Jersey Financial Services Commission

Counterparty credit risk part

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Chapter content

1 Application and definitions

1.1 This Part applies to a JIB.

1.2 In this Part, the following definitions shall apply:

SFT

Securities Financing Transaction

OTC

Over-the-counter

2 Level of application

2.1 A JIB must comply with this Part on the basis of its consolidated position, unless the JFSC has agreed a variance in accordance with the Risk-Based Capital Requirements Part.

3 Securities financing transactions

3.1 Other than those covered by a valid bilateral netting agreement, the reporting institution should adopt the "economic substance" approach for capital treatment of repo-style transactions and report them as balance sheet assets in the following manner:

3.2 Repos of securities - where the reporting institution has sold securities under repo agreements, the securities sold should continue to be treated as assets with capital requirement provided for the credit risk to the securities;

3.3 Reverse repos of securities - where the reporting institution has acquired securities under reverse repo agreements, the transaction should be treated as a collateralised lending to the counterparty, providing the securities acquired meet the relevant criteria for recognising collateral. The capital requirement should then be provided for the credit risk to the counterparty, taking into account the credit risk mitigation effect of the collateral, in accordance with the Credit risk mitigation (CRR) part and the relevant credit risk part;

3.4 Securities lending - the treatment is similar to that of repo transactions. This means that the securities lent should continue to remain as an asset on the balance sheet of the JIB, with the capital requirement being derived from the credit risk of the securities; and

3.5 Securities borrowing - the treatment depends on whether the collateral provided is cash or other securities:

(1) Where the collateral provided is cash, it should be treated as a collateralised lending to the counterparty, providing the securities received meet the relevant criteria for recognising collateral, as set out in the Credit risk mitigation (CRR) part. The capital requirement should then be derived in accordance with the Credit risk mitigation (CRR) part and the relevant credit risk part.

(2) Where the collateral provided is not cash but securities, the securities borrowed should be reported as assets on the balance sheet of the JIB and risk weighted according to the relevant credit risk part.

3.6 For securities lending or borrowing where the contractual agreement is made between the securities borrower/lender and the custodian (e.g. Clearstream Banking or Euroclear Bank) and the securities borrower/lender has no knowledge as from/to whom the security is borrowed/lent, the custodian becomes the “counterparty” of the stock borrower/lender.

4 Off-balance sheet exposures: over-the-counter (OTC) derivatives

OTC classifications

4.1 For OTC derivatives, a JIB must classify each contract as either

(1) Interest rate contracts

(2) Foreign exchange and gold contracts

(3) Equity contracts

(4) Other precious metal contracts

(5) Other commodity contracts

Specific guidance

4.2 The following derivative contracts may be excluded from the calculation of RWAs

1.1.1 Exchange rate contracts (except those which are based on gold) with an original maturity of 14 calendar days or less; or

1.1.2 Forward exchange rate contracts arising from swap deposit arrangements. Under such contracts, the money deposited by the customer remains under the control of the reporting institution at all times during the transaction and the institution will be in a position to ensure that the customer does not default on the settlement of the forward contract.

Categorisation and add-on factors for OTC derivative contracts

4.3 The add-on factors, used to determine the Credit Equivalent Amount applicable to OTC derivative transactions, are set out in the following table according to their residual maturities:

	Interest Rate	FX and Gold	Equities	Precious Metals (except Gold)	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over 1 year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

4.4 For contracts structured to settle outstanding exposures following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity should be set equal to the time until the next reset date.

4.5 In the case of interest rate contracts that meet these criteria, and the remaining time to final maturity of the contracts is more than one year, the add-on factor is subject to a floor of 0.5%.

4.6 For forwards, swaps, purchased options and similar derivative contracts other than those contracts the value of which is derived from the value of exchange rate, gold, interest rate, equity, or precious metal, the add-on factor is that applicable to “Other Commodities”.

4.7 JIBs must use the replacement cost method to risk weight credit exposures to counterparties under OTC derivatives, as set out below.

4.8 For OTC derivative transactions covered by a valid bilateral netting agreement, a JIB may reduce the exposure by the netted amount.

4.9 The ‘**amount outstanding’** must be calculated as the total nominal value of all relevant OTC contracts classified according to type, maturity and the risk weighting of the counterparty.

4.10 The ‘**replacement cost** must be calculated as the sum of all positive mark-to-market valuations relating to these contracts. Where contracts are covered by a valid bilateral netting agreement, this must be calculated as the net amount of the sum of the positive and negative mark-to-market values of the individual contracts covered by the bilateral netting agreement, if positive.

4.11 The ‘**exposur**e’ will then be the sum of:

(1) the replacement cost and

(2) the ‘**add-on amount’**, which is derived by multiplying the amount outstanding” of each contract by the appropriate “add-on factor” for that classification (as set out in 4.3 above).

4.12 Single currency floating/floating (basis) interest rate swaps should be classified as being less than 1 year to maturity and hence attract an add-on of 0%; the “Credit Equivalent Amount” is simply the positive mark-to-market.

4.13 In the absence of CRM, the RWAs should be calculated by applying the relevant credit risk part to each exposure.

4.14 Where the (net) exposure to the counterparty is protected fully or partially by recognised credit risk mitigation, the impact of credit risk mitigation on the exposure must be taken into account, in accordance with the Credit risk mitigation part before applying the relevant credit risk part to calculate the RWAs.

5 Settlement risk - free deliveries

5.1 A ‘**free delivery’** occurs when a JIB has paid away (or received) its side of a transaction and has yet to receive (or pay away) the securities/cash concerned. For free deliveries, an immediate exposure arises where a JIB has settled its side of the transaction but has yet to receive the countervalue. The JIB will be deemed to have a claim on the other party for the amount of the cash or equivalent to the current market value of the securities, whichever is still outstanding.

5.2 For example, if Bank A sells shares in Company C to Bank B and if Bank B pays for the shares immediately and Bank A is to deliver at some future date, Bank B should hold capital for counterparty risk on Bank A.

5.3 The requirement for free deliveries should be calculated as:

(1) Four working days or less past settlement date: The risk weighted assets (RWA) should be calculated, starting from an exposure equal to the mark-to-market of the receivable and then converted into RWAs using the relevant credit risk part for the counterparty.

(2) More than four working days past settlement date: A capital charge must be calculated as the mark-to-market of the receivable. The RWAs must then be calculated as 12.5 times this amount.

5.4 For clarity, this treatment should also be applied to exchange traded contracts involving physical delivery. No requirements arise in respect of delivery risk on spot and forward foreign exchange transactions are considered necessary.

6 Settlement risk: failed DvP trades

6.1 Where a transaction involves the delivery of an instrument against the receipt of cash attracts a counterparty risk charge in in cases of unsettled transactions as defined below.

(1) An unsettled transaction is one where delivery of the instrument is due to take place against the receipt of cash, but which remains unsettled more than 4 business days after the due settlement date.

6.2 As an example of where this is applicable, if Bank A sells shares in Company C to Bank B and Bank A fails to deliver on time, Bank B should hold capital for counterparty risk on Bank A in addition to RWAs resulting from the holding of equity in Company C. This is because if the price moves in Bank B's favour, then the risk is that Bank A will not deliver and Bank B will have to pay a higher price to replace the purchase.

6.3 JIBs' systems should be set up in such a manner that, where a deal attracts a counterparty risk charge, this charge continues to apply when settlement is due but has not been completed. JIBs are expected to adopt this for all such transactions.

6.4 No capital charges in respect of settlement risk on spot and forward foreign exchange transactions of any type are considered necessary.

6.5 Unsettled transactions should attract a capital charge based upon the difference between the amount due and the current market value of the instrument, if this has a potential loss. The capital requirement must be calculated as the potential loss multiplied by the factor in the table below.

6.6 This applies only to trades where a loss may arise for the JIB if the trade fails to settle. Failed trades must be reported once the date is more than four days after the agreed settlement date.

6.7 The capital charge for such transactions is not multiplied by the counterparty risk weight. The RWAs must then be calculated as 12.5 times this amount.

A: Factors for failed DvP transactions

Number of working days after due settlement date.	Factor
5 – 15	8%
16 – 30	50%
31 – 45	75%
46 or more	100%