

**Explanatory notes**  
**on the announcement of the amendment of the**  
**Principles concerning the Own Funds and Liquidity of Institutions**  
**of July 20, 2000**

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**General notes**

The announcement of the amendment of the Principles concerning the Own Funds and Liquidity of Institutions relates to Principle I (Announcement of October 29, 1997; Federal Gazette p. 13555), which is to be amended in line with the following EU banking directives:

- Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions (Official Journal of the European Communities, No. L 204/13)
- Directive 98/32/EC of the European Parliament and of the Council of 22 June 1998 amending, as regards in particular mortgages, Council Directive 89/647/EEC on a solvency ratio for credit institutions (Official Journal of the European Communities, No. L 204/26) (referred to hereinafter as Council Directive 98/32/EC or **mortgage directive**)
- Directive 98/33/EC of the European Parliament and of the Council of 22 June 1998 amending Article 12 of Council Directive 77/780/EEC on the taking up and pursuit of the business of credit institutions, Articles 2, 5, 6, 7, 8 of and annexes II and III to Council Directive 89/647/EEC on a solvency ratio for credit institutions and Article 2 of and Annex II to Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions (Official Journal of the European Communities, No. L 204/29).

With regard to the Basle Capital Accord, which Principle I generally adheres to within the terms permissible under EU law, the amendment to the Basle market risk regulations of January 1996 (referred to hereinafter as the Basle "modification"), made in September 1997, concerning the use of institutions' internal models for calculating the partial capital charges for the specific market risk of trading book positions has now been fully incorporated into Principle I.

Additionally, a number of amendments are to be made in Principle I and the accompanying "Explanatory notes" of October 29, 1997 - I 7 - A 223 - 2/93 in line with the now revised provisions in the Banking Act as well as provisions arising from the Banking Act. Furthermore, various passages of the text of the Principle and the "Explanatory notes" have been revised to take due account of the introduction of the euro since the start of stage three of Economic and Monetary Union. Finally, a number of editorial errors have been corrected and obvious errors from the announcement of October 29, 1997 have been rectified.

Apart from the three above-mentioned amending directives, no new developments have taken place in the field of EU banking law relevant to the present context. As a result, there is very limited scope for formulating the amendments which are now to be made in Principle I, especially as the options contained in the EU directives were already very largely exhausted when Principle I was revised in 1997.

In those instances where the objects of the three above-mentioned amending directives were not already taken into consideration in the old version of Principle I, the implementation of those parts of the amending directives that are outstanding relates to the following areas of Principle I: Owing to CAD II, the weighting provisions for the market risks resulting from commodity contracts and commodity-related (financial) instruments are to be amended. Since the provisions pertaining to the capital requirements for the market price change risks arising from such contracts have already been incorporated (see Part IV: Commodities position), only the provisions relating to the settlement and counterparty risk positions of the trading book are still to be amended (see section 27).<sup>1</sup> Another part of CAD II concerns the use of institutions' internal models suitable for calculating the (partial) capital charges for the general and specific market risk of the trading book risk positions. The relevant requirements of the directive are likewise contained in the previous Principle I (see Part VII: Internal risk models). However, the provisions in Principle I relating to the use of suitable internal models for calculating the partial capital charges for the specific market risk of the net interest position and net equity position are to be amended. The other amendments on the basis of CAD II concern individual points that will be dealt with in the context of the respective provision.

Owing to the mortgage directive, section 13 (4) 3 is to be amended: this provides for the application of a 50 % weighting to commercial mortgage loans: The reduced weighting will now apply beyond the previously established reference date of January 1, 2001 up to December 31, 2006. The conditions under which the weighting applies are defined in accordance with the requirements of the directive. This likewise applies with regard to the criteria for applying the 50 % weighting to securities secured by mortgages pursuant to section 13 (4) 4. The Federal Banking Supervisory Office has already issued circulars providing information on both provisions of the mortgage directive (see circular 14/98

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<sup>1</sup> Sections given without further details relate to Principle I (as amended by the announcement of October 27, 1997).

of August 26, 1998 - I 5 - H 112 - 6/93 regarding the conditions for applying the 50 % weighting to commercial mortgages and circular 9/99 of April 26, 1999 - I 5 - A 233 - 1/98 regarding the treatment of securities backed by mortgages). The objects of the circulars are now being incorporated in Principle I, thus concluding the implementation of the mortgage directive.

The objects of RL 98/33/EC were already included in the previous version of Principle I: the number of amendments to be made as a result of this amending directive is therefore small. The amendments mainly concern section 13: The Federal Banking Supervisory Office has consented to derivative contracts settled through certain clearing houses not having to be taken into consideration when calculating the capital charges for the risk assets up to December 31, 2006.

Under the Basle market risk regulations amended in September 1997 and the amended EU Capital Adequacy Directive (CAD) (Annex VIII, item 6), in determining the (partial) capital charges for the market risk positions of the trading book when using a suitable internal model, the weighting factor to be set by the banking supervisory authorities for the 60-day average of the potential risk amounts is at least 3. This weighting factor also applies when determining the partial capital charges for the specific market risk (net interest position or net equity position) if the partial capital charges are calculated using an institution's internal model that is to be deemed to be unreservedly suitable with regard to the recording of the special risk (known as non-surcharge models). If the special requirements for the use of institutions' internal models for calculating the partial capital charges for the specific market risks are not already covered by the criteria for using suitable risks models anchored in Part VII of Principle I, the relevant requirements from Annex VIII No. 4 CAD have been newly included in Principle I (this concerns the inclusion of concentration risks). Furthermore, a number of points have been clarified and elucidated.

The amendments to be made as a result of the start of stage three of Economic and monetary union concern, firstly, the provision for translating risk assets into foreign currency pursuant to section 6 (2) and, secondly, the various passages in the "Explanatory notes" of October 29, 1997. Additionally, owing to the "Large Exposures Regulation" (*Kreditbestimmungsverordnung*) being renamed as "Regulation governing large exposures and loans of three million Deutsche Mark or more" (*Großkredit- und Millionenkreditverordnung*) when it was thoroughly revised at the end of 1997 and the amendment made with the regulation of March 8, 1999, the relevant references in the text of the Principle are to be corrected (*Verordnung über die Erfassung, Bemessung, Gewichtung und Anzeige von Krediten im Bereich der Großkredit- und Millionenkreditvorschriften des Gesetzes über das Kreditwesen* {Regulation on the recording, measuring, weighting and reporting of loans in the area of requirements of the Banking Act relating to large exposures and loans of three million Deutsche Mark or more} [Regulation governing large exposures and loans of three million Deutsche Mark or more] of December 29, 1997 [Federal Law Gazette I, p. 3156], as most recently amended by the regulation of March 8, 1999 [Federal Law Gazette I p. 310]). Corrections of editorial errors and rectification of obvious shortcomings will be dealt with in the relevant passages below.

The structure and breakdown of Principle I remain unchanged. Amendments are being made only if they are unavoidable. Following the complete revision of Principle I in 1997, which was preceded by several years of preparation and intensive consultation with the central associations of the institutions and which necessitated changing the credit institutions' external reporting system, the area of change is now being kept within narrow bounds. Owing to the manageable scale of the amendments, it is not necessary to re-announce the entire text of the Principle. The "Explanatory notes" - I 7 - A 223 - 2/93 of October 29, 1997 remain valid unless they relate to provisions which are being amended on this basis of this announcement. The present "Explanatory notes" refer to the amendments and additions.

## **Specific amendments**

### **Section 1 (1) sentence 3 Consideration of special circumstances**

Owing to the deletion of section 1 (5) (see below), the reference to subsection (5) in subsection (1) sentence 3 is to be deleted. Owing to the deletion of subsection (5), the earlier qualification regarding the consideration in Principle I of an institution's or group's positive special circumstances no longer applies. Nevertheless, the minimum requirements for an institution's or group's own funds specified in Article 4 (1) CAD must not be undershot. If provision is made for the implementation of the EC legal requirement in Principle I, the minimum requirements are specified in section 2. Reference to section 2 as the relevant limit for the consideration of positive special circumstances is now made in subsection (1) sentence 3. The limit applies to institutions and to groups (see section 3 (1)).

### **Section 1 (4) Application of Part IV to the business in goods normally conducted by mixed-activity credit cooperatives**

In the light of the provision of the CAD (see Annex VII) specifying a capital requirement to safeguard against market price risks arising from commodities and commodity-price-related transactions (commodity derivatives) - irrespective of whether the commodities or the commodity derivatives are assigned to the banking book or the trading book -, a general exemption of the business in goods normally conducted by mixed-activity credit cooperatives from the provisions of Part IV is no longer possible . Section 1 (4) therefore has to be deleted. The mixed-activity credit cooperatives and the associations which represent them were unable to demonstrate that the business in goods normally conducted by these institutions is not subject to any kind of market price risk. If, however, no unmatched positions are established during the whole time such business is conducted, the institutions may disregard this business when calculating the commodities position under the provisions of Part IV. Reference to this is made in the newly inserted sentence 3 under section 16 (1) (see below).

### **Section 1 (5) Consideration of positive special circumstances in Principle I**

After examining the relevant basis in EU law, the previous qualification regarding the consideration of positive special circumstances of an institution or group in Principle I is being reduced to the necessary extent. No differentiation is made between the institutions and

groups as provided for the application of the provisions pursuant to the individual parts of Principle I. As a result, it has been possible to delete section 1 (5) . The consideration of special circumstances is now provided for conclusively in section 1 (1).

In deciding whether positive special circumstances are taken into consideration, the Federal Banking Supervisory Office has to observe the provisions of sections 2 and 3 (1) as minimum requirements. Sections 2 and 3 (1) are based on the provision of Article 4 (1) CAD. Article 4 (1) CAD tells the responsible authorities in the member states which risks of the institutions are to be backed by own funds in accordance with which provisions. As far as the provisions of Principle I are concerned, this requirement is to be observed in all cases by the deposit-taking credit institutions, the financial services institutions referred to in section 1 (2) and the relevant groups. The minimum capital requirements for the credit and market price risks of an institution are specified in section 2 with reference to the relevant provisions for inclusion of the individual risk categories in the other parts of Principle I. Section 3 (1) contains the corresponding provision for groups. Since these are minimum requirements, positive special circumstances that fall short of these requirements may not be taken into consideration. Above and beyond that, however, the Federal Banking Supervisory Office is able to exercise a certain amount of discretion in applying the individual credit-risk and market-risk provisions of Principle I. If the literal application of a risk-capturing provision demonstrably results in a risk-inadequate outcome in a specific case, the Federal Banking Supervisory Office, upon request by the institution, will review which revision is to be made in including the risk. There are, however, inherent limits to the scope of discretion available: Firstly, the own funds ratio of at least 8 % is to be observed as a binding minimum standard. If an institution has fewer own funds at its disposal than required under section 2, the requirement of adequate own funds being available is not fulfilled. Secondly, a revision must not contravene the risk-capturing provisions of Principle I. A revision may therefore not go beyond a modification of specific provisions which conforms with the weighting system and the basic features of Principle I. The general requirements of the Solvency Ratio Directive and CAD must be observed when deciding the extent to which an institution claiming an inaccurate portrayal of the credit and market price risks and furnishing supporting documentation may be accommodated. This follows from the principle that national provisions which come under the harmonisation of EU legislation be interpreted in conformity with the directives. Since the Solvency Ratio Directive and CAD contain certain alternative options, however, the directive requirements are not fixed and immovable in every case, but leave the responsible authorities in the member states a certain scope for discretion.

In the underlying principles, no differentiation among various institutions is now made with regard to the scope of application for the consideration of special circumstances. This is based on the following reasoning: previously, the differentiation regarding the possibility of taking positive special circumstances into consideration was linked to the criterion of whether the institution in question was a deposit-taking institution, a securities trading bank or a financial services institution to which the provisions of the Solvency Ratio Directive and CAD must be applied. For the other institutions, to which the aforementioned requirements of the EC directives do not necessarily apply, taking special circumstances into consideration was regarded as possible. This is not consistent insofar as no distinction is made with regard to the resulting effects of applying Principle I (by way of an example, a

high degree of financial soundness is demonstrated if the capital requirements of Principle I are fulfilled).

**Section 2 (1)**  
**Editorial amendment**

For the sake of clarification, reference is now made to section 4 in connection with the risk assets mentioned under section 2 (1). To that extent, the reference to section 5 in connection with the market risk positions mentioned under section 2 (2) is reiterated for risk assets. This clarification is being made because section 2 specifies the ultimately crucial requirements of Principle I, which has to be worded unambiguously.

**Section 5 (3) 2**  
**Principal risks inherent in repurchase agreements and securities lending and borrowing which constitute settlement and counterparty risk positions of the trading book**

When weighting the settlement and counterparty risk positions of the trading book pursuant to the provisions of section 27, the principal risk of all repurchase agreements and securities lending and borrowing, the underlying transactions of which are financial instruments (including commodities) of the trading book (see below), is now to be captured. The wording of section 5 (3) 2, which refers to the weighting of the settlement and counterparty risk positions of the trading book, is therefore to be amended accordingly: The previous restriction of repurchase agreements and securities lending and borrowing to securities of the trading book is no longer applicable.

**Section 6 (2); section 14 (1), (3) and (4); section 15 (3) sentence 3; section 16 (1); section 19 (2); section 29 (1), (2), (3) and (4); section 30 sentence 1**  
**Translation of risk assets denominated in a foreign currency**

Since the start of stage three of Economic and monetary union on January 1, 1999, the currency used for preparing the report for Principle I may be D-Mark (for a limited period up to January 1, 2002) or euro. The provision for translating risk asset denominated in a foreign currency therefore has to be amended accordingly. The new wording of section 6 (2) is based on the object of section 6 (2) Principle II (Announcement of November 25, 1998, Federal Gazette p. 16.985). The new provision of section 6 (2) corresponds to the provision for currency translation in accordance with the Bundesbank's guidelines on the balance sheet statistics. The special provision regarding the capturing of "structural" currency positions pursuant to subsection (2) second half of sentence 1 is retained.

Foreign currency positions comprise all currencies not denominated in euro or one of the national currencies of the EMU member states. The reference exchange rates ascertained by the ECB on the respective reporting date and published by the Bundesbank (ESCB reference rates) are to be used for currency translation. For currencies for which no ESCB reference rates are published, the midpoints of ascertainable buying and selling rates are to be applied.

To designate the currency in which the report for Principle I is made - i.e. euro or, up to January 1, 2002, Deutsche Mark - the term "reporting currency", which is borrowed from CAD, is introduced in section 6 (2) sentence 1 and is used throughout Principle I. In the following passages of Principle I, the words "Deutsche Mark" have been replaced by "reporting currency": section 14 (1), 3 and 4; section 16 (1); section 19 (2); section 29 (1), (2), (3) and 4; section 30 sentence 1. Owing to these changes in designation, the words "in foreign currency and in Deutsche Mark" in section 15 (3) sentence 3 have been deleted: When determining the asset positions for the calculation and weighting of the overall currency position, loss provisions on asset items are to be deducted from these items, irrespective of how the loss provisions on asset items have been made and irrespective of the currency in which they are denominated.

**Section 7 number 6a  
Inclusion/Weighting of the stock-in-trade**

The extended scope of application of the provisions under Part IV concerning the commodities position means that the stock-in-trade which is to be regarded as asset items in Part II has to be redefined. The previous provision was for the weighting of the stock-in-trade of credit cooperatives conducting business in goods, which corresponded closely to the earlier exemption of business in goods normally conducted by mixed-activity credit cooperatives from the provisions under Part IV. Since the exemption provision under section 1 (4) has now been deleted, Part IV will apply in future to mixed-activity credit cooperatives as well. Since commodity stocks pursuant to section 16 (2) 1 are also to be taken into consideration when calculating the commodities position, commodity stocks would be recorded twice if the stock-in-trade were additionally to be included in accordance with section 7 (6a). In order to prevent such double recording, section 7 number 6a now clearly states that the stock-in-trade to be included is that which is not counted when calculating and weighting the commodities position in accordance with Part IV. This includes those goods which, as a part of matched positions, are not subject to any price risk and are exempted from inclusion pursuant to section 16 (1) sentence 3. Since they are subject to a credit risk which has to be weighted, the provisions of Part II are applied.

#### **Section 9 (1) sentence 5**

#### **Weighting the replacement costs of swap and futures contracts as well as option rights forming part of the transactions in goods usually conducted by mixed-activity credit cooperatives**

There is no longer a basis in EC law for the formerly granted option of using the original-exposure method - instead of the marking-to-market method otherwise envisaged - for weighting the counterparty risk of swap and futures contracts, and of option rights forming part of the transactions in goods normally conducted by mixed-activity credit cooperatives. The provisions of the Solvency Ratio Directive which have been amended on the basis of Directive 98/33/EC now prescribe that the marking-to-market method (designated as method 1 in Annex II of the Solvency Ratio Directive) be used for calculating the capital charges for covering the counterparty risk of commodity derivatives. Sentence 5 under section 9 (1) has therefore been deleted.

The rescindment of the option to select the method does not affect the cross-currency business of the mixed-activity credit cooperatives, however, to the extent that, given matching commodities futures transactions, the weighting principles applying to derivative contracts do not have any bearing at all. This is because the commodities future purchase is included as an off-balance-sheet transaction within the meaning of section 8 number 1 (f) (assets purchased under outright forward purchase agreements) and counted at the value of the commodity. The weighting is performed "in anticipation" of the commodities to be taken into stock and the associated commodity counterparty risk. With matched commodities futures transactions, there is no additional weighting of the commodities futures sale, since the maximum counterparty risk is determined by the value of the commodities purchased under the forward contract.

#### **Section 9 (2) number 2**

#### **Relevant maturity in the case of futures contracts and option rights in respect of variable-yield securities**

In the futures contracts in respect of variable-yield securities (floating-rate notes), the period of time remaining until the next following interest rate adjustment date is deemed to be the relevant maturity. This maturity arrangement under section 9 (2) number 2 is now extended to options on variable-yield securities in order to eliminate uncertainty in this matter which existed hitherto owing to the lack of an explicit provision.

#### **Section 12 (1)**

#### **Conditions for taking into consideration bilateral netting agreements and contracts for novation leading to a reduced weighting**

The amendment in section 12 (1) implements two changes which relate to the relevant provisions of the "Regulation governing large exposures and loans of three million Deutsche Mark or more": Firstly, the earlier "Large Exposures Regulation" has been replaced by the "Regulation governing large exposures and loans of three million Deutsche Mark or more", to which reference is now made.

Secondly, it is made clear that the recognition by the Federal Banking Supervisory Office of the risk-reducing effect of derivative contracts included in legally effective bilateral netting agreements that used to be required pursuant to sections 2a and 2b of the "Large Exposures Regulation" and section 5 of the "Regulation governing large exposures and loans of three million Deutsche Mark or more" (in its earlier version) is no longer applicable insofar as, owing to the Regulation amending the Regulation governing large exposures and loans of three million Deutsche Mark or more of March 8, 1999 (Federal Law Gazette I p. 310), the prudential recognition procedure has been replaced by the reporting procedure with the possibility of prohibition by the Federal Banking Supervisory Office pursuant to section 5 (2) of the "Regulation governing large exposures and loans of three million Deutsche Mark or more". Since the changeover of the procedure was already implemented in practice some time ago, the amendment of section 12 (1) will not produce any perceptible material changes for the institutions.

### **Section 13 (1) Zero weightings**

The first sentence explicitly states that the conditions listed under subsection (1) for applying a zero weighting are subject to the provision of section 6. In respect of the weighting of risk assets, which are counted towards the own funds of an institution to which the provisions of the Solvency Ratio Directive apply, this means that the 100% weighting also applies if one of the counterparties listed under subsection (1) has assumed an explicit guarantee for the fulfilment of the claims arising from the risk asset or collateral as mentioned under subsection (1) (see section 6 number 1).

### **Section 13 (1) 1 (a) Application of the counterparty-related zero risk weighting to claims on certain promotional institutions**

Since the basis for the zero weighting of risk assets constituting claims on or carrying the explicit guarantee of the Reconstruction Loan Corporation (*Kreditanstalt für Wiederaufbau*) has now changed, the reference to this in the "Explanatory notes" of October 29, 1997 (page 50) is no longer applicable. The counterparty-related zero weighting continues to apply to the Reconstruction Loan Corporation and is also extended to other promotional institutions which are operated by the central, regional and local authorities listed under in subsection 1 under number 1 (a), which are not in competition with other institutions and for whose assets the respective central, regional and local authorities have assumed a liability equivalent to an explicit guarantee. This provision is restricted to the group of public, legally independent financing institutions for the direct implementation of governmental promotional measures, which conduct banking business within the meaning of section 1 (1) sentence 2 of the Banking Act. Public institutions without a special promotional mandate and public-law institutions whose guarantors do not explicitly guarantee the fulfilment of the payment obligations over and above the usual uncalled guarantor's liability, do not come under this provision.

The basis for the zero weighting of risk assets constituting claims on or carrying the explicit guarantee of the Reconstruction Loan Corporation is the amendment to the Reconstruction Loan Corporation Act made on the basis of Article 23 of the Third Financial Market Promotion Act of March 24, 1998 (Federal Law Gazette I p. 567), pursuant to which the Federal Government assumes liability for the loans taken up by the Reconstruction Loan Corporation, the issued bonds, forward contracts, option rights and other loans to the Reconstruction Loan Corporation as well as for loans to third parties, if these are explicitly guaranteed by the Reconstruction Loan Corporation (section 1a of the Reconstruction Loan Corporation Act). This provision corresponds to the object of the former section 2 (2) sentence 2 of the Banking Act, which has been repealed on the basis of Article 16 item 3 of the Third Financial Market Promotion Act. The solution found for the Reconstruction Loan Corporation applies accordingly to the German Equalisation Bank (*Deutsche Ausgleichsbank*) (section 2a of the German Equalisation Bank Act [*Ausgleichsbankgesetz*]), introduced on the basis of Article 22 of the Third Financial Market Promotion Act). The promotional institutions, to which the zero risk weighting applies, include the Baden-Württemberg State Credit Bank - Promotional Bank (*Landeskreditbank Baden-Württemberg - Förderbank*)- which is privileged by law (section 5 (3) of the Baden-Württemberg State Credit Bank - Promotional Bank - Act [*Gesetz über die Landeskreditbank Baden-Württemberg - Förderbank*] of November 11, 1998).

#### **Section 13 (1) 2 (b)**

#### **Risk assets secured by collateral in the form of securities issued by a special fund of the Federal Government or of a Land Government**

For the sake of clarity, securities issued by special funds of the Federal Government and Länder Governments, and by promotional institutions within the meaning of subsection (1) 1 a under subsection (1) 2 (b) are added to the list of securities which are eligible as collateral for the zero weighting of secured risk assets. This thereby creates consistency with subsection (1) 1 (a). The amendment of subsection (1) 2 (b) clarifies the situation, since the said special funds are legally dependent entities which are maintained by the Federal Government or the Land Government in question and the securities issued by these special funds were, for that reason, in the past already included in the group of eligible collateral. This applies equally to the securities of legally independent promotional institutions.

#### **Section 13 (1) 3**

#### **Correction of an editorial error**

The exception under section 13 (1) 3 to the effect that only foreign-exchange-related derivative transactions with an original maturity of less than 15 calendar days are not to be taken into account does not apply if these transactions are covered by a recognised bilateral netting arrangement (see section 12 (4)). As part of the announcement of the amendment, a previous erroneous reference under section 13 (1) 3 to the provision of section 12 has been corrected.

## **Section 13 (1) 5**

### **Limited-period exemption from weighting of derivative contracts which are cleared by a recognised clearing house**

The insertion of the new number 5 into section 13 (1) implements the option granted to the member states pursuant to Article 6 (3) of the Solvency Ratio Directive, under which, until December 31, 2006, the competent authorities may exempt from the application of the weighting provisions for the counterparty risk OTC contracts cleared by a clearing house where the clearing house acts as the legal counterparty and all participants fully collateralise on a daily basis the exposure they present to the clearing house. The protection must cover both the current exposure and the potential future exposure. The prerequisite for exemption is that the competent authorities must be satisfied that the posted collateral provides freedom from risk: Firstly, the posted collateral must give the same level of protection as asset items secured, to the satisfaction of the competent authorities, by collateral in the form of Zone A central government or central bank securities or by cash deposits placed with the lending institutions. Secondly, the risk of a build-up of the clearing house's exposure beyond the market value of the posted collateral has to be eliminated. The member states have to inform the Commission of the use they make of this option.

The prior consent of the Federal Banking Supervisory Office is required for the institutions to exempt the derivative contracts cleared by such a clearing house from weighting in accordance with the provisions of Part II of Principle I. The Federal Banking Supervisory Office will, upon application by the clearing house, satisfy itself as to whether the aforementioned conditions have been met and announce the outcome in a circular to the institutions. An application to this effect may also be made by one or more institutions to which Principle I applies or by a central association of the institutions on behalf of the clearing house. The application should specify which derivative contracts are to come under the exemption from weighting. Additionally, the application has to be supported by detailed documentation on the clearing house's legal and economic background, the associated institutions, the way in which the clearing system works and, in particular, the securities required for protection against the counterparty risk. If international relationships exist, it should be stated on which legal basis the derivative contracts are cleared and the collateral is posted and utilised. In a separate annex, the precautions concerning risk protection are to be compared with the operation of the marking-to-market method pursuant to section 10. Reference is to be made to potential residual risks and precautionary measures in the event of an emergency. Furthermore, the clearing house has to provide a declaration that the risk of the clearing house's exposure exceeding the market value of the posted collateral has been eliminated. The Federal Banking Supervisory Office reserves the right to request further documents or appraisals in specific instances. If the clearing house is domiciled in a country other than Germany, the Federal Banking Supervisory Office will, as a rule, contact the competent banking supervisory authorities in that country. If the foreign banking supervisory authority has already taken a decision in connection with the option pursuant to Article 6 (3) of the Solvency Ratio Directive, the Federal Banking Supervisory Office will take due account of the relevant reasons for that decision - insofar as they are known to the Federal Banking Supervisory Office - as part of its examination of the conditions. So far, the Federal Banking Supervisory Office has not yet taken any decisions about clearing houses, the precautions of which are to be deemed to be adequate in terms

of an exemption from weighting of the derivative contracts cleared by the clearing houses pursuant to section 13 (1) 5.

### **Section 13 (3) 20 % weighting**

In line with the reference made under subsection 1, the introductory sentence in subsection 3 makes it clear that a 20 % weighting is to be applied only if this is permitted in accordance with subsection 6.

### **Section 13 (3) number 1 (f) and section 6 number 1 Treatment of risk assets that are counted towards an institution's own funds**

The newly inserted number 1 in section 13 (6) makes it clear that a 100 % weighting is to be given to risk assets that are counted towards a third institution's own funds, to which the provisions of the Solvency Ratio Directive apply and for which a 20 % counterparty weighting has been set. This applies to both participations and to shares, bonds and assets which represent components of the own funds of another institution. This implements Article 6 (1) (d) 6 of the Solvency Directive, pursuant to which a 100 % weighting is to be applied to risk assets which form the components of the own funds of other credit institutions which are not deducted from the own funds of the lending institutions. The relevant reference in subsection (3) 1 (f) has been amended accordingly ("own funds" has been substituted for the term "liable capital").

The unreduced 100 % weighting also applies to the bonds and assets which are counted towards own funds, carrying the explicit guarantee of a counterparty that is given privileged treatment in Principle I. This clarification has practical relevance with regard to the treatment of subordinated loans and participation rights, which are counted towards an institution's own funds and which carry the guarantee of government bodies. In specific instances, these may be "hidden" government measures for promoting and strengthening the capital adequacy of public institutions, which have to be rated critically with regard to the competitive implications if the guarantees are granted on non-market terms. In this connection, reference is made to the eleventh recital of the Own Funds Directive, pursuant to which, in order to avoid distortions of competition, public credit institutions must not include in their own funds guarantees granted to them by the member states or local authorities. Since, in terms of the prudential risk potential, a strengthening of the liability side is (*ceteris paribus*) equivalent to an easing of the strain on the asset side, it would cause problems if the financing of components of public institutions' own funds were to be promoted by the inclusion of government guarantees in favour of the own funds' creditors reducing the weighting in Principle I of those creditors.

The previous provision of subsection 6 has now been moved to its position under number 2 (100 % weighting for all other risk assets).

### **Section 13 (4) 3**

#### **Limited-period application of a 50 % weighting to certain commercial mortgage loans**

The new version of section 13 (4) 3 adapts the provision of Principle I concerning the 50 % weighting of certain commercial mortgage loans to the requirements of Article 11 (4) of the Solvency Ratio Directive, which has been amended on the basis of Article 1 (2) of the Mortgage Loan Directive. The new version implements in Principle I the object of circular 14/98 (1998 - I 5 - H 112 - 6/93) of August 26, 1998 to the institutions.

Pursuant to Article 11 (4) of the Solvency Ratio Directive, for a limited period until December 31, 2006, the competent banking supervisory authorities may permit the institutions - under certain conditions, including special requirements pertaining to determining the value - to apply a 50 % weighting to loans which are entirely and completely secured by mortgages on offices or multi-purpose commercial premises situated within the territory of the member state. This option which is open to the member states is implemented by taking as a basis for the maximum mortgage lending value alternative (b) under (i), which links the loan-to-value ratio of the property that serves as collateral for the mortgage loan to the mortgage lending value (with additional attention paid to the market value). Specifically, the following applies:

Only loans which are secured by mortgages on offices or multi-purpose commercial premises may be given privileged treatment. Mortgages on other commercially used property do not effect a reduction in weighting (including, for example, property that is used for mining). The office and commercial premises must be situated in the area in which the Banking Act applies or in a member state which makes use of the option pursuant to Article 11 (4) of the Solvency Ratio Directive. The privileged treatment is for a limited period until December 31, 2006. The 50 % weighting of loans granted before December 31, 2006 may be retained under the conditions listed below if changes in the contractual terms of the mortgage loan are ruled out. Changes in interest or redemption rates are not deemed to be changes in the contractual terms.

The application of the 50 % weighting to the above-mentioned mortgage loans is subject to three conditions, all of which have to be fulfilled:

1. The amount of the loan may not exceed 60 % of the mortgage lending value (section 12 (1) of the German Mortgage Bank Act) and 50 % of the saleable value of the property used as collateral for the mortgage loan . The Mortgage Loan Directive defines the saleable value (which, however, is referred to as the "market value" in the German-language version of the directive) as the price at which the property could be sold under private contract between a willing seller and an arm's length buyer on the date of valuation, it being assumed that the property is publicly exposed to the market, that market conditions permit orderly disposal and that a normal period, having

regard to the nature of the property, is available for the negotiation of the sale. This is consistent with the definition of the saleable value under section 194 BauGB. The saleable value, however, does not have to be determined solely in accordance with the Determination of Value Regulation (*Wertermittlungsverordnung*) of December 6, 1988 as amended. It is also possible for the value to be determined by using recognised professional methods, provided they have been authorised by the responsible department of the Federal Banking Supervisory Office. The mortgage lending value and the saleable value do not have to be determined by different valuers. The valuer who assesses the mortgage lending value may also assess the saleable value. Subsequent determination of the saleable value is not necessary for the mortgages of loans granted before circular 14/98 of August 26, 1998 - I 5 - H 112 - 6/93 (reprinted in the collection of texts by Consbruch/Möller/Bähre/Schneider: *Kreditwesengesetz* under No. 3.104).

2. The mortgage lending value is to be revalued at least every three years or revalued if the market value falls by more than 10%; with particular reference to the underlying assumptions about the relevant market developments. The Mortgage Loan Directive concentrates on a fall in "market prices". Since this term cannot be regarded as being unambiguously defined either in the directive or in professional circles, it would seem prudent to refer to a fall in the saleable value. In practice, market prices are likely to be near to the saleable value if not, in fact, identical to it. The revaluation also concerns loans which were in the institution's portfolio before circular 14/98 was issued. A revaluation assumes, as a minimum requirement, that a knowledgeable and qualified person - who may be a member of staff of the bank granting the loan who is not involved in processing the loan - examines whether the original assessment of the underlying conditions as well as the other assumptions about the market in question, on which the appraisals were based, are still valid and documents this in a verifiable manner. If it transpires that the earlier assumptions and findings are no longer accurate, the mortgage lending value should be recalculated. An ongoing analysis of the market is to be used to determine whether the saleable value has fallen by more than 10 % on the basis of the circumstances obtaining on the regional market in question.
3. The property must be used or let by the owner either now or in the future. The possibility of using the property does not include the granting of loans for property development. The Mortgage Loan Directive expressly rules out the application of the privileged weighting to loans for property development. Loans granted as project funding are likewise excluded from privileged treatment.

Which properties are to be regarded as offices or multi-purpose commercial premises is not defined either in the Solvency Ratio Directive or in the Mortgage Loan Directive. The definition of the terms is therefore left to the discretion of the competent authorities of the member states. The underlying intention of the provision is that the possibility of the said commercial properties being used by a third party is a general defining criterion. In specific cases, it may be practical to use an appropriate classification of the Federal Statistical Office for the properties "office and administrative buildings" and "commercial buildings including warehouses". The Federal Statistical Office counts non-residential buildings which are predominantly used for office and administrative purposes as "office and administrative buildings". Commercial office and administrative buildings belong to this group, as do bank and insurance firm buildings as well as public sector office buildings. "Commercial buildings including warehouses" are defined as non-residential buildings in which primarily goods are displayed and/or sold or which are intended for the storage of goods of all kinds. Commercial buildings include buildings for the retail trade excluding factory or workshop buildings, filling stations excluding servicing and car-wash buildings as well as market halls and premises which are made available by local authorities for holding fairs and markets. Storage buildings are deemed to be built-on locations for the storage of goods of all kinds.

#### **Section 14 (1) sentence 2**

#### **Translation of gold positions when calculating the overall currency position**

Previously, the rates quoted on the Frankfurt Gold Exchange were used as the basis for translating gold positions into Deutsche Mark. The discontinuation of the Frankfurt Gold Exchange together with the Frankfurt Currency Exchange has meant that a new provision has had to be made for translating gold positions. The new provision has been made by an amendment of the second half-sentence of section 14 (1) sentence 2, in accordance with which the basis for translation into the reporting currency is the rate quoted on the market that is to be regarded as representative in terms of the volume of turnover. The clause is modelled on a corresponding provision for the translation of commodities positions (see section 16 (1) and the relevant "Explanatory notes"). Accordingly, an institution has to document the decision on which market it regards as being representative for determining the spot prices used for the translation as well as the reasons for that decision; the documentation is to be submitted to the Federal Banking Supervisory Office on request. In a large number of cases, the London Gold Market is likely to come under consideration as the representative market. When using the quoted fixings of the London Gold Bullion Association, the last fixing before the end of each business day (afternoon fixing) should be used as a basis. Section 6 (2), to which reference is made in the first half-sentence of section 14 (1) sentence 2, also applies.

**Section 15 (1) sentence 1 number 6 and (2) sentence 1 number 6**  
**Treatment of irrevocable guarantees in connection with non-currency options**

The amendment in section 15 concerns the correction of an editorial error: Irrevocable guarantees which, when called, lead to an increase in the non-currency options referred to under subsection (1) sentence 1 number 5 and subsection (2) sentence 1 number 5, are now to be included among the asset and liability positions pursuant to section 15 (1) sentence 1 and subsection (2) sentence 1.

**Section 15 (1) sentence 2 and (2) sentence 2**  
**Treatment of expected income and expenditure in connection with non-currency options**

The above-mentioned amendment is likewise implemented in subsection (1) sentence 2 and (2) sentence 2. Expected income and expenditure which are demonstrably secured by asset and liability positions in non-currency options purchased may be allocated to the asset or liability positions as chosen by the institution on a lasting basis.

**Section 16 (1) sentence 3**  
**Treatment of commodity contracts which constitute matched commodities positions for the entire duration of the contract**

The exception provided for under section 16 (1) sentence 3 is based on Annex VII item 3 of CAD, pursuant to which commodities positions which are purely stock financing may be excluded from the commodities risk calculation. This refers to contracts which, by their intention, constitute a matched commodities position for the duration of the contract. Since the price at which the stocked commodity will be sold at a future date is already fixed, there is no commodity price risk, although there may be a counterparty risk arising from the futures contract and an interest rate risk arising from the stock financing. Such commodities contracts, where there is *a priori* no possibility of a price risk, may be ignored when calculating the commodities risk positions which are subject to weighting requirements. The exclusion of such contracts from the application of the provisions pursuant to Part IV requires the approval of the Federal Banking Supervisory Office. Approval, is deemed to be granted if the institutions give informal notification to the Federal Banking Supervisory Office of their wish to apply the exception provision pursuant to section 16 (1) sentence 3 furnishing a detailed statement of the relevant positions and if the Federal Banking Supervisory Office has not objected to this request. Instead of the individual institutions, the competent associations may also give notification on behalf of the associated institutions concerned, provided that the notification contains information related to the individual institutions. The purpose of notification is to inform the banking supervisory authorities of the aforementioned commodity contracts and the resulting risks. Although commodity contracts which constitute matched commodities positions are not subject to a commodity price risk, they are subject to a counterparty risk, which is to be weighted in accordance with the provisions of Part II. If an institution allocates the said commodity contracts to the trading book, the contracts are also to be included when calculating the net interest position pursuant to section 18 (1) number 1a if they constitute interest rate risks. The reference to section 18 in the "Explanatory notes" on the

Announcement of the amendment of the Principles concerning the Capital and die Liquidity of Credit Institutions of October 29, 1997 - I 7- A 223 - 2/93 -, which states that the interest rate risks associated with equity and commodity derivatives are not to be included when the calculating capital requirements in accordance with Part V, is therefore no longer applicable (page 91).

The exception provision of section 16 (1) sentence 3 is likely to apply, in particular, to that cross-currency business conducted by mixed-activity credit cooperatives, in which the physical stocks of commodities or the commodities acquired at a forward date are sold at a later date on previously agreed terms and the financing costs are fixed until the fulfilment of the forward sale.

**Section 18 (2) sentence 2**  
**Inclusion of the underwriting of securities when determining the trading book risk positions**

When determining the net interest and net equity positions, the weightings listed in Table 5 under section 18 (2) are to be assigned to the underwriting of interest-rate or equity-price-related securities on the basis of the time from the date of the initial commitment. This provision is based on Annex I item 39 CAD. It was already the case that, conversely, underwriting commitments received from third parties may be included with effect of reducing the position. For the sake of clarification, this is now stated explicitly in the newly inserted sentence 2.

**Section 19 (1) sentence 3**  
**Inclusion of trading book assets when determining net positions**

The newly inserted sentence 3 under section 19 (1) makes it clear that assets which are allocated to the trading book are to be treated like securities when applying the provisions under Part V for trading book risk positions. This means that the positions in these assets are treated in the same way as the positions in securities. This clarification has practical relevance with regard to the net interest positions, since these trading book assets are typically claims arising from unsecuritised money market instruments or assets in the form of forward deposits that are allocated to the trading book. The fact that positions in the said assets are treated in the same way as the corresponding securities net interest positions means that the general weighting principles for the general and the specific market risk of net interest positions apply without restriction. If received forward deposits constitute negative net interest positions, the resulting specific market risk would likewise have to be included in a strict application of the marking-to-market principle, where all price changes in interest-rate-sensitive positions are included on each business day. If they constitute negative net interest positions, in the event of a positive market assessment of the institution this approach results in a rise in the partial capital charge for the specific risk. This outcome appears to be paradoxical since, as a rule, the aforementioned market assessment is likely to be associated with a higher financial standing on the part of the institution. For that reason, we agree to negative net interest positions of forward deposits being excluded from the determination of the net interest position in respect of the specific risk pursuant to section 23 until further notice.

Claims in the form of commissions resulting from positions of the trading book are not deemed to be assets within the meaning of subsection (1) sentence 3 .

**Section 22, Table 8**  
**Time bands when applying the duration method**

Owing to a clerical error, the marking in Table 8 for distinguishing between the medium-term and long-term time bands was incorrectly placed, giving a potentially erroneous impression of the demarcation between the maturity bands when applying the duration method. This error has been rectified by moving the bottom dividing line in Table 8: In line with the division of zones under section 21 (1) sentence 4, to which reference is made under section 22 (1) sentence 2, the three time bands which follow the short-term maturity zone are combined to form the medium-term maturity zone and the remaining time bands are combined to form the long-term maturity zone.

**Section 25 (1) sentence 2**  
**Net positions arising from forward contracts on a commonly used stock index**

In the light of the revision of the basis under EC law arising from Annex I item 37 CAD and the corresponding passage in the Basle Market Risk Paper of January 1996 (Part A.2 item 7), the earlier provision that net positions in stock index contracts are to be assigned a zero weighting in all cases when determining the partial capital charge for the specific risk in net equity positions was no longer tenable. Exempting the special equity-price risk in stock index forward contracts from the capital requirements is justified only if these forward contracts are traded on a stock exchange and if, in the opinion of the competent authorities, they refer to indices with a high degree of diversification. The criterion of a high degree of diversification was hitherto not required as a precondition for the specific risk in the aforementioned stock index contracts to be exempted from weighting. In order to remedy this shortcoming, section 25 (1) sentence 2 has been reworded so that only those net positions arising from forward contracts on a commonly used stock index are to be excluded. The listing in the "Explanatory notes" to section 25 (2) sentence 3 indicates which stock indices are to be regarded as commonly used stock indices. Not only may it be assumed that the equities included in the commonly used stock indices are highly liquid; there is also the justified assumption that the stock indices are highly diversified.

The commonly used stock indices include:

- |                       |                     |
|-----------------------|---------------------|
| – AEX (Netherlands)   | – HEX 20 (Finland)  |
| – AllOrds (Australia) | – IBEX35 (Spain)    |
| – BEL20 (Belgium)     | – MIB 30 (Italy)    |
| – BVL 30 (Portugal)   | – Nikkei225 (Japan) |
| – DAX30 (Germany)     | – TSE35 (Canada)    |

- DAX100 (Germany)
- MDAX (Germany)
- Dow Jones Stoxx 50
- Dow Jones Stoxx
- Dow Jones Euro Stoxx
- Dow Jones Industrial Average
- Dow Jones Euro Stoxx 50
- CAC40 (France)
- FTSE100 (United Kingdom)
- FTSE Eurotop 100
- FTSE mid-250 (United Kingdom)
- HangSeng (Hong Kong)
- ATX (Austria)
- OMX (Sweden)
- SMI (Switzerland)
- StraitTimes (Singapore)
- S&P500 (USA)
- NASDAQ 100 (USA)

The Dow Jones Euro Stoxx 50, the Dow Jones Stoxx, the Dow Jones Stoxx 50, the Dow Jones Euro Stoxx, the Dow Jones Industrial Average, as well as the FTSE mid-250 and the FTSE Eurotop 100 for the United Kingdom have been added to the list of commonly used stock indices contained in the "Explanatory notes" - I 7 - A 233 - 2/93 of October 29, 1997 (page 133).

The provision of section 25 also applies to stock index options traded on a financial futures exchange.

#### **Section 27 (1)**

#### **Settlement and counterparty risk positions of the trading book in the case of transactions in financial instruments including commodities**

Under subsection (1) a second sentence has been inserted which makes clear that commodities are deemed to be financial instruments when applying the provisions pursuant to section 27. The reason for this clarification is that commodities are mentioned separately alongside financial instruments in the framework definition of the trading book in Article 2 No. 6 CAD. This distinction, which is ultimately of only terminological importance, has not been adopted in Principle I. The term "financial instruments" has also taken the place of "securities" or "debt instruments and equities". In that respect, terminology has been brought into line with the provisions of the "Regulation governing large exposures and loans of three million Deutsche Mark or more". Commodities have been equated with financial instruments for the following reason: If, for the institution's internal purpose, commodities and commodity derivatives are to be equated with trading book positions and the provisions under Part V are applicable, the settlement and free delivery risks as well as replacement risks now have to be included when determining the partial capital charge for the settlement and counterparty risk positions. This follows from a corresponding requirement of Annex II CAD, which is specified by CAD II. The provisions concerning the settlement and counterparty risk in connection with securities and securities transactions of the trading book are extended to commodities and commodity-price-related transactions of the trading book. The amendment concerns the settlement risk, the free delivery risk, the settlement and counterparty risk in connection with repurchase agreements and securities lending and borrowing, and the replacement risk in OTC transactions.

**Section 27 (1) 4****Limited-period exemption from weighting of derivative contracts which are cleared by a recognised clearing house**

The exemption of derivative contracts which are cleared by a recognised clearing house from weighting as risk assets pursuant to the provisions of Part II of Principle I until December 31, 2006 applies, under the conditions stated in section 13 (1) 5, likewise with regard to determining the replacement costs of such contracts within the context of section 27. The appropriate amendment of section 27 (1) 4 has implemented the option granted pursuant to Annex II No. 5 CAD in favour of the institutions, which was stipulated on the basis of Article 3 No. 2 of Council Directive 98/33/EC. The comments in the "Explanatory notes" to section 13 (1) 5 apply accordingly with regard to the conditions for exemption from weighting. Decisions taken by the Federal Banking Supervisory Office in respect of section 13 (1) 5, likewise apply with regard to section 27 (1) 4.

**Section 27 (2) 1****Capital charges for settlement and counterparty risk positions of the trading book in transactions with financial instruments**

The amendment to section 27 (1) sentence 1 numbers 1 and 2, pursuant to which, when determining the settlement and the free delivery risks, not only transactions in debt instruments and equities, but also other transactions in financial instruments (including commodities) have to be included, has meant that an editorial amendment has had to be made in section 27 (2) 1. However, owing to the chosen wording, no editorial amendment was required for number 2 of section 27 (2) concerning the capital charges for the free delivery risk.

### **Section 27 (3)**

#### **Conditions for weighting the settlement and counterparty risk positions in repurchase agreements and securities lending and borrowing on a net basis**

Since the wording of section 27 (3) conflicted on one point with the practical circumstances, the conditions for weighting the settlement and counterparty risks positions arising from repurchase agreements and securities lending and borrowing on a net basis have been reworded: In terms of the requirement that the risk positions be measured daily at market value (see number 1), it is crucial that the institution which is subject to Principle I meets this requirement. It is not enough, however, to address this requirement to the transferee or borrower, which also might be impractical if the transferee or borrower is not an institution to which Principle I applies. An additional, practical problem that an institution acting as a transferor or lender does not necessarily know whether the transferee or borrower measures the risks at market value on a daily basis and, owing to this gap in information, is prevented from determining the capital charge pursuant to section 27 (2) number 3 on a net basis. The amended version of section 27 (3) removes these obstacles.

### **Section 32 (1) sentence 1**

#### **Combining market risk positions when using internal models**

The amendments corrects an editorial inaccuracy and makes it clear that the option under section 32 for determining the capital charges and partial capital charges for the market risk positions using internal risk models does not extend to the settlement and counterparty risk positions mentioned in section 5 (3) number 2. This does not involve a material change in the existing legal situation since the model alternative was already confined to partial capital charges for the general and specific market risks for the area of interest and equity risks and to the capital charges for the area of foreign exchange and commodity risks. The clarification that has now been made is also consistent with Annex VIII No. 1 CAD, which allows the model alternative only as a substitute for the methods pursuant to Annexes I, III and VII, whereas provision for determining the capital charges for the settlement and counterparty risks is made in Annex II.

### **Section 32 (1) sentence 2**

#### **Temporary use of suitable risk models for the calculation of individual capital charges or partial capital charges**

The amendment now makes clear in the text of Principle I itself that "partial use" may not generally be made on a long-term basis, but - in conformity with the intention of the Basle market risk regulations, may be only a temporary measure of assistance for institutions which are progressing towards a wide-ranging application of their own internal risk models. This is consistent with the Basle market risk regulations (see Part B. 2d) and Annex VIII No. 2(ii) CAD, pursuant to which the risk model must be closely integrated into the institution's daily risk-management system and its results must accordingly be an integral part of the planning, monitoring and managing of the institution's market risk profile. Failure to apply the risk model to all risk areas would regularly result in the risks for the various risk

areas being measured and determined differently and the risks therefore not being comparable or comparable only to a very limited extent. Such a situation could not possibly form a reasonable basis for consistent risk management (and still less so for a management of the whole bank by risk-adjusted income based on it). Besides the question of whether this would be an infringement of the "Minimum requirements for trading activities" (item 3.1), it would be open to doubt whether the above-mentioned requirement of the Basle market risk regulations (Part B. 2d, integral part) would be met. This does not, of course, apply to risk areas of only secondary importance, which may continue to be excluded if there are significant technical and/or conceptual obstacles to their being incorporated into the risk model. Furthermore, until further notice the restriction to only temporary use does not apply to the use of internal risk models for calculating the partial capital charges for the general price risk and the use of the standard methods for determining the partial capital charges for the specific risk, unless, in specific cases, the mathematical-statistical procedures of the internal risk model permit the partial capital charge for the specific risk to be calculated in an uncomplicated manner. This is generally likely to be the case if, for example, in the area of equity price risk each type of equity is treated as an autonomous risk factor in the risk model. In all cases, an institution using an internal risk model should seek to incorporate all relevant risk areas in its risk model quickly and comprehensively and resist the temptation to use the facility of "partial use" to reduce its capital requirements by exploiting the possibility available in some cases of lower weightings of the standard methods.

#### **Section 33 (1) sentence 2**

#### **Combining the partial capital charges for the general price risk and the specific risk**

The previous version of Principle I lacked a provision on how the partial capital charges for the general price risk and the specific risk are to be combined using internal models, in particular, how to measure the increased surcharge to be applied in accordance with the Basel "modification". Furthermore, no provision was made for the distinction made in the Basel "modification" between models which completely capture the specific risk including the default and event risks that are to be recorded in it (non-surcharge models) and models which are not able to capture the default and event risks (surcharge models).

The substance of the amendment that has been made will be explained in a Federal Banking Supervisory Office circular on the specific risk, which is in preparation.

**Section 33 (1) sentence 1**  
**Size of the scaling factor**

As a result of the newly appended sentence 2 in subsection (1), the second half-sentence in section 33 (2) sentence 1 is no longer applicable. The capital charge to be calculated pursuant to section 33 (1) sentence 2 first half-sentence for the value-at-risk numbers in accordance with subsection 1 sentence 1 number 2 when using an internal surcharge model is, in practical terms, identical to the application of the scaling factor of 4 that was expressly stated previously. The chosen method of presentation now conforms with the wording of Annex VIII No. 8 CAD and the Basle modification (see Part B.8, item 3 of the Basle market risk regulations).

**Section 33 (2) sentence 3**  
**Determining the surcharge**

Pursuant to section 37 of Principle I, back-testing of internal risk models has to take the form of a comparison of the value-at-risk with the hypothetical changes in the portfolio's value; this is consistent with Annex VIII No. 7 CAD, pursuant to which the competent authorities may prescribe the use of the hypothetical changes in value. In practice, the expression "clean back-testing" has been adopted for this procedure.

The above-mentioned provision of the CAD provides that "clean back-testing" has to be used consistently and that a parallel use of "clean" and "dirty" back-testing is therefore not permissible on a long-term basis. The experience of the Federal Banking Supervisory Office has shown, however, that institutions are generally not immediately in a position to comply with the "clean back-testing" requirement of section 37 (1). The amendment is intended to make clear that the Federal Banking Supervisory Office may take due account of such deficiencies or of qualitative shortcomings of the back-testing when determining the surcharge without being compelled to refuse recognition of, or consent to the use of, the model without reference to the circumstances.

**Section 33 (2) sentence 3**  
**No setting of time intervals for the surcharge from the outset**

The experience of the Federal Banking Supervisory Office indicates that it is impracticable to set a time interval when the surcharge is initially set or when revising a surcharge that has already been set. It is therefore being rescinded. The institutions nevertheless still have the option of applying to the Federal Banking Supervisory Office for a revision of the surcharge that has been set, provided that at least six months have passed since the surcharge was last set and the circumstances that led to the setting of a surcharge have been eliminated on a lasting basis.

**Section 35 (1) sentence 2**  
**Inclusion of concentration risks**

The amendment adopts the essential requirements of Annex VIII No. 4 CAD pertaining to risk models that are intended to capture the specific risk.

The requirement of the first indent (ability of the risk model to explain the historical price variation in the portfolio) is already contained in the general wording of section 35 sentence 1. When using quality criteria, i.e. yardsticks for the model forecasts' ability to fit the historical data, it is expected that the model is able to explain a significant part of the historical price variation in the portfolio or that explicit risk factors for the specific risk are incorporated into the modelling in a suitable form.

The requirement of the second indent for capturing (issuer-related) concentration risks, i.e. adequately capturing the diversification effect, was not previously contained in Principle I. The newly appended sentence 2 in subsection 1 is designed to implement this requirement. Accordingly, in the case of models which are intended to model the specific risk, it has to be demonstrated that increasing shares of positions in securities with a specific risk also result in higher value-at-risk numbers.

The requirement of the third indent for model robustness, which is expressed in CAD in the form that the model is robust to an adverse environment, i.e. that the assumptions made by the institution about the underlying distributions have to be sufficiently appropriate, is a requirement that relates generally to the suitability of the model and which was therefore already included in what is now sentence 1 of section 35 (1). The requirement simultaneously includes the stipulation that appropriate stress tests be conducted pursuant to section 36 (5) of Principle I

The requirement of the fourth indent (performing back-testing) remains unaffected by this, since this is already included in the present Principle I (section 37) in general form.

**Section 36 (2) sentence 1**  
**Calculation, analysis and annotation of the value-at-risk**

The past experience of the Federal Banking Supervisory Office has shown that the responsibilities of the risk control unit were not sufficiently comprehensive in their formulation. On grounds of legal certainty, the description of the responsibilities to be assigned by the management to the independent risk control unit has been worded more precisely. This also takes due account of the requirement under Annex VIII No. 2(ii) CAD, pursuant to which the risk control unit has not only to produce but also analyse the reports on the output of the risk-measurement model. The results of the analysis have to be recorded in written form ("annotated"). Although this is obvious, this requirement has been included in the text of the Principle for the sake of clarity.

**Section 36 (2) sentence 2**  
**Organisational separation of the trading unit up to the managerial level**

The member of senior management responsible for risk controlling may not have any operational influence in the sense of contracting positions, since there is otherwise the possibility of exerting an influence on the design of risk models and the risks captured by them or of otherwise influencing the tasks of the risk control unit, which must be ruled out. Opportunities to exercise operational influence arise not only from trading activities *per se* but also in connection with the authorisation to contract, change or close risk positions autonomously. This is not in contradiction to the requirement of Annex VIII No. 2(iii) CAD, pursuant to which the level of management responsible for risk controlling must have sufficient authority to enforce both reductions of individual risk positions taken as well as in the institution's overall risk exposure, since this requirement concerns only the ability to initiate such measures but does not include conducting them oneself.

The amendment that has been made also adopts *mutatis mutandis* the "Minimum requirements for trading activities" (item 4.4). The amendment also implements the requirement under Annex VIII No. 2(ii) CAD, pursuant to which the risk control unit that is independent from business trading units reports directly to senior management. The underlying requirement of the risk control unit being independent from business trading would be thwarted if the responsible member of senior management were to have operational powers and independence from the business trading unit could thus be undermined in this way.

**Section 36 (5) sentence 1**  
**Calculation of crisis scenarios**

The Federal Banking Supervisory Office's previous experience of model testing pursuant to section 32 Principle I have revealed the necessity of defining the requirement pertaining to the frequency with which stress tests are to be conducted and of setting a limit for the time intervals. Under the new sentence 1, stress tests are to be conducted at intervals which are appropriate to the risks arising from the scale and structure of the business or a portfolio of the institution. In particular, complex option positions may generally be made subject to stress tests more frequently than only once a month and on a daily basis, if necessary. In this respect, the requirement pursuant to Annex VIII No. 2(vii) CAD of "frequent" stress testing in compliance with the institution's business structure has also been defined more closely with regard to the aspect of timing.

**Section 36 (5) sentence 2**  
**Calculation of crisis scenarios for subportfolios**

The previous experience of the Federal Banking Supervisory Office has revealed the necessity, for the sake of explicit standards and on grounds of legal certainty, of anchoring the requirement to conduct stress tests also at the subportfolio level in the text of Principle 1 as well. This is necessary because it is only when stress tests are conducted at the subportfolio level that it is possible to make meaningful statements about any existing extreme possibilities of loss, which are blurred in an aggregate analysis at the level of the institution's overall portfolio or are offset by other, contrary effects from other subportfolios. For the detection and analysis of risks and, consequently, the purposeful handling of risk positions it is necessary, however, not to be satisfied with a netted and aggregated analysis, but to undertake detailed studies instead. This requirement corresponds to that in section 37 (1) sentence 1 for clean back-testing at the subportfolio level, which alone can ensure that weaknesses in the model are detected. To that extent, the requirements of Annex VIII No. 2(vii) CAD and of the Basel market risk regulations (Part B.5, item 1) for "rigorous" stress tests have been worded more precisely.