Annex 11

The Simplified Standardised Approach[256]

I. Credit risk ─ general rules for risk weights

1. Exposures should be risk weighted net of specific provisions.

A. Claims on sovereigns and central banks

2. Claims on sovereigns and their central banks will be risk-weighted on the basis of the consensus country risk scores of export credit agencies (ECA) participating in the "Arrangement on Officially Supported Export Credits". These scores are available on the OECD's website.[257] The methodology establishes eight risk score categories associated with minimum export insurance premiums. As detailed below, each ECA risk score will correspond to a specific risk weight category.

ECA risk scores	0-1	2	3	4 to 6	7
Risk weights	0%	20%	50%	100%	150%

3. At national discretion, a lower risk weight may be applied to banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and funded[258] in that currency.[259] Where this discretion is exercised, other national supervisory authorities may also permit their banks to apply the same risk weight to domestic currency exposures to this sovereign (or central bank) funded in that currency.

B. Claims on other official entities

4. Claims on the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community will receive a 0% risk weight.

5. The following Multilateral Development Banks (MDBs) will be eligible for a 0% risk weight:

- the World Bank Group, comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC),
- the Asian Development Bank (ADB),

256 This approach should not be seen as another approach for determining regulatory capital. Rather, it collects in one place the simplest options for calculating risk-weighted assets.

257 The consensus country risk classification is available on the OECD's website (http://www.oecd.org) in the Export Credit Arrangement web-page of the Trade Directorate.

258 This is to say that the bank should also have liabilities denominated in the domestic currency.

259 This lower risk weight may be extended to the risk weighting of collateral and guarantees.

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

6. The standard risk weight for claims on other MDBs will be 100%.

7. Claims on domestic public sector entitles (PSEs) will be risk-weighted according to the risk weight framework for claims on banks of that country. Subject to national discretion, claims on a domestic PSE may also be treated as claims on the sovereign in whose jurisdiction the PSEs are established.[260] Where this discretion is exercised, other national supervisors may allow their banks to risk weight claims on such PSEs in the same manner.

C. Claims on banks and securities firms

8. Banks will be assigned a risk weight based on the weighting of claims on the country in which they are incorporated (see paragraph 2). The treatment is summarised in the table below:

ECA risk scores for sovereigns	0-1	2	3	4 to 6	7
Risk weights	20%	50%	100%	100%	150%

260 The following examples outline how PSEs might be categorised when focusing upon the existence of revenue raising powers. However, there may be other ways of determining the different treatments applicable to different types of PSEs, for instance by focusing on the extent of guarantees provided by the central government:

- **Regional governments and local authorities** could qualify for the same treatment as claims on their sovereign or central government if these governments and local authorities have specific revenue-raising powers and have specific institutional arrangements the effect of which is to reduce their risks of default.
- **Administrative bodies responsible to central governments, regional governments or to local authorities and other non-commercial undertakings** owned by the governments or local authorities may not warrant the same treatment as claims on their sovereign if the entities do not have revenue raising powers or other arrangements as described above. If strict lending rules apply to these entities and a declaration of bankruptcy is not possible because of their special public status, it may be appropriate to treat these claims in the same manner as claims on banks.
- **Commercial undertakings** owned by central governments, regional governments or by local authorities might be treated as normal commercial enterprises. However, if these entities function as a corporate in competitive markets even though the state, a regional authority or a local authority is the major shareholder of these entities, supervisors should decide to consider them as corporates and therefore attach to them the applicable risk weights.

9. When the national supervisor has chosen to apply the preferential treatment for claims on the sovereign as described in paragraph 3, it can also assign a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20%, to claims on banks of an original maturity of 3 months or less denominated and funded in the domestic currency.

10. Claims on securities firms may be treated as claims on banks provided such firms are subject to supervisory and regulatory arrangements comparable to those under this Framework (including, in particular, risk-based capital requirements).[261] Otherwise such claims would follow the rules for claims on corporates.

D. Claims on corporates

11. The standard risk weight for claims on corporates, including claims on insurance companies, will be 100%.

E. Claims included in the regulatory retail portfolios

12. Claims that qualify under the criteria listed in paragraph 13 may be considered as retail claims for regulatory capital purposes and included in a regulatory retail portfolio. Exposures included in such a portfolio may be risk-weighted at 75%, except as provided in paragraph 18 for past due loans.

13. To be included in the regulatory retail portfolio, claims must meet the following four criteria:

- Orientation criterion ─ The exposure is to an individual person or persons or to a small business;
- Product criterion ─ The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g. instalment loans, auto loans and leases, student and educational loans, personal finance) and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property (see paragraph 15).
- Granularity criterion ─ The supervisor must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. One way of achieving this may be to set a numerical limit that no aggregate exposure to one counterpart[262] can exceed 0.2% of the overall regulatory retail portfolio.

[261] That is, capital requirements that are comparable to those applied to banks in this Framework. Implicit in the meaning of the word “comparable” is that the securities firm (but not necessarily its parent) is subject to consolidated regulation and supervision with respect to any downstream affiliates.

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

- Low value of individual exposures. The maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of €1 million.

14. National supervisory authorities should evaluate whether the risk weights in paragraph 12 are considered to be too low based on the default experience for these types of exposures in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate.

F. Claims secured by residential property

15. Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.

16. National supervisory authorities should evaluate whether the risk weights in paragraph 15 are considered to be too low based on the default experience for these types of exposures in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate.

G. Claims secured by commercial real estate

17. Mortgages on commercial real estate will be risk-weighted at 100%.

H. Treatment of past due loans

18. 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 (including partial write-offs), will be risk-weighted as follows:[263]

- 150% risk weight when provisions are less than 20% of the outstanding amount of the loan;
- 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan; and
- 100% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan, but with supervisory discretion to reduce the risk weight to 50%.

19. For the purpose of defining the secured portion of the past due loan, eligible collateral and guarantees will be the same as for credit risk mitigation purposes (see Section II).[264] Past due retail loans are to be excluded from the overall regulatory retail

[263] Subject to national discretion, supervisors may permit banks to treat non-past due loans extended to counterparties subject to a 150% risk weight in the same way as past due loans described in paragraphs 18 to 20.

[264] There will be a transitional period of three years during which a wider range of collateral may be recognised, subject to national discretion.

portfolio when assessing the granularity criterion specified in paragraph 13, for risk-weighting purposes.

20. In addition to the circumstances described in paragraph 18, where a past due loan is fully secured by those forms of collateral that are not recognised in paragraph 50, a 100% risk weight may apply when specific provisions reach 15% of the outstanding amount of the loan. These forms of collateral are not recognised elsewhere in the simplified standardised approach. Supervisors should set strict operational criteria to ensure the quality of collateral.

21. In the case of qualifying residential mortgage loans, when such loans are past due for more than 90 days they will be risk-weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50% at national discretion.

I. Higher-risk categories

22. National supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments.

J. Other assets

23. The treatment of securitisation exposures is presented separately in Section III. The standard risk weight for all other assets will be 100%.[265] Investments in equity or regulatory capital instruments issued by banks or securities firms will be risk-weighted at 100%, unless deducted from the capital base according to Part 1 of the present Framework.

K. Off-balance sheet items

24. Off-balance sheet items under the simplified standardised approach will be converted into credit exposure equivalents through the use of credit conversion factors (CCF). Counterparty risk weights for OTC derivative transactions will not be subject to any specific ceiling.

25. Commitments with an original maturity up to one year and commitments with an original maturity over one year will receive a CCF of 20% and 50%, respectively. However, any commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, will receive a 0% credit conversion factor.[266]

25(i). Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances) will receive a CCF of 100%.

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[265] However, at national discretion, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and therefore risk-weighted at 0%. In addition, cash items in the process of collection can be risk-weighted at 20%.

[266] In certain countries, retail commitments are considered unconditionally cancellable if the terms permit the bank to cancel them to the full extent allowable under consumer protection and related legislation.

25(ii). Sale and repurchase agreements and asset sales with recourse,[267] where the credit risk remains with the bank will receive a CCF of 100%.

26. A CCF of 100% will be applied to the lending of banks' securities or the posting of securities as collateral by banks, including instances where these arise out of repo-style transactions (i.e. repurchase/reverse repurchase and securities lending/securities borrowing transactions). See Section II for the calculation of risk-weighted assets where the credit converted exposure is secured by eligible collateral.

26(i). Forward asset purchases, forward forward deposits and partly-paid shares and securities[268], which represent commitments with certain drawdown will receive a CCF of 100%.

26(ii). Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) will receive a CCF of 50%.

26(iii). Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) will receive a CCF of 50%.

27. For short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment), a 20% credit conversion factor will be applied to both issuing and confirming banks.

28. Where there is an undertaking to provide a commitment on an off-balance sheet items, banks are to apply the lower of the two applicable CCFs.

29. The credit equivalent amount of transactions that expose banks to counterparty credit risk must be calculated under the rules specified in Section VII of Annex 4 of this Framework.

30. Banks must closely monitor securities, commodities, and foreign exchange transactions that have failed, starting the first day they fail. A capital charge to failed transactions must be calculated in accordance with Annex 3 of this Framework.

31. With regard to unsettled securities, commodities, and foreign exchange transactions, the Committee is of the opinion that banks are exposed to counterparty credit risk from trade date, irrespective of the booking or the accounting of the transaction. Therefore, banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis. Furthermore, when such transactions are not processed through a delivery-versus-payment (DvP) or payment-versus-payment (PvP) mechanism, banks must calculate a capital charge as set forth in Annex 3 of this Framework.

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[267] 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.

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II. Credit risk mitigation

A. Overarching issues

1. Introduction

32. Banks use a number of techniques to mitigate the credit risks to which they are exposed. Exposure may be collateralised in whole or in part with cash or securities, or a loan exposure may be guaranteed by a third party.

33. Where these various techniques meet the operational requirements below credit risk mitigation (CRM) may be recognised.

2. General remarks

34. The framework set out in this section is applicable to the banking book exposures under the simplified standardised approach.

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

36. The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM. Principal-only ratings will also not be allowed within the framework of CRM.

37. Although banks use CRM techniques to reduce their credit risk, these techniques give rise to risks (residual risks) which may render the overall risk reduction less effective. Where these risks are not adequately controlled, supervisors may impose additional capital charges or take other supervisory actions as detailed in Pillar 2.

38. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks to the bank, such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.

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

3. Legal certainty

40. In order for banks to obtain capital relief, all documentation used in collateralised transactions and for documenting guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks 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.

4. Proportional cover

41. Where the amount collateralised or guaranteed (or against which credit protection is held) is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, i.e. the bank and the guarantor share losses on a pro-rata basis, capital

relief will be afforded on a proportional basis, i.e. the protected portion of the exposure will receive the treatment applicable to the collateral or counterparty, with the remainder treated as unsecured.

B. Collateralised transactions

42. A collateralised transaction is one in which:

- banks have a credit exposure or potential credit exposure; and
- that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by the counterparty[269] or by a third party on behalf of the counterparty.

43. Under the simplified standardised approach, only the simple approach from the standardised approach will apply, which, similar to the 1988 Accord, substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralised portion of the exposure (generally subject to a 20% floor). Partial collateralisation is recognised. Mismatches in the maturity or currency of the underlying exposure and the collateral will not be allowed.

1. Minimum conditions

44. In addition to the general requirements for legal certainty set out in paragraph 40, the following operational requirements must be met.

45. The collateral must be pledged for at least the life of the exposure and it must be marked to market and revalued with a minimum frequency of six months.

46. In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty — or by any related group entity — would provide little protection and so would be ineligible.

47. The bank must have clear and robust procedures for the timely liquidation of collateral.

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

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

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

2. Eligible collateral

50. The following collateral instruments are eligible for recognition:

- Cash (as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure,[270, 271]
- Gold,
- Debt securities issued by sovereigns rated category 4 or above,[272] and
- Debt securities issued by PSE that are treated as sovereigns by the national supervisor and that are rated category 4 or above.[272]

3. Risk weights

51. Those portions of claims collateralised by the market value of recognised collateral receive the risk weight applicable to the collateral instrument. The risk weight on the collateralised portion will be subject to a floor of 20%. The remainder of the claim should be assigned to the risk weight appropriate to the counterparty. A capital requirement will be applied to banks on either side of the collateralised transaction: for example, both repos and reverse repos will be subject to capital requirements.

52. The 20% floor for the risk weight on a collateralised transaction will not be applied and a 0% risk weight can be provided where the exposure and the collateral are denominated in the same currency, and either:

- the collateral is cash on deposit; or
- the collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.

C. Guaranteed transactions

53. Where guarantees meet and supervisors are satisfied that banks fulfil the minimum operational conditions set out below, they may allow banks to take account of such credit protection in calculating capital requirements.

1. Minimum conditions

54. A guarantee (counter-guarantee) must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it must be irrevocable; there must be no clause in the contract that would increase the effective cost of

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270 Cash funded credit linked notes issued by the bank against exposures in the banking book which fulfil the criteria for credit derivatives will be treated as cash collateralised transactions.

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

272 The rating category refers to the ECA country risk score as described in paragraph 2.

cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional; there should be no clause in the protection contract outside the control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

55. In addition to the legal certainty requirements in paragraph 40 above, the following conditions must be satisfied:

(a) On the qualifying default or 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 actions 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 obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. Where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount

2. Eligible guarantors (counter-guarantors)

56. Credit protection given by the following entities will be recognised: sovereign entities,[273] PSEs and other entities with a risk weight of 20% or better and a lower risk weight than the counterparty.

3. Risk weights

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

58. As specified in paragraph 3, a lower risk weight may be applied at national discretion to a bank's exposure to the sovereign (or central bank) where the bank is incorporated and where the exposure is denominated in domestic currency and funded in that currency. National authorities may extend this treatment to portions of claims guaranteed by the sovereign (or central bank), where the guarantee is denominated in the domestic currency and the exposure is funded in that currency.

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

[273] This includes the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community.

D. Other items related to the treatment of CRM techniques

Treatment of pools of CRM techniques

60. In the case where a bank has multiple CRM covering a single exposure (e.g. a bank has both collateral and guarantee partially covering an exposure), the bank will be required to subdivide the exposure into portions covered by each type of CRM tool (e.g. portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately. When credit protection provided by a single protection provider has differing maturities, they must be subdivided into separate protection as well.

III. Credit risk — Securitisation framework

A. Scope of transactions covered under the securitisation framework

61. 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 a liquidation.

62. Banks' exposures to securitisation are referred to as "securitisation exposures".

B. Permissible role of banks

63. A bank operating under the simplified standardised approach can only assume the role of an investing bank in a traditional securitisation. An investing bank is an institution, other than the originator or the servicer that assumes the economic risk of a securitisation exposure.

64. A bank is considered to be an originator if it originates directly or indirectly credit exposures included in the securitisation. A servicer bank is one that manages the underlying credit exposures of a securitisation on a day-to-day basis in terms of collection of principal and interest, which is then forwarded to investors in securitisation exposures. A bank under the simplified standardised approach should not offer credit enhancement, liquidity facilities or other financial support to a securitisation.

C. Treatment of Securitisation Exposures

65. Banks using the simplified standardised approach to credit risk for the type of underlying exposure(s) securitised are permitted to use a simplified version of the standardised approach under the securitisation framework.

66. The standard risk weight for securitisation exposures for an investing bank will be 100%. For first loss positions acquired, deduction from capital will be required. The deduction will be taken 50% from Tier 1 and 50% from Tier 2 capital.

IV. Operational risk

67. The simplified standardised approach for operational risk is the Basic Indicator Approach under which banks must hold capital equal to a fixed percentage (15%) of average annual gross income, where positive, over the previous three years.

68. Gross income is defined as net interest income plus net non-interest income.[274] It is intended that this measure should: (i) be gross of any provisions (e.g. for unpaid interest); (ii) be gross of operating expenses, including fees paid to outsourcing service providers;[275] (iii) exclude realised profits/losses from the sale of securities in the banking book;[276] and (iv) exclude extraordinary or irregular items as well as income derived from insurance.

69. Banks using this approach are encouraged to comply with the Committee's guidance on *Sound Practices for the Management and Supervision of Operational Risk* (February 2003).

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[274] As defined by national supervisors and/or national accounting standards.

[275] In contrast to fees paid for services that are outsourced, fees received by banks that provide outsourcing services shall be included in the definition of gross income.

[276] Realised profit/losses from securities classified as "held to maturity" and "available for sale", which typically constitute items of the banking book (e.g. under certain accounting standards), are also excluded from the definition of gross income.