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Release Handbook Summary

Release 14

Taken together, the legal instruments contain the definitive version of the Handbook at any particular time. The instruments are placed on the FSA website as soon as practicable after they have been made by the FSA Board. The consolidated version of the Handbook published on the FSA website is updated monthly (usually on the first of each month) and incorporates those changes made by previous legal instruments that have come into effect since the last update. The hardcopy version of the Handbook is updated periodically to bring it into line with the electronic consolidated version. There is currently some delay in publishing hardcopy updates. However, we are working to reduce that delay so far as is practicable with the aim of producing more timely updates to the hardcopy version. Over the coming weeks we will therefore be publishing several consecutive releases as we catch up. The legal instruments and electronic consolidated version of the Handbook can be accessed at www.fsa.gov.uk/handbook.

This release contains pages to be inserted in to your paper version of the Handbook in order to bring it up to date. These pages came into force between 2 December 2002 - 1 January 2003 (this is not an exhaustive summary of changes which came into effect in this period – some will be included in Release 15). Please remove existing pages and insert the new pages into your Handbook as follows:

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CHANGES TO SOURCEBOOK OR MANUAL		REMOVE		INSERT		BOARD DATE	EFFECTIVE DATE
		Page number	Number of sheets/ leaves	Page number	Number of sheets/ leaves		
Glossary	S	S9-S18	5	S9-S18	5	21 November 02	1 January 03
BUSINESS STANDARDS							

CHANGES TO SOURCEBOOK OR MANUAL		REMOVE		INSERT		BOARD DATE	EFFECTIVE DATE
		Page number	Number of sheets/ leaves	Page number	Number of sheets/ leaves		
IPRU(BSOC): Interim Prudential sourcebook for building societies							
Volume 1, Chapter 1	Contents (add 1.19)	1-2	1	1-2	1	21 November 02	1 January 03
	1.11.1G, 1.12.1G	11-14	2	11-14	2	21 November 02	1 January 03
	1.19 (Title), 1.19.1G	17-18	1	17-18	1	21 November 02	1 January 03
Volume 1, Chapter 2	2.6.10G	6-11	3	6-11	3	21 November 02	1 January 03
Volume 1, Chapter 3	3.3.1G	3-4	1	3-4	1	21 November 02	1 January 03
Volume 1, Chapter 4	Contents (add Annex 4B), 4.3.8G, 4.4.6G, 4A.1.1G, 4A.4.4G, 4A.7G, Annex 4B (all)	Ch.3 Page 9- Ch.5 Page 1	15	Ch.3 Page 9- Ch.5 Page 1	32	21 November 02	1 January 03
Volume 1, Chapter 5	5C.2G, 5C.3G, 5C.4G, 5C.5G	16-17	1	16-17	1	21 November 02	1 January 03
Volume 1, Chapter 7	Contents (add Annex 7A), 7.2.3G, 7.5.3G, 7.6.2R, Annex 7A	Ch.7 Page 1- Ch.8 Page 1	5	Ch.7 Page 1- Ch.8 Page 1	6	21 November 02	1 January 03
Volume 1, Chapter 8	8.3.2G	Ch.8 Page 2- Ch.9 Page 1	5	Ch.8 Page 2- Ch.9 Page 1	5	21 November 02	1 January 03
MAR: Market conduct							
Chapter 2	2.6.5R, 2.6.6G	17-18	1	17-18	1	21 November 02	1 January 03



Glossary of definitions

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<i>function</i>	
<i>significant management (settlements) function</i>	<i>controlled function</i> CF20 in the <i>table of controlled functions</i> , described more fully in SUP 10.9.18R.
<i>significant management function</i>	any of the <i>controlled functions</i> 16 to 20 in the <i>table of controlled functions</i> .
<i>Single Market Directives</i>	(as defined in paragraph 1 of Schedule 3 to the <i>Act</i> (EEA Passport Rights)) the <i>Banking Consolidation Directive</i> , the <i>Insurance Directives</i> and the <i>Investment Services Directive</i> .
<i>single-priced AUT</i>	an <i>AUT</i> for the <i>units</i> of which there is only one <i>price</i> applicable by reference to a <i>valuation point</i> .
<i>skilled person</i>	a <i>person</i> appointed to make a report required by section 166 of the <i>Act</i> (Reports by skilled persons) for provision to the <i>FSA</i> and who must be a <i>person</i> : <ul style="list-style-type: none"> (a) nominated or approved by the <i>FSA</i>; and (b) appearing to the <i>FSA</i> to have the skills necessary to make a report on the matter concerned.
<i>small business</i>	(in <i>COMP</i>) a <i>partnership</i> , <i>body corporate</i> , unincorporated association or mutual association with an annual turnover of less than £1 million (or its equivalent in any other currency at the relevant time).
<i>small e-money issuer</i>	(as defined by article 9C(10) of the <i>Regulated Activities Order</i> (Persons certified as small issuers etc)) a <i>person</i> to whom a certificate has been given by the <i>FSA</i> under that article (and whose certificate has not been revoked).
<i>small e-money issuer certificate</i>	a certificate given by the <i>FSA</i> under article 9C of the <i>Regulated Activities Order</i> (Persons certified as small issuers etc).
<i>small friendly society function</i>	<i>controlled function</i> CF6 in the <i>table of controlled functions</i> , described more fully in SUP 10.6.26R.
<i>small personal investment firm</i>	a <i>personal investment firm</i> : <ul style="list-style-type: none"> (a) which is not an <i>ISD investment firm</i>; (b) which is not a <i>network</i>; and (c) which has fewer than 26 <i>financial advisers</i> or <i>representatives</i>.
<i>small self-administered scheme</i>	an <i>occupational pension scheme</i> of a kind described in article 4(4) and 4(5) of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177).
<i>smaller denomination share</i>	a <i>share</i> to which are attached rights in a smaller denomination as provided by regulation 45 of the <i>OEIC regulations</i> .
<i>social insurance</i>	(in relation to a <i>class of contract of insurance</i>) the <i>class of contract of insurance</i> , specified in paragraph IX of Part II of Schedule 1 to the <i>Regulated Activities Order</i> (Contracts of long-term insurance), of a kind referred to in article 1(3) of the <i>First Life Directive</i> ("operations

	relating to the length of human life which are prescribed by or provided for in <i>social insurance</i> legislation, when they are effected or managed at their own risk by assurance undertakings in accordance with the laws of an <i>EEA State</i> ").
<i>Society</i>	the society incorporated by Lloyd's Act 1871 by the name of Lloyd's.
<i>Society guarantee fund</i>	(in <i>LLD</i>) the guarantee fund calculated by the <i>Society</i> under <i>LLD</i> 11.5.2R.
<i>Society margin</i>	(in <i>LLD</i>) the margin calculated by the <i>Society</i> under <i>LLD</i> 11.5.1R.
<i>Society's basic market activity</i>	(in accordance with section 315(2)(a) of the <i>Act</i> (The <i>Society</i> : authorisation and permission)) <i>arranging deals in contracts of insurance written at Lloyd's</i> .
<i>Society's regulatory functions</i>	the <i>Society's</i> powers, duties or functions in relation to <i>members</i> or <i>underwriting agents</i> which are or may be exercised for the purposes of supervising or regulating the market at Lloyd's.
<i>Society's secondary market activity</i>	(in accordance with section 315(2)(b) of the <i>Act</i> (The <i>Society</i> : authorisation and permission)) arranging deals in participation in Lloyd's syndicates.
<i>soft commission agreement</i>	an agreement in any form under which a <i>firm</i> receives goods or services in return for <i>designated investment business</i> put through or in the way of another <i>person</i> .
<i>sole trader</i>	an individual who is a <i>firm</i> .
<i>sole trader function</i>	<i>controlled function</i> CF7 in the <i>table of controlled functions</i> , described more fully in <i>SUP</i> 10.6.30R.
<i>solicited real time financial promotion</i>	(in accordance with article 8 of the <i>Financial Promotion Order</i>) (as more fully described in <i>COB</i> 3.10.1R (Meaning of "solicited" and "unsolicited" real time financial promotion) and <i>AUTH</i> App 1.10 (Types of financial promotion))) a <i>real time financial promotion</i> which is solicited, that is, it is made in the course of a personal visit, telephone call or other interactive dialogue if that call, visit or dialogue: <ul style="list-style-type: none"> (a) was initiated by the recipient of the <i>financial promotion</i>; or (b) takes place in response to an express request from the recipient of the <i>financial promotion</i>.
<i>special purpose vehicle</i>	a <i>body corporate</i> , explicitly established for the purpose of securitising assets, whose sole purpose (either generally or when acting in a particular capacity) is to carry out one or more of the following functions: <ul style="list-style-type: none"> (a) issuing <i>designated investments</i>, other than <i>life policies</i>; (b) redeeming or terminating or repurchasing (whether with a view to re-issue or to cancellation) an issue (in whole or part) of <i>designated investments</i>, other than <i>life policies</i>; (c) entering into transactions or terminating transactions involving

designated investments in connection with the *issue*, redemption, termination or re-purchase of *designated investments*, other than *life policies*;

<i>specific costs</i>	<i>management expenses</i> other than <i>base costs</i> and <i>establishment costs</i> .
<i>specific costs levy</i>	a levy, forming part of the <i>management expenses levy</i> , to meet the <i>specific costs</i> in the financial year of the <i>compensation scheme</i> to which the levy relates, each <i>participant firm's</i> share being calculated in accordance with COMP 13.5.7R.
<i>specific non-real time financial promotion</i>	a <i>non-real time financial promotion</i> which identifies and promotes a particular <i>investment</i> or service.
<i>specified investment</i>	any of the following <i>investments</i> specified in Part III of the <i>Regulated Activities Order</i> (Specified Investments): <ul style="list-style-type: none">(a) <i>deposit</i> (article 74);(aa) <i>electronic money</i> (article 74A);(b) <i>contract of insurance</i> (article 75); for the purposes of the <i>permission</i> regime, this is sub-divided into:<ul style="list-style-type: none">(i) <i>general insurance contract</i>;(ii) <i>long-term insurance contract</i>;and then further sub-divided into <i>classes</i> of <i>contract of insurance</i>;(c) <i>share</i> (article 76);(d) <i>debenture</i> (article 77);(e) <i>government and public security</i> (article 78);(f) <i>warrant</i> (article 79);(g) <i>certificate representing certain securities</i> (article 80);(h) <i>unit</i> (article 81);(i) <i>stakeholder pension scheme</i> (article 82);(j) <i>option</i> (article 83); for the purposes of the <i>permission</i> regime, this is sub-divided into:<ul style="list-style-type: none">(i) <i>option</i> (excluding a <i>commodity option</i> and an <i>option</i> on a <i>commodity future</i>);(ii) <i>commodity option</i> and an <i>option</i> on a <i>commodity future</i>;(k) <i>future</i> (article 84); for the purposes of the <i>permission</i> regime, this is sub-divided into:<ul style="list-style-type: none">(i) <i>future</i> (excluding a <i>commodity future</i> and a <i>rolling spot forex contract</i>);(ii) <i>commodity future</i>;

	(iii) <i>rolling spot forex contract</i> ;
	(l) <i>contract for differences</i> (article 85); for the purposes of the <i>permission</i> regime, this is sub-divided into: <ul style="list-style-type: none"> (i) <i>contract for differences</i> (excluding a <i>spread bet</i> and a <i>rolling spot forex contract</i>); (ii) <i>spread bet</i>; (iii) <i>rolling spot forex contract</i>;
	(m) <i>underwriting capacity of a Lloyd's syndicate</i> (article 86(1));
	(n) <i>membership of a Lloyd's syndicate</i> (article 86(2));
	(o) <i>funeral plan contract</i> (article 87);
	(p) <i>rights to or interests in investments</i> (article 89).
<i>spread bet</i>	a <i>contract for differences</i> that is a gaming contract, whether or not section 412 of the <i>Act</i> (Gaming contracts) applies to the contract; in this definition, "gaming" has the meaning given in the Gaming Act 1968, which is in summary: the playing of a game of chance for winnings in money or money's worth, whether any <i>person</i> playing the game is at risk of losing any money or money's worth or not.
<i>SSAS</i>	<i>small self-administered scheme</i> .
<i>stabilising action</i>	any action contemplated by <i>MAR 2.2.3R</i> or <i>MAR 2.4.2R</i> .
<i>stabilising manager</i>	the single <i>person</i> responsible for <i>stabilising action</i> under <i>MAR 2</i> (Price stabilising rules).
<i>stabilising period</i>	(in relation to a <i>relevant security</i> and an <i>associated security</i>) the period: <ul style="list-style-type: none"> (a) beginning with the date on which the earliest <i>public announcement</i> of the <i>offer</i> which states the <i>offer price</i> is made; and (b) ending on the thirtieth <i>day</i> after the <i>closing date</i> or, if it is earlier than that <i>day</i>, the sixtieth <i>day</i> after the <i>date of allotment</i>; except that, in relation to a <i>debenture</i> and a <i>government and public security</i> , the period begins with the date on which the earliest <i>public announcement</i> of the <i>offer</i> is made (whether or not that announcement states the <i>offer price</i>).
<i>stabilising price</i>	the initial price (at or below the <i>offer price</i>) up to which the <i>stabilising manager</i> has determined that he may wish to intervene in the market by way of <i>stabilising action</i> ; and if the effect of <i>MAR 2.5.4R</i> is to raise that price above the initial stabilising price, then "stabilising price" thereafter means that new, higher, price.
<i>stakeholder pension scheme</i>	(a) (in relation to a <i>specified investment</i>) the <i>investment</i> specified in article 82 of the <i>Regulated Activities Order</i> (Rights under a stakeholder pension scheme) which is rights under a stakeholder pension scheme in (b);

	(b) (in relation to a scheme) a scheme established in accordance with Part I of the Welfare Reform and Pensions Act 1999 and the Stakeholder Pension Schemes Regulations 2000.
<i>standard terms</i>	(in <i>DISP</i>) the contractual terms made under paragraph 18 of Schedule 17 to the <i>Act</i> (The Ombudsman Scheme), under which <i>VJ participants</i> participate in the <i>Voluntary Jurisdiction</i> .
<i>standing independent valuer</i>	the <i>person</i> appointed as such under <i>CIS</i> 12.3.1R (Standing independent valuer).
<i>state of the commitment</i>	(in <i>SUP</i> 18) (in accordance with paragraph 6(1) of Schedule 12 to the <i>Act</i> (Transfer schemes: certificates)) (in relation to a commitment entered into at any date): <ul style="list-style-type: none"> (a) if the <i>policyholder</i> is an individual, the State in which he had his habitual residence at that date; (b) if the <i>policyholder</i> is not an individual, the State in which the establishment of the <i>policyholder</i> to which the commitment relates was established at that date; <p>in this definition, "commitment" means (in accordance with article 2 of the Financial Services and Markets Act 2000 (Control of Business Transfers) (Requirements on Applicants) Regulations 2001 (SI 2001/3625 any contract of insurance of a kind referred to in article 1 of the <i>First Life Directive</i>.</p>
<i>state of the risk</i>	(in <i>SUP</i> 18) (in accordance with paragraph 6(3) of Schedule 12 to the <i>Act</i> (Transfer schemes: certificates)) (in relation to the <i>EEA State</i> in which a risk is situated): <ul style="list-style-type: none"> (a) if the insurance relates to a building or to a building and its contents (so far as the contents are covered by the same policy), the <i>EEA State</i> in which the building is situated; (b) if the insurance relates to a vehicle of any type, the <i>EEA State</i> of registration; (c) in the case of <i>policies</i> of a duration of four months or less covering travel or holiday risks (whatever the class concerned), the <i>EEA State</i> in which the <i>policyholder</i> took out the <i>policy</i>; (d) in a case not covered by (a) to (c): <ul style="list-style-type: none"> (i) if the <i>policyholder</i> is an individual, the <i>EEA State</i> in which he has his habitual residence at the date when the contract is entered into; and (ii) otherwise, the <i>EEA State</i> in which the establishment of the <i>policyholder</i> to which the <i>policy</i> relates is situated at that date.
<i>Statement of Principle</i>	one of the Statements of Principle issued by the <i>FSA</i> under section 64(1) of the <i>Act</i> (Conduct: Statements and codes) with respect to the conduct of <i>approved persons</i> and set out in <i>APER</i> .
<i>statutory notice</i>	a <i>warning notice</i> , <i>decision notice</i> or <i>supervisory notice</i> .

<i>statutory notice decision</i>	a decision by the <i>FSA</i> on whether or not to give a <i>statutory notice</i> .
<i>statutory notice associated decision</i>	a decision which is made by the <i>FSA</i> and which is associated with a decision to give a <i>statutory notice</i> , including a decision: <ul style="list-style-type: none"> (a) to determine or extend the period for making representations; (b) to determine whether a copy of the <i>statutory notice</i> needs to be given to any third party and the period for him to make representations; (c) to refuse access to <i>FSA</i> material; (d) as to the information which it is appropriate to publish about the matter to which a <i>final notice</i> or an effective <i>supervisory notice</i> relates.
<i>stock lending</i>	the disposal of a <i>designated investment</i> subject to an obligation or right to reacquire the same or a similar <i>designated investment</i> from the same counterparty.
<i>stock lending activity</i>	the activity of undertaking a <i>stock lending</i> transaction.
<i>stocks and shares component</i>	a <i>qualifying investment</i> as prescribed in paragraph 7 of the <i>ISA Regulations</i> .
<i>store card</i>	a card restricted to paying for goods or services from a particular supplier or group of suppliers and where the price of the goods or services is paid directly to the supplier or group of suppliers by the customer or the <i>firm</i> , but excluding a <i>plastic card</i> used to pay for goods or services through a network such as Visa or MasterCard.
<i>sub-fund</i>	<ul style="list-style-type: none"> (a) (in relation to an <i>umbrella scheme</i>) a separate part of the <i>scheme property</i> of that <i>scheme</i> that is pooled separately; (b) (in relation to a <i>collective investment scheme</i> that is not an <i>authorised fund</i>) any part of that <i>scheme</i> that is equivalent to a <i>sub-fund</i> of an <i>umbrella scheme</i>.
<i>sub-group</i>	(in <i>ELM</i>) (in relation to a <i>person</i>): <ul style="list-style-type: none"> (a) that <i>person</i>; and (b) any <i>person</i> that is either: <ul style="list-style-type: none"> (i) a <i>subsidiary undertaking</i> of that <i>person</i>; or (ii) an <i>undertaking</i> in which that <i>person</i> or a <i>subsidiary undertaking</i> of that <i>person</i> holds a <i>participation</i>.
<i>sub-scheme</i>	one of the three sub-schemes to which the <i>FSCS</i> allocates liabilities for <i>compensation costs</i> , as described in <i>COMP 13.6.7R</i> .
<i>subsidiary</i>	(as defined in section 736 of the Companies Act 1985 ("Subsidiary", "holding company" and "wholly-owned subsidiary")) (in relation to another <i>body corporate</i> ("H")) a <i>body corporate</i> of which H is a <i>holding company</i> .
<i>subsidiary</i>	(1) (except for the purposes of determining whether a <i>person</i> has

<i>undertaking</i>	<p><i>close links</i> with another <i>person</i>) an <i>undertaking</i> of which another <i>undertaking</i> is its <i>parent undertaking</i>.</p> <p>(2) (for the purposes of determining whether a <i>person</i> has <i>close links</i> with another <i>person</i>) (in accordance with section 343(8) of the <i>Act</i> (Information given by auditor or actuary to the FSA) and paragraph 3(3) of Schedule 6 to the <i>Act</i> (Threshold conditions)):</p> <p>(a) an <i>undertaking</i> in (1);</p> <p>(b) an <i>undertaking</i> ("S") if:</p> <p>(i) another <i>undertaking</i> (its parent) is a member of S;</p> <p>(ii) a majority of S's board of directors who have held office during the financial year and during the preceding financial year have been appointed solely as a result of the exercise of the parent's voting rights; and</p> <p>(iii) no one else is the parent undertaking of S under any of (a) (i) to (iii) or b(i) or (ii) in the definition of <i>parent undertaking</i>.</p>
<i>sufficiency liquid</i>	(in <i>ELM</i>) (in relation to an <i>investment</i>) complying with the requirements about liquidity in <i>ELM</i> 3.3.11R (Test for liquidity).
<i>suitability letter</i>	a letter that must be provided to a <i>customer</i> under <i>COB</i> 5.3.14R (Requirement for a suitability letter) and that contains the information required by <i>COB</i> 5.3.16R.
<i>SUP</i>	the Supervision manual.
<i>supervisory notice</i>	(as defined in section 395(13) of the <i>Act</i> (The Authority's procedures)) a notice given by the <i>FSA</i> in accordance with section 53(4), (7) or (8)(b); 78(2) or (5); 197(3), (6) or (7)(b); 259(3), (8) or (9)(b); 268(3), (7)(a) or (9)(a) (as a result of subsection (8)(b)); 282(3), (6) or (7)(b); or 321(2) or (5).
<i>supplementary levy</i>	(in <i>DISP</i>) a levy, additional to the <i>general levy</i> , for the purposes of recovering the <i>establishment costs</i> .
<i>suretyship</i>	<p>(in relation to a <i>class</i> of <i>contract of insurance</i>) the <i>class</i> of <i>contract of insurance</i>, specified in paragraph 15 of Part I of Schedule 1 to the <i>Regulated Activities Order</i> (Contracts of general insurance), namely:</p> <p>(a) a <i>contract of insurance</i> against the risks of loss to the <i>person</i> insured arising from their having to perform contracts of guarantee entered into by them;</p> <p>(b) fidelity bonds, performance bonds, administration bonds, bail bonds or customs bonds or similar contracts of guarantee where these are:</p> <p>(i) effected or carried out by a <i>person</i> not carrying on a banking business;</p> <p>(ii) not effected merely incidentally to some other business</p>

	carried on by the <i>person</i> effecting them; and
	(iii) effected in return for the payment of one or more premiums.
<i>surrender value</i>	<p>(a) where the contract is a contract of life assurance or a contract for an annuity, the amount (including a nil amount) payable by the <i>firm</i> or other body issuing the contract on surrender of the <i>policy</i>;</p> <p>(b) where the contract is a <i>pension contract</i>, the amount payable on the transfer of the investor's accrued rights under that contract to another <i>pension contract</i>;</p> <p>(c) where the contract is a <i>Holloway sickness policy</i>, the amount payable by the <i>firm</i> on surrender on or before the <i>projection date</i> for the <i>policy</i>;</p> <p>(d) where the contract is for any other matter, the amount payable by the <i>firm</i> on the surrender of the <i>policy</i>.</p>
<i>Swiss general insurance company</i>	<p>(in accordance with article 1(2) of the Financial Services and Markets Act 2000 (Variation of Threshold Conditions) Order 2001 (SI 201/2507)) a <i>person</i>:</p> <p>(a) whose head office is in Switzerland;</p> <p>(b) who is authorised by the supervisory authority in Switzerland as mentioned in article 7.1 of the <i>Swiss Treaty Agreement</i>; and</p> <p>(c) who is seeking to carry on, or is carrying on, from a branch in the <i>United Kingdom</i>, a <i>regulated activity</i> consisting of the <i>effecting</i> or <i>carrying out</i> of <i>contracts of insurance</i> of a kind which is subject to that agreement.</p>
<i>Swiss Treaty Agreement</i>	the agreement of 10 October 1989 between the European Economic Community and the Swiss Confederation on direct insurance other than life insurance, approved on behalf of the European Economic Community by the Council Decision of 20 June 1999 (No 91/390/EEC).
<i>syndicate</i>	one or more <i>persons</i> , to whom a particular syndicate number has been assigned by or under the authority of the <i>Council</i> , <i>carrying out</i> or <i>effecting contracts of insurance</i> written at Lloyd's.
<i>syndicate actuary</i>	an <i>actuary</i> appointed to a <i>syndicate</i> as required by LLD 10.9.4R(1).
<i>syndicate year</i>	a year of account of a <i>syndicate</i> .
<i>synthetic cash</i>	a position in a <i>derivative</i> that offsets an exposure in property to the point where that exposure has effectively been neutralised, and the effect of the combined holding of both property and the position in the <i>derivative</i> is the same as if the <i>authorised fund</i> had received or stood to receive the value of the property in cash.
<i>synthetic future</i>	<p>(a) a synthetic bought future, that is, a bought call <i>option</i> coupled with a written put <i>option</i>; or</p> <p>(b) a synthetic sold future, that is, a bought put <i>option</i> coupled with a</p>

written call *option*;

provided that in either case the two *options*:


- (i) are bought and written, whether simultaneously or not, on a single *eligible derivatives* market;
- (ii) relate to the same underlying *security* or other asset;
- (iii) give the purchasers of the *options* the same rights of exercise (whether at the same price or not); and
- (iv) will expire together, if not exercised.

SYSC

the part of the *Handbook* in High Level Standards which has the title Senior Management Arrangements, Systems and Controls.

systems and controls function

any of *controlled functions* 13 to 15 in the *table of controlled functions*.



Interim Prudential sourcebook: Building Societies

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Interim Prudential Sourcebook for Building Societies

1 SOLVENCY

CONTENTS

SECTION	PAGE NO.
1 Solvency	2
1.1 Introduction	2
1.2 Rules	2
1.3 The Purpose of Capital	3
1.4 EU Directives	3
1.5 Threshold Ratios	4
1.6 Own Funds	7
1.7 Minority Interests	8
1.8 Deductions	9
1.9 Limits on Tier 2 Capital	10
1.10 Solvency Ratio	10
1.11 Solo Consolidation	12
1.12 Mortgage Subsidiaries	12
1.13 Exclusions from Consolidation	13
1.14 Mortgage Indemnity Insurance Captives	14
1.15 Securitisation	14
1.16 Deductions in Respect of Holdings in Other Institutions	16
1.17 Capital Cost and Pricing	17
1.18 Capital Adequacy Directive (CAD)	17
1.19 Credit Derivatives	17
ANNEX	
1A Calculation of "Own Funds"	18
1B Risk Asset Weights	22
1C Treatment of Off-Balance Sheet Items	31
1D Holdings of Capital Instruments of Other Credit and Financial Institutions to be Excluded from "Own Funds" Calculations	40
1E Interim Profits: Verification Procedures	42
1F Definition of Relevant Authority	45
1G Definitions of Zone A and Zone B Countries	46
1H Society Only Solvency Ratio Calculations Definitions	47
1J Society Threshold Appraisal Sheet	48

Interim Prudential Sourcebook for Building Societies

1 Solvency

1.1 Introduction

1.1.1 G This chapter replaces PN 1998/1 issued by the Commission. It includes rules and guidance for societies on the Threshold Condition in Schedule 6 paragraph 4(1) of the Act (the resources of a firm must, in the opinion of the FSA , be adequate in relation to the regulated activities it seeks to carry on) – see also COND 2.4 - and on Principle 4 ("a firm must maintain adequate financial resources "). It describes the purpose of capital in a deposit-taking institution and the particular risks faced by building societies. It describes how societies should calculate their solvency ratio for capital adequacy purposes, what funds are eligible for inclusion in own funds and the FSA's methodology for setting Threshold Ratios. It should be read in conjunction with Chapter 2.

1.1.2 G This chapter further explains that the FSA will set each society a Threshold Ratio based on the FSA's assessment of a society's risk profile. Societies are expected to meet their Threshold Ratio at all times on both a consolidated and society only basis. The setting of a Threshold Ratio by the FSA does not absolve the society's board from maintaining such higher capital ratio as it considers prudent for the maintenance and management of the society's business and its future plans.

1.1.3 G Finally this chapter explains how the capital adequacy requirement should be calculated and sets out the FSA's methodology for setting threshold ratios.

1.2 Rules

1.2.1 R A society must maintain adequate capital resources commensurate with the nature and scale of its business and the risks inherent in its business. Where a society has subsidiary undertakings it must also maintain capital resources commensurate with the scale and nature of the activities of the whole group.

1.2.2 R A society must maintain own funds of at least £1m.

Annexes 1B and 1C. The relevant risk weight (a percentage) is applied to the balance sheet value of an asset, or in the case of off balance sheet items, to the nominal value multiplied by the appropriate credit conversion factor. Asset values and values attributed to off balance sheet items should also be determined on a basis consistent with the Accounts Regulations and should be net of any specific provisions. Where a society has subsidiary undertakings, the solvency ratio should be calculated on a consolidated basis. Consolidation should be on the same basis as applies to the society's statutory accounts (i.e. the Accounts Regulations). Where subsidiary undertakings, either singly or in aggregate, have either:

- (1) total gross assets equal to or greater than 1% of the society's assets; or
- (2) income which is equal to or greater than 1% of the society's total income; or
- (3) profits or losses which are equal to or greater than 1% of the society's profits;

the society should also calculate its solvency ratio on a society only basis and both calculations should meet the society's solvency ratio threshold (see Annex 1H for definitions of terms used in (1), (2) and (3)). Societies should report their solvency ratios quarterly in the QFS1 return.

1.10.2 G The percentage weights given in the BCD are minima: the directive explicitly recognises that national authorities may set higher weightings as they see fit. The FSA has decided to do so for securities issued by Zone A or Zone B countries. These are weighted at 10% or 20%, according to residual maturity, as a proxy for interest-rate risk, rather than at 0% as the BCD permits.

1.10.3 G The FSA uses the "mark-to-market" approach for the measurement of off balance sheet risks associated with interest-rate and foreign exchange contracts, and societies are expected to report on this basis. Treatment of off-balance sheet items is shown in Annex 1C.

1.11 Solo Consolidation

1.11.1 G The FSA recognises that for structural reasons societies have historically conducted certain core business through subsidiaries which they might otherwise have preferred to conduct themselves. In such cases the FSA may agree or expect societies to consolidate such subsidiary undertakings when calculating their society only solvency ratio. However, in so doing the FSA may expect the society to deduct a percentage of the subsidiary undertaking's capital from the society's own funds when making the society only solvency ratio calculation. This deduction will reflect the FSA's view of any enhanced risk in opting to conduct the business through a subsidiary rather than the society itself. At the minimum there is a risk that the environment which made the subsidiary route profitable may change leaving the society with a cost to unwind the structure. The FSA will discuss with societies where solo consolidation is considered appropriate or necessary, but see section 1.12, which sets out the FSA's criteria for solo consolidation of mortgage subsidiaries. The FSA also applies these criteria to other types of subsidiaries where they are proposed for solo consolidation. Where solo consolidation occurs societies should confirm annually in writing to the FSA that the solo consolidated subsidiaries continue to meet the criteria under which solo consolidation is agreed and that there has been no change in the type of business conducted by the subsidiary undertaking. Confirmation should be received within two months of the society's year end.

1.12 Mortgage Subsidiaries

1.12.1 G The principle of solo consolidation can be applied not only to capital adequacy but also to large exposures (see Chapter 7 Large Exposures) and although these are two distinct issues the grounds for confusion are much reduced if it is possible and prudent to adopt a common approach in respect of specific subsidiaries or categories of subsidiaries. Provided they comply with certain criteria, mortgage subsidiaries are a suitable category for solo consolidation in respect of both large exposures and capital adequacy. To enable the FSA to make valid comparisons across the building society sector it is important that all mortgage subsidiaries which meet the criteria are treated in a similar manner; however, under the BCD the FSA is required to give its approval to applications from each society individually. All societies which have mortgage subsidiaries which:

- (1) are under the effective day to day control of the society's executives;

- (2) are at least 75 per cent owned by the society;
- (3) are not subject to the capital requirements of another regulator;
- (4) have no restrictions on winding up and upstreaming capital at any time;

and either:

- (5) have no third party creditors at all (this is not intended to include small administrative creditors such as the electricity bill); or
- (6) are constituted so that the society can substitute itself for the mortgage subsidiary and perform its obligations to third party creditors;

should apply to the FSA to solo consolidate these subsidiaries confirming that they meet the above mentioned criteria.

1.13 Exclusions from Consolidation

1.13.1 G Subject to a limited degree of discretion allowed to the supervisory authorities, the BCD requires building societies to consolidate subsidiary undertakings which are financial or credit institutions (defined in Annex 1D) for the purposes of calculating their solvency ratio. However unless:

- (1) the inclusion of a particular non financial institution or non-credit institution subsidiary undertaking would result in a higher solvency ratio than if it were to be excluded; or
- (2) the FSA specifically requires the subsidiary undertaking to be excluded;

societies should include all their subsidiary undertakings when calculating their solvency ratio. Exclusion is likely where the FSA believes that a subsidiary's inclusion in the

consolidation would be misleading or inappropriate. Life insurance and general insurance companies fall into this category and societies should calculate their solvency ratio after reversing the impact of the investment in, or consolidation of, these subsidiary undertakings. In the society only ratio calculation, the carrying value of the investment should be removed from the weighted asset total, and an equal deduction made from the society's own funds. In the consolidated ratio calculation, the weighted assets of the insurance subsidiary should be removed from the consolidated weighted assets, and the reserves of the subsidiary consolidated into group own funds should be reversed out, including any benefit of the embedded value taken through the group's reserves. The only profits of the subsidiary that may count as group own funds are those that have been distributed to the parent society i.e. as dividends.

1.14 Mortgage Indemnity Insurance Captives

1.14.1 G Societies which own a MIG Captive should include the captive when calculating their consolidated solvency ratio (for rules and guidance on mortgage indemnity insurance, see chapter 8). For the society only solvency ratio the FSA has adopted a composite treatment which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk, albeit in concentrated form, and is not using its capital to "gear up" and assume new external liabilities. Out of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the actual capital requirement imposed by the local insurance supervisor) should be deducted from the society's own funds, in the society only calculation. The remainder should be risk-weighted at 100% as if an ordinary investment in a subsidiary.

1.15 Securitisation

1.15.1 G In considering how to treat societies' securitisation transactions, the three key points are:

1.16.4 G The FSA has decided not to apply the limits to participation in insurance companies but see section 1.13 for capital treatment in respect of holdings in insurance companies. The FSA has also decided not to apply the limits in other cases but to recommend a 100% deduction from own funds of the amount of the holding in excess of 15%.

1.17 Capital Cost and Pricing

1.17.1 G When acquiring assets societies should consider what effect the profit or cost derived from those assets will have on their solvency ratios. The higher the weighting which an asset carries the greater the capital cost and societies will need to decide whether they can, or should, pass on such cost or accept a lower rate of return.

1.18. Capital Adequacy Directive (CAD)

1.18.1 G Societies on the "Trading" approach to financial risk management (described in chapter 4, Financial Risk Management), under which they can trade securities and maintain unhedged foreign exchange positions within defined limits, should calculate the capital requirements for their trading book and foreign exchange positions separately in accordance with the FSA's guidance to banks (as set out in the IPSB for banks). In moving to the "Trading" approach societies will need to satisfy the FSA that they have the systems to calculate and report their capital position in accordance with the FSA's guidance.

1.19. Credit Derivatives

1.19.1 G Where societies use credit derivatives, provided that they meet the criteria set out in Annex 4B to chapter 4, the risk weighting of an asset should be based on the position after taking account of the credit derivative applied to that asset.

CALCULATION OF "OWN FUNDS"

G

1A.1 Tier 1 Capital

1A.1.1 Reserves as disclosed in the latest year end balance sheet;

plus

cumulative interim profits for the year to date which have been verified by the society's external auditors (see Annex 1E); or

less

cumulative losses (if any) for the year to date.

1A.1.2 Deferred shares which meet the requirements of chapter 2, currently PIBS, and deferred shares which were issued prior to the Building Societies (Deferred Shares) Order 1991 (SI 1991/701) and which met the statutory requirements then in force.

1A.1.3 Tier 1 minority interests in a subsidiary undertaking which meets the requirements of section 1.7.

1A.1.4 Deduct intangible assets from the sum of 1A.1.1, 1A.1.2 and 1A.1.3 to calculate Tier 1 capital.

1A.2 Tier 2 Capital

1A.2.1 Term subordinated debt and undated subordinated debt, which meet the requirements of chapter 2; together with general provisions for bad debt and revaluation reserves.

Limits

2.6.7 G Not only does the issuing of PIBS directly reduce the endowment effect of reserves but, by increasing the potential to issue Tier 2 capital, it provides scope for reducing the endowment effect still further. The FSA would not expect a society to issue PIBS in excess of 50% of its reserves.

Secondary Market: Stockbrokers

2.6.8 G A stockbroking subsidiary of a society may accept orders for the purchase and sale of the society's PIBS but, to ensure that the society's capital in the form of PIBS is not reduced except with FSA consent, neither the society nor any subsidiary undertaking may trade, buying and reselling on its own account, as opposed to executing client orders.

Retail Issues

2.6.9 G Societies issuing PIBS as retail instruments directly to the public will be expected to take the utmost care that retail investors are made fully aware of the risks of investing in PIBS as opposed to investing in societies' normal investment share accounts. Issues of PIBS, whether retail or not, should be restricted to minimum denominations of not less than £1000.

Controllers

2.6.10 G Societies issuing PIBS should be aware of the requirements on controllers and potential controllers to notify the FSA under sections 178 and 190 of the Act of the acquisition of, or a change in control, where the exemption set out in the Financial Services and Markets Act 2000 (Controllers)(Exemption)(No.2) Order (SI 2001/3338) does not apply. Guidance on when the exemption does not apply is set out in SUP 11.3.2A G. Societies should also be aware of the requirements on firms in SUP 11.4 to notify the FSA of changes in Control, as well as those in SUP 16.4 to submit an annual controller report to the FSA.

2.7 Undated Subordinated Debt

2.7.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Undated Subordinated Debt should meet the conditions in paragraphs 2.7.2 to 2.7.7.

Permanence

2.7.2 G Undated Subordinated Debt should be permanent. Repayment may normally only occur on the winding up of a society and no other events of default entitling the holders of such debt to repayment are possible. However, undated debt may be issued on terms which permit the society, in accordance with a board resolution, to repay undated debt, subject to the prior consent of the FSA. The decision to repay the debt should be genuinely at the instance of the society's board. Such consent would only be given if the FSA were satisfied that the remaining capital would be adequate for the society's present, and future foreseeable needs. It is unlikely to be given within the first five years of issue.

Subordination

2.7.3 G In the event of winding up, Undated Subordinated Debt should, together with deferred shares, rank so as to support the solvency of the society. That is to say, the terms of the issue should provide that the claims of a holder of Undated Subordinated Debt, in the winding up of the borrower, shall be limited to such amount as would have been payable if, immediately prior to the commencement of a winding up, the holder held deferred shares of equivalent value instead of subordinated debt. Upon winding up, the holders of Undated Subordinated Debt should rank after all creditors and holders of non-deferred shares, including creditors in respect of term subordinated debt but their claims should, nevertheless, rank ahead of any existing PIBS or other deferred shares in issue by that society.

Interest Deferral

2.7.4 G Interest payments on Undated Subordinated Debt should rank after those on all other deposits, including other types of Subordinated Debt, and all non-deferred shares. The terms of issue should prohibit the payment, or crediting, of interest on Undated Subordinated

Debt unless all amounts payable on non-deferred shares, or deposits with the society, in respect of any earlier or concurrent period, have been paid.

2.7.5 G The interest payment due on Undated Subordinated Debt at a particular date may be deferred by the board if, after the payment, the society would otherwise be in breach of capital adequacy requirements. However, such interest need only be deferred, not cancelled, i.e. it may be cumulative. Societies may make a scrip issue of Undated Subordinated Debt in satisfaction of the interest payments.

2.7.6 G The terms of issue should allow for the extreme situation by prohibiting the society from paying interest on Undated Subordinated Debt if the society is insolvent, or would be insolvent, after making the payment.

Conversions/Takeovers/ Mergers

2.7.7 G The issue terms should provide that the loss absorption characteristics of Undated Subordinated Debt will continue as a feature of the corresponding liability of the successor company in the case of transfer of business to a company or the successor society in the case of a merger. In order to preserve, as far as possible, the relative rankings of PIBS-holders and holders of Undated Subordinated Debt through the conversion process, issues of PIBS should become a form of Undated Subordinated Debt on conversion, ranking behind any Undated Subordinated Debt previously issued by the society. This avoids the situation in which, upon conversion, PIBS could have become, say, 10 year term subordinated debt of the successor company and be repaid ahead of undated subordinated debt already in issue by the society. This stipulation was first introduced on 15 April 1994 and may not feature in earlier issues of PIBS.

2.8 Term Subordinated debt

2.8.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Term Subordinated Debt should meet the conditions in paragraphs 2.8.2 to 2.8.11.

Subordination

2.8.2 G On winding up, Term Subordinated Debt should rank after all types of ordinary (i.e. non-deferred) shares, and interest due thereon, and other liabilities excluding PIBS and Undated Subordinated Debt.

Maturity

2.8.3 G The original maturity should be not less than five years and one day. Where the debt is drawn down in tranches the minimum term should be calculated from the date of the last draw down.

Amount Eligible as Own Funds

2.8.4 G With a discounted issue it is the amount actually received, not the amount due to be repaid at the end of the term, which counts as own funds.

2.8.5 G Subordinated loan capital in its final four years to maturity should not count in full as part of own funds but should be amortised on a straight line basis by 20% p.a. The debt should be included in the capital base according to the following schedule:

Years to maturity	Amount included in own funds
More than 4	100%
Less than and including 4 but more than 3	80%
Less than and including 3 but more than 2	60%
Less than and including 2 but more than 1	40%
Less than and including 1	20%

2.8.6 G If repayment is by instalments then either:

- (1) the debt is divided into its constituent instalments and during the five years preceding the repayment of any instalment of debt, its contribution to own funds is written down on a straight line basis; or
- (2) where the debt repayment schedule is of equal annual, semi annual, or quarterly instalments over the last three to five years of the debt term, the amounts which may be counted as own funds during the last five years of its term are calculated by multiplying the principal debt outstanding by the residual term outstanding, and dividing the result by five.

Early Repayment

2.8.7 G There should be no provision allowing early repayment of the debt other than in the event of approval being granted by the FSA. Only a society or its successor may request this approval for repayment.

2.8.8 G Early repayment should not be capable of being triggered by performance conditions, cross-default clauses, negative pledges, or by mergers, or transfers - in circumstances where the FSA gives a direction under section 42 B (1), (3) or (4) of the 1986 Act.

2.8.9 G However, the loan terms may require the borrower to consult the lender(s) and/or trustee about partial transfers of engagements, or transfer of business where the lender(s) or trustee is not satisfied that the successor company will keep its authorisation under the Act.

2.8.10 G The terms may also provide for certain events of default which would allow the lender or his trustee to require early repayment of the loan but only in a winding up/dissolution of a society or in a winding up of its successor. The permitted events of default should be restricted to:

- (1) the commencement of the winding up of the society or its successor;

- (2) the commencement of the dissolution of a society where it is dissolved otherwise than by virtue of any one or more of sections 93(5), 94(10) or 97(9) and 97(10) of the 1986 Act;
- (3) the cancellation of a society's registration under the 1986 Act otherwise than under section 103 (1)(a) of the 1986 Act.

2.8.11 G The FSA would consider any request for early repayment in the light of the projected capital position of the society if repayment were allowed. Approval would only be given where the FSA was satisfied that the society's capital would remain adequate after repayment for the society's existing and proposed business.

2.9 Notification to the FSA

2.9.1 G It is the responsibility of the society's board to satisfy itself that the terms of issue (which include the relevant sections of the society's rules) meet the guidance in this chapter and the 1986 Act: this would normally be on the basis of specialist legal advice. Before including any issued capital in a society's calculation of its solvency ratio for capital adequacy purposes the FSA expects to receive from the society:

- (1) evidence, usually in the form of a certified board minute, that the board has considered the specialist legal advice provided to the society, and that the board is satisfied that the society has the power to make the issue and that the issue will meet the guidance in this chapter;
- (2) a copy of the legal opinion provided to the society which should cover at least the following points:
 - (a) that the society has the power to make the issue (having made the necessary amendments to rules, etc.);
 - (b) that any terms not contained within the society's rules are consistent with the rules;
 - (c) that the terms of the issue (including the terms within the society's rules) comply with the guidance set out in this chapter.

Code, adapted for the particular circumstances of building societies. Societies are encouraged to adopt this code to apply principles of good governance practice within their business.

3.3 Fit and Proper

3.3.1 G As set out in SUP, all directors of building societies, including non-executives, will be Approved Persons and thus are expected to meet the “fit and proper” criteria and comply with the Principles for Approved Persons and the Code of Practice. The attention of societies is drawn to the distinction between the controlled functions of director and non-executive director set out in SUP 10.6.2 to 10.6.10.

3.3.2 G Under section 60 of the 1986 Act, directors of building societies are elected by the members, and subsection (4) makes clear that, subject to certain conditions, any natural person is eligible to be elected a director. (Subsection (4A) however provides that a person subject to a prohibition order under section 56(2) of the Act is not eligible.) Members have the right under a society’s rules to nominate candidates and the FSA has no power to intervene in elections for board directors. Where members nominate a candidate, in the FSA’s view it is not open to the board to refuse to accept a candidate’s nomination on the grounds that, in the board’s view, he (or she) is not fit and proper (except, of course, in the limited circumstances of a prohibition order being in force in relation to that person). However, the board should, prior to the election, take such steps as are practicably open to it to establish whether there are any matters concerning the candidate’s fitness and propriety of which the members should be aware in advance of the election. If there are such matters, the board should bring them to the attention of the members. The FSA will not vet candidates for election.

3.3.3 G On election, all directors, whether recommended by the board or nominated by members, have the same status. The FSA would, in the exercise of its responsibilities under the Act concerning the regulation of Approved Persons, apply the requirements for approval equally to all directors upon election (i.e. before the elected individuals can take up controlled functions).

3.4 Other requirements and guidance

3.4.1 G Part VII of the 1986 Act contains requirements relating to the management of building societies. This section contains further guidance on this Part of the 1986 Act and

sets out some factors the FSA will take into account in assessing the adequacy of a society's board and management arrangements for the purposes of setting its threshold solvency ratio.

3.4.2 G Section 58(2) of the 1986 Act requires each building society to have a chairman and this person plays a key role in the strategic direction of the society. The chairman should not have any executive post in the society. This assists in the separation of strategic direction from the day to day running of the business and helps the chairman take an independent view of management performance. It also protects against undue concentration of power.

3.4.3 G Given the mutual status of building societies, a clear majority of directors on a society's board should be non-executive. The appropriate ratio of non-executives to executives will vary with the scale, nature and complexity of the society's business. The board should have an appropriate range of skills and experience to control and direct the society's activities effectively. The composition of the board should be reviewed at regular intervals.

3.4.4 G It will rarely be appropriate or desirable for a chief executive or other executive director to remain as a non-executive board member after his or her retirement.

3.4.5 G The composition of a board should change progressively over time in a planned manner. As societies increasingly innovate in their mainstream business and use wider powers, so they should recognise the need to enhance their overall board and management resources and expertise accordingly. Non-executive directors should not be given the expectation that they will remain on the board, automatically standing for re-election every 3 years, until the retirement age in the society's rules. They should serve for fixed terms, both initially and for any subsequent term.

3.4.6 G Each society is required by section 59(1) of the 1986 Act to have a chief executive. The chief executive plays a key role in the running of the society and has specific responsibilities in SYSC. He or she should be a member of the board.

3.4.7 G Smaller societies may not need as many executives on the board as larger societies, but every society should have at least one executive director on the board.

3.4.8 G Where executives are appointed under formal service contracts, the board should consider carefully the terms of such contracts. It should have regard not only to the need to

Board Procedures

3A.11 G A board should establish a remuneration committee, consisting only of non-executive directors, to develop a general policy, and to make recommendations, on the pay of executive directors.

3A.12 G A board should establish an audit committee of non-executive directors consisting of at least three members.

3A.13 G It is a board's responsibility to ensure that an objective and professional relationship is maintained with the external auditors.

3A.14 G A board should ensure that the society has specific written procedures for the consideration of loan applications by directors or persons connected with them and that all directors are familiar with these procedures.

3A.15 G If a director or any person connected with a director participates in an existing share option scheme, that director should not be allowed to vote on, or to use any discussion to promote, any transaction (such as sale of a subsidiary undertaking) under which that director or connected person would benefit financially.

3A.16 G A board should have a procedure that enables individual directors to obtain independent professional advice at the society's expense for the furtherance of their duties.

3A.17 G Each director should have access to the advice and services of the secretary and any separately appointed compliance officer(s).

Reporting

3A.18 G A board should present a balanced and understandable assessment of the society's position to the members.

3A.19 G Directors should explain their responsibility for preparing the accounts next to a statement by the external auditors about their reporting responsibilities.

3A.20 G Directors should (if it be the case) report that the society is a going concern, with supporting assumptions or qualifications as necessary.

Interim Prudential Sourcebook for Building Societies

4 FINANCIAL RISK MANAGEMENT

CONTENTS

	SECTION	PAGE
4.1	Introduction	2
4.2	Rules	2
4.3	Financial Risks	4
4.4	Statutory Restrictions	8
4.5	Supervisory Approach	10
4.6	Management Responsibilities	12
4.7	Risk Management Systems	13
4.8	Counterparty Risk	15
4.9	Operational Risk	18
4.10	Independent Review and Controls	20
	ANNEX	
4A.	Supervisory Approach Categories	21
4B	Credit Derivatives	29

4.1 Introduction

4.1.1 G This chapter replaces PN 1998/4, issued by the Commission, and contains rules and guidance for societies on financial risk management, a key part of compliance with Principle 3 (“a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”).

4.1.2 G This chapter describes the key financial risks to which societies are exposed, explains the statutory restrictions on funding, market making, trading and use of derivative instruments, sets out the framework within which the FSA will supervise the treasury activities of societies, including details of the five “approach” categories (Administered, Matched, Extended, Comprehensive and Trading) applied, and emphasises the respective responsibilities of boards and management for monitoring and controlling financial risks. (Unless otherwise explicitly stated, references in this chapter to “societies” are to society groups, consolidated to include all subsidiary undertakings.)

4.2. Rules

4.2.1 R A society must have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.

4.2.2 G Societies should have systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, foreign exchange and similar (e.g. index related) risks, and for reporting exposures to senior management and the board on a regular, and timely, basis. Societies should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

4.2.3 G Societies should have credit limits in place for all counterparties both for placing liquidity and for transacting derivative contracts (further guidance also in Chapter 5 (Liquidity)).

4.2.4 G Societies' boards should ensure that there are adequate internal controls in place covering all treasury activities, including appropriate segregation of duties between initiation of a transaction and confirmation/settlement/ accounting for it, such controls to be the subject of regular review by internal auditors with the requisite skills and experience.

4.2.5 R A society must maintain, and submit to the FSA, a board-approved policy statement on financial risk management.

4.2.6 R A society making any significant change to its policy statement on financial risk management must provide the FSA with a copy of the amended statement as soon as possible after it has been adopted.

4.2.7 G Boards have ultimate responsibility for understanding and controlling the degree of risk, by type, which is being taken by their societies. They should approve the general business strategies, including the treasury section of the society's corporate plan, and the risk management policies that control the extent of risk which is taken, and should give clear guidance on the level of risk considered to be acceptable – such strategies and guidance to be reviewed regularly by the board.

4.2.8 G The policy statement establishes guidelines for the society's senior managers on the control of financial risks, including: operational risk; structural risk; funding risk; and counterparty credit (including settlement) risk. Such documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act.

4.2.9 G Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework i.e. why and how treasury activities are expected to support the society's core business, and the "approach" category being followed, derived, where possible, from the results of a financial risk audit. They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management. The documents should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities. Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

4.3 Financial risks

Funding risks

4.3.1 G Building societies' current core business, financing long-term residential mortgages with short-term personal savings, necessarily involves a high degree of maturity transformation, and this constitutes the major financial risk that all societies need to manage.

4.3.2 G Wholesale deposit funding, available from a range of sources, provides a useful supplement to the stocks, and inflows, of personal savings. Wholesale markets typically provide funding at longer and/or more definite maturity, often at advantageous rates, but may concentrate the refinancing risks societies face.

4.3.3 G The particular constitution of building societies means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives building society share accounts to be as secure as (or even more secure than) bank deposits. However, unlike depositors with banks, share account investors are contributories, not creditors, so they rank after deposit funders, including suppliers of wholesale funding. A society which gears itself up significantly with wholesale funds thereby dilutes the security of its share account investors, whilst at the same time increasing its refinancing and liquidity risks.

4.3.4 G Guidance on the management of short-term cashflow mismatches, and the liquidity requirements which flow from such positions, is given in Chapter 5 (Liquidity). Risks arising from the interest basis/structure or currency of the funding are covered later in this chapter.

Structural risks

4.3.5 G Most societies are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements ("basis" risk), for example, the risk that it may not be possible to increase administered mortgage rates in line with increases in money market (LIBOR) rates, resulting in a margin squeeze where funding is LIBOR-based. In this chapter, risks which arise from the different interest rate or currency

characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as “structural” risks.

Operational risks

4.3.6 G The extension of building society activities into new forms of funding, liquidity and off balance sheet instruments has dramatically increased the operational risks involved. The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes. Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

Key risk categories

4.3.7 G The key financial risks which, in order to comply with Rule 4.2.1, societies should manage and control are:

- (1) Maturity mismatch, including the risks:
 - (a) that the society may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the society itself);
 - (b) associated with the bunching of roll-over dates for wholesale funding or maturities of term retail funding;
 - (c) from concentration on a limited number of funding providers, giving rise to increased dependence particularly on roll-over days; and
 - (d) arising from the prepayment (early redemption) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural v. contractual maturity risks);

(2) Interest rate risk to a society's earnings (most significantly, to its interest margin) and to its economic value (the present value of future cashflows) arising from:

- (a) repricing mismatches, e.g. where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding, or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income); repricing risk is inherent in fixed rate instruments, the market value of which will change with interest rate movements (e.g. Gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);
- (b) yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause assets and liabilities to reprice relative to each other - possibly exposing positions which were hedged against a parallel shift in rates only;
- (c) interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference Gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate;
- (d) balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet - which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a society to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit

deterioration leading to rising provision levels);

- (e) optionality (i.e. explicit/contracted option contracts, such as “caps”, “collars” and “floors”, which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period. and embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a “floor” - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an “option” which may not be adequately “hedged” by way of early redemption charges); and
 - (f) product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions.
- (3) Currency risk, arising from the effects of changing exchange rates on unmatched assets and liabilities denominated in different currencies; and
 - (4) Index related risk, arising from the effects of movements in an index of financial assets (e.g. the FTSE 100), or similar reference rate, on unmatched assets or liabilities paying or receiving a return based on that index/rate.

4.3.8 G Societies’ financial risk management policies should also cover:

- (1) Settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis;
- (2) Counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction;
- (3) Investment risk: associated with the financial consequences of capital projects including diversification investments; and

- (4) Operational risk: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.
- (5) Credit risk: the control and mitigation of the risk of borrower default, whether relating to wholesale assets, such as large commercial loans or items of liquidity, or to retail assets such as residential mortgages. Societies should take account of the requirements at 6.2.1R and 6.2.2R for assessing the ability and willingness of borrowers to repay their loans, and for a board-approved policy statement on lending. 5B.2.4G provides guidance on credit risk on liquidity.

4.4 Statutory restrictions

Funding limit

4.4.1 G Section 7 of the 1986 Act provides that at least 50% of the funds (excluding those qualifying as own funds) of a building society (or, if appropriate, of the society's group) must be raised in the form of shares held by individual members of the society (excluding share accounts held by individuals as bare trustees for corporate bodies).

Structural risk management restrictions

4.4.2 G Section 9A prohibits a society or its subsidiary undertakings (subject to certain defined exemptions) from:

- (1) acting as a market maker in securities, commodities, or currencies;
- (2) trading in commodities or currencies; or
- (3) entering into any transactions involving derivative investments.

4.4.3 G Section 9A contains definitions of the above terms, and societies are directed particularly to section 9A(9) for the purposes of compliance monitoring.

4.4.4 G Section 9A also includes a “purpose” test for entering into derivatives contracts and a “safe harbour” clause for society counterparties stating that any transaction in contravention of the section 9A prohibitions is not, however, thereby invalid and may be enforced against the society.

4.4.5 G The exemptions in section 9A fall into two broad categories:

- (1) those which allow a society or subsidiary undertaking to provide certain retail services to its customers, including:
 - (a) acting as market maker in currency or securities transactions of less than £100,000;
 - (b) trading in currencies (but not commodities) up to a value of £100,000 per transaction;
 - (c) entering into “contracts for differences” in respect of customers who wish to hedge exposures arising from their own loans or deposits with, the society group; or
 - (d) acting as market maker or entering into “derivative investments” in its capacity as manager of a collective investment scheme; and
- (2) those which allow a society or subsidiary undertaking to use “derivative investments” in order to limit the extent to which it, or a connected undertaking, will be affected by changes in interest rates, exchange rates, any index of retail prices, any index of residential property prices, any index of the prices of securities, or the creditworthiness of any borrower(s).

4.4.6 G The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in 4.4.5(2) above. The factor relating to credit worthiness was added to the original list in section 9A(4)(b) by the Building Societies (Restricted Transactions) Order 2001 (SI 2001/1826). The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

4.4.7 G Boards should have procedures and controls to ensure that use of section 9A exemptions by their society (and subsidiary undertakings, if any) is within the law. The exemptions permitting transactions of up to £100,000 (as market-maker in currency or securities transactions, or trading currencies) may not be abused by artificially breaking up larger transactions into a number of smaller amounts falling within the £100,000 ceiling (section 9A(8) is the relevant anti-avoidance provision). Compliance with the 1986 Act may be assisted by specifying the purposes and circumstances in which hedging transactions may be undertaken, or derivatives used, both in the financial risk management policy documents and in the internal arrangements for delegation, identifying the specific authority in section 9A. Whatever the hedging policies adopted, and however the control and authorisation arrangements are organised, it is important that they should be accurately and fully documented.

4.5 Supervisory approach

Funding limits

4.5.1 G Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, societies should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of deposit liabilities (i.e. an inversion of the “nature limit”). In order to avoid any possibility of an inadvertent breach of the 1986 Act, it is expected that such internal limits will be set at levels below the 50% statutory maximum.

4.5.2 G In setting funding limits, the board should consider wholesale and other deposit funding requirements over the period of their society’s current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely. Where societies have significant levels of offshore deposit funding or commercial deposit funding, boards should set policy sub-limits for these sources (e.g., a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale funding and 10% for offshore funding - the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously).

Supervisory standards for treasury activities

4.5.3 G Under section 5 of the 1986 Act, a society’s principal purpose is residential mortgage lending, financed by members’ savings, not undertaking, and trading in, financial risk for profit. Societies should therefore adopt a risk-averse approach to maturity mismatch and to structural risk

management. A degree of maturity mismatch and structural risk is inherent in normal building society operations, but boards should set risk limits which either:

- (1) ensure that, as far as possible, such exposures are minimised; or
- (2) where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels which would not compromise the current or future viability of their societies.

4.5.4 G Societies should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates.

4.5.5 G To comply with rule 4.2.1, a society's system for financial risk management must be **adequate**. The policy statement required under rule 4.2.5 must be appropriate for the society's business needs and the complexity of its existing and proposed treasury activities. The FSA has devised five models, described as supervisory approaches, of increasing sophistication, to assist societies to comply with these rules. The approaches are described as "administered", "matched", "extended", "comprehensive" and "trading". A society that conducts its treasury activities in accordance with the most suitable (for it) of these five models, can readily demonstrate that it complies with rules 4.2.1 and 4.2.5. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in Annex 4A.

Supervisory discussions on change of approach

4.5.6 G The FSA anticipates that societies will wish to develop further their treasury expertise, and that a change of "approach" may be necessary. In this respect, the "approach" categories should be seen, not as discrete compartments, but rather as stages in the continuous evolution of financial risk management, with a change of "approach" marking a milestone in that progress. Societies should develop their financial risk management and systems to the level appropriate to support the scale and nature of their business and the FSA will be encouraging societies to enhance their treasury capabilities where this is considered to be necessary.

4.5.7 G Whilst the "approach" benchmarks have no legal significance, the process of moving between approaches provides a useful opportunity for the FSA to review a society's progress, and to

satisfy itself that policies, limits and systems are appropriate for the treasury activities planned, and that therefore compliance with rule 4.2.1 is adequately established.

4.5.8 G Any society which wishes to move between approaches should contact the FSA at an early stage. The FSA will wish to be satisfied that the society has the requisite expertise, management information systems, accounting systems and controls before any significant change in the society's treasury activities is implemented.

4.6 Management responsibilities

4.6.1 G Senior management of a society are responsible for:

- (1) ensuring that board policies for managing treasury risk are implemented through the operation of effective:
 - (a) control procedures;
 - (b) risk measurement systems; and
 - (c) risk reporting systems; and
- (2) maintaining clear lines of authority and responsibility for controlling treasury risk, including:
 - (a) recruitment of sufficient personnel (including ensuring adequate cover for sickness and holidays) with appropriate specialist skills and expertise to control and monitor structural risk;
 - (b) setting and monitoring appropriate control limits within the board policy levels delegated; and
 - (c) maintaining effective internal controls through daily monitoring of treasury activities, and appropriate segregation of duties.

4.7 Risk management systems

4.7.1 G In order to demonstrate compliance with rule 4.2.1, a society should have in place information systems that are capable of:

- (1) measuring the level of maturity mismatch and structural risk inherent in its balance sheet;
- (2) assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value;
- (3) reporting accurately, and promptly, on risk positions - to management, to the board and, if requested, to the FSA;
- (4) recording accurately, and on a timely basis, all new transactions and/or cashflows which will affect calculations of structural risk exposures;
- (5) managing the settlement timetable and processes for individual treasury instruments; and
- (6) monitoring credit risk and settlement risk positions incurred with individual and groups of counterparties.

4.7.2 G The scale and scope of the risk measurement system employed should reflect the sophistication of a society's treasury operations, those societies wishing to adopt the "Comprehensive" or "Trading" approaches requiring more complex techniques to capture different facets of risk.

Control limits

4.7.3 G Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the society's business. Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiaries. The size of the limits set will be a

factor in the FSA's assessment of the overall risk profile of the society, and thus in the threshold solvency ratio which is set for it.

4.7.4 G The structure of limits should enable the board and management to monitor actual levels of sensitivity, under different pre-defined market index, interest rate and exchange rate scenarios, against the policy specified maxima, to ensure that corrective action can be taken if required.

4.7.5 G The number and type of limits which should be applied will depend upon the relative sophistication of a society's treasury operations, and further guidance on the FSA's expectations for each policy approach is set out in Annex 4A.

4.7.6 G Where limits are set as part of the overall board policy, these should be treated as absolute, and therefore no excesses should be tolerated. Any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in such circumstances (including arrangements for informing the board and the FSA of the breach). Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

Stress testing

4.7.7 G The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of such stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic. Boards and management should, periodically, review the extent of such stress testing to ensure that any "worst case" scenarios remain valid. Contingency plans should be in place to deal with the consequences should such scenarios become reality.

Board information reporting

4.7.8 G The FSA attaches considerable importance to the quality, timeliness, and frequency of the management information which the board uses to inform itself of the society's risk positions and to

satisfy itself that treasury activities are being undertaken in accordance with its policies and guidelines. Information obtained by the board should not be confined to the current position, but should include regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

4.8 Counterparty risk

4.8.1 G Counterparty limits should cover:

- (1) full risk exposures (e.g. deposits or marketable instruments);
- (2) market risk exposures (e.g. mark to market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates);
and
- (3) settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

4.8.2 G Boards should determine the extent to which authority to set counterparty limits is delegated to management, but delegation to a single individual should not be permitted. Personnel with dealing mandates should not be given authority to set new or increased counterparty limits. No dealings should take place with counterparties which do not have a pre-approved limit.

4.8.3 G Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For societies with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate - less active societies may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements. In all cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

4.8.4 G Where reliance is placed on sources of information or opinion external to both the society and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals. Where ratings are reduced (or put on “watch” with “negative implications”), or where a society becomes aware of information on a counterparty which might affect its perceived creditworthiness, it should have systems for reviewing individual counterparty limits and, possibly, suspending/removing individual names from authorised lists in an expeditious manner. Arrangements for obtaining published information on counterparties should also be included in procedures manuals.

4.8.5 G Exposures to counterparties should be monitored on a consolidated basis, aggregating exposures of the society and any subsidiaries (where applicable), and setting total exposure limits for groups of connected counterparties (e.g. a commercial bank and its merchant bank subsidiary). Similarly, country, sector and market concentrations should be monitored continuously against agreed limits.

Large shareholdings and deposits

4.8.6 G Undue dependence on individual funding sources that account for a large proportion of a society’s overall liabilities will involve risk of liquidity problems should those funds be withdrawn or not be available for roll-over. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

4.8.7 G A small society is relatively more exposed to this type of risk, and should consider the implications of concentration on individual shareholders or depositors when assessing its liquidity levels and need for committed facilities. In the management of large retail investment accounts, a society should normally avoid:

- (1) obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and
- (2) allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of shares, deposits and loans, to exceed 5% of shares, deposits and loans.

Committed facilities

4.8.8 G A society with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, should consider arranging committed facilities (or to maintain higher than average levels of liquidity). In arranging committed facilities, a society should consider:

- (1) the credit standing and capacity of the provider of the facility;
- (2) the documented basis of the commitment (i.e. is it an unconditional commitment or a “best endeavours” arrangement); and
- (3) the cost/fee structure compared to alternatives.

In extreme cases , there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn “events of default” or “material adverse change” clauses, and face the legal consequences (if any) rather than lend money to a society in difficulties. Societies should not, therefore, become over reliant on committed facilities to plug short term cashflow difficulties.

4.9 Operational risk

General

4.9.1 G Treasury is an area which is particularly vulnerable to losses arising out of errors, fraud, or wilful override of controls in order to “trade out” of loss making positions.

Segregation of duties

4.9.2 G Societies should ensure that, for all transactions undertaken, separate individuals are responsible for agreeing the deal, for preparing settlement instructions and for authorising payments. Societies should aim to ensure that there is complete segregation of duties between:

- (1) dealers,
- (2) those responsible for confirming the deals with counterparties and making and receiving the payments resulting from the deals, and
- (3) those reconciling bank statements.

4.9.3 G In more active treasuries duties should be split between a “front office” (dealing and deal support), a “middle office” (risk management) - essential only for those societies with more complex treasury operations - and a “back office” (confirmation, and settlement), with accounting and payment functions carried out either by the back office, or by a separate finance department. Physical segregation of the dealers from the settlement staff, to ensure that the former have no access to post or fax facilities used for confirmations, should be in place where accommodation and numbers of staff permit.

Reporting lines

4.9.4 G Where treasury activity and personnel numbers are high enough to allow the creation of separate “front” and “back offices”, the reporting line for the latter should be independent of the former, so as to ensure that no conflicts of interest arise at the next level of management.

4.9.5 G A society adopting the “Comprehensive” or “Trading” approach should ensure that its “middle office” risk management function has clearly defined duties, and reports structural risk exposures directly to senior management and the board. The risk function should be independent of the profit centres of the society.

Remuneration policy

4.9.6 G Whilst it is clearly important that societies should offer salary levels sufficient to attract treasury personnel with the required qualifications and experience, remuneration policies should not encourage individual risk taking at the society’s expense. In particular, bonus schemes for treasury staff should not be based on numbers of transactions or gross income targets.

IT security

4.9.7 G Reliance on computerised dealing, information, treasury management and risk assessment systems renders societies particularly vulnerable to software or hardware failure. In accordance with Chapter 9 (Systems), boards of societies should:

- (1) have in place tested contingency plans for business recovery in the event of

unforeseen disaster;

- (2) ensure that treasury IT systems access, both physical and logical, is subject to robust security;
- (3) exercise strong control over the development and modification of treasury IT systems; and
- (4) involve internal audit in reviewing the development or modification of treasury IT systems.

4.10 Independent review and controls

Internal audit

4.10.1 G Each board should ensure that its society's internal audit department has the skills and resources available to undertake an audit of the treasury function. Internal audit should evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and should assess the effectiveness of treasury management procedures.

4.10.2 G Societies with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience. The work of outsourced internal audit should be fully integrated into the society's overall audit procedures and plans, with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to the society's own external auditors – even if the function were to be performed by a completely different branch of the audit firm (see also chapter 11 on Outsourcing).

External audit

4.10.3 G The FSA may commission reports on treasury systems from external auditors under section 166 of the Act or from other appropriate skilled persons, whenever a society seeks to broaden the scope of its treasury operations. Societies which move to the “Comprehensive” or “Trading” approaches should carry out a post-implementation review in conjunction with their external auditors

or other professional advisers. The FSA may, from time to time, commission an external review of a society's treasury, procedures and controls, in order to satisfy the FSA that these remain adequate and appropriate.

4A.1 Supervisory approach categories

4A.1.1 G This Annex provides guidance on the five models, or supervisory approaches, to financial risk management described in paragraph 4.5.5G. Where societies have subsidiary treasury operations, it is expected that these will fall into the same approach category as that of the parent society. An outline description of each approach is set out below, and table 4A.7G “Summary of the five approaches” at the end of this Annex summarises the key features.

4A.2 “Administered” approach

4A.2.1 G Societies in this category are expected to have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates. In general, it is anticipated that the “Administered” approach will:

- (1) tend to suit small or very small societies;
- (2) where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board - existence of a specific finance function (and Finance Director) being unlikely.

4A.2.2 G Societies adopting this approach:

- (1) should not offer fixed rate products (defined as repricing more than one year and one day later than the current date) on either side on the balance sheet;
- (2) should have policies limiting the levels of deposit funding to less than 10% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 10% of share and deposit liabilities;

- (3) will hold a simple range of liquid assets (whether counting as prudential liquidity or not), with marketable fixed rate instruments held only provided that these have a residual maturity of 5 years or less; and
- (4) should place no fixed rate time deposits having a maturity greater than 1 year.

4A.2.3 G Societies adopting the “Administered” approach do not need specific risk management reporting, but the market value of fixed rate investments with maturities of more than one year, as compared to their purchase price, will be monitored by the monthly monitoring returns.

4A.3 “Matched” approach

4A.3.1 G Societies adopting this approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis. Characteristic of small to medium sized societies, with limited treasury skills or resources, typically the Chief Executive of such societies will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through a board sub-committee).

4A.3.2 G Societies adopting this approach should:

- (1) have in place policy statements covering the intention to offer fixed rate (i.e. >1 year to repricing date) products on one or both sides of the balance sheet;
- (2) set limits (as a % of total assets) for fixed rate loan assets and share or deposit liabilities, and for holdings of fixed rate liquid assets (whether counting as prudential liquidity or not);
- (3) set an overall limit for hedging transactions (nominal value of transactions %SDL);

- (4) have in place policies limiting the levels of deposit funding to less than 25% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 25% of share and deposit liabilities.

4A.3.3 G The policies of such societies can allow use of standard hedging products for transactions permitted by section 9A, e.g.:

- (1) swaps (including FTSE index swaps);
- (2) Forward Rate Agreements; and
- (3) plain vanilla over the counter (“OTC”) options such as swaptions, caps, collars and floors (options purchased only);

for the purpose only of matching individual products and within the exemptions permitted by section 9A - structural hedging of the whole balance sheet should not be permitted.

4A.3.4 G Risk management for such societies will be achieved internally through:

- (1) matching reports (detailing individual products and the hedging instruments associated with them); and
- (2) gap analysis - for gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. Basis risk should be minimised by setting cautious limits for fixed rate and market rate assets and liabilities.

4A.3.5 G Gap monitoring reports should be updated and considered by the board at least monthly.

By implication, societies adopting this approach should not be taking an interest rate view for the purposes of determining a hedging strategy.

4A.4 “Extended” approach

4A.4.1 G The principal difference between the “Matched” and the “Extended” approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions. The approach will thus allow a society to allocate reserves to specific repricing bands representing a considered view of the characteristics of such reserves and/or the assets deemed to “represent” such reserves, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view. Societies adopting this approach will have the capability to fund in currency and to hold a limited range of currency liquid assets (see Chapter 5, Liquidity), subject to aiming for elimination of all currency exchange mismatch, within an expected maximum limit of 2% of own funds.

4A.4.2 G As a result, a society adopting the “Extended” approach will:

- (1) adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and
- (2) use the output of such analysis to enable it to position its balance sheet to take advantage of a particular interest view.

4A.4.3 G Management of interest risk for such societies will typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view. Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities.

4A.4.4 G Hedging instruments available to be authorised by the board will be the same as for the “Matched” approach, with the addition of (as far as permitted by section 9A):

- (1) exchange traded futures/options and FTSE (or similar) OTC swaps/options (options to be purchased only);
- (2) foreign exchange swaps and forward contracts, used to hedge currency funding; and
- (3) credit derivatives.

4A.4.5 G Risk management systems should be based on:

- (1) full balance sheet gap analysis;
- (2) possibly supplemented by static simulation.

4A.4.6 G Gap limits could allow leeway for risk positions - to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

4A.4.7 G Basis risk should be controlled through limits on the minimum levels of administered rate assets and liabilities, and limits on the extent of mismatch between LIBOR-based and administered rate balances.

4A.4.8 G Positions should be monitored internally by way of frequent updates (monthly minimum).

4A.5 “Comprehensive” approach

4A.5.1 G The principal differences between the “Extended” and the “Comprehensive” approaches lie in:

- (1) the depth and quality of the risk management systems put in place to monitor and control structural risk;

- (2) the frequency of analysis undertaken; and
- (3) the currencies in which treasury operations would be undertaken.

4A.5.2 G Like the “Extended” approach societies, “Comprehensive” approach societies will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate “middle office” risk management function, segregated from “front office” (dealing) and “back office” (settlement/accounting).

4A.5.3 G Hedging instruments available for use under agreed board policy will include those for the “Extended” approach plus (as far as permitted by section 9A):

- (1) currency options.

4A.5.4 G Risk analysis should extend beyond static gap/static sensitivity analysis to:

- (1) dynamic simulation (projecting forward balance sheet elements and simulating the impact of different interest rate scenarios);
- (2) possibly duration (modified or dollar, reflecting the change in percentage or money value of positions for a given change in interest rates) for individual portfolio elements, or present value of a basis point move (PVBP) calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and
- (3) possibly value at risk (VaR), using correlation/historic simulation and/or Monte Carlo simulation;

the impact on both earnings and economic value being assessed internally on a very regular basis.

4A.5.5 G Risk positions could reflect an interest view, subject to sensitivity limits set by board/ALCO and incorporating basis risk assessment/control. Foreign exchange mismatch (i.e. exchange rate exposure) is expected to be limited to less than 2% own funds (within Capital Adequacy Directive de minimis levels).

4A.6 “Trading” approach

4A.6.1 G A category for those societies which wish to take advantage of the ability to trade in securities. Essentially, such societies will adopt the “Comprehensive” approach for the purpose of managing interest risk arising in their “banking books”, but with additional policies, financial instruments, systems and expertise for managing the market risks inherent in running separate “trading books”. Currency positions exceeding 2% of own funds are permitted, but are expected to be subject to overall board limits.

4A.6.2 G Such a society should control the additional market risks through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and VaR models.

4A.6.3 G Societies adopting this approach will be subject to the Capital Adequacy Directive in respect of their trading books – see Chapter 1 (Solvency).

4A.7G Summary of the five approaches

POLICY APPROACH	RISK MANAGEMENT	RISK ANALYSIS	HEDGING INSTRUMENTS	FUNDING	PRUDENTIAL & OTHER LIQUIDITY	LOAN ASSETS
ADMINISTERED	CE (+FD) & board Dealing/settlement segregation (minimum 2 persons)	None (But, if fixed rate liquid assets held, then mark to market value and sensitivity analysis required)	None	Sterling only Deposit Liabilities < 35%SDL No fixed rate (> 1 Year) provided that funds received from the wholesale market do not exceed 10% SDL	Sterling only No non-marketable > 1 Yr. No marketable > 5 Yrs	No fixed rate (1 Yr. +)
MATCHED	CE/FD (or FM), (ALCO) & board Dealing/settlement segregation (minimum 2 persons)	Matching report & Monthly (minimum) Gap analysis (Reserves NFR) - No structural hedging No Interest View Minimal limits (to cover residual balances + pipeline products only)	Interest rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors (purchase only)	Sterling only Deposit Liabilities <35%SDL provided that funds received from the wholesale market do not exceed 25% SDL	Sterling only	Limit on fixed rate (1 Yr. +)
EXTENDED	(CE)/FD/Treasurer + ALCO & board Treasury segregation (front office/back office)	Monthly (minimum) Static Gap (& Static Simulation) - Reserves hedged Interest view Sensitivity limits (earnings, economic value & basis risk)) No FX mismatch	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options (purchase only) FX Swaps/Forward Contracts Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency Minimum level of administered rate liabilities	Sterling + Currency (limited range of currency instruments)	Minimum Level Of administered Rate Assets
COMPREHENSIVE	FD/Treasurer/Risk Manager + ALCO & board Treasury segregation (front office/middle office/back office)	Very frequent Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR.) Sensitivity limits (earnings & economic value) Basis risk limits FX mismatch <2% Own Funds	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options Exotic Options FX Swaps/Forward Contracts/ Options Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency
TRADING	FD/Treasurer/Risk Manager /+ Market Risk Committee/ ALCO & board Treasury segregation (front office/middle office/back office) + banking book/ trading book	Banking Book: Daily (minimum) Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Trading Book: VaR - CAD capability	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options/ Exotic Options Retail derivatives/FX permitted. FX Swaps/Forward Contracts/ Options Equity Options Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency

4B Credit Derivatives

4B.1 Introduction

4B.1.1 G This annex contains guidance for building societies on credit derivatives.

4B.1.2G This annex consists of the guidance for banks on credit derivatives (chapter CD of IPRU(BANK)) as modified by additional guidance specific to building societies set out below.

4B.2 Additional Guidance for Building Societies

4B.2.1G This annex sets out additional guidance on credit derivatives for building societies over and above that set out in chapter CD of IPRU(BANK). These additions mostly arise as a result of the particular constitutional structure of building societies and the provisions of the 1986 Act. The FSA will expect societies, when planning to use credit derivatives, to consider these issues in formulating their policies.

4B.2.2G A building society intending to use credit derivatives should have effective systems to measure, record, monitor and control the exposure to each protection seller that is incurred and to identify any residual exposure (net of protection) to the underlying assets for which it is buying protection.

4B.2.3G As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the assets for which the society retains the full risk. The FSA will consider this, where relevant, in assessing a society's threshold solvency ratio.

4B.2.4G Nothing in chapter CD should be taken as contradicting the statutory requirements under the 1986 Act, in particular section 9A, which take precedence, as necessary, over chapter CD.

4B.2.5G The guidance contained in chapter CD applies to building societies with the

following modifications:

- (1) All references to banks should be taken to include building societies.
- (2) References to the Capital Overview and Large Exposures chapters of IPRU(BANK) do not apply to building societies. They should be taken to refer, instead, to chapters 1 (Solvency) and 7 (Large Exposures) in Volume 1 of IPRU(BSOC). The guidance in chapter CD relating to capital requirements, large exposures, liquidity or solvency should be construed in accordance with the relevant IPRU(BSOC) rules and guidance.
- (3) References to the trading book contained elsewhere in the chapter, apart from the material set out in 4B.2.7 below, will not normally be relevant to building societies

4B.2.6G Sections 1, 2, 3, 5, 9 and 10 of chapter CD will normally apply to all building societies proposing to use credit derivatives. Section 8, which deals with credit spread options, is unlikely to be relevant to building societies.

4B.2.7G Sections 4, 6 and 7 of chapter CD will not normally be relevant to building societies, because:

- (1) section 6 of chapter CD deals with banks as protection sellers, and because of the overriding provisions of section 9A of the 1986 Act, a building society can normally use credit derivatives only as a protection buyer and not as a protection seller.
- (2) sections 4 and 7, which deal with banking/trading book division, and trading book treatments, are unlikely to apply to building societies, because all derivatives are allocated to the banking book for building societies.

4B.2.8G Societies adopting the Extended, Comprehensive and Trading approaches (see Annex 4A) are free to use credit derivatives, but not all such societies may wish to do so. The FSA considers that those societies on the Administered or Matched approaches should not use credit derivatives.

CREDIT DERIVATIVES

1 INTRODUCTION

1.1 Legal Sources

1 The FSA's supervisory approach has been developed through consultation with market practitioners and other regulators internationally, and policy will be reviewed as the market continues to develop. There are no internationally agreed regulations explicitly covering credit derivatives under the Basel Accord and EU directives though the treatment of credit derivatives is relevant to the assessment of capital adequacy, and large exposures. The FSA aims to achieve consistency where possible with the capital and large exposures treatment of other similar instruments. The sources identified in the Legal Sources sections of the Capital Overview and Large Exposures chapters are relevant to this chapter.

2 The policy is set out in a separate chapter because it results from the application of a few general principles. Where these principles feed into the mechanism for calculating capital and large exposures, there are cross references to the relevant chapter of the IPRU (BANK).

1.2 Application

3 These obligations apply to all UK banks which use credit derivatives as either protection buyer or protection seller.

See s2.1

- a) Protection buyer and credit risk seller are used interchangeably, as are protection seller/credit risk buyer. These terms are defined below.

4 The policy set out in this chapter does not apply to overseas and EEA banks.

1.3 How this chapter is organised

5 Section 2 outlines basic types of credit derivative and the rationale for their use by banks.

Section 3 highlights risk management issues raised by credit derivatives.

Section 4 covers the trading book/banking book division and valuation.

Sections 5 and 6 cover factors determining the capital treatment of credit derivatives in the banking book for the protection buyer and protection seller, respectively. This section does not cover credit spread options.

Section 7 covers the capital treatment of credit derivatives in the trading book, excluding credit spread options.

Section 8 covers the capital treatment of credit spread options.

Section 9 covers risk transfer requirements.

Section 10 covers factors determining exposures recorded for large exposures purposes.

2 DEFINITIONS, RATIONALE AND TYPES OF PRODUCT

2.1 Definitions and rationale

1 *Credit derivatives* is a general term used to describe various swap and option contracts designed to transfer credit risk on loans or other assets from one party, the *protection buyer*, to another party, the *protection seller*. The protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer, which are linked to the credit standing of a *reference asset* or assets. The term credit derivative may also be used to describe cash instruments where repayment of principal is linked to the credit standing of a reference asset.

- a) *Protection buyer* and *credit risk seller* are used interchangeably in this chapter, as are *protection seller* and *credit risk buyer*.
- b) A *reference asset* is an asset to which payments under the credit derivative contract or instrument are linked; it is usually a security, but could also be a loan or another form of obligation (such as a counterparty exposure under an off balance sheet transaction).

2 Transfer of credit risk may be for the whole life of the reference asset or for a shorter period, and it may be for the full amount of the asset or part of it. A credit derivative may be referenced to a single asset or to a basket of obligations of a single *borrower* or several borrowers.

- a) *Borrower* and *obligor* are used interchangeably to describe the entity generating the reference asset.

3 Banks may use credit derivatives for a number of reasons. These include:

- reducing capital required to support assets on the balance sheet;
 - reducing *credit risk concentrations*;
 - freeing up credit lines;
 - creating *new assets and synthetic assets* to meet wider investor demand; and
 - managing assets on a portfolio basis.
- a) Credit derivatives may be used to reduce *credit risk concentrations* without damaging an existing relationship with the borrower, since there is no transfer of title of the asset.

- b) *New assets and synthetic assets* may widen investment opportunities by, for example, filling gaps in the maturity and credit quality spectrum and providing investment opportunities which some investors would otherwise be unable to access.

2.2 Types of credit derivative

2.2.1 General

4 There are four common types of credit derivative:

- credit default products;
- total return swaps;
- credit linked notes;
- credit spread options.

5 The following examples illustrate how A can assume credit risk on a bond issued by X using various types of credit derivative. B, the counterparty in these transactions, is assumed to own bond X, and is hedging (or laying off) the risk on it. B might, alternatively, have no existing exposure to bond X, in which case it would be taking an unhedged short position in bond X; or B might have an asset similar to bond X, in which case it would be partially hedging that *underlying asset*, but could be exposed to basis risk between the *underlying asset* and bond X (the *reference asset*).

- a) *An underlying asset* is the asset that a protection buyer is seeking to hedge, which is not necessarily identical to the reference asset of the credit derivative used.

See s2.1

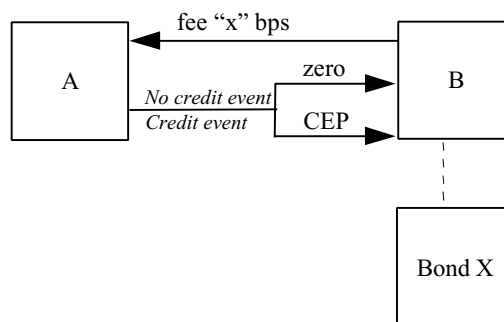
- b) *Reference asset* is defined in section 2.1 above.

6 These examples assume that risk is transferred directly from the risk seller to the risk buyer. In practice, there is often an intermediate transfer to an *SPV*, which then issues notes to risk buyers.

- a) *SPV* - special purpose vehicle.
- b) Where the risk transfer is made through an unfunded credit derivative (credit default product or a total return swap), the vehicle often invests the funds received from the note issue in a *collateral security* in order to achieve a return on the cash; this return can be paid to investors in addition to the risk seller's payment for the protection.
- i) *Collateral securities* are usually government or other bonds.

2.2.2 *Credit default product*

7 A sells credit protection to B for five years on \$50 million nominal of bond X. B pays A a fee of x basis points. Under the terms of the contract, if a defined *credit event* occurs on bond X, A will pay B the *credit event payment* 90 days after the event. If no credit event occurs, the contract will expire after 5 years without any payment from A to B.

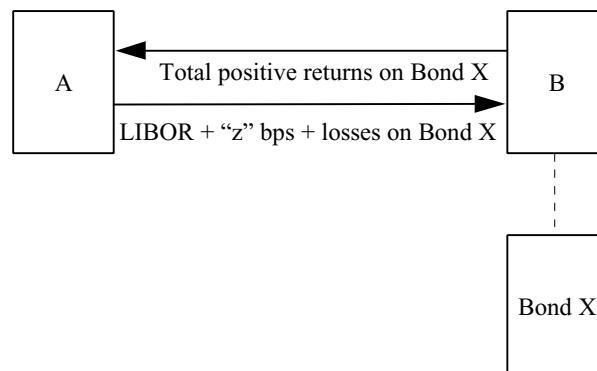


- a) Credit default products (CDPs) are structured so that a payout occurs only when a contractually defined *credit event* (or one of several events) occurs. Credit events normally include bankruptcy, and any payment default on the reference asset and reschedulings, but may also include lesser events such as ratings downgrades. In some contracts a pre-determined materiality (or loss) threshold must also be exceeded for the payment to be triggered.
- b) The *credit event payment* (CEP) is the amount that is paid following a credit event. This is defined in the contract, and is normally one of three types:
 - payment of par value in exchange for physical delivery of the reference asset; some contracts may allow delivery of a variety of assets of the reference name;
 - payment of a fixed amount (sometimes known as a *binary payout*);
 - or
 - payment of par less recovery value. (The reference asset will normally retain some value after a credit event has triggered settlement of the contract. The recovery value is normally determined at a date up to three months after the credit event, by means of a dealer poll or auction.)
- c) Although CDPs may have some of the characteristics of an option, they are often documented as a swap and are treated as a swap by the FSA for capital purposes.

8 In the above example, A has assumed the default risk on bond X from B without funding the position. B has hedged its default risk on bond X, but has acquired a credit exposure to A, since B depends on A to make the credit event payment.

2.2.3 Total return swap

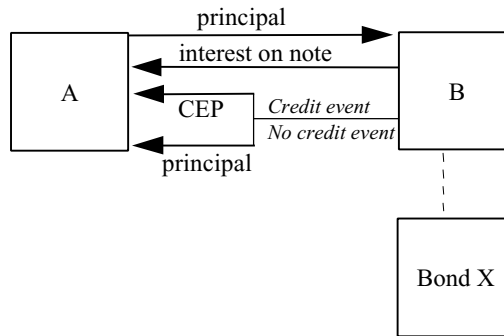
9 A and B enter into a total return swap (TRS) for five years referenced to a notional amount of \$50 million nominal of bond X. B makes periodic payments to A of all cashflows arising from bond X plus any increase in the market value of bond X since the last payment date. On the same dates, A makes payments to B of an interest rate related flow (e.g. LIBOR + z basis points) plus any decrease in the market value of bond X. (Payments may be exchanged on a net basis). If there is a defined credit event, the TRS will usually terminate and the credit event payment will be calculated as though the next normal payment date had been brought forward.



10 B has transferred to A the total performance of bond X (including market risk and default risk) for the duration of the contract, or until there is a credit event. A has assumed this risk without having to fund its position. A and B have acquired credit exposure to each other, since each depends on the other to make payments due under the swap.

2.2.4 Credit linked note

11 B issues \$50 million nominal of a five-year note referenced to bond X, and the note pays a fixed or floating rate interest. If no credit event occurs on bond X, the note will mature at par in five years. If a defined credit event occurs on bond X, the note will be redeemed for the credit event payment, 90 days after the credit event.



12 A has assumed the credit risk on bond X, and has to fund the position (in contrast to the credit default swap illustrated above). It has also acquired exposure to B of the full amount of the funding it has provided. B has hedged its risk on bond X without acquiring any credit exposure to A, as it has received full cash funding from A.

2.2.5 **Credit spread product**

13 Credit spread products are diverse. A typical example might be as follows: A sells to B a put option on \$50 million nominal of an asset swap on bond X, exercisable at any time in the next year, in exchange for a payment of premium. The option gives B the right to put the asset swap on bond X to A at a strike spread over a pre-determined benchmark rate.

- a) A credit spread option may include further features, for example, relating to a ratings downgrade of bond X.

14 A and B have acquired exposure to changes in the credit spread of bond X relative to the benchmark rate which are characteristic of a barrier option. B has also acquired credit exposure to A, since B depends on A to pay amounts due on exercise of the option.

3 RISK MANAGEMENT ISSUES

3.1 Introduction

1 Credit derivatives raise many of the same risk management issues as other new products, credit products, and derivatives. This section highlights areas that are of particular relevance to credit derivatives. Additional conditions to be met before risk transfer is recognised for capital adequacy purposes are set out in section 9.

3.2 Systems

2 Banks using credit derivatives should have adequate systems in place to manage the associated risks.

3 These are likely include:

- adequate management information systems to make senior management aware of the risks being undertaken. This might include information on the level of activity in each of the different products; the ability of the bank (if it is the risk buying organisation) to pursue the underlying borrower when a credit event payment has been triggered; and contractual characteristics of the products (such as fall-back provisions should a dealer poll fail to determine a recovery value following a credit event, and tailoring of standard documentation for particular transactions).
- procedures for ensuring that the credit risk of a reference asset acquired through a credit derivative transaction and any counterparty credit risk arising from an unfunded OTC credit derivative is captured within the bank's normal credit approval and monitoring regime. Banks should be able assess the initial credit risk involved in undertaking the transaction and also to monitor the credit risk on an on-going basis. Information asymmetry (between the buyer and seller of credit risk) may be a significant issue if there is no widely-traded asset of the reference obligor.
- systems to assess and take account of the possibility of default correlation between the reference asset and the protection provider.
- valuation procedures (including assessment and monitoring of the liquidity of the credit derivative and the reference asset) and procedures to determine an appropriate liquidity reserve to be held against uncertainty in valuation. This is particularly

important for credit derivatives where the reference asset is illiquid (e.g., a loan), or if the derivative has multiple reference obligors.

3.3 Other operational risks

- 4 The FSA takes into account significant operational risks when setting a bank's minimum (or "trigger") capital ratio, and may in exceptional cases set an explicit capital requirement against such risk.
- 5 Banks should consider how to limit and monitor any legal and reputational risk associated with credit derivatives.
- a) Banks should consider, amongst other things, whether credit derivatives require regulation as insurance business in any of the relevant jurisdictions.
 - b) Banks should consider whether conflicts of interest might arise within the institution in respect of privileged information if there is no widely traded asset of the reference obligor.
 - c) Banks should ensure that transfer of credit risk through a credit derivative does not contravene any terms and conditions relating to the reference asset, and where necessary all consents have been obtained
 - d) Where credit risk to many obligors has been transferred as a package, the bank should consider whether the reputation of the bank might be damaged by subsequent deterioration in the quality of these assets

3.4 Liquidity

- 6 Where a bank has transferred significant credit risk using funded credit derivatives it should be able to demonstrate capability to refinance the exposures that have been transferred.
- a) For example, where the bank has bought protection of shorter maturity than the assets being protected, it should consider how it would obtain funding if a replacement contract were not to be found on maturity of the protection.
- 7 Where a bank has hedged significant credit risk using unfunded credit derivatives of shorter maturity than the underlying exposures, it should consider whether it would have sufficient capital to support the risk in the event of a replacement contract being unavailable immediately on maturity of the credit risk protection, or how such "rollover" risk could otherwise be avoided or limited.

3.5 Remaining asset base

See ch SE

8

As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the assets remaining on a bank's supervisory balance sheet, in terms of both quality and spread. The FSA will consider these implications in assessing the bank's overall capital requirements.

4 TRADING BOOK/BANKING BOOK DIVISION

4.1 Introduction

4.1.1 *General principles*

1 Credit derivatives should meet the standard criteria applied to other financial instruments in order to be eligible to be held in a bank's trading book. The standard criteria include ability of the bank to mark to market positions daily on a prudent and consistent basis, and demonstration of trading intent. As with other financial instruments, inclusion of credit derivatives should be within each bank's trading book policy statement agreed with the FSA.

See s5, 6, 7 and
8

2 Credit derivatives not included in the trading book should be included in the banking book. Capital treatment of credit derivatives in the banking book is covered in sections 5, 6 and 8 and in the trading book in sections 7 and 8.

See ch CB

a) The criteria for the trading book are set out in the chapter on the trading book/banking book division.

See s9

b) The activity of issuing credit linked notes with trading intent is eligible to be included in the trading book subject to the risk transfer requirements set out in section 9.

c) Credit derivatives referenced to relatively illiquid reference assets (such as loans) are eligible to be included in the trading book, but an appropriate reserve against uncertainty in valuation should be agreed for illiquid credit risky positions in the trading book policy statement.

4.1.2 *Marking to market*

3 Where credit derivatives referenced to relatively illiquid assets are included in the trading book, the FSA may require significant extra capital to be held against uncertainty in valuation.

4.1.3 *Trading intent*

4 In assessing whether a bank has demonstrated trading intent in relation to credit derivatives business; the FSA may take into account the market structure available to support the business.

a) Factors taken into consideration could include how the positions are managed, the use of standard documentation and market conventions, the number of market makers in the product and in instruments hedging it, and the availability of screen prices.

5 BANKING BOOK - PROTECTION BUYER

5.1 Introduction

1 This section sets out the factors that determine the banking book capital treatment for a protection buyer. Capital needed will depend on the particular structure of the contract/instrument.

See s9 2 The following section assumes that the risk transfer conditions set out in section 9 of this chapter have been met.

See s8 3 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

5.2 Funded or unfunded

4 Where an asset is protected in full or in part by a *funded credit derivative*, the FSA recognises the transfer of credit risk by reducing the risk weighted exposure to the reference/underlying asset. The extent to which the risk weighted exposure can be reduced depends on the amount of the funding received and the other factors set out below.

a) A *funded credit derivative* usually refers to a credit linked note. However, both total return swaps and credit default products may also be structured so that exposure to the reference/underlying is funded at inception.

b) This treatment is parallel to that of a loan sub-participation.

See ch BC s3 5 Where an asset is protected in full or in part by an *unfunded credit derivative*, banks may choose to replace the risk weighting of the protected asset with the risk weighting of the counterparty to the credit derivative contract. The extent to which the risk weightings can be replaced depends on the amount of protection received under the contract and the other factors set out below.

a) An *unfunded credit derivative* usually refers to a total return swap or a credit default product.

b) This treatment is parallel to that of a guarantee.

c) If the risk weighting of the counterparty selling protection is higher than that of the protected asset, the risk weighting does not have to be increased.

- 6 *Materiality thresholds* may affect the amount of protection that is recognised. All credit derivatives involving materiality thresholds should be referred to the FSA.
- a) A *materiality threshold* may either determine the level of loss that must be reached before a credit event is triggered, or may reduce the amount of the payout.

5.3 **Payout structure**

- 7 Where the credit event payment is a fixed amount (or binary payout), exposure to the underlying is recognised as guaranteed/reduced by the amount that the bank will receive/retain if the credit event occurs.
- 8 Where the credit event payment is defined as par less a recovery amount or there is payment of par in exchange for physical delivery of the reference asset, exposure to the underlying asset can be recognised as guaranteed/reduced to zero for the amount protected under the contract.

5.4 **Asset mismatch**

- 9 Where the reference asset and the underlying are the same, protection will be recognised subject to the other factors listed in this section.
- 10 Where the reference asset and the underlying asset being hedged are different, protection can still be recognised if the following criteria are met:
- reference and underlying asset are of the same obligor; and
 - reference asset ranks *pari passu* with, or is more junior in a liquidation than the asset being hedged; and
 - there are cross default clauses between the reference asset and the underlying asset.
- a) The FSA may be prepared to accept asset mismatches where there are not cross default clauses if the bank can demonstrate, to the FSA's satisfaction that there are other structural features which eliminate the basis risk between the reference asset and the underlying asset.

5.5 Currency mismatch

11 Where the credit derivative is denominated in a different currency from the reference/underlying asset, the amount of credit protection recognised is reduced by 8% to take account of the contingent foreign currency risk.

- a) For example, a bank has a £1million asset which is protected by a \$ denominated, recovery based, single asset, maturity matched credit derivative, of, say, \$1.5million. If the exchange rate at the outset is \$1.5: £1, the amount of protection recognised would be £920k. If the amount of protection purchased were \$1.62million, the asset would be recognised as fully protected.
- b) The FSA may consider disapplying the 8% reduction in protection where a bank can demonstrate to the FSA's satisfaction that it has hedged the contingent foreign currency risk.

12 Foreign currency positions created by credit derivatives should also be recorded when measuring the bank's foreign exchange exposure. Funded credit derivatives should be treated like all other cash positions. Unfunded credit derivatives should be treated like guarantees.

See ch FX

- a) Further guidance on the calculation of a bank's foreign exchange exposure is contained in the chapter on foreign exchange risk.

5.6 Maturity of the credit derivative compared with the reference/underlying asset

13 Where the maturity of the credit derivative matches that of the underlying asset, the exposure is recognised as guaranteed/reduced and no additional capital is considered to be needed.

14 Where the maturity of the credit derivative is less than that of the underlying asset, recognition of the protection depends on the residual maturity of the credit derivative.

- a) The maturity of credit derivatives with a *step up* and call option is assumed to be the date of the call.
- b) If the protection seller has the option to terminate the credit derivative, the maturity is deemed to be the date at which the option is first exercisable.

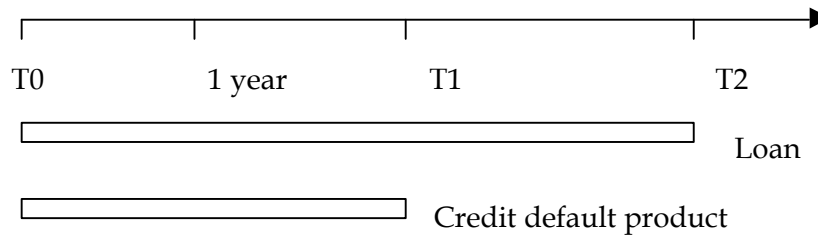
i) A *step up* is an increase in the protection payment.

15 If the residual maturity of the credit derivative is less than one year, no protection is recognised.

See ch BC s4 16 If the residual maturity of the credit derivative is one year or over, protection is recognised, but an additional capital charge is made for forward credit exposure to the underlying asset when the credit derivative contract matures. This forward exposure is treated like a commitment with uncertain drawdown, i.e. it attracts a 50% credit conversion factor ('CCF') against the risk weight of the underlying asset.

Example :

time scale:



Suppose that the underlying asset is a loan to a corporate of a tenor equal to T2, risk weighted at 100%, and credit risk protection is bought from a Zone A bank in the form of a credit default product maturing at T1:

At T0, the risk weight on the loan is reduced to 20% (guaranteed portion of the exposure) with an additional capital charge for the forward exposure of 50% (CCF) x 100%. So the total capital charge is 20% + 50%, = 70%.

Once the residual maturity to T1 reaches one year, protection ceases to be recognised and the risk weight of the loan reverts to 100%.

If the underlying position is an undrawn commitment, the capital treatment resulting from the acquisition of maturity mismatched unfunded protection at T0 is: 20% [risk weight for a Zone A bank] x 50% (CCF) + 50% (original risk weight of corporate x CCF) x 50% (CCF). So the total capital charge is 10% + 25%, = 35%.

17 If the sum of the capital needed for the underlying asset (after protection has been recognised) plus the forward exposure exceeds the original capital requirement for the underlying asset, the credit derivative can be ignored and the underlying asset weighted as normal.

5.7 Multiple names

See s9 18 Where the credit derivative is referenced to more than one obligor (sometimes known as a basket or multiple name product) the nature of the credit protection provided depends on the structure of the contract. Additional conditions would need to be met to ensure transfer of credit risk is not jeopardised by reputational risk, as set out in section 9 of this chapter.

19 If the contract terminates and pays out on the first asset to default in the basket, then protection is only recognised against one asset in the basket. Banks may choose which asset in the basket attracts protection.

20 If the contract allocates protection proportionately amongst assets in the basket (sometimes known as a *green bottle structure*) protection is recognised in setting capital requirements against all the assets in the basket according to the proportions in the contract.

See s9 21 If a bank provides credit enhancement to a special purpose vehicle to which it has transferred credit risk through credit derivatives, the credit enhancement is treated as a deduction from capital in accordance with the FSA's policy on securitisation.

5.8 Open short positions and unrecognised protection

22 Where a bank buys protection in the absence of an underlying exposure (i.e., it has an open short position), or where bought protection is not recognised in calculating the capital needed for an underlying exposure, the credit derivative is ignored for capital adequacy purposes.

6 BANKING BOOK - PROTECTION SELLER

6.1 Introduction

1 This section sets out the factors that determine the banking book capital treatment of a protection seller.

See s8

2 This section does not apply to credit spread options. The capital treatment of credit spread options is set out in section 8.

6.2 Funded or unfunded

3 Through a funded credit derivative, a bank acquires exposure to the reference asset (since performance of the credit derivative depends on that of the reference asset), and also to the credit derivative counterparty (since the bank relies on the counterparty to pass on funds during the life of the contract, and on maturity or following a credit event). Where the counterparty is an SPV, a bank may also have exposure to the collateral securities purchased with the money received from the issuance of securities.

4 The amount at risk is limited to the funding provided, however, and this on-balance-sheet exposure is recorded at the higher of the risk weights of the reference obligor and the counterparty holding the funds and, where applicable, the collateral security.

See ch BC

5 Where a bank has sold protection through an unfunded credit derivative, it acquires exposure to the reference asset only. This *exposure* is recorded as a direct credit substitute weighted according to the risk weight of the reference asset.

a) The *exposure* will be the maximum payout under the contract.

6.3 Multiple names

See s6.2

6 Credit derivatives referenced to single names are treated as set out above.

7 Where credit derivatives are referenced to more than one obligor (a basket or multiple name product), the nature of the credit risk acquired depends on the structure of the contract.

8 If the contract terminates and pays out on the first asset to default in the basket, the bank should hold capital against all the names in the basket.

- a) The FSA may consider that this is not needed where a bank can demonstrate, to the FSA's satisfaction, a very strong correlation between the assets in the basket.

9 This means that risk weightings are applied to the maximum payout amount under the contract for each of the names in the basket, capped at the equivalent of a deduction from capital.

10 A structure which is referenced to the assets in the basket proportionately should be risk weighted according to the assets in the basket in the proportions set out in the contract.

6.4 Payout structure

11 Where the amount of the protection is fixed in the contract, the risk weighted exposure to the reference asset(s) is the amount of the payout.

12 Where the credit amount payment is based on par less recovery value or where there is physical delivery in exchange for par value, the risk weighted exposure to the reference asset(s) is the maximum payout under the contract.

7 TRADING BOOK TREATMENT

7.1 Introduction

1 This section sets out the capital treatment considered to be applicable to credit derivatives in the trading book.

See s8 2 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

7.2 Models

See chs TS and TV 3 Banks may apply to the FSA to include credit derivatives in recognised models under CAD1 and also CAD2 models. Banks may apply for recognition of CAD2 models which quantify partial offsets of specific risk positions where there is a maturity or asset mismatch.

See chs TS and ch TV 4 For details of the benchmarking approach to such models see elsewhere.

See s7.3 5 Banks which do not have recognised models covering credit derivatives should follow the standard approach set out below.

7.3 Standard approach

7.3.1 Introduction

See ch TI 6 This section describes the positions to be recorded for credit derivatives for the purposes of calculating specific risk and general market risk charges under the standard approach. The calculation of specific and general market risk charges is described in the chapter on interest rate position risk.

7.3.2 General principles

7 Total return swaps are represented as two legs: one is a notional position in the reference asset with general and specific risk of the reference asset; the other, representing interest payments under the swap, is a notional position in a Zone A government bond with the appropriate fixed or floating rate.

8 Credit default products are represented as a notional position in the specific risk of the reference asset only (i.e., no general risk position is created in the reference asset). If premium or interest payments are due under the swap, these cashflows are represented as a notional position in a Zone A government bond with the appropriate fixed or floating rate.

9 Credit linked notes are treated as a position in the note itself, with an embedded credit default product. The credit linked note has specific risk of the issuer and general market risk according to the coupon or interest rate of the note. The embedded credit default product creates a notional position in the specific risk of the reference asset (with no additional general market risk position created).

7.3.3 *Specific risk - single reference asset*

See s5.2 10 As noted above, total return swaps, credit default products and credit-linked notes create a specific risk position in the reference asset; the credit risk seller has a short position and the credit risk buyer has a long position.

See ch TI s5 a) For the specific risk position to be treated as a qualifying debt item, the reference asset should meet the standard conditions for a qualifying debt item as defined in the chapter on interest rate position risk.

11 The buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer.

7.3.4 *Specific risk - multiple reference assets*

12 Where a total return swap is referenced to multiple names, and the returns on assets are exchanged according to their proportions in the basket, the bank should record long or short positions in all the reference assets according to the proportions underlying the swap.

See s5.2 13 Where credit default products and credit linked notes are referenced to multiple names the positions recorded depend on the structure of the contract.

14 The credit risk seller of a first to default product or note should record a short position in one reference asset in the basket only. Banks may choose which asset in the basket to record as a short position.

15 The credit risk buyer in a first to default product or note should record long positions in each of the assets in the basket, with the total capital charge for the product capped at the equivalent of deduction from capital, with the exception noted below.

- a) The amount of the position recorded will be the value of the note.
- b) The FSA may consider disapplying the additive treatment where a bank can demonstrate, to the FSA's satisfaction, that there is a very strong correlation between the reference assets in the basket.

16 Where the credit default product or credit linked note is a proportionate structure, positions should be recorded in the reference assets according to the proportions in the contract.

17 Where a multiple-name credit-linked note is rated such as to meet the conditions for recognition as a qualifying debt item, the buyer of credit risk may record the specific risk position in the reference assets as a single long specific risk position with specific risk of the note issuer.

See ch TI s5

a) Qualifying debt items are defined in the chapter on interest rate position risk.

18 The credit risk buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer, whether the credit derivative meets the definition of qualifying or not.

7.3.5 *Specific risk offset*

19 Banks may net notional positions in reference assets created by credit derivatives with positions in underlying assets or other notional positions created by other credit derivatives if the following conditions are met:

(a) the underlying and reference assets are issued by the same obligor;

See ch TI s3

(b) the underlying and reference asset specific risk positions meet the matching criteria set out in the chapter on interest rate position risk; and

See s9

(c) the conditions set out below are met.

See s7.2

Where the reference asset and the underlying asset do not meet the criteria for netting, no offset is considered to be justified under the standard approach.

20 Materiality thresholds may reduce the amount of the specific risk offset. All credit derivatives involving materiality thresholds should be referred to the FSA.

See s5.2

a) The definition of a materiality threshold is given elsewhere.

7.3.6 Maturity mismatch

21 Where a credit default product or credit linked note is of shorter maturity than the reference asset, a specific risk offset is allowed between long and short specific risk positions, but a forward position in specific risk of the reference asset is recorded. The net result is a single specific risk charge for the longer maturity position in the reference asset.

a) The maturity of a credit derivative with a *step up* and call option is assumed to be the date of the call.

i) A *step up* is an increase in the protection payment.

22 This treatment does not apply to total return swaps, where no forward position in specific risk of the reference asset is recorded in cases of maturity mismatch.

7.3.7 General market risk

See ch TI s6

23 Credit default products do not normally create a general market risk position.

24 Total return swaps create a long or short position in the reference asset and a short or long position in the notional bond representing the interest rate related leg of the contract.

25 Credit linked notes create a long position in the note itself for the credit risk buyer.

7.4 Counterparty risk**7.4.1 General principles**

26 Each party to a total return swap relies on the other for payment, therefore each party records a counterparty risk charge.

See ch DU and
TC

a) The counterparty risk charge is calculated as set out in chapters DU and TC

27 The credit risk seller in credit default product relies on the credit risk buyer to pay the credit event payment if a credit event occurs, and therefore records a counterparty risk charge. The credit risk buyer is exposed to the credit risk seller only if there are future premiums or interest rate related payments outstanding, and these are recorded as a sundry debtor and risk weighted in the normal way.

- See chs DU and TC
- a) The counterparty risk charge is calculated as set out in the chapters on counterparty risk treatments common to the banking and the trading book and counterparty risk in the trading book.
- 28 There is no counterparty risk charge for credit linked notes.
- 7.4.2 Potential future credit exposure (add-on)**
- 29 The add-on used when calculating the counterparty exposure for an unfunded OTC credit derivative is determined by whether the reference asset is recognised as a qualifying debt item. If the reference asset is a qualifying debt item, the counterparty risk charge is calculated using interest rate add-ons. Otherwise, equity add-ons should be used.
- See ch TI s5
- a) Qualifying debt items are defined in the chapter on interest rate position risk.
- 7.5 Foreign exchange risk**
- See ch FX
- 30 Where the credit derivative is denominated in a currency other than the reporting bank's base currency, it will feed into the bank's monitoring of its foreign exchange position in the normal way.

8 CREDIT SPREAD OPTIONS

8.1 General

1 The capital needed for credit spread options are analogous to those of other options on credit risk assets.

8.2 Banking book

8.2.1 *Protection buyer*

2 The capital reduction/guarantee treatment set out in section 5 in respect of the underlying asset is not considered to be available to the purchaser of a credit spread option.

- a) The amount of protection provided by a credit spread option depends on its mark to market value. However the assumption underlying the banking book framework is accrual accounting.

See ch DU

3 Protection bought using a credit spread option is ignored for capital purposes.

8.2.2 *Protection seller*

4 Protection sold using a credit spread option is recorded as a direct credit substitute. The amount of exposure will be the par value of the nominal amount of the reference asset.

8.3 Trading book

5 The option carve out treatment should be used for credit spread options only after prior consultation with the FSA. Banks should normally apply for recognition of option models covering credit spread options.

9 RISK TRANSFER CRITERIA

9.1 Scope

1 This section sets out conditions to be met before risk transfer (i.e. protection)/short position is recognised in setting capital requirements for banks which buy protection using credit derivatives in the banking book (see section 6) or selling credit risk in the trading book (see section 7). This section does not apply to credit spread options (see section 8).

2 Where these criteria are not met, protection bought should be ignored in the banking book (and the bank should continue to weight the underlying asset as normal) and a short credit risk position recorded in the trading book should not be offset against another specific risk position.

3 Sections 9.2 to 9.4 apply to both the banking book and the trading book.

4 Section 9.2 applies to all credit derivatives, whether funded or unfunded, single name or multiple names.

5 Section 9.3 applies to funded credit derivatives referenced to single names or multiple names.

- a) For the purposes of section 9, first to default structures referenced to multiple names are considered to be referenced to a *single* name. This is because protection is only recognised against one asset in the basket for capital purposes.

6 Section 9.4 applies to packaged credit derivative transactions, which are funded.

- a) For the purposes of section 9, *packaged* transactions include proportionate credit derivatives referenced to multiple names, and structures which bundle together a series of single name credit derivatives.

9.2 General criteria

7 In order for the protection bought/short position to be recognised the following criteria should be met for all credit derivatives:

- (a) The credit risk transfer should not contravene any terms and conditions relating to the reference asset and where necessary all consents should have been obtained;

- a) This relates mainly to reference assets which are loans.
- (b) At a minimum, the credit events in a credit default product or credit-linked note should cover credit events in the reference asset itself; and
- (c) The credit risk buyer should have no formal recourse to the credit risk seller for losses.

9.3 Criteria for funded single name credit derivatives

8 In order for protection/offsetting short position to be recognised, the following criteria should be met:

- (a) the protection buyer should have no obligation to repay any funding received under the credit derivative except at termination or as a result of a defined credit event (in accordance with the terms of payment defined in the contract); and
 - a) The protection buyer may retain the option to repay funding, provided that the reference asset remains fully performing.
 - b) In proportionate transactions involving baskets of assets, the protection seller may retain the option to refinance where the pool of assets has been reduced by repayment to less than 10% of its maximum value but only where the reference assets are fully performing.
 - c) An exception to this restriction is where the obligation arises from warranties given in respect of the asset at the time of the transaction, provided that these are not in respect of the future creditworthiness of the reference asset.
- (b) the protection buyer should have given notice to the protection seller that it is under no obligation to repay the funding (except as defined in (a) above), nor to support any losses suffered by the protection seller, and that the protection seller acknowledges the absence of that obligation.
 - a) Notice and acknowledgement also applies to the ultimate investors, where the initial protection seller is an SPV.
 - b) This criterion may be met by a highly visible and unequivocal statement that the protection buyer does not stand behind the asset(s) and will not make good any losses suffered in the offering circular (or other analogous documentation).

See ch NE

- 9 For those unfunded transactions where collateral has been taken, the conditions in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

9.4 Criteria for funded packaged transactions

- 10 This section applies to funded credit derivatives referenced to multiple names which have a proportionate payout structure, or where a series of funded single name credit derivatives are packaged together. This section does not apply to unfunded structures or to multiple-name credit derivatives with a first to default structure.
- 11 Packaging of the credit risk of multiple assets for transfer may create operational risks which would be negligible for a single asset. For example, the commercial reputation of a protection buyer could be committed by association with a package of assets, and clean transfer of the risk could be jeopardised by pressure on the protection buyer subsequently to provide support to reduce losses of the credit risk buyer. Such reputational risk is less if the assets concerned are disclosed and they are freely tradable assets.
- 12 The following criteria should be met for protection/offsetting short position to be recognised. Some of these criteria may not need to be met if all the reference obligors are disclosed and all the reference assets are freely tradable assets.
- (a) The bank selling credit risk should be satisfied that the transaction protects it from any liability to the credit risk buyer and ultimate investors, except where the bank has been negligent.
- a) Banks can achieve this by ensuring that their auditors and legal advisers are satisfied that the terms of the scheme protect them from liability to the credit risk buyer and ultimate investors and that the scheme meets the FSA's policy.
- (b) The credit risk should initially be transferred to a special purpose vehicle (SPV). The protection buyer should not own any share capital or other form of proprietary interest in or control over the SPV, either directly or indirectly.
- a) This applies also to any other group entity within the protection buyer's group that is covered by the FSA's consolidated supervision.

- b) Share capital includes for this purpose all classes of ordinary and preference share capital.
 - c) Control, for these purposes means that the Board of the company used as a vehicle should be independent of the credit risk seller, although the credit risk seller may have one director representing it.
- (c) The name of the SPV should not include the name of the protection buyer nor imply any connection with it.
- (d) The protection buyer should not directly reimburse the vehicle for any of the recurring expenses of the scheme. Although the credit risk seller may make a one off contribution at the initiation of the scheme to enhance the credit-worthiness of the vehicle. Any credit enhancement provided will be treated as a deduction from capital.
- a) Any such credit enhancement should be disclosed in the offering circular (or analogous documentation).
- (e) The credit risk seller should not fund the vehicle (other than the initial credit enhancement described above); in particular it should not provide temporary finance to a scheme to cover cash shortfalls.
- a) The credit risk seller may enter into interest rate and currency swaps with the SPV as long as they do not provide support for losses in the vehicle.

See ch NE

13

For those unfunded transactions where collateral has been taken, the criteria in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

10 LARGE EXPOSURES

10.1 Introduction

See ch LE

1 The factors that should be considered in determining large exposures recorded for credit derivatives are the same as those for determining capital adequacy, with the exception of the factors noted in this section. Large exposures are covered fully in the chapter on large exposures.

- a) The amount of protection recognised will normally be the same for large exposures as for capital adequacy purposes.

2 Sections 10.2 to 10.5 apply to credit default products, credit linked notes and total return swaps. Section 10.6 applies to credit spread options.

10.2 Banking book and trading book – protection buyer

10.2.1 *Maturity mismatch*

3 For capital adequacy purposes forward credit exposure left by a maturity mismatched credit derivative is treated as an undrawn commitment. Undrawn commitments are treated as an exposure for large exposures purposes, and hence maturity mismatched credit derivatives do not reduce exposure to the underlying.

10.2.2 *Currency*

4 Where the base currency of a funded credit derivative is different from that of the underlying asset, no protection is recognised for large exposures purposes.

10.2.3 *Multiple names*

5 Protection bought/short position created through a credit derivative referenced to multiple names in a first to default structure is recognised for one asset in the basket only for both large exposures and capital adequacy. The same asset should be chosen in each case.

10.3 Banking book - protection buyer

10.3.1 *Unfunded*

6 Where an unfunded credit derivative is treated as a guarantee for capital purposes, banks may choose to record their exposure either to the underlying or to the counterparty in the credit derivative

transaction, provided that the treatment adopted is in line with the bank's large exposures policy statement.

10.4 Banking book - protection seller

10.4.1 *Funded*

7 Where a credit derivative is funded, banks should report exposure to both the reference asset(s) and the credit derivative counterparty/issuer for large exposures purposes.

- a) First to default multiple name credit derivatives result in exposures to more than one reference asset.

10.5 Trading book

10.5.1 *Asset mismatch*

See ch LE

8 Offsetting of long and short positions should be calculated in accordance with the chapter on large exposures. Long and short positions may be offset provided the policy in that chapter is followed.

10.6 Credit spread options

This section applies to both the banking book and the trading book.

10.6.1 *Protection buyer/credit risk seller*

9 No protection/offset is recognised for the purchaser of a credit spread option for LE purposes

10.6.2 *Protection seller/credit risk buyer*

10 A credit spread option creates an exposure to the reference asset for LE purposes. The exposure is the par value of the nominal amount of the reference asset.

Interim Prudential Sourcebook for Building Societies

5 LIQUIDITY

CONTENTS

SECTION	PAGE
5.1 Introduction	2
5.2 Rules	2
5.3 The Prudential Regime for Liquidity	3
5.4 Short-term Liquidity	4
5.5 Supervisory Approach to Liquidity	6
5.6 Board and Management Responsibilities	6
5.7 Society-only Approach to Liquidity	8
5.8 Outsourcing of Liquidity Management and Brokers' Advice	8
ANNEXES	
5A Prudential Liquidity	10
5B Policy Statement on Liquidity	14
5C Inter-society Holdings	17

- (3) stocklending;
- (4) mortgage backed securities (including, where applicable, US MBS);
- (5) foreign currency securities and the handling of foreign currency exposures;
- (6) commercial paper.

5B.2.7 G The society's policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls.

5B.2.8 G Liquidity implications and the role of standby facilities should be included in the policy statement.

5B.2.9 G The role of external professional advisers should be clearly stated, where applicable.

Inter-society Holdings

5C.1 G Societies may hold other societies' liabilities as prudential liquidity. Such holdings may include deposits and holdings of all forms of securities and money market instruments issued by other societies, including commercial paper, but should exclude Permanent Interest Bearing Shares and other forms of issued capital.

5C.2 G A society's aggregate holding of other societies' liabilities should not exceed 5% SDL or £5m whichever is the higher, including liquid assets which, although not counting as prudential liquidity (i.e., deposits with longer than 3 months to run to maturity) are held as other investments and fall within the "liquid assets" heading in the annual accounts. The total should also include undrawn as well as drawn amounts under committed facilities provided to other societies. This measure is to be continuous.

5C.3 G The FSA expects societies to invest no more than 20% of their prudential liquidity or £5m, whichever is the higher (up to a limit of 5% SDL or £5m whichever is the higher) in aggregate holdings of other societies' liabilities.

5C.4 G Committed facility agreements with other societies should be reported to the FSA in the MFS1 return (table D2). Only the amount drawn down (lent) will constitute a liquid asset, but the whole amount counts towards the aggregate exposure to other societies' liabilities as explained above.

5C.5 G Smaller societies (with total assets of less than £1 billion), can be, as a sub-sector, exposed to collective funding risk. Such risk would be exacerbated if smaller societies relied on committed facilities from each other. Accordingly, it would not, in the FSA's view, be prudent for smaller societies to rely on, or to provide, committed loan facilities from, or to, other smaller societies.

Interim Prudential Sourcebook for Building Societies

7 LARGE EXPOSURES

CONTENTS

SECTION	PAGE
7.1 Introduction	2
7.2 Scope of this chapter	2
7.3 Definitions	3
7.4 Controls on Large Exposures	4
7.5 Exposures to Connected Undertakings	5
7.6 Reporting and Notification of Large Exposures	7
7.7 Systems: Rules and Guidance	8
7.8 Exemptions	8
 ANNEX	
7A Form LEPR1	10

Interim Prudential Sourcebook for Building Societies

7 Large Exposures

7.1 Introduction

7.1.1 G This chapter replaces PN 1998/7 issued by the Commission. It implements the large exposures provisions of the BCD for building societies. It also sets out rules and guidance on monitoring, controlling and reporting of large exposures by societies to the FSA.

7.2 Scope of this Chapter

7.2.1 G The purpose of the large exposures provisions of the BCD is to limit and control the extent to which credit institutions may commit themselves to large exposures to counterparties individually and in aggregate. Large exposures to a single counterparty and to a limited number of counterparties can create concentrations of risk in the balance sheet of a credit institution. It is the responsibility of each society's board to set its own limits for large exposures, within the general framework set by the BCD and the rules and guidance specific to societies contained in this chapter. The limits set out in this chapter are maxima. Each society should set its own prudential limits in order both to avoid the over-concentration of risk referred to above and to allow a margin for manoeuvre so as to ensure that the limits set out in this chapter can never be exceeded. Each society should set its own internal limits at a lower level than the maxima set out in this chapter.

7.2.2 G The large exposures provisions of the BCD cover all commercial asset exposures, liquid asset exposures, off balance sheet items and exposures to connected undertakings. The limits set out in this chapter therefore apply to all these areas. It should be noted that asset exposures where no counterparty is involved are not covered by the BCD (for example, fixed assets).

7.2.3 G Where societies are protecting large exposures by the use of credit derivatives, they should have regard to section 10 of chapter CD of IPRU(BANK) (see Annex 4B).

7.3 Definitions

7.3.1 G Under the terms of the BCD an exposure means any of the assets or off balance sheet items referred to in Article 43 or Annexes II and IV of the BCD respectively, before the application of risk weightings and credit conversion factors. Those items that are relevant to building societies are identified in Annexes 1B and 1C of chapter 1. In the BCD, an exposure to a counterparty or group of connected counterparties is defined as a large exposure where its value is equal to or exceeds 10% of own funds. The calculation of own funds for building societies is explained in chapter 1, particularly in Annex 1A.

7.3.2 G The BCD excludes from the definition of "exposure" the following:

- (1) all elements entirely covered by own funds provided that such own funds are not included in the calculation of the solvency ratio or of other monitoring ratios provided for in Community acts;
- (2) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment;
- (3) in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is the earlier.

7.3.3 G A society considering the use of the option in paragraph 7.3.2(1) should consult the FSA well before it commits itself to a large exposure. The FSA will consider requests from societies wishing to exercise the option on a case by case basis.

7.3.4 G The calculation of the amount attributable to an off-balance sheet exposure follows the methodology established in the BCD and explained in Annex 1C. Full risk items are counted at full nominal value. For interest rate and foreign exchange contracts, the method set out in Annex 1C is to be used, but without any risk weighting by counterparty.

7.3.5 G Exposures are connected where a group of counterparties are connected: a group of connected counterparties is defined in the BCD as:

- (1) "two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or
- (2) two or more natural or legal persons between whom there is no relationship of control but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties".

7.3.6 G Control in this context means the relationship between a parent undertaking and a subsidiary undertaking, as defined in Part VII of the Companies Act 1985 or Part VIII of the Companies (Northern Ireland) Order 1986 (which implemented Article 1 of Directive 83/349/EEC), or a similar relationship between any natural or legal person and an undertaking. All individual exposures to the same counterparty or to a group of connected counterparties should be aggregated for the purpose of calculating a large exposure.

7.4 Controls on Large Exposures

7.4.1 G In accordance with the BCD, large exposures of societies which do not have any subsidiary undertakings should be monitored on an unconsolidated basis. Large exposures of societies with subsidiaries should, in general, be monitored on a fully consolidated basis. The basis of consolidation should be that set out in chapter 1. For convenience, the term "supervised group" is used in the following paragraphs to refer to a society and those subsidiaries subject to consolidated supervision, taken together, and in relation to a

supervised group "own funds" means the consolidated own funds of the group. Intra-group exposures (i.e. exposures to connected undertakings) are covered separately in paragraphs 7.5.1 to 7.5.3.

7.4.2 G In accordance with the BCD the following limits will apply:

- (1) A society or supervised group should not incur exposure to an individual counterparty or group of connected counterparties in excess of 25% of own funds;
- (2) the aggregate of all large exposures of a society or supervised group should not exceed 800% of own funds; the aggregate of these exposures should not exceed 300% without the FSA's written approval.

7.4.3 G The BCD allows certain exemptions from the limits on large exposures, giving the competent authorities in each Member State the discretion to use these as appropriate. It also allows for certain exposures to be reduced by the application of weighting factors (in effect, partially exempting those exposures). The exemptions which the FSA allows societies are set out in section 7.8.

7.5 Exposures to Connected Undertakings

7.5.1 G The BCD takes a different approach to the control of exposures by a credit institution to counterparties with which it is connected (i.e. typically to other companies in the same group). Under Article 49.2, subject to applicable exemptions, all such exposures, collectively, are subject to a single aggregate limit of 20% of own funds. Building societies, however, have two particular features which are not shared by the generality of credit institutions. First, a building society will always be the parent entity in a group; it cannot be a subsidiary nor form a minor part of a diversified non-financial conglomerate. Second, under the 1986 Act, as originally enacted, building societies were able to carry out certain activities only through subsidiary companies or other associated undertakings. Although subsequent legislation allows activities to be carried out by the parent society which previously had to be carried out by subsidiaries, the FSA anticipates that societies may still wish to carry on certain activities in dedicated subsidiaries. Given this, the FSA applies, in relation to the single

aggregate limit of 20% of own funds, an exemption for all exposures to a society's own subsidiaries that are subject to consolidated supervision. At the same time, the FSA limits exposures to individual subsidiaries to 20% of own funds.

7.5.2 G The FSA's approach to consolidated supervision in relation to capital adequacy is set out in chapter 1, including the criteria for excluding a subsidiary undertaking from the calculation of the consolidated solvency ratio. The same approach will apply to the control of large exposures. The limits on a society's exposures to counterparties connected with it are therefore as follows:

- (1) in relation to any single subsidiary undertaking or sub-group of subsidiary undertakings within the supervised group, the society may not incur an exposure in excess of 20% of own funds;
- (2) the aggregate of all exposures of the supervised group to counterparties connected with the society but outside the supervised group may not exceed 20% of own funds;
- (3) large exposures to counterparties connected with the society still count towards the overall limit of 300% of own funds (or 800%, if the FSA agrees as set out in paragraph 7.4.2(2)) unless otherwise exempted.

7.5.3 G The FSA will also allow further partial exemption to societies in respect of exposures of the kind referred to in paragraph 7.5.2(1). This exemption will draw upon the principle of solo consolidation described in section 1.11. An exposure of the kind referred to in paragraph 7.5.2(1) will be exempt from the limits on large exposures in paragraphs 7.5.2(1) to 7.5.2(3) where it is agreed by the FSA that the subsidiary undertaking concerned may be solo consolidated. Subsidiary undertakings which fall into this category will probably be those undertaking core business but where the society has decided for structural reasons to undertake the business through a subsidiary. Sections 1.11 and 1.12 set out the criteria under which the FSA considers applications for solo consolidation. Societies will need to explain on what basis they consider it appropriate or necessary for solo consolidation to be granted. In all cases, the society should specify the maximum exposure that it is planning to incur.

7.6 Reporting and Notification of Large Exposures

7.6.1 G The FSA may require large exposures to be reported quarterly and has included reporting of large exposures on a consolidated basis in Table L of the quarterly return QFS1 for building societies. Table L of QFS1 also collects additional information on off balance sheet exposures.

7.6.2 R A society contemplating a new exposure which will exceed 20% of own funds (or when aggregated with an existing exposure to the same counterparty or group of connected counterparties would exceed 20% of own funds) must give prior notification to the FSA of such exposure, before making any commitment, using the standard reporting form, LEPR1, contained in Annex 7A. Exposures falling within this category should also be reported quarterly by means of Table L of QFS1.

7.6.3 R Exposures of between 10% and 20% of own funds must be reported by each society to the FSA. This information should be reported quarterly by means of Table L of QFS1.

7.6.4 G If a society exceeds the 300% aggregate limit (or the 800% limit, if the FSA so agrees), this should be reported immediately to the FSA in writing.

7.6.5 G Societies should also report to the FSA within two months of the end of their financial year:

- (1) confirming that the criteria under which solo consolidation was granted continue to apply. If any do not continue to apply, details of the changed circumstances should be provided;
- (2) confirming that the activities of the subsidiary undertaking(s) continue to be limited to those engaged in at the time that the FSA approved solo consolidation;

- (3) in respect of each case where solo consolidation has been granted, the amount of the current exposure.

7.7 Systems: Rules and Guidance

7.7.1 R Each society must maintain adequate systems and controls which enable it to:

- (1) **monitor and control its large exposures in accordance with its large exposures policy (referred to in Rule 7.7.3); and**
- (2) **make timely and accurate reports to the FSA on its large exposures.**

7.7.2 G Each society should ensure its internal audit programme covers the system for monitoring and control of large exposures.

7.7.3 R Each society must set out its policy on large exposures as part of its Financial Risk Management, Liquidity and Lending Policy Statements.

7.7.4 G Paragraphs 4.2.5, 4.2.6, 5.2.7, 5.2.9, 6.2.2 and 6.2.3 contain rules about policy statements and rule 7.7.3 should be read in conjunction with those rules.

7.8 Exemptions

7.8.1 G This section sets out the exemptions which the FSA allows to societies. In some cases, the FSA allows partial exemption by applying a weighting to the asset amount. The weighting of asset items means multiplying the asset value in the balance sheet by the percentage weight and including the weighted amount in any calculation of large exposures. This process is distinct from, though having some similarities to, the risk weighting of asset items for solvency ratio purposes and it is important that the two processes, and the respective weightings, are not confused.

7.8.2 G Assets constituting claims on the central government or central banks of Zone A countries are fully exempt. Annex 1G defines Zone A and contains a full list of current Zone

A countries. Although the Channel Islands, Gibraltar, Bermuda and the Isle of Man may be regarded as OECD members for the purpose of calculating a society's solvency ratio they may not be so regarded for large exposure purposes.

7.8.3 G Assets constituting claims carrying the explicit guarantee of the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.4 G Other exposures attributable to, or guaranteed by, the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.5 G Asset items and other exposures effectively and legally secured by cash deposits with the society or with any subsidiary undertaking of the society which is also a credit institution (defined in the BCD as an undertaking with both a deposit taking and a lending business) are fully exempt. Societies should note that this definition excludes most existing subsidiaries.

7.8.6 G Claims on and exposures to other credit institutions (including to other building societies) are subject to weightings, for the purpose of calculating exposures, as follows:

- (1) Maturity of one year or less: 0% (i.e. fully exempt);
- (2) Subject to prior written agreement from the FSA, societies' derivative exposures to banks, other building societies and investment firms subject to the Capital Adequacy Directive (CAD) (or subject to a regime that the FSA deems to be equivalent to CAD) with a maturity of over one year but under three years: 20% (i.e. partially exempt)

except where the exposure represents the own funds (as defined in the BCD) of the other institution (e.g. subordinated debt), in which case the exemption does not apply.

7.8.7 G Societies should note that the exemptions in paragraph 7.8.6 do not apply to their own subsidiaries, which also happen to be credit institutions or investment firms subject to CAD.

SENSITIVE: COMMERCIAL

Building Society: Pre-Reporting Statement of Large Exposures Form LEPR1 Reporting Date:/...../20...

Name of Society:

[Empty box for Name of Society]

Statement completed by: Name: [BLOCK CAPITALS]

[Empty box for Name of person completing statement]

Address:

[Empty boxes for Address and Post Code]

Position Held:

[Empty box for Position Held]

Signature:

[Empty box for Signature]

Telephone:

[Empty box for Telephone]

Details of Large Exposure (£000)

The society wishes to take on the following exposure that represents more than 20% of its capital.

Lender Name	Name of counterparty or connected group	Actual Exposure	TOTAL Exposure	Security Value
.....

Please provide a brief description of the main elements of the proposed exposure

[Large empty box for description of exposure]

Own funds at latest financial quarter end:

[Empty box for Own funds at latest financial quarter end]

SUBMISSION: This notification should be sent to the society's usual supervisory contact at the FSA.

[Empty box for Latest quarter end:/...../20...]

Interim Prudential Sourcebook for Building Societies

8 MORTGAGE INDEMNITY INSURANCE

CONTENTS

	SECTION	PAGE
8.1	Introduction	2
8.2	Rules	2
8.3	Factors the FSA will consider in assessing compliance with rule 8.2.1	3
8.4	Captive Mortgage Indemnity Insurance Companies (MIG captives)	3
8.5	Self-insurance and non-insurance	8
8.6	Charging for Self-insurance	9
8.7	“Excess of Loss” Insurance	9
8.8	Mortgage Book Acquisitions	9
8.9	Capital Adequacy	9
8.10	Systems	10

Interim Prudential Sourcebook for Building Societies

8 Mortgage Indemnity Insurance

8.1 Introduction

8.1.1 G This chapter replaces PN 1998/8 issued by the Commission and contains rules and guidance for societies on mortgage indemnity insurance. The acronym MIG (Mortgage Indemnity Guarantee) is used throughout, as it is widely understood as shorthand for mortgage indemnity insurance.

8.1.2 G The chapter outlines the types of cover available to societies to protect themselves against the risks of high loan to value (“LTV”) lending. These include the use of a captive insurance company, excess of loss and self-insurance as well as MIG provided by an external insurer, which may be the preferred option for most societies. The chapter sets out factors the FSA will take into account in assessing the adequacy of a society’s policy for protecting itself against high LTV risk and comments briefly on capital adequacy and systems.

8.2 Rules

8.2.1 R A society undertaking any new lending at a high LTV ratio must have an adequate policy in place to provide protection against the greater risks involved with such lending. In this rule, “high LTV” means lending with an LTV ratio in excess of 80%.

8.2.2 G The extent of the protection in place will be a factor in determining the society's threshold solvency ratio. Factors that the FSA will consider in assessing the adequacy of the policy required in 8.2.1 are set out in the guidance in the rest of this chapter.

8.3 Factors the FSA will consider in assessing compliance with rule 8.2.1

8.3.1 G In deciding how to manage risk from high LTV lending, societies should assess the monetary value to them of the types of cover available and consider the risks and benefits associated with each type of cover, including the losses they could bear. They should assess the systems and accounting implications of changes to the type and level of cover provided.

8.3.2 G Societies have a number of options for managing risk from high LTV lending. They may dispense with MIG altogether, in conjunction with a change to lending policy to "re-balance" the risk profile of the society's loan portfolio. They may continue MIG cover on the best terms available or approach alternative MIG insurers, to establish whether cover on better terms than the standard MIG contract is available. They can consider other forms of insurance, such as excess of loss, self-insurance, and use of a captive insurance company. Credit derivatives may, appropriately used, provide an acceptable alternative to mortgage indemnity insurance (societies should refer to the guidance on credit derivatives set out at Annex 4B, which incorporates chapter CD from IPRU(BANK)).

8.3.3 G Whilst societies should regard the covenant of the borrower as their principal source of repayment, a comfortable margin in the value of the security is of vital importance. Past experience suggests that it would be imprudent to continue with high LTV lending without obtaining some form of additional protection against the risks involved.

8.3.4 G Therefore, societies undertaking high LTV lending that end their MIG cover and put nothing else in its place, should reduce substantially the proportion of new high LTV lending they undertake. If societies in this position decide not to reduce the level of high LTV lending, the FSA will take into account the society's increased risk profile in setting its threshold solvency ratio.

8.3.5 G The remainder of this chapter focuses on the types of protection against high LTV risk which are available.

8.4 Captive Mortgage Indemnity Insurance Companies (MIG Captives)

8.4.1 G The use of a MIG captive can be a sensible way to manage risk from high LTV lending. This section sets out the factors the FSA will take into account when assessing whether the use of a captive by a society meets the requirement in rule 8.2.1.

8.4.2 G A captive is a means of retaining and managing risk, wholly or partially, within the group. A society should first consider whether, and to what extent, it wishes to retain risk before deciding on any particular mechanism for risk retention. It should consider what its objectives are for high LTV risk and then assess how various forms of cover, including a MIG captive, could meet the objectives. Under the standard MIG contract, the lender retains a significant portion of risk and a captive may be a suitable means for managing that risk.

8.4.3 G A captive could take on all or part of the society's mortgage indemnity business. A wholly-owned captive should not provide unlimited MIG cover to its parent society: cover should be capped in some way, perhaps with a limit on claims arising from any one year's lending. The terms of cover provided by the captive to the parent, and the premiums charged, should be reviewed at least annually. Very generous cover may mean that the captive cannot fully meet the claims on it, and if a captive is unable to meet those claims the loss will revert to the society.

8.4.4 G For smaller societies an "association captive", owned by a group of societies, can be suitable for handling their mortgage indemnity risks. There may be practical difficulties involved, for example, the need for each society to be comfortable with the lending policy of its fellow-owners and the need to pool information. Proper oversight is likely to be more difficult when a captive is multi-owned.

8.4.5 G Society MIG captives should normally be wholly-owned by one or more building societies and provide MIG cover only to the owner society/societies (or to respective subsidiaries). Any scheme which envisages wider ownership, writing MIG business for other lenders or other lines of insurance business should address the different risks involved. Such a company would, of course, not be a pure MIG captive and the FSA's capital requirements are likely to reflect this.

8.4.6 G Societies should consider how the captive will set its premiums. A sensible starting point might be the amount paid for the equivalent external MIG cover and information about the society's lending book, and its claims propensity, should be collected to enable the business to be rated accurately in future. Initial assumptions about the size and frequency of claims should be tested against actual experience. If the captive underprices the cover it may be difficult for the society, because of borrower resistance or competitive pressures, if the captive were to increase premiums later.

8.4.7 G Societies should consider over what period income can prudently be recognised by the captive, having regard to industry good practice for this kind of business and the likely timescale for emergence of claims. Regular reviews should compare the profit earning period chosen with actual claims experience. Societies should undertake detailed financial modelling to show what premium the captive can be expected to receive and what claims will arise for each annual tranche of lending over, say, a 10 year period. This will involve a full analysis of the performance of the society's mortgage book and societies should take the appropriate professional, including actuarial, advice.

8.4.8 G A captive is an appropriate vehicle for carrying normal MIG losses but is unsuitable for bearing exceptional losses over and above the normal level. Societies with or intending to establish MIG captives should obtain reinsurance to cover the risk of exceptional losses. Societies should consider what price the captive can pay for reinsurance and still remain commercially viable. Societies should also assess the terms on which reinsurance cover is offered, especially any restrictions on lending criteria, the financial standing of the reinsurer and its commitment to the MIG market.

8.4.9 G A captive may be exposed to greater risk in its early years of operation and societies should consider additional protection during this period. A captive may, for example, take out financial reinsurance or finite risk insurance to smooth cashflow.

8.4.10 G A captive needs capital to ensure that it can meet claims in all circumstances. In setting capital for a captive, societies should consider whether the captive is robust enough to weather exceptional losses arising from a "severe adverse case". Such a case might include high interest rates, a high level of borrower default and falls in both house prices and turnover

- comparable to the worst experience during the period 1989-1992. It would be reasonable to assume that the "severe adverse case" would affect three consecutive years' lending.

8.4.11 G The captive should assess its probable maximum liability to claims at any one time, on each year of lending, based on a "severe adverse case". The residual risk to the captive from each year of lending can be calculated taking into account this probable maximum liability, capped by reinsurance if used, and offset by the amount built up from net premiums and investment income. This is the "risk gap" for that year of lending. The relevant local insurance supervisors (most captives are located offshore) will impose their own capital requirements, and the FSA expects societies to comply with these. However, societies and their advisers should develop their own methodologies for assessing the prudent level of capital for the captive over and above the regulatory minimum. The FSA will take into account the society's methodology for setting capital (including the concepts set out above) in assessing the adequacy of a society's policy for managing high LTV risk.

8.4.12 G A society may either make the full amount of its capital commitment available immediately to the captive as fully paid share capital or keep part of its commitment in reserve. At least the capital requirements of the local insurance supervisor should be met through fully paid share capital. Societies can provide part of the overall capital commitment in the form of issued but uncalled, or partly paid share capital - where the captive is entitled to call for payment at any time and at its sole discretion.

8.4.13 G For solvency ratio purposes, a subsidiary MIG captive should be included in the consolidated calculation in accordance with Chapter 1 (Solvency). In calculating the society only solvency ratio, the FSA has adopted a composite treatment for building societies which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk and is not using its capital to "gear up" and assume new external liabilities. Of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the capital requirement of the local insurance supervisor) should be deducted from the society's own funds, in the society-only calculation. The remainder should be risk-weighted at 100% as an investment in a subsidiary.

8.4.14 G Societies should consider where any captive should be domiciled and the choice of location should be made according to clear criteria (including convenience to facilitate effective oversight). Whichever location is chosen, the captive will need to obtain authorisation from the local supervisory authority and the FSA will communicate with that body about any application for authorisation.

8.4.15 G The society should put in place controls to oversee the operation of its captive. The captive should be overseen at a high level within the society and within a department (e.g. finance) independent of the lending/marketing function. The society should consider what regular information the captive should provide to the parent to enable proper oversight.

8.4.16 G The captive managers should meet regularly with the captive's board to discuss issues such as the adequacy of reserves and premium rates. The FSA also expects societies to commission an external review of the performance of the captive including actuarial advice on the same issues, say every two years, with a minimum of every three years.

8.4.17 G Local insurance supervisors have detailed rules about the type of asset which count towards the captive's solvency margin. The captive's investment policy should be clearly documented, specifying acceptable types of instrument and counterparties. The captive's directors should set investment policy rather than the captive managers or fund managers. In the early years of the captive's life, the funds should be invested in a prudent combination of bank/building society deposits, government securities and other high quality securities. The captive may deposit funds with the parent society provided the society meets the criteria specified in the captive's investment policy (although local insurance supervisors are unlikely to permit the captive to deposit 100% of its funds back with the parent).

8.4.18 G Societies may consider arrangements whereby a third party, such as a UK composite insurer, owns a captive insurance company which "rents" underwriting capacity to a society for its own MIG business (known in the market as a "rent-a-captive"). Any society intending to follow this route should consider the basis of the cover and the availability of reinsurance cover and, as a result of these factors, how much risk it retains.

8.4.19 G The activities of society-owned MIG captives may be expanded to enable them to write other business including insurance of other risks incurred by the parent society or

another part of the society group and reinsurance of other lines of business originated by the parent society group.

8.4.20 G Where such business is written by society-owned MIG captives, sufficient capital and reserves should be maintained to enable the risk gap for MIG business to be met in full. For these new lines of business, at least the capital requirements of the local insurance supervisor should be met through fully paid share capital.

8.4.21 G To avoid "double gearing", a society's investment in these new lines of business, and loans of a capital nature to finance such business, should be excluded, in full, when calculating its solvency ratio as set out in Chapter 1 (Solvency).

8.4.22 G Capital and reserves maintained for MIG business should be legally "ring-fenced" from the capital and reserves held to meet new lines of business. Captives should therefore adopt an appropriate and effective legal structure.

8.5 Self-Insurance and Non-Insurance

8.5.1 G Self-insurance is another way of containing high LTV risk. This section sets out the factors that the FSA will have regard to when assessing the adequacy of any policy for managing high LTV risk which uses this approach.

8.5.2 G With self-insurance some or all of the risk is retained by the society and either borrowers are charged a "premium" (e.g. a fee or additional interest) or the society absorbs the cost through self-charging. The FSA will consider either to be a prudent approach, provided charges to borrowers or the level of self-charging is adequate.

8.5.3 G With non-insurance some or all of the risk is retained by the society, but no charge or self-charge is made. In such cases, the society will be deemed to have no protection against the risk associated with high LTV lending and should follow the guidance in paragraph 8.3.4.

8.5.4 G Societies may combine an external MIG policy with self-insurance or non-insurance. This will arise, for example, under the co-insurance arrangements applied by many insurers, where the external MIG covers 80% of the risk but the society retains the remaining 20%. Where a society has a co-insurance arrangement or a cap on claims with their MIG insurers, it should consider what action should be taken in respect of that proportion of the risk it retains.

8.6 Charging for Self-Insurance

8.6.1 G Societies which retain some or all of their MIG risk without using a captive will need a methodology for determining the amount of risk being accepted and the level of charge to borrowers (or self-charging) for carrying that additional risk.

8.6.2 G To assess the level of charge or self-charging required, societies should devise a methodology to assess the relative risk from differing loan products, borrower types and types and location of property. Such a methodology should use historical statistical information evaluated using a range of assumptions (future interest rates, property prices etc). Independent specialist advice (e.g. from a firm of actuaries) is highly desirable.

8.7 Excess of Loss Insurance

8.7.1 G Excess of loss or stop loss insurance is another way of protecting against risks arising from high LTV lending. Such policies meet claims once a certain threshold loss to the society (the excess or deductible) has been reached. They usually have a defined upper limit, after which losses revert to the society, and they may involve an element of co-insurance.

8.8 Mortgage Book Acquisitions

8.8.1 G Societies should also consider the risks arising from high LTV lending where they have acquired the loans through a mortgage book acquisition. Following completion of the transaction, the principles of this chapter should be applied to the portfolio of loans

acquired. Societies should also ensure that any captive acquired meets the rule and guidance in this chapter within a reasonable time of the acquisition.

8.9 Capital Adequacy

8.9.1 G As set out in Chapter 1 (Solvency), the FSA will consider the lending policy and the MIG arrangements of each society when reviewing its threshold solvency ratio. The assessment will focus on the degree of risk accepted or retained by the society rather than the mechanism used to manage the risk.

8.9.2 G However, the FSA considers that the magnitude of risk retained by a society that either self-insures its entire MIG risk on-balance sheet, or places its entire MIG risk with a captive without reinsurance or takes no action to cover the uninsured portion of MIG risk under the standard external contract, is such that, other things being equal, the FSA is likely to raise that society's threshold ratio.

8.10 Systems

8.10.1 G Societies should ensure that their systems are adequate to monitor and control the risks arising from high LTV lending. (Systems should, of course be adequate to monitor and control all lending, but this chapter focuses on high LTV lending). For example, where societies self-insure, they should operate adequate systems for collecting charges from borrowers (or self-charging) and should set up systems to collect data on the performance of the loan book to help them set appropriate charge levels and assess likely future losses. Where any kind of captive arrangement is used, a society's systems should collect data on the performance of the loan book to refine the underwriting, pricing and reserving/reinsurance policies of the captive.

Interim Prudential Sourcebook for Building Societies

9 SYSTEMS

CONTENTS

SECTION	PAGE
9.1 Introduction	2
9.2 Rules and Evidential Provisions	2
9.3 Accounting Records and Systems	3
9.4 Systems of Business Control	5
9.5 Documentation of Systems	10
9.6 Internal Audit	13
9.7 Board Review and Oversight	18
Annex 9A: Accounting and other Records	20
Annex 9B: Internal Control Systems	23



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2.6 Management of stabilisation

2.6.1

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The purpose of this section and of section 2.7 is to provide an orderly structure for the management of *stabilising action* even where it is to be carried out on a devolved basis, whether in the *United Kingdom* or elsewhere. The central management has to be in the hands of one *stabilising manager*. If authorised in the *United Kingdom*, the *stabilising manager* has to set up, operate and be legally responsible for a single stabilisation register ■ MAR 2.7.2R) which must be kept in the *United Kingdom* or be capable of being inspected by the relevant regulators. These sections accordingly build on the base requirement for *authorised persons* at ■ MAR 2.3.2R(3).

2.6.2

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- (1) This section, and section ■ MAR 2.7, apply only where the *stabilising manager* is a *firm* or is employed by a *firm*.
- (2) Where the *stabilising manager* is employed by a *firm*, this section and MAR 2.7 shall have effect as if the obligations imposed on the *stabilising manager* were imposed on the *firm*.

2.6.3

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01.12.01/001

No bid may be made or transaction effected in the course of stabilising action unless the stabilising manager:

- (1) has established the relevant register in compliance with ■ MAR 2.7.2R; and
- (2) is in compliance with the registration requirements in ■ MAR 2.7.2R in respect of all earlier transactions effected in the course of *stabilising action* in connection with the *offer* in question.

2.6.4

R
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No bid may be made or transaction effected in the course of *stabilising action* except by:

- (1) the *stabilising manager* himself; or
- (2) a *person* appointed by the *stabilising manager* to act as his agent on terms which:
 - (a) make the agent responsible to the *stabilising manager*; and
 - (b) make the *stabilising manager* as responsible to others for the acts or omissions of the agent as if they had been done or omitted by the *stabilising manager*.

2.6.5

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- (1) The *stabilising manager* may not during the *stabilising period* enter into a transaction as principal in *relevant securities* or *associated securities* with any agent of his appointed under ■ MAR 2.6.4R.
- (2) Paragraph (1) does not apply if, at the time of the transaction, neither the *stabilising manager* nor the agent knew or could reasonably have been expected to know the identity of his counterparty.
- (3) Paragraph (1) does not apply where:
 - (a) the transaction between the *stabilising manager* and his agent is undertaken solely for the purpose of re-allocating the economic risk of positions that were taken by the *stabilising manager* and his agent in the course of *stabilising action* and is priced accordingly; and
 - (b) the *relevant securities* are, and the transactions are in, *investments* that:
 - (i) fall within article 77 or 78 of the *Regulated Activities Order* (bonds, etc), or article 79 (instruments, etc) or 80 (certificates, etc) which confer rights only in respect of *investments* falling within article 77 or 78 ; and
 - (ii) are not exchangeable for or convertible into, and do not give rights to acquire, dispose or subscribe for, *investments* falling within article 76 of the *Regulated Activities Order* (shares, etc), or articles 79 or 80 which confer rights in respect of *investments* falling within article 76.

2.6.6

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01.01.03/001

■ MAR 2.6.5R prohibits transactions between a *stabilising manager* and his agent unless it is not reasonable to expect both the principal and agent to know the identity of their counterparty or where ■ MAR 2.6.5R(3) applies. ■ MAR 2.6.5R(3) is designed to permit a transaction between a *stabilising manager* and his agent that takes place in the debt markets, typically at the end of the *business day* or *stabilising period*, that "squares up" positions taken in the course of *stabilising action*. The reference to price in ■ MAR 2.6.5R(3)(a) reflects the need to be mindful that although the transaction may in practice, for example, be effected at a price that is the average of the constituent transactions, so not the prevailing market price, the purpose behind the transaction is to re-allocate economic risk established in the course of *stabilising action* and is not to mislead the market. ■ MAR 2.6.5R(3)(b) has been drafted to ensure that the prohibition in ■ MAR 2.6.5R(1) remains applicable to the issue of and transactions in any *investment* that provides a right to acquire or subscribe for, or may eventually be converted or exchanged into, a *share*.