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RESERVE BANK OF INDIA
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July 2, 2013

The Chairman and Managing Director/
Chief Executives Officer of
All Scheduled Commercial Banks
(Excluding Regional Rural Banks)

Madam / Dear Sir,

Capital Requirements for Banks' Exposures to Central Counterparties

Please refer to the paragraph 77 (extract enclosed) of the Monetary Policy Statement for 2013-14 announced on May 3, 2013. It was indicated therein that the final guidelines on capital requirements for banks' exposures to central counterparties, based on the interim framework of the Basel Committee on Banking Supervision (BCBS), will be issued by end-June 2013.

2. The finalised guidelines on capital requirements for banks' exposures to central counterparties are annexed. These instructions would become effective from January 1, 2014.

Yours faithfully,

(Chandan Sinha)
Principal Chief General Manager

Encl: as above

**Extract of Paragraph 77 of
Monetary Policy Statement for 2013-14**

Banks' Exposures to Central Counterparties (CCP)

77. As announced in the SQR, draft guidelines were issued on: (i) composition of capital disclosure requirements; and (ii) capital requirements for banks' exposures to central counterparties. It is proposed to:

- issue the final guidelines on composition of capital disclosure requirements by end-May 2013; and
- issue the final guidelines on capital requirements for banks' exposures to central counterparties by end-June 2013.

Capital Requirements for Banks' Exposures to Central Counterparties

I. Background

(a) Central clearing reduces systemic risk by reducing the contagion / risk of problems at one institution getting transmitted to other institutions. However, central clearing also concentrates too much risk within central counterparties (CCPs) and the failure of a CCP can be catastrophic for the entire financial system. In view of this, the Basel Committee on Banking Supervision (BCBS) has formulated an interim framework¹ for the capitalization of banks' exposure to CCPs in a way that incentivizes robust regulation and supervision of CCPs and also promotes high standards of risk management within the CCPs. Under this framework, banks' exposure to CCPs arising from OTC derivatives, exchange traded derivatives and securities financing transactions (SFTs) will be subjected to capital requirements for counterparty credit risk.

(b) Accordingly, guidelines on capital requirements for banks' exposures to central counterparties are being introduced in India as an interim framework², by way of additions / amendments to the 'Master Circular on Basel III Capital Regulations' issued vide [Master Circular DBOD.No.BP.BC.2 /21.06.201/2013-14 dated July 1, 2013](#). However, these guidelines will be implemented with effect from January 1, 2014.

(c) Presently, treatment of exposures to central counterparties for the purpose of capital adequacy is as under:

(i) The exposures of banks on account of derivatives trading and securities financing transactions (e.g. Collateralised Borrowing and Lending Obligations - CBLOs, Repos) to central counterparties (CCPs) including those attached to

¹ Please refer to the interim rules for the 'Capitalisation of bank exposures to central counterparties' (bcbs227.pdf), released by the Basel Committee on Banking Supervision in July 2012.

² A reference is invited to the Consultative Document on 'Capital treatment of bank exposures to central counterparties' issued by the Basel Committee on Banking Supervision on June 28, 2013 (<http://www.bis.org/publ/bcbs253.pdf>). The revised proposals will be considered for implementation in India as and when finalized by the Basel Committee.

stock exchanges for settlement of exchange traded derivatives, are assigned zero exposure value for counterparty credit risk, on the presumption that such exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

(ii) A Credit Conversion Factor (CCF) of 100% are applied to the securities posted as collaterals with CCPs and the resultant off-balance sheet exposure are assigned risk weights appropriate to the nature of the CCPs; 20% for Clearing Corporation of India Limited (CCIL), and as per the external ratings for other CCPs.

(iii) The deposits kept by banks with the CCPs also attract risk weights appropriate to the nature of the CCPs; 20% for Clearing Corporation of India Limited (CCIL) and as per the external ratings for other CCPs.

(d) To clarify terms used in these guidelines, certain definitions have been **added** to the paragraph 5.15.3.3 of Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2 /21.06.201/2013-14 dated July 1, 2013). In addition, a few consequential changes (deletion / amendments) to the Basel III Capital Regulation and Guidelines on Implementation of the Internal Rating Based (IRB) Approaches for Calculation of Capital Charge for Credit Risk ([circular DBOD.No.BP.BC.67/21.06.202/2011-12 dated December 22, 2011](#)) have become necessary. Please refer to **Appendix 1** of these guidelines for changes.

II. Capital requirements for exposures to Central Counterparties (CCPs)

Following paragraphs (i.e. from **5.15.3.8** to **5.15.3.10**) will be added to the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/ 21.06.201/2013-14 dated July 1, 2013):

5.15.3.8 Scope of Application

- (i) Exposures to central counterparties arising from OTC derivatives transactions, exchange traded derivatives transactions and securities financing transactions (SFTs) will be subject to the counterparty credit risk treatment as indicated in this paragraph below.
- (ii) Exposures arising from the settlement of cash transactions (equities, fixed income, spot FX, commodity etc.) are not subject to this

treatment. The settlement of cash transactions remains subject to the treatment described in paragraph 5.15.4 of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013).

(ii) When the clearing member-to-client leg of an exchange traded derivatives transaction is conducted under a bilateral agreement, both the client bank and the clearing member are to capitalise that transaction as an OTC derivative.

(iii) For the purpose of capital adequacy framework, CCPs will be considered as financial institution. Accordingly, a bank's investments in the capital of CCPs will be guided in terms of paragraph 4.4.9 of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013).

(iv) Capital requirements will be dependent on the nature of CCPs viz. Qualifying CCPs (QCCPs) and non-Qualifying CCPs. A Qualifying CCP has been defined under **Part A: Additions to paragraph 5.15.3.3 in Appendix 1.**

(a) Regardless of whether a CCP is classified as a QCCP or not, a bank retains the responsibility to ensure that it maintains adequate capital for its exposures. Under Pillar 2, a bank should consider whether it might need to hold capital in excess of the minimum capital requirements if, for example, (i) its dealings with a CCP give rise to more risky exposures or (ii) where, given the context of that bank's dealings, it is unclear that the CCP meets the definition of a QCCP.

(b) Banks may be required to hold additional capital against their exposures to QCCPs via Pillar 2, if in the opinion of RBI, it is necessary to do so. This might be considered appropriate where, for example, an external assessment such as an Financial Sector Assessment Program (FSAP) of International Monetary Fund / World Bank has found material shortcomings in the CCP or the regulation of CCPs, and the CCP and / or the CCP regulator have not since publicly addressed the issues identified.

(c) Where the bank is acting as a clearing member, the bank should assess through appropriate scenario analysis and stress testing whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of those transactions. This assessment will include potential future or contingent exposures resulting from future drawings on default fund commitments, and/or from secondary commitments to take over or replace offsetting transactions from clients of another clearing member in case of this clearing member defaulting or becoming insolvent.

(d) A bank must monitor and report to senior management and the appropriate committee of the Board (e.g. Risk Management Committee) on a regular basis (quarterly or at more frequent intervals) all of its exposures to CCPs, including exposures arising from trading through a CCP and exposures arising from CCP membership obligations such as default fund contributions.

(e) Unless Reserve Bank (DBOD) requires otherwise, the trades with a former QCCP may continue to be capitalised as though they are with a QCCP for a period not exceeding three months from the date it ceases to qualify as a QCCP. After that time, the bank's exposures with such a central counterparty must be capitalised according to rules applicable for non-QCCP.

5.15.3.9 Exposures to Qualifying CCPs (QCCPs)

(i) Trade exposures

Clearing member exposures to QCCPs

(a) Where a bank acts as a clearing member of a QCCP for its own purposes, a risk weight of 2% must be applied to the bank's trade exposure to the QCCP in respect of OTC derivatives transactions, exchange traded derivatives transactions and SFTs.

(b) The exposure amount for such trade exposure will be calculated in accordance with the Current Exposure Method (CEM) for derivatives and rules as applicable for capital adequacy for Repo / Reverse Repo-style transactions³.

(c) Where settlement is legally enforceable on a net basis in an event of default and regardless of whether the counterparty is insolvent or bankrupt, the total replacement cost of all contracts relevant to the trade exposure determination can be calculated as a net replacement cost if the applicable close-out netting sets meet the requirements set out in **Appendix 2** of these guidelines.

(d) Banks will have to demonstrate that the conditions mentioned in **Appendix 2** are fulfilled on a regular basis by obtaining independent and reasoned legal opinion as regards legal certainty of netting of exposures to QCCPs. Banks may also obtain from the QCCPs, the legal opinion taken by the respective QCCPs on the legal certainty of their major activities such as settlement finality, netting,

³ Please refer to paragraph 7.3.8 of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013).

collateral arrangements (including margin arrangements); default procedures etc.

Clearing member exposures to clients

The clearing member will always capitalise its exposure (including potential CVA⁴ risk exposure) to clients as bilateral trades, irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the QCCP. However, to recognize the shorter close-out period for cleared transactions, clearing members can capitalize the exposure to their clients by multiplying the EAD by a scalar which is not less than 0.71.

Client bank exposures to clearing member

I. Where a bank is a client of the clearing member, and enters into a transaction with the clearing member acting as a financial intermediary (i.e. the clearing member completes an offsetting transaction with a QCCP), the client's exposures to the clearing member will receive the treatment applicable to the paragraph "clearing member exposure to QCCPs" of this section (mentioned above), if following conditions are met:

- (a) The offsetting transactions are identified by the QCCP as client transactions and collateral to support them is held by the QCCP and / or the clearing member, as applicable, under arrangements that prevent any losses to the client due to:
 - (i) the default or insolvency of the clearing member;
 - (ii) the default or insolvency of the clearing member's other clients; and
 - (iii) the joint default or insolvency of the clearing member and any of its other clients.

The client bank must obtain an independent, written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and administrative authorities would find that the client would bear no losses on account of the insolvency of an intermediary under the relevant law, including:

- the law(s) applicable to client bank, clearing member and QCCP;
- the law of the jurisdiction(s) of the foreign countries in which the client bank, clearing member or QCCP are located
- the law that governs the individual transactions and collateral; and

⁴ Please refer to Guidelines on Implementation of Basel III Capital Regulations in India - Clarifications (Circular DBOD.No.BP.BC.88/21.06.201/2012-13 dated March 28, 2013) in terms of which CVA risk capital charges would become effective as on January 1, 2014.

- the law that governs any contract or agreement necessary to meet this condition (a).

(b) Relevant laws, regulations, rules, contractual, or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the QCCP, or by the QCCP, should the clearing member default or become insolvent. In such circumstances, the client positions and collateral with the QCCP will be transferred at the market value unless the client requests to close out the position at the market value. In this context, it may be clarified that if relevant laws, regulations, rules, contractual or administrative agreements provide that trades are highly likely to be ported, this condition can be considered to be met. If there is a clear precedent for transactions being ported at a QCCP and intention of the participants is to continue this practice, then these factors should be considered while assessing if trades are highly likely to be ported. The fact that QCCP documentation does not prohibit client trades from being ported is not sufficient to conclude that they are highly likely to be ported. Other evidence such as the criteria mentioned in this paragraph is necessary to make this claim.

II. Where a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions mentioned above are met and the concerned CCP is a QCCP, a risk weight of 4% will apply to the client's exposure to the clearing member.

III. Where the client bank does not meet the requirements in the above paragraphs, the bank will be required to capitalize its exposure (including potential CVA risk exposure) to the clearing member as a bilateral trade.

IV. Under situations in which a client enters into a transaction with the QCCP with a clearing member guaranteeing its performance, the capital requirements will be based on paragraph 5 of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013).

Treatment of posted collateral

(a) In all cases, any assets or collateral posted must, from the perspective of the bank posting such collateral, receive the risk weights that otherwise applies to such assets or collateral under the capital adequacy framework, regardless of the fact that such assets have been posted as collateral. Thus collateral posted from Banking Book will receive Banking Book treatment and collateral posted from Trading Book will receive Trading Book treatment. Where assets or collateral of a clearing member or client are posted with a QCCP or a

clearing member and are not held in a bankruptcy remote manner, the bank posting such assets or collateral must also recognise credit risk based upon the assets or collateral being exposed to risk of loss based on the creditworthiness of the entity⁵ holding such assets or collateral.

(b) Collateral posted by the clearing member (including cash, securities, other pledged assets, and excess initial or variation margin, also called over-collateralisation), that is held by a custodian⁶, and is bankruptcy remote from the QCCP, is not subject to a capital requirement for counterparty credit risk exposure to such bankruptcy remote custodian.

(c) Collateral posted by a client, that is held by a custodian, and is bankruptcy remote from the QCCP, the clearing member and other clients, is not subject to a capital requirement for counterparty credit risk. If the collateral is held at the QCCP on a client's behalf and is not held on a bankruptcy remote basis, a 2% risk weight will be applied to the collateral if the conditions established in paragraph on "client bank exposures to clearing members" of this section are met (mentioned above). A risk weight of 4% will be made applicable if a client is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions mentioned in paragraph on "client bank exposures to clearing members" of this section are met.

(d) If a clearing member collects collateral from a client for client cleared trades and this collateral is passed on to the QCCP, the clearing member may recognize this collateral for both the QCCP - clearing member leg and the clearing member - client leg of the client cleared trade. Therefore, initial margins (IMs) as posted by clients to clearing members mitigate the exposure the clearing member has against these clients.

(ii) Default Fund Exposures to QCCPs

(a) Where a default fund is shared between products or types of business with settlement risk only (e.g. equities and bonds) and products or types of business which give rise to counterparty credit risk i.e., OTC derivatives, exchange traded derivatives or SFTs, all of the default fund contributions will receive the risk weight determined according to the formulae and methodology set forth below, without apportioning to different classes or types of business or products.

⁵ Where the entity holding such assets or collateral is the QCCP, a risk-weight of 2% applies to collateral included in the definition of trade exposures. The relevant risk-weight of the QCCP will apply to assets or collateral posted for other purposes.

⁶ In this paragraph, the word "custodian" may include a trustee, agent, pledgee, secured creditor or any other person that holds property in a way that does not give such person a beneficial interest in such property and will not result in such property being subject to legally-enforceable claims by such persons, creditors, or to a court-ordered stay of the return of such property, should such person become insolvent or bankrupt.

(b) However, where the default fund contributions from clearing members are segregated by product types and only accessible for specific product types, the capital requirements for those default fund exposures determined according to the formulae and methodology set forth below must be calculated for each specific product giving rise to counterparty credit risk. In case the QCCP's prefunded own resources are shared among product types, the QCCP will have to allocate those funds to each of the calculations, in proportion to the respective product specific exposure i.e. EAD.

(c) Clearing member banks are required to capitalise their exposures arising from default fund contributions to a qualifying CCP by applying the following formula:

- Clearing member banks may apply a risk-weight of 1111% to their default fund exposures to the qualifying CCP, subject to an overall cap on the risk-weighted assets from all its exposures to the QCCP (i.e. including trade exposures) equal to 20% of the trade exposures to the QCCP. More specifically, the Risk Weighted Assets (RWA) for both bank *i*'s trade and default fund exposures to each QCCP are equal to⁷:

$$\text{Min} \{(2\% * TE_i + 1111\% * DF_i); (20\% * TE_i)\}$$

Where;

-TE_{*i*} is bank *i*'s trade exposure to the QCCP; and

-DF_{*i*} is bank *i*'s pre-funded contribution to the QCCP's default fund.

5.15.3.10 Exposures to Non-qualifying CCPs

(a) Banks must apply the Standardised Approach for credit risk according to the category of the counterparty, to their trade exposure to a non-qualifying CCP⁸.

(b) Banks must apply a risk weight of 1111% to their default fund contributions to a non-qualifying CCP.

(c) For the purposes of this paragraph, the default fund contributions of such banks will include both the funded and the unfunded contributions which are liable to be paid should the CCP so require. Where there is a liability for unfunded contributions (i.e. unlimited binding commitments) the Reserve Bank will determine in its Pillar 2 assessments the amount of unfunded commitments to which an 1111% risk weight should apply.

⁷ The 2% risk weight on trade exposures does not apply additionally, as it is included in the equation.

⁸ In cases where a CCP is to be considered as non-QCCP and the exposure is to be reckoned on CCP, the applicable risk weight will be according to the ratings assigned to the CCPs.

**Capital Requirements for Banks' Exposures to Central Counterparties –
Additions / Deletion / Amendments to Existing Guidelines**

Part A: Addition to the sub-paragraph 5.15.3.3

Definitions and general terminology

(Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013).

- A **central counterparty** (CCP) is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement. For the purposes of the capital framework, a CCP is a financial institution.
- A **qualifying central counterparty** (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator / overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.
- A **clearing member** is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants⁹.
- A **client** is a party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing

⁹ For the purposes of these guidelines, where a CCP has a link to a second CCP, that second CCP is to be treated as a clearing member of the first CCP. Whether the second CCP's collateral contribution to the first CCP is treated as initial margin or a default fund contribution will depend upon the legal arrangement between the CCPs. In such cases, if any, RBI should be consulted for determining the treatment of this initial margin and default fund contributions.

member guaranteeing the performance of the client to the CCP.

- **Initial margin** means a clearing member's or client's funded collateral posted to the CCP to mitigate the potential future exposure of the CCP to the clearing member arising from the possible future change in the value of their transactions. For the purposes of these guidelines, initial margin does not include contributions to a CCP for mutualised loss sharing arrangements (i.e. in case a CCP uses initial margin to mutualise losses among the clearing members, it will be treated as a default fund exposure).
- **Variation margin** means a clearing member's or client's funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.
- **Trade exposures** include the current¹⁰ and potential future exposure of a clearing member or a client to a CCP arising from OTC derivatives, exchange traded derivatives transactions or SFTs, as well as initial margin.
- **Default funds**, also known as clearing deposits or guarantee fund contributions (or any other names), are clearing members' funded or unfunded contributions towards, or underwriting of, a CCP's mutualised loss sharing arrangements. The description given by a CCP to its mutualised loss sharing arrangements is not determinative of their status as a default fund; rather, the substance of such arrangements will govern their status.
- **Offsetting transaction** means the transaction leg between the clearing member and the CCP when the clearing member acts on behalf of a client (e.g. when a clearing member clears or novates a client's trade).

Part B: Deletion / Amendments to existing guidelines

Consequential changes to the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013) and Guidelines on Implementation of the Internal Rating Based (IRB) Approaches for Calculation of Capital Charge for Credit Risk (Circular DBOD.No.BP.BC.67/21.06.202/2011-12 dated December 22, 2011) i.e. deletion / amendments are as under:

I. Deletion

¹⁰ For the purposes of this definition, the current exposure of a clearing member includes the variation margin due to the clearing member but not yet received.

A. Following paragraphs of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013) will be deleted consequent upon the implementation of the new framework on capital requirements for bank exposure to CCPs.

5.14.3 As indicated in paragraph 5.15.3.4(iii), the deposits kept by banks with the CCPs will attract risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20 per cent and for other CCPs, it will be according to the ratings assigned to these entities.

5.15.3.4(i): The exposures on account of derivatives trading and securities financing transactions (e.g. Collateralised Borrowing and Lending Obligations - CBLOs, Repos) to Central Counter Parties (CCPs) including those attached to stock exchanges for settlement of exchange traded derivatives, will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

5.15.3.4(ii) A CCF of 100% will be applied to the banks securities posted as collaterals with CCPs and the resultant off-balance sheet exposure will be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20% and for other CCPs, it will be according to the ratings assigned to these entities.

5.15.3.4(iii): The deposits kept by banks with the CCPs will attract risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20 per cent and for other CCPs, it will be according to the ratings assigned to these entities.

B. Paragraphs 1 and 2 of Annex 7 of Guidelines on Implementation of the Internal Rating Based (IRB) Approaches for Calculation of Capital Charge for Credit Risk (Circular DBOD.No.BP.BC.67/21.06.202/2011-12 dated December 22, 2011) as mentioned below will be deleted:

Transactions involving Central Counterparties

1. The exposures to Central Counter Parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. Collateralised Borrowing and Lending Obligations, Repos, Reverse Repos) outstanding against them will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

2. Banks' securities posted as collaterals with CCPs and the resultant off-balance sheet exposure will be assigned risk weights as per the standardised approach appropriate to the nature of the CCPs and will be subject to review.

II. Amendments

Following paragraphs of Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013) and Internal Rating Based (IRB) Approaches for Calculation of Capital Charge for Credit Risk (Circular DBOD.No.BP.BC.67/ 21.06.202/2011-12 dated December 22, 2011) will be amended, with changes indicated in bold and underlined:

Paragraph 5.15.4 (iii) of the Master Circular on Basel III Capital Regulations (Master Circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated July 1, 2013):

Failure of transactions settled through a delivery-versus-payment system (DvP), providing simultaneous exchanges of securities for cash, expose banks to a risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price (i.e. positive current exposure). Failed transactions where cash is paid without receipt of the corresponding receivable (securities, foreign currencies, or gold,) or, conversely, deliverables were delivered without receipt of the corresponding cash payment (non-DvP, or free delivery) expose banks to a risk of loss on the full amount of cash paid or deliverables delivered. Therefore, a capital charge is required for failed transactions and must be calculated as under. The following capital treatment is applicable to all failed transactions, including transactions through recognised clearing houses **and Central Counterparties**. Repurchase and reverse-repurchase agreements as well as securities lending and borrowing that have failed to settle are excluded from this capital treatment.

Paragraph 5 (iii) of guidelines on Internal Rating Based (IRB) Approaches for Calculation of Capital Charge for Credit Risk (Circular DBOD.No.BP.BC.67/ 21.06.202/ 2011-12 dated December 22, 2011):

Failure of transactions settled through a delivery-versus-payment system (DvP), providing simultaneous exchanges of securities for cash, expose banks to a risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price (i.e. positive current exposure). Failed transactions where cash is paid without receipt of the corresponding receivable (securities, foreign currencies, or gold,) or, conversely, deliverables were delivered without receipt of the corresponding cash payment (non-DvP, or free delivery) expose banks to a risk of loss on the full amount of cash paid or deliverables delivered. Therefore, a capital charge is required for failed transactions and must be calculated. The following capital treatment is applicable to all failed transactions, including transactions through recognised clearing houses **and Central Counterparties**. Repurchase and reverse-repurchase agreements as well as securities lending and borrowing that have failed to settle are excluded from this capital treatment.

**Requirements for Recognition of Net Replacement Cost
in Close-out Netting Sets**

A. For repo-style transactions

The effects of bilateral netting agreements covering repo-style transactions will be recognised on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must:

- (a) provide the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;
- (b) provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other;
- (c) allow for the prompt liquidation or setoff of collateral upon the event of default; and
- (d) be, together with the rights arising from the provisions required in (a) to (c) above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy.

B. For Derivatives transactions

(a) Banks may net transactions subject to novation under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.

(b) Banks may also net transactions subject to any legally valid form of bilateral netting not covered in (a), including other forms of novation.

(c) In both cases (a) and (b), a bank will need to satisfy that it has:

- (i) A netting contract or agreement with the counterparty which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances;

(ii) Written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be such a net amount under:

- The law of the jurisdiction in which the counterparty is chartered and, if the foreign branch of a counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
- The law that governs the individual transactions; and
- The law that governs any contract or agreement necessary to effect the netting.

(iii) Procedures in place to ensure that the legal characteristics of netting arrangements are kept under review in the light of possible changes in relevant law.

(d) Contracts containing walkaway clauses will not be eligible for netting for the purpose of calculating capital requirements under these guidelines. A walkaway clause is a provision which permits a non-defaulting counterparty to make only limited payments or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor.