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COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies

SEC(2009) 974 final

SEC(2009) 975 final

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

A new capital requirements framework, based on the 'Basel-II' revised international capital framework, was adopted in June 2006 as the Capital Requirements Directive ('CRD'): this comprises Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

There is widespread recognition that further regulatory reform is needed to address weaknesses in the regulatory capital framework and in the risk management of financial institutions that contributed to the turmoil in global financial markets. As part of its response to the financial crisis, in November 2008 the Commission mandated a High Level Group chaired by Mr. Jacques de Larosière to propose recommendations for reforming the European financial supervision and regulation. The thirty one recommendations¹ of that Group represented a comprehensive set of proposals for regulatory and supervisory repair. With regard to remuneration structures, the Larosière Report recommends that compensation incentives should be better aligned with shareholder interests and long-term profitability by basing the structure of financial sector compensation schemes on the principles that bonuses should reflect actual performance, should not be guaranteed, and that the assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle.²

Building on the Group's recommendations, in its Communication "Driving European Recovery" for the spring European Council of March 4, 2009³ the Commission set out an ambitious programme of financial services reform. The present proposal is one of the several measures that the Commission has already taken to implement that programme.

The Communication stated that a proposal for the revision of the CRD to be presented by the Commission by June 2009 would:

- include provisions to reinforce capital requirements for assets that banks hold in the trading book for short-term resale;
- upgrade the capital requirements for complex securitisations, both in the banking and in the trading book; and
- enable supervisory authorities to impose capital 'sanctions' on financial institutions the remuneration policies of which are found to generate unacceptable risk.

Similar objectives were also agreed by leaders of the G20 at the meeting in London on 2 April 2009. The Declaration on Strengthening of the Financial System⁴ announces an agreement to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system; and to endorse and implement the Financial Stability Forum's principles on pay and compensation and to support sustainable compensation schemes.⁵

¹ http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

² Recommendation 11.

³ http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_en.pdf

⁴ http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

⁵ European leaders expressed their support for these measures at the European Council of March 19-20, 2009

On the same date, the Financial Stability Forum ('FSF') published a report on Addressing Procyclicality in the Financial System and Principles on Sound Compensation Practices in the financial industry,⁶ aimed at aligning employees' incentives with the long-term profitability of the firm.

The report of the FSF on Addressing Procyclicality sets out recommendations to mitigate procyclicality which cover three areas: bank capital framework, bank loan loss provisions, and leverage and valuation. The Basel Committee on Banking Supervision has issued Recommendations intended to mitigate the risk that the regulatory capital framework might amplify the transmission of shocks between the financial and real sectors. This includes proposals to reduce the reliance on cyclical VAR-based capital estimates and enhance the risk coverage for re-securitization instruments and default and migration risk for non-securitized credit products. In support of the recommendations of the FSF and the G20, the Basel Committee is working on developing more detailed changes to the current rules to a timetable set by the G20.

The FSF Principles on Sound Compensation Practices call for effective governance of compensation, and for compensation to be adjusted for all types of risk, to be symmetric with risk outcomes, and to be sensitive to the time horizon of risks. They also recommend that implementation by firms should be reinforced through supervision.

The Commission took the first step towards addressing the problems that arise from poorly designed compensation structures when, on 30th April 2009, it adopted Recommendations on the regime for the remuneration of directors of listed companies⁷ and on remuneration policies in the financial services sector.⁸ The Communication that accompanied the Recommendations indicated that the CRD would be modified to bring the remuneration arrangements of banks and investment firms within prudential oversight.

The Committee of European Banking Supervisors ('CEBS') has also developed principles on remuneration policies, which were published on 20th April 2009. The scope of the principles covers remuneration policies applying throughout an organisation, and focuses on key aspects including the alignment of company and individual objectives; governance with respect to oversight and decision-making; performance measurement; and forms of remuneration.

The current proposal is intended to give effect to the commitments set out in the Commission Communication of 4 March, and is consistent with the high level international objectives agreed by G20 leaders.

Finally, in accordance with the undertakings set out in its Communication of 4 March, the Commission will propose further changes to the CRD in October 2009 to address liquidity risk and excessive leverage, introduce provisions for dynamic capital reserving, and remove national options and discretions to advance progress towards a common rule book.

2. PUBLIC CONSULTATION

An open internet consultation on proposed draft revisions to trading book and securitization provisions was conducted from March 25 until April 29, 2009. Eighteen responses were received.

⁶ http://www.fsforum.org/publications/r_0904a.pdf

⁷ Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (C(2009)3177/2).

⁸ Commission Recommendation on remuneration policies in the financial services sector (C(2009)3159/2).

The responses generally supported the objectives of the Commission's draft proposals. Some respondents expressed concerns that the approach to re-securitisations was not sufficiently targeted. However, such concerns arose from an assumption that the Commission intended what would in effect be a general ban by requiring the deduction from capital of *all* re-securitisations. This was not the Commission's intention, and that has been made clear by modifications which represent a more differentiated approach.

A separate online public consultation on a proposed draft of remuneration policy provisions ran from April 29 until May 6, 2009 on DG MARKT website. Twenty three responses were received from financial institutions and industry representatives, Member States and regulators.

The majority of respondents expressed support for the principle that remuneration policies within the banking sector should be consistent with sound and effective risk management, and that this should be brought within the scope of supervisory review under the CRD.

Some expressed concerns that because remuneration policies and practices are tailored to the structure and business model of individual institutions, the principles set out in the CRD should not be too prescriptive. The Commission believes that the text permits the necessary flexibility by requiring firms to comply with the principles in a way that is appropriate to their size, internal organisation and nature, scope and complexity of their activities. In addition, other respondents were concerned that including remuneration for employees, other than executives, within the scope of supervisory review might impact adversely on collective agreements that banks and investment firms have in place for non-management employees.

3. IMPACT ASSESSMENT

Altogether, fourteen different policy options have been assessed. The summary below describes the preferred policy option and its expected impact.

Trading Book

With respect to capital requirements for bank trading books, the following targeted amendments, aligned with what is envisaged by the Basel Committee, will be introduced:

- Adding an additional capital buffer based on stress scenario VAR to the ordinary VAR. This change is expected to roughly double current trading book capital requirements.
- Extending the existing charge for default risk in the trading book to capture losses short of issuer default, e.g. rating downgrades, to address the fact that recent losses on traded debt most of the time did not involve issuers actually defaulting. The impact of this change will depend on the composition of banks' portfolios in the post-crisis environment.
- Basing the charge for securitisation positions in the trading book on the existing simple risk weights for the banking book. Again, the impact of this change will depend on the composition of banks' portfolios in the post-crisis environment.

Generally, banks tend to maintain capital levels that are in line with internally developed 'targets', and which may lead to higher capital levels than those required by minimum capital requirements. Therefore, it is not straightforward to estimate how much additional capital banks would have to raise in order to comply with the proposed amendments. An increase in the minimum capital required might be partially absorbed by existing capital buffers. For instance, the overall solvency ratio for large euro-area financial institutions at the end of first half of 2008 was on average 11.4%, implying an average capital buffer (over the minimum capital requirements) of 3.4% of risk-weighted assets.

Re-securitizations

In line with the approach developed by the Basel Committee, re-securitization positions would be assigned a higher capital requirement than other securitisation positions to reflect the higher risk of unexpected impairment losses.

For particularly complex re-securitizations, the proposals reinforce both the due diligence requirements and the supervisory process to enforce them. For investments in re-securitizations of particularly high complexity, banks will have to demonstrate to their supervisor that necessary due diligence standards have been met. If they cannot do so, a general deduction from capital would apply. In instances where compliance with required due diligence is found to be inadequate, institutions would be debarred from future investment in such instruments.

The impact of these measures on the future credit supply – the funding of which is facilitated in part by issuance of re-securitizations such as certain collateralized debt obligations (CDOs) - should be assessed in the light of the level of their issuance in the post-crisis market environment. Evidence shows that total CDO issuance in Europe contracted from €88.7 billion in 2007 to €47.9 billion in 2008. This contraction would have been even more pronounced had the European Central Bank and the Bank of England not been accepting securitization as collateral: in 2008, 95% of all securitization issuance was retained by banks for 'repo' purposes, with primary market remaining effectively closed due to significantly diminished investor appetite for these instruments. Against such trends, any incremental impact on the CDO issuance and credit supply would appear to be limited. However, this measure could limit recovery of the secondary market for the affected instruments.

Disclosure of Securitization Risks

Disclosure requirements, in line with internationally agreed standards, would be enhanced in several areas such as securitization exposures in the trading book and sponsorship of off-balance sheet vehicles.

These changes will improve investor understanding of banks' risk profile and, by enhancing transparency, reinforce banks' risk management. The incremental administrative burden for the EU banking industry is estimated at €1.3 million per year and is expected to fall mostly on larger institutions with more advanced approaches to risk management.

Supervisory Review of Remuneration Policies

The proposed amendments will impose on credit institutions and investment firms to have remuneration policies that are consistent with effective risk management. The relevant principles will be set out in the CRD, but will be closely aligned with those set out in Commission Recommendation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial services sector.

Making the relevant principles of the Recommendation binding will increase the rate of compliance by credit institutions and investment firms.

The proposal allows firms the flexibility to comply with the new obligation and high level principles in a way that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities. This approach is likely to minimise the up-front and on-going compliance costs for firms, and was therefore preferred over an alternative of requiring a strict and uniform compliance by all firms, irrespective of their size, with the principles set out in Commission Recommendation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial services sector.

BUDGETARY IMPLICATION

The proposal has no implication for the Community budget.

4. LEGAL ELEMENTS OF THE PROPOSAL

Given that changes need to be introduced into an existing Directive, an amending Directive is the most appropriate instrument. This amending Directive should have the same legal basis as the Directive it amends. Therefore, the proposal is based on Article 47(2) EC, which provides the legal basis for the harmonisation of rules relating to the taking up and pursuit of the business of, inter alia, credit institutions.

In accordance with the principles of proportionality and subsidiarity as set out in Article 5 EC, the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore be better achieved by the Community. Its provisions do not go beyond what it is necessary to achieve the objectives pursued.

Only Community legislation can ensure that credit institutions operating in more than one Member State are subject to the same requirements for prudential supervision, in this case by ensuring that the already harmonised capital requirements framework for credit institutions and investment firms is further strengthened by reinforced capital requirements for trading book items, appropriate due diligence and upgraded capital requirements for complex re-securitisations, and the introduction of explicit rules and appropriate supervisory measures and sanctions with regard to remuneration structures.

5. DETAILED EXPLANATION OF THE PROPOSAL

5.1. Capital requirements for re-securitisation

(Article 1(1) and (9) and Annex I, paragraph (3))

Re-securitisations are securitisations that have underlying securitisation positions, typically in order to repackage medium-risk securitisation exposures into new securities. They have generally been considered low credit risk by rating agencies and market participants. However, given their complexity and sensitivity to correlated losses, such re-securitisations entail higher risks than straight securitisations. Therefore, this proposal comprises a set of capital requirements that are higher than for straight securitisation positions of the same rating.

Furthermore, the proposal includes a strengthened supervisory process for re-securitisations that are particularly complex. The sample-based supervisory review that applies to securitisations and re-securitisations of normal complexity is not sufficiently rigorous for some re-securitisations, where the high level of complexity of the instrument in question casts doubt on the ability of the bank to understand fully the nature and risks of the underlying exposures. The proposal therefore requires that compliance with the applicable due diligence standards for banks that invest in such products be checked for each individual investment made. CEBS will converge supervisory practice by agreeing which types of re-securitisations are 'highly complex', so that the ability of institutions to perform proper due diligence in relation to such instruments can be verified by supervisors on a case-by-case basis. In exceptional cases where a bank cannot demonstrate to its regulator that it has complied with the required due diligence in respect of a highly complex re-securitisation, a risk weight of 1250% will be applied to the position in that re-securitisation. This capital treatment applies to new re-securitisations issued after 31 December 2010, and will only apply to an existing re-securitisation position after 31 December 2014 if new underlying exposures are added or

substituted after that date. Accordingly, the 1250% risk weight cannot be applied to banks' legacy positions in re-securitisations (unless the underlying exposures of those positions are changed after the end of 2014).

5.2. Technical changes

(Article 1(5) and Annex II, point (4); Article 1(7); Article 2(2) and (3); Annex I, point (2) and Annex II, point (2))

In 2006 the Commission and CEBS set up the Capital Requirements Directive Transposition Group (CRDTG) in 2006 to facilitate a coherent implementation and application throughout the EU of the CRD. According to the CRDTG, certain technical provisions of that Directive need to be further specified. For instance, this directive will clarify that capital requirements for settlement risk also apply in the non-trading book.

5.3. Disclosure requirements

(Article 1(11) and Annex I, point (4))

The existing disclosure requirements in the CRD regarding institutions' securitisation exposures are strengthened by this proposal. In particular, the disclosure requirements will in future cover the risks not only of securitisation positions in the non-trading book, but also those in the trading book.

5.4. Market risk capital requirements for securitisations

(Article 1(4), (6) and (8); Article 2(1); Annex II, point (1))

Capital requirements for securitisations in the trading book are currently calculated as if these instruments were normal debt positions. This contrasts with the banking book, where there is a separate, more differentiated and risk sensitive set of capital requirements. This proposal envisages that the trading book capital requirements be based on those for equivalent securities in the banking book.

5.5. Internal models based capital requirements for market risks

(Annex II, point (3))

Institutions may currently calculate their capital requirements for market risks in the trading book using their own models that estimate the potential losses from future adverse market movements. Over 2007-2008, it became clear that internal models systematically underestimated the potential loss in stressed conditions. This led to inadequate capital requirements and cyclical volatility of banks' capital as the market environment deteriorated. Accordingly, this directive will strengthen the capital requirements based on internal models in several respects:

- there will be a requirement to estimate separately the potential losses in a protracted period of adverse circumstances, thereby enhancing the resilience of models under stress conditions and reducing their potential for pro-cyclicality;
- institutions will be required to estimate not only the risk of losses from default of debt items in the trading book, but also the potential losses from deterioration in credit quality short of default;
- to address doubts about the ability of internal models to adequately capture the particular risk profile of securitisation positions, institutions will be required to assess a separate standardised capital charge for the risks of securitisation positions in the trading book.

5.6 Remuneration policies

(Article 1(2) and (3); Annex I, point (1) and point (4)(iii))

Under the current European supervisory framework, there is no express requirement that the remuneration policies of financial institutions should be subject to supervisory oversight. As a result, supervisory authorities have generally not focused on the implications of remuneration policies for risk and effective risk management.

The purpose of this proposed amendment to the CRD is:

- to impose a binding obligation on credit institutions and investment firms to have remuneration policies and practices that are consistent with and promote sound and effective risk management, accompanied by high level principles on sound remuneration;
- to bring remuneration policies within the scope of the supervisory review under the CRD, so that supervisors would be able to require the firm to take measures to rectify any problems that they might identify;
- to ensure that supervisors may also impose financial or non-financial penalties (including fines) against firms that fail to comply with the obligation.

The proposed requirement will apply to credit institutions and, by virtue of Article 34 of Directive 2006/49/EC, to investment firms that are authorised and regulated under Directive 2004/39/EC on markets in financial instruments.

The scope of the proposed obligation is restricted to remuneration for staff whose professional activities have a material impact on the risk profile of the bank or investment firm. This targets the remuneration policies for those individuals who take decisions that may affect the level of risk assumed by the institution.

The proposed high-level principles on sound remuneration are not intended to prescribe the amount and form of remuneration, and institutions remain responsible for the design and application of their particular remuneration policy. Firms have flexibility as to how the principles are applied in a way that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. Credit institutions and investment firms carry out different activities and have different levels of tolerated risk: remuneration structures and application of the principles will vary accordingly.

Prudential oversight in the course of the supervisory review would focus on whether the remuneration policies and practices are consistent with sound risk management given the nature of the firm's business. In order to align supervisory assessments, and to assist firms in complying with the principles, the proposal requires CEBS to ensure the existence of guidelines on sound remuneration policies.

If a supervisor identifies problems it may require the credit institution or investment firm to take qualitative or quantitative measures to address those problems. Those measures may include a ('qualitative') requirement for the firm to rectify the situation by changing its remuneration structure to reduce the inherent risk and – in appropriate cases – a ('quantitative') requirement for the firm to hold additional own funds against the risk.

In addition, competent authorities must also have the power under the CRD to impose penalties for a breach of any requirement of the Directive (including the proposed requirement in relation to remuneration policies). This sanctioning power is separate from the power to require firms to take qualitative or quantitative measures. The proposed amendment to Article 54 CRD is intended to ensure that supervisors have both financial and non-financial sanctions at their disposal, and that such sanctions are effective, proportionate and dissuasive.

This proposed amendment of the CRD complements the Commission Recommendation on remuneration policies in the financial services sector. The more detailed principles set out in the Commission Recommendation, along with the CEBS guidelines, will be relevant to compliance with the obligation under the CRD. They should provide further guidance as to how the obligation might be met, and a framework for regulators when assessing firms' remuneration structures.

5.7 General clarification of supervisory review under Article 136(2)

The proposed new sub-paragraph of Article 136(2) is intended to clarify that, when carrying out the supervisory review, competent authorities should take into account both the quantitative and the qualitative aspects of credit institutions' assessment of internal capital under Article 123, and credit institutions' arrangements, processes, mechanisms and strategies under Articles 22. This clarification applies to the entire review process, and is not restricted to the review of the new requirement relating to remuneration policies and practices. The objective is to facilitate further convergence of supervisory practices across the EU.

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 47(2) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Economic and Social Committee⁹,

Acting in accordance with the procedure laid down in Article 251 of the Treaty¹⁰,

Whereas:

- (1) Excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally. While the causes of such risk-taking are many and complex, there is agreement by supervisors and regulatory bodies, including the G20 and the Committee of European Banking Supervisors, that the inappropriate remuneration structures of some financial institutions have been a contributory factor. Remuneration policies which give incentives to take risks that exceed the general level of risk tolerated by the institution can undermine sound and effective risk management and exacerbate excessive risk-taking behaviour.
- (2) Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions¹¹ requires credit institutions to have arrangements, strategies, processes and mechanisms to manage the risks to which they are exposed. By virtue of Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions¹² that requirement applies to investment firms within the meaning of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC¹³. Directive 2006/48/EC requires competent authorities to review those arrangements, strategies, processes and mechanisms, and to determine whether the own funds held by the credit

⁹ OJ C , , p. .

¹⁰ OJ C , , p. .

¹¹ OJ L 177, 30.6.2006, p. 1.

¹² J L 177, 30.6.2006, p.201.

¹³ OJ L 145, 30.4.2004, p.1.

institution or investment firm concerned ensure a sound management and coverage of the risks to which the institution or firm is or might be exposed. That supervision is carried out on a consolidated basis in relation to banking groups, and includes financial holding companies and affiliated financial institutions in all jurisdictions.

- (3) In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, the requirements of Directive 2006/48/EC should be supplemented by an express obligation for credit institutions and investment firms to establish and maintain, for those categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management.
- (4) Because excessive and imprudent risk-taking may undermine the financial soundness of financial institutions and destabilise the banking system, it is important that the new obligation concerning remuneration policies and practices should be implemented in a consistent manner. It is therefore appropriate to specify core principles on sound remuneration to ensure that the structure of remuneration does not encourage excessive risk-taking by individuals and is aligned with the risk appetite, values and long-term interests of the institution. In order to ensure that the design of remuneration policies is integrated in the risk management of the financial institution, the management body (supervisory function) of each credit institution or investment firm should establish the general principles to be applied, and the policies should be subject to at least annual independent internal review.
- (5) Remuneration policy should aim at aligning the personal objectives of staff members with the long-term interests of the credit institution or investment firm concerned. The assessment of the performance-based components of remuneration should be based on longer-term performance and take into account the outstanding risks associated with the performance. The assessment of performance should be set in a multi-year framework, for example of three to five years, in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over the business cycle of the firm
- (6) Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector¹⁴ also sets out principles on sound remuneration policies as to how firms might comply with this obligation, that are consistent with and complement the principles set out in this Directive.
- (7) The provisions on remuneration should be without prejudice to the rights, where applicable, of social partners in collective bargaining.
- (8) In order to ensure fast and effective enforcement, competent authorities should also have the power to impose either financial or non-financial measures or penalties for breach of a requirement under Directive 2006/48/EC, including the requirement to have remuneration policies that are consistent with sound and effective risk management. Those measures and penalties should be effective, proportionate and dissuasive.
- (9) In order to ensure effective supervisory oversight of the risks posed by inappropriate remuneration structures, the remuneration policies and practices adopted by credit

¹⁴ C(2009) 3159

institutions and investment firms should be included in the scope of supervisory review under Directive 2006/48/EC. In the course of that review, supervisors should assess whether those policies and practices are likely to encourage excessive risk-taking by the staff in question.

- (10) In order to promote supervisory convergences in the assessment of remuneration policies and practices, the Committee of European Banking Supervisors should ensure the existence of guidelines on sound remuneration policies in the banking sector. The Committee of European Securities Regulators should assist in the elaboration of such guidelines to the extent that they also apply to remuneration policies for persons involved in the provision of investment services and the carrying out of investment activities by credit institutions and by investment firms within the meaning of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.¹⁵
- (11) Since poorly designed remuneration policies and incentive schemes are capable of increasing to an unacceptable extent the risks to which credit institutions and investment firms are exposed, it is appropriate that competent authorities impose qualitative or quantitative measures on the relevant entities that are designed to address problems that have been identified in relation to remuneration policies in the Pillar 2 supervisory review. Qualitative measures available to competent authorities include requiring credit institutions or investment firms to reduce the risk inherent in their activities, products or systems, including structures of remuneration to the extent that they are inconsistent with effective risk management. Quantitative measures include a requirement to hold additional own funds.
- (12) In order to ensure adequate transparency to the market of their remuneration structures and the associated risk, credit institutions and investments forms should disclose information on their remuneration policies and practices for those staff whose professional activities have a material impact on the risk profile of the institution. However, this obligation should be without prejudice to Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with the regard to the processing of personal data and the free movement of such data.¹⁶
- (13) The review of risks to which the credit institution might be exposed should result in effective supervisory measures. It is therefore necessary that further convergence be reached with a view to supporting joint decisions by supervisors and ensuring equal conditions of competition within the Community.
- (14) There should be a separate capital treatment for securitisations which re-package other securitisations and are subject to a higher credit risk than normal securitisations and provides credit institutions and investment firms with clear disincentives against investment in securitisations of particularly high complexity and risk.
- (15) Banks investing in re-securitisations are required under Directive 2006/48/EC to exercise due diligence also with regard to the underlying securitisations and the non-securitisation exposures ultimately underlying the former. Depending on the complexity of the layers of securitisation structures and depending on the complexity and the diversity (or both) of the non-securitisation exposures that ultimately underlie

¹⁵ OJ L 145, 30.4.2004, p.1.

¹⁶ OJ L 281, 23.11.95, p.31.

the re-securitisations, the required due diligence may be impossible or uneconomical (or both) to carry out. This is in particular the case where the ultimate underlying exposures are, for example, leveraged buy-out or project finance debt. In these cases, institutions should not invest in such highly complex re-securitisations. In their review of the required due diligence, competent authorities should devote particular attention to such highly complex securitisations and require their full deduction from capital, unless it has been convincingly demonstrated to their satisfaction that in each individual case of highly complex re-securitisation exposures, the institution has performed the due diligence required by Directive 2006/48/EC, including with regard to the ultimate underlying exposures.

- (16) In order to promote the convergence of supervisory practices with regard to the supervision of due diligence for highly complex re-securitisations, the Committee of European Banking Supervisors should establish guidelines, which should include a definition of or criteria for the types of re-securitisations that should be considered as 'highly complex' for this purpose. That definition or those criteria should be adapted to developments in market practices.
- (17) The provisions on prudent valuation in Directive 2006/49/EC should apply to all instruments measured at fair value, whether in the trading book or non-trading book of institutions. It should be clarified that, where the application of prudent valuation would lead to a lower carrying value than actually recognised in the accounting, the absolute value of the difference should be deducted from own funds.
- (18) Institutions should have a choice whether to apply a capital requirement to or deduct from own funds those securitisation positions that receive a 1 250 % risk weight under this Directive, irrespective of whether the positions are in the trading or the non-trading book.
- (19) Capital requirements for settlement risks should also apply to the non-trading book.
- (20) Originator or sponsor institutions should not be able to circumvent the prohibition of implicit support by using their trading books in order to provide such support.
- (21) Without prejudice to the disclosures explicitly required by this Directive, the aim of the disclosure requirements should be to provide market participants with accurate and comprehensive information regarding the risk profile of individual institutions. Therefore institutions should be required to disclose additional information not explicitly listed in this Directive if necessary to meet this objective.
- (22) In order to ensure a coherent implementation throughout the Community of Directive 2006/48/EC, the Commission and the Committee of European Banking Supervisors set up a working group (Capital Requirements Directive Transposition Group - CRDTG) in 2006, entrusted with the task of discussing and resolving issues related to the implementation of that Directive. According to the CRDTG, certain technical provisions of Directives 2006/48/EC and 2006/49/EC need to be further specified. It is therefore appropriate to adjust those provisions.
- (23) Where an external credit assessment for a securitisation position incorporates the effect of credit protection provided by the investing institution itself, the institution should not be able to benefit from the lower risk weight resulting from that protection. This should not lead to the deduction from capital of the securitisation if there are other ways to determine a risk weight in line with the actual risk of the position, not taking into account such credit protection.

- (24) In the field of securitisation, disclosure requirements of institutions should be considerably strengthened. They should in particular also take into account the risks of securitisation positions in the trading book.
- (25) Specific risk charges for securitisation positions should be aligned with the capital requirements in the banking book since the latter provide for a more differentiated and risk-sensitive treatment of securitisation positions.
- (26) Given recent weak performance, the standards for internal models to calculate market risk capital requirements should be strengthened. In particular, their capture of risks should be completed regarding credit risks in the trading book. Furthermore, capital charges should include a component adequate to stress conditions to strengthen capital requirements in view of deteriorating market conditions and in order to reduce the potential for pro-cyclicality. Given the recent particular difficulties of treating securitisation positions using approaches based on internal models, institutions' ability to model securitisation risks in the trading book should be limited and a standardised capital charge for securitisation positions in the trading book should be required by default.
- (27) Directives 2006/48/EC and 2006/49/EC should therefore be amended accordingly,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Directive 2006/48/EC is amended as follows:

- (1) In Article 4, the following points (40a) and (40b) are inserted:
- "(40a) 're-securitisation' means a securitisation where one or more of the underlying exposures meet the definition of a securitisation position;
- (40b) 're-securitisation position' means an exposure to a re-securitisation;"
- (2) Article 22 is amended as follows:
- (a) Paragraph 1 is replaced by the following:
- "1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management."
- (b) The following paragraph 3 is added:
- "3. The Committee of European Banking Supervisors shall ensure the existence of guidelines on sound remuneration policies which comply with the principles set out in point 22 of Annex V. The Committee of European Securities Regulators shall cooperate closely with the Committee of European Banking Supervisors in ensuring the existence of guidelines on remuneration policies for categories of staff involved in the provision of investment services and activities meaning of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

- (3) In Article 54, the following paragraph is added:
- "Member States shall ensure that, for the purposes of the first paragraph, their respective competent authorities have the power to impose financial and non-financial penalties or measures. Those penalties or measures must be effective, proportionate and dissuasive."
- (4) Article 57 is amended as follows:
- (a) In the first paragraph, point (r) is replaced by the following:
- "(r) the exposure amount of securitisation positions which receive a risk weight of 1 250 % under Annex IX, Part 4 and the exposure amount of securitisation positions in the trading book that would receive a 1 250% risk weight in the same credit institutions non-trading book.
- (b) The following paragraph is added:
- For the purposes of point (r), exposure amounts shall be calculated in the manner specified in Annex IX, Part 4."
- (5) In Article 64, the following paragraph 5 is added:
- "5. Credit institutions shall apply the requirements of Part B of Annex VII to Directive 2006/49/EC to all their assets measured at fair value when calculating the amount of own funds and shall not include in the amount of own funds any amounts necessary as adjustments under those requirements."
- (6) Article 66(2) is replaced by the following:
- "2. The total of the items in points (l) to (r) of Article 57 shall be deducted half from the total of the items in points (a) to (c) minus (i) to (k) of that Article, and half from the total of the items in points (d) to (h) of that Article, after application of the limits laid down in paragraph 1 of this Article. To the extent that half of the total of the items in points (l) to (r) exceeds the total of the items in points (d) to (h) of Article 57, the excess shall be deducted from the total of the items in points (a) to (c) minus (i) to (k) of that Article.
- Items in point (r) of Article 57 shall not be deducted if they have been included for the purposes of Article 75 in the calculation of risk-weighted exposure amounts as specified in Annex IX, Part 4 or in the calculation of capital requirements as specified in Annex I to Directive 2006/49/EC."
- (7) In Article 75, point (c) is replaced by the following:
- "(c) in respect of all their business activities, for foreign exchange risk, for settlement risk and for commodities risk, the capital requirements determined according to Article 18 of Directive 2006/49/EC;"
- (8) Article 101(1) is replaced by the following:
- "1. The following shall not, with a view to reducing potential or actual losses to investors, provide support to the securitisation beyond its contractual obligations:
- (a) any originator credit institution which, in respect of a securitisation, has done any of the following:
- (i) made use of Article 95 in the calculation of risk-weighted exposure amounts;

- (ii) sold instruments from its trading book to an SSPE to the effect that it does not hold capital for the specific risk of these instruments anymore;

(b) a sponsor credit institution."

- (9) The following Article 122b is inserted after Article 122a:

"Article 122b

1. Notwithstanding the risk weights for general re-securitisation positions in Annex IX, Part 4, the competent authorities shall require that credit institutions apply a 1250 % risk weight to positions in highly complex re-securitisations, unless the credit institution has demonstrated to the competent authority for each such re-securitisation position concerned that it has complied with the requirements set out in Article 122a(4) and (5).
2. Paragraph 1 shall apply in respect of positions in new re-securitisations issued after 31 December 2010. In respect of positions in existing re-securitisations, paragraph 1 shall apply from 31 December 2014 where new underlying exposures are added or substituted after that date."

In Article 136(2), the following paragraph is added:

"For the purposes of determining the appropriate level of own funds in the supervisory review process carried out in accordance with Article 124, the competent authorities shall assess whether any imposition of a specific own funds requirement in excess of the minimum level is required to capture risks to which a credit institution might be exposed, taking into account the following:

- (a) the quantitative and qualitative aspects of credit institutions' internal capital assessment referred to in Article 123;
- (b) the credit institutions' arrangements, processes and mechanisms referred to in Article 22;
- (c) the outcome of the supervisory review process carried out in accordance with Article 124."

- (10) Article 145(3) is replaced by the following:

"3. Credit institutions shall adopt a formal policy to comply with the disclosure requirements laid down in paragraphs 1 and 2, and have policies for assessing the appropriateness of their disclosures, including their verification and frequency. Credit institutions shall also have policies for assessing whether their disclosures convey their risk profile comprehensively to market participants.

Where those disclosures do not convey the risk profile comprehensively to market participants, credit institutions shall publicly disclose the information necessary in addition to that required according to paragraph 1. However, they shall only be required to disclose information which is material and not proprietary or confidential according to the technical criteria set out in Annex XII, Part 1."

- (11) The Annexes are amended as set out in Annex I to this Directive:

Article 2

Directive 2006/49/EC is amended as follows:

- (1) In the first subparagraph of Article 3(1), the following point (t) is added:
"(t) 'securitisation position' and 're-securitisation position' mean securitisation position and re-securitisation position as defined in Directive 2006/48/EC."
- (2) In Article 17(1), the introductory phrase is replaced by the following:
"Where an institution calculates risk-weighted exposure amounts for the purposes of Annex II to this Directive in accordance with Articles 84 to 89 of Directive 2006/48/EC, then for the purposes of the calculation provided for in point 36 of Part 1 of Annex VII to Directive 2006/48/EC, the following shall apply:"
- (3) In Article 18(1), point (a) is replaced by the following:
"(a) the capital requirements, calculated in accordance with the methods and options laid down in Articles 28 to 32 and Annexes I, II, and VI and, as appropriate, Annex V, for their trading book business, and points 1 to 4 of Annex II for their non trading book business."
- (4) The Annexes are amended as set out in Annex II to this Directive

Article 3

Transposition

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 31 December 2010 at the latest. They shall forthwith communicate to the Commission the text of those provisions and a correlation table between those provisions and this Directive.
When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.
2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 4

Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 5

Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President

ANNEX I

Annexes V, VI, IX and XII to Directive 2006/48/EC are amended as follows:

(1) In Annex V, the following Section 11 is added:

"11. REMUNERATION POLICIES

22. When establishing and applying the remuneration policies for those categories of staff whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles in a way that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities:
- (a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;
 - (b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution;
 - (c) the management body (supervisory function) of the credit institution establishes the general principles of the remuneration policy and is responsible for its implementation;
 - (d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration defined by the management body (supervisory function);
 - (e) Where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution;
 - (f) Fixed and variable components of total remuneration are appropriately balanced; the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible bonus policy, including the possibility to pay no bonus;
 - (g) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;
 - (h) the measurement of performance used to calculate bonuses or bonus pools includes an adjustment for current and future risks and takes into account the cost of the capital and the liquidity required;
 - (i) payment of the major part of a significant bonus is deferred for an appropriate period and is linked to the future performance of the firm.

(2) Annex VI, Part 1 is amended as follows:

(a) Point 8 is replaced by the following:

"8. Without prejudice to points 9, 10 and 11, exposures to regional governments and local authorities shall be risk weighted as exposures to institutions, subject to point 11a. This treatment is independent of the exercise

of discretion as specified in Article 80(3). The preferential treatment for short-term exposures specified in points 31, 32 and 37 shall not be applied."

(b) The following point 11a is inserted:

"11a. Without prejudice to points 9, 10 and 11, exposures to regional governments and local authorities of the Member States denominated and funded in the domestic currency of that regional government and local authority shall be assigned a risk weight of 20%."

(3) Annex IX is amended as follows:

(a) In Part 3, point 1, the following point (c) is added:

"(c) The credit assessment shall not be based or partly based on unfunded support provided by the credit institution itself."

(b) Part 4 is amended as follows:

(i) In point 5, the following sentence is added:

"Where no credit assessment of a nominated ECAI can be used for a position in asset backed commercial paper because of the requirement set out in point 1(c) of Part 3, the credit institution may use the risk-weight assigned to a liquidity facility in order to calculate the risk-weighted exposure amount for the commercial paper if the commercial paper of an ABCP-program and the liquidity facility form overlapping positions."

(ii) Point 6 is replaced by the following:

"6. Subject to point 8, the risk-weighted exposure amount of a rated securitisation or re-securitisation position shall be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated by the competent authorities in accordance with Article 98 as laid down in Table 1."

(iii) Table 1 is replaced by the following:

Table 1

Credit Quality Step	1	2	3	4 (only for credit assessments other than short-term credit assessments)	all other credit quality steps
Securitisation positions	20%	50%	100%	350%	1250%
Re-securitisation positions	40%	100%	225%	650%	1250%

(iv) Table 2 is deleted.

(v) Point 46 is replaced by the following:

"46. Under the Ratings Based Method, the risk-weighted exposure amount of a rated securitisation position or re-securitisation shall be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated by the competent authorities in accordance with Article 98, as set out in the Table 4, multiplied by 1,06."

(vi) Table 4 is replaced by the following:

Table 4

Credit Quality Step		Securitisation Positions			Re-securitisation Positions	
Credit assessments other than short term	Short term credit assessments	A	B	C	D	E
1	1	7%	12%	20%	20%	30%
2		8%	15%	25%	25%	40%
3		10%	18%	35%	35%	50%
4	2	12%	20%		40%	65%
5		20%	35%		60%	100%
6		35%	50%		100%	150%
7	3	60%	75%		150%	225%
8		100%			200%	350%
9		250%			300%	500%
10		425%			500%	650%
11		650%			750%	850%
all other and unrated		1250%				

(vii) Point 47 is replaced by the following:

"47. The weightings in column C of table 4 shall be applied where the securitisation position is not a re-securitisation position and where the effective number of exposures securitised is less than six. For the remainder of the securitisation positions that are not re-securitisation positions, the weightings in column B shall be applied unless the position is in the most senior tranche of a

securitisation, in which case the weightings in column A shall be applied. For re-securitisation positions the weightings in column E shall be applied unless the re-securitisation position is in the most senior tranche of the re-securitisation and none of the underlying exposures were themselves re-securitisation exposures, in which case column D shall be applied. When determining whether a tranche is the most senior, it is not required to take into consideration amounts due under interest rate or currency derivative contracts, fees due, or other similar payments."

(viii) Point 48 is deleted:

(ix) Point 49 is replaced by the following:

"49. In calculating the effective number of exposures securitised multiple exposures to one obligor must be treated as one exposure. The effective number of exposures is calculated as:

$$N = \frac{(\sum_i EAD_i)^2}{\sum_i EAD_i^2}$$

where EAD_i represents the sum of the exposure values of all exposures to the i th obligor. If the portfolio share associated with the largest exposure, $C1$, is available, the credit institution may compute N as $1/C1$."

(x) Point 50 is deleted.

(xi) Point 52 is replaced by the following:

"52. Subject to points 58 and 59, under the Supervisory Formula Method, the risk weight for a securitisation position shall be the risk weight to be applied in accordance with point 53. However, the risk weight shall be no less than 20% for re-securitisation positions and no less than 7% for all other securitisation positions."

(xii) In point 53, the sixth paragraph is replaced by the following:

" N is the effective number of exposures calculated in accordance with point 49. In the case of re-securitisations, the credit institution must look at the number of securitisation exposures in the pool and not the number of underlying exposures in the original pools from which the underlying securitisation exposures stem."

(12) (4) Annex XII, Part 2 is amended as follows:

(a) Points 9 and 10 are replaced by the following:

"9. The credit institutions calculating their capital requirements in accordance with points (b) and (c) of Article 75 shall disclose those requirements separately for each risk referred to in those provisions. In addition, the capital requirement for specific interest rate risk of securitisation positions shall be disclosed separately.

10. The following information shall be disclosed by each credit institution which calculates its capital requirements in accordance with Annex V to Directive 2006/49/EC:

(a) for each sub-portfolio covered:

- (i) the characteristics of the models used;
 - (ii) for the incremental risk capital charge the methodologies used and the risks measured through the use of an internal model including a description of the approach used by the credit institution to determine liquidity horizons, the methodologies used to achieve a capital assessment that is consistent with the required soundness standard and the approaches used in the validation of the model;
 - (iii) a description of stress testing applied to the sub-portfolio;
 - (iv) a description of the approaches used for back-testing and validating the accuracy and consistency of the internal models and modelling processes;
- (b) the scope of acceptance by the competent authority;
 - (c) a description of the extent and methodologies for compliance with the requirements set out in Annex VII, Part B to Directive 2006/49/EC;
 - (d) the highest, the lowest and the mean of the following:
 - (i) the daily value-at-risk measures over the reporting period and as per the period end;
 - (ii) the stressed value-at-risk measures over the reporting period and as per the period end;
 - (iii) the incremental risk capital charge over the reporting period and as per the period-end;
 - (e) the amount of capital for incremental risk, together with the weighted average liquidity horizon for each sub-portfolio covered;
 - (f) a comparison of the daily end-of-day value-at-risk measures to the one-day changes of the portfolio's value by the end of the subsequent business day together with an analysis of any important overshooting during the reporting period."

(b) Point 14 is replaced by the following:

"14. Credit institutions calculating risk weighted exposure amounts in accordance with Articles 94 to 101 or capital requirements according to point 16a of Annex I to Directive 2006/49/EC shall disclose the following information, where relevant separately for their trading and non-trading book:

- (a) a description of the credit institution's objectives in relation to securitisation activity;
- (b) the nature of other risks including liquidity risk inherent in securitised assets;
- (c) the type of risks in terms of seniority of underlying securitisation positions and in terms of assets underlying these latter securitisation positions assumed and retained with re-securitisation activity;
- (d) the different roles played by the credit institution in the securitisation process;
- (e) an indication of the extent of the credit institution's involvement in each of them;

- (f) a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures including, how the behaviour of the underlying assets impacts securitisation exposures and a description of how those processes differ for re-securitisation exposures;
- (g) a description of the credit institution's policy governing the use of hedging and unfunded protection to mitigate the risks of retained securitisation and re-securitisation exposures, including identification of material hedge counterparties by relevant type of risk exposure;
- (h) the approaches to calculating risk weighted exposure amounts that the credit institution follows for its securitisation activities including the types of securitisation exposures to which each approach applies;
- (i) the types of SSPEs that the credit institution, as sponsor, uses to securitise third-party exposures including whether and in what form and to what extent the credit institution has exposures to these SSPEs, both on- and off-balance sheet exposure;
- (j) a summary of the credit institution's accounting policies for securitisation activities, including:
 - (i) whether the transactions are treated as sales or financings;
 - (ii) the recognition of gains on sales;
 - (iii) the methods and key assumptions and inputs for valuing securitisation positions;
 - (iv) the treatment of synthetic securitisations if this is not covered by other accounting policies;
 - (v) how assets awaiting securitisation are valued and whether they are recorded in the credit institutions non-trading book or the trading book;
 - (vi) policies for recognising liabilities on the balance sheet for arrangements that could require the credit institution to provide financial support for securitised assets;
- (k) the names of the ECAs used for securitisations and the types of exposure for which each agency is used;
- (l) where applicable, a description of the Internal Assessment Approach as set out in Annex IX, Part 4 including the structure of the internal assessment process and relation between internal assessment and external ratings, the use of internal assessment other than for IAA capital purposes, the control mechanisms for the internal assessment process including discussion of independence, accountability, and internal assessment process review; the exposure types to which the internal assessment process is applied and the stress factors used for determining credit enhancement levels, by exposure type;
- (m) an explanation of significant changes to any of the quantitative disclosures in points (i) to (l) since the last reporting period;
- (n) separately for the trading and the non-trading book, the following information broken down by exposure type:

- (i) the total amount of outstanding exposures securitised by the credit institution, separately for traditional and synthetic securitisations and securitisations for which the credit institution acts only as sponsor;
 - (ii) the aggregate amount of on-balance sheet securitisation exposures retained or purchased and off-balance sheet securitisation exposures;
 - (iii) the aggregate amount of assets awaiting securitisation;
 - (iv) for securitised facilities subject to the early amortisation treatment, the aggregate drawn exposures attributed to the seller's and investors' interests respectively, the aggregate capital requirements incurred by the credit institution against its retained (the seller's) shares of the drawn balances and undrawn lines and the aggregate capital requirements incurred by the credit institution against the investor's shares of drawn balances and undrawn lines;
 - (v) the amount of securitisation exposures that are deducted from own funds or risk-weighted at 1 250%;
 - (vi) a summary of current year's securitisation activity, including the amount of exposures securitised and recognised gain or loss on sale;
- (o) separately for the trading and the non-trading book, the following information:
- (i) the aggregate amount of securitisation exposures retained or purchased and the associated capital requirements, broken down between securitisation and re-securitisation exposures and further broken down into a meaningful number of risk-weight or capital requirement bands, for each capital requirements approach used;
 - (ii) the aggregate amount of re-securitisation exposures retained or purchased broken down according to the exposure before and after hedging/insurance and the exposure to financial guarantors, broken down according to guarantor credit worthiness categories or guarantor name;
- (p) for the non-trading book and regarding exposures securitised by the credit institution, the amount of impaired/past due assets securitised and the losses recognised by the credit institution during the current period, both broken down by exposure type;
- (q) for the trading book, the total outstanding exposures securitised by the credit institution and subject to a capital requirement for market risk, broken down into traditional/synthetic and by exposure type."
- (c) The following point 15 is added:
- "15. The following information shall be disclosed regarding the remuneration policy and practices of the credit institution for those categories of staff whose professional activities have a material impact on their risk profile:

- (a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the name of the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders;
- (b) information on link between pay and performance;
- (c) information on the criteria used for performance measurement and the risk adjustment;
- (d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based;
- (e) the main parameters and rationale for any bonus scheme and any other non-cash benefits."

ANNEX II

Annexes I, II, V and VII to Directive 2006/49/EC are amended as follows:

(1) Annex I is amended as follows:

(a) Point 14 is amended as follows:

(i) The first paragraph is replaced by the following:

"14. The institution shall assign its net positions in the trading book in instruments that are not securitisation positions as calculated in accordance with point 1 to the appropriate categories in Table 1 on the basis of their issuer/obligor, external or internal credit assessment, and residual maturity, and then multiply them by the weightings shown in that table. It shall sum its weighted positions resulting from the application of this point and of point 16a (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk."

(ii) The fourth paragraph is deleted.

(b) The following point 16a is inserted:

"16a. The institution shall calculate the capital requirement for its net positions in the trading book in instruments that are securitisation positions as follows:

(a) for securitisation positions that would be subject to the Standardised Approach for credit risk in the same institution's non-trading book, 8% of the risk-weighted exposure amounts under the Standardised Approach as set out in Part 4 of Annex IX to Directive 2006/48/EC;

(b) for securitisation positions that would be subject to the Internal Ratings Based Approach in the same institution's non-trading book, 8% of the risk-weighted exposure amounts under the Internal Ratings Based Approach as set out in Part 4 of Annex IX to Directive 2006/48/EC. The Supervisory Formula Method may only be used with supervisory approval by institutions other than an originator institution that may apply it for the same securitisation position in its non-trading book. Where relevant, estimates of PD and LGD as inputs to the Supervisory Formula Method shall be determined in accordance with Articles 84 to 89 of directive 2006/48/EC or alternatively and subject to separate supervisory approval, based on an approach as set out in point 5a of Annex V;

(c) Paragraphs (a) and (b) notwithstanding, for re-securitisation positions that would be subject to a 1 250 % risk weight according to Article 122b(1) of Directive 2006/48/EC if they were in the same institutions non-trading book, 8% of the risk-weighted exposure amount according to that Article."

(c) Point 34 is replaced by the following:

"34. The institution shall sum all its net long positions and all its net short positions in accordance with point 1. It shall multiply its overall gross position by 8% in order to calculate its capital requirement against specific risk."

- (d) Point 35 is deleted.
- (2) In Annex II, point 7, the second paragraph is replaced by the following:
- "However, in the case of a credit default swap, an institution the exposure of which arising from the swap represents a long position in the underlying shall be permitted to use a figure of 0% for potential future credit exposure, unless the credit default swap is subject to closeout upon insolvency of the entity the exposure of which arising from the swap represents a short position in the underlying, even though the underlying has not defaulted, in which case the figure for potential future credit exposure of the institution shall be limited to the amount of premia which are not yet paid by the entity to the institution."
- (3) Annex V is amended as follows:
- (a) Point 1 is replaced by the following:
- "1. The competent authorities shall, subject to the conditions laid down in this Annex, allow institutions to calculate their capital requirements for position risk, foreign-exchange risk and/or commodities risk using their own internal risk-management models instead of or in combination with the methods described in Annexes I, III and IV. Explicit recognition by the competent authorities of the use of models for supervisory capital purposes shall be required in each case."
- (b) In point 4, the second paragraph is replaced by the following:
- "Competent authorities shall examine the institution's capability to perform back-testing on both actual and hypothetical changes in the portfolio's value. Back-testing on hypothetical changes in the portfolio's value is based on a comparison between the portfolio's end-of-day value and, assuming unchanged positions, its value at the end of the subsequent day. Competent authorities shall require institutions to take appropriate measures to improve their back-testing programme if deemed deficient. At a minimum, competent authorities shall require institutions to perform back-testing on hypothetical (using changes in portfolio value that would occur were end-of-day positions to remain unchanged) outcomes."
- (c) Point 5 is replaced by the following:
- "5. For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions, the competent authorities shall recognise the use of an institution's internal model if, in addition to compliance with the conditions in the remainder of this Annex, the internal model meets the following conditions:
- (a) it explains the historical price variation in the portfolio;
 - (b) it captures concentration in terms of magnitude and changes of composition of the portfolio;
 - (c) it is robust to an adverse environment;
 - (d) it is validated through back-testing aimed at assessing whether specific risk is being accurately captured. If competent authorities allow this back-testing to be performed on the basis of relevant sub-portfolios, these must be chosen in a consistent manner;

- (e) it captures name-related basis risk. This means that institutions shall demonstrate that the internal model is sensitive to material idiosyncratic differences between similar but not identical positions;
- (f) it captures event risk.

The institution's internal model shall conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios. In addition, the internal model shall meet minimum data standards. Proxies shall be appropriately conservative and may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio.

The institution may choose to exclude from the calculation of its specific risk capital requirement using an internal model those positions for which it meets a capital requirement for position risks according to point 16a of Annex I.

As techniques and best practices evolve, institutions shall avail themselves of these new techniques and practices."

- (d) The following points 5a to 5k are inserted:

"5a. Institutions subject to point 5 for traded debt instruments shall have an approach in place to capture, in the calculation of their capital requirements, the default and migration risks of its trading book positions that are incremental to the risks captured by the value-at-risk measure as specified in point 5. An institution shall demonstrate that its approach meets soundness standards comparable to the approach set out in Articles 84 to 89 of Directive 2006/48/EC, under the assumption of a constant level of risk, and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging and optionality.

Scope

5b. The approach to capture the incremental default and migration risks shall cover all positions subject to a capital charge for specific interest rate risk but shall not cover those subject to the specific treatment of point 16a of Annex I. Subject to supervisory approval, the institution may choose to consistently include all listed equity positions and derivatives positions based on listed equities for which such inclusion is consistent with how the bank internally measures and manages risk. The approach must reflect the impact of correlations between default and migration events. It must not reflect the impact of diversification between default and migration events on the one hand and other market risk factors on the other hand.

Parameters

5c. The approach to capture the incremental risks must measure losses due to default and internal or external ratings migration at the 99,9 % confidence interval over a capital horizon of one year.

Correlation assumptions shall be supported by analysis of objective data in a conceptually sound framework. The approach to capture the incremental risks shall appropriately reflect issuer concentrations. Concentrations that can arise

within and across product classes under stressed conditions shall also be reflected.

The approach shall be based on the assumption of a constant level of risk over the one-year capital horizon, implying that given individual trading book positions or sets of positions that have experienced default or migration over their liquidity horizon are re-balanced at the end of their liquidity horizon to attain the initial level of risk. Alternatively, an institution may choose to consistently use a one-year constant position assumption.

5d. The liquidity horizons shall be set according to the time required to sell the position or to hedge all material relevant price risks in a stressed market, having particular regard to the size of the position. Liquidity horizons shall reflect actual practice and experience during periods of both systematic and idiosyncratic stresses. The liquidity horizon shall be measured under conservative assumptions and shall be sufficiently long that the act of selling or hedging, in itself, would not materially affect the price at which the selling or hedging would be executed.

The determination of the appropriate liquidity horizon for a position or set of positions is subject to a floor of three months.

The determination of the appropriate liquidity horizon for a position or set of positions shall take into account an institution's internal policies relating to valuation adjustments and the management of stale positions. When an institution determines liquidity horizons for sets of positions rather than for individual positions, the criteria for defining sets of positions shall be defined in a way that meaningfully reflects differences in liquidity. The liquidity horizons shall be greater for positions that are concentrated, reflecting the longer period needed to liquidate such positions. The liquidity horizon for a securitisation warehouse shall reflect the time to build, sell and securitise the assets, or to hedge the material risk factors, under stressed market conditions.

5e. Hedges may be incorporated into an institution's approach to capture the incremental default and migration risks. Positions may be netted when long and short positions refer to the same financial instrument. Hedging or diversification effects associated with long and short positions involving different instruments or different securities of the same obligor, as well as long and short positions in different issuers, may only be recognised by explicitly modelling gross long and short positions in the different instruments. Institutions shall reflect the impact of material risks that could occur during the interval between the hedge's maturity and the liquidity horizon as well as the potential for significant basis risks in hedging strategies by product, seniority in the capital structure, internal or external rating, maturity, vintage and other differences in the instruments. An institution shall reflect a hedge only to the extent that it can be maintained even as the obligor approaches a credit or other event.

For trading book positions that are hedged via dynamic hedging strategies, a rebalancing of the hedge within the liquidity horizon of the hedged position may be recognised provided that the institution (i) chooses to model rebalancing of the hedge consistently over the relevant set of trading book positions, (ii) demonstrates that the inclusion of rebalancing results in a better risk measurement, and (iii) demonstrates that the markets for the instruments

serving as hedges are liquid enough to allow for this rebalancing even during periods of stress. Any residual risks resulting from dynamic hedging strategies must be reflected in the capital charge.

- 5f. The approach to capture the incremental default and migration risks must reflect the nonlinear impact of options, structured credit derivatives and other positions with material nonlinear behaviour with respect to price changes. The institution shall also have due regard to the amount of model risk inherent in the valuation and estimation of price risks associated with such products.
- 5g. The approach to capture the incremental default and migration risks shall be based on objective data.

Validation

- 5h. As part of the independent review of their risk measurement system and the validation of their internal models as required in this annex, institutions shall, with a view to the approach to capture incremental default and migration risks, in particular:
 - (i) validate that its modelling approach for correlations and price changes is appropriate for its portfolio, including the choice and weights of its systematic risk factors;
 - (ii) perform a variety of stress tests, including sensitivity analysis and scenario analysis, to assess the qualitative and quantitative reasonableness of the approach, particularly with regard to the treatment of concentrations. Such tests shall not be limited to the range of events experienced historically;
 - (iii) apply appropriate quantitative validation including relevant internal modelling benchmarks.

The approach to capture the incremental risks must be consistent with the institution's internal risk management methodologies for identifying, measuring, and managing trading risks.

Documentation

- 5i. An institution shall document its approach to capturing incremental default and migration risks so that its correlation and other modelling assumptions are transparent to competent authorities.

Internal approaches based on different parameters

- 5j. If the institution uses an approach to capturing incremental default and migration risks that does not comply with all requirements of this point but that is consistent with the institution's internal methodologies for identifying, measuring, and managing risks it shall be able to demonstrate that its approach results in a capital requirement that is at least as high as if it was based on an approach in full compliance with the requirements of this point. Competent authorities shall review compliance with the previous sentence at least yearly. The Committee of European Banking Supervisors shall monitor the range of practices in this area and draw up guidelines in order to secure a level playing field.

Frequency of calculation

- 5k. An institution shall calculate the approach to capture the incremental risks at least weekly.
- (e) Point 7 is replaced by the following:
- "7. For the purposes of points 10b(a) and 10b(b), the results of the institution's own calculation shall be scaled up by a multiplication factor (m_+) of at least 3."
- (f) In Point 8, the first paragraph is replaced by the following:
- "For the purposes of point 10b(a) and 10b(b), the multiplication factor (m_+) shall be increased by a plus-factor of between 0 and 1 in accordance with Table 1, depending on the number of overshootings for the most recent 250 business days as evidenced by the institution's back-testing of the value-at-risk measure as set out in point 10. Competent authorities shall require the institutions to calculate overshootings consistently on the basis of back-testing on hypothetical changes in the portfolio's value. An overshooting is a one-day change in the portfolio's value that exceeds the related one-day value-at-risk measure generated by the institution's model. For the purpose of determining the plus-factor the number of overshootings shall be assessed at least quarterly."
- (g) Point 9 is deleted.
- (h) Point 10 is amended as follows:
- (i) Point (c) is replaced by the following:
- "(c) a 10-day holding period;"
- (ii) Point (e) is replaced by the following:
- "(e) monthly data set updates."
- (i) The following points 10a and 10b are inserted:
- "10a. In addition, each institution shall calculate a 'stressed value-at-risk' based on the 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of the current portfolio, with value-at-risk model inputs calibrated to historical data from periods of significant financial stress relevant to the firm's portfolio. The choice of such historical data shall be subject to yearly review and approval by competent authorities. The Committee of European Banking Supervisors shall monitor the range of practices in this area and draw up guidelines in order to ensure convergence. Institutions shall calculate the stressed value-at-risk at least weekly.
- 10b. Each institution must meet, on a daily basis, a capital requirement expressed as the sum of:
- (a) The higher of (1) its previous day's value-at-risk number measured according to point 10 (VaR_{t-1}); and (2) an average of the daily value-at-risk measures according to point 10 on each of the preceding sixty business days (VaR_{avg}), multiplied by the multiplication factor (m_+);

plus

(b) The higher of (1) its latest available stressed-value-at-risk number according to point 10a ($sVaR_{t-1}$); and (2) an average of the stressed value-at-risk numbers calculated in the manner and frequency specified in point 10a during the preceding sixty business days ($sVaR_{avg}$), multiplied the multiplication factor (m_+);

plus

(c) The sum of its weighted positions (regardless of whether they are long or short) resulting from the application of point 16a of Annex I;

plus

(d) The higher of the institution's most recent and the institution's 12 weeks average measure of incremental default and migration risk according to point 5a."

(j) In Point 12, the first paragraph is replaced by the following:

"The risk-measurement model shall capture a sufficient number of risk factors, depending on the level of activity of the institution in the respective markets. Where a risk factor is incorporated in the institution's pricing model but not in the risk-measurement model, the institution must be able to justify this omission to the satisfaction of the competent authority. In addition, the risk-measurement model shall capture nonlinearities for options and other products as well as correlation risk and basis risk. Where proxies for risk factors are used they shall show a good track record for the actual position held. In addition, the following shall apply for individual risk types:"

(4) Annex VII, Part B is amended as follows:

(a) In point 2, point (a) is replaced by the following:

"(a) documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the institution's assumptions of what market participants would use in pricing the position, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures;"

(b) Point 3 is replaced by the following:

"3. Institutions shall mark their positions to market whenever possible. Marking to market is the at least daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers."

(c) Point 5 is replaced by the following:

"5. Where marking to market is not possible, institutions must conservatively mark to model their positions/portfolios before applying trading book capital treatment. Marking to model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input."

(d) In point 6, point (a) is replaced by the following:

"(a) senior management shall be aware of the elements of the trading book or of other fair-valued positions which are subject to mark to model and shall understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business;"

(e) Points 8 and 9 are replaced by the following:

"Valuation adjustments

8. Institutions shall establish and maintain procedures for considering valuation adjustments.

General standards

9. The competent authorities shall require the following valuation adjustments to be formally considered: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where relevant, model risk."

(f) Points 11 to 15 are replaced by the following:

"11. Institutions shall establish and maintain procedures for calculating an adjustment to the current valuation of less liquid positions. Such adjustments shall where necessary be in addition to any changes to the value of the position required for financial reporting purposes and shall be designed to reflect the illiquidity of the position. Under those procedures, institutions shall consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. Those factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes including trading volumes during periods of market stress, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

12. When using third party valuations or marking to model, institutions shall consider whether to apply a valuation adjustment. In addition, institutions shall consider the need for establishing adjustments for less liquid positions and on an ongoing basis review their continued suitability.

13. When valuation adjustments give rise to material losses of the current financial year, these shall be deducted from an institution's original own funds according to point (k) of Article 57 of Directive 2006/48/EC.

14. Other profits/losses originating from valuation adjustments shall be included in the calculation of 'net trading book profits' mentioned in point (b) of Article 13(2) and be added to/deducted from the additional own funds eligible to cover market risk requirements according to such provisions.

15. Valuation adjustments which exceed those made under the accounting framework to which the institution is subject shall be treated in accordance with point 13 if they give rise to material losses, or point 14 otherwise."