of trading or in order to hedge other elements of the trading book.

3 OBJECTIVE

This Standard is intended to:

(a) Outline the overall framework adopted by the Central Bank for the calculation of minimum capital requirements and constituents of capital, also known as Pillar 1 of the *International Convergence of Capital Measurement and Capital Standards* developed by the Basel Committee on Banking Supervision (BCBS); and

(b) Ensure that all LFIs maintain a level of capital that is consistent with the risks to which they are exposed from their business activities.

4 APPLICATION

This Standard applies to all applicable LFIs. In addition, these LFIs shall conduct their affairs in conformity with other applicable legal requirements. By issuing this Standard, the Central Bank aims to strengthen the overall framework adopted for assessing the adequacy of LFIs' regulatory capital.

5 OVERVIEW OF THE STANDARD

The resilience of a banking sector is based on a solid regulatory capital framework, establishing the quality and quantity of the regulatory capital base, as well as a broad risk coverage. Capital provides a buffer to absorb unanticipated losses incurred by an LFI as a result of its risk exposures and, in the event of problems, enables the LFI to continue operating while those problems are being addressed or resolved. Consistent with the capital framework – Pillar 1 developed by the BCBS, the approach used by the Central Bank for assessing an LFI's capital adequacy focuses on the following elements:

a. The components and quality of capital held by the LFI to support these exposures[6];
b. Minimum capital requirements for credit risk under the standardised approach[7], including credit risk mitigation (CRM) techniques[8];
c. Minimum capital requirements for operational risk under the Basic Indicator Approach (BIA)[9]; and
d. Minimum capital requirements for market risk[10] arising from changes in market prices of interest rate sensitive products and stocks in the trading book, as well as commodities and foreign exchange in both the trading and banking books;

All LFIs are required to maintain a minimum capital adequacy ratio (CAR) of at least 8.0 per cent at all times. However, the Central Bank may require individual LFIs to increase this minimum based on several criteria, such as:

(a) The characteristics of the LFI (size, risk profile, the volatility of its earnings);
(b) Exposure to risks not considered such as credit concentration risk, interest rate risk in the banking book, liquidity risk, strategic risk and reputational risk;
(c) Degree of diversification of activities and types of assets;
(d) The degree of concentration of counterparty exposure in an LFI's portfolio;
(e) The experience and quality of management and other personnel;
(f) The adequacy of internal systems and controls; and
(g) Shareholder/controller support and control.

The CAR is calculated by dividing an LFI's total qualifying/eligible capital (as defined in section 7.0) by its total risk-weighted assets (RWA).

Total RWA are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (that is, the reciprocal of the minimum capital ratio of 8.0 per cent)

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[6] Based on BCBS's: "*Basel III: A global regulatory framework for more resilient LFIs and banking systems" - Section I: Definition of Capital,* December 2010 (rev June 2011)

[7] Based on BCBS's: "*International Convergence of Capital Measurement and Capital Standards - A Revised Framework*", 2004 (rev. June 2006)

[8] Based on BCBS's: "*Basel III: Finalizing post-crisis reforms",* December 2017

[9] Based on BCBS's "*Basel III: Finalizing post-crisis reforms*", December 2017

[10] Based on BCBS's: "International Convergence of Capital Measurement and Capital Standards - A Revised Framework", 2004 (rev. June 2006) and BCBSs "*Minimum capital requirements for market risk*", January 2016

and adding the resulting figures to the sum of RWA for credit risk (as defined in section 8.0).

Each LFI must maintain a minimum ratio eligible Tier 1 capital to total RWA of 6.0 per cent and the predominant form of Tier 1 capital must be met with common equity, by maintaining a minimum of 4.5 per cent of RWA consisting of CET 1 capital. These relationships can be expressed by the following simple formulas:

1) $CAR = \frac{Total\ qualifying/eligible\ capital}{Total\ RWA} \geq 8\%$

2) $Tier\ 1\ ratio = \frac{Tier\ 1\ capital}{Total\ RWA} \geq 6\%$

3) $CET\ 1\ ratio = \frac{CET\ 1\ capital}{Total\ RWA} \geq 4.5\%$

PART ONE: SCOPE OF APPLICATION

6 SCOPE OF APPLICATION

The scope of application of this framework includes, on a consolidated basis, LFIs incorporated in the Eastern Caribbean Currency Union (ECCU) and regulated by the Central Bank under the Eastern Caribbean Central Bank Agreement Act (1983). The framework will also include, on a fully consolidated basis, any holding company that is the parent entity within a financial group to ensure that the risk of the whole banking group is fully captured.

6.1 Treatment of significant minority investments

LFIs should exclude from the consolidated banking group's capital, by deduction of the equity and other regulatory investments, significant minority investments in banking, securities and other financial entities, where control does not exist. However, LFIs may apply pro rata consolidation for joint ventures that are treated as pro rata for accounting purposes. For purposes of determining significant investments, the pro-rata inclusion will be equity interest of between 20.0 per cent and 50.0 per cent.

6.2 Treatment of Insurance Institutions

LFIs that own an insurance subsidiary involved in carrying on insurance business in principle, bear the full entrepreneurial risks of the subsidiary and should recognise on a group-wide basis the risks included in the whole group. LFIs should exclude from the consolidated group's capital, any equity and other regulatory capital investments in insurance subsidiaries and significant minority investments in insurance entities. Under the deduction approach, LFIs should exclude from their balance sheets relevant assets and liabilities, as well as any third party capital investments in insurance subsidiaries. LFIs should apply a 100.0 per cent risk weight (RW) to investments in subsidiaries involved in insurance brokerage.

The Central Bank may consider alternative approaches that would include a group-wide perspective for determining capital and avoid double counting of capital, which is to apply a RW of 100.0 per cent to investments in insurance subsidiaries.

The capital invested in a majority-owned or controlled insurance entity may exceed the amount of regulatory capital required for such an entity (leaving "*surplus capital*" within the insurance entity). LFIs may recognise such surplus capital in calculating their capital adequacy, in limited circumstances where:

(a) The authority is satisfied that there is no legal, regulatory or other obstacle to the prompt transfer of the surplus capital out of the insurance subsidiary as required; and
(b) Such recognition would also have regard to the practical implications of a transfer example, in terms of exchange rate and taxation effects or the consequences for external credit assessment ratings.

LFIs that are permitted to recognise surplus capital in insurance subsidiaries must publicly disclose the amount of such surplus capital recognised in its capital. Where LFIs have a majority ownership interest in an insurance entity (50.0 per cent or more but less than 100.0 per cent), surplus capital recognised should be proportionate to the percentage interest owned. LFIs will not be permitted to recognise surplus capital in significant minority-owned insurance entities (less than 50.0 per cent ownership), as it is unlikely that the bank would be able to direct the transfer of the capital in an entity that it does not control.

Majority owned or controlled non-consolidated insurance subsidiaries for which capital investments are deducted or subject to an alternative group-wide approach, should be adequately capitalised in order to reduce the possibility of future potential losses to the LFI. In the event of a capital shortfall, the Central Bank will monitor any corrective action taken by the subsidiary; and where timely remediation is not possible; the shortfall will be deducted from the LFI's capital.

6.3 Significant Investments in Commercial Entities

LFIs must deduct significant minority and majority investments in commercial entities that exceed:

(a) 15.0 per cent of the LFI's total capital for individual investments; and
(b) 60.0 per cent of the LFI's total capital for the aggregate of all investments in commercial entities.

Investments in significant minority and majority-owned and controlled commercial entities below the materiality levels should receive a risk weight of 100.0 per cent.

6.4 Deduction of Investments

Any deduction of investments that is made pursuant to the scope of application will be deducted as 50.0 per cent from Tier 1 and 50.0 per cent from Tier 2 capital, respectively.

PART TWO: CAPITAL COMPOSITION

Reference section 7.0 when completing the capital composition prudential reporting form in the Prudential Return 16 (PR16).

7 DEFINITION OF CAPITAL

This section provides a framework for the constituents of capital for licensees in line with the Basel III requirements, by outlining the characteristics that an instrument must have in order to qualify as regulatory capital and the adjustments to be made in determining the regulatory capital of all LFIs.

7.1 Components of Capital

In order to be eligible for inclusion in regulatory capital, an LFI's capital should have the following characteristics:

a) Provide a permanent and unrestricted commitment of funds;
b) Be freely available to absorb losses;
c) Not impose any unavoidable servicing charges against earnings; and
d) Rank behind the claims of depositors and other creditors in the event the LFI is wound up.

7.2 Total qualifying/eligible capital shall consist of the sum of the following elements:

(a) Tier 1 Capital (going-concern capital), which will comprise:
   i. Common Equity Tier 1 (CET1) capital; and
   ii. Additional Tier 1 (AT1) capital.
(b) Tier 2 capital (gone-concern capital).

For each of the categories above, there is an individual set of criteria that the instruments are required to meet before they can be included in the relevant category (see section 7.5).

7.3 Limits and Minima

The LFI shall at all times maintain the minimum ratios as follows:

Ratio	Minimum Capital Level
CET1	4.5% of risk-weighted assets
Tier 1 (CET1 + AT1)	6.0% of risk-weighted assets
Total Capital (Tier 1 + Tier 2)	8.0% of risk-weighted assets[11]

For the purpose of determining the capital adequacy ratio of an LFI, the total capital shall be the sum of Tier 1 and Tier 2 capital net of regulatory adjustments applied. An LFI must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements in this Standard for the particular category of capital in which it is included.

7.3.1 Capital Conservation Buffer (CCoB)

In addition to the forgoing, Basel III introduced the CCoB[12] . The CCoB is:

(a) Set at 2.5 per cent of total risk-weighted assets;
(b) Comprised of CET1 capital only; and
(c) Distinct and established above the regulatory minimum capital requirement.

7.4 Capital Consolidation

The Central Bank regulates the capital adequacy of LFIs on a stand-alone and consolidated basis. Generally, an LFI should consolidate the financial statements of all its subsidiaries using internationally acceptable financial reporting standards. Scenarios for calculating capital on a consolidated basis are as follows:

1) Ordinary Shares Issued by Consolidated Subsidiaries

Investments arising from the issue of ordinary shares by a fully consolidated subsidiary of an LFI shall receive recognition in CET1 capital only if:

(a) The instrument giving rise to the minority interest would, if issued by the LFI, meet all the criteria for classification as ordinary shares for regulatory capital purposes; and

[11] The minimum capital requirement for the industry is currently 8.0 per cent, however, the ECCB reserves the right to impose higher capital requirements as per section 47 of the Act, to address risks in the licensed financial institution, the licensed financial holding company or in the financial system.

[12] The ECCB will not adopt the CCoB at this time but reserves the right to implement it at any time.

(b) The subsidiary that issued the instrument is itself an LFI[13].

The amount of minority interest recognised in CET1 capital will be calculated as follows:

(a) Total minority interest meeting the two criteria above minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders.

(b) Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of:

   i. The minimum CET1 requirement of the subsidiary (4.5 per cent) (plus the capital conservation buffer (2.5 per cent[14]) or 7.0 per cent of RWA); and

   ii. The portion of the consolidated minimum CET1 requirements (plus the capital conservation buffer (that is, 7.0 per cent of consolidated RWA)) that relates to the subsidiary.

(c) The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.

2) Tier 1 Qualifying Capital Issued by Consolidated Subsidiaries

Tier 1 capital instruments issued by a fully consolidated subsidiary of a licensee to third party investors may receive recognition in Tier 1 capital only if the instruments would, if issued by the licensee; meet all the criteria for classification as Tier 1 capital. The amount of this Tier 1 capital that will be recognised in AT 1 capital will exclude amounts recognised in CET1 capital.

The amount of capital that will be recognised in Tier 1 capital will be calculated as follows:

a) Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third party investors.

b) Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of:

   i) The minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer: (that is, 8.5 per cent of risk weighted assets); and

[13] Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's CET1 if the parent bank or affiliate has entered into any arrangements to fund directly minority investment in the subsidiary whether through a special purpose vehicle or through another vehicle or arrangement. The treatment outlined above, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.

[14] Until a capital conservation buffer is introduced by the Central Bank, it will be taken as 0%.

ii) The portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (that is, 8.5 per cent of consolidated risk weighted assets) that relates to the subsidiary.

c) The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third party investors.

3) *Tier 1 and Tier 2 Qualifying Capital Issued by Consolidated Subsidiaries*

Total capital instruments (that is, Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of an LFI bank to third party investors may receive recognition in Total Capital only if the instruments would, if issued by the LFI, meet all of the criteria for classification as Tier 1 or Tier 2 capital. The amount of this Total Capital that will be recognised in Tier 2 will exclude amounts recognised in CET1 capital and amounts recognised in Additional Tier 1 capital.

The amount of this capital that will be recognised in consolidated Total Capital will be calculated as follows:

(a) Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.

(b) Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:

   i. The minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (that is, 10.5 per cent of risk weighted assets); and

   ii. The portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (that is, 10.5 per cent of consolidated risk weighted assets) that relates to the subsidiary.

(c) The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

All items that are deducted from total capital are also excluded from total assets in calculating an LFI's total on-balance sheet risk-weighted assets.

7.5 Components of Capital

An LFI must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements for the particular category of capital in which it is included.

7.5.1 *Common Equity Tier 1 (CET1)*

CET1 capital consists of the sum of the following elements:

(a) **Common shares/paid up capital**;

(b) **Stock surplus** (share premium) resulting from the issue of instruments included in CET1 capital;

(c) **Retained earnings**, after deducting any interim or final dividends which have been declared by the Board of the reporting bank or banking group entity on any class of shares and any interim losses incurred since the end of the last financial reporting period;

(d) Accumulated other comprehensive income (including interim profit or loss). **Please Note**: **Accumulated other comprehensive income in the form of unrealised gains and or unaudited profits <u>should only</u> be included as part of Tier 1 capital when they have been realised and or audited**;

(e) Statutory reserves including the reserve maintenance fund[15];

(f) Common shares issued by consolidated subsidiaries of the LFI and held by third parties (that is, minority interest) that meet the criteria for inclusion in CET1 capital;

(g) Other disclosed reserves; and

(h) Regulatory adjustments applied in the calculation of CET1.

Where applicable, for the subsidiaries of foreign banks operating in the ECCU, CET 1 capital shall consist of the sum of the following items:

i. Funds from Head Office for the purpose of meeting capital adequacy;

[15] Pursuant to section 45 of the Banking Act 2015

ii. Statutory reserves kept in books in the ECCU;
iii. Retained earnings; and
iv. Non-repatriable interest-free funds from Head Office for the purpose of acquisition of property and held in a separate account and have the ability to absorb losses regardless of their source.

Less: regulatory adjustments applicable on CET 1 capital as mentioned in section 7.5.1.2 below.

7.5.1.1 *Criteria for inclusion in CET1 Capital*

For an instrument to be included in CET1 capital it must meet all of the criteria that follow for classification as common shares issued by the bank directly:

a) Represents the most subordinated claim in liquidation of the LFI.
b) The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (that is, has an unlimited and variable claim, not a fixed or capped claim).

c) The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

d) The LFI does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

e) Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that an LFI is unable to pay distributions that exceed the level of distributable items).

f) There are no circumstances under which the distributions are obligatory. Nonpayment is therefore not an event of default.
g) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

h) It is the form of issued capital that takes the first and proportionately greatest share of any losses as they occur[16]. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.

i) The paid-in amount is recognised as equity capital (that is, not recognised as a liability) for determining balance sheet insolvency.

j) The paid-in amount is classified as equity under the relevant international accounting standards.

k) It is directly issued and paid-in[17] and the LFI cannot directly or indirectly have funded the purchase of the instrument.

l) The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[18] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

m) It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.

n) It is clearly and separately disclosed as equity on the bank's balance sheet prepared in accordance with the relevant international accounting standards.

7.5.1.2 *Regulatory Adjustments in the Calculation of CET1 Capital*

An LFI must make the following regulatory adjustments to determine CET1 capital at the solo or consolidated level, as the case may be. Assets deducted from CET1 capital should not be included in RWA.

[16] In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares.

[17] Paid-in capital generally refers to capital that has been received with finality by the institution, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor.

[18] A related entity can include a parent company, a sister company, a subsidiary or any other affiliates. A holding company is a related entity

i. *Goodwill and Other Intangibles*

Goodwill[19] and other intangible assets[20] shall be deducted in the calculation of CET1 capital. The full amount shall be deducted, net of any associated deferred tax liability that would be extinguished if the goodwill becomes impaired or derecognised under the accounting standards.

Subject to prior supervisory approval, LFIs that report under local generally accepted accounting principles may use the International Financial Reporting Standards (IFRS) definition of intangible assets to determine which assets are classified as intangible and are thus required to be deducted.

ii. *Cash Flow Hedge Reserve*

The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) shall be derecognised in the calculation of CET1 capital. In this regard, positive amounts shall be deducted and negative amounts shall be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognised for prudential purposes.

iii. *Cumulative Gains and Losses Due to Changes in Own Credit Risk on Fair Valued Financial Liabilities*

Derecognise in the calculation of CET1 capital, all unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the LFI's own credit risk.

iv. *Defined Benefit Pension Fund Assets and Liabilities*

Any defined benefit pension fund liabilities, as included in the balance sheet, shall be fully recognised in the calculation of CET1 Capital. That is, it cannot be increased through derecognising these liabilities.

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[19] Including any goodwill included in the valuation of capital investments in unconsolidated major stake companies

[20] Intangible assets include but are not limited to copyright, patents, intellectual property and capitalised information technology software costs. These assets only have value to a profit-making bank and are normally written off as they are completely worthless when a bank is liquidated.

For each defined benefit pension fund that is an asset on the balance sheet, the asset shall be deducted in the calculation of CET1 Capital net of any associated deferred tax liabilities which would be extinguished if the asset becomes impaired or derecognised under the accounting standards. Assets in the fund to which the bank has unrestricted and unfettered access may, with the prior approval of the Central Bank, offset the deduction. Such offsetting assets shall be given the RW they would receive if they were owned directly by the LFI.

v. *Deferred Tax Assets*

Deferred tax assets (DTAs) that rely on future profitability of the LFI to be realised are to be deducted in the calculation of CET1 capital. DTAs may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. Where these DTAs relate to temporary differences (for example, allowance for credit losses), the amount to be deducted is set out in the "*Threshold Deductions*" section below.

All other such assets, for example, those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment[21] and DTAs that are to be deducted in full.

DTAs arising from any other source will be required to be deducted from CET1 capital as a prudent measure. An over-installment of tax or, in some jurisdictions, current year tax losses carried back to prior years may give rise to a claim or receivable from the government or local tax authority. Such amounts are typically classified as current tax assets for accounting purposes. The recovery of such a claim or receivable would not rely on the future profitability of the LFI and would be assigned the relevant sovereign risk weighting.

[21] Refer to paragraph 87 of the BCBS June 2011.

vi. *Investment in Own Shares (Treasury Stock)*

All of an LFI's investments in its own common shares (treasury stock), whether held directly or indirectly, will be deducted in the calculation of CET1 capital (unless already derecognised under IFRS.

In addition, any own stock which the institution could be contractually obliged to purchase should be deducted in the calculation of CET1 capital. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book.

vii. *Reciprocal Cross Holdings in the Capital of Banking, Financial and Insurance Entities*

Reciprocal cross holdings in common share capital (for example, LFI A holds shares of LFI B and LFI B in return holds shares of LFI A) that are designed to artificially inflate the capital position of the LFI shall be fully deducted in the calculation of CET1 capital.

Please Note: The reciprocal cross holdings in Additional Tier 1 and Tier 2 instruments in sections 7.5.2 and 7.5.3 below are similarly deducted from the respective tiers of capital.

viii. *Gain on Sale Related to Securitisation Transactions*

Increases in equity capital resulting from securitisation transactions (for example, capitalised future margin income, gains on sale) should be deducted in the calculation of CET 1 capital.

ix. *Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation[22] and where the LFI does not own more than 10.0 per cent of the issued common share capital of the entity.*

The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10.0 per cent of the issued common share capital of the entity. In addition:

[22] Investments in entities that are outside of the scope of regulatory consolidation refer to investments in entities that have not been consolidated at all, or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.

a) Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital[23].
b) Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (for example, subordinated debt). It is the net long position that is to be included (that is, the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).
c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
d) If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment[24].
e) National discretion applies, to allow banks with prior supervisory approval, to exclude certain investments temporarily[25], where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

Please Note:
If the total of all holdings listed above in aggregate exceeds 10.0 per cent of the bank's common equity (after applying all other regulatory adjustments in full listed prior to this one), then the amount above 10.0 per cent is required to be deducted, applying a corresponding deduction approach. This means that the deduction should be applied to the same component of capital for which the capital would qualify, if it were issued by the bank itself. Accordingly:

i. The amount to be deducted from common equity should be calculated as the total of all holdings which in aggregate exceed 10.0 per cent of the bank's common equity (as per above) multiplied by the common equity holdings as a percentage of the total capital

[23] If banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions as a result of their holdings of index securities, national authorities may permit banks, subject to prior supervisory approval, to use a conservative estimate.

[24] If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.

[25] On a case by case basis, the ECCB will establish an appropriate timeline.

holdings (of the investee(s)). This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity.

ii. Similarly, the amount to be deducted from Additional Tier 1 capital should be calculated as the total of all holdings which in aggregate exceed 10.0 per cent of the bank's common equity (as per above), multiplied by the Additional Tier 1 capital holdings as a percentage of the total capital holdings (of the investee(s)).

iii. The amount to be deducted from Tier 2 capital should be calculated as the total of all holdings which in aggregate exceed 10.0 per cent of the bank's common equity (as per above) multiplied by the Tier 2 capital holdings as a percentage of the total capital holdings (of the investee(s)).

If, under the corresponding deduction approach, a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital. For example, if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1.

Amounts below the threshold, which are not deducted, will continue to be risk weighted.[26] Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book should be treated as per the standardised approach. For the application of risk weighting, the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold. **See Box 1.**

[26] If the total of all such holdings exceeds 10% of the bank's issued common equity, the excess is deducted from regulatory capital. Amounts below the threshold are not deducted and are subject to the applicable risk weight framework.

Box 1: Summary of Treatment of Non-Significant Investments

Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the LFI does not own more than 10.0 per cent of the issued common share capital of the entity
If the total of all holdings in aggregate exceed 10.0 *per cent* of the bank's CET1 (after applying all other regulatory adjustments in full listed prior to this one), deduct the amount above 10.0 per cent, applying a corresponding deduction approach.
Risk weight the amounts below the 10.0 per cent threshold, which are not deducted: • Treat trading book instruments as per the market risk rules; and • Treat banking book instruments as per the standardised approach. For the application of risk weighting, the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold.

x. *Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the LFI owns more than 10.0 per cent of the issued common share capital of the entity, or where the entity is an affiliate of the LFI.*

The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the LFI owns more than 10.0 per cent of the issued common share capital of the issuing entity or where the entity is an affiliate of the LFI.

In addition:

a) Investments include direct, indirect and synthetic holdings of capital instruments. For example, LFIs should look through holdings of index securities to determine their underlying holdings of capital.

b) Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (for example subordinated debt). It is the net long position that is to be included (that is the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.

d) If the capital instrument of the entity in which the LFI has invested does not meet the criteria for CET1, Additional Tier 1, or Tier 2 capital of the LFI, the capital is to be considered common shares for the purposes of this regulatory adjustment.

e) LFIs may, with the prior approval of the Central Bank, temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

Please Note:

All investments included above that are **not common shares** must be fully deducted from the corresponding tier of capital (that is, following a corresponding deduction approach). This means the deduction should be applied to the same tier of capital for which the capital would qualify if it were issued by the LFI itself (for example, investments in the Additional Tier 1 capital of other entities must be deducted from the LFI's Additional Tier 1 capital).

If an LFI is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next highest tier of capital (for example, if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from CET1 capital).

Investments included above **that are common shares** will be subject to the threshold deductions as described in the next section.

xi. *Threshold Deductions*

Instead of a full deduction, the following items will each receive limited recognition[27] when calculating CET1, with recognition capped at 10.0 per cent of the LFI's common equity (after the application of all regulatory adjustments):

a) Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) where the LFI owns more than 10.0 per cent of common equity of the individual entity;

b) Mortgage servicing rights (MSRs), including those related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of MSRs in joint ventures subject to proportional

[27] This means that each item is individually capped.

consolidation or equity method accounting; and

c) DTAs arising from temporary differences.

Please Note:

An LFI must deduct the amount by which the aggregate of the three items above (a, b, and c) exceeds 15.0 per cent of its CET1 capital (calculated prior to the deduction of these items but after application of all other regulatory adjustments applied in the calculation of CET1 capital). The items included in the 15.0 per cent aggregate limit are subject to full disclosure.

Regulatory adjustments (that is, deductions and prudential filters) including the amounts above the 15.0 per cent limit for significant investments in financial institutions, MSRs, and DTAs from temporary differences **will be fully deducted from CET1 capital**.[28]

The amount of the three items that **are not deducted** in the calculation of CET1 capital will be risk weighted at **250.0 per cent**. **See Box 2.**

Box 2: Summary of Treatment of Significant Investments

Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, where the LFI owns more than 10.0 per cent of the issued common share capital of the issuing entity, or where the entity is an affiliate of the LFI.
All investments that are **not** common shares (that is, AT1 and Tier 2 items) to be **fully deducted** from **the corresponding tier of capital.**
Investments included **that are common shares** will be subject to threshold deductions. Instead of a full deduction, the following items may each receive limited recognition when calculating CET1, with recognition capped at 10.0 per cent of the bank's common equity (after the application of all regulatory adjustments): a) Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); b) MSRs; and c) DTAs arising from temporary differences. • LFIs to deduct (from CET1 Capital) the amount by which the aggregate of the three items above (a, b, and c) exceeds 15.0 per cent of its CET1 capital
The amount of these three items that are not deducted in the calculation of CET1 capital will be risk weighted at **250.0 per cent**.

[28] See Annex 2 of the BCBS "*Basel III: A global regulatory framework for more resilient LFIs and banking systems*" June 2011 document for an example https://www.bis.org/publ/bcbs189.htm .

xii. *Other Adjustments*

An LFI shall make any other deductions required under any other guidelines and/or as may be required by the Central Bank.

xiii. *Other Requirements*

The Central Bank requires LFIs to implement policies and procedures to ensure appropriate audit, verification or review procedures.

7.5.2 *Additional Tier 1 (AT1) Capital*

Additional Tier 1 capital consists of the sum of the following elements:

(a) Instruments issued by the LFI that meet the criteria for inclusion in AT1 capital (and are not included in CET1 Capital);
(b) Stock surplus (share premium) resulting from the issue of instruments included in AT1 Capital;
(c) Instruments issued by consolidated subsidiaries of the LFI and held by third parties (that is minority interest) that meet the criteria for inclusion in AT1 capital and are not included in CET1 capital; and
(d) Regulatory adjustments applied in the calculation of AT1 Capital.

Where applicable, for the foreign branch banks operating in the ECCU, Additional Tier I (AT1) capital shall consist of the sum of the following items:

i. Head Office borrowings in foreign currency by foreign LFIs operating in the ECCU for inclusion in AT1 capital which comply with the regulatory requirements.

ii. Any other item specifically allowed by the Central Bank from time to time for inclusion in AT1 capital.

Less: regulatory adjustments applicable on AT1 Capital as mentioned in section 7.5.2.2 below.

7.5.2.1 *Criteria for Inclusion in Additional Tier 1 Capital*

An instrument must satisfy the following criteria to be included in Additional Tier 1 Capital:

1. The instrument is issued and fully paid in cash;

2. Subordinated to depositors, general creditors and subordinated debt of the LFI;

3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the LFI's depositors and/or creditors.

4. Is perpetual, that is, there is no maturity date and there are no other incentives to redeem. (non-cumulative)

5. May be callable at the initiative of the issuer only after a minimum of five years from the issue date, subject to the following requirements:
    a. A call option can be exercised only with the prior approval of the Central Bank;
    b. The institution shall not create an expectation that the call option will be exercised; and
    c. The institution must not exercise a call option unless:
        i. The institution replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the LFI; or
        ii. The institution demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6. Any repayment of principal (for example, through repurchase or redemption) must be with prior approval of the Central Bank and LFI should not assume or create market expectations that supervisory approval will be given;

7. With regard to dividend or coupon discretion:
    a. The institution must have full discretion at all times to cancel distributions/payments;
    b. Cancellation of discretionary payments must not be an event of default;
    c. The institution must have full access to cancelled payments to meet obligations as they fall due; and
    d. Cancellation of distributions/payments must not impose restrictions on the institution except in relation to distributions to common stockholders;

8. Dividends/coupons on the instrument must be paid out of distributable items;

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the institution or the group or any related party;

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law governing the provisions of the capital instrument;

11. Where the instrument is classified as a liability for accounting purposes, it must have principal loss absorption through either:
    a. Conversion to common shares at an objective pre-specified trigger point; or

    b. A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
        i. Reduces the claim of the capital instrument in liquidation of the LFI;
        ii. Reduces the amount to be repaid when a call option is exercised; and
        iii. Partially or fully reduces dividend or coupon payments on the capital instrument.

12. Neither the LFI nor a related party over which the LFI exercises control or significant influence can purchase the instrument, nor can the LFI directly or indirectly fund the purchase of the instrument.

13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (for example, a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[29] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital.

15. The main features of the capital instruments are disclosed clearly and accurately.

16. The agreement governing the issuance of the capital instrument shall not be changed without the prior approval of the Central Bank where such proposed changes could impact its eligibility as AT1 Capital.

[29] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

7.5.2.2 ***Regulatory Adjustments to Additional Tier 1 Capital***

A licensee shall apply the following regulatory adjustments in the calculation of AT1 Capital at the solo or consolidated level, as the case may be.

Where the amount of AT1 Capital is insufficient to cover the amount of deductions required to be made from this category of capital, the shortfall must be deducted from CET1 Capital.

(a) Investment in own Additional Tier 1 Capital

Investments in the LFI's own AT1 capital instruments, whether held directly or indirectly by the institution or any of its banking group entities, shall be deducted in the calculation of AT1 Capital.

Any AT1 capital instruments, which the reporting LFI or any of its banking group entities could be contractually obliged to purchase, shall also be included in the deduction. This adjustment shall apply to exposures in both the banking book and trading book.

(b) Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

These comprise of:

i. Direct, indirect and synthetic holdings of AT1 Capital instruments in banking, financial and insurance entities. This includes:
   - Holdings of AT1 Capital instruments held in the banking book;
   - Net long positions[30] in AT1 Capital Instruments[31] held in the trading book; and
   - Underwriting positions in AT1 Capital instruments held for more than five working days.

ii. The amount of such capital investments to be deducted in the calculation of AT1 Capital shall be in accordance with section 7.4 above.

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[30] 'Net long positions' are the gross long positions net of short positions in the same underlying exposures where the maturity of the short positions either match the maturity of the long positions or have residual maturities of at least one year. They include netting positions in physical instruments and derivatives over the same underlying exposure (including those associated with looking through holdings of index securities).

[31] This includes investments in capital instruments resulting from the holdings of index securities. Financial institutions are permitted to net long short positions in the same index security subject to maturity matching provisions.

7.5.3 *Tier 2 Capital*

Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital, but nonetheless contribute to the overall strength of an LFI and its capacity to absorb losses. Tier 2 capital (prior to regulatory adjustments) consists of the sum of the following elements:

(a) Unaudited undivided profits: comprise the year to date profit or loss. Accumulated other comprehensive income (including interim profit or loss) in the form of unrealised gains and or unaudited profits should be included as part of Tier 2 capital and only transferred to Tier 1 when they have been realised and or audited;

(b) Instruments issued by the institution that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);

(c) Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

- *Contributed/Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;* contributed/Stock surplus (that is share premium) that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the contributed/stock surplus are permitted to be included in Tier 2 capital.

(d) Instruments issued by consolidated subsidiaries of the bank and held by third parties (that is, minority interest) that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital;

(e) Revaluation reserves with fixed asset revaluation limited for 20.0 per cent of Tier 1; available for sale assets;

(f) Other asset revaluation reserves (discounted by 55.0 per cent);

Please refer to the *Prudential Standard on the Treatment of Impaired Assets for Financial Institutions Licensed Under the Banking Act (TIAS).*

(g) Regulatory Loan Loss Reserve: In keeping with the TIAS, where the provisions based on the Central Bank's classification methodology is higher than that determined under the International Financial Reporting Standards, LFIs are required to compute the difference. The difference shall be a deduction from the LFI's Tier 1 capital (appropriated from Retained Earnings) and placed in Regulatory Loan Loss Reserves in Tier II Capital;

(h) Certain loan loss provisions such as general provisions/general loan-loss reserve (for LFIs using the Standardised Approach for credit risk): Provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2. However, provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, (that is, specific provisions), should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier 2 will be **limited to a maximum of 1.25 per cent of credit RWA calculated under the Standardised Approach**;

(i) Subordinated term debt and limited life preference shares (limited to 50.0 per cent of Tier I Capital): Conventional unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited-life redeemable preference shares. Such instruments are subordinated to the claims of both depositors and general creditors; and

(j) Regulatory adjustments applied in the calculation of Tier 2 Capital.

If the institution does not have sufficient Tier 2 capital needed to make the required deductions from Tier 2 capital, the shortfall must be deducted from Additional Tier 1 capital.

Where applicable, for the foreign branch banks operating in the ECCU, Tier 2, capital shall consist of the sum of the following items:

i. General provisions[32]; and
ii. Head Office borrowings in foreign currency received that meet the criteria of Tier 2 debt capital.

Less: regulatory adjustments applicable on Tier 2 capital as mentioned in section 7.5.3.2 below.

[32] Limited to 1.25% of RWA for credit risk.

7.5.3.1 Criteria for inclusion in Tier 2 Capital

The objective of Tier 2 is to provide loss absorption on a gone-concern basis. The following sets out the minimum set of criteria for an instrument to meet or exceed in order for it to be included in Tier 2 capital:

1. The instrument should be issued by the institution and **fully paid-in in cash**.

2. The instrument is **subordinated to depositors and general creditors** of the institution.

3. Is neither secured **nor covered by a guarantee of the issuer** or related entity or other arrangement **that legally or economically enhances the seniority of the claim vis-à-vis depositors and general creditors of LFIs**.

4. The instrument must have a **minimum original maturity of at least five years** and there are no step-ups or other incentives to redeem.

5. The amount of the instrument that will be eligible for inclusion in Tier 2 capital shall be amortized on a straight-line basis as follows:

Years to Maturity	**Amount Eligible for Inclusion in Tier 2**
5 years or more	100 percent
4 years and less than 5 years	80 percent
3 years and less than 4 years	60 percent
2 years and less than 3 years	40 percent
1 year and less than 2 years	20 percent
Less than 1 year	0 percent

6. The instrument may be **callable** at the initiative of the issuer only **after a minimum of five years**, subject to the following requirements:

   a. To exercise a call option an LFI must receive **approval from the Central Bank**;

   b. An LFI must not do anything that creates an expectation that the call will be exercised; and

c. LFIs must not exercise a call unless:
   i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the LFI; or
   ii. The LFI demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

7. The investor must have **no rights to accelerate the repayment** of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

8. The instrument **cannot have a credit sensitive dividend feature**, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the LFI, or the group or any related party.

9. Neither the LFI nor a related party over which the LFI exercises control or significant influence can have purchased the instrument, nor can the LFI directly or indirectly have funded the purchase of the instrument.

10. If the instrument is not issued out of an operating entity[33] or the holding company in the consolidated group (for example, an SPV), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

7.5.3.2 Regulatory Adjustments to Tier 2 Capital
Net Tier 2 Capital is defined as Tier 2 Capital including all regulatory adjustments, but may not be lower than zero. If the total of all Tier 2 deductions exceeds Tier 2 Capital available, the excess must be deducted from Tier 1 Capital.

An LFI shall apply the following regulatory adjustments in the calculation of Tier 2 Capital at the solo or consolidated level.

a) Investment in own Tier 2 Capital

Investments in the institution's own Tier 2 capital instruments, whether held directly or indirectly by the institution or any of its banking group entities, shall be deducted in the calculation of Tier 2 Capital. Any own Tier 2 capital instruments, which the reporting

[33] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

institution or any of its banking group entities could be contractually obliged to purchase, shall also be included in the deduction. This adjustment shall apply to exposures in both the banking book and trading book.

b) *Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation.*

These comprise:

i. Direct, indirect and synthetic holdings of Tier 2 Capital instruments in banking, financial and insurance entities including:
   - Holdings of Tier 2 Capital instruments held in the banking book;
   - Net long positions in Tier 2 Capital instruments held in the trading book; and
   - Underwriting positions in Tier 2 Capital instruments held for more than five working days.

ii. The amount of such capital investments to be deducted in the calculation of Tier 2 Capital shall be in accordance with section 7.4 above.

c) *Other Regulatory Adjustment*: An LFI shall make any other deductions required under any other guidelines and/or as may be required by the Central Bank.

7.6 Regulatory Reporting Requirements

All LFIs must provide the Central Bank with reports on the components of their capital adequacy calculations on the schedule provided on a quarterly basis (or more frequently if required).

An LFI must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements prescribed for the relevant category of capital, in which it is included.

The Central Bank may, in writing, require an LFI to:

a. Exclude from its regulatory capital any component of capital that in the opinion of the Central Bank does not represent a genuine contribution to the financial strength of the bank; or
b. Reallocate to a lower category of capital any component of capital that in the opinion of the Central Bank does not fully satisfy the requirements for the category of capital to which it was originally allocated.

c. An LFI must provide the Central Bank, as soon as practicable, with copies of documentation associated with the issue of Tier 1 and Tier 2 Capital instruments and provide a description of the main features of the capital instrument issued.
d. An LFI must notify the Central Bank prior to any subsequent modification of the terms and conditions of an instrument that may affect its eligibility to continue to qualify as regulatory capital.

PART THREE: CAPITAL CHARGE (CREDIT, MARKET AND OPERATIONAL RISK)

Reference sections 8.0 to 10.0 when completing the prudential reporting forms in the PR16 for credit, market and operational risk.

8 CREDIT RISK MINIMUM CAPITAL REQUIREMENT

The following section sets out the minimum capital requirements for credit risk exposures in the banking book by establishing prescribed risk weights (RW) in accordance with the risk classes for regulatory capital purposes. LFIs must apply the prescribed RW to both on-balance sheet and off-balance sheet exposures. Exposures are to be risk weighted net of specific provisions. RWs will be based on the risk rating assigned by Credit Rating Agencies (CRAs)[34] deemed eligible by the Central Bank. **Appendix I** outlines the criteria to be used in recognising a CRA as eligible for capital adequacy purposes. It also outlines key issues related to the use of ratings assigned by eligible CRAs.

In addition, all LFIs are required to comply with the Central Bank's *Valuation Prudential Standard* and any other applicable prudential standard(s).

8.1 Risk Weight Categories

8.1.1 *Cash items*

A 0.0 per cent RW will apply to cash. Gold bullions, held in the institution's own vaults or on an allocated basis to the extent backed by bullion liabilities, will also be risk weighted at 0.0 per cent. A 20.0 per cent RW will apply to cash items in the process of collection.

8.1.2 *Claims on Sovereigns*[35]

1) Claims on sovereigns and their central banks will be risk weighted as follows:

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[34] Also known as External Credit Assessment Institutions (ECAIs). The notations follow the methodology used by one institution, Standard & Poor's and is an example only; other external credit assessment institutions could equally well be used. The ratings used throughout this document, therefore, do not express any preferences or determinations on external assessment institutions by the Central Bank.

[35] For risk weighting claims on sovereigns, the Central Bank recognises the country risk scores assigned by CRAs. LFI may use the risk scores published by individual CRAs recognised by the Central Bank instead of the consensus risk scores of CRAs participating in the OECD's Arrangement on Officially Supported Export Credits.

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%

2) Claims on ECCU sovereigns or the Central Bank which are both denominated and funded in Eastern Caribbean (EC) dollars shall be risk weighted at 0 per cent.

3) The 0 per cent risk weight shall apply to claims which are fully guaranteed by ECCU Governments and are denominated and funded in EC dollars. The guarantee must be explicit, unconditional, legally enforceable and irrevocable.

4) Where exposures to ECCU sovereigns or their guaranteed exposures are non-performing, a RW of 20.0 per cent will be applied to the facility.

Claims on foreign sovereigns may be assigned the preferential risk weight applied by the foreign jurisdiction where the exposure is funded and denominated in the currency of that jurisdiction.

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

1) Claims on PSEs will be assigned a RW that is one category less favourable than the sovereign RW as follows:

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

2) A risk weight of 20.0 per cent shall apply to claims on a public sector entities (PSEs) in the ECCU which are both funded and denominated in EC dollars.

3) If the major shareholder of a PSE is the state, a regional authority or a local authority and the entity operates like a corporate in a competitive market, it will be treated as a commercial undertaking. Claims on such PSEs will be risk weighted as claim on corporates.

8.1.4 *Claims on Banks*

Claims on banks will be treated as follows:

a) *Maturity more than three months*

Claim on banks with a maturity of more than three months shall be risk weighted based on the external credit assessment of the bank or the credit rating of instruments issued by the bank as follows:

Unrated banks will be risk-weighted at 50.0 per cent.

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
RW long term	20%	50%	50%	100%	150%	50%

b) *Maturity three months or less*

Claims to banks with an original maturity of three months or less will be treated as a short-term claim. Short-term claims on banks will be assigned a risk weight based on the credit rating of the bank as follows:

Credit Rating of Bank	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
RW Short Term Claims	20%	20%	20%	50%	150%	20%

Short term claims on banks that are funded and denominated in the EC currency may be assigned RW of 20.0 per cent.

Short term claims which are rolled over (that is, where the effective maturity is longer than 3 months) or restructured shall not be risk weighted as a short term claim.

8.1.5 *Claims on securities firms*

Claims on securities firms will be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to banks (including, in particular, risk-based capital requirements). Otherwise, such claims will be risk weighted as claims on corporates.

8.1.6 *Claims on corporates*

The following claims will be subject to the treatment prescribed in the following paragraphs:

(a) Claims on corporates (excluding venture capital and private equity investment corporations);
(b) Claims on insurance companies;
(c) Other financial institutions (credit unions, building societies and development LFIs); and
(d) Claims on securities companies that do not qualify for the treatment for claim on banks (as stated in section 8.1.5).

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

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

The Central Bank reserves the right to increase the standard RW for unrated claims where it determines that a higher RW is warranted by the overall default experience. Subject to approval by the Central Bank, an LFI may opt to RW all its corporate claims at 100.0 per cent without regard to external ratings. However, where this option is adopted, LFIs must apply it consistently, whether ratings are available or not.

8.1.7 *Claims included in the regulatory retail portfolios*

Claims that qualify under the regulatory retail portfolio shall receive a 75.0 per cent RW. To qualify under the regulatory retail portfolio, the exposure must meet the following criteria:

(a) ***Orientation Criterion*** - The exposure is to an individual person, any member of a borrower group, any borrower group, or small business[36];

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

i. Fully cash secured claims (inclusive of credits);
ii. Revolving credits and lines of credit (including credit cards and overdrafts);
iii. Personal term loans and leases (for example, installment loans, auto loans and leases, student and educational loans, personal finance); or
iv. Facilities and commitments to small businesses.

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. Aggregate exposures[37] to one counterparty or a group of connected counterparties must not exceed 0.2 per cent of the regulatory retail portfolio.

(d) ***Low value of individual exposures*** — the maximum aggregated retail exposure to one counterpart or group of connected counterparty must not exceed an absolute threshold of EC$1.0m. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.

Claims that do not satisfy the above criteria will be risk weighted at 100.0 per cent. In addition, the Central Bank reserves the right to review the assigned RWs. Past due loans and claims secured by residential property are excluded from the regulatory retail portfolio for risk weighting purposes.

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[36] Small business means an entity that has annual revenue or projected revenue of less than $2.0m EC dollars; and employs or intends to employ less than 50 permanent employees.

[37] Aggregated exposure means gross amount (that is, not taking any credit risk mitigation into account) of all forms of debt exposures (for example, 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 (for example, in the case of a small business that is affiliated with another small business, the limit would apply to the bank's aggregated exposure on both businesses).

8.1.8 ***Claims secured by residential property***

Loans secured by mortgages on residential property (residential mortgage loans) will be risk weighted at 50.0 per cent provided all the following conditions are met:

i. The property is or will be occupied by the borrower or that is rented;
ii. The loan is not past due for more than 90 days; and
iii. The loan has a loan to value (LTV)[38] ratio which does not exceed 80.0 per cent.

Where a residential mortgage loan satisfies (a) and (b) above but the LTV ratio exceeds 80.0 per cent, a 75.0 per cent RW will be applied (to the portion above 80.0 per cent LTV). Where an LFI does not hold information regarding LTVs for their individual residential mortgage exposures, but satisfies (a) and (a) above, a 100.0 per cent RW will be applied to the entire portfolio of residential mortgage exposures.

Where a residential mortgage loan does not satisfy (a) or (b), a 100.0 per cent RW must be applied.

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

8.1.9 ***Claims secured by commercial real estate***

A RW of 100.0 per cent will be applied to claims secured by commercial real estate.

8.1.10 ***Risk weight multiplier to certain exposures with currency mismatch***[39]

For unhedged retail and residential real estate exposures to individuals where the lending currency differs from the currency of the borrower's source of income, LFIs will **apply a 1.5 times multiplier to the applicable risk weight for these categories of exposures** according to sections 8.1.7 and 8.1.8, subject to a maximum RW of 150.0 per cent.

[38] The LTV should be calculated based on the current balance of the loan inclusive of interest. LFIs should ensure compliance with the ECCB's Valuation Standard, internal policies, and any other directives from the Central Bank

[39] Excludes exposures with a currency mismatch between Eastern Caribbean dollar and USD denominated exposures. The risk weight multiplier is applicable for exposures with currency mismatches between USD and any other currencies.

An unhedged exposure refers to an exposure to a borrower that has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the borrower's income and the currency of the loan. A natural hedge exists where the borrower, in his/her normal operating procedures, receives foreign currency income that matches the currency of a given loan (for example, remittances, rental incomes, salaries). A financial hedge generally includes a legal contract with a financial institution (for example, forward contract). For the purposes of application of the multiplier, only these natural or financial hedges are considered sufficient where they cover at least 90.0 per cent of the loan instalment, regardless of the number of hedges.

For all other exposures that have a currency mismatch, LFIs should also apply a multiplier of 1.5 times to the applicable risk weight, in accordance with the relevant sections of the Standard.

8.1.11 *Securitisation exposures*

LFIs will require authorisation from the Central Bank to engage in securitisations, as originators or investors.

Please refer to ***Appendix II*** *"Securitisation* Framework" before applying the proposed minimum required capital for these exposures. The risk-weighted asset amount of a securitisation tranche will be computed by multiplying the amount of the position by the appropriate RW determined in accordance with the following tables:

(a) Short-term ratings - For exposures with short-term ratings, the following RWs will apply:

External credit assessment	A–1/P–1	A–2/P–2	A–3/P–3	All other ratings
Risk weight	20%	50%	100%	1250%

(b) Long-term ratings - Specifically, for exposures with long-term ratings, RWs will be determined according to the following table:

External credit assessment	AAA to AA-	A+ to A-	BBB + to BBB-	BB+ to BB-	All other ratings
Risk weight	20%	50%	100%	350%	1250%

8.1.12 ***Past Due Loans***

(a) Unsecured Portions of Past Due Loans

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:

i. 150.0 per cent RW, when specific provisions are less than 20.0 per cent of the outstanding amount of the loan.

ii. 100.0 per cent RW when specific provisions are no less than 20.0 per cent up to 49.0 per cent of the outstanding amount of the loan.

iii. 50.0 per cent RW when specific provisions are 50.0 per cent or more of the outstanding amount of the loan.

For the secured portion of past due loans, eligible collateral and guarantees will be the same as for credit risk mitigation purposes (see section 8.2).

(b) Secured Portions of Past Due Loans

LFIs should apply the same RW on the secured portion of past due loans secured by eligible collateral or guarantees, as if they were not past due, provided the credit risk mitigation criteria set out in Section 8.2 continues to be satisfied.

Qualifying residential mortgage loans (see section 8.1.8) that are past due for more than 90 days will be risk weighted at 100.0 per cent, net of specific provisions. If such loans are past due, but specific provisions are no less than 20.0 per cent of their outstanding amount, a RW of 80.0 per cent may be applied with Central Bank approval.

8.1.13 ***Higher Risk Categories***

A RW of 150.0 per cent will apply to assets such as venture capital and private equity investments[40].

8.1.14 ***Other Assets***

The standard RW for all other assets will be 100.0 per cent.

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[40] 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).

8.1.15 *Off-Balance Sheet Instruments*

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

Off-Balance Sheet Exposure[41]	CCF
i. Commitments that are unconditionally cancellable 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 (for example, documentary credits collateralised by the underlying shipment). iii. A 20% conversion factor will be applied to both issuing and conforming LFIs.	**20%**
i. Commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines. ii. Certain transaction-related contingent items including performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions. iii. Note issuance facilities and revolving underwriting facilities.	**50%**
i. Direct credit substitutes, for example, 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. iii. Asset sales with recourse where the credit risk remains with the financial organization.[42] iv. Others.	**100%**

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.

[41] In case of doubts for products not listed here, refer to BCBS': "*International Convergence of Capital Measurement and Capital Standards - A Revised Framework*", 2004 (rev. June 2006), p.82-89.

[42] 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.

LFIs will need authorisation from the Central Bank to engage in Over-the-Counter (OTC) derivatives other than simple forwards on foreign currency (FX) and interest rates, FX swaps, currency swaps on interest rates swaps.

These transactions expose LFIs to counterparty risk. The treatment that shall be applied to determine the credit equivalent amount of the OTC derivatives is the so called "current exposure method"[43]. By this method, LFIs must calculate the current replacement cost by marking contracts to market / model, thus capturing the current exposure without any need for estimation, and then adding a factor (the "add-on") to reflect the potential future exposure over the remaining life of the contract. In order to calculate the credit equivalent amount of these instruments under this method, an LFI would sum:

- The total replacement cost (obtained by "marking to market") of all its contracts with positive value; and
- An amount for potential future credit exposure calculated on the basis of the total notional principal amount of its book, split by residual maturity as follows:

	Interest Rates	FX and Gold	Equities	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 (like swaps), 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.

[43] BCBS: Annex IV of the "*International Convergence of Capital Measurement and Capital Standards* - A Revised Framework", 2004 (rev. June 2006). This approach was replaced by the "*The standardised approach for measuring counterparty credit risk exposures*", March 2014 (rev. April 2014), but given the reduced level of OTC derivatives transactions within the ECCU area still considered more convenient to apply.

- 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 per cent.
- Other 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 based on their mark-to-market value.

Securities Financing Transactions (SFTs) are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements. The credit equivalent amount of SFTs that expose an LFI to counterparty credit risk is to be calculated as follows:

$E^* = \max\{0; 1.15 \cdot E - (0.85 - H_{FX}) \cdot C\}$, where
E* = credit equivalent (after risk mitigation);
E = current value of the exposure;
C = the current value of the collateral received; and
HFx = 8% when collateral and exposures are denominated in different currencies, otherwise 0.

Once the LFI has calculated the credit equivalent amounts of any off-balance sheet item, they are to be weighted according to the category of counterparty in the same way as in the main framework, including concessionary weighting in respect of exposures backed by eligible guarantees and collateral.

8.2 Credit Risk Mitigation

The framework set out in this section is applicable to banking book exposures that are risk-weighted under the standardised approach. LFIs will not be allowed to use credit derivatives even for the purposes of credit risk mitigation whether on-balance sheet netting, without authorisation from the Central Bank.

8.2.1 *CRM techniques and requirements*

LFIs will be allowed to use the following CRM techniques:

(a) Collateralisation where-

i. LFIs have a credit exposure or a potential credit exposure; and

ii. That credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty.
iii. Where LFIs take eligible financial collateral, the Basel II framework offers two approaches (simple and comprehensive) to reduce the regulatory capital requirements, but only the simple will be allowed (see section 8.2.2.1).

(b) On balance-sheet netting – LFIs may agree to net loans owed to them against deposits from the same counterparty.

(c) Guarantees by a third party. Where guarantees fulfill the minimum operational conditions set out in section 8.2.4. LFIs may take account of the credit protection offered by such CRM techniques in calculating capital requirements.

Where these techniques meet the general and legal requirements as set out at below, CRM will be recognised.

8.2.1.1 General Requirements for CRM Techniques:

a) No transaction in which CRM techniques are used shall receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.
b) The effects of CRM must not be double-counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on exposures for which the RW already reflects that CRM.
c) While the use of CRM techniques reduces or transfers credit risk, it may simultaneously increase other risks (that is, residual risks). Residual risks include legal, operational, liquidity and market risks and LFIs must employ robust procedures and processes to control these risks. Where these risks are not adequately controlled, the Central Bank may impose additional capital charges or take other supervisory actions.
d) In order for CRM techniques to provide protection, the credit quality of the counterparty must not have a material positive correlation with the employed CRM technique or with the resulting residual risks. For example, securities issued by the counterparty provide little protection as collateral and are thus ineligible.
e) Where an LFI has multiple CRM techniques covering a single exposure, the LFI must subdivide the exposure into portions covered by each type of CRM technique and the risk-weighted assets of each portion must be calculated separately.

8.2.1.2 Legal requirement:

a) For LFIs to obtain capital relief for any use of CRM techniques, all documentation used in collateralised transactions and third party guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. LFIs must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.

8.2.2 COLLATERALISED TRANSACTIONS

Before capital relief is granted in respect of any form of collateral, the standards set out below must be met:

- The legal mechanism by which collateral is pledged or transferred must ensure that the LFI has the right to liquidate or take legal possession of it, in a timely manner, in the event of default, insolvency or bankruptcy of the counterparty (and, where applicable, of the custodian holding the collateral). Additionally, LFIs must take all steps necessary to fulfil those requirements under the law applicable to the LFI's interest in the collateral for obtaining and maintaining an enforceable security interest, for example, by registering it with a registrar, or for exercising a right to net or set off in relation to the title transfer of the collateral.

- LFIs 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.

- Where the collateral is held by a custodian, LFIs must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

8.2.2.1 The Simple Approach

Under the simple approach, the RW of the counterparty is replaced by the RW of the collateral instrument collateralising or partially collateralising the exposure.

For collateral to be recognised in the simple approach, it must be:

a) Pledged for at least the life of the exposure; and
b) Marked to market and revalued with a minimum frequency of six months.

Those portions of exposures collateralised by the market value of recognised collateral receive the RW applicable to the collateral instrument. The RW on the collateralised portion is subject to a floor of 20.0 per cent except under the conditions specified below. The remainder of the exposure must be assigned the RW appropriate to the counterparty.

Maturity mismatches are not allowed under the simple approach.

The following collateral instruments are eligible for recognition under the simple approach:

a) Cash (as well as certificates of deposit or comparable instruments issued by the lending LFI) on deposit with the LFI that is incurring the counterparty exposure.

b) Gold.

c) Debt securities rated by a recognised CRA where these are either:
   i. At least BB– when issued by sovereigns or PSEs that are treated as sovereigns by the national supervisor; or
   ii. At least BBB– when issued by other entities (including LFIs and other prudentially regulated financial institutions); or
   iii. At least A-3/P-3 for short-term debt instruments.

d) Debt securities not rated by a recognised CRA where these are:
   i. Issued by an LFI; and
   ii. Listed on a recognised exchange; and
   iii. Classified as senior debt; and
   iv. All rated issues of the same seniority by the issuing bank are rated at least BBB– or A-3/P-3 by a recognised CRA;
   v. The bank holding the securities as collateral has no information to suggest that the issue justifies a rating below BBB– or A-3/P-3 (as applicable); and
   vi. The supervisor is confident that the market liquidity of the security is adequate.

e) Equities (including convertible bonds) that are included in a main index.

Exemptions to the 20.0 per cent Risk Weight Floor

The 20.0 per cent floor for the RW on a collateralised transaction does not apply and a 0.0 per cent RW may be applied where the exposure and the collateral are denominated in the same currency, and either:

(a) The collateral is cash on deposit with the bank that is incurring the counterparty exposure; or

(b) The collateral is in the form of sovereign / PSE securities eligible for a 0.0 per cent RW, and its market value has been discounted by 20.0 per cent.

8.2.3 ON-BALANCE SHEET NETTING

Where an LFI,

a) has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;
b) is able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement;
c) monitors and controls its roll-off risks; and
d) monitors and controls the relevant exposures on a net basis,

it may use the net exposure of loans and deposits as the basis for its capital adequacy calculation in accordance with the following formula: $E^* = \max\{0, [E - C \times (1 - H_{fx})]\}$, where:
E* = credit equivalent (after risk mitigation);
E = current value of the assets (loans) to be guaranteed;
C = the current value of the collateral received, that is, the liabilities (deposits);
HFx = 8% when collateral and exposures are denominated in different currencies, otherwise.

8.2.4 THIRD-PARTY GUARANTEES

If the operational requirements outlined below are met, LFIs can substitute the RW of the counterparty with the RW of the guarantor:

a) It represents a direct claim on the protection provider/guarantor;

b) It is explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;

c) Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it is irrevocable; there is 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

d) It must be unconditional; there should be no clause in the protection contract outside the direct control of the LFI that could prevent the protection provider/guarantor from being obliged to pay out in a timely manner in the event that the underlying counterparty fails to make the payment(s) due.

In addition to the legal certainty requirements in section 8.2.1.2, in order for a guarantee to be recognised, the following requirements must be satisfied:

a) On the qualifying default/non-payment of the counterparty, the bank 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 action in order to pursue the counterparty for payment.

b) The guarantee is an explicitly documented obligation assumed by the guarantor.

c) Except as noted in the following sentence, the guarantee covers all types of payments the underlying counterparty is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. The guarantee should cover payment of principal, interests and any other uncovered payments.

8.2.4.1 Eligible guarantors (counter-guarantors) / protection providers

Credit protection given by the following entities can be recognised when they have a lower RW than the counterparty:

(a) Sovereign entities, PSEs, banks, securities firms and other prudentially regulated financial institutions[44] with a lower RW than the counterparty;

(b) Other entities that are externally rated except when credit protection is provided to

[44] A prudentially regulated financial institution is defined as: a legal entity supervised by a regulator that imposes prudential requirements consistent with international norms or a legal entity (parent company or subsidiary) included in a consolidated group where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated insurance companies, broker/dealers, thrifts and futures commission merchants, and qualifying central counterparties.

a securitisation exposure. This would include credit protection provided by a parent, subsidiary and affiliate companies when they have a lower RW than the obligor; and

(c) When credit protection is provided to a securitisation exposure, other entities that currently are externally rated BBB– or better and that were externally rated A– or better at the time the credit protection was provided. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower RW than the obligor.

8.2.4.2 Risk-weight treatment when credit protection is provided by third parties:

a) General risk-weight treatment:

The protected portion is assigned the RW of the protection provider. The uncovered portion of the exposure is assigned the RW of the underlying counterparty. Materiality thresholds on payments below which the protection provider is exempt from payment in the event of loss are equivalent to retained first-loss positions. The portion of the exposure that is below a materiality threshold must be assigned a RW of 1250.0 per cent by the LFI.

b) Proportional cover:

Where losses are shared pari passu on a pro rata basis between the LFI and the guarantor, capital relief is afforded on a proportional basis, that is, the protected portion of the exposure receives the treatment applicable to eligible guarantees/credit derivatives (with Central Bank's approval), with the remainder treated as unsecured.

c) Tranched cover:

Where the LFI transfers a portion of the risk of an exposure in one or more tranches to a protection seller or sellers and retains some level of the risk of the loan, and the risk transferred and the risk retained are of different seniority, LFIs may obtain credit protection for either the senior tranches (for example, the second-loss portion) or the junior tranche (for example, the first-loss portion). In this case, the rules as set out in the Appendix II apply.

d) Currency mismatches:

Where the credit protection is denominated in a currency different from that in which the exposure is denominated - that is, there is a currency mismatch, the amount of the exposure deemed to be protected (GA) will be reduced by the application of a haircut (H_{FX}) using the following formula:

$G_A = G * (1 - H_{FX})$

where:

G = nominal amount of the credit protection

H_{FX} = haircut appropriate for currency mismatch between the credit protection and underlying obligation and will be calculated as $H_{FX} = 8\%$ ·

The standard supervisory haircut of 8.0 per cent 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:

LFIs will extend the preferential RW treatment, described in section 8.1.2, to portions of exposures guaranteed by an ECCU sovereign (or Central Bank /Eastern Caribbean Partial Credit Guarantee Scheme (ECPCGC), where the guarantee is denominated in the domestic currency and the exposure is funded in that currency. An exposure may be covered by a guarantee that is indirectly counter-guaranteed by a sovereign. Such an exposure may be treated as covered by a sovereign guarantee provided that:

a) The sovereign counter-guarantee covers all credit risk elements of the exposure;

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 exposure; 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.

8.2.5. Maturity Mismatch

A maturity mismatch occurs when the residual maturity of a credit protection/collateral arrangement (for example, hedge) is less than that of the underlying exposure. In cases where the residual maturity of the collateral is less than that of the underlying exposure ('maturity mismatch'),

For the purposes of calculating RWA, when there is a maturity mismatch, the credit protection may only be recognised if the original maturity of the arrangement is greater than or equal to one year, and its residual maturity is greater than or equal to three months. In such cases, credit risk mitigation may be partially recognised as: $P_a = P * \frac{t-0.25}{T-0.25}$, where:

P_a = value of the credit protection/collateral adjusted for maturity mismatch

P = value of credit protection (including the collateral amount or guarantee) adjusted for any haircuts
t = min {T, residual maturity of the credit protection arrangement/collateral expressed in years}
T = min {5 years, residual maturity of the exposure expressed in years}

9 MARKET RISK MINIMUM CAPITAL REQUIREMENT

9.1 Definitions and Important Concepts

Market risk is defined as the risk of losses in on and off-balance-sheet positions arising from movements in market prices of instruments. The risks subject to this requirement are:

(a) The risks pertaining to interest rate related instruments and equities in the trading book; and
(b) Foreign exchange risk and commodities risk throughout the bank.

Instruments comprise financial instruments, foreign exchange, and commodities. A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both primary financial instruments (or cash instruments) and derivative financial instruments. Other than simple forwards on FX and interest rates, FX swaps, currency swaps on interest rates swaps, LFIs will need authorisation from the Central Bank to engage in any kind of derivatives including those traded through institutional exchanges (like futures and options). Licensees will also need authorisation to take short positions.

A financial asset is any asset that is cash, the right to receive cash or another financial asset or a commodity, or an equity instrument. A financial liability is the contractual obligation to deliver cash or another financial asset or a commodity.

A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge[45] other elements of the trading book.

9.2 Requirements

To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely**.** LFIs must fair-value at least daily any trading book instrument and recognise any valuation changes in the profit and loss account.

Any instrument an LFI holds for one or more of the following purposes must be designated as a trading book instrument:

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[45] A hedge is a position that materially or entirely offsets the component risk elements of another trading book position or portfolio.

a) Short-term resale;
b) Profiting from short-term price movements;
c) Locking in arbitrage profits; and/or
d) Hedging risks that arise from instruments meeting criteria (a), (b) or (c) above.

LFIs must have clearly defined policies, procedures and documented practices for determining which instruments to include in or to exclude from the trading book for purposes of calculating their regulatory capital, ensuring compliance with the criteria exposed, and taking into account the LFI's risk management capabilities and practices. Compliance with the policies and procedures must be fully documented and subject to periodic (at least yearly) internal audit and the results must be available for supervisory review.

Licensees will be strictly limited to move instruments between the trading book and the banking book by their own choice after initial designation and needs to be authorized by the Central Bank. Switching instruments for regulatory arbitrage is strictly prohibited. Market events, changes in the liquidity of a financial instrument, or a change of trading intent alone are not valid reasons for re-designating an instrument to a different book. Without exception, a capital benefit as a result of switching will not be allowed in any case or circumstance.

Licensees should also measure their vulnerability to loss in stressed market conditions in both their banking and trading book portfolios by conducting stress tests, incorporating extreme but plausible assumptions for the relevant risk factors and giving special considerations to positions that may be difficult to liquidate or offset in stressful situations. The board and senior management should consider the results of stress tests when establishing and reviewing strategies, policies and limits for market risk.
In cases where LFIs undertake significant market risk in the course of their business strategy, capital should be allocated specifically to support this risk. Should the Central Bank, through its risk assessment process, conclude that the market risk exposure of an LFI is high relative to current capital, it will discuss this concern with senior management of the bank. Depending on the circumstances, the Central Bank may require an LFI to strengthen its capital position or reduce its level of market risk exposure.

9.3 Applicability

The requirement to allocate capital is in respect of the exposure to risks derived from changes in interest rates and equity prices in LFIs' trading book and exposure to risks derived from changes in foreign exchange rates and commodity prices in the overall banking activity.

In computing the capital charge for market risk, LFIs must include:
(a) Interest rate risk sensitive instruments (like bonds and swaps) held for trading;
(b) Equities;
(c) Overall foreign exchange exposure; and
(d) Commodity position.

The requirement applies to all LFI that have trading book exposures (items a), b) and d) see paragraphs 5.5.1 and 5.5.2 below) that exceed a threshold of **3.0 per cent** of total on-balance and off-balance sheet assets. Licensees whose trading book exposures do not meet the previous criterion are exempted from calculating all market risk capital charges except the capital charge on its open foreign exchange positions (see section 9.4.3). This will include typically LFI that do not engage in trading activities. Where an LFI's trading book exceeds the established threshold above for a short period only of less than three (3) months, the Central Bank may exempt the LFI from the market risk capital reporting requirements.

9.3.1 Methodology for Calculation of Market Risk Capital Charge

The Central Bank has determined that eligible LFIs subject to the market risk capital requirements should use the Standardised Approach[46]. In this approach, the capital requirement is the sum of the capital requirement calculated for each of the various market risks sub-categories (interest rate risk, equity price risk, commodity price risk, and foreign exchange risk), determined separately.

Within the interest rate and equity position risk categories, separate capital charges for specific risk and the general market risk arising from debt and equity positions are calculated:

a) *Specific risk* is defined as the risk of loss caused by an adverse price movement of a debt instrument or security due principally to factors related to the issuer; and

[46] Section VI.C. of BCBS's: "International Convergence of Capital Measurement and Capital Standards - A Revised Framework", 2004 (rev. June 2006)

b) *General market risk* is defined as the risk of loss arising from adverse changes in market prices. For commodities and foreign exchange, there is only a general market risk capital requirement.

Thus, in assessing the capital requirements, LFIs will be required to make general and/or specific risk calculations for each class of instruments as set out in the table below.

The Application of Specific and General Market Risk Capital Charge

	Specific	**General**
Foreign Exchange Risk		✓
Interest Rate Position Risk	✓	✓
Equities Positions Risk	✓	✓
Commodities Risk		✓

It is noteworthy that:

a. On and off-balance sheet assets held in the trading book are subject to only market risk capital requirements and will not be subject to credit risk capital requirement.

b. On and off-balance sheet interest rate assets funded in foreign currency held in the trading book will be subject to only market risk capital requirement (with a charge for specific interest rate risk, general interest rate risk and foreign exchange risk).

c. Equities will always be subject to only market risk capital requirement (with a charge for equity risk, and foreign exchange risk if funded in foreign currency).

d. On and off-balance sheet interest rate assets funded in foreign currency held in the banking book (for example, held to maturity or available for sale) will be subject to a capital requirement for credit risk as well as foreign exchange risk.

The capital charges derived from the different elements of risk under the Standardised Approach for measuring market risk (foreign exchange, interest rate, equity and commodities), are summed to obtain the total market risk capital charge. If multiplied by 12.5 (that is, the reciprocal of the minimum 8.0 per cent risk asset ratio), it yields the risk-weighted assets for market risk, that will be required to calculate the CAR ratio.

9.4 Measurement Rules for Individual Market Risk Sub-risk Categories

9.4.1 Interest Rate Risk

This section describes the Standardised Approach for measuring the interest rate risk[47] in the trading book. The holding or taking of positions in debt securities and other interest rate related instruments in the trading book gives rise to interest rate risk.

The instruments covered include all fixed-rate and floating-rate debt securities and instruments that behave like them, such as non-convertible preference shares.

The following list includes financial instruments in the trading book that will attract an interest rate risk capital requirement:

a) Bonds/loan stocks, debentures etc.;
b) Non-convertible preference shares;
c) Convertible securities such as preference shares and bonds, which are treated as debt instruments;
d) Certificates of Deposit;
e) Treasury bills;
f) Commercial paper; and
g) Interest rate exposure embedded in other financial instruments.

The minimum capital requirement is expressed in terms of two separately calculated charges:

i. One applying to the specific risk of each security; and
ii. The other to the interest rate risk in the portfolio (general market risk), where long and short positions in different securities or instruments can be offset.

The total capital requirement for interest rate risk is the sum of the general market interest rate risk capital requirements across currencies, and the specific risk capital requirements.

[47] Interest rate risk is the risk that a bank will face adverse changes in its earnings and/or economic value of equity resulting from changes in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship.

9.4.1.1 INTEREST RATE – SPECIFIC RISK CALCULATION

The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. In this regard, LFIs:

a) Must calculate their specific risk by multiplying the absolute value of the individual debt position in the trading book by the relevant risk weight table below;
b) Must not offset between different issues as offsetting will be restricted to matched positions in the identical issue. Even if the issuer is the same, no offsetting will be permitted between different issues.

In measuring the specific risk for interest rate related instruments, LFI may net, by value, long and short positions in the same debt instrument to generate the individual net position in that instrument. Instruments will be considered to be the same where:

(a) The issuer is the same;
(b) They have an equivalent ranking in liquidation; and
(c) The currency, the coupon and the maturity are the same.

The specific risk capital charges are set out in the table below for the three broad categories of securities that may give rise to interest rate risk (government, qualifying and other):

1) The category "*government*"[48] debt instruments include all forms of government (and Central Bank) paper including bonds, treasury bills and other short-term instruments and all paper subject to a direct government guarantee.

ECCU government debt and government guaranteed debt denominated in Eastern Caribbean dollars and funded by the bank in that currency should be risk weighted at zero (0) per cent.

The Central Bank reserves the right to apply a higher specific risk weight to securities issued by certain foreign governments, especially to securities denominated in a currency other than that of the issuing government.

[48] Including, at national discretion, local and ECCU governments subject to a risk weight of zero (0) per cent. A risk weight of 20.0 per cent will be applied where such exposures are non-performing.

Computation of the Specific Risk Capital Charge for Issuer Risk

Categories	External credit Assessment	Specific risk capital charge
Government	AAA to AA-	0.0%
	A+ to BBB-	0.25% (residual term to final maturity 6 months or less)
		1.00% (residual term to final maturity greater than 6 months and up to and including 24 months)
		1.60% (residual term to final maturity exceeding 24 months)
	BB+ to B-	8.00%
	Below B-	12.00%
	Unrated	8.00%
Qualifying		0.25% (residual term to final maturity 6 months or less)
		1.00% (residual term to final maturity greater than 6 months and up to and including 24 months)
		1.60% (residual term to final maturity exceeding 24 months)
Other	BB+ to BB-	8.00%
	Below BB-	12.00%
	Unrated	8.00%

2) The "*qualifying*" category includes rated investment grade securities issued by or fully guaranteed by:

a) Public sector entities;
b) Multilateral development banks; and
c) Banks in countries that have implemented the Basel II framework, together with or investment firms in those jurisdictions provided they are subject to equivalent regulatory and supervisory arrangements comparable to those under this Framework.

3) The "*Other*" category includes securities that are:

(a) Rated investment-grade[49] by at least two CRAs approved by the Central Bank; or
(b) Rated investment-grade by one CRA and not less than investment-grade by any other CRA approved by the Central Bank (subject to supervisory oversight);
(c) Deemed to be of comparable investment quality by LFIs, provided that the issuer is rated investment grade by at least two CRAs approved by Central Bank; or
(d) Unrated (subject to Central Bank approval) but deemed to be of comparable investment quality by the reporting bank, and where the issuer has securities listed on a recognised stock exchange.

Specific Risk Rules for Non-Qualifying Issuers

Instruments issued by a non-qualifying issuer will receive the same specific risk charge as a non-investment grade corporate borrower under the standardised approach for credit risk.

However, in certain cases where the specific risk charge for debt instruments which trade at exceptionally high yields relative to corresponding government debt securities may be underestimated, the Central Bank reserves the right to on a case by case basis:
a) Apply a higher specific risk charge of 12.0 per cent to such instruments; and/or
b) Disallow offsetting of these instruments in calculating general market risk between such instruments and any other debt instruments.

The "Other" category includes all those instruments which are not in "Government" or "Qualifying' categories above for example, private sector issuers.

9.4.1.2 Interest rate – General Risk Calculation

The capital requirements for general market risk are designed to capture the risk of loss arising from changes in market interest rates. The "maturity method" will be applied, whereby positions are allocated across a maturity ladder and the capital charge is then calculated as a sum of the following components:

a) The net short or long position in the whole trading book;
b) A small proportion of the matched positions in each time-band (the "vertical disallowance"); and
c) A larger proportion of the matched positions across different time-bands (the

[49] For example- Baa or above by Moody's; BBB or above by Standard and Poor's and AA- and above for CariCRIS.

"horizontal disallowance").

Vertical disallowance is designed to capture the basis risk which is the risk that the relationship between changes in prices of similar instruments, even in the same time zone, is not stable over time. Horizontal disallowance on the other hand captures the imperfect correlation of interest rates along the yield curve, applicable to securities in different time bands.

Separate maturity ladders should be used for each currency and capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign.

In the case of those currencies in which the value and volume of business is insignificant (< 5.0 per cent of the total currencies), separate maturity ladders for each currency are not required. Rather, the LFI may construct a single maturity ladder and slot, within each appropriate time-band, the net long or short position for each currency. However, these individual net positions are to be summed within each time-band, irrespective of whether they are long or short positions, to produce a gross position figure for the time-band.

The long or short positions in debt securities and other sources of interest rate exposures including derivative instruments (with Central Bank's approval) are slotted into a maturity ladder comprising thirteen time-bands (or fifteen time-bands in case of low coupon instruments) as follows:

(a) Fixed rate instruments should be allocated according to the residual term to maturity;
(b) Floating-rate instruments according to the residual term to the next repricing date; and
(c) Opposite positions of the same amount in the same issues (but not different issues by the same issuer), whether actual or notional, can be omitted from the interest rate maturity framework.

The specific steps for calculating the general risk capital charge using the maturity method are as follows:

1) The first step in the calculation is to weight the positions in each time-band by a factor designed to reflect the price sensitivity of those positions to assumed changes in interest rates. The weights for each time-band are set out in the table below. Zero-coupon bonds and deep-discount bonds (defined as bonds with a coupon of less than 3.0 per cent) should be slotted according to the time-bands set out in the second column of the table below:

Maturity Method - Time Bands and Risk Weights

COUPON 3% OR MORE	COUPON LESS THAN 3%	RISK WEIGHT	ASSUMED CHANGES IN YIELD
1 month or less	1 month or less	0.00%	1.00
1 to 3 months	1 to 3 months	0.20%	1.00
3 to 6 months	3 to 6 months	0.40%	1.00
6 to 12 months	6 to 12 months	0.70%	1.00
1 to 2 years	1.0 to 1.9 years	1.25%	0.90
2 to 3 years	1.9 to 2.8 years	1.75%	0.80
3 to 4 years	2.8 to 3.6 years	2.25%	0.75
4 to 5 years	3.6 to 4.3 years	2.75%	0.75
5 to 7 years	4.3 to 5.7 years	3.25%	0.70
7 to 10 years	5.7 to 7.3 years	3.75%	0.65
10 to 15 years	7.3 to 9.3 years	4.50%	0.60
15 to 20 years	9.3 to 10.6 years	5.25%	0.60
over 20 years	10.6 to 12 years	6.00%	0.60
	12 to 20 years	8.00%	0.60
	over 20 years	12.50%	0.60

2) The next step in the calculation is to offset the weighted longs and shorts in each time-band, resulting in a single short or long position for each band. Since, however, each band would include different instruments and different maturities, a 10.0 per cent capital charge to reflect basis risk and gap risk will be levied on the smaller of the offsetting positions, be it long or short (vertical disallowance)[50].

3) The result of the above calculations is to produce two sets of weighted positions, the net long or short positions in each time-band and the vertical disallowances, which have no sign.
4) In addition, however, LFIs will be allowed to conduct two rounds of "horizontal offsetting", first between the net positions in each of three zones (zero to one year, one year to four years and four years and over) in the table below, and subsequently

[50] For example, if within a band the weighted longs amount to $10.0m and the weighted shorts amount to $9.0m, the so-called 'vertical disallowance' is 10.0 per cent of $9.0m that is, $900,000 or $0.9m.

between the net positions in the three different zones. The horizontal disallowance is computed when an LFI has offsetting (opposite) long and short positions in the adjacent time buckets. Horizontal disallowance arises due to unequal changes in yield curve for different time buckets at the same time period.

Horizontal Disallowance

ZONES	TIME-BAND	WITHIN THE ZONE		BETWEEN ADJACENT ZONES	BETWEEN ZONES 1 AND 3
Zone 1	0 - 1 month 1 - 3 months 3 - 6 months 6 - 12 months	40%			
Zone 2	1 - 2 years 2 - 3 years 3 - 4 years 4 - 5 years	30%		40%	100%
Zone 3	5 - 7 years 7 - 10 years 10 - 15 years 15 - 20 years over 20 years	30%		40%	

The offsetting will be subject to a scale of disallowances expressed as a fraction of the matched positions, as set out in the table above. The weighted long and short positions in each of three zones may be offset, subject to the matched portion attracting a disallowance factor that is part of the capital charge. The residual net position in each zone may be carried over and offset against opposite positions in other zones, subject to a second set of disallowance factors.

In the case of residual currencies, the gross positions in each time-band will be subject to the risk weights set out in the relevant table above, with no further offsets.

9.4.2 Equity risk

This section sets out a minimum capital standard to cover the risk of holding or taking positions in equities and all other instruments that exhibit market behaviour similar to equities, but not to non-convertible preference shares as these are covered by the interest rate risk requirements. Long and short positions in the same issue may be reported on a net basis. Equity risk capital requirements will apply to positions and exposures on the following instruments:

a) Common shares, whether voting or non-voting;
b) Convertible preference shares or securities that behave like equities;
c) Convertible debt securities which convert into equity instruments and are trading as equities; and
d) Any other instruments exhibiting equity characteristics.

The minimum capital standard for equities is expressed in terms of two separately calculated charges:

(a) The "specific risk" of holding a long or short position in an individual equity; and
(b) The "general market risk" of holding a long or short position in the market as a whole.

9.4.2.1 Specific Risk

Specific risk is the risk that the value of individual equity positions may move against the bank. The charge is measured as a proportion of the sum of the absolute value of all long equity positions and of all short equity positions (that is, the LFI's gross equity positions) and a capital charge of 8.0 per cent must be held against this risk. Long and short positions in issues of the same issuer may be netted.

9.4.2.2 General Market Risk

General market risk is the risk that the equity market may move against the LFI and will be assessed on the overall net position (the difference between the sum of the long and the sum of the short positions) in an equity market and will carry an 8.0 per cent charge.
Equity securities listed in more than one country must be allocated to either the country where the issuer is incorporated and listed or the country where the security was

purchased or sold, but not both[51]. Calculations should be expressed in the domestic currency equivalent of the denomination of the equity, converted at spot rates at the reporting date. The capital charge for both specific and general market risk will be 8.0 per cent.

9.4.3 Foreign exchange risk

This section sets out a minimum capital requirement to cover the risk of holding or taking positions in foreign currencies, including gold. Foreign exchange risk is the risk to earnings and capital arising from adverse movements in currency exchange rates[52]. This reflects the impact of adverse movements on the value of open foreign currency positions. LFIs are exposed to interest rate risk that arises from the mismatching of term foreign currency positions. Foreign exchange risk may arise from foreign currency transactions and services, foreign exchange trading, investments denominated in foreign currencies and investments in foreign subsidiaries and is caused by:

(a) Currency mismatches between an LFI's assets and liabilities (both on- and off-balance sheet), inclusive of capital; and
(b) Currency cash flow mismatches.

Application of Capital Charge for Foreign Exchange Risk

The capital charge for foreign exchange risk is applied to the entire business, both banking book and trading book. Thus, where an LFI falls below the threshold in section 9.3 at which trading book treatment applies, it is still necessary to calculate and apply a capital charge on its open foreign exchange positions.

Two processes are needed to calculate the capital requirement for foreign exchange risk:

a) The first is to measure the exposure in a single currency position; and
b) The second is to measure the risks inherent in an LFI's mix of long and short positions in different currencies.

The LFI's net open position in each currency should be calculated by summing:

a) The net spot position (that is, all asset items less all liability items, including accrued

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[51] That is, on a market-by-market basis whereby a separate calculation has to be carried out for each national market in which the bank holds equities.

[52] The ECCB decided to exclude the United States dollar given the fixed exchange rate peg. However, LFIs must report their exposures in USD. The ECCB reserves the right to revise the capital requirement for USD denominated exposures.

interest, denominated in the currency in question);

b) The net forward position (that is, all amounts to be received less all amounts to be paid under forward foreign exchange transactions, including currency futures and the principal on currency swaps not included in the spot position);
c) Guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable;
d) Net future income / expenses not yet accrued but already fully hedged; and
e) Depending on particular accounting conventions in different countries, any other item representing a profit or loss in foreign currencies.

Interest accrued (earned but not yet received) should be included as a position. Accrued expenses should also be included. Unearned but expected future interest and anticipated expenses may be excluded unless the amounts are certain and LFIs have taken the opportunity to hedge them. If LFIs include future income/expenses they should do so on a consistent basis, and not be permitted to select only those expected future flows which reduce their position. Forward currencies and gold positions will be valued at current spot market exchange rates.

An LFI doing negligible business in foreign currency and which does not take foreign exchange positions for its own account may be exempted from capital requirements on these positions provided that:

(a) Its foreign currency business, defined as the greater of the sum of its gross long positions and the sum of its gross short positions (if authorized) in all foreign currencies, does not exceed 100.0 per cent of eligible capital; and

(b) Its overall net open position as defined in the paragraph above does not exceed 2.0 per cent of its eligible capital.

LFIs will calculate the minimum capital by using the "shorthand method"[53], whereby the nominal amount (or net present value) of the net position in each foreign currency and in gold is converted at spot rates into the reporting currency. **Except for exposures denominated in the US dollar, LFIs will apply a FX risk capital charge of 8.0 per cent of the overall net open position for all other currencies and gold.** The net open position is measured by aggregating:

[53] Shorthand method means the procedure for measuring the overall foreign exchange risk exposure by: (1) adding separately all short positions on one side and all long positions on the other side; (2) comparing the two totals; and (3) taking the larger of the two totals as the overall open position.

(a) The sum of the net short positions or the sum of the net long positions, whichever is the greater; plus; and
(b) The net position (short or long) in gold, regardless of sign.

9.4.4 Commodity Risk

This section establishes a minimum capital requirement to cover the risk of holding or taking positions in commodities, including precious metals, but excluding gold which is treated as a foreign currency in section 9.4.3.

A commodity is defined as a physical product which is or can be traded on a secondary market, for example, agricultural products, minerals (including oil) and precious metals.

Commodity risk comprises directional risk which is the most important risk, basis risk, interest rate risk and forward gap risk. Directional risk is the exposure to changes in spot prices arising from net open positions. Basis risk is the risk that the relationship between the prices of similar commodities alters over time. Forward gap and interest rate risk is the exposure to changes in forward prices arising from maturity mismatches.

The price risk in commodities is often more complex and volatile than that associated with currencies and interest rates. Commodity markets may also be less liquid than those for interest rates and currencies and, as a result, changes in supply and demand can have a more dramatic effect on price and volatility. LFIs need also to guard against the risk that arises when a short position falls due before the long position.

Commodities risk will be measured under the simplified approach, where long and short positions in each commodity may be reported on a net basis for the purposes of calculating open positions. However, positions in different commodities will as a general rule not be offsettable in this fashion.

The capital charge for directional commodity risk is equal to the sum of the following two items:

i. 15.0 per cent of the net position, long or short (in absolute value), in each commodity; and
ii. An additional capital charge equivalent to 3.0 per cent of LFIs' gross positions, long plus short, in each commodity to protect LFIs against basis risk and interest rate risk.

9.5 Reporting Requirements

Once an LFI has a trading book that is consistent with the definition under section 9.2 above, and meets the reporting threshold, it will be required to:

a) Report on its trading book activities using the relevant market risk related prudential reporting forms on a quarterly basis or a frequency otherwise determined by the Central Bank.

However, **all** LFIs are required to report in the relevant prudential reporting forms, their interest rate risk exposures and foreign currency exposures in the respective forms, on a quarterly basis or a frequency otherwise determined by the Central Bank.

In applying this Standard, LFIs should note that:

a) Where a banking group, subject to consolidated supervision by the Central Bank, exceeds the trading book threshold at a consolidated level, but it has subsidiaries that do not meet the threshold, it may apply to have such subsidiaries excluded from the provisions of this Standard. However, the Central Bank will monitor such institutions on a solo basis to ensure that significant imbalances do not go unsupervised;

b) Where a group is subject to consolidated supervision by the Central Bank, and it manages its market-related activities centrally, it may report short and long positions in the same instrument (including terms) on a net basis, no matter where in the group the transaction was booked. The Central Bank reserves the right, however, to request that LFIs take individual positions into the measurement system without offset.
This can occur in instances where there are legal or procedural difficulties limiting the consolidated management of risks; and

c) On-balance sheet assets held in the trading book are subject to market risk capital requirements only (that is, debt and equity securities held in the trading book shall be excluded from the credit risk computation).

10 OPERATIONAL RISK MINIMUM CAPITAL REQUIREMENT

This section provides the rules and guidance on the operational risk capital requirements.

10.1 Definition

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk but excludes strategic risk and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

The operational risk capital charge represents the minimum amount of capital that an LFI should maintain as a cushion against losses arising from operational risk.

10.2 Central Bank's Measurement Methodology

The Central Bank requires LFIs to calculate and report the capital available for operational risk using the Basic Indicator Approach (BIA).

10.3 The Basic Indicator Approach

Under this approach, gross income serves as a proxy for the scale of operational risk exposure. LFIs are required to hold capital for operational risk that is at least equal to a fixed percentage (denoted "Alpha") of their average gross positive income over the last three-year period.

Any perceived shortfall of capital held for operational risk would need to be addressed during the Supervisory Review and Evaluation Process under Pillar 2. All LFIs are required to comply with the Central Bank's *Prudential Standard for the Management of Operational Risk* and any other applicable prudential standard(s).

10.3.1 Calculation of the Capital Charge for Operational Risk

The capital charge for operational risk under the BIA approach is calculated for the three most recent years ending with the current reporting quarter as follows:

$K = \{(GI_1 + GI_2 + GI_3) * \alpha\}/n$

Where,

K = capital charge under the BIA

GI = only positive annual gross income over the previous three years (that is, GI in years with negative gross income, if any, shall be excluded)

α = 15.0 per cent

n= number of the previous three years for which gross income is positive

i. *Calculate the average gross income:* This is achieved by computing the average gross positive income over the most recent three-year period of positive income. Figures for any reporting period in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average[54];

ii. *Calculate the Capital Charge*: Multiply the gross income by α = 15.0 per cent; and

iii. *Calculate the Risk Weighted Assets (RWA) equivalent amount.* This is derived by multiplying the capital charge by 12.5.

The following rules apply:

a) Gross income is defined as the sum of net interest income and net non-interest income. It is intended that this measure should:
   i. Be gross of any provisions (example- unpaid interest);
   ii. Be gross of any operating expenses, including fees paid to outsourcing service providers;
   iii. Exclude realised or unrealised profit/losses from the sale or impairment of securities in the banking book;
   iv. Exclude income from extraordinary or irregular items; and
   v. Exclude income derived from insurance claims/recoveries.

b) The GI will be calculated as a moving average over the three years so that:
   i. GI1 = last 12 months (t to t-12) ending with the current reporting quarter;
   ii. GI2 = previous 12 months t-24); and
   iii. GI3 = the last months (t-25 – t -36).

c) The period for calculating the moving average for each year would coincide with the

54 If all the three years' gross income is negative, the Central Bank will advise accordingly.

respective reporting quarters.

d) An LFI should treat any partial year of operation of six months or more as a full year. Any partial year of operation of less than six months should be disregarded. If any partial year is to be counted as a full year, the gross income of that partial year should be annualised.

e) LFI that do not have sufficient gross income data to meet the three-year requirement[55] may use its gross income projections in the business plan for all or part of the three year time period when calculating its relevant indicator.

f) Since negative gross income leads to exclusion of data points for that year both from the numerator and the denominator of the BIA operational risk formula, it could at times result in some distortions. For example, an LFI that has negative gross income for one of three years might end up with a higher operational risk capital charge than if it were to have positive gross income for that year, even if it was a small amount. To ensure that such distortions do not occur, the Central Bank would review and consider appropriate actions.

10.4 Operational Risk Capital Charge and Regulatory Capital

The operational risk capital charge is part of the overall capital charge. The regulatory capital formula includes charges for credit risk, operational risk and market risk. Following the computation of the operational risk capital charge using the BIA, its RWA equivalent (12.5*Operational risk charge) is added to the total risk-weighted assets for credit risk and market risk to arrive at the total risk weighted assets.

10.5 Regulatory Reporting Requirements

All LFIs must report their operational risk capital adequacy calculations, using the relevant reporting form, to the Central Bank on a quarterly basis.

55 For example, in the case of newly formed LFIs and mergers and acquisitions

APPENDIX I: EXTERNAL CREDIT ASSESSMENT

Under the Standardised Approach, LFIs will rely on the credit assessments prepared by CRAs. For such ratings to be used for capital adequacy purposes, the CRA must first be recognised as eligible by the Central Bank, as well as an appropriate mapping of the ratings of individual CRA ratings. With regard to CRAs, the Central Bank currently recognises Standard and Poor's, Fitch Rating Services, Moody's Investor Services and Caribbean Information and Credit Rating Services Limited (CariCRIS). However, LFIs may approach the Central Bank to seek recognition for other agencies appearing to them to meet the eligibility criteria below.

For risk rating purposes, the rating of the client by any recognised CRA is valid for one year.

A.1 Eligibility Criteria

1) The Central Bank will determine on a continuing basis whether a CRA meets the eligibility criteria provided below.

2) The IOSCO[56] Code of Conduct Fundamentals for Credit Rating Agencies[57] will also be referenced when determining CRA eligibility.

3) The assessments of CRAs may be recognised on a limited basis, for example, by type of claims or by jurisdiction.

4) The supervisory process for recognising CRAs will be made public.

5) A CRA must satisfy each of the **following eight criteria**:
   (a) *Objectivity*: The methodology for assigning external ratings must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, external ratings must be subject to ongoing review and responsive to changes in financial condition.

   Before being recognised by supervisors, a rating methodology for each market segment, including rigorous back-testing, must have been established for at least one year and

[56] International Organisation of Securities Commissions

[57] This resource can be accessed at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD482.pdf.

preferably three years.

(b) *Independence*: A CRA should be independent and should not be subject to political or economic pressures that may influence the rating. In particular, a CRA should not delay or refrain from taking a rating action based on its potential effect (economic, political or otherwise). The rating 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 CRA may be seen as creating a conflict of interest. Furthermore, a CRA should separate operationally, legally and, if practicable, physically its rating business from other businesses and analysts.

(c) *International Access/Transparency*: the following should be publicly available on a non-selective basis, unless they are private ratings, which should be at least available to both domestic and foreign institutions with legitimate interest and on equivalent terms:

i. The individual ratings;
ii. The key elements underlining the assessments; and
iii. Whether the issuer participated in the rating process.

In addition, the CRA's general procedures, methodologies and assumptions for arriving at ratings should be publicly available.

(d) Disclosure: A CRA should disclose the following information:

i. Its code of conduct;
ii. The general nature of its compensation arrangements with assessed entities;
iii. Any conflict of interest;
iv. The CRA's compensation arrangements;
v. 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 ratings, for example, the likelihood of 'AA' ratings becoming 'A' over time. All ratings should be disclosed as soon as practicably possible after issuance.

(e) *Resources*: A CRA 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. In particular, CRAs should assign analysts with appropriate knowledge and experience to assess the creditworthiness of the type of entity or obligation being rated. Such assessments should be based on methodologies combining qualitative and quantitative approaches.

(f) *Credibility*: To some extent, credibility is derived from the criteria above. In addition, the reliance on a CRA's external ratings by independent parties (investors, insurers, trading partners) is evidence of the credibility of the ratings of a CRA. The credibility of a CRA is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, a CRA does not have to assess firms in more than one country.

(g) *No abuse of unsolicited ratings:* CRAs must not use unsolicited ratings to put pressure on entities to obtain solicited ratings. Supervisors should consider whether to continue recognising such CRAs as eligible for capital adequacy purposes, if such behaviour is identified.

(h) *Cooperation with the supervisor:* CRAs should notify the supervisor of significant changes to methodologies and provide access to external ratings and other relevant data in order to support initial and continued determination of eligibility.

A.2 The Mapping Process

1) The Central Bank will assign eligible CRAs' assessments to the RWs available under the risk weighting framework outlined in this document, that is, deciding which assessment categories correspond to which RWs.

2) The mapping process would be objective and result in a RW assignment consistent with that of the level of credit risk reflected in the tables above (for the respective RW category). It would cover the full spectrum of RWs.

3) When conducting such a mapping process, factors that supervisors should assess include, among others:

    a) The size and scope of the pool of issuers that each CRA covers;

    b) The range and meaning of the ratings that it assigns; and

    c) The definition of default used by the CRA.

4) LFIs must use the chosen CRAs and their ratings consistently for all types of claim where they have been recognised by their supervisor as an eligible CRA, for both risk-weighting and risk management purposes.
5) LFIs will not be allowed to "cherry-pick" the ratings provided by different CRAs and to arbitrarily change the use of CRAs.

6) If there is only one rating by a CRA chosen by an LFI for a particular claim, that rating should be used to determine the RW of the exposure.

7) If there are more than one rating by CRAs chosen by an LFI that map into different RWs, the higher RW will be applied.

A. 3 Determination of whether an exposure is rated: Issue-specific and issuer ratings

1) Where an LFI invests in a particular issue that has an issue-specific assessment, the RW of the claim will be based on this assessment.

2) Where the claim is an investment in an issue that has not been specifically assessed, the LFI can rely on a specific credit assessment of an issued debt and/or on a credit assessment of the issuer. The following general principles will apply:
   a) Where the borrower has a specific rating for an issued debt – but the LFI's exposure is not an investment in this particular debt – a high-quality credit rating (one which maps into a RW lower than that which applies to an unrated claim) on that specific debt may only be applied to the LFI's unrated exposure if this claim ranks in all respects pari passu or senior to the claim with a rating. If not, the external rating cannot be used and the unassessed claim will receive the RW for unrated exposures.
   b) Where the borrower has an issuer rating, this rating typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a high-quality issuer rating. Other unassessed exposures of a highly rated issuer will be treated as unrated. If either the issuer or a single issue has a low-quality rating (mapping into a RW equal to or higher than that which applies to unrated exposures), an unassessed exposure to the same counterparty that ranks pari passu or is subordinated to either the senior unsecured issuer rating or the exposure with a low-quality rating will be assigned the same RW as is applicable to the low-quality assessment.

c) Where the issuer has a specific high-quality rating (one which maps into a lower RW) that only applies to a limited class of liabilities (such as a deposit assessment or a counterparty risk assessment), this may only be used in respect of exposures that fall within that class.

3) Whether LFIs 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 LFIs have with regard to all payments owed to them.

A.4 Recognised CRAs

1) The following CRAs will be recognised for capital adequacy purposes:
(a) CariCRIS;
(b) Moody's Investors Service;
(c) Standard and Poor's (S&P);
(d) Fitch Rating Services;

2) The list of eligible CRAs will be updated subject to applicants satisfying the eligibility criteria outlined above.

3) The ratings of the respective CRAs are to be mapped as follows:

Short Term Rating

S&P	Fitch		Moody	CariCRIS	
				Regional	National
A-1	F-1		P-1	CariP1/P1+	P1/P1+
A-2	F-2		P-2	CariP2/P2+	P2/P2+
A-3	F-3		P-3	CariP3/P3+	P3/P3+

Long term Rating

S&P	Fitch	Moody's	CariCRIS
AAA to AA-	AAA to AA-	Aaa to Aa3	AAA
A1 to A3	A+ to A-	A1 to A3	AAA
BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	AA+ to AA-
BB+ to B-	BB+ to B-	Ba1 to B3	A+ to BBB-

S&P	Fitch	Moody's	CariCRIS
Below B- (that is, or CCC+ and below)	Below B- (that is, or CCC+ and below)	Below B3 Caa1+ and below	BB+ and below
Unrated	Unrated	Unrated	Unrated

A.5 Short Term / Long Term Assessments

1) For risk-weighting purposes, short-term ratings are deemed to be issue-specific. They can only be used to derive RWs for exposures arising from the rated facility. They cannot be generalised to other short-term exposures, except under the conditions where short-term ratings are available (see below).
2) In no event can a short-term rating be used to support a RW for an unrated long-term exposure. Short-term ratings may only be used for short-term exposures against LFIs and corporates.

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

Short Term Rating				
S&P / Moody's	**Fitch**	**CariCRIS (Regional)**	**CariCRIS (National)**	**Risk Weight**
A-I /P-I[58]	F1	CariP1/P1+	P1/P1+	20%
A2/P-2	F2	CariP2/P2+	P2/P2+	50%
A3/P3	F3	CariP3/P3+	P3/P3+	100%
Others[59]				150%

4) If a short-term rated facility attracts a 50.0 per cent RW, unrated short-term exposures cannot attract a RW lower than 100.0 per cent.

5) If an issuer has a short-term facility with an external rating that warrants a RW of 150.0 per cent, all unrated exposures, whether long-term or short-term, should also receive a 150.0 per cent RW, unless the bank uses recognised CRM techniques for such exposures.

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[58] 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 "- ".

[59] This category includes all non-prime and B or C ratings.

6) In cases where short-term ratings are available, the following interaction with the general preferential treatment for short-term exposures to LFIs will apply (see section 8.1.4):
   a) The general preferential treatment for short-term exposures applies to all exposures to LFIs of up to three months' original maturity when there is no specific short-term claim assessment.
   b) When there is a short-term rating and such a rating maps into a RW that is more favourable (that is, lower) or identical to that derived from the general preferential treatment, the short-term rating should be used for the specific exposure only. Other short-term exposures would benefit from the general preferential treatment.
   c) When a specific short-term rating for a short-term exposure to an LFI maps into a less favourable (higher) RW, the general short-term preferential treatment for interbank exposures cannot be used. All unrated short-term exposures should receive the same RW as that implied by the specific short-term rating.
7) When a short-term rating is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognising CRAs, as described in section A.1, in terms of its short-term ratings.

A.6 Other issues

1) 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.

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

3) Level of application of the rating: external assessments for one entity within a corporate group cannot be used to RW other entities within the same group.

4) As a general rule, LFIs should use solicited ratings from eligible CRAs. The Central Bank may allow LFIs to use unsolicited ratings in the same way as solicited ratings, if it is satisfied that the credit assessments of unsolicited ratings are not inferior in quality to the general quality of solicited ratings.

APPENDIX II: SECURITISATION FRAMEWORK

I. Introduction

This section provides a simplified securitisation framework to be applied to those LFIs active in securitisation activities. However, certain transactions, such as synthetic securitisations or resecuritisations is not allowed without explicit authorisation from the Central Bank. This securitisation framework includes elements from both Basel II and Basel III.

II. Definitions

LFIs' exposures to securitisation are hereinafter referred to as "securitisation exposures". Securitisation exposures can include but are not restricted to the following: asset-backed securities (ABS), mortgage-backed securities (MBS), credit enhancements and liquidity facilities. Underlying instruments in the pool being securitised may include but are not restricted to the following: loans, commitments, ABS and MBS, corporate bonds, equity securities, and private equity investments. The underlying pool may include one or more exposures.

This section of the Standard employs the interpretation established in the Banking Act, 2015. However, the following terms are defined for the purpose of this section:

a) A traditional securitisation is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. The stratified/tranched structures that characterise securitisations differ from ordinary senior/subordinated debt instruments in that junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

b) Originating bank: for risk-based capital purposes, a bank is considered to be an originator with regard to a certain securitisation if it meets either of the following conditions:

   i) The bank originates directly or indirectly underlying exposures included in the securitisation; or

   ii) The bank serves as a sponsor of an asset-backed commercial paper (ABCP) conduit or similar programme that acquires exposures from third-party entities.

c) ABCP programme: this programme predominantly issues commercial paper to third-party investors with an original maturity of one year or less and is backed by assets or other exposures held in a bankruptcy-remote, special purpose entity.

d) Clean-up call: is an option that permits the securitisation exposures (for example, ABS) to be called before all of the underlying exposures or securitisation exposures have been repaid.

e) Credit enhancement: is a contractual arrangement in which the financial institution or other entity retains or assumes a securitisation exposure and, in substance, provides some degree of added protection to other parties to the transaction. This can also be achieved by providing additional collateral (for example, over-collaterialisation) or third party guarantee.

f) Early amortisation: is a mechanism that, once triggered, accelerates the reduction of the investor's interest in underlying exposures of a securitisation of revolving credit facilities and allows investors to be paid out prior to the originally stated maturity of the securities issued. A securitisation of revolving credit facilities is a securitisation in which one or more underlying exposures represent, directly or indirectly, current or future draws on a revolving credit facility. Examples of revolving credit facilities include but are not limited to credit card exposures, home equity lines of credit, commercial lines of credit, and other lines of credit.

g) Excess spread (or future margin income): is defined as gross finance charge collections and other income received by the trust or special purpose entity minus certificate interest, servicing fees, charge-offs, and other senior SPE or trust expenses.

h) Implicit support: arises when a financial institution provides support to a securitisation in excess of its predetermined contractual obligation.

i) Mortgage backed securities: mortgage backed securities means securitisation notes/securities issued by the Special purpose entity (SPE) against underlying exposures that are all secured by commercial or residential real estate mortgages. In cases where securities issued are all secured by residential mortgages, these are referred to as residential mortgage backed securities.

j) Securitisation: is a structure where a pool of assets is transferred by an originator to a SPE and the cash flow from this pool of assets is used to service securitisation exposures of at least two different tranches reflecting different degrees of credit risk, where payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the originator.

k) Securitisation exposure amount: for risk-based capital purposes, is the sum of the on-balance sheet amount of the exposure, or carrying value – which takes into account purchase discounts and write-downs / specific provisions the bank took on this securitisation exposure – and the off-balance sheet exposure amount, where applicable.

l) Senior securitisation exposure (tranche): is considered so, if it is effectively backed or secured by a first claim on the entire amount of the assets in the underlying securitised pool.

m) Special purpose entity (SPE): is a corporation, trust or other entity organised for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE, and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. SPEs, normally a trust or similar entity, are commonly used as financing vehicles in which exposures are sold to the SPE in exchange for cash or other assets funded by debt issued by the trust. Any reference to SPE in this standard would also refer to the trust settled or declared by the SPE as a part of the process of securitisation.

n) Tranche: is a contractually established segment of the pool of exposures. It means a piece, fragment or slice of a securitisation/structured financing. It is basically a collection of securities that are separated and grouped based on various characteristics and sold to investors. Tranches can have different maturities, credit ratings, and yields– or interest rates.

o) Tranche maturity: for risk-based capital purposes, tranche maturity (MT) is the tranche's remaining effective maturity in years.

III. OPERATIONAL REQUIREMENTS FOR THE RECOGNITION OF RISK TRANSFERENCE

A. Operational requirements for traditional securitisations

An originating LFI may exclude underlying exposures from the calculation of RWA only if all of the following conditions have been met.

a) Significant credit risk associated with the underlying exposures has been transferred to third parties.

b) The transferor does not maintain effective or indirect control over the transferred exposures. The exposures are legally isolated from the transferor in such a way that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. LFIs should obtain legal opinion that confirms true sale.

c) The transferor is deemed to have maintained effective control over the transferred credit risk exposures if it:

   i. Is able to repurchase from the transferee the previously transferred exposures in order to realise their benefits; or

   ii. Is obligated to retain the risk of the transferred exposures. The transferor's retention of servicing rights to the exposures will not necessarily constitute indirect control of the exposures.

d) The securities issued are not obligations of the transferor. Thus, investors who purchase the securities only have claim to the underlying exposures.

e) The transferee is an SPE and the holders of the beneficial interests in that entity have the right to pledge or exchange them without restriction.

f) Clean-up calls must satisfy the conditions set out in the operational requirements and treatment of clean-up calls (see section C.).

g) The securitisation does not contain clauses that:

   i. Require the originating LFI to alter the underlying exposures such that the pool's credit quality is improved unless this is achieved by selling exposures to independent and unaffiliated third parties at market prices;

   ii. Allow for increases in a retained first-loss position or credit enhancement provided by the originating LFI after the transaction's inception; or

   iii. Increase the yield payable to parties other than the originating LFI, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.

h) There must be no termination options/triggers except eligible clean-up calls, termination for specific changes in tax and regulation or early amortisation provisions.

LFIs meeting these conditions must still hold regulatory capital against any securitisation exposures they retain.

B. Operational requirements for securitisations containing early amortisation provisions

A securitisation transaction is deemed to fail the operational requirements set out in section III. A. if:

(a) The LFI originates/sponsors a securitisation transaction that includes one or more revolving credit facilities, and
(b) The securitisation transaction incorporates an early amortisation or similar provision that, if triggered, would:

i. Subordinate the LFI's senior or pari passu interest in the underlying revolving credit facilities to the interest of other investors;
ii. Subordinate the LFI's subordinated interest to an even greater degree relative to the interests of other parties; or
iii. In other ways, increase the LFI's exposure to losses associated with the underlying revolving credit facilities.

If a securitisation transaction contains one of the following examples of an early amortisation provision and meets the operational requirements set forth in section III. A. an originating LFI may exclude the underlying exposures associated with such a transaction from the calculation of RWA, but must still hold regulatory capital against any securitisation exposures they retain in connection with the transaction:

(a) Replenishment structures where the underlying exposures do not revolve and the early amortisation ends the ability of the LFI to add new exposures;

(b) Transactions of revolving credit facilities containing early amortisation features that mimic term structures (that is, where the risk on the underlying revolving credit facilities does not return to the originating LFI) and where the early amortisation provision in a securitisation of revolving credit facilities does not effectively result in subordination of the originator's interest;

(c) Structures where an LFI securitises one or more revolving credit facilities and where investors remain fully exposed to future drawdowns by borrowers even after an early amortisation event has occurred; or

(d) The early amortisation provision is solely triggered by events not related to the performance of the underlying assets or the selling LFIs, such as material changes in tax laws or regulations.

C. Operational requirements and treatment of clean-up calls

For securitisation transactions that include a clean-up call, no capital will be required due to the presence of a clean-up call if the following conditions are met:

i. The exercise of the clean-up call must not be mandatory, in form or in substance, but rather must be at the discretion of the originating LFIs;
ii. The clean-up call must not be structured to avoid allocating losses to credit enhancements or positions held by investors or otherwise structured to provide credit enhancement; and
iii. The clean-up call must only be exercisable when 10.0 per cent or less of the original underlying portfolio or securities issued remains.

Securitisation transactions that include a clean-up call that does not meet all the criteria stated in the previous paragraph result in a capital requirement for the originating LFIs. For a traditional securitisation, the underlying exposures must be treated as if they were not securitised. Additionally, LFIs must not recognise in regulatory capital any gain on sale.

If a clean-up call, when exercised, is found to serve as a credit enhancement, the exercise of the clean-up call must be considered a form of implicit support provided by the LFIs and must be treated in accordance with the supervisory guidance pertaining to securitisation transactions.

IV. DUE DILIGENCE REQUIREMENTS

For an LFI to use the risk weight approaches of the securitisation framework, it must have the information specified in the next three paragraphs. Otherwise, the LFI must assign a 1250.0 per cent RW to any securitisation exposure for which it cannot perform the required level of due diligence.

As a general rule, an LFI must, on an ongoing basis, have a comprehensive understanding of the risk characteristics of its individual securitisation exposures, whether on- or off-balance sheet, as well as the risk characteristics of the pools underlying its securitisation exposures.

LFIs must be able to access performance information on the underlying pools on an ongoing basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographical diversification.

An LFI must have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of the LFI's exposures to the transaction, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

V. IMPLICIT SUPPORT

Implicit support arises when an LFI provides support to a securitisation in excess of its predetermined contractual obligation. When an LFI provides implicit support to a securitisation, it must, at a minimum, hold capital against all of the underlying exposures associated with the securitisation transaction as if they had not been securitised. Additionally, LFIs would not be permitted to recognise in regulatory capital any gain on sale. Furthermore, the LFI is required to disclose publicly that:

(a) It has provided non-contractual support; and
(b) The capital impact of doing so.

VI. TREATMENT OF CREDIT RISK MITIGATION FOR SECURITISATION EXPOSURES

An LFIs may recognise credit protection purchased on a securitisation exposure when calculating capital requirements subject to the following:

(a) Collateral recognition is limited to that permitted under the credit risk mitigation framework (see section 8.2 of this Standard);

(b) Credit protection provided by the entities listed in this Standard may be recognised; and

(c) Where guarantees fulfil the minimum operational conditions as specified in this Standard, LFIs can take account of such credit protection in calculating capital requirements for securitisation exposures.

Collateral in this context refers to that which is used to hedge the credit risk of a securitisation exposure rather than the underlying exposures of the securitisation transaction.

Full or proportional cover

When an LFI provides full (or pro rata) credit protection to a securitisation exposure, the LFIs must calculate its capital requirements as if it directly holds the portion of the securitisation exposure on which it has provided credit protection (see section II (l)).

Provided that the conditions set out before are met, the LFI buying full (or pro rata) credit protection may recognise the CRM on the securitisation exposure in accordance with the CRM framework.

Tranched protection

In the case of tranched credit protection, the original securitisation tranche will be decomposed into protected and unprotected sub-tranches:

(a) The protection provider must calculate its capital requirement as if directly exposed to the particular sub-tranche of the securitisation exposure on which it is providing protection, and as determined by the hierarchy of approaches for securitisation exposures and according to the paragraphs that follow.

(b) Provided that the conditions set out in paragraph credit protection recognition are met, the protection buyer may recognise tranched protection on the securitisation exposure.