Annex 3

Capital Treatment for Failed Trades and Non-DvP Transactions

I. Overarching principles

1. Banks should continue to develop, implement and improve systems for tracking and monitoring the credit risk exposures arising from unsettled and failed transactions as appropriate for producing management information that facilitates action on a timely basis, pursuant to paragraph 88 and 89 of this Framework.

2. Transactions settled through a delivery-versus-payment system (DvP)[234], providing simultaneous exchanges of securities for cash, expose firms to a risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price (i.e. positive current exposure). Transactions where cash is paid without receipt of the corresponding receivable (securities, foreign currencies, gold, or commodities) or, conversely, deliverables were delivered without receipt of the corresponding cash payment (non-DvP, or free-delivery) expose firms to a risk of loss on the full amount of cash paid or deliverables delivered. The current rules set out specific capital charges that address these two kinds of exposures.

3. The following capital treatment is applicable to all transactions on securities, foreign exchange instruments, and commodities that give rise to a risk of delayed settlement or delivery. This includes transactions through recognised clearing houses that are subject to daily mark-to-market and payment of daily variation margins and that involve a mismatched trade. Repurchase and reverse-repurchase agreements as well as securities lending and borrowing that have failed to settle are excluded from this capital treatment[235].

4. In cases of a system wide failure of a settlement or clearing system, a national supervisor may use its discretion to waive capital charges until the situation is rectified.

5. Failure of a counterparty to settle a trade in itself will not be deemed a default for purposes of credit risk under this Framework.

6. In applying a risk weight to failed free-delivery exposures, banks using the IRB approach for credit risk may assign PDs to counterparties for which they have no other banking book exposure on the basis of the counterparty's external rating. Banks using the Advanced IRB approach may use a 45% LGD in lieu of estimating LGDs so long as they apply it to all failed trade exposures. Alternatively, banks using the IRB approach may opt to apply the standardised approach risk weights or a 100% risk weight.

[234] For the purpose of this Framework, DvP transactions include payment-versus-payment (PvP) transactions.

[235] All repurchase and reverse-repurchase agreements as well as securities lending and borrowing, including those that have failed to settle, are treated in accordance with Annex 4 or the sections on credit risk mitigation of this Framework.

II. Capital requirements

7. For DvP transactions, if the payments have not yet taken place five business days after the settlement date, firms must calculate a capital charge by multiplying the positive current exposure of the transaction by the appropriate factor, according to the Table 1 below.

Table 1

Number of working days after the agreed settlement date	**Corresponding risk multiplier**
From 5 to 15	8%
From 16 to 30	50%
From 31 to 45	75%
46 or more	100%

A reasonable transition period may be allowed for firms to upgrade their information system to be able to track the number of days after the agreed settlement date and calculate the corresponding capital charge.

8. For non-DvP transactions (i.e. free deliveries), after the first contractual payment/delivery leg, the bank that has made the payment will treat its exposure as a loan if the second leg has not been received by the end of the business day[236]. This means that a bank under the IRB approach will apply the appropriate IRB formula set out in this Framework, for the exposure to the counterparty, in the same way as it does for all other banking book exposures. Similarly, banks under the standardised approach will use the standardised risk weights set forth in this Framework. However, when exposures are not material, banks may choose to apply a uniform 100% risk-weight to these exposures, in order to avoid the burden of a full credit assessment. If five business days after the second contractual payment/delivery date the second leg has not yet effectively taken place, the bank that has made the first payment leg will deduct from capital the full amount of the value transferred plus replacement cost, if any. This treatment will apply until the second payment/delivery leg is effectively made.

[236] If the dates when two payment legs are made are the same according to the time zones where each payment is made, it is deemed that they are settled on the same day. For example, if a bank in Tokyo transfers Yen on day X (Japan Standard Time) and receives corresponding US Dollar via CHIPS on day X (US Eastern Standard Time), the settlement is deemed to take place on the same value date.