



Pursuant to Article 23, paragraph 1, to Article 35, paragraph 1, subparagraph 1.1 of the Law No. 03/L-209 of the Central Bank of the Republic of Kosovo (Official Gazette of the Republic of Kosovo, No. 77/16 August 2010), and Articles 15, 16 and 85 of the Law No. 04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions (Official Gazette of the Republic of Kosovo, No. 11/11 May 2012), the Board of the Central Bank of the Republic of Kosovo at the meeting held on November 29 , 2018, approved the following:

REGULATION ON CAPITAL ADEQUACY OF BANKS

CHAPTER I

Article 1

Purpose and Scope

1. The purpose of this Regulation is to ensure that banks hold capital sufficient to cover the risks involved in their business, to maintain the minimum capital level and also a capital adequacy ratio which reflects the risk exposures of the bank both on- and off-balance sheet.
2. This Regulation shall apply to all banks in the Republic of Kosovo that are licensed by the CBK, excluding branches of foreign banks.

Article 2

Definitions

1. All terms used in this Regulation are as defined in the Law No.04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions (hereinafter: *the Law on Banks*) and/or as further defined herein for the purpose of this Regulation:

1.1 Bank – means a shareholder company engaged in the business of banking, including a subsidiary, licensed by the CBK;

1.2 Branch of foreign bank - is a person that is organized and licensed to operate banking activities within the Republic of Kosovo but its parent bank has its head office and holds a license to engage in the business of banking in a jurisdiction other than the Republic of Kosovo;

1.3 Total capital – means the sum of a bank’s Tier 1 capital and its Tier 2 capital;

1.4 Risk-asset – means any monetary asset which is carried on the balance sheet of a bank such as a loan which entails any risk of loss in value to that bank;

1.5 Off-balance sheet items – means the contingent liabilities of a bank including direct credit substitutes issued by it such as guarantees of indebtedness, standby letters of credit and other contingencies which must be disclosed as footnotes on its balance sheet but for which no definite risk value is available for purposes of inclusion in the principle part of its balance sheet;

1.6 Goodwill – means the excess of the current value of a bank asset over the value at which it is carried on the bank's books as more fully defined under international accounting standards;

1.7 Intangible asset – means the identifiable non-monetary assets of a bank, which have no physical substance, which are carried and controlled by it as a result of past events and from which future economic benefits are expected to flow as more fully defined under international accounting standards;

1.8 A direct credit substitute – means any arrangement in which a bank assumes risk of credit-related losses from assets or other claims that it has not transferred, when the risk of credit loss exceeds the banks pro rata share of the assets or other claims;

1.9 Trade-related letters of credit – means short-term self-liquidating instruments used to finance the movement of goods and are collateralized by the underlying goods;

1.10 Operational risk – means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputation risk;

1.11 Loan-to-value ratio – is or means defined as the outstanding principal balance on the loan amount divided by the current estimated market value of the residence;

1.12 A deferred tax asset has the same meaning as under the applicable accounting framework;

1.13 Deferred tax assets that rely on future profitability means deferred tax assets the future value of which may be realized only in the event the bank generates taxable profit in the future;

1.14 A deferred tax liability has the same meaning as under the applicable accounting framework;

1.15 Distributions mean the payment of dividends or interest in any form;

1.16 Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

1.17 Intangible asset has the same meaning as under the applicable accounting framework and includes goodwill;

1.18 Own funds means the sum of Tier 1 capital and Tier 2 capital;

1.19 Own funds instruments means capital instruments issued by the bank that qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments;

1.20 Minority interest means the amount of Common Equity Tier 1 capital of a subsidiary of a bank that is attributable to natural or legal persons other than those included in the prudential scope of consolidation of the bank; Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary;

1.21 Capital conservation buffer means the own funds that a bank is required to maintain in accordance with paragraph 2 of Article 5 of this regulation;

1.22 Profit has the same meaning as under the applicable accounting framework;

1.23 Reciprocal cross holding means a holding by an institution of the own funds instruments or other capital instruments issued by financial sector entities where those entities also hold own funds instruments issued by the institution;

1.24 Retained earnings means profits and losses brought forward as a result of the final application of profit or loss under the applicable accounting framework;

1.25 Share premium account has the same meaning as under the applicable accounting framework;

1.26 Temporary difference has the same meaning as under the applicable accounting framework;

1.27 Synthetic holding means an investment by an institution in a financial instrument the value of which is directly linked to the value of the capital instruments issued by a financial sector entity;

1.28 Distributable items means the amount of the profits at the end of the last financial year plus any profits brought forward and reserves available for that purpose before distributions to holders of own funds instruments less any losses brought forward, profits which are non-distributable pursuant to provisions in legislation or the institution's bye-laws and sums placed

to non-distributable reserves in accordance with applicable national law or the statutes of the institution, those losses and reserves being determined on the basis of the individual accounts of the institution and not on the basis of the consolidated accounts;

1.29 Exposure means an asset or off-balance sheet item;

1.30 Loss means economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument;

1.31 Expected loss or “EL” means the ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one year period to the amount outstanding at default;

1.32 Joint stock companies are defined as companies that have issued common shares, irrespective of whether these shares are held privately or publically;

1.33 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right;

1.34 An SPE/SPV is a legal entity created at the direction of a sponsoring firm (which may also be referred to as the sponsor, originator, seller, or administrator). The sponsor is typically a major bank, finance company, investment bank or insurance company. An SPE can take the form of a corporation, trust, partnership, corporation or a limited liability company; An SPE is a vehicle whose operations are typically limited to the acquisition and financing of specific assets or liabilities. In this respect, a distinction should be drawn between asset securitisations and liability securitisations. Asset securitisations are usually undertaken by banks and finance companies, and typically involve issuing bonds that are backed by the cashflows of income-generating assets (ranging from credit card receivables to residential mortgage loans). Liability securitisations are usually undertaken by insurance companies, and typically involve issuing bonds that assume the risk of a potential insurance liability (ranging from a catastrophic natural event to an unexpected claims level on a certain product type);

1.35 Sponsor means an institution other than an originator institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities;

1.36 Securitization means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having both of the following characteristics:

1.36.1 payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures;

1.36.2 the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

1.37 Securitization position means an exposure to a securitization;

1.38 Re-securitization means securitization where the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitization position;

1.39 Re-securitization position means an exposure to a re- securitization;

1.40 Eligible capital means the sum of the following:

1.40.1 Tier 1 capital as referred to in Article 6 of this regulation;

1.40.2 Tier 2 capital as referred to in Article 12 of this regulation that is equal to or less than one third of Tier 1 capital;

1.41 Discretionary pension benefits means enhanced pension benefits granted on a discretionary basis by an institution to an employee as part of that employee's variable remuneration package, which do not include accrued benefits granted to an employee under the terms of the company pension scheme;

1.42 Accumulated other comprehensive income has the same meaning as under International Accounting Standard (IAS) 1;

1.43 Defined benefit pension fund assets means the assets of a defined pension fund or plan, as applicable, calculated after they have been reduced by the amount of obligations under the same fund or plan;

1.44 Corresponding deduction approach means that the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. Component of capital may be Tier 1 or Tier 2 capital;

1.45 Underwriting is a process where a bank agrees to purchase a new issue of securities from the issuer and distribute these securities to investors;

1.46 Business organizations – means, business organizations, later on enterprises, regulated by Law on Business organizations and classified according to Law on Accounting, Financial Reporting and Audit of the Republic of Kosovo in force.

1.47 Speculative immovable property financing - means loans for the purposes of the acquisition of or development or construction on land in relation to immovable property, or of and in relation to such property, with the intention of reselling for profit;

1.48 Credit risk mitigation means a technique used by a bank to reduce the credit risk associated with an exposure or exposures which a bank continues to hold;

1.49 Funded credit protection means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of a bank derives from the right of that bank, in the event of the default of the counterparty or on the occurrence of other specified credit events

relating to the counterparty, to liquidate, or to obtain transfer or appropriation of, or to retain certain assets or amounts, or to reduce the amount of the exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the bank;

1.50 Unfunded credit protection means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of a bank derives from the obligation of a third party to pay an amount in the event of the default of the borrower or the occurrence of other specified credit events;

1.51. Institution means a credit institution or an investment firm;

1.52 Investment firm means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis;

1.53 Derivative – means a financial instrument the price of which derives from a different asset;

1.54 Derivative or derivative contract means a financial instrument as set out in points 4) to 7) of Annex V of this regulation;

1.55 OTC derivative or OTC derivative contract means a derivative contract the execution of which does not take place on a regulated market;

1.56 Regulated market means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its nondiscretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly;

1.57 Multilateral trading facility (MTF) means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract;

1.58 Market operator means a person or persons who manages and/or operates the business of a regulated market. The market operator may be the regulated market itself;

1.59 Money-market instruments means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;

1.60 Marking to market means the valuation of positions at readily available close out prices that are sourced independently, including exchange prices, screen prices or quotes from several independent reputable brokers;

1.61 Marking to model means any valuation which has to be benchmarked, extrapolated or otherwise calculated from one or more market inputs;

1.62 Recognized exchange means an exchange which meets all of the following conditions:

1.62.1 it is a regulated market;

1.62.2 it has a clearing mechanism whereby contracts listed in Annex IV are subject to daily margin requirements which, in the opinion of the CBK, provide appropriate protection;

1.63 Commodity means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity;

1.64 Financial instrument means:

1.64.1 a contract that gives rise to both a financial asset of one party and a financial liability or equity instrument of another party

1.64.2 an instrument specified in Annex V

1.64.3 a derivative financial instrument

1.64.4a primary financial instrument

1.64.5 a cash instrument.

1.65 Warrant means a security which gives the holder the right to purchase an underlying asset at a stipulated price until or at the expiry date of the warrant and which may be settled by the delivery of the underlying itself or by cash settlement;

1.66 Repurchase agreement and reverse repurchase agreement mean any agreement in which an institution or its counterparty transfers securities or commodities or guaranteed rights relating to title - to securities or commodities where that guarantee is issued by a recognised exchange which holds the rights to the securities or commodities and the agreement does not allow an institution to transfer or pledge a particular security or commodity to more than one counterparty at one time, subject to a commitment to repurchase them - or substituted securities or commodities of the same description - at a specified price on a future date specified, or to be specified, by the transferor, being a repurchase agreement for the institution selling the securities or commodities and a reverse repurchase agreement for the institution buying them;

1.67 Securities or commodities lending and Securities or commodities borrowing mean any transaction in which a bank or its counterparty transfers securities or commodities against appropriate collateral, subject to a commitment that the borrower will return equivalent securities or commodities at some future date or when requested to do so by the transferor.

1.68 Positions held with trading intent means any of the following:

- 1.68.1 proprietary positions and positions arising from client servicing and market making;
- 1.68.2 positions intended to be resold short term;
- 1.68.3 positions intended to benefit from actual or expected short term price differences between buying and selling prices or from other price or interest rate variations;

1.69 Reference obligation means an obligation used for the purposes of determining the cash settlement value of a credit derivative;

1.70 Credit derivative means a derived financial instrument, i.e. a contract where the credit protection provider undertakes to pay out to the protection buyer upon occurrence of default of an obligor or another contractually specified credit event the amount equal to one of the following:

- 1.70.1 the decline in the value of the reference obligation with respect to the initial value
- 1.70.2 the entire notional value of the reference obligation in exchange for the delivery of that obligation or another equivalent financial instrument,
- 1.70.3 a specified fixed amount;

1.71 Credit Default Swap means a type of credit derivative under which the credit protection buyer transfers the credit risk of the reference asset to the credit protection provider. The credit protection provider undertakes to compensate the credit protection buyer in the event of the occurrence of other specified credit events specified in the contract. For this service the protection buyer pays the protection seller a periodic premium.

1.72 Total Return Swap means contracts under which the protection buyer agrees to transfer all the cash flows generated by the reference obligation to the protection provider. The protection provider, for his part, agrees to transfer the cash flows associated with changes in a reference rate to the protection buyer. On the payment dates (or the termination date of the contract), the protection buyer transfers to the provider the amount of the potential revaluation of reference obligation (i.e. a value equal to the positive difference between the market value and the initial value of the reference obligation). In the case of a decline in the value of the reference obligation, the protection provider transfers to the buyer the respective amount which compensates this decline.

1.73 Credit Linked Notes means a derivative financial instrument which enables the credit protection buyer to transfer the risk associated with the asset on which the CLN is based. The credit protection provider receives from the buyer an increased regular coupon rate and regular value of the asset at maturity unless a credit event occurs prior to maturity of the asset on which the CLN is based;

1.74 First-to-default credit derivative means a contract relating to a certain number of exposures under the terms of which the first default among the exposures shall trigger payment by protection provider

1.75 Nth-to-default credit derivative means a contract relating to a certain number of exposures under the terms of which the nth default among the exposures shall trigger payment by the protection provider

1.76 Delta means the expected change in an option price as a proportion of a small change in the price of the instrument underlying the option

1.77 Trading book means all positions in financial instruments and commodities held by a bank either with trading intent, or in order to hedge positions held with trading intent

1.78 Margin lending transactions means transactions in which a bank extends credit in connection with the purchase, sale, carrying or trading of securities. Margin lending transactions do not include other loans that are secured by collateral in the form of securities

1.79 Transferable securities means those classes of securities which are negotiable on the capital market

1.80 Convertible means a security which, at the option of the holder, may be exchanged for another security;

1.81 Stock financing means positions where physical stock has been sold forward and the cost of funding has been locked in until the date of the forward sale;

1.82 Underlying asset means a financial instrument (e.g. stocks, future contracts, commodities, currencies, indexes, etc.) based on which derives a derivative price

1.83 Futures contracts are agreements for delayed delivery of financial instruments or commodities in which the buyer agrees to purchase and the seller agrees to deliver, at a specified future date, a specified instrument at a specified price or yield. Futures contracts are standardized and are traded on organized exchanges where the exchange or a clearing house acts as the counterparty to each contract.

1.84 Forward contracts are agreements for delayed delivery of financial instruments or commodities in which the buyer agrees to purchase and the seller agrees to deliver, at a

specified future date, a specified instrument or commodity at a specified price or yield. Forward contracts are not traded on organized exchanges and their contractual terms are not standardized.

1.85 Option contracts are contracts which convey either the right or the obligation, depending upon whether the institution is the purchaser or the writer, to buy or sell a financial instrument or commodity at a specified price on or before a specified future date. Some options are traded on organized exchanges. Also, options can be written to meet the specialized needs of the counterparty to the transaction. These customized option contracts are known as over-the-counter (OTC) options. Thus, over-the-counter option contracts include all option contracts not traded on an organized exchange.

1.86 Swaps are OTC transactions in which two parties agree to exchange payment streams based on a specified notional amount for a specified period.

CHAPTER II

OWN FUNDS

Elements of own funds

Article 3

Minimum Capital

1. According to paragraph 1 of Article 15 of the Law no.04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions, banks should have at least seven (7) million Euros of paid-in capital, subject to the restrictions in paragraph 2 of Article 15 of the Law no.04/L-093 on Banks, Microfinance Institutions and Non-Bank Financial Institutions, at all times.

Article 4

Elements of capital

1. Total regulatory capital of a bank consists of the sum of the following elements:

1.1 Tier 1 Capital

1.1.1 Common Equity Tier 1

1.1.2 Additional Tier 1

1.2 Tier 2 Capital

2. For each of the categories above in paragraph 1 of this Article there is a single set of criteria that instruments of the banks are required to meet before inclusion in the relevant category.

Article 5

Own funds requirements

1. All elements above in paragraph 1 of Article 4 of this regulation are net of the associated regulatory adjustments and are subject to the following restrictions:

1.1 Common Equity Tier 1 must be at least 4.9% of risk-weighted assets at all times.

1.2 Tier 1 Capital must be at least 9.0% of risk-weighted assets at all times including capital conservation buffer.

1.3 Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 12.0% of risk-weighted assets at all times.

2. In addition to Common Equity Tier 1 banks must have a capital conservation buffer of Common Equity Tier 1 equal to 2.5% of risk-weighted assets on an individual and consolidated basis.

3. Tier 2 capital is equal to or less than one third of Tier 1 capital.

4. Additional Tier 1 capital is equal to or less than one third of CET1 capital.
5. Total risk exposure amount shall be calculated as the sum of points 5.1 to 5.3 of this paragraph:
 - 5.1 the risk weighted exposure amounts for credit risk, calculated in accordance with Chapter III of this regulation.
 - 5.2 the own funds requirements, determined in accordance with Chapter V of this regulation.
 - 5.3 the own funds requirements determined in accordance with Chapter VI of this regulation.
6. The following provisions shall apply in the calculation of the total exposure amount referred to in paragraph 5 of this article:
 - 6.1 the own funds requirements referred to in points 5.2 and 5.3 of that paragraph shall include those arising from all the business activities of a bank;
 - 6.2 banks shall multiply the own funds requirements set out in points 5.2 and 5.3 of that paragraph by 8.33.

Article 6

Tier 1 capital

The Tier 1 capital of a bank consists of the sum of the Common Equity Tier 1 capital and Additional Tier 1 capital of the bank.

Article 7

Common Equity Tier 1 capital

1. Common Equity Tier 1 capital consists of the sum of the following elements:
 - 1.1 Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes;
 - 1.2 Stock surplus (share premium) resulting from the issue of instruments included Common Equity Tier 1;
 - 1.3 Retained earnings;
 - 1.4 Accumulated other comprehensive income and other disclosed reserves;
 - 1.5 Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital;
 - 1.6 Regulatory adjustments applied in the calculation of Common Equity Tier 1.
2. For the purposes of point 1.3 of the paragraph 1 of this article, banks may include interim or year-end profits in Common Equity Tier 1 capital before the bank has taken a formal decision confirming the final profit or loss of the bank for the year only with the prior permission of the CBK.
3. Referring paragraph 2 of this article CBK shall grant permission where the following conditions are met:

- 3.1 those profits have been verified by external audit of the bank which are responsible for the auditing of the accounts of that bank or those profits are verified by CBK examinations;
 - 3.2 the bank has demonstrated that any foreseeable charge or dividend has been deducted from the amount of those profits;
 - 3.3 a verification of the interim or year-end profits of the bank shall provide an adequate level of assurance that those profits have been evaluated in accordance with the principles set out in the applicable accounting framework.
4. Banks shall send for approval all documents to CBK which prove the fulfillment of the conditions according to paragraph 3 of this article.

Article 8

Criteria for classification as common shares for regulatory capital purposes

1. For an instrument to be included in Common Equity Tier 1 capital it must meet all of the criteria as follows:
 - 1.1 Represents the most subordinated claim in liquidation of the bank. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
 - 1.2 Principal is perpetual and never repaid outside of liquidation.
 - 1.3 The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
 - 1.4 Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items). There are no circumstances under which the distributions are obligatory. Nonpayment is therefore not an event of default. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
 - 1.5 It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others. The paid in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency. The paid in amount is classified as equity under the relevant accounting standards.
 - 1.6 It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.
 - 1.7 The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.

- 1.8 It is only issued with the approval of the owners of the issuing bank.
- 1.9 It is clearly and separately disclosed on the bank's balance sheet.

Article 9
Additional Tier 1 capital

- 1. Additional Tier 1 capital consists of the sum of the following elements:
 - 1.1 Instruments issued by the bank that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);
 - 1.2 Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
 - 1.3 Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1 and
 - 1.4 Regulatory adjustments applied in the calculation of Additional Tier 1 Capital.

Article 10
Criteria for inclusion in Additional Tier 1 capital

- 1. Criteria for an instrument issued by the bank to meet or exceed in order for it to be included in Additional Tier 1 capital are as follows:
 - 1.1 Issued and paid-in.
 - 1.2 Subordinated to depositors, general creditors and subordinated debt of the bank.
 - 1.3 Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.
 - 1.4 Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.
 - 1.5 May be callable at the initiative of the issuer only after a minimum of five years:
 - 1.5.1 To exercise a call option a bank must receive prior supervisory approval; and
 - 1.5.2 A bank must not do anything which creates an expectation that the call will be exercised; and
 - 1.5.3 Banks must not exercise a call unless:
 - 1.5.3.1 They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
 - 1.5.3.2 The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.
 - 1.6 Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.

- 1.7. Dividend/coupon discretion:
 - 1.7.1 The bank must have full discretion at all times to cancel distributions/payments
 - 1.7.2 Cancellation of discretionary payments must not be an event of default
 - 1.7.3 Banks must have full access to cancelled payments to meet obligations as they fall due
 - 1.7.4 Cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.
- 1.8 Dividends/coupons must be paid out of distributable items.
- 1.9 The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.
- 1.10 The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
- 1.11 Instruments classified as liabilities for accounting purposes must have principal loss absorption through either:
 - 1.11.1 conversion to common shares at an objective pre-specified trigger point or
 - 1.11.2 a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.
 - 1.11.2.1 The write-down will have the following effects:
 - 1.11.2.1.1 Reduce the claim of the instrument in liquidation;
 - 1.11.2.1.2 Reduce the amount re-paid when a call is exercised; and
 - 1.11.2.1.3 Partially or fully reduce coupon/dividend payments on the instrument.
 - 1.11.3 A trigger event occurs when the Common Equity Tier 1 capital ratio of the bank referred to in paragraph 1, point 1.1 of Article 5 falls below either of the following:
 - 1.11.3.1 5,125 %;
 - 1.11.3.2 a level higher than 5,125 %, where determined by the bank and specified in the provisions governing the instrument;
 - 1.11.4 Banks may specify in the provisions governing the instrument one or more trigger events in addition to that referred to point 1.11.3 of this Article;
 - 1.11.5 Where the provisions governing the instruments require them to be converted into Common Equity Tier 1 instruments upon the occurrence of a trigger event, those provisions shall specify either of the following:
 - 1.11.5.1. the rate of such conversion and a limit on the permitted amount of conversion;
 - 1.11.5.2. a range within which the instruments will convert into Common Equity Tier 1 instruments;

- 1.11.6 Where the provisions governing the instruments require their principal amount to be written down upon the occurrence of a trigger event, the write down shall reduce all the following:
- 1.11.6.1 the claim of the holder of the instrument in the insolvency or liquidation of the bank;
 - 1.11.6.2 the amount required to be paid in the event of the call or redemption of the instrument;
 - 1.11.6.3 the distributions made on the instrument.
- 1.11.7 Write down or conversion of an Additional Tier 1 instrument shall, under the applicable accounting framework, generate items that qualify as Common Equity Tier 1 items.
- 1.11.8 The amount of Additional Tier 1 instruments recognized in Additional Tier 1 items is limited to the minimum amount Common Equity Tier 1 items that would be generated if the principal amount of the Additional Tier 1 instruments were fully written down or converted into Common Equity Tier 1 instruments.
- 1.11.9 The aggregate amount of Additional Tier 1 instruments that is required to be written down or converted upon the occurrence of a trigger event shall be no less than the lower of the following:
- 1.11.9.1 the amount required to restore fully the Common Equity Tier 1 ratio of the bank to 5,125 %;
 - 1.11.9.2 the full principal amount of the instrument.
- 1.11.10 When a trigger event occurs banks shall do the following:
- 1.11.10.1 immediately inform the CBK;
 - 1.11.10.2 inform the holders of the Additional Tier 1 instruments;
 - 1.11.10.3 write down the principal amount of the instruments, or convert the instruments into Common Equity Tier 1 instruments without delay, but no later than in one month, in accordance with the requirement laid down in this Article.
- 1.11.11 A bank issuing Additional Tier 1 instruments that convert to Common Equity Tier 1 on the occurrence of a trigger event shall ensure that its authorised share capital is at all times sufficient, for converting all such convertible Additional Tier 1 instruments into shares if a trigger event occurs. All necessary authorisations shall be obtained at the date of issuance of such convertible Additional Tier 1 instruments. The bank shall maintain at all times the necessary prior authorization to issue the Common Equity Tier 1 instruments into which

such Additional Tier 1 instruments would convert upon occurrence of a trigger event.

- 1.11.12 A bank issuing Additional Tier 1 instruments that convert to Common Equity Tier 1 on the occurrence of a trigger event shall ensure that there are no procedural impediments to that conversion by virtue of its incorporation or statutes or contractual arrangements.
- 1.12 Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.
- 1.13 The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
- 1.14 If the instrument is not issued out of an operating entity or the holding company in the consolidated group, proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

Article 11

Stock surplus (share premium) resulting from the issue of instruments included in additional Tier 1 capital

Stock surplus (i.e. share premium) that is not eligible for inclusion in Common Equity Tier 1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital.

Article 12

Tier 2 capital

1. Tier 2 capital consists of the sum of the following elements:
 - 1.1 Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);
 - 1.2 Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;
 - 1.3 Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital;
 - 1.4 Certain loan loss provisions as specified in Article 15 and 16 of this regulation; and
 - 1.5 Regulatory adjustments applied in the calculation of Tier 2 Capital.

Article 13

Criteria for inclusion in Tier 2 Capital

1. Minimum set of criteria for an instrument to meet or exceed in order for it to be included in Tier 2 capital are as follows:

- 1.1 Issued and paid-in.
- 1.2 Subordinated to depositors and general creditors of the bank.
- 1.3 Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.
- 1.4 Maturity:
 - 1.4.1 minimum original maturity of at least five years.
 - 1.4.2 recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis.
 - 1.4.3 there are no step-ups or other incentives to redeem.
- 1.5 May be callable at the initiative of the issuer only after a minimum of five years:
 - 1.5.1 To exercise a call option a bank must receive prior supervisory approval;
 - 1.5.2 A bank must not do anything that creates an expectation that the call will be exercised; and
 - 1.5.3 Banks must not exercise a call unless:
 - 1.5.3.1 They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
 - 1.5.3.2 The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.
- 1.6 The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
- 1.7 The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.
- 1.8 Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument;
- 1.9 If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

Article 14

Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 Capital

Stock surplus (i.e. share premium) that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital.

Article 15

General provisions/general loan-loss reserves (for banks using the Standardized Approach for credit risk)

1. Provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialize and therefore qualify for inclusion within Tier 2.
2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded.
3. General provisions/general loan-loss reserves eligible for inclusion in Tier 2 will be limited to a maximum of 1.25 percentage points of credit risk-weighted risk assets calculated under the standardized approach.

Article 16

Excess of total eligible provisions under the Internal Ratings-based Approach

Where the total expected loss amount is less than total eligible provisions, banks may recognize the difference in Tier 2 capital up to a maximum of 0.6% of credit risk weighted assets calculated under the IRB approach.

Article 17

Minority interest (i.e. non-controlling interest) and other capital issued out of consolidated subsidiaries that is held by third parties Common shares issued by consolidated subsidiaries

1. Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if:
 - 1.1 the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and
 - 1.2 the subsidiary that issued the instrument is itself a bank.
2. The amount of minority interest meeting the criteria in paragraph 1 of this Article that will be recognized in consolidated Common Equity Tier 1 will be calculated as follows:
 - 2.1 Total minority interest meeting the two criteria in paragraph 1 of this article minus the amount of the surplus Common Equity Tier 1 of the subsidiary attributable to the minority shareholders.
 - 2.2 Surplus Common Equity Tier 1 of the subsidiary is calculated as the Common Equity Tier 1 of the subsidiary minus the lower of:
 - 2.2.1 the minimum Common Equity Tier 1 requirement of the subsidiary plus the capital conservation buffer (i.e. 7.4% of risk weighted assets) and

- 2.2.2 the portion of the consolidated minimum Common Equity Tier 1 requirement plus the capital conservation buffer (i.e. 7.4% of consolidated risk weighted assets) that relates to the subsidiary.
- 2.3 The amount of the surplus Common Equity Tier 1 that is attributable to the minority shareholders is calculated by multiplying the surplus Common Equity Tier 1 by the percentage of Common Equity Tier 1 that is held by minority shareholders.

Article 18

Tier 1 qualifying capital issued by consolidated subsidiaries

1. Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under Article 17 of this regulation) may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital.

2. The amount of this capital that will be recognized in Tier 1 in accordance with paragraph 1 of this article will be calculated as follows:

2.1 Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third party investors.

2.2 Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of:

2.2.1 the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (i.e. 9.0% of risk weighted assets) and

2.2.2 the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (i.e. 9.0% of consolidated risk weighted assets) that relates to the subsidiary.

2.2.3 The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third party investors.

3. The amount of this Tier 1 capital referred to in paragraph 1 and 2 of this article that will be recognized in Additional Tier 1 will exclude amounts recognized in Common Equity Tier 1 under Article 17 of this regulation.

Article 19

Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries

1. Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under Article 17 and 18 of this regulation) may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

2. The amount of this capital that will be recognized in consolidated Total Capital in accordance with paragraph 1 of this article will be calculated as follows:
 - 2.1 Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.
 - 2.2 Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of:
 - 2.2.1 the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (i.e. 12.0% of risk weighted assets) and
 - 2.2.2 the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (i.e. 12.0% of consolidated risk weighted assets) that relates to the subsidiary.
 - 2.3 The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.
3. The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 under Article 17 of this regulation and amounts recognized in Additional Tier 1 under Article 18 of this regulation.
4. Where capital has been issued to third parties out of a special purpose vehicle (SPV), none of this capital can be included in Common Equity Tier 1.
5. The capital prescribed in paragraph 4 above, can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the bank itself had issued the capital directly to the third parties, only if it meets all the relevant entry criteria and the only asset of the SPV is its investment in the capital of the bank in a form that meets or exceeds all the relevant entry criteria (as required by criterion in point 1.14 for Additional Tier 1 in Article 10 and criterion in point 1.9 for Tier 2 in Article 13 of this regulation).
6. In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the bank, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may be included in the bank's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in Article 18 and Article 19 of this regulation.

Article 20

Additional value adjustments

Banks shall apply the requirements for prudent valuation to all their assets in the trading book measured at fair value when calculating the amount of their own funds and shall deduct from Common Equity Tier 1 capital the amount of any additional value adjustments necessary.

Article 21
Regulatory Adjustments

Adjustments set out in Article 22 to 29 of this regulation are applied in the calculation of Common Equity Tier 1.

Article 22
Losses for the current financial year

Banks shall deduct losses for the current financial year from Common Equity Tier 1.

Article 23
Goodwill and other intangibles (except mortgage servicing rights)

1. Goodwill and all other intangibles must be deducted in the calculation of Common Equity Tier 1, including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation.
2. With the exception of mortgage servicing rights, the full amount is to be deducted net of any associated deferred tax liability which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards.
3. The amount to be deducted in respect of mortgage servicing rights is set out in Article 34 “threshold deductions” below.

Article 24
Deferred tax assets

1. Deferred tax assets (DTAs) that rely on future profitability of the bank to be realized are to be deducted in the calculation of Common Equity Tier 1.
2. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority.
3. Where these DTAs in paragraph 1 above relate to temporary differences, the amount to be deducted is set out in Article 34 “threshold deductions” of this regulation. All other such assets are to be deducted in full net of deferred tax liabilities as described above.
4. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the treatment according to Article 34 “threshold deduction” and DTAs that are to be deducted in full.

Article 25
Cash flow hedge reserve

1. The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of Common Equity Tier 1.
2. Positive amounts in paragraph 1 of this article should be deducted and negative amounts should be added back.
3. The treatment according to paragraph 1 and 2 of this article specifically identifies the element of cash flow hedge reserve that is to be derecognized for prudential purposes.

Article 26
Shortfall of the stock of provisions to expected losses

1. The deduction from capital in respect of a shortfall of the stock of provisions to expected losses under the IRB approach should be made in the calculation of Common Equity Tier 1.
2. For provisions referred to in paragraph 1 of this article the full amount is to be deducted and should not be reduced by any tax effects that could be expected to occur if provisions were to rise to the level of expected losses.

Article 27
Gain on sale related to securitization transactions

Banks shall derecognize in the calculation of Common Equity Tier 1 any increase in equity capital resulting from a securitization transaction, such as that associated with expected future margin income (FMI) resulting in a gain-on-sale.

Article 28
Cumulative gains and losses due to changes in own credit risk of the bank on fair valued financial liabilities

Banks shall derecognize in the calculation of Common Equity Tier 1, all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

Article 29
Defined benefit pension fund assets and liabilities

1. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of Common Equity Tier 1 (Common Equity Tier 1 cannot be increased through derecognizing these liabilities).

2. For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or derecognized under the relevant accounting standards.

Article 30
Investments in own shares (treasury stock)

1. Banks shall deduct all of their investments in their own common shares, whether held directly or indirectly in the calculation of Common Equity Tier 1 (unless already derecognized under the relevant accounting standards). In addition, any own stock which the bank could be contractually obliged to purchase should be deducted in the calculation of Common Equity Tier 1.

2. The treatment described in paragraph 1 of this article will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:

2.1 Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.

2.2 Banks should look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short position in own shares resulting from short positions in the same underlying index. In such cases the short positions may involve counterparty risk (which will be subject to the relevant counterparty credit risk charge).

3. Following the same approach outlined in paragraph 2 above, banks must deduct investments in their own Additional Tier 1 in the calculation of their Additional Tier 1 capital and must deduct investments in their own Tier 2 in the calculation of their Tier 2 capital.

Article 31
Reciprocal cross holdings in the capital of banking, financial and insurance entities

1. Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full.

2. Banks must apply a “corresponding deduction approach” to such investments in the capital of other banks, other financial institutions and insurance entities.

3. The deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself.

Article 32

Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than (5%) of the issued common share capital of the entity

1. The regulatory adjustment described in this article applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than (5%) of the issued common share capital of the entity. In addition:

- 1.1 Investments include direct, indirect and synthetic holdings of capital instruments.
- 1.2 Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments.
- 1.3 It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).
- 1.4 Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
- 1.5 If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.

2. If the total of all holdings listed above in paragraph 1 (excluding exposures to bank related persons), in aggregate exceed 10% of the bank's common equity (after applying all other regulatory adjustments in full listed prior to this one) then the amount above 10% is required to be deducted, applying a corresponding deduction approach.

3. The deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself.

4. The amount referred in paragraph 3 to be deducted from common equity should be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity.

5. The amount to be deducted from Additional Tier 1 capital should be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity multiplied by the Additional Tier 1 capital holdings as a percentage of the total capital holdings.

6. The amount to be deducted from Tier 2 capital should be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the Tier 2 capital holdings as a percentage of the total capital holdings.

7. If, under the corresponding deduction approach, a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital.
8. Amounts below the threshold, which are not deducted, will be risk weighted. Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book should be treated as per the internal ratings-based approach or the standardized approach (as applicable). For the application of risk weighting the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold.

Article 33

Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

1. The regulatory adjustment described in this article applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank owns more than (5%) of the issued common share capital of the issuing entity or where the entity is an affiliate of the bank. In addition:
 - 1.1 Investments include direct, indirect and synthetic holdings of capital instruments.
 - 1.2 Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments.
 - 1.3 It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).
 - 1.4 Underwriting positions held for five working days or less can be excluded.
 - 1.5 Underwriting positions held for longer than five working days must be included.
 - 1.6 If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.
2. All investments included above in paragraph 1 of this article (excluding exposures to bank related persons) that are not common shares must be fully deducted following a corresponding deduction approach. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it was issued by the bank itself. If the bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital (e.g. if a bank does not have enough Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1).
3. Investments included above in paragraph 1 that are common shares will be subject to the threshold treatment described in the Article 34.

Article 34
Threshold deductions

1. Instead of a full deduction, the following items may each receive limited recognition when calculating Common Equity Tier 1, with recognition capped at 10% of the bank's common equity (after the application of all regulatory adjustments set out in Article 31), collectively referred to as specified items:

1.1 Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) as referred to in Article 33;

1.2 Mortgage servicing rights (MSRs); and

1.3 DTAs that arise from temporary differences.

2. The amount of the three items in paragraph 1, point 1.1, 1.2 and 1.3 of this article, that are not deducted in the calculation of Common Equity Tier 1 will be risk weighted at 250%.

3. Banks must deduct the amount by which the aggregate of the three items above in paragraph 1 point 1.1, 1.2 and 1.3 of this article exceeds 15% of its common equity component of Tier 1 (calculated prior to the deduction of these items but after application of all other regulatory adjustments applied in the calculation of Common Equity Tier 1).

4. The amount of the three items that remains recognized after the application of all regulatory adjustments must not exceed 15% of the Common Equity Tier 1 capital.

5. To determine the maximum amount of the specified items that can be recognized, banks should multiply the amount of CET1 (after all deductions, including after the deduction of the specified items in full) by 17.65%.

6. The items included in the 15% aggregate limit are subject to full disclosure.

Article 35
Investments in equity of insurance entities

1. A Bank that owns an insurance subsidiary bears the full entrepreneurial risks of the subsidiary and should recognize on a group-wide basis the risks included in the whole group.

2. For calculating Common Equity Tier 1 banks should deduct all equity and other regulatory capital investments in insurance subsidiaries and also significant minority investments in insurance entities.

3. The bank should remove from its balance sheet assets and liabilities, as well as third party capital investments in an insurance subsidiary.

Article 36
Investments in equity of non-financial entities

1. For calculating Common Equity Tier 1, banks should deduct all equity interest in a legal entity that is engaged in activities other than financial activities if such interests:

- 1.1 Represent a greater than five percent (5%) interest in such legal entity;
- 1.2 Exceeds fifteen percent (15%) of the bank's regulatory capital;
- 1.3 When aggregated with all such equity interests held by the bank in non-financial companies, exceeds twenty five percent (25%) of the bank's regulatory capital.

Article 37
Minimum requirements to ensure loss absorbency at the point of non-viability

1. Additional Tier 1 and Tier 2 capital instruments should fully absorb losses at the point of non-viability of the issuing bank.
2. The point of non-viability should be understood as the point at which CBK determines that the bank meets the conditions for resolution or the point at which the CBK decides that the bank would cease to be viable if those capital instruments were not written down or converted.
3. The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by banks must have a provision that requires such instruments, at the option of the CBK, to either be written off or converted into common equity upon the occurrence of the trigger event.
4. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock.
5. The issuing banks must maintain at all times all prior authorization necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.
6. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Article 38
Capital Planning

The CBK requires banks to develop an internal process for capital adequacy planning in relation to their risk profiles, which continuously presents the adequate level of capital, estimated by the bank. The bank's internal process for planning the adequacy level of capital will be subject to CBK assessment.

Article 39
Disclosure requirements

1. To help improve transparency of regulatory capital and improve market discipline, banks are required to disclose the following:
 - 1.1 a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements;
 - 1.2 separate disclosure of all regulatory adjustments and the items not deducted from Common Equity Tier 1 according to Article 32;
 - 1.3 a description of all limits and minimum requirements, identifying the positive and negative elements of capital to which the limits and minimum requirements apply;
 - 1.4 a description of the main features of capital instruments issued;
 - 1.5 banks which disclose ratios involving components of regulatory capital, must accompany such disclosures with a comprehensive explanation of how these ratios are calculated.
2. Banks are also required to make available on their websites the full terms and conditions of all instruments included in regulatory capital.

CHAPTER III

RISK WEIGHTED EXPOSURE AMOUNTS FOR CREDIT RISK

Article 40
General provisions

1. This chapter sets out the rules for the calculation of capital requirements for credit risk under the Standardized Approach for banks. It sets out:
 - 1.1 the determination of exposure value,
 - 1.2 the definition of exposure classes and
 - 1.3 the calculation of risk-weighted exposure amounts;
2. Banks must use the Standardized Approach to calculate capital requirements for credit risk.
3. The capital requirements for credit risk is calculated at least in the amount of 12% of the total of risk-weighted exposure amounts calculated in accordance with the provisions of Article 43 of this Regulation.
4. Risk-weighted exposure amounts for credit risk represent the sum of the value of the balance-sheet assets positions and off-balance sheet items multiplied by relevant credit risk weights.
5. For the purpose of calculating risk-weighted exposure amounts, banks must use credit assessments of an eligible External Credit Assessment Institution (ECAI) or eligible Export

Credit Agency (ECA) according to the provisions stipulated in the Regulation on the use of External Credit Assessments for the purpose of calculation the Regulatory Capital.

Article 41 **Exposure value**

1. The exposure value of an asset item shall be its accounting value remaining after specific credit risk adjustments (after deduction of specific reserve amount, collateral amount or any other deduction), related to the asset item have been applied.
2. The exposure value of an off-balance sheet item listed in Annex 1 of this regulation shall be the following percentage of its nominal value after reduction of specific credit risk adjustments (after deduction of specific reserve amount, collateral amount or any other deduction) :
 - 2.1 100 % if it is a full-risk item;
 - 2.2 50 % if it is a medium-risk item;
 - 2.3 20 % if it is a medium/low-risk item;
 - 2.4 0 % if it is a low-risk item.
3. The off-balance sheet items referred to in the second paragraph of this article shall be assigned to risk categories as indicated in Annex I.
4. Where an exposure is subject to funded credit protection, the exposure value applicable to that item may be amended in accordance with Chapter IV of this regulation.
5. The exposure value shall be determined in compliance with Regulation on Reporting of Banks to the CBK.

Article 42 **Exposure classes**

1. For the purposes of calculating risk-weighted exposure amounts, a bank must classify each exposure, unless deducted from own funds, to one of the following exposure classes:
 - 1.1 exposures to central governments or central banks;
 - 1.2 exposures to regional governments or local authorities;
 - 1.3 exposures to public sector entities;
 - 1.4 exposures to multilateral development banks;
 - 1.5 exposures to international organizations;

- 1.6 exposures to institutions;
- 1.7 exposures to corporates;
- 1.8 retail exposures;
- 1.9 exposures secured by mortgages on immovable property;
- 1.10 exposures in default;
- 1.11 exposures associated with particularly high risk;
- 1.12 exposures to institutions and corporates with a short-term credit assessment;
- 1.13 exposures in the form of investment funds;
- 1.14 equity exposures;
- 1.15 other items.

Article 43

Calculation of risk weighted exposure amounts

1. To calculate risk-weighted exposure amounts, risk weights shall be applied to all exposures, unless deducted from own funds, in accordance with Article 44 to 58 of this regulation. The application of risk weights shall be based on the exposure class to which the exposure is assigned and, to the extent specified in this chapter, its credit quality. Credit quality may be determined by reference to the credit assessments of External Credit Assessment Institutions (ECAI) or the credit assessments of Export Credit Agencies (ECA) in accordance with the Regulation on the use of external credit assessments for the purpose of calculation of the regulatory capital.
2. For the purposes of applying a risk weight, as referred to in paragraph 1, the exposure value shall be multiplied by the risk weight specified or determined in this Chapter.
3. Where an exposure is subject to credit protection the risk weight applicable to that item may be amended in accordance with Chapter IV of this regulation.
4. Exposures for which no calculation is provided in this Chapter shall be assigned a risk-weight of 100 %.

Article 44

Exposures to central governments or central banks

1. Banks shall assign a 100% risk weight for Exposures to central governments or central banks, unless the treatments set out in paragraphs 2 to 6 apply.
2. Exposures to central governments and central banks for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 1, of this Article, which corresponds to the credit assessment of the ECAI.
3. Exposures to the ECB shall be assigned a 0 % risk weight.
4. Exposures to the Government of the Republic of Kosovo shall be assigned a 0% risk weight.

5. Exposures to the Central Bank of the Republic of Kosovo shall be assigned a 0% risk weight.
6. Exposures to central governments and central banks for which a credit assessment by a nominated ECAI is not available or is not carried out, shall be assigned a risk weight according to Table 2 of this article which corresponds to the credit assessment of the Export Credit Agency recognized by the Central Bank of the Republic of Kosovo.

Table 1.

Credit quality step	1	2	3	4	5	6
Risk weight	0%	20%	50%	100%	100%	150%

Table 2.

Credit quality level - ECA	0	1	2	3	4	5	6	7
Risk weight	0%	0%	20%	50%	100%	100%	100%	150%

Article 45

Exposures to regional governments or local authorities

1. For the purpose of this Regulation, regional governments and local authorities shall be considered the following:
 - 1.1 in the Republic of Kosovo: local municipalities and funds established and financed at local levels;
 - 1.2 in other countries: units of regional governments and local authorities treated as regional government or local authority units under the regulations of those countries governing banks' operations.
2. Exposures to regional governments or local authorities shall be risk-weighted as exposures to institutions (preferential treatments for short-term claims shall not be used).
3. Exposures to regional governments or local authorities with prior approval of CBK, shall be treated as exposures to central governments or central banks in whose jurisdiction they are established where there is no difference in risk between such exposures because of the specific revenue-raising powers of the former, and the existence of specific institutional arrangements the effect of which is to reduce their risk of default.
4. Notwithstanding paragraphs 2 and 3 of this article, exposures to local authorities established in the Republic of Kosovo shall be assigned a risk weight of 0%.

Article 46

Exposures to public sector entities (PSEs)

1. For the purpose of this Regulation, public sector entities shall be administrative bodies accountable to central governments, regional government and local authority units and state-owned non-profit legal persons which obligations are guaranteed by the state.
2. Exposures to public sector entities for which a credit assessment by a nominated ECAI is not available shall be assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the public sector entity is incorporated are assigned in accordance with Table 3 of this article:

Table 3.

Credit quality step to which central government is assigned	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	100%	150%

3. For exposures to public sector entities incorporated in countries where the central government is unrated, the risk weight shall be 100 %.
4. Exposures to public sector entities for which a credit assessment by a nominated ECAI is available shall be treated as exposures to institutions (preferential treatments for short-term claims shall not be used).
5. Exposures to public sector entities established in the Republic of Kosovo shall be assigned a risk weight of 20%.
6. In exceptional circumstances, with prior approval of CBK, exposures to public-sector entities may be treated as exposures to the central government, regional government or local authority in whose jurisdiction they are established where in the opinion of the competent authorities of this jurisdiction there is no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government, regional government or local authority.
7. Notwithstanding the above paragraphs, exposures to public sector entities with an original maturity of three months or less, the risk weight shall be 20 %.

Article 47

Exposures to multilateral development banks

1. Exposures to multilateral development banks that are not referred to in paragraph 3 of this article shall be treated in the same manner as exposures to institutions (preferential treatments for short-term claims shall not be used).
2. The Inter-American Investment Corporation, the Black Sea Trade and Development Bank, the Central American Bank for Economic Integration and the CAF-Development Bank of Latin America shall be considered multilateral development banks.
3. Exposures to the following multilateral development banks shall be assigned a 0 % risk weight:
 - 3.1 the International Bank for Reconstruction and Development;
 - 3.2 the International Finance Corporation;
 - 3.3 the Inter-American Development Bank;
 - 3.4 the Asian Development Bank;
 - 3.5 the African Development Bank;
 - 3.6 the Council of Europe Development Bank;
 - 3.7 the Nordic Investment Bank;
 - 3.8 the Caribbean Development Bank;
 - 3.9 the European Bank for Reconstruction and Development;
 - 3.10 the European Investment Bank;
 - 3.11 the European Investment Fund;
 - 3.12 the Multilateral Investment Guarantee Agency;
 - 3.13 the International Finance Facility for Immunisation;
 - 3.14 the Islamic Development Bank.
4. A risk weight of 20 % shall be assigned to the portion of unpaid capital subscribed to the European Investment Fund.

Article 48

Exposures to international organisations

1. Exposures to the following international organisations shall be assigned a 0 % risk weight:
 - 1.1 the European Union;
 - 1.2 the International Monetary Fund;
 - 1.3 the Bank for International Settlements;

Article 49
Exposures to institutions¹

1. Exposures to rated institutions

1.1 Exposures to institutions with a residual maturity of more than three months for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 4 of this article which corresponds to the credit assessment of the ECAI.

Table 4.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	50%	100%	100%	150%

1.2 Exposures to an institution of up to three months residual maturity for which a credit assessment by a nominated ECAI is available shall be assigned a risk-weight according to Table 5 of this article which corresponds to the credit assessment of the ECAI.

Table 5.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	20%	20%	50%	50%	150%

1.3 The interaction between the treatment of short term credit assessment under Article 55 and the general preferential treatment for short term exposures set out in paragraph 2 shall be as follows:

1.3.1 If there is no short-term exposure assessment, the general preferential treatment for short-term exposures as specified in paragraph 2 shall apply to all exposures to institutions of up to three months residual maturity;

1.3.2 If there is a short-term assessment and such an assessment determines the application of a more favorable or identical risk weight than the use of the general preferential treatment for short-term exposures, as specified in paragraph 2, then the short-term assessment shall be used for that specific exposure only. Other short-term exposures shall follow the general preferential treatment for short-term exposures, as specified in paragraph 2;

1.3.3 If there is a short-term assessment and such an assessment determines a less favorable risk weight than the use of the general preferential treatment for short-

¹ "institutions" are credit institutions and investment firms.

term exposures, as specified in paragraph 2, then the general preferential treatment for short-term exposures shall not be used and all unrated short-term claims shall be assigned the same risk weight as that applied by the specific short-term assessment.

2. Exposures to unrated institutions

2.1 Exposures to institutions for which a credit assessment by a nominated ECAI is not available shall be assigned a risk weight according to the credit quality step to which exposures to the central government of the jurisdiction in which the institution is incorporated are assigned in accordance with Table 6.

Table 6.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	100%	150%

2.2 Exposures to unrated institutions incorporated in countries where the central government is unrated, the risk weight shall be 100 %.

2.3 Exposures to unrated institutions with an original effective maturity of three months or less, the risk weight shall be 20 %.

2.4 Notwithstanding point 2.2 of this paragraph, exposures to banks which are licensed and supervised by the CBK with residual maturity up to one year shall be risk weighted 20%.

Article 50

Exposures to corporates

- Exposures for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 7 of this article which corresponds to the credit assessment of the ECAI.
- Exposures for which such a credit assessment is not available shall be assigned a 100 % risk weight or the risk weight of exposures to the central government of the jurisdiction in which the corporate is incorporated, whichever is the higher.

Table 7.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

Article 51
Retail exposures

1. Exposures that comply with the following criteria shall be assigned a risk weight of 75 %:
 - 1.1 the exposure shall be either to a natural person or persons, or to a small or medium-sized enterprise (SME);
 - 1.2 the exposure shall be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced;
 - 1.3 no aggregate exposure to one counterpart (borrower) or group of connected counterparties cannot exceed 0.2% of the retail portfolio, or an absolute threshold of 100,000 Euro.
2. Securities shall not be eligible for the retail exposure class.
3. Mortgage loans are excluded to the extent that they qualify for treatment as exposures secured by residential or commercial property.
4. Exposures that do not comply with the criteria referred to in points 1.1 to 1.3 of the first paragraph of this article shall be risk weighted with 100% risk weight in the retail exposures class.

Article 52
Exposures secured by mortgages on immovable property

1. Exposures secured by mortgages on immovable property shall be assigned a risk weight of 100% except exposures in paragraphs 2 to 4 of this article.
2. A 35% risk weight shall be assigned to qualifying residential mortgage loan Category – A as specified with the CBK regulation on Residential Mortgage Loans.
3. A 50% risk weight shall be assigned to qualifying residential mortgage loan Category – B as specified with the CBK regulation on Residential Mortgage Loans.
4. A 75% risk weight shall be assigned to Loans or the portions thereof supported by collateral in the form of first lien residential mortgages whose underlying indebtedness is not more than 30 days past due (if a loan is more than 30 day past due, than whole exposure of the same customer should be weighted same as the loan with the exception for cash covered loans and if the source of payment for other exposures are different from the one for the loan), subject to the following conditions:

4.1 Ownership of residential property must be verified and documented;

4.2 Maximum current loan-to-value cannot exceed sixty-five (65%) percent; and

4.3 Market value of mortgaged property must be supported by an independent assessment of value, which can be in the form of an appraisal conducted by a qualified real property appraiser, in accordance with the regulation, issued by CBK, on Appraisal of Immovable Properties.

5. Exposures secured by commercial property shall be assigned a risk weight of 100%.

Article 53

Non-performing exposures

1. Non-performing exposures are exposures which are determined in the Regulation on Credit Risk Management.

2. The unsecured part of any exposure that is past due for more than 90 days, net of specific provisions shall be risk weighted 100 %.

3. For the purpose of determining the secured part of the non-performing exposure, eligible collateral and guarantees shall be those eligible for credit risk mitigation.

Article 54

Exposures associated with particularly high risk

1. Banks shall assign a 150% risk weight to exposures that are associated with particularly high risks, where appropriate.

2. Exposures with particularly high risks shall include any of the following:

2.1 investments in venture capital firms;

2.2 speculative immovable property financing;

2.3 other exposures which CBK considers with particularly high risks.

3. When assessing whether an exposure other than exposures referred to in the paragraph 2 is associated with particularly high risks, institutions shall take into account the following risk characteristics:

- 3.1 there is a high risk of loss as a result of a default of the obligor;
- 3.2 it is impossible to assess adequately whether the exposure falls under point 3.1 of this paragraph.

Article 55

Exposures to institutions and corporates with a short-term credit assessment

Exposures to institutions and exposures to corporates for which a short-term credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 8 which corresponds to the credit assessment of the ECAI.

Table 8.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	150%	150%	150%

Article 56

Exposures in the form of investment funds

- 1. Risk weights shall be assigned to exposures in investment funds for which the long-term credit assessment of a nominated ECAI is available in accordance with Table 9 in this paragraph.

Table 9.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

- 2. A risk weight of 100% shall be assigned to exposures in investment funds for which the long-term credit assessment of a nominated ECAI is not available.

Article 57

Equity exposures

- 1. The following exposures shall be considered equity exposures:
 - 1.1 non-debt exposures conveying a subordinated, residual claim on the assets or income of the issuer;

- 1.2 debt exposures and other securities, partnerships, derivatives, or other vehicles, the economic substance of which is similar to the exposures specified in point 1.1.
2. Equity exposures shall be assigned a risk weight of 100 %, unless they are required to be deducted from regulatory capital.
3. Investments in equity or regulatory capital instruments issued by institutions shall be classified as equity exposures, unless deducted from regulatory capital or treated as high risk items in accordance with Article 54 of this regulation.

Article 58
Other items

1. Tangible assets, such as commercial properties/premises, factories, equipment, other fixed assets and other real estate claimed as a result of foreclosures or other takings of land or buildings as a result of credit defaults, shall be assigned a risk weight of 100%.
2. Prepayments and accrued income for which a bank is unable to determine the counterparty shall be assigned a risk weight of 100%.
3. Cash items in the process of collection shall be assigned a 20 % risk weight.
4. Cash in hand and equivalent cash items shall be assigned a 0 % risk weight.
5. Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities shall be assigned a 0 % risk weight.
6. Exposures, for which the manner of credit risk weighting is not provided within this Regulation, shall be assigned as the other items and risk weighted 100%.
7. Claims for the funds which are fully established by one or more central governments, central banks, multilateral development banks, or entities of public sector rated assigned as risk-weighted according to the jurisdiction where established, to which shall be applied 0% risk weight as per the requirements of this regulation. The only source of these funds shall be the payment funds from the abovementioned institutions in form of participation, excluding any other fund financed through debts.
8. Claims on Kosovo Credit Guarantee Fund shall be assigned a 0% risk weight for the guaranteed part of the exposure.

CHAPTER IV

CREDIT RISK MITIGATION

Article 59

General Requirements

Principles for recognizing the effect of credit risk mitigation techniques

1. When determining the risk weights, banks may use a number of techniques to mitigate the credit risks to which they are exposed. Exposure may be collateralized in whole or in part with cash or securities, or an exposure guaranteed by a third party.
2. Where these various techniques meet the operational requirements set out below, the CBK may recognize credit risk mitigation (CRM).
3. The framework set out in this chapter is applicable to the banking book exposures under the standardized approach.
4. No exposure in respect of which a bank obtains credit risk mitigation shall produce a higher risk-weighted exposure amount or expected loss amount than an otherwise identical exposure in respect of which a bank has no credit risk mitigation.
5. The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on exposures for which an issue-specific rating is used that already reflects that CRM. Principal-only ratings will also not be allowed within the framework of CRM.
6. Although banks use CRM techniques to reduce their credit risk, these techniques give rise to risks (residual risks) which may render the overall risk reduction less effective. Where these risks are not adequately controlled, CBK may impose additional capital charges or take other supervisory actions in accordance with the legal and regulatory framework.
7. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks to the bank, such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile.
8. Where a bank calculating risk-weighted exposure amounts under the Standardized Approach has more than one form of credit risk mitigation covering a single exposure it shall do both of the following:

- 8.1 subdivide the exposure into parts covered by each type of credit risk mitigation tool;
- 8.2 calculate the risk-weighted exposure amount for each part obtained in point 8.1 separately in accordance with the risk weights determined in Chapter III of this regulation.
9. Where the amount collateralised or guaranteed (or against which credit protection is held) is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, i.e. the bank and the guarantor share losses on a pro-rata basis, capital relief will be afforded on a proportional basis, i.e. the protected portion of the exposure will receive the treatment applicable to the collateral or counterparty, with the remainder treated as unsecured.
10. A collateralized transaction is one in which:
- 10.1 Banks have a credit exposure or potential credit exposure; and
 - 10.2 that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by the counterparty or by a third party on behalf of the counterparty.
11. Under the standardized approach for credit risk, only the CRM simple approach from the standardized approach will apply, which, substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralized portion of the exposure (generally subject to a 20% floor). The 20% floor for the risk weight on a collateralized transaction does not apply and a 0% risk weight may be applied where the exposure and the collateral are denominated in the same currency, and either:
- 11.1 the collateral is cash on deposit, or
 - 11.2 the collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.
12. Partial collateralisation is recognized by CBK. Mismatches in the maturity or currency of the underlying exposure and the collateral will not be allowed.

Article 60

Principles governing the eligibility of credit risk mitigation techniques

1. The technique used to provide the credit protection together with the actions and steps taken, and procedures and policies implemented by the bank shall be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.
2. In order for banks to obtain capital relief, all documentation used in collateralized transactions and for documenting guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.

3. Banks shall take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address the risks related to that arrangement.

4. To modify the risk weighted exposure amounts for credit risk by the effects of risk mitigation techniques, banks may use the following credit protection instruments:

4.1 Funded credit protection instruments, which includes financial collateral, and

4.2 Unfunded credit protection instruments, which includes guarantees and counter-guarantees.

5. Banks may recognize funded credit protection in the calculation of the effect of credit risk mitigation only where the assets relied upon for protection meet both of the following conditions:

5.1 they are included in the list of eligible assets set out in Article 61 of this regulation, as applicable;

5.2 they are sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed.

6. Banks may recognize funded credit protection in the calculation of the effect of credit risk mitigation only where they have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy — or other credit event set out in the transaction documentation — of the obligor and, where applicable, of the custodian holding the collateral. The degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be too high.

7. In the case of unfunded credit protection, a protection provider shall qualify as an eligible protection provider only where the protection provider is included in the list of eligible protection providers set out in Article 62 of this regulation.

8. In the case of unfunded credit protection, a protection agreement shall qualify as an eligible protection agreement only where it meets both the following conditions:

8.1 it is included in the list of eligible protection agreements set out in Article 62 of this regulation;

8.2 it is legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach

used to calculate risk-weighted exposure amounts and to the degree of recognition allowed;

8.3 the protection provider meets the criteria laid down in Article 64 of this regulation.

9. Credit protection shall comply with the requirements set out in Article 63 and Article 64 of this regulation, as applicable.

10. Banks shall be able to demonstrate to the CBK that they have adequate risk management processes to control those risks to which it may be exposed as a result of carrying out credit risk mitigation.

11. Notwithstanding the fact that credit risk mitigation has been taken into account for the purposes of calculating risk-weighted exposure amounts and, where applicable, expected loss amounts, banks shall continue to undertake a full credit risk assessment of the underlying exposure and be in a position to demonstrate the fulfilment of this requirement to the CBK.

Article 61 **Funded Credit Protection** **Financial Collateral**

1. Banks may use the following items as eligible financial collateral:

- 1.1 Cash (as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank;
- 1.2 Debt securities issued by the Government of the Republic of Kosovo
- 1.3 Debt securities issued by central governments or central banks, which securities have a credit assessment by an ECAI or export credit agency recognized as eligible for the purposes determining risk weights in accordance with chapter III of this regulation which is determined by CBK to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to central governments and central banks under Article 44 of this regulation.

Article 62 **Unfunded Credit Protection** **Guarantees and Counter-guarantees**

1. Banks may use the following parties as eligible providers of unfunded credit protection:

- 1.1 central governments and central banks which have a credit assessment by an ECAI or export credit agency recognised as eligible for the purposes determining risk weights

- in accordance with Chapter III of this regulation, which is determined by CBK to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to central governments and central banks under Article 44;
- 1.2 the Government of the Republic of Kosovo;
 - 1.3 multilateral development banks assigned 0% risk weight;
 - 1.4 international organisations which are treated with 0% risk weight under Article 48 of Chapter III of this regulation;

Article 63

Requirements for financial collateral

1. Financial collateral shall qualify as eligible collateral where all the requirements laid down in paragraphs 2 to 4 of this Article are met.
2. The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. Where the value of the collateral is reduced significantly, this shall not alone imply a significant deterioration of the credit quality of the obligor. Where the credit quality of the obligor becomes critical, this shall not alone imply a significant reduction in the value of the collateral. Securities issued by the obligor, or any related group entity, shall not qualify as eligible collateral.
3. Banks shall fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of the collateral arrangements under the law applicable to their interest in the collateral. Banks shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions. They shall re-conduct such review as necessary to ensure continuing enforceability.
4. Banks shall fulfil all the following operational requirements:
 - 4.1 they shall properly document the collateral arrangements and have in place clear and robust procedures for the timely liquidation of collateral;
 - 4.2 they shall use robust procedures and processes to control risks arising from the use of collateral, including risks of failed or reduced credit protection, valuation risks, risks associated with the termination of the credit protection, concentration risk arising from the use of collateral and the interaction with the bank's overall risk profile;
 - 4.3 they shall have in place documented policies and practices concerning the types and amounts of collateral accepted;
 - 4.4 they shall calculate the market value of the collateral, and revalue it accordingly, at least once every six months and whenever they have reason to believe that a significant decrease in the market value of the collateral has occurred;

4.5 where the collateral is held by a third party, they shall take reasonable steps to ensure that the third party segregates the collateral from its own assets;

4.6 they shall have in place collateral management policies to control, monitor and report the following:

4.6.1 the concentration risk to particular types of collateral assets;

4.6.2 the reuse of collateral including the potential liquidity shortfalls resulting from the reuse of collateral received from counterparties;

4.6.3 the surrender of rights on collateral posted to counterparties.

5. In addition to meeting all the requirements set out in paragraphs 2 to 4 of this article, for financial collateral to qualify as eligible collateral under the Financial Collateral Simple Method the residual maturity of the protection shall be at least as long as the residual maturity of the exposure.

Article 64

Requirements common to guarantees

1. Credit protection deriving from a guarantee shall qualify as eligible unfunded credit protection where all the following conditions are met:

1.1 the credit protection is direct;

1.2 the extent of the credit protection is clearly defined and incontrovertible;

1.3 the credit protection contract does not contain any clause, the fulfilment of which is outside the direct control of the lender, that:

1.3.1 would allow the protection provider to cancel the protection unilaterally;

1.3.2 would increase the effective cost of protection as a result of a deterioration in the credit quality of the protected exposure;

1.3.3 could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due;

1.3.4 could allow the maturity of the credit protection to be reduced by the protection provider;

1.4 the credit protection contract is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

2. A bank shall demonstrate to CBK that it has in place systems to manage potential concentration of risk arising from its use of guarantees. A bank shall be able to demonstrate to the satisfaction of

the CBK how its strategy in respect of its use of guarantees interacts with its management of its overall risk profile.

3. A bank shall fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of its unfunded credit protection.

4. A bank shall have conducted sufficient legal review confirming the enforceability of the unfunded credit protection in all relevant jurisdictions. It shall repeat such review as necessary to ensure continuing enforceability.

Article 65

Sovereign counter-guarantees

1. Banks may treat the exposures referred to in paragraph 2 of this Article as protected by a guarantee provided by the entities listed in that paragraph, provided all the following conditions are satisfied:

1.1 the counter-guarantee covers all credit risk elements of the claim;

1.2 both the original guarantee and the counter-guarantee meet the requirements for guarantees set out in Articles 64 and 66 (paragraph 1), except that the counter-guarantee need not be direct;

1.3 the cover is robust and nothing in the historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct guarantee by the entity in question.

2. The treatment set out in paragraph 1 shall apply to exposures protected by a guarantee which is counter-guaranteed by any of the following entities:

2.1 central governments and central banks which have a credit assessment by an ECAI or export credit agency recognized as eligible for the purposes determining risk weights in accordance with Chapter III of this regulation, which is determined by CBK to be associated with credit quality step 2 or above under the rules for the risk weighting of exposures to central governments and central banks under Article 44 of this regulation;

2.2 the Government of the Republic of Kosovo;

2.3 multilateral development banks assigned 0% risk weight;

2.4 international organisations which are treated with 0% risk weight under Article 48 of chapter III of this regulation;

3. Banks shall apply the treatment set out in paragraph 1 also to an exposure which is not counter-guaranteed by any entity listed in paragraph 2 where that exposure's counter-guarantee is in turn directly guaranteed by one of those entities and the conditions listed in paragraph 1 are satisfied.

Article 66

Additional requirements for guarantees

1. Guarantees shall qualify as eligible unfunded credit protection where all the conditions in Article 64 and all the following conditions are met:

1.1 on the qualifying default of or non-payment by the counterparty, a bank has the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided and the payment by the guarantor shall not be subject to the bank first having to pursue the obligor;

1.2 the guarantee is an explicitly documented obligation assumed by the guarantor;

1.3 either of the following conditions is met:

1.3.1 the guarantee covers all types of payments the obligor is expected to make in respect of the claim;

1.3.2 where certain types of payment are excluded from the guarantee, a bank has adjusted the value of the guarantee to reflect the limited coverage.

2. In the case of guarantees provided in the context of mutual guarantee schemes or provided by or counter-guaranteed by entities listed in Article 65 paragraph 2, the requirements in point 1.3.1 of paragraph 1 of this Article shall be considered to be satisfied where either of the following conditions is met:

2.1 a bank has the right to obtain in a timely manner a provisional payment by the guarantor that meets both the following conditions:

2.1.1 it represents a robust estimate of the amount of the loss, including losses resulting from the non-payment of interest and other types of payment which the borrower is obliged to make, that a bank is likely to incur;

2.1.2 it is proportional to the coverage of the guarantee;

2.2 a bank can demonstrate to the satisfaction of the CBK that the effects of the guarantee, which shall also cover losses resulting from the non-payment of interest and other types of payments which the borrower is obliged to make, justify such treatment.

CHAPTER V
ON THE CALCULATION OF CAPITAL REQUIREMENTS FOR MARKET RISK

Article 67
Trading book²

1. When calculating the capital requirements for covering risks, a bank should divide its positions in the trading book and banking book.
2. In order to be included in the trading book, the positions in the financial instruments and commodities must be released from any restrictive provisions that limit their availability for trade or protect their value.

Article 68
Trading intent

1. Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations. The term ‘positions’ should include proprietary positions and positions arising from client servicing and market making. Positions/portfolios held with trading intent should comply with the following requirements:

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

1.2 there must be clearly defined policies and procedures for the active management of the positions, which should include the following:

1.2.1 positions managed on a trading desk;

1.2.2 position limits are set and monitored for appropriateness;

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

1.2.4 positions are reported to senior management as an integral part of the bank's risk management process; and

1.2.5 positions are actively monitored with reference to reliable 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

² The holding of non-trading-book positions in financial instruments in order to invest own funds shall not be considered.

inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and

- 1.2.6 there must be clearly defined policy and procedures to monitor the position against the bank's trading strategy including the monitoring of turnover and stale positions in the bank's trading book.
2. CBK may request the exclusion from the trading book of those items, whose tradability, currently or for a long time, is not evident (e.g. lack of liquidity and tradability), especially if the holding period intention of such instruments is longer than that qualifying for the short term trade purpose.
3. CBK may suspend the inclusion in the trading book of those items for which banks do not have the necessary resources and experience to actively manage them, and where appropriate IT supported systems are missing.

Article 69

Systems and controls for management and valuation of the trading book

1. Banks should establish and maintain sufficient systems and controls to provide prudent and reliable valuation estimates, in their internal written procedures:
2. Systems and controls should include at least the following elements:
 - 2.1 documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, guidelines for the use of unobservable inputs reflecting the bank's assumptions of the approach market participants would use in pricing this unique position, frequency of independent valuation, procedures for adjusting valuations, month-end and ad-hoc verification procedures;
 - 2.2 reporting lines for the department accountable for the valuation process that are clear and independent of the front office.
 - 2.3 The reporting line should ultimately be to a main board executive director.
 - 2.4 The bank should designate a body or a person, depending on the size and the complexity of the bank's operations, which is directly responsible for market risks management.

Article 70
Valuation adjustments to trading book positions

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

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

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

4. The following requirements must be complied with when marking to model:
 - 4.1 senior management should be aware of the elements of the trading book or of other fair-valued positions which are subject to mark to model and should understand the materiality of the uncertainty thereby created in the reporting of the risk/performance of the business;
 - 4.2 market inputs should 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 should be assessed on a frequent basis;
 - 4.3 where available, valuation methodologies which are accepted market practice for particular financial instruments or commodities should be used;
 - 4.4 where the model is developed by the bank itself, it should be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;
 - 4.5 Banks should periodically examine the validity, and if necessary, improve the internal model of valuing positions in the trading book.
 - 4.6 there should be formal change control procedures in place and a secure copy of the model should be held and periodically used to check valuations;
 - 4.7 risk management should be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and

4.8 the model should 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).

5. 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.

6. Banks should establish and maintain procedures for considering valuation adjustments.

7. The CBK should require the following valuation adjustments to be formally considered:

- 7.1 unearned credit spreads,
- 7.2 close-out costs,
- 7.3 operational risks,
- 7.4 early termination,
- 7.5 investing and funding costs,
- 7.6 future administrative costs and,
- 7.7 where relevant, model risk.

8. Banks should establish and maintain procedures for calculating an adjustment to the current valuation of less liquid positions, which could arise from both market events and bank related situations (e.g. concentrated positions and/or static positions). Such adjustments should where necessary be in addition to any changes to the value of the position required for financial reporting purposes and should be designed to reflect the illiquidity of the position. Under those procedures, banks should consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. Those factors include:

- 8.1 the amount of time it would take to hedge out the position/risks within the position,
- 8.2 the volatility and average of bid/offer spreads,
- 8.3 the availability of market quotes (number and identity of market makers)
- 8.4 the volatility and average of trading volumes including trading volumes during periods of market stress,
- 8.5 market concentrations,
- 8.6 the aging of positions,

- 8.7 the extent to which valuation relies on marking-to-model, and
- 8.8 the impact of other model risks.

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

Article 71

Internal hedging

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 Articles 68, 69 and 70 of this Chapter are met. In particular:

- 1.1 internal hedges should not be primarily intended to avoid or reduce capital requirements;
- 1.2 internal hedges should be properly documented and subject to particular internal approval and audit procedures;
- 1.3 the internal transaction should be dealt with at market conditions;
- 1.4 the bulk of the market risk that is generated by the internal hedge should be dynamically managed in the trading book within the authorized limits; and
- 1.5 internal transactions should be carefully monitored. Thus, monitoring must be ensured by adequate, defined and approved 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. When a bank hedges a non-trading book credit risk exposure using a credit derivative booked in its trading book, the non-trading book exposure should not be deemed to be hedged for the purposes of calculating capital requirements unless the bank purchases from an eligible third party protection provider a credit derivative meeting the requirements.

Article 72

Capital requirement for market risk

1. The capital requirements for market risks shall be a sum of capital requirement for:

- 1.1 position risk in debt and equity instruments
- 1.2 foreign exchange risk
- 1.3 settlement risk and free deliveries
- 1.4 positions hedged by credit derivatives
- 1.5 commodities and
- 1.6 options

SUBCHAPTER I

CALCULATING OWN FUNDS REQUIREMENTS FOR POSITION RISK

Article 73

Own funds requirements for position risk

The bank's own funds requirement for position risk shall be the sum of the own funds requirements for the general and specific risk of its positions in debt and equity instruments.

Article 74

Netting

1. The absolute value of the excess of a bank's long (short) positions over its short (long) positions in the same equity, debt and convertible issues and identical financial futures, options, warrants and covered warrants shall be its net position in each of those different instruments. In calculating the net position, positions in derivative instruments may be treated as positions in the underlying (or notional) security or securities, in accordance with Articles 75 to 77 of this Chapter. Banks' holdings of their own debt instruments shall be disregarded in calculating specific risk.

2. No netting is allowed between a convertible and an offsetting position in the instrument underlying it.

3. All net positions, irrespective of their signs, must be converted on a daily basis into the bank's reporting currency at the prevailing spot exchange rate before their aggregation.

Article 75

Interest rate futures and forwards

1. Interest-rate futures, forward-rate agreements (FRAs) and forward commitments to buy or sell debt instruments shall be treated as combinations of long and short positions.
2. A long interest-rate futures position shall be treated as a combination of a borrowing maturing on the delivery date of the futures contract and a holding of an asset with maturity date equal to that of the instrument or notional position underlying the futures contract in question.
3. A sold FRA will be treated as a long position with a maturity date equal to the settlement date plus the contract period, and a short position with maturity equal to the settlement date.
4. Both the borrowing and the asset holding shall be included in the first category set out in Table 1 in Article 83 (see table 1 - Traded debt instruments) in order to calculate the own funds requirement for specific risk for interest-rate futures and FRAs.
5. A forward commitment to buy a debt instrument shall be treated as a combination of a borrowing maturing on the delivery date and a long (spot) position in the debt instrument itself. The borrowing shall be included in the first category set out in Table 1 in Article 83 for purposes of specific risk, and the debt instrument under whichever column is appropriate for it in the same table.
6. For the purposes of this Article, “long position” means a position in which a bank has fixed the interest rate it will receive at some time in the future, and “short position” means a position in which it has fixed the interest rate it will pay at some time in the future.

Article 76

Options and warrants

1. Options and warrants on interest rates, debt instruments, equities, equity indices, financial futures, swaps and foreign currencies shall be treated as if they were positions equal in value to the amount of the underlying instrument to which the option refers, multiplied by its delta for the purposes of this chapter. The latter positions may be netted off against any offsetting positions in the identical underlying securities or derivatives. The delta used shall be that of the exchange concerned.
2. For OTC-options, or where delta is not available from the exchange concerned, the bank may calculate delta itself using an appropriate model, subject to permission by CBK.

3. The permission shall be granted by CBK if the model appropriately estimates the rate of change of the option's or warrant's value with respect to small changes in the market price of the underlying.

4. Banks shall adequately reflect other risks, apart from the delta risk, associated with options in the own funds requirements.

Article 77

Swaps

Swaps shall be treated for interest-rate risk purposes on the same basis as on-balance-sheet instruments. Thus, an interest-rate swap under which a bank receives floating-rate interest and pays fixed-rate interest shall be treated as equivalent to a long position in a floating-rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed-rate instrument with the same maturity as the swap itself.

Article 78

Interest rate risk on derivative instruments

1. Banks treat as fully offsetting any positions in derivative instruments covered in Articles 75 to 77 of this regulation which meet the following conditions at least:

1.1 the positions are of the same value and denominated in the same currency;

1.2 the reference rate (for floating-rate positions) or coupon (for fixed-rate positions) is closely matched;

1.3 the next interest-fixing date or, for fixed coupon positions, residual maturity corresponds with the following limits:

1.3.1 less than one month hence: same day;

1.3.2 between one month and one year hence: within seven days;

1.3.3 over one year hence: within 30 days.

Article 79

Credit Derivatives

1. When calculating the own funds requirement for general and specific risk of the party who assumes the credit risk (the 'protection seller'), unless specified differently, the notional amount of the credit derivative contract shall be used. Notwithstanding the first sentence, the bank may elect to replace the notional value by the notional value plus the net market value change of the credit derivative since trade inception, a net downward change from the protection seller's perspective carrying a negative sign. For the purpose of calculating the specific risk charge, other than for total

return swaps, the maturity of the credit derivative contract, rather than the maturity of the obligation, shall apply. Positions are determined as follows:

- 1.1 a total return swap creates a long position in the general risk of the reference obligation and a short position in the general risk of a government bond with a maturity equivalent to the period until the next interest fixing and which is assigned a 0 % risk weight under the Standardized Approach for Credit Risk. It also creates a long position in the specific risk of the reference obligation;
 - 1.2 a credit default swap does not create a position for general risk. For the purposes of specific risk, the bank shall record a synthetic long position in an obligation of the reference entity, unless the derivative is rated externally and meets the conditions for a qualifying debt item, in which case a long position in the derivative is recorded. If premium or interest payments are due under the product, these cash flows shall be represented as notional positions in government bonds;
 - 1.3 a single name credit linked note creates a long position in the general risk of the note itself, as an interest rate product. For the purpose of specific risk, a synthetic long position is created in an obligation of the reference entity. An additional long position is created in the issuer of the note. Where the credit linked note has an external rating and meets the conditions for a qualifying debt item, a single long position with the specific risk of the note need only be recorded;
 - 1.4 in addition to a long position in the specific risk of the issuer of the note, a multiple name credit linked note providing proportional protection creates a position in each reference entity, with the total notional amount of the contract assigned across the positions according to the proportion of the total notional amount that each exposure to a reference entity represents. Where more than one obligation of a reference entity can be selected, the obligation with the highest risk weighting determines the specific risk;
2. For the party who transfers credit risk (the protection buyer), the positions are determined as the mirror principle of the protection seller, with the exception of a credit linked note (which entails no short position in the issuer). When calculating the own funds requirement for the “protection buyer”, the notional amount of the credit derivative contract shall be used. Notwithstanding the first sentence, the bank may elect to replace the notional value by the notional value plus the net market value change of the credit derivative since trade inception, a net downward change from the protection seller's perspective carrying a negative sign. If at a given moment there is a call option in combination with a step-up, such moment is treated as the maturity of the protection.

Article 80
Securities sold under a repurchase agreement or lent

The transferor of securities or guaranteed rights relating to title to securities in a repurchase agreement and the lender of securities in a securities lending shall include these securities in the calculation of its own funds requirement under this Chapter provided that such securities are trading book positions.

Article 81
Specific and general risks

1. The position risk on a traded debt instrument or equity (or debt or equity derivative) shall be divided into two components in order to calculate the capital required against it, for specific and general risk.
2. Specific-risk is the risk of a price change in the instrument concerned due to factors related to its issuer or, in the case of a financial derivative instrument, the issuer of the underlying instrument.
3. General risk is the risk of a price change in the instrument due (in the case of a traded debt instrument or debt derivative) to a change in the level of interest rates or (in the case of an equity or equity derivative) to a broad equity- market movement unrelated to any specific attributes of individual securities.

SUBCHAPTER II

TRADED DEBT INSTRUMENTS

Article 82
Calculation of capital requirement for position risk of debt instruments

1. Banks must classify its net positions in debt instruments according to the currency in which they are denominated. The capital requirement for general and specific risk must be calculated for the net position in each currency separately.
2. The capital requirement for position risk on debt instruments shall be calculated as the sum of the capital requirement for specific and general risk on the debt instruments.
3. Specific risk capital requirement for debt instruments shall be calculated in accordance with Articles 83 to 84 of this chapter.

4. Capital requirement for general risk on debt instruments shall be calculated in accordance with Article 85 of this chapter.

Article 83 **Specific risk**

1. Banks must classify all net positions in debt instruments into the appropriate debt instrument category from Table 1 on the basis of their issuer/obligor and their residual maturity. The classified net positions in debt instruments must then be multiplied by the weightings prescribed in accordance with Table 1 in this paragraph for the individual category of debt instrument to which they belong. Specific risk capital requirement for debt instruments shall be calculated as the sum of its weighted positions (regardless of whether they are long or short).

Table 1: Categories of debt instruments and prescribed weightings for the calculation of specific risk capital requirement (capital charge) for debt instruments

	Categories of debt instruments	Weightings for specific risk capital charge
1	Debt securities issued or guaranteed by central governments, issued by central banks, international organizations, multilateral development banks or Member States' regional governments or local authorities, and which would qualify for credit quality step 1 in accordance with the Standardized Approach for Credit Risk, or which would receive a 0% risk weight under the described rules.	0%
2	<p>Debt securities issued or guaranteed by central governments, or issued by central banks, international organizations, multilateral development banks or Member States' regional governments or local authorities, and which would qualify for credit quality step 2 or 3 in accordance with the Standardized Approach for Credit Risk.</p> <p>Debt securities issued or guaranteed by institutions and which would qualify for credit quality step 1 or 2 in accordance with the Standardized Approach for Credit Risk.</p> <p>Debt securities issued or guaranteed by institutions and which would qualify for credit quality step 3 in accordance with Article 18 of the Standardized Approach for Credit Risk.</p>	<p>0.25%, if the residual term to final maturity is 6 months or less</p> <p>1.00%, if the residual term to final maturity is greater than 6 and up to and including 24 months</p> <p>1.60%, if the residual term to final maturity exceeds 24 months</p>

	<p>Debt securities issued or guaranteed by corporates and which would qualify for credit quality step 1 or 2 in accordance with the Standardized Approach for Credit Risk.</p> <p>Other qualifying items as defined in paragraph 3 of this article.</p>	
3	<p>Debt securities issued or guaranteed by central governments, or issued by central banks, international organizations, multilateral development banks or Member States' regional governments or local authorities or institutions, and which would qualify for credit quality step 4 or 5 in accordance with the Standardized Approach for Credit Risk.</p> <p>Debt securities issued or guaranteed by corporates and which would qualify for credit quality step 3 or 4 in accordance with the Standardized Approach for Credit Risk.</p> <p>Exposures for which a credit assessment by a nominated ECAI is not available.</p>	8.00%
4	<p>Debt securities issued or guaranteed by central governments, or issued by central banks, international organizations, multilateral development banks or Member States' regional governments or local authorities or institutions, and which would qualify for credit quality step 6 in accordance with the Standardized Approach for Credit Risk.</p> <p>Debt securities issued or guaranteed by corporates and which would qualify for credit quality step 5 or 6 in accordance with the Standardized Approach for Credit Risk.</p>	12.00%

2. Banks must use the maximum weighting shown in Table 1 in first paragraph of this article, which is 12%, for debt instruments for which there is an increased risk due to the insufficient solvency of the issuer or liquidity of the instrument.

Article 84
Other qualifying items

1. Other qualifying items are:

1.1 long and short positions in assets for which a credit assessment by a nominated ECAI is not available and which meet all of the following conditions:

1.1.1 they are considered by the bank concerned to be sufficiently liquid;

1.1.2 their investment quality is, according to the bank's own discretion, at least equivalent to that of the assets referred to under Table 1 second row;

1.1.3 they are listed on at least one regulated market

1.2 long and short positions in assets issued by institutions subject to the own funds requirements set out in this Chapter which are considered by the bank concerned to be sufficiently liquid and whose investment quality is, according to the bank's own discretion, at least equivalent to that of the assets referred to under Table 1 second row;

1.3 securities issued by institutions that are deemed to be of equivalent, or higher, credit quality than those associated with credit quality step 2 under the Standardized Approach for credit risk.

2. Banks that make use of point 1.1 or 1.2 of this article shall have a documented methodology in place to assess whether assets meet the requirements in those points and shall notify this methodology to the CBK.

Article 85
General risk

Banks may use an approach to calculate the capital requirement for general risk based on maturity (in accordance with Article 86 of this Chapter), or based on duration (in accordance with Article 87 of this Chapter). The bank must apply the chosen approach on a consistent basis.

Article 86
Maturity-based approach

1. The procedure for calculating capital requirements against general risk involves two basic steps. First, all positions shall be weighted according to maturity (as defined in paragraph 2 of this article), in order to compute the amount of capital required against them. Second, allowance shall be made for this requirement to be reduced when a weighted position is held alongside an opposite weighted position within the same maturity band. A reduction in the requirement shall also be allowed when the opposite weighted positions fall into different maturity bands, with the size of this reduction depending both on whether the two positions fall into the same zone, or not, and on the particular zones they fall into. There are three zones (groups of maturity bands) altogether.

2. Banks shall assign its net positions to the appropriate maturity bands in column 2 or 3, as appropriate, in Table 2 in paragraph 4 of this article. It shall do so on the basis of residual maturity in the case of fixed-rate instruments and on the basis of the period until the interest rate is next set in the case of instruments on which the interest rate is variable before final maturity. Banks shall also distinguish between debt instruments with a coupon of 3 % or more and those with a coupon of less than 3 % and thus allocate them to column 2 or column 3 in Table 2. Banks shall then multiply each of them by the weighing for the maturity band in question in column 4 in Table 2.

3. Banks shall then work out the sum of the weighted long positions and the sum of the weighted short positions in each maturity band. The amount of the former which are matched by the latter in a given maturity band shall be the matched weighted position in that band, while the residual long or short position shall be the unmatched weighted position for the same band. The total of the matched weighted positions in all bands shall then be calculated.

4. Banks shall compute the totals of the unmatched weighted long positions for the bands included in each of the zones in Table 2 in order to derive the unmatched weighted long position for each zone. Similarly, the sum of the unmatched weighted short positions for each band in a particular zone shall be summed to compute the unmatched weighted short position for that zone. That part of the unmatched weighted long position for a given zone that is matched by the unmatched weighted short position for the same zone shall be the matched weighted position for that zone. That part of the unmatched weighted long or unmatched weighted short position for a zone that cannot be thus matched shall be the unmatched weighted position for that zone.

Table 2.

Zone	Maturity band		Weighting (in %)	Assumed interest rate change (in %)
	Coupon of 3% or more	Coupon less than 3%		
(1)	(2)	(3)	(4)	(5)
One	0 ≤ 1 month	0 ≤ 1 month	0,00	-
	> 1 ≤ 3 months	> 1 ≤ 3 months	0,20	1,00
	> 3 ≤ 6 months	> 3 ≤ 6 months	0,40	1,00
	> 6 ≤ 12 months	> 6 ≤ 12 months	0,70	1,00
Two	> 1 ≤ 2 years	> 1,0 ≤ 1,9 years	1,25	0,90
	> 2 ≤ 3 years	> 1,9 ≤ 2,8 years	1,75	0,80
	> 3 ≤ 4 years	> 2,8 ≤ 3,6 years	2,25	0,75
Three	> 4 ≤ 5 years	> 3,6 ≤ 4,3 years	2,75	0,75
	> 5 ≤ 7 years	> 4,3 ≤ 5,7 years	3,25	0,70
	> 7 ≤ 10 years	> 5,7 ≤ 7,3 years	3,75	0,65
	> 10 ≤ 15 years	> 7,3 ≤ 9,3 years	4,50	0,60
	> 15 ≤ 20 years	> 9,3 ≤ 10,6 years	5,25	0,60

	> 20 years	> 10,6 ≤ 12,0 years	6,00	0,60
		> 12,0 ≤ 20,0 years	8,00	0,60
		> 20 years	12,50	0,60

5. The amount of the unmatched weighted long (short) position in zone one which is matched by the unmatched weighted short (long) position in zone two shall then be computed. This shall be referred to in paragraph 9 as the matched weighted position between zones one and two. The same calculation shall then be undertaken with regard to that part of the unmatched weighted position in zone two which is left over and the unmatched weighted position in zone three in order to calculate the matched weighted position between zones two and three.

6. A bank may, reverse the order in paragraph 5 so as to calculate the matched weighted position between zones two and three before calculating that position between zones one and two.

7. The remainder of the unmatched weighted position in zone one shall then be matched with what remains of that for zone three after the latter's matching with zone two in order to derive the matched weighted position between zones one and three.

8. Residual positions, following the three separate matching calculations in paragraphs 5, 6 and 7, shall be summed.

9. The bank's capital requirement shall be calculated as the sum of:

- 9.1 10 % of the sum of the matched weighted positions in all maturity bands;
- 9.2 40 % of the matched weighted position in zone one;
- 9.3 30 % of the matched weighted position in zone two;
- 9.4 30 % of the matched weighted position in zone three;
- 9.5 40 % of the matched weighted position between zones one and two and between zones two and three (see paragraph 5);
- 9.6 150 % of the matched weighted position between zones one and three; and
- 9.7 100 % of the residual unmatched weighted positions.

Article 87

Duration-based approach

1. Under an approach based on duration, banks must take the market value of each fixed rate debt instrument and calculate its yield to maturity, which is the implied discount rate for that instrument. In the case of floating rate instruments, the bank shall take the market value of each instrument and calculate its yield for a period equal to the time when the interest rate can next be changed.

2. The bank shall then calculate the modified duration of each debt instrument on the basis of the following formula:

$$MD = \frac{D}{(1 + r)}$$

Where:

MD = modified duration

D = duration

r = yield to maturity

C_t = cash payment in time t

m = total maturity

t = time

$$D = \frac{\sum_{t=1}^m \frac{tC_t}{(1+r)^t}}{\sum_{t=1}^m \frac{C_t}{(1+r)^t}}$$

3. Banks must then classify each debt instrument in the appropriate zone in Table 3 of this paragraph.

They must do this on the basis of the modified duration.

Table 3. Classifying debt instruments according to modified duration

Zone	Modified duration (in years)	Assumed interest rate change (in %)
(1)	(2)	(3)
One	> 0.0 ≤ 1.0	1,00
Two	> 1.0 ≤ 3.6	0,85
Three	> 3.6	0,70

4. Banks shall then calculate the duration-weighted position for each instrument by multiplying its market price by its modified duration and by the assumed interest-rate change for an instrument with that particular modified duration (see column 3 in Table 3).

5. A Bank shall calculate its duration-weighted long and its duration-weighted short positions within each zone. The amount of the former which are matched by the latter within each zone shall be the matched duration-weighted position for that zone.

A Bank shall then calculate the unmatched duration-weighted positions for each zone. It shall then follow the procedures laid down for unmatched weighted positions in points 5 to 8 defined in article 86.

6. The bank's capital requirement shall then be calculated as the sum of the following:

- 6.1 2 % of the matched duration-weighted position for each zone;
- 6.2 40 % of the matched duration-weighted positions between zones one and two and between zones two and three;
- 6.3 150 % of the matched duration-weighted position between zones one and three; and
- 6.4 100 % of the residual unmatched duration-weighted positions.

SUBCHAPTER III

EQUITIES

Article 88

Net positions in equity instruments

1. The bank shall separately sum all its net long positions and all its net short positions in accordance with Article 74 of this Chapter. The sum of the absolute values of the two figures shall be its overall gross position.
2. The bank shall calculate, separately for each market, the difference between the sum of the net long and the net short positions. The sum of the absolute values of those differences shall be its overall net position.

Article 89

Specific risk of equity instruments

The bank shall multiply its overall gross position by 12 % in order to calculate its own funds requirement against specific risk.

Article 90

General risk of equity instruments

The own funds requirement against general risk shall be the bank's overall net position multiplied by 12 %.

Article 91

Stock indices

1. Stock-index futures, the delta-weighted equivalents of options in stock-index futures and stock indices collectively referred to hereafter as 'stock-index futures', may be broken down into

positions in each of their constituent equities. These positions may be treated as underlying positions in the equities in question, and may, be netted against opposite positions in the underlying equities themselves. Banks shall notify the CBK of the use they make of that treatment.

2. Where a stock-index future is not broken down into its underlying positions, it shall be treated as if it were an individual equity. However, the specific risk on this individual equity can be ignored if the stock-index future in question is exchange traded and represents a relevant appropriately diversified index.

SUBCHAPTER IV

UNDERWRITING

Article 92

Reduction of net positions

1. In the case of the underwriting of debt and equity instruments, a bank may use the following procedure in calculating its own funds requirements. The bank shall first calculate the net positions by deducting the underwriting positions which are subscribed or sub-underwritten by third parties on the basis of formal agreements. The bank shall then reduce the net positions by the reduction factors in Table 4 and calculate its own funds requirements using the reduced underwriting positions.

Table 4.

Working day 0	100%
Working day 1	90%
Working days 2 to 3	75%
Working day 4	50%
Working day 5	25%
After working day 5	0%

'Working day zero' shall be the working day on which the bank becomes unconditionally committed to accepting a known quantity of securities at an agreed price.

2. The bank shall notify the CBK the use they make of paragraph 1.

SUB-CHAPTER V

SPECIFIC RISK OWN FUNDS REQUIREMENTS FOR POSITIONS HEDGED BY CREDIT DERIVATIVES

Article 93

Allowance for hedges by credit derivatives

1. An allowance shall be given for hedges provided by credit derivatives, in accordance with the principles set out in paragraphs 2 to 6 of this article.

2. Banks shall treat the position in the credit derivative as one 'leg' and the hedged position that has the same nominal, or, where applicable, notional amount, as the other 'leg'.

3. Full allowance shall be given when the values of the two legs always move in the opposite direction and broadly to the same extent. This will be the case in the following situations:

3.1 the two legs consist of completely identical instruments;

3.2 a long cash position is hedged by a total rate of return swap (or vice versa) and there is an exact match between the reference obligation and the underlying exposure (i.e., the cash position). The maturity of the swap itself may be different from that of the underlying exposure.

In these situations, a specific risk own funds requirement shall not be applied to either side of the position.

4. An 80 % offset will be applied when the values of the two legs always move in the opposite direction and where there is an exact match in terms of the reference obligation, the maturity of both the reference obligation and the credit derivative, and the currency of the underlying exposure. In addition, key features of the credit derivative contract shall not cause the price movement of the credit derivative to materially deviate from the price movements of the cash position. To the extent that the transaction transfers risk, an 80 % specific risk offset will be applied to the side of the transaction with the higher own funds requirement, while the specific risk requirements on the other side shall be zero.

5. Partial allowance shall be given, absent the situations in paragraphs 3 and 4, in the following situations:

5.1 the position falls under paragraph 3 point 3.2 but there is an asset mismatch between the reference obligation and the underlying exposure. However, the positions meet the following requirements:

5.1.1 the reference obligation ranks *pari passu* with or is junior to the underlying obligation;

5.1.2 the underlying obligation and reference obligation share the same obligor and have legally enforceable cross- default or cross-acceleration clauses;

5.2 the position falls under paragraph 3 point 3.1 or paragraph 4 but there is a currency or maturity mismatch between the credit protection and the underlying asset. Such currency mismatch shall be included in the own funds requirement for foreign exchange risk;

5.3 the position falls under paragraph 4 but there is an asset mismatch between the cash position and the credit derivative. However, the underlying asset is included in the (deliverable) obligations in the credit derivative documentation.

In order to give partial allowance, rather than adding the specific risk own funds requirements for each side of the transaction, only the higher of the two own funds requirements shall apply.

6. In all situations not falling under paragraphs 3 to 5, an own funds requirement for specific risk shall be calculated for both sides of the positions separately.

Article 94

Allowance for hedges by first and nth-to default credit derivatives

1. In the case of first-to-default credit derivatives and nth-to- default credit derivatives, the following treatment applies for the allowance to be given in accordance with Article 93:

1.1 where a bank obtains credit protection for a number of reference entities underlying a credit derivative under the terms that the first default among the assets shall trigger payment and that this credit event shall terminate the contract, the institution may offset specific risk for the reference entity to which the lowest specific risk percentage charge among the underlying reference entities applies according to Table 1 in Article 83 (Traded Debt Instruments);

1.2 where the nth default among the exposures triggers payment under the credit protection, the protection buyer may only offset specific risk if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases, the methodology set out in point 1.1 for first-to-default credit derivatives shall be followed appropriately amended for nth-to-default products.

SUBCHAPTER VI

OWN FUNDS REQUIREMENTS FOR COMMODITIES RISK

Article 95

Choice of approaches for commodities risk

Subject to Articles 96 to 101, Banks shall calculate the own funds requirement for commodities risk with one of the approaches set out in Articles 99, 100 or 101 of this regulation.

Article 96

Ancillary commodities business

1. Banks with ancillary agricultural commodities business may determine the own funds requirements for their physical commodity stock at the end of each year for the following year where all of the following conditions are met:
 - 1.1 at any time of the year it holds own funds for this risk which are not lower than the average own funds requirement for that risk estimated on a conservative basis for the coming year;
 - 1.2 it estimates on a conservative basis the expected volatility for the figure calculated under point 1.1;
 - 1.3 its average own funds requirement for this risk does not exceed 5 % of its own funds or EUR 1 million and, taking into account the volatility estimated in accordance with point 1.2, the expected peak own funds requirements do not exceed 6,5 % of its own funds;
 - 1.4 the bank monitors on an ongoing basis whether the estimates carried out under points 1.1 and 1.2 still reflect the reality.
2. Banks shall notify the CBK of the use they make of the option provided in paragraph 1.

Article 97

Positions in commodities

1. Each position in commodities or commodity derivatives shall be expressed in terms of the standard unit of measurement. The spot price in each commodity shall be expressed in the reporting currency.
2. Positions in gold or gold derivatives shall be considered as being subject to foreign-exchange risk, as appropriate, for the purpose of calculating commodities risk.
3. For the purpose of Article 100, par.1, the excess of a bank's long positions over its short positions, or vice versa, in the same commodity and identical commodity futures, options and warrants shall be its net position in each commodity. Derivative instruments shall be treated, as laid down in Article 98, as positions in the underlying commodity.
4. For the purposes of calculating a position in a commodity, the following positions shall be treated as positions in the same commodity:
 - 4.1 positions in different sub-categories of commodities in cases where the sub-categories are deliverable against each other;
 - 4.2 positions in similar commodities if they are close substitutes and where a minimum correlation of 0,9 between price movements can be clearly established over a minimum period of one year.

Article 98
Particular instruments

1. Commodity futures and forward commitments to buy or sell individual commodities shall be incorporated in the measurement system as notional amounts in terms of the standard unit of measurement and assigned a maturity with reference to expiry date.

2. Commodity swaps where one side of the transaction is a fixed price and the other the current market price shall be treated, as a series of positions equal to the notional amount of the contract, with, where relevant, one position corresponding with each payment on the swap and slotted into the maturity bands in Article 99 par. 1). The positions shall be long positions if the bank is paying a fixed price and receiving a floating price and short positions if the bank is receiving a fixed price and paying a floating price. Commodity swaps where the sides of the transaction are in different commodities are to be reported in the relevant reporting ladder for the maturity ladder approach.

3. Options and warrants on commodities or on commodity derivatives shall be treated as if they were positions equal in value to the amount of the underlying to which the option refers, multiplied by its delta for the purposes of this Chapter. The latter positions may be netted off against any offsetting positions in the identical underlying commodity or commodity derivative. The delta used shall be that of the exchange concerned. For OTC options, or where delta is not available from the exchange concerned the bank may calculate delta itself using an appropriate model, subject to permission by the CBK. Permission shall be granted if the model appropriately estimates the rate of change of the option's or warrant's value with respect to small changes in the market price of the underlying.

Banks shall adequately reflect other risks associated with options, apart from the delta risk, in the own funds requirements.

4. Where a bank is either of the following, it shall include the commodities concerned in the calculation of its own funds requirement for commodities risk:

4.1 the transferor of commodities or guaranteed rights relating to title to commodities in a repurchase agreement;

4.2 the lender of commodities in a commodities lending agreement.

Article 99
Maturity ladder approach

1. The bank shall use a separate maturity ladder in line with Table 1 of this article for each commodity. All positions in that commodity shall be assigned to the appropriate maturity bands.

Physical stocks shall be assigned to the first maturity band between 0 and up to and including 1 month.

Table 1.

Maturity band (1)	Spread rate (in %) (2)
$0 \leq 1$ month	1,50
$> 1 \leq 3$ months	1,50
$> 3 \leq 6$ months	1,50
$> 6 \leq 12$ months	1,50
$> 1 \leq 2$ years	1,50
$> 2 \leq 3$ years	1,50
> 3 years	1,50

2. Positions in the same commodity may be offset and assigned to the appropriate maturity bands on a net basis for the following:

- 2.1 positions in contracts maturing on the same date;
- 2.2 positions in contracts maturing within 10 days of each other if the contracts are traded on markets which have daily delivery dates.

3. The bank shall then calculate the sum of the long positions and the sum of the short positions in each maturity band. The amount of the former which are matched by the latter in a given maturity band shall be the matched positions in that band, while the residual long or short position shall be the unmatched position for the same band.

4. That part of the unmatched long position for a given maturity band that is matched by the unmatched short position, or vice versa, for a maturity band further out shall be the matched position between two maturity bands. That part of the unmatched long or unmatched short position that cannot be thus matched shall be the unmatched position.

5. The bank's own funds requirement for each commodity shall be calculated on the basis of the relevant maturity ladder as the sum of the following:

- 5.1 the sum of the matched long and short positions, multiplied by the appropriate spread rate as indicated in the second column of Table 1 for each maturity band and by the spot price for the commodity;
- 5.2 the matched position between two maturity bands for each maturity band into which an unmatched position is carried forward, multiplied by 0,6 %, which is the carry rate and by the spot price for the commodity;
- 5.3 the residual unmatched positions, multiplied by 15 % which is the outright rate and by the spot price for the commodity.

6. The bank's overall own funds requirement for commodities risk shall be calculated as the sum of the own funds requirements calculated for each commodity in accordance with paragraph 5.

Article 100 **Simplified approach**

1. The bank's own funds requirement for each commodity shall be calculated as the sum of the following:

- 1.1 15 % of the net position, long or short, multiplied by the spot price for the commodity;
- 1.2 3 % of the gross position, long plus short, multiplied by the spot price for the commodity.

2. The Bank's overall own funds requirement for commodities risk shall be calculated as the sum of the own funds requirements calculated for each commodity in accordance with paragraph 1.

Article 101 **Extended maturity ladder approach**

1. Banks may use the minimum spread, carry and outright rates set out in the following table 2 of this article instead of those indicated in Article 99 of this regulation provided that the banks:

- 1.1 undertake significant commodities business;
- 1.2 have an appropriately diversified commodities portfolio;
- 1.3 are not yet in a position to use internal models for the purpose of calculating the own funds requirement for commodities risk.

Table 2.

	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
Spread rate (%)	1,0	1,2	1,5	1,5
Carry rate (%)	0,3	0,5	0,6	0,6
Outright rate (%)	8	10	12	15

2. Banks shall notify the use they make of this Article to CBK together with evidence of their efforts to implement an internal model for the purpose of calculating the own funds requirement for commodities risk.

SUBCHAPTER VII

TREATMENT OF OPTIONS

Article 102

Own fund requirement for options

1. Banks that only buy options may use the simplified approach to calculate own fund requirements.
2. Banks using the simplified approach, should calculate capital charges for general market risk and specific risk.
3. Capital charges calculated according to paragraph 2 of this article, are then added to the relevant category, i.e. traded debt instruments, equities, foreign exchange and commodities.
4. Banks, for long call and long put positions, should calculate the own fund requirements as the lesser of:
 - 4.1 the market value of the underlying security multiplied by the sum of specific and general market risk charges for the underlying, and
 - 4.2 the market value of the option.
5. Banks, for long cash and long put positions or short cash and long call positions, should calculate the own fund requirements by multiplying the market value of the underlying security by the sum of specific and general market risk charges for the underlying less the amount the option is in the money (if any) bounded at zero.
6. Banks shall calculate the options in the money as follows:
 - 6.1 for call options, as the difference between the market value of the underlying instrument and the strike price; and
 - 6.2 for put options, as the difference between strike price and the market value of the underlying instrument.

SUBCHAPTER VIII

SETTLEMENT RISK AND FREE DELIVERIES

Article 103

Own fund requirement for Settlement Risk

1. Banks which perform transactions in debt securities, equity securities, derivatives, currencies, and commodities, may expose to the risk of a loss arising from failure to settle at the maturity date.
2. If these transactions are not settled at the agreed maturity date, the banks must calculate the prices difference to which it is exposed. This is the difference between the agreed settlement price for the debt instrument, equity, foreign currency or commodity in question and its current market value, where the difference is positive (entails a loss for the bank).
3. If from this difference the bank incurs a loss, then this price difference must be multiplied by the appropriate weighing factor in column B of Table 1 of this Article in order to calculate its capital requirement.

Table 1. Capital requirements for settlement risk

A. Number of working days after due settlement date	B. Weighing factors, in percent of total capital
5 – 15 days	8
16 – 30 days	50
31 – 45 days	75
46 days or more	100

4. In the event of system-wide failure of a settlement or clearing system, the CBK may temporarily wave, in part or in full, the application of capital requirements to unsettled transactions until the situation is rectified. In such circumstances, the failure of counterparty to settle a trade shall not be deemed as a default, for the purposes of credit risk.

Article 104

Own fund requirement for Free Deliveries

1. The risk associated with ‘free deliveries’ differs from ‘settlement risk’ in the sense that the latter case the bank has not yet made any payment or delivery, whereas the free delivery risk relates to trading activities in the context of which the bank already made a payment or delivery, but the payment or delivery due from the counterparty is still outstanding.
2. A bank is required to hold capital against the free deliveries risk, as set out in Table 2, if:

2.1 it has paid for securities, foreign currencies or commodities before receiving them or it has delivered securities, foreign currencies or commodities before receiving payment for them; and

2.2 in the case of cross-border transactions, one day or more has elapsed since it made that payment or delivery.

Table 2. Capital treatment for free deliveries

	A	B	C
Transaction Type	Up to first contractual payment or delivery leg	From first contractual payment or delivery leg up to four days after second contractual payment or delivery leg	From 5 business days post second contractual payment or delivery leg until extinction of the transaction
Free delivery	No capital charge	Treat as an exposure (based on the risk-weighted exposures set out in the Regulation for RWA's for Credit)	Deduct value transferred plus current positive value

3. In applying a risk weight to free delivery exposures treated according to column C of Table 2, banks may apply a 100 % risk weight to all such exposures.

4. If the amount of positive exposure resulting from free delivery transactions is not material, banks may apply a risk weight of 100 % to these exposures.

5. Banks that have made payment or delivery and have not received the deliverable or payment from the counterparty by the fourth business day after the agreed delivery date, must deduct from the regulatory capital the larger between the amount transferred and the fair value of the underlying receivable instrument, or between the cash receivable and the fair value of the transferred deliverable.

SUBCHAPTER IX

FOREIGN EXCHANGE RISK

Article 105

Calculating capital requirements for foreign- exchange risk

1. If the sum of a bank's overall net foreign-exchange position and its net gold position exceeds 2 % of its total regulatory capital, it must multiply the sum of its net foreign-exchange position and its net gold position by 12 % in order to calculate the capital requirement against foreign-exchange risk.

2. A two-stage calculation shall be used for capital requirements for foreign- exchange risk.

2.1 Firstly, the bank's net open position in each currency (including the reporting currency) and in gold shall be calculated. This net open position shall consist of the sum of the following elements (positive or negative):

- 2.1.1 the net spot position (i.e. all asset items less all liability items, including accrued interest, in the currency in question or, for gold, the net spot position in gold);
- 2.1.2 the net forward position (i.e. all amounts to be received less all amounts to be paid under forward exchange and gold transactions, including currency and gold futures and the principal on currency swaps not included in the spot position);
- 2.1.3 irrevocable guarantees (and similar instruments) that are certain to be called and likely to be irrecoverable;
- 2.1.4 net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank and with the prior consent of the CBK, net future income/expenses not yet entered in accounting records but already fully hedged by forward foreign-exchange transactions may be included here). Such discretion must be exercised on a consistent basis;

2.2. Secondly, net short and long positions in each currency other than the reporting currency and the net long or short position in gold shall be converted at spot rates into the reporting currency.

- 2.2.1. They shall then be summed separately to form the total of the net short positions and the total of the net long positions respectively.
- 2.2.2. The higher of these two totals shall be the bank's overall net foreign-exchange position.

3. Net positions in composite currencies may be broken down into the component currencies according to the quotas in force.

Article 106

Exceptions in the case of the foreign exchange risk

1. Any position which a bank has deliberately taken in order to hedge against the adverse effect of the exchange rate on its capital ratio may be excluded from the calculation of net open currency positions. Such positions should be of a non-trading nature and their exclusion, and any variation of the terms of their exclusion, shall require the consent of the CBK. Such positions are:

- 1.1 the position is of a structural (i.e. non-trading positions)nature
- 1.2 the excluded position protects only the bank's capital adequacy ratio
- 1.3 the exclusion of the position is applied consistently

CHAPTER VI

OWN FUNDS REQUIREMENTS FOR OPERATIONAL RISK

Article 107 Operational Risk

1. Banks shall apply the basic indicator approach (BIA) for calculation of own funds requirements.

1.1 The BIA requires a capital charge of 15 % (fifteen percent) of gross income be added to the risk weighted assets of the bank in calculating the risk-asset ratio. Gross income is defined as net interest income plus net non-interest income. It is intended that this measure should:

- 1.1.1. be gross of any provisions (e.g. for unpaid interest);
- 1.1.2. be gross of operating expenses, including fees paid to outsourcing service providers;
- 1.1.3. exclude realized profits/losses from the sale of securities; and
- 1.1.4. exclude extraordinary or irregular items as well as income derived from insurance.

1.2 For newly established banks with less than three years data, the new bank shall use any actual gross income earned to date for purposes of deriving the average gross income, while leaving the gross income for any remaining quarters as zero.

- 2 Subject to the CBK's prior approval, banks may use SA to calculate its operational risk capital charges. Under the SA the capital requirement for operational risk is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines (see Annex VI and VII). In each year, a negative capital requirement in one business line, resulting from a negative relevant indicator may be imputed to the whole. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the average for that year shall be zero. The three-year average is calculated on the basis of the last three twelve-monthly observations at the end of the financial year. When audited figures are not available, business estimates may be used.

CHAPTER VII

FINAL PROVISIONS

Article 108

Reporting to the Central Bank of the Republic of Kosovo

Banks shall submit to CBK reporting forms prescribed by CBK according to respective instructions provided, not later than fifteen days (15) after the end of each month, with other regular monthly reports.

Article 109

Enforcement, Remedial Measures and Civil Penalties

Any violation of the provisions of this Regulation shall be subject to corrective and punitive measures, as defined in the Law on the Central Bank and the Law on Banks.

Article 110

Abrogation

Upon the entry into force of this Regulation, it shall abrogate the Regulation on Bank Capital Adequacy issued by the CBK Board on December 22, 2015, and any other provisions that may be in conflict with this Regulation.

Article 111
Annexes

Annexes I, II, III, IV, V, VI dhe VII are integral part of this regulation.

Article 112
Entry into force

This regulation enters into force on 01.01.2020.

The Chairman of the Board of the Central Bank of the Republic of Kosovo

Prof. Dr. Flamur Mrasori

ANNEX I

CLASSIFICATION OF OFF-BALANCE-SHEET ITEMS

1. Full risk (100% CCF):
 - 1.1 Guarantees having the character of credit substitutes,
 - 1.2 Acceptances,
 - 1.3 Endorsements on bills not bearing the name of another credit institution,
 - 1.4 Transactions with recourse,
 - 1.5 Irrevocable standby letters of credit having the character of credit substitutes,
 - 1.6 Assets purchased under outright forward purchase agreements,
 - 1.7 Forward forward deposits,
 - 1.8 The unpaid portion of partly-paid shares and securities,
 - 1.9 Asset sale and repurchase agreements, and
 - 1.10 All other off-balance sheet items which carry high risk, classified by the bank and assessed by CBK.

2. Medium risk (50% CCF):
 - 2.1 Documentary credits issued or confirmed (which do not represent medium/low risk item),
 - 2.2 Warranties and indemnities, including tender, performance, customs and tax bonds and guarantees not having the character of credit substitutes,
 - 2.3 Irrevocable standby letters of credit not having the character of credit substitutes,
 - 2.4 Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year,
 - 2.5 Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs), and
 - 2.6 All other off-balance sheet items which carry medium risk, classified by the bank and assessed by CBK.

3. Medium/low risk (20% CCF):
 - 3.1 Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions,
 - 3.2 Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year which may not be cancelled unconditionally at any time without notice or that do not effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.
 - 3.3 All other off-balance sheet items which carry medium/low risk, classified by the bank and assessed by CBK.

4. Low risk (0% CCF):

- 4.1 Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) which may be cancelled unconditionally at any time without notice, or that do effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness.
- 4.2 Retail credit lines (credit cards and overdrafts) are considered as unconditionally cancellable if the terms permit the credit institution to cancel them to the full extent at any time.
- 4.3 All other off-balance sheet items which carry low risk, classified by the bank and assessed by CBK.

ANNEX II

Assignment of long-term and short term credit ratings in respective credit quality levels and the minimum insurance premiums

1. Long term credit assessment

Credit quality step	ECAIs		
	Moody's	S&P	Fitch
1	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-	AAA AA+ AA AA-
2	A1 A2 A3	A+ A A-	A+ A A-
3	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-
4	Ba1 Ba2 Ba3	BB+ BB BB-	BB+ BB BB-
5	B1 B2 B3	B+ B B-	B+ B B-

6	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC
	C	C	C
		D	D

2. Short term credit assessment

Credit quality step	ECAIs		
	Moody's	S&P	Fitch
1	P-1	A-1+, A-1	F-1+,F-1
2	P-2	A-2	F-2
3	P-3	A-3	F-3
4	N.P	B-1, B-2, B-3, C	Below F3
5	N.P	B-1, B-2, B-3, C	Below F3
6	N.P	B-1, B-2, B-3, C	Below F3

3. Minimum Insurance Premiums

Minimum Insurance Premiums	ECA
0	0%
1	0%
2	20%
3	50%
4	100%
5	100%
6	100%
7	150%

ANNEX III

RECOGNISED EXCHANGES AND CLEARING HOUSES

1. Banks may request that stock exchanges or clearing houses be added to this list.

1.1. Recognised stock exchanges

Alberta Stock Exchange
American Stock Exchange
Amsterdam Pork and Potato Terminal Market (Termijnmarkt Amsterdam BV)
Amsterdam Stock Exchange (Amsterdamse Effectenbeurs)
Antwerp (Effectenbeursvennootschap van Antwerpen)
Athens Stock Exchange (ASE)
Australian Stock Exchange
Basle Stock Exchange (Basler Effektenbörse)
Barcelona Stock Exchange (Bolsa de Valores de Barcelona)
Belgian Futures & Options Exchange (BELFOX)
Berlin Stock Exchange (Berliner Börse)
Bilbao Stock Exchange (Bolsa de Valores de Bilbao)
Bologna Stock Exchange (Borsa Valori de Bologna)
Bordeaux (Bourse de Bordeaux)
Bremen Stock Exchange (Bremer Wertpapierbörse)
Brussels Stock Exchange (Société de la Bourse des Valeurs Mobilières)/ (Effecten Beursvennootschap van Brussel)
Chicago Board of Trade
Chicago Board Options Exchange
Chicago Mercantile Exchange
Coffee, Sugar and Cocoa Exchange Inc.
Copenhagen Stock Exchange (Københavns Fondsbørs)
DTB Deutsche Terminbörse
The Dublin Stock Exchange
Düsseldorf Stock Exchange (Rheinisch-Westfälische Börse zu Düsseldorf)
European Options Exchange
Financieel Termijnmarkt, Amsterdam
Finnish Options Exchange
Florence Stock Exchange (Borsa Valori di Firenze)
Frankfurt Stock Exchange (Frankfurter Wertpapierbörse)
Genoa Stock Exchange (Borsa Valori di Genova)
Geneva Stock Exchange (Bourse de Genève)
Hamburg Stock Exchange (Hanseatische Wertpapier Börse Hamburg)
Hannover (Niedersächsische Börse zu Hannover)
Helsinki Stock Exchange (Helsingin Arvopaperipörssi Osuuskunta)
Hong Kong Futures Exchange

International Petroleum Exchange of London Ltd
Irish Futures & Options Exchange (IFOX)
Kansas City Board of Trade
Lille (Bourse de Lille)
Lisbon Stock Exchange (Bolsa de Valores de Lisboa)
Ljubljana Stock Exchange (Ljubljanska Borza d.d.)
London International Financial Futures & Options Exchange
London Metal Exchange Ltd
London Stock Exchange
Luxembourg Stock Exchange (Société de la Bourse de Luxembourg SA)
Lyon (Bourse de Lyon)
Madrid Stock Exchange (Bolsa de Valores de Madrid)
Marché à Terme International de France (MATIF)
Marché des Options Négociables de Paris (MONEP)
Marseille (Bourse de Marseille)
MEFF Renta Fija
MEFF Renta Variable
Mercato Italiano Derivati (IDEM)
Mercato Italiano Futures (MIF)
Mid American Commodity Exchange
Milan Stock Exchange (Borsa Valori de Milano)
Montreal Exchange
Munich Stock Exchange (Bayerische Börse in München)
Nagoya Stock Exchange
Nancy (Bourse de Nancy)
Nantes (Bourse de Nantes)
Naples Stock Exchange (Borsa Valori di Napoli)
National Association of Securities Dealers Incorporated
(NASDAQ)
New York Cotton Exchange
New York Futures Exchange
New York Mercantile Exchange
New York Stock Exchange
OM Stockholm AB
OMLX, The London Securities and Derivatives Exchange Ltd
Oporto Stock Exchange (Bolsa de Valores do Porto)
Osaka Securities Exchange
Oslo Stock Exchange (Oslo Bors)
Pacific Stock Exchange
Palermo Stock Exchange (Borsa Valori de Palermo)
Paris Stock Exchange
Philadelphia Board of Trade
Philadelphia Stock Exchange
Rome Stock Exchange (Borsa Valori di Roma)
Singapore International Monetary Exchange Limited (SIMEX)
Stockholm Stock Exchange (Stockholm Fondbörs)

Stock Exchange of Hong Kong Ltd
Stock Exchange of Singapore
Stuttgart Stock Exchange (Baden-Württembergische Wertpapierbörse zu Stuttgart)
Swiss Futures and Options Exchange (SOFFEX)
Sydney Futures Exchange
Tokyo Stock Exchange
Tokyo International Financial Futures Exchange
Toronto Stock Exchange
Trieste Stock Exchange (Borsa Valori di Trieste)
Turin Stock Exchange (Borsa Valori de Torino)
Valencia Stock Exchange (Bolsa de Valores de Valencia)
Vancouver Stock Exchange
Venice Stock Exchange (Borsa Valori de Venezia)
Vienna Stock Exchange
Zurich Stock Exchange (Zürcher Börse)

1.2. Recognised clearing houses

Austrian Kontroll Bank (OKB)
Board of Trade Clearing Corporation
Cassa di Compensazione e Garanzia S. p. A (CCG)
Central Securities Clearing Corporation (KDD Centralna Klirinško Depotna Družba d.d.)
Commodity Clearing Corporation
The Emerging Markets Clearing Corporation
European Options Clearing Corporation Holding BV (EOCC)
Guarantee Fund for Danish Options and Futures (Garantifonden for Danske Optioner OG Futures)
(FUTOP)
Kansas City Board of Trade Clearing Corporation
Hong Kong Futures Exchange Clearing Corporation Ltd
Hong Kong Securities Clearing Company Ltd
London Clearing House (LCH)
Norwegian Futures & Options Clearing House (Norsk Opsjonsentral A.S.)
N.V. Nederlandse Liquidatiekas (NLKKAS)
OM Stockholm AB (OM)
Options Clearing Corporation
OTOB Clearing Bank AG (OTOB)
Société de Compensation des Marchés Conditionnels (SCMC)
Sydney Futures Exchange Clearing House (SFECH Ltd)

ANNEX IV
Types of derivatives

1. Interest-rate contracts:
 - 1.1. single-currency interest rate swaps;
 - 1.2. basis-swaps;
 - 1.3. forward rate agreements;
 - 1.4. interest-rate futures;
 - 1.5. interest-rate options purchased;
 - 1.6. other contracts of similar nature.

2. Foreign-exchange contracts and contracts concerning gold:
 - 2.1 cross-currency interest-rate swaps;
 - 2.2 forward foreign-exchange contracts;
 - 2.3 currency futures;
 - 2.4 currency options purchased;
 - 2.5 other contracts of a similar nature;
 - 2.6 contracts of a nature similar to (a) to (e) concerning gold.

3. Contracts of a nature similar to those in points 1.1 to 1.5 and 2.1 to 2.4 of this Annex concerning other reference items or indices. This includes as a minimum all instruments specified in points 4 to 7, 9 and 10 of Annex V not otherwise included in point 1 or 2 of this Annex.

ANNEX V

Financial Instruments

- 1) Transferable securities;
- 2) Money-market instruments;
- 3) Units in collective investment undertakings;
- 4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
- 5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
- 6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
- 7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;
- 8) Derivative instruments for the transfer of credit risk;
- 9) Financial contracts for differences.
- 10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

ANNEX VI

Formula for calculating the operational risk capital charge under BIA is:

$$KBIA = \{\Sigma(GI1 \dots n \times \alpha)\} / n \text{ Where}$$

KBIA = capital charge under BIA

GI = annual gross income of the banks, where positive, over the preceding three years n = number of the preceding three years where annual gross income is positive

$$\alpha = 15\%$$

The formula for calculating the operational risk capital charge under SA:

$$KSA = \{\Sigma_{\text{years 1-3}} \max[\Sigma(GI1-8 \times \beta1-8), 0]\} / 3 \text{ Where}$$

KSA = capital charge under SA

GI1-8 = annual gross income in a given year for each of the eight business lines B1-8 = a fixed beta factor (as defined in Annex VII).

ANNEX VII

Standardized approach

Business line	List of activities	Percentage
Corporate finance	<p>Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis</p> <p>Services related to underwriting</p> <p>Investment advice</p> <p>Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to the mergers and the purchase of undertakings</p> <p>Investment research and financial analysis and other forms of general recommendation relating to transactions in financial instruments</p>	18%
Trading and sales	<p>Dealing on own account</p> <p>Money broking</p> <p>Reception and transmission of orders in relation to one or more financial instruments</p> <p>Execution of orders on behalf of clients</p> <p>Placing of financial instruments without a firm commitment basis</p> <p>Operation of Multilateral Trading Facilities</p>	18%
Retail brokerage (Activities with a individual physical persons or with small and medium sized entities)	<p>Reception and transmission of orders in relation to one or more financial instruments</p> <p>Execution of orders on behalf of clients</p> <p>Placing of financial instruments without a firm commitment basis</p>	12%
Commercial banking	<p>Acceptance of deposits and other repayable funds</p> <p>Lending</p> <p>Financial leasing</p>	15%

	Guarantees and commitments	
Retail banking (Activities with a individual physical persons or with small and medium sized entities meeting the criteria set out in Article 79 for the retail exposure class)	Acceptance of deposits and other repayable funds Lending Financial leasing Guarantees and commitments	12%
Payment and settlement	Money transmission services, Issuing and administering means of payment	18%
Agency services	Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management	15%
Asset management	Portfolio management Managing of UCITS Other forms of asset management	12%