ANNEX VII

TRADING

Part A — Trading Intent

1. Positions/portfolios held with trading intent shall comply with the following requirements:

   a) there must be a clearly documented trading strategy for the position/instrument or portfolios, approved by senior management, which shall include expected holding horizon;

   b) there must be clearly defined policies and procedures for the active management of the position, which shall include the following:

      i) positions entered into on a trading desk;

      ii) position limits are set and monitored for appropriateness;

      iii) dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;

      iv) positions are reported to senior management as an integral part of the institution's risk management process; and

      v) positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge-ability of the position or its component risks, including the assessment of, the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and

   c) there must be clearly defined policy and procedures to monitor the position against the institution's trading strategy including the monitoring of turnover and stale positions in the institution's trading book.

Part B — Systems and Controls

1. Institutions shall establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.

2. Systems and controls shall include at least the following elements:

   a) documented policies and procedures for the process of valuation. This includes clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures; and

   b) reporting lines for the department accountable for the valuation process that are clear and independent of the front office.

   The reporting line shall ultimately be to a main board executive director.

Prudent Valuation Methods

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

4. When marking to market, the more prudent side of bid/offer shall be used unless the institution is a significant market maker in the particular type of financial instrument or commodity in question and it can close out at mid market.

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

6. The following requirements must be complied with when marking to model:

   a) senior management shall be aware of the elements of the trading book which are subject to mark to model and shall understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business;

   b) market inputs shall be sourced, where possible, in line with market prices, and the appropriateness of the market inputs of the particular position being valued and the parameters of the model shall be assessed on a frequent basis;

   c) where available, valuation methodologies which are accepted market practice for particular financial instruments or commodities shall be used;

   d) where the model is developed by the institution itself, it shall be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;

   e) there shall be formal change control procedures in place and a secure copy of the model shall be held and periodically used to check valuations;

   f) risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and

   g) the model shall be subject to periodic review to determine the accuracy of its performance (e.g. assessing the continued appropriateness of assumptions, analysis of profit and loss versus risk factors, comparison of actual close out values to model outputs).

   For the purposes of point (d), the model shall be developed or approved independently of the front office and shall be independently tested, including validation of the mathematics, assumptions and software implementation.

7. Independent price verification should be performed in addition to daily marking to market or marking to model. This is the process by which market prices or model inputs are regularly verified for accuracy and independence. While daily marking to market may be performed by dealers, verification of market prices and model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/trading activity, more frequently). Where independent pricing sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

Valuation adjustments or reserves

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

General standards

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

Standards for less liquid positions

10. Less liquid positions could arise from both market events and institution-related situations e.g. concentrated positions and/or stale positions.

11. Institutions shall consider several factors when determining whether a valuation reserve is necessary for less liquid positions. These factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

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

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

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

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

Part C — Internal Hedges

1. An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of positions. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in Parts A and B are met. In particular:

   a) internal hedges shall not be primarily intended to avoid or reduce capital requirements;

   b) internal hedges shall be properly documented and subject to particular internal approval and audit procedures;

   c) the internal transaction shall be dealt with at market conditions;

   d) the bulk of the market risk that is generated by the internal hedge shall be dynamically managed in the trading book within the authorised limits; and

   e) internal transactions shall be carefully monitored.

   Monitoring must be ensured by adequate procedures.

2. The treatment referred to in point 1 applies without prejudice to the capital requirements applicable to the 'non-trading book leg' of the internal hedge.

3. Notwithstanding points 1 and 2, when an institution hedges a non-trading book credit risk exposure using a credit derivative booked in its trading book (using an internal hedge), the non-trading book exposure is not deemed to be hedged for the purposes of calculating capital requirements unless the institution purchases from an eligible third party protection provider a credit derivative meeting the requirements set out in point 19 of Part 2 of Annex VIII to Directive 2006/…/EC with regard to the non-trading book exposure. Where such third party protection is purchased and is recognised as a hedge of a non-trading book exposure for the purposes of calculating capital requirements, neither the internal nor external credit derivative hedge shall be included in the trading book for the purposes of calculating capital requirements.

Part D — Inclusion In The Trading Book

1. Institutions shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirements, consistent with the criteria set out in Article 11 and taking into account the institution's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and subject to periodic internal audit.

2. Institutions shall have clearly defined policies and procedures for overall management of the trading book. At a minimum these policies and procedures shall address:

   a) the activities the institution considers to be trading and as constituting part of the trading book for capital requirement purposes;

   b) the extent to which a position can be marked-to-market daily by reference to an active, liquid two-way market;

   c) for positions that are marked-to-model, the extent to which the institution can:

      i) identify all material risks of the position;

      ii) hedge all material risks of the position with instruments for which an active, liquid two-way market exists; and

      iii) derive reliable estimates for the key assumptions and parameters used in the model;

   d) the extent to which the institution can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;

   e) the extent to which legal restrictions or other operational requirements would impede the institution's ability to effect a liquidation or hedge of the position in the short term;

   f) the extent to which the institution can, and is required to, actively risk manage the position within its trading operation; and

   g) the extent to which the institution may transfer risk or positions between the non-trading and trading books and the criteria for such transfers.

3. Competent authorities may allow institutions to treat positions that are holdings in the trading book as set out in Article 57(l), (m) and (n) of Directive 2006/…/EC as equity or debt instruments, as appropriate, where an institution demonstrates that it is an active market maker in these positions. In this case, the institution shall have adequate systems and controls surrounding the trading of eligible own funds instruments.

4. Term trading-related repo-style transactions that an institution accounts for in its non-trading book may be included in the trading book for capital requirement purposes so long as all such repo-style transactions are included. For this purpose, trading-related repo-style transactions are defined as those that meet the requirements of Article 11(2) and of Annex VII, Part A, and both legs are in the form of either cash or securities includable in the trading book. Regardless of where they are booked, all repo-style transactions are subject to a non-trading book counterparty credit risk charge.