GUERNSEY FINANCIAL SERVICES COMMISSION
ISLE OF MAN FINANCIAL SUPERVISION COMMISSION
JERSEY FINANCIAL SERVICES COMMISSION

DISCUSSION PAPER ON:

BASEL III LEVERAGE RATIO

Issued: 27 June 2014

GLOSSARY OF TERMS

The following table sets out a glossary of terms used in this paper.

Basel Committee	Basel Committee on Banking Supervision
Basel II	"*International Convergence of Capital Measurement and Capital Standards*", re-issued in comprehensive form in June 2006 by the Basel Committee
Basel III	Collectively, a series of documents issued by the Basel Committee that either revise Basel II or establish new international standards regarding the financial management of international banks
Basel III capital adequacy standard	"*A global regulatory framework for more resilient banks and banking systems*", issued in December 2010 by the Basel Committee and revised in June 2011
Capital Paper	Tri-Party Group Discussion Paper on Basel III: Capital Adequacy issued in December 2013
Capital Requirements Regulation	REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms
CCF	Credit Conversion Factor
CDs	Crown Dependencies – Guernsey, Isle of Man and Jersey
CET1	Common Equity Tier 1 capital
Initial DP	Tri-Party Group " Discussion Paper on Basel III", issued in September 2012
EBA	European Banking Authority
FPC	Financial Policy Committee
GFSC	Guernsey Financial Services Commission
D-SIBs	Domestic Systemically Important Banks
G-SIBs	Global Systemically Important Banks
IOMFSC	Isle of Man Financial Supervision Commission
JFSC	Jersey Financial Services Commission
Leverage Ratio Paper	"Basel III leverage ratio framework and disclosure requirements" issued in January 2014 by the Basel Committee.
MNA	Master Netting Agreement
OBS	Off-Balance Sheet
PRA	(UK) Prudential Regulation Authority
RC	Replacement Cost
SFT	Securities Financing Transaction
Tri-Party Group	comprises the GFSC, IOMFSC and JFSC

CONTENTS

Glossary of Terms 2

Contents 3

INTRODUCTION 4

1. Background 4
2. International Developments 5

LEVERAGE RATIO PROPOSAL 7

3. Leverage Ratio Proposal for the Crown Dependencies 7
4. Proposed reporting format 8
5. Leverage ratio definition and reporting guidance 9

Appendix A Leverage ratio reporting template 11

Appendix B Detailed completion notes for derivative and SFT exposures 12

Appendix C Netting 17

INTRODUCTION

1 Background

1.1 In June 2006, the Basel Committee on Banking Supervision ("**Basel Committee**") issued, in comprehensive form, a framework for supervisory regulations governing the capital adequacy of international banks. This document, "*International Convergence of Capital Measurement and Capital Standards*", has become known as "**Basel II**".

1.2 Latterly, the Basel Committee has worked to revise Basel II. This work has resulted in a number of documents being issued that either revise Basel II or establish new international standards regarding the financial wellbeing of international banks. Collectively, this initiative is described by the Basel Committee as "**Basel III"** and it encompasses both capital adequacy and liquidity measures.

1.3 The Tri-Party Group - The Jersey Financial Services Commission ("**JFSC**"), Guernsey Financial Services Commission ("**GFSC**") and Isle of Man Supervision Commission ("**IOMFSC**") - worked together to establish a unified approach, reflecting our similar responsibilities as host supervisors, wherever possible, to implementing Basel II during the period 2005 to 2008.

1.4 The Tri-Party Group distributed a Discussion Paper on Basel III in September 2012 (the **"Initial DP")** to all banks that are incorporated in the Crown Dependencies ("**CDs**") – Guernsey, Isle of Man and Jersey - to provide information on Basel III and an indication of the Group's initial views and in order to solicit feedback.

1.5 The Tri-Party Group distributed a further Discussion Paper on Basel III: Capital Adequacy (the "**Capital Paper**") in December 2013. The Capital Paper contained detailed proposals regarding capital adequacy, building on those in the Initial DP and feedback received to it. The Capital Paper also indicated that proposals with respect to the implementation of a Leverage Ratio framework would follow and such proposals are made herein. In January 2014, a further Discussion Paper was issued on "Domestic Systemically Important Banks ("**D-SIBS**") (including Recovery and Resolution)".

1.6 The Tri-Party Group is distributing this paper to all banks incorporated in the CDs to provide information on the proposed approach in the CDs and solicit feedback as part of the wider work on Basel III. A period of three months to 26 September 2014 has been set aside for this. Banks are asked to submit feedback to their supervisor but be aware that the content of feedback will be made available to the other CD supervisors on a no-names basis.

1.7 This paper contains detailed proposals for a leverage ratio reporting framework in the CDs, building on proposals in the Initial DP and feedback received to it. In addition to the proposals of the Tri-Party Group, questions are also raised in order to prompt feedback on these proposals.

2 International developments

Basel III

2.1 The Basel Committee set out its original proposals for implementation of a leverage ratio in "*A global regulatory framework for more resilient banks and banking systems*", issued in December 2010 and revised June 2011[1]. These proposals were subject to further revision and the current version of the framework is described in the Committee's paper "*Basel III leverage ratio framework and disclosure requirements*"[2] ("**The Leverage Ratio Paper**"), issued in January 2014.

2.2 Basel III proposes the introduction of a minimum regulatory leverage ratio to supplement risk-based capital requirements. The Basel II risk-based capital requirements failed to prevent the build-up of excessive on- and off-balance sheet leverage in the global banking system prior to the financial crisis. The objective of the leverage ratio is to constrain leverage build up while providing a simple, transparent "backstop" measure to reinforce risk-based requirements.

2.3 Implementation of the leverage ratio requirement in Basel Committee member jurisdictions began with reporting to supervisors from 1 January 2013, from which time it is available to be used by supervisors as part of their Pillar 2 approach, and will continue with public disclosure starting 1 January 2015. The Basel Committee will consider final adjustments to the definition and calibration of the leverage ratio and, if agreed, these will be made by 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018. A minimum requirement for total Tier 1 capital of 3% of adjusted assets for the leverage ratio is being tested during the parallel run period (i.e. from 1 January 2013 to 1 January 2017).

*European Capital Requirements Regulation ("**CRR**")*

2.4 The CRR introduces a reporting requirement for banks to calculate a leverage ratio (calculated broadly on a consistent basis as that under Basel III). The CRR requires firms to disclose the leverage ratio from 2015 and the EBA will undertake a review of the leverage ratio framework in 2016 with a view to the European Commission introducing legislation for a minimum requirement in 2017.

Switzerland

2.5 The Swiss G-SIBs were required to fulfil a Basel III consistent leverage ratio requirement from 2013 with other banks to begin test reporting during 2014. A proposal to raise the leverage ratio requirement for Swiss G-SIBs is under consideration with levels between 6% and 10% having been discussed.

UK Banking Reform

2.6 The CRR will apply in the UK as it is directly applicable in all Member States without the need for implementation by a national legal instrument. Certain steps have, however,

[1] http://www.bis.org/publ/bcbs189.htm
[2] http://www.bis.org/publ/bcbs270.pdf

been taken to adopt earlier use of the leverage ratio in the UK. The interim Financial Policy Committee (“**FPC**”) recommended that the largest UK banks publicly disclose their leverage ratios; such disclosures began last year in respect of the 2012 financial year end. In June 2013, the PRA completed its capital shortfall exercise, which responded to the interim FPC's March 2013 recommendations on capital adequacy of major UK banks and building societies. This included requiring two banks to produce plans to meet capital shortfalls in respect of a 3% Common Equity Tier 1 (“**CET1**”) based leverage ratio after adjustments (it should be noted that the numerator used was CET1 as opposed to total Tier 1 Capital under Basel III).

LEVERAGE RATIO PROPOSAL

3 Leverage Ratio Proposal for the Crown Dependencies

3.1 With respect to the implementation of a leverage ratio requirement in the CDs, no decision has been made as yet. The Tri-Party Group has previously proposed that in considering whether adoption of any aspect of Basel III is appropriate, where such aspects identify and address shortcomings in Pillars 1 and 2, as already adopted in the CDs, then these should be implemented, unless a counter-argument can be made.

3.2 The leverage ratio is intended as a complementary measure to the risk-based capital adequacy framework under Pillars 1 and 2 and addresses potential model risk and measurement error under Pillar 1 by complementing the risk-based measure with a simple, transparent and independent measure of risk. Concerns over the ability of the leverage ratio to adequately capture off balance sheet exposures are perhaps less relevant in the CDs where, typically, banks' exposures are dominated by balance sheet exposures.

3.3 In response to the Initial DP, several banks raised concerns about the implementation of a leverage ratio as an additional minimum regulatory requirement. There was concern that such a minimum requirement may be irrelevant, particularly in respect of subsidiaries which engage in up-streaming to parent, and that implementation may constrain business. Some banks suggested that an alternative measure adjusted for exposures to parent may be used or that a leverage ratio should not be applied to up-streaming banks at all. Both suggestions rely on a view that exposures to group present a lower risk than third party exposures and therefore that the leverage ratio requirement should be adjusted to compensate for differing levels of risk.

3.4 The observation can be made that experience during the recent financial crisis was that exposure to the parent via up-streaming was a significant source of risk in the cases of those institutions which experienced stress. To ignore up-streaming would therefore seem to be inappropriate. The observation can also be made, of course, that there is already a risk-weighted leverage framework in place, i.e. the current minimum regulatory capital requirement based on Risk Weighted Assets. The purpose of the leverage ratio is to provide a simple, non-risk based model to complement existing measures and therefore it is proposed that there should be no modification to the calculation or application of the ratio.

3.5 However, the Tri-Party Group does acknowledge that implementation of a Leverage Ratio may have the potential to constrain banks' business and therefore there is no proposal to introduce the leverage ratio as a minimum regulatory requirement until there is a full understanding of both the degree of leverage in the CDs' banking sectors and the impact of the implementation of a leverage ratio standard.

3.6 It is, therefore, proposed that banks in the CDs should be required to report a leverage ratio before the end of 2015. Any decision with respect to the implementation, and calibration, of a minimum regulatory requirement will be deferred.

3.7 It should be noted, however, that in the absence of a minimum regulatory requirement based on the leverage ratio, CD supervisors continue to have the option to take banks' leverage levels into consideration in their review of banks' capital adequacy under Pillar 2.

4 Proposed reporting format

4.1 The decision has been taken to utilise, to the extent possible, the templates contained in the Leverage Ratio Paper. This sets out a leverage ratio disclosure framework for internationally active banks. The framework appears to be adequate for reporting purposes and many of the banks incorporated in the CDs will be subject to either it or similar disclosure requirements on a consolidated level.

4.2 Section 5 sets out the Tri-Party Group proposal for the reporting framework and the basis for the calculation of the leverage ratio.

4.3 It is proposed that timescales for implementation of the leverage ratio reporting framework be aligned with those for the implementation of the revisions to the definition of capital as set out in the Capital Paper. Local timescales for introduction would be established by the relevant supervisor, with local-only consultation, in order to ensure practical issues are addressed.

4.4 The Tri-Party Group proposes that only locally incorporated banks should be included within the scope of the proposed leverage ratio reporting requirement. Branches of overseas banks would be outside the scope of this proposal.

4.5 It is proposed that reporting be provided on a quarterly basis, as part of the local prudential reporting framework in each island.

1. ***Question: Do you agree that the proposed scope of application of the framework is appropriate?***

2. ***Question: Do you agree that the proposed frequency of reporting is appropriate?***

5 Leverage ratio definition and reporting guidance

Leverage ratio definition

5.1 It is proposed that the leverage ratio is defined as the Capital Measure (the numerator) divided by the Exposure Measure (the denominator), with this ratio expressed as a percentage.

5.2 It is proposed that the Capital Measure for the leverage ratio is Tier 1 capital as defined in section 5 of the Capital Paper.

5.3 It is proposed that the Exposure Measure for the leverage ratio should generally follow the accounting measure of assets subject to the following principles:

- on-balance sheet, non-derivative exposures are included in the Exposure Measure net of specific provisions and valuation adjustments (e.g. credit valuation adjustments);

- netting of loans and deposits is not allowed.

5.4 Physical or financial collateral, guarantees or credit risk mitigation purchased would not be allowed to reduce on-balance sheet exposures.

5.5 A bank's total Exposure Measure would be the sum of the following exposures: (a) on-balance sheet exposures, (b) derivative exposures, (c) securities financing transaction exposures, and (d) other off-balance sheet exposures. The specific treatment for these four main exposure categories is defined in the guidance below.

3. *Question: Do you agree that Tier 1 capital is the appropriate numerator for the leverage ratio?*

Reporting guidance

5.6 The proposed reporting form for the leverage ratio and its components is set out in **Appendix A**.

On-balance sheet exposures

5.7 It is proposed to require that Item 1, "*On-balance sheet assets*", be used to report *all* on-balance sheet assets in the Exposure Measure including on-balance sheet derivative collateral and collateral for securities financing transactions ("**SFTs**")[3] (but excluding on-balance sheet derivative and SFT assets that are covered in paragraph 5.10 and in detail in Appendix B).

5.8 It is proposed to require that Item 2, "*Assets deducted in determining Basel III Tier 1 capital*", be used to report on-balance sheet assets deducted from Tier 1 capital. To ensure consistency, on-balance sheet assets deducted from Tier 1 capital (as set out in paragraphs 5.16 to 5.43 and paragraphs 6.19 to 6.25 of the Capital Paper) should be

[3] Securities Financing Transactions are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depend on market valuations and the transactions are often subject to margin agreements.

deducted from the Exposure Measure. It should be noted that liability items (e.g. gains and losses due to changes in own credit risk on fair valued liabilities) should not be deducted from the Exposure Measure.

5.9 It is proposed to require that Item 3, "*Total on-balance sheet exposures*", would then be computed as the sum of Item 1 and Item 2.

Derivative and SFT exposures

5.10 Whilst levels of derivative and SFT exposures are minimal in most banks, it is considered appropriate to require reporting based on the full requirements of Basel III so that they are appropriately handled in cases where they are relevant. Full completion guidance, only relevant to banks with such exposures, is provided in Appendix B.

Other Off-balance sheet exposures

5.11 It is proposed that Item 17, "*Off-balance sheet exposure at gross notional amount*", be used to report total off-balance sheet ("OBS") exposure on a gross notional basis, before any adjustment for credit conversation factors according to paragraph 5.12.

5.12 It is proposed that Item 18, "*Adjustments for conversion to credit equivalent amount*", be used to report a negative amount representing the reduction in gross amount of OBS exposures due to the application of credit conversion factors ("**CCFs**"). The CCFs are those that apply under the Standardised Approach to Credit Risk, except that they are subject to a floor of 10%.

5.13 It is proposed that Item 19, "*Other off-balance sheet exposure*", would then be computed as the sum of Items 17 and 18.

Leverage Ratio

5.14 It is proposed that Item 20 "*Tier 1 capital*", be used to report Tier 1 capital as defined under section 5 of the Capital Paper as at the reporting date.

5.15 It is proposed that Item 21, "*Total Exposures*", would then be computed as the sum of Items 3, 11, 16 and 19.

5.16 It is proposed that Item 22, "*Basel III leverage ratio*", would be computed as Item 20 divided by Item 21 with the ratio expressed as a percentage.

4. ***Question:*** **Are there any obstacles to calculation of the leverage ratio?**

APPENDIX A

Leverage ratio reporting template		
	Item	Leverage Ratio Framework
	On-balance sheet exposures	
1	On-balance sheet items (exclude derivatives and SFTs; include collateral)	
2	(Assets deducted in determining Basel III Tier 1 capital)	
3	**Total on-balance sheet exposures** (excluding derivatives and SFTs)	
	Derivative exposures	
4	Replacement cost (net of eligible cash variation margin)	
5	Add-on amount	
6	Gross up for derivatives collateral provided	
7	(Deductions of receivables assets for cash variation margin provided in derivatives transactions)	
8	(Exempted CCP leg of client-cleared trade exposures)	
9	Gross notional credit derivatives sold	
10	(Notional offsets and add-on deductions for written credit derivatives)	
11	**Total derivative exposures**	
	Securities financing transaction exposures	
12	Gross SFT assets (with no recognition of accounting netting), after adjusting for sale accounting transactions	
13	(Netted amounts of cash payables and cash receivables of gross SFT assets)	
14	SFT counterparty exposure	
15	Agent transaction exposures	
16	**Total securities financing transaction exposures**	
	Other off-balance sheet exposures	
17	Off-balance sheet exposure at gross notional amount	
18	Adjustments for conversion to credit equivalent amount	
19	**Other off-balance sheet exposures**	
	Capital and Total Exposures	
20	**Tier 1 capital** (end of reporting period value)	
21	**Total Exposures** (end of reporting period value)	
	Leverage Ratio	
22	**Basel III leverage ratio (%)**	

APPENDIX B - Detailed completion notes for derivative and SFT exposures

Derivative Exposures

1 It is proposed that banks calculate their derivative exposures, including where a bank sells protection using a credit derivative, as the replacement cost ("RC") for the current exposure plus an add-on for potential future exposure ("PFE"), as calculated under the Standardised Approach to Credit Risk).

2 It is proposed to require that Item 4, "*Replacement cost*", be used to report the bank's RC for all of its derivatives exposures (equivalent to the "Positive Mark-to-Market" element of the Credit Equivalent Amount as calculated under the Standardised Approach to Credit Risk).

3 It is proposed to require that Item 5, "*Add-on amount*", be used to report the add-on for PFE (equivalent to the "Add-on Amount" element of the Credit Equivalent Amount as calculated under the Standardised Approach to Credit Risk).

4 Collateral received does not necessarily reduce the economic leverage inherent in a bank's derivatives position and, therefore, as a general rule, collateral received may not be netted against derivatives exposures whether or not netting is permitted under the bank's operative accounting or risk-based framework. When calculating the exposure amount a bank must not reduce the exposure amount by any collateral received from the counterparty. Furthermore, the RC must be grossed up by any collateral amount used to reduce its value, including when collateral received by a bank has reduced the derivatives assets reported on-balance sheet under its operative accounting framework.

5 With regard to *collateral provided*, banks must gross up their exposure measure by the amount of any derivatives collateral provided where the provision of that collateral has reduced the value of their balance sheet assets under their operative accounting framework. Item 6 should be used to report this amount.

6 Item 7, "*Deductions of receivables assets for cash variation margin provided in derivatives transactions*" should be used to report adjustments permitted regarding the treatment of cash variation margin. In the treatment of derivative exposures for the purpose of the leverage ratio, the cash portion of variation margin exchanged between counterparties may be viewed as a form of pre-settlement payment (and hence not as collateral), if the following conditions are met:

(i) For trades not cleared through a qualifying central counterparty (QCCP)[4] the cash received by the recipient counterparty is not segregated.

[4] A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a central counter party (CCP) (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

(ii) Variation margin is calculated and exchanged on a daily basis based on mark-to-market valuation of derivatives positions.

(iii) The cash variation margin is received in the same currency as the currency of settlement of the derivative contract.

(iv) Variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty.

(v) Derivatives transactions and variation margins are covered by a single master netting agreement (MNA)[5] between the legal entities that are the counterparties in the derivatives transaction. The MNA must explicitly stipulate that the counterparties agree to settle net any payment obligations covered by such a netting agreement, taking into account any variation margin received or provided if a credit event occurs involving either counterparty. The MNA must be legally enforceable and effective in all relevant jurisdictions, including in the event of default and bankruptcy or insolvency.

7 If the conditions in paragraph 6 are met, the cash portion of variation margin received may be used to reduce the RC reported in Item 4, and the receivables assets from cash variation margin provided may be deducted from the leverage ratio exposure measure using Item 7, as follows:

7.1 In the case of cash variation margin received, the receiving bank may reduce the RC (but not the PFE reported) of the exposure amount of the derivative asset by the amount of cash received if the RC of the derivative contract(s) has not already been reduced by the same amount of cash variation margin received under the bank's operative accounting standard.

7.2 In the case of cash variation margin provided to a counterparty, the posting bank may deduct the resulting receivable from its leverage ratio exposure measure, where the cash variation margin has been recognised as an asset under the bank's operative accounting framework.

For the avoidance of doubt, cash variation margin may not be used to reduce the PFE amount.

8 It is proposed that Item 8 "Exempted CCP leg of client-cleared trade exposures" be used to report certain deductions relating to the treatment of clearing services. Where a bank acting as clearing member (CM)[6] offers clearing services to clients, the clearing member's trade exposures to the central counterparty (CCP) that arise when the clearing member is

[5] To the extent that the criteria in this paragraph include the term "master netting agreement", this term should be read as including any "netting agreement" that provides legally enforceable rights of offsets.

[6] A clearing member is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.

obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults, must be captured by applying the same treatment that applies to any other type of derivatives transactions. However, if the clearing member, based on the contractual arrangements with the client, is not obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that a QCCP defaults, the clearing member need not recognise the resulting trade exposures to the QCCP in the leverage ratio exposure measure. Hence it should include the exposure in Items 4 and 5 but enter an offsetting negative amount in Item 8.

9 Where a client enters directly into a derivatives transaction with the CCP and the CM guarantees the performance of its clients' derivative trade exposures to the CCP, the bank acting as the clearing member for the client to the CCP must calculate its related leverage ratio exposure resulting from the guarantee as a derivative exposure as set out in paragraphs 1 to 7, as if it had entered directly into the transaction with the client, including with regard to the receipt or provision of cash variation margin, and include the amounts within Items 4 to 7.

10 It is proposed to require that Item 9, "*Gross notional credit derivatives sold*", be used to report the full effective notional value[7] referenced by a written credit derivative. This amount is in addition to any exposure amount reported in relation to the same derivative in Items 4, 5 and 6 and represents the credit exposure arising from the credit worthiness of the reference entity.

11 It is proposed to require that Item 10, "*Notional offsets and add-on deductions for written credit derivatives*" be used to report a negative amount with amount determined as the sum of:

11.1 the effective notional amounts which may be reduced by purchased credit protection (The effective notional amount of a written credit derivative may be reduced by the effective notional amount of a purchased credit derivative on the same reference name provided:

- the credit protection purchased is on a reference obligation which ranks pari passu with or is junior to the underlying reference obligation of the written credit derivative in the case of single name credit derivatives; and
- the remaining maturity of the credit protection purchased is equal to or greater than the remaining maturity of the written credit derivative;

11.2 the effective notional amounts, which may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital with respect to the written credit derivative; and

11.3 the individual add-on amount relating to a written credit derivative (not offset by eligible purchased credit protection) reported under Item 5.

12 It is proposed to require that Item 11, "*Total derivative exposures*" would then be computed as the sum of *Items* 4 to 10.

[7] The effective notional amount is obtained by adjusting the notional amount to reflect the true exposure of contracts that are leveraged or otherwise enhanced by the structure of the transaction.

SFT Exposures

13 It is proposed that Item 12 "*Gross SFT assets (with no recognition of accounting netting)*", be used to report gross SFT assets recognised for accounting purposes (i.e. with no recognition of accounting netting)[8], adjusted to exclude the value of securities received in an SFT where the bank has recognised the securities as an asset on its balance sheet (e.g. under IFRS US GAAP).

14 It is proposed that Item 13 "*Netted amounts of cash payables and cash receivables of gross SFT assets*", be used to report gross SFTs cash payables and cash receivables in SFTs with the same counterparty measured net, if all the following criteria are met:

(a) Transactions have the same explicit final settlement date;

(b) The right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of: (i) default; (ii) insolvency; and (iii) bankruptcy; and

(c) The counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date. To achieve such equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.

15 It is proposed that Item 14, "*SFT counterparty exposure*", be used to report a measure of counterparty credit risk as current exposure, to be calculated as follows:

15.1 Where no qualifying MNA is in place, the current exposure (E^*) for transactions with a counterparty must be calculated on a transaction by transaction basis: that is, each transaction is treated as its own netting set, as shown in the following formula:

$$E^* = \max \{0, [(E) - (C)]\}$$

where E is the total fair value of securities and cash lent and C is the total fair value of cash and securities received under the transaction.

15.2 Where a qualifying MNA[9] is in place, the current exposure (E^*) is the greater of zero and the total fair value of securities and cash lent to a counterparty for all transactions included in the qualifying MNA ($\Sigma(E)$) less the total fair value of

[8] Gross SFT assets recognised for accounting purposes should reflect no recognition of the accounting netting of (cash) payables against (cash) receivables (e.g. as currently permitted under the IFRS and US GAAP accounting frameworks). This regulatory treatment is prudent and has the additional benefit of avoiding inconsistencies from netting which may arise across different accounting regimes.

[9] See Appendix C

cash and securities received from the counterparty for those transactions ($\Sigma(C)$). This is illustrated in the following formula:

$$E^* = \max \{0, [\Sigma(E) - \Sigma(C)]\}$$

16 It is proposed that Item 15, "*Agent transaction exposure*", be used to report exposures arising where a bank acts as an agent in an SFT and provides a guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided. This exposure should be calculated using the same methodology as that used for Item 14.

17 *Adjustment for sales accounting transactions:* leverage may remain with the lender of the security in an SFT whether or not sale accounting is achieved under the operative accounting framework. As such, where sale accounting is achieved for an SFT under the bank's operative accounting framework, the bank must first reverse all sales-related accounting entries, and then calculate its exposure as if the SFT had been treated as a financing transaction under the accounting framework (i.e. in this last step, the bank must include the sum of exposure amounts in Item 12 calculated using the same methodology as that used for Item 12 above for such an SFT) for the purposes of determining its Exposure Measure.

18 It is proposed that Item 16, "*Total securities financing transaction exposures*", would then be computed as the sum of Items 12 to 15.

APPENDIX C

Qualifying master netting agreement: the effects of bilateral netting agreements covering repo-style transactions will be recognised on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must:

(a) provide the non-defaulting party with the right to terminate and close out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;

(b) provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other;

(c) allow for the prompt liquidation or setoff of collateral upon the event of default; and

(d) be, together with the rights arising from provisions required in (a) and (c) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default regardless of the counterparty's insolvency or bankruptcy.

Netting across positions in the banking book and trading book will only be recognised when the netted transactions fulfil the following conditions:

(a) All transactions are marked to market daily, and

(b) The collateral instruments used in the transactions are recognised as eligible financial collateral in the banking book.