

Annex 10

Overview of Methodologies for the Capital Treatment of Transactions Secured by Financial Collateral under the Standardised and IRB Approaches

1. The rules set forth in the standardised approach — Credit Risk Mitigation (CRM), for collateralised transactions generally determine the treatment under both the standardised and the foundation internal ratings-based (IRB) approaches for claims in the banking book that are secured by financial collateral of sufficient quality. Banks using the advanced IRB approach will typically take financial collateral on banking book exposures into account by using their own internal estimates to adjust the exposure's loss given default (LGD). One exception for a bank using the advanced IRB approach pertains to the recognition of repo-style transactions subject to a master netting agreement, as discussed below.

2. Collateralised exposures that take the form of repo-style transactions (i.e. repo/reverse repos and securities lending/borrowing) are subject to special considerations. Such transactions that are held in the trading book are subject to a counterparty risk capital charge as described below. Further, all banks, including those using the advanced IRB approach, must follow the methodology in the CRM section, which is outlined below, for repo-style transactions booked in either the banking book or trading book that are subject to master netting agreements if they wish to recognise the effects of netting for capital purposes.

Standardised and Foundation IRB Approaches

3. Banks under the standardised approach may use either the simple approach or the comprehensive approach for determining the appropriate risk weight for a transaction secured by eligible financial collateral. Under the simple approach, the risk weight of the collateral substitutes for that of the counterparty. Apart from a few types of very low risk transactions, the risk weight floor is 20%. Under the foundation IRB approach, banks may only use the comprehensive approach.

4. Under the comprehensive approach, eligible financial collateral reduces the amount of the exposure to the counterparty. The amount of the collateral is decreased and, where appropriate, the amount of the exposure is increased through the use of haircuts, to account for potential changes in the market prices of securities and foreign exchange rates over the holding period. This results in an adjusted exposure amount, E^* . Banks may either use supervisory haircuts set by the Committee or, subject to qualifying criteria, rely on their "own" estimates of haircuts. Where the supervisory holding period for calculating the haircut amounts differs from the holding period set down in the rules for that type of collateralised transaction, the haircuts are to be scaled up or down as appropriate. Once E^* is calculated, the standardised bank will assign that amount a risk weight appropriate to the counterparty. For transactions secured by financial collateral other than repos subject to a master netting agreement, foundation IRB banks are to use E^* to adjust the LGD on the exposure.

Special Considerations for Repo-Style Transactions

5. Repo-style transactions booked in the trading book, will, like OTC derivatives held in the trading book, be subject to a counterparty credit risk charge. In calculating this charge, a bank under the standardised approach must use the comprehensive approach to collateral; the simple approach will not be available.

6. The capital treatment for repo-style transactions that are not subject to master netting agreements is the same as that for other collateralised transactions. However, for banks using the comprehensive approach, national supervisors have the discretion to determine that a haircut of zero may be used where the transaction is with a core market participant and meets certain other criteria (so-called carve-out treatment). Where repo-style transactions are subject to a master netting agreement whether they are held in the banking book or trading book, a bank may choose not to recognise the netting effects in calculating capital. In that case, each transaction will be subject to a capital charge as if there were no master netting agreement.

7. If a bank wishes to recognise the effects of master netting agreements on repo-style transactions for capital purposes, it must apply the treatment the CRM section sets forth in that regard on a counterparty-by-counterparty basis. This treatment would apply to all repo-style transactions subject to master netting agreements, regardless of whether the bank is under the standardised, foundation IRB, or advanced IRB approach and regardless of whether the transactions are held in the banking or trading book. Under this treatment, the bank would calculate E^* as the sum of the net current exposure on the contract plus an add-on for potential changes in security prices and foreign exchange rates. The add-on may be determined through the supervisory haircuts or, for those banks that meet the qualifying criteria, own estimate haircuts or an internal VaR model. The carve-out treatment for haircuts on repo-style transactions may not be used where an internal VaR model is applied.

8. The calculated E^* is in effect an unsecured loan equivalent amount that would be used for the exposure amount under the standardised approach and the exposure at default (EAD) value under both the foundation and advanced IRB approaches. E^* is used for EAD under the IRB approaches, thus would be treated in the same manner as the credit equivalent amount (calculated as the sum of replacement cost plus an add-on for potential future exposure) for OTC derivatives subject to master netting agreements.