PART I – ACCOUNTING, AUDITING, FINANCIAL REPORTING, AND RECORD KEEPING REQUIREMENTS

For the purpose of these Financial Market Rules:

"**Authorised Person**" shall mean either a Regulated Market or a Central Securities Depository or where applicable an operator of a Regulated Market and a Central Securities Depository

"**Central Securities Depository**" means a person authorised in terms of Part IV of the Financial Markets Act, 1990 (henceforth referred to as "the Act") to provide one or more of the functions stipulated in article 26 of the Act.

"Regulated Market" means a person in respect of whom the Competent Authority has issued an authorisation in terms of article 4 of the Act.

1.0 Accounting / Record Keeping

1.01 An Authorised Person shall maintain proper accounting records to show and explain the Authorised Person's own transactions, assets and liabilities.

1.02 The accounting records shall:

a. disclose with reasonable accuracy, at all times, the financial position of the Authorised Person; and

b. enable the financial statements required by the MFSA to be prepared within the time limits specified in these Rules.

1.03 In particular, the financial records shall contain:

a. entries from day to day of all sums of money received and expended and the matters to which they relate;

b. a record of all income and expenses, explaining their nature;

c. a record of all assets and liabilities, including any guarantees, contingent liabilities or other financial commitments; and

d. entries from day to day of all transactions on the Authorised Person's own account.

1.04 The Authorised Person shall retain accounting records for a minimum period of ten years. During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.

1.05 The Authorised Person shall agree with the MFSA its Accounting Reference Date (financial year end).

Reporting Requirements

1.06 Authorised Persons shall have internal control mechanisms and administrative and accounting procedures which permit the verification of their compliance with these Rules as well as effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems.

1.07 Authorised Persons shall in each year prepare an Annual Financial Return in the form set out in Appendix I of these Rules. The Annual Financial Return shall be submitted to the MFSA within one month of the Accounting Reference Date.

1.08 An Annual Financial Return reflecting the figures of the audited annual financial statement and confirmed by the auditors shall be submitted to the MFSA within four months of the Accounting Reference Date.

1.09 Audited annual financial statements prepared in accordance with International Financial Reporting Standards, together with a copy of the auditors' management letter and the auditors' report required by Rule 1.22, shall be submitted to the MFSA within four months of the Accounting Reference Date.

1.10 In addition to the Annual Financial Return and audited annual financial statements, Authorised Persons shall prepare an Interim Financial Return, in the form set out in Appendix I to these Rules, at dates three, six and nine months after the Accounting Reference Date. The first Interim Financial Return should cover the three months immediately following the Accounting Reference Date, the second Interim Financial Return should cover the six months immediately following the Accounting Reference Date and the third Interim Financial Return should cover the nine months immediately following the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA. The Interim Financial Return shall be submitted to the MFSA within one month of the date up to which it has been prepared.

1.11 Financial Returns shall be signed by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Authorised Person is expected to provide a certified true copy of such Board Resolution to the MFSA.

1.12 The Authorised Person shall prepare and submit such additional financial returns as the MFSA may require.

1.13 The Authorised Person shall be responsible for the correct compilation of the Financial Returns. The nature and content of the financial returns shall be as follows:

a. they shall be in the form set out in Appendix I of these Rules;

b. they shall be in agreement with the underlying accounting records;

c. accounting policies shall be consistent with those adopted in the audited annual financial statements and shall be consistently applied. These accounting policies should adequately cater for amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure, as the case may be, or vice versa, unless duly authorised by the MFSA;

d. information to be included in the financial returns shall be prepared in accordance with International Financial Reporting Standards;

e. investments shall be included in the balance sheet at valuations arrived at in accordance with the provisions of International Financial Reporting Standards;

f. financial returns shall not be misleading as a result of the misrepresentation or omission or miscalculation of any material item;

1.14 If so notified in writing by the MFSA, the Authorised Person shall be required to prepare and submit additional financial information for the purposes of consolidated supervision.

1.15 The Authorised Person shall notify the MFSA immediately if it becomes aware:

a. that it is in breach of the requirements in respect of financial resources, records, reporting or procedures and controls;

b. that it will be unable to submit an Annual or Interim Financial Return on the due date.

The notice shall give reasons and shall explain what action is being taken to rectify matters.

1.16 The Authorised Person shall notify the MFSA immediately if:

a. it is notified that its auditor intends to qualify the audit report;

b. it becomes aware of actual or intended legal proceedings against it;

c. the Authorised Person's counterparties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

Audit

1.17 The Authorised Person shall appoint an auditor approved by the MFSA. The Authorised Person shall replace its auditor if requested to do so by the MFSA. The MFSA's consent shall be sought prior to the appointment or replacement of an auditor.

The Authorised Person shall make available to its auditor the information and explanations he needs to discharge his responsibilities as an auditor and in order to meet the MFSA's requirements.

1.18 The Authorised Person shall not appoint an individual as an auditor, nor appoint an audit firm where the individual directly responsible for the audit, or his firm is:

a. a director, partner, qualifying shareholder, officer, representative or employee of the Authorised Person;

b. a partner of, or in the employment of, any person in (a) above;

c. a spouse, parent, step-parent, child, step-child or other close relative of any person in (a) above;

d. a person who is not otherwise independent of the Authorised Person;

e. a person disqualified by the MFSA from acting as an auditor of an

Authorised Person.

For this purpose, an auditor shall not be regarded as an officer or an employee of the Authorised Person solely by reason of being auditor of that Authorised Person.

1.19 The Authorised Person shall obtain from its auditor a signed letter of engagement defining clearly the extent of the auditor's responsibilities and the terms of his appointment. The Authorised Person shall confirm in writing to its auditor its agreement to the terms in the letter of engagement. The auditor shall provide the MFSA with a letter of confirmation in the form set out in Appendix II to these Rules.

1.20 The letter of engagement shall include terms requiring the auditor:

a. to provide such information or verification to the MFSA as the MFSA may request;

b. to afford another auditor all such assistance as he may require;

c. to vacate his office if he becomes disqualified to act as auditor for any reason;

d. if he resigns, or is removed or not reappointed, to advise the MFSA of that fact and of the reasons for his ceasing to hold office. The auditor shall also be required to advise the MFSA if there are matters he/she considers should be brought to the attention of the MFSA;

e. to report immediately to the MFSA any fact or decision of which he becomes aware in his capacity as auditor of the Authorised Person which:

   i. is likely to lead to a serious qualification or refusal of his audit report on the accounts of the Authorised Person; or

   ii. constitutes or is likely to constitute a material breach of the legal and regulatory requirements applicable to the Authorised Person in or under the Act;

   iii. gravely impairs the ability of the Authorised Person to continue as a going concern; or

   iv. relates to any other matter which has been prescribed.

1.21 If at any time the Authorised Person fails to have an auditor in office for a period exceeding four weeks the MFSA shall be entitled to appoint a person to fill the vacancy; the fees and charges so incurred being payable by the Authorised Person.

1.22 In respect of each annual accounting period, the Authorised Person shall require its auditor to prepare a management letter in accordance with International Standards on Auditing. The auditor must also confirm to the MFSA that the audit has been conducted in accordance with International Standards on Auditing and whether, in the auditor's opinion:

a. the Annual Financial Return together with the audited annual financial statements are in agreement with the Authorised Person's accounting records;

b. the Annual Financial Return has been prepared in accordance with the MFSA's requirements and is consistent with the audited annual financial statements;

c. the Authorised Person's Financial Resources have been properly calculated in accordance with the MFSA's requirements and exceed the Authorised Person's Financial Resources Requirement [as set out in the next section of these Rules] as at the Accounting Reference Date;

d. proper accounting records have been kept, and adequate systems for their control have been maintained, as required by the MFSA, during the period covered by the Annual Financial Return;

e. all information and explanations necessary for the purpose of the audit have been obtained.

1.23 Where, in the auditor's opinion, one or more of the requirements have not been met, the auditor shall be required to include in his report a statement specifying the relevant requirements and the respects in which they have not been met. Where the auditor is unable to form an opinion as to whether the requirements have been met, the auditor shall be required to specify the relevant requirements and the reasons why he has been unable to form an opinion.

1.24 Authorised Persons in receipt of a management letter from their auditor which contains recommendations to remedy any weaknesses identified during the course of the audit, are required to submit to the MFSA by not later than six months from the end of the financial period to which the management letter relates, a statement setting out in detail the manner in which the auditor's recommendations have been/ are being implemented. In the instance where Authorised Persons have not taken / are not taking any action in respect of any one or more recommendations in the auditor's management letter, the reasons are to be included.

1.26 Authorised Persons are required to include in the Directors' Report (which should form part of the annual audited financial statements to members of the company), a statement regarding breaches of the Financial Market Rules or other regulatory requirements which occurred during the reporting period, and which were subject to an administrative penalty or other regulatory sanction.

Where there have been no breaches, it is sufficient merely to say so. However, if there have been breaches, a summary must be provided of the breach(es) committed and regulatory sanction imposed.

Risk Management and the Internal Capital Adequacy Assessment Process

1.27 The Authorised Person shall have in place an effective risk management process by taking the following actions with a view to manage its risks:

[a] establish, implement and maintain adequate risk management policies and procedures which identify the risks, including, particularly operational risk relating to the Authorised Person's activities, processes and systems, and where appropriate, set the level of risk tolerated by the Authorised Person;

[b] adopt effective arrangements, processes and mechanisms to manage the risks relating to the Authorised Person's activities, processes and systems, in light of that level of risk tolerance.

The Authorised Person shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. This is hereinafter referred to as the Authorised Person's Internal Capital Adequacy Assessment Process.

The Authorised Person shall, on yearly basis, review its risk management and internal capital adequacy assessment process ('RMICAAP') with the aim of ensuring that this process remains comprehensive and proportionate to the nature, scale and complexity of the activities of the Authorised Person concerned.

In preparing, reviewing and updating its RMICAAP, an Authorised Person shall refer to the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories.

1.28 As at the 31st January of every calendar year, the Authorised Person shall confirm to the MFSA that it has an RMICAAP in place and that this is comprehensive and proportionate to the nature, scale and complexity of the activities of the Authorised Person. Such confirmation shall be signed by two directors of the Authorised Person.

1.29 The Authorised Person may from time to time be requested by the MFSA to submit a RMICAAP Report outlining the arrangements, strategies, processes and mechanisms implemented by the Authorised Person to comply with Rule 1.27. The report shall *inter alia* indicate: **[i]** the risks to which the Authorised Person is/could be exposed; and **[ii]** the manner in which the Authorised Person is managing/intends to manage these risks. Such report shall be signed by two directors of the Authorised Person.

1.30 Taking into account the technical criteria set out in the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories, the MFSA shall review the RMICAAP Report submitted by an Authorised Person in terms of Rule 1.29 and evaluate the extent to which the Authorised Person has arrangements, strategies, processes and mechanisms in place which ensure a sound management and coverage of all material risks.

PART II – FINANCIAL RESOURCES REQUIREMENTS AND GUIDANCE ON THE COMPILATION OF THE FINANCIAL RETURN

2.0 Financial Resources Requirement

2.01 The Authorised Person shall at all times maintain own funds equal to or in excess of its capital resources requirement. This shall constitute the Authorised Person's Financial Resources Requirement.

2.02 Authorised Persons shall comply with any further financial resources requirements set by the MFSA. If the MFSA so determines, the Authorised Person will be given due notice in writing of the additional financial resources requirements which shall be applied.

2.03 The Authorised Person shall immediately advise the MFSA if at any time it is in breach of its Financial Resources Requirement. In this case, the MFSA may, if the circumstances justify it, allow the Authorised Person a limited period within which to restore its financial resources to the required level.

3.0 The Capital Resources Requirement

3.01 The Capital Resources Requirement of an Authorised Person shall be the higher of (i) and (ii) below:

i. Initial Capital;

ii. the sum of the non-trading book business risk components, the trading book risk components, the commodities instruments - risk component, the large exposures risk component, the foreign exchange risk component, and the operational risk component.

4.0 General Outline of the Initial Capital and the Risk Components

4.1 This section is aimed at explaining the elements which make up the capital resources requirement. Firstly a definition of initial capital is given and this is followed by the minimum capital requirements for the various categories of Authorised Persons. A description of each of the risk components is given in Rules 4.1.2 to 4.1.7. This is followed by an illustration of all the applicable risk components for Authorised Persons.

4.1.1 <u>*Types of Authorised Persons and Initial Capital*</u>

For the purpose of these Rules, '***initial capital***' shall be comprised of:

i. **equity capital** meaning: share capital subscribed by shareholders or other proprietors, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares; and

ii. **reserves** meaning: revenue reserves, interim net profits/retained profits for the year, unrealised fair value movements in held for trading financial instruments and other reserves.

Type of Authorised Person	**Initial Capital EURO**
Regulated Market	**730,000**
Central Securities Depository	**730,000**
Regulated Market and Central Securities Depository	**1,460,000**

4.1.2 *Risks associated with non-trading book business*

This category is made up of the credit/ counterparty risk component, being the possibility of a loss occurring due to:

i. the failure of a debtor of an Authorised Person to meet its contractual debt obligations; or

ii. the loss in value of any other asset which forms part of the Authorised Person's balance sheet.

4.1.3 *Risks associated with trading book business*

This category is made up of four risk components:

i. The position risk component:
The risk of losses, arising from movements in market prices, in on and off balance sheet investments in financial instruments which qualify as trading book business.

ii. The settlement risk component:
Settlement risk is the risk that the Authorised Person's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

iii. The counterparty risk component:
Counterparty risk is the amount of capital which the Authorised Person must hold against exposures in financial derivative instruments and credit derivatives.

iv. Free deliveries:
Free Deliveries caters for the risk that the Authorised Person has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

4.1.4 *Commodities Instruments - Risk Component*

Commodities Risk is the risk component required to cover the Authorised Person's risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market, including commodity derivatives.

4.1.5 *Large Exposures Risk Component*

The purpose of the large exposure requirement is to ensure that an Authorised Person manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements.

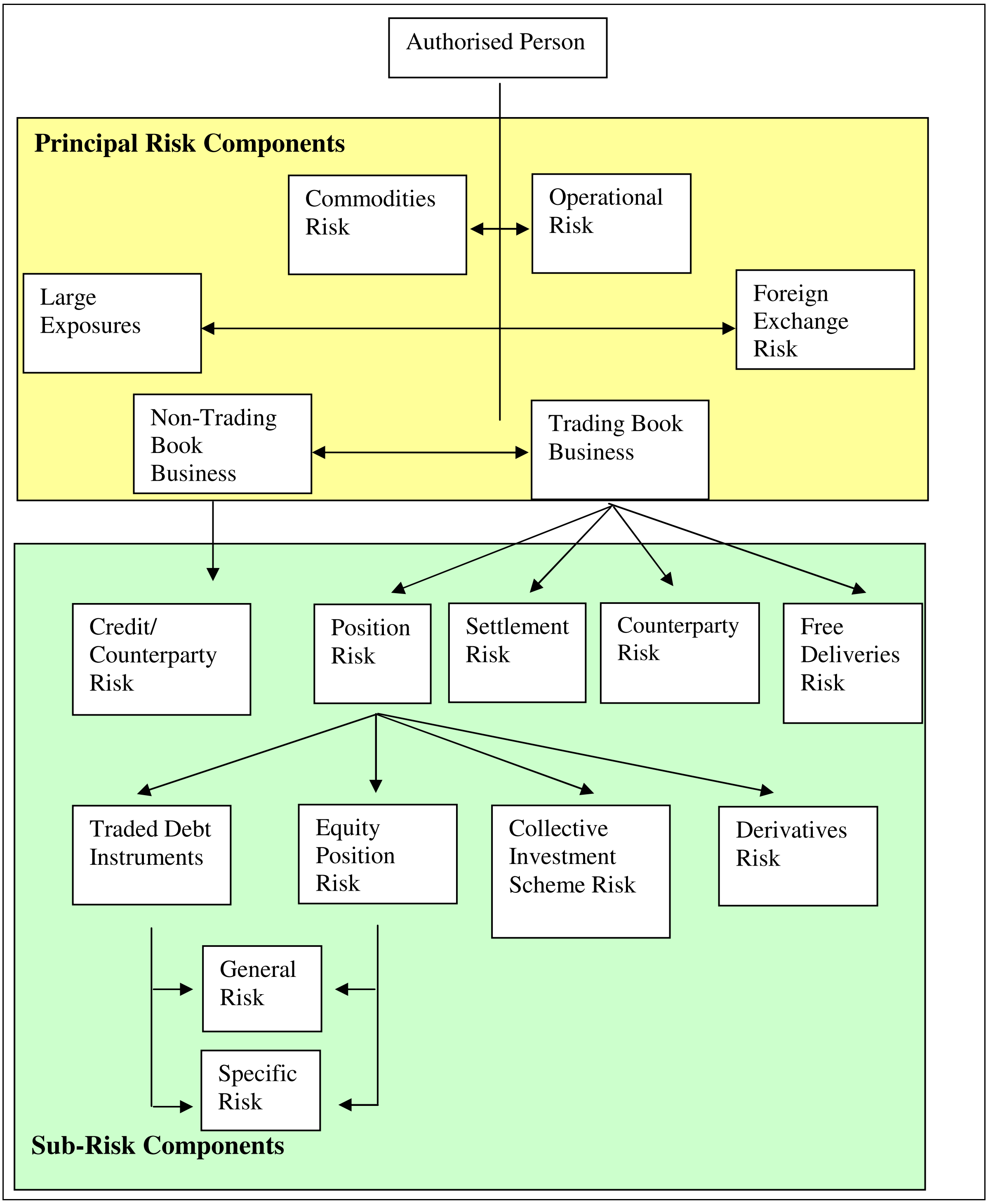
4.1.6 *Foreign Exchange Risk Component*

Foreign Exchange Risk is the risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

4.1.7 *Operational Risk Component*

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

Table outlining the various risk components



5.0 Trading Book

5.1 The trading book of an Authorised Person shall consist of all positions in financial instruments held either with trading intent or in order to hedge other elements of the trading book and, which are either free of any restrictive covenants on their tradability or are able to be hedged.

Provided that where the following requirements are met, trading book positions may be accounted for as non-trading book positions:

a. the trading book business of the Authorised Person does not normally exceed 5 %; and

b. their trading-book positions do not normally exceed EURO 15 Million; and

c. the trading book business of the Authorised Person never exceeds 6% of total business (being the combined off and on balance sheet business) and total trading book positions never exceed EUR 20 million.

In order to calculate the proportion that trading book business bears to total business for the purposes of points (a) and (c) above, Authorised Persons may refer to either: (i) to the size of the combined on and off-balance-sheet business, to the income statement or (ii) to the own funds of the institutions in question, or to a combination of those measures.

When the size of on and off balance-sheet business is assessed, **debt instruments** shall be valued at their market prices or their principal values, **equities** at their market prices and **derivatives** according to the nominal or market values of the instruments underlying them. Long positions and short positions shall be summed regardless of their signs.

If an Authorised Person subject to the exemption from the trading book requirement, exceeds:

i. either or both of the limits imposed in paragraphs (a) and (b); or

ii. either or both of the limits imposed in paragraph (c).

the Authorised Person shall be required to: (a) notify the MFSA immediately and (b) meet the requirements outlined in Rule 7.2.2.

5.2 The trading book shall also include all positions in derivative financial instruments whether or not these are held for trading.

5.3 In complying with Rule 5.1 above, an Authorised Person shall abide by the following conditions:

5.3.1 *Positions held with trading intent*

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 and positions arising from client servicing and market making.

5.3.2 *Trading intent*

Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the Authorised Person to manage the position or portfolio. These shall include the following:

a. The Authorised Person shall have a clear documented trading strategy for the position/instrument or portfolios. Such strategy shall be approved by senior management, and shall include the expected holding horizon;

b. The Authorised Person shall have clearly defined policies and procedures for the active management of the position, which shall include the following:

   i. positions entered into on a trading desk;

   ii. position limits are set and monitored for appropriateness;

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

   iv. positions are reported to senior management as an integral part of the Authorised Person's risk management process; and

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

c. The Authorised Person shall have clearly defined policies and procedures to monitor the positions against the Authorised Person's trading strategy including the monitoring of turnover and stale positions in the Authorised

Person's trading book.

5.3.3 <u>*Systems and controls*</u>

Authorised Persons shall establish and maintain systems and controls to manage their trading book. Such systems and controls shall be sufficient to provide prudent and reliable valuation estimates and shall include:

a. Documented policies and procedures for the process of valuation.

These should include clearly defined responsibilities of the various areas involved in the determination of the valuations, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures; and reporting lines for the department accountable for the valuation process that are clear and independent of the front office. The reporting line shall ultimately be to a main board executive director.

b. Prudent valuation methods as follows:

i. Marking to market, comprising as a minimum, the daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers;

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

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

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

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

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

- where available, valuation methodologies which are accepted market practice for particular financial instruments shall be used;

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

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

- the person/s responsible for risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and

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

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

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.

c. *Procedures for considering valuation adjustments/reserves* which make provision for (i) unearned credit spreads; (ii) close-out costs; (iii) operational risks; (iv) early termination; (v) investing and funding costs; (vi) future administrative costs and (vii) where relevant, model risk.

d. *Standards for less liquid positions as follows:*

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

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

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

iv. When valuation adjustments/reserves give rise to material losses in the current financial year, these shall be deducted from the Authorised Person's income statement.

v. Other profits/losses originating from valuation adjustments/reserves shall be included in the calculation of 'net trading book profits' and are to be added to/deducted from the Total Own Funds eligible to cover the risk components according to such provisions.

vi. Valuation adjustments/reserves which exceed those made under the accounting framework to which the Authorised Person is subject shall be treated in accordance with either point (iv) if they give rise to material losses, or otherwise in accordance with point (v) above.

e. *Policies and procedures covering inclusion in the trading book* as follows:

i. Authorised Persons shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirement, consistent with the criteria set out in rules 5.3.1 and 5.3.2 above and taking into account the Authorised Person's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and for those Authorised Person having an internal audit function.

ii. Authorised Persons shall have clearly defined policies and procedures for overall management of the trading book. As a minimum these policies and procedures shall address:

- the activities the Authorised Person considers to be trading and as constituting part of the trading book for capital requirement purposes;

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

- for positions that are marked-to-model, the extent to which the Authorised Person can: (i) identify all material risks of the position; (ii) hedge all material risks of the position with instruments for which an active, liquid two-way market exists; and (iii) derive reliable estimates for the key assumptions and parameters used in the model;

- the extent to which the Authorised Person can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;

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

- the extent to which the Authorised Person can, and is required to, actively risk manage the position within its trading operation; and

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

5.3.4 *Internal Hedging*

When including internal hedging in their trading book, Authorised Persons shall comply with the following:

a. 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 Rules. 5.3.1 and 5.3.2 are met. In particular:

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

– internal hedges shall be properly documented and subject to particular internal approval and audit procedures

– the internal transaction shall be dealt with at market conditions;

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

– internal transactions shall be carefully monitored;

– monitoring must be ensured by adequate procedures.

b. The treatment referred to in point (a) applies without prejudice to the capital requirements applicable to the 'non-trading book leg' of the internal hedge.

6.0 The Automated Financial Return

This section of the Rules provides detailed instructions on how Authorised Persons are to use the Automated Financial Return. It then provides an explanation of how Authorised Persons are to complete a number of worksheets in the Return, namely:

i. Cover Sheet;
ii. the Input Sheet (Sheet 1);
iii. the Income Statement (Sheet 2);
iv. the Balance Sheet (Sheet 3);
v. Representations (Sheet 15); and
vi. Validation Sheet.

Detailed explanations of the:

i. Own Funds (Sheet 4);
ii. the Risk Components (Sheets 5 – 13); and
iii. the Capital Resources Requirement (Sheet 14)

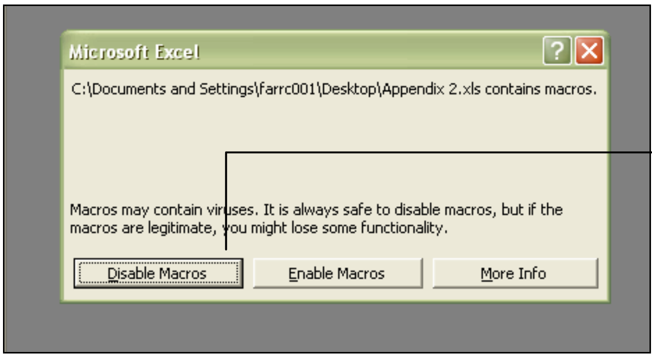
are provided in section 7.0 of these Rules

6.1 *Instructions for using the Automated Financial Return*

a. This section of the Rules provides guidance for Authorised Persons when compiling the automated Interim Financial Return (“IFR”), the automated Annual Financial Return (“AFR”) and the automated Annual Audited Financial Return (“AAFR”). Unless otherwise specified, the term “Return” and in these Rules refers to the IFR, AFR and AAFR.

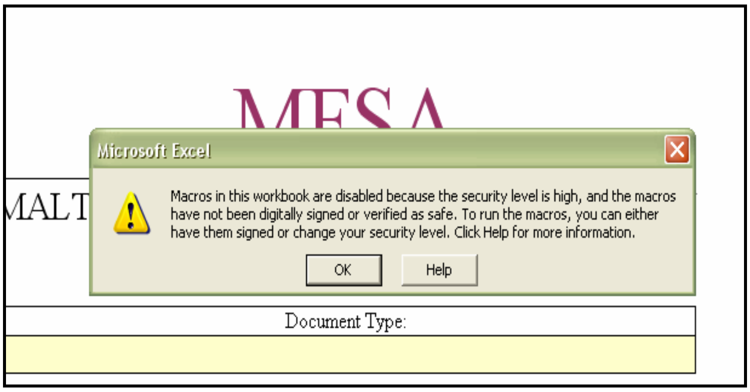
b. The Return is compiled via an Ms Excel file titled, “FMR APPENDIX 1.XLS”. This file has been optimised for use on Microsoft Excel 2002. Some functions may not work if converted for use with other software or previous versions of Excel. These Excel files are to be retained as Master Copies.

   When opening the Excel Spreadsheet named “FMR APPENDIX 1.XLS” a window will open up which will gives the option to enable the macros. Click on the button “Enable Macros” prior to proceeding with the compilation of the Return.



Click on this ICON to enable Macros

If a further pop-up window appears on screen, as shown in the figure below, kindly amend the program's settings as described on the next page.



If this note pops up, then amend the settings of your computer as follows: Click on "Tools", "Options", "Security", "Macro Security", "Medium" or "Low".

c. Each Return consists of sixteen worksheets. To select a worksheet, go to the "CONTENTS" sheet and click on the button next to the required sheet.

d. The worksheets are password protected. With the exception of cells highlighted in yellow, all cells in this program are locked and only these cells allow the inputting, deleting and amending of values.

e. In instances where the cells are linked, only the values need to be inputted once.

f. Subtotals are calculated automatically.

g. A number of worksheets require manual intervention by being prompted to execute a function or to input a value. Any computer prompted instructions are to be followed carefully.

h. Authorised Persons are to provide additional details where required. This is required at the bottom of “SHEETS 2 and 3”. It is preferable that entries should not exceed the space provided for this purpose.

i. A number of worksheets require the Authorised Person to provide supporting documentary evidence of how a particular figure was calculated. Authorised Persons are to attach such documents as annexes to the Return and clear reference to the relevant worksheet should be included.

j. The compilation of the automated Return should start from the first worksheet (that is, the “COVER SHEET”). Details should be inserted (as and where appropriate) starting from the top and moving to the end of each worksheet.

k. The following is an outline of all the applicable sheets together with an indication of which sheets require manual input and those which are fully automated:

Sheet	**Sheet title**	**Action to be taken**
Cover Sheet		Manual Input (mandatory)
Contents Sheet	**Contents**	N/A
Sheet 1	**Input Sheet**	Manual Input (mandatory)
Sheet 2	**Income Statement**	Manual Input (where applicable)
Sheet 3	**Balance Sheet**	Manual Input (where applicable)
Sheet 4	**Own Funds**	Manual Input (where applicable)

Sheet	Sheet title	Action to be taken
Sheet 5	**Credit/Counterparty Risk**	Fully Automated
Sheet 6	**Position Risk Component** Traded Debt Instruments (Specific Risk Component)	Manual Input (where applicable)
Sheet 7	**Position Risk Component** Traded Debt Instruments (General Risk Component)	Fully Automated
Sheet 8	**Position Risk Component** Equity	Manual Input (where applicable)
Sheet 9	**Position Risk Component** Collective Investment Schemes	Manual Input (where applicable)
Sheet 10	**Settlement Risk Component**	Fully Automated
Sheet 11	**Free Deliveries**	Fully Automated
Sheet 12	**Large Exposures Risk Component**	Manual Input (where applicable)
Sheet 13	**Foreign Exchange Risk Component**	Manual Input (where applicable)
Sheet 14	**Capital Resources Requirement**	Manual Input (where applicable)

<u>**Sheet**</u>	<u>**Sheet title**</u>	<u>**Action to be taken**</u>
Sheet 15	**Representations**	Manual Input (mandatory)
Validation Sheet		Fully Automated

l. For ease of reference, the sheets which require manual input have been marked in blue in the "CONTENTS" Sheet.

m. Users should not key in "0" or "-" whenever a value is nil but should leave the cell empty.

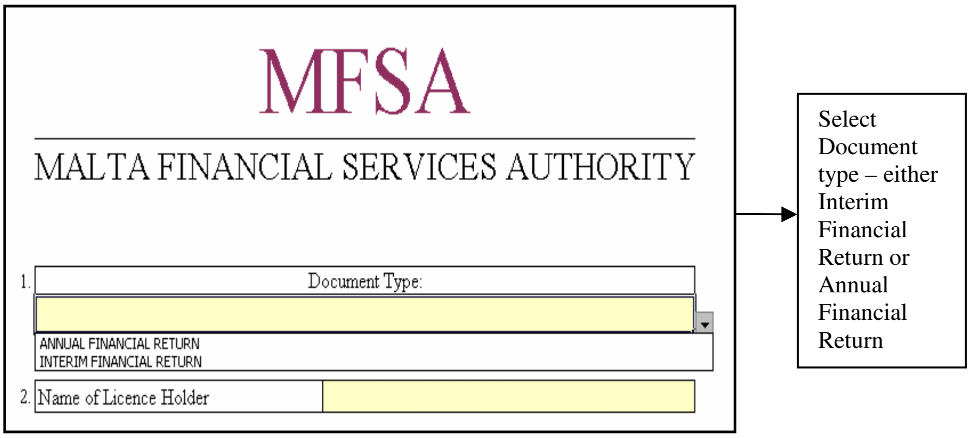
n. **Only the worksheets which are marked in red in the "CONTENTS" sheet must be printed.**

o. **Returns should be submitted by their due date in both hardcopy (signed) and electronic format (by diskette, compact disc or e-mail). Please note that the submission of Returns by e-mail is at the Authorised Person's own discretion and risk (since communications by e-mail may not be secure).**

6.2 *Cover Sheet*

a. All cells in items 1 to 8 which are highlighted in yellow are to be completed.

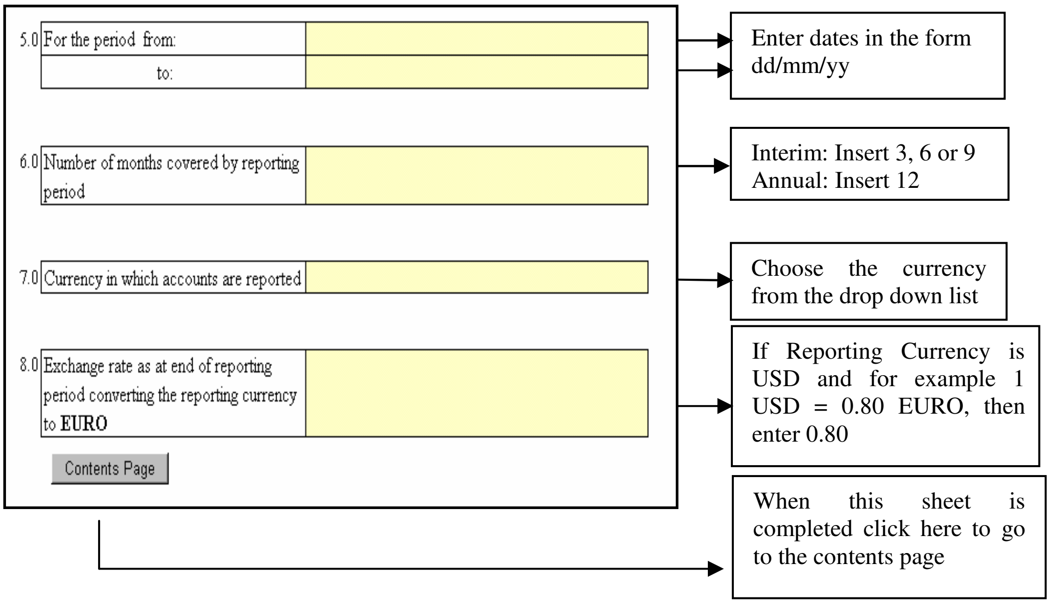
b. Item 1: Select document type – either Annual or Interim Financial Return – from the drop down list depending on the period for which the Return is being compiled.



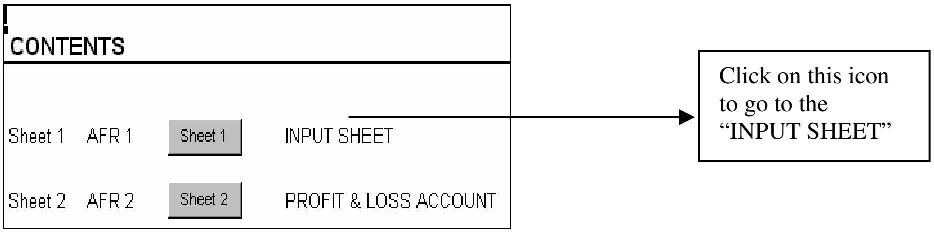
c. Returns are to be prepared in the currency in which the Audited Annual Financial Statements are compiled. The Reporting Currency of the accounts should be inserted in ISO Code.

d. Irrespective of the Reporting Currency, the relevant Middle Exchange Rate converting EUR to the Reporting Currency is to be inserted in Item 8.

e. Upon satisfactory completion of items 1 – 8, click on the button “Contents Page” at the bottom of this sheet to go to the “Contents Sheet”.



6.3 *Input Sheet – Sheet 1*



a. Click on the button "SHEET 1" in the 'Contents Sheet' to go to the "INPUT SHEET".

b. The Input Sheet has a similar structure to a Trial Balance. All amounts on the credit (mainly items of income and liabilities) are to have a negative figure, by inserting a '-' sign before the figure. On the other hand, all the amounts on the debit (mainly assets and expenses) should be indicated as positive by inserting the '+' sign before the figure. If a negative amount is filled in a cell representing an asset, the program will prompt the Authorised Person to insert a positive amount. In general, the Authorised Person will not be allowed to insert a negative amount in a cell representing an asset or an expense. Similarly such Authorised Person will not be allowed to insert a positive amount in a cell representing an item of income or a liability. For convenience, some cells have an automated pop-up window explaining what must be inserted.

c. The "INPUT SHEET" is mainly divided into six sections as follows:
   i. Income
   ii. Expenditure
   iii. Assets
   iv. Liabilities
   v. Capital & Reserves
   vi. Other

d. Under the "Income and Expenditure" sections, the revenue/ expenses earned/ incurred by the Authorised Person during the reporting period are to be included.

   (N.B.) Besides providing for taxation in the Annual Income statement included in the AFR, Authorised Persons are also required to provide for taxation in the Interim (monthly, quarterly or half-yearly – as applicable) Income statement in the IFR.

e. Allowable Commissions and Fees, Item 2 (a) in the "Revenue" section relates to commissions and fees payable, provided they are directly attributable to commissions and fees receivable which are included in total revenue.

f. For the purpose of the IFRS prudential reporting framework report: (i) Unrealised fair value movements on financial instruments which are designated at inception as instruments to be maintained at fair value through the profit and loss account, Item 2(o)(ii)) Unrealised fair value movements on "held for trading" financial instruments, Item 2 (p)(iii) fair value movements on 'available for sale' financial instruments as per IAS 39, Item 2 (t), and (iv) revaluations on property as per IAS 40, Item 2 (u).

g. Exceptional Expenditure, Item 2(c)(i) in the "Expenditure" section are items of expenditure for which the MFSA's no-objection should be sought prior to their inclusion in the Return.

h. Under the "Assets" section, financial instruments, both long and short positions, held on the Authorised Person's (item 3 (d)) balance sheet are to be categorised under one of the available headings. The long or short position in a particular investment is the net of any long or short positions held in that same investment. Short positions in any financial instrument are to be included as positions held with trading intent only. The Authorised Person must include both the balance sheet value and the market value of these financial instruments. Where financial instruments are held at fair values, the Authorised Person must input the market value under both cells. It is important that financial instruments are inserted under their appropriate heading.

i. Collective investment schemes, Item 3 (e)(iii), are any amounts receivable by the Authorised Person from transactions in collective investment schemes.

j. Group creditors - due within 1 year, Item 4 (c) and Group creditors - due after more than 1 year, Item 4.0 (g). These represent amounts receivable from group companies and/ or connected persons. The definition of "Group" to be considered is that defined in the Companies Act, 1995 and "connected counterparty" as defined in Rule 7.2.4 (A)(iii).

k. The Authorised Person must also indicate under Item 6 (a) whether it has any assets or liabilities denominated in a Foreign Currency. If the answer is "YES" the Authorised Person must compile Sheet 13 which deals with Foreign Exchange Risk adjustments.

l. Secured Liabilities, Item 6(b). Under item (i), the Authorised Person must include the total secured liabilities which are due within 1 year. On the other hand, under item (ii) the Authorised Person must insert that part of the amount inserted in (i) which is secured by a charge on land and buildings.

Under item (iii), the Authorised Person must include the total secured liabilities which are due after more than 1 year. Similarly, under item (iv) the Authorised Person must insert that part of the amount inserted in (iii) which is secured by a charge on land and buildings.

m. The Authorised Person is to input the relevant figures for items 6(c), 6(d), 6(e), 6(f), 6(g), and 6(i) if these are applicable.

n. The Authorised Person should indicate the credit/ counterparty risk calculation which has been used in the Return in Item 6 (h).

o. The Authorised Person should indicate under Item 6 (j) whether it holds positions in derivative financial instruments. If the answer is "YES" the Authorised Person should refer to Rule 7.2.2.1 of these Rules and include the total Derivative Risk component in Sheet 14 item 3(a).

p. If the Authorised Person held positions in commodities during the reporting period, then Item 6 (k) should be marked as "YES". The Authorised Person should refer to Rule 7.2.3 and include the total Commodities Instruments - Risk Component in Sheet 14 Item 4.

q. Once the relevant parts of Sections 1 – 6 have been completed click on the button "Print Set-up". Automatically, all those cells which have been left empty will be hidden. After printing this sheet, the user may click on the button "Show all" and all the hidden cells will re-appear. Click on the button "Return to Contents" to return to the contents page.

6.4 *Income Statement – Sheet 2*

a. This sheet is fully automated except for Items 8.0 and 20.0.

b. The space provided in Item 8.0 ("Details of 'Other FMA related revenue' and/or Any other details or comments") is to be used to explain Item 5.0 ("Other FMA related revenue").

c. The space provided in Item 20.0 ("Details of Exceptional items of expenditure allowed by MFSA, other variable expenditure and other fixed expenditure") should provide explanations to Item 10.0 (a) ("Exceptional Items of expenditure allowed by MFSA"), item 11.0 (j) ('Other Variable Expenditure') and item 11.0 (k) ('Other Fixed Expenditure').

6.5 *Balance Sheet – Sheet 3*

a. This sheet is fully automated except for Item 12.0.

b. The space provided in Item 12.0 ("Details of 'Amounts due to/ from other connected persons' and/or 'Amounts due to/ from Group Companies' and/or Any other details or comments") should include explanations to the following Items:

i. Item 3.0 (c)(*"Amounts due from Group Companies"*)
ii. Item 3.0(d) (*"Amounts due from other connected persons"*)
iii. Item 4.0 (c) (*"Amounts due to Group Companies – within 1 year"*)
iv. Item 4.0(d) (*"Amounts due to other connected persons – within 1 year"*)
v. Item 7.0(b) (*"Amounts due to Group Companies – after more than 1 year"*)
vi. Item 7.0 (c) (*"Amounts due to other connected persons – after more than 1 year"*)

6.6 *Sheet 15 – Representations*

a. Where applicable, all the cells marked in yellow are to be inputted.

b. Some cells enable the user to select a reply from a drop down menu.

c. Items 1 – 3 of this sheet must be filled by the Authorised Person.

d. The date when the Authorised Person approved the Return is to be inputted in item 4.

e. The Authorised Person may add further details/comments in item 5 of this Sheet.

f. The Return is to be signed by two Directors or other authorised signatories. When the Return is signed by the latter, the Authorised Person should provide a certified true copy of the Board of Directors' Resolution authorising the individual to sign the Return on behalf of the Directors.

g. Where the Return is being compiled as an Audited Annual Financial Return, items 6 and 7 of the Return are to be completed. Furthermore, it must also be signed by the auditor of the Authorised Person

6.8 *Validation Sheet*

Prior to submitting the Return to the MFSA, the Authorised Person must ensure that all Validations are marked "OK". Where the Validation is marked "ERROR", the Authorised Person should check and correct the relevant sheet accordingly.

7.0 The various elements which make up the calculation of the Own Funds, the Risk Components and the Fixed Overheads Requirement

7.1 *Own Funds*

Own Funds means the sum of tier one capital, tier two capital and tier three capital.

7.1.1 <u>*Tier One Capital*</u>

Tier one Capital is made up of items of a capital nature which: (a) are permanent; (b) are able to absorb losses; (c) rank for repayment upon winding up after all other debts and liabilities; and (d) do not yield a fixed return to their investors but provide dividends/ interest at the discretion of the board of directors of the Authorised Person.

Tier one capital, being the summation of points (A) + (B) – (C) - (D) below:

(A) Core Tier One Capital:

i. Ordinary share capital:
The nominal paid–up value of the share capital. The unpaid element of partly paid-up shares or authorized share capital is to be excluded.

ii. Share premium account:
Any amount received in excess of the nominal value of any issued ordinary shares.

iii. Revenue reserves:
Revenue Reserves as at the beginning of the reporting period.

iv. Interim net profits/retained profits for the year:
Profits for the reporting period.

v. Other reserves

(B) Non - Core Tier One Capital:

i. Perpetual non-cumulative preference shares:
Perpetual (non-redeemable) non-cumulative preference shares, which have been issued and paid up.

ii. Minority Interests (applicable for the scope of consolidation)
That portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

(C) Deductions from Tier One Capital:

i. Investments in own shares:
Own Shares held at book value.

ii. Goodwill:
Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

iii. Other Intangible assets:
Any other indefinable non-monetary assets without physical substance.

iv. Material current year losses/retained losses for the year:
Losses for the reporting period.

(D) Additional deductions from Tier One Capital (IFRS Prudential Filters):

For the purpose of prudential filters for regulatory capital, any unrealised losses on Items (i) to (iii) below are to be fully deducted.

i. Deduct 100% of unrealised losses on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - (in accordance with IAS 39).

ii. Deductions in relation to fair value movements on 'available for sale' financial instruments as per IAS 39.

iii. Unrealised losses on revaluation of property as per IAS 40.

7.1.2 Tier Two Capital

Tier two Capital consists of instruments that combine the features of debt and equity wherein they are structured like debt but exhibit some of the loss absorption and funding flexibility forms of equity.

Tier two capital, being the summation of points (A) + (B) + (C) – (D) below:

(A) Upper Tier Two Capital:
Perpetual securities are securities including cumulative preference shares which fulfil the following conditions: (a) they may not be reimbursed on the bearer's initiative or without the prior agreement of the MFSA; (b) the debt agreement must provide for the Authorised Person to have the option of deferring the payment of

interest on the debt; (c) the lender's claims on the reporting Authorised Person must be wholly subordinated to those of all non-subordinated creditors; (d) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the reporting Authorised Person in a position to continue trading; (e) only full paid-up amounts are to be considered.

(B) Lower Tier Two Capital:

i. Fixed Term Preference Share Capital
Fixed term cumulative and non-cumulative preference shares (if not redeemable within 5 years), which have been issued and paid up.

ii. Bank and/or other third party guarantees
Bank or third party guarantees approved by the MFSA. The guarantee must be in the form set out in Appendix IV or V.

N.B. As explained in Rule 7.1.4 total tier two capital shall not be greater than 100% of total tier one capital after deductions. Lower tier two capital must at all times be less than 50% of total tier one capital after deductions.

iii. Subordinated Loan Capital
Subordinated loans which have been approved by the MFSA. The subordinated loans must be approved by the MFSA and must be in the form set out in Appendix III.

N.B. As explained in Rule 7.1.4 total tier two capital shall not be greater than 100% of total tier one capital after deductions. Lower tier two capital must at all times be less than 50% of total tier one capital after deductions.

iv. Internal ratings based approach (IRB) to risk weight exposure:
Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

(C) Prudential Filters additions to Own Funds

i. Unrealised profits on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - (in accordance with IAS 39)

   This calculation adds back 65% of additions to fair value movements on assets to be maintained at fair value through the profit and loss account.

ii. Additions in relation to fair value movements on 'available for sale' financial instruments as per IAS 39

This calculation adds back 65% of additions to fair value movements on available for sale financial assets.

iii. Unrealised gains on revaluation of property

This calculation adds back 65% of the Unrealised losses on revaluation of property done in terms of IAS 40.

(D) Deductions from Tier Two Capital

i. Material Holdings in credit and financial institutions

These being holdings by the Authorised Person of more than 10% of the capital of other credit or financial institutions as defined in the European Directive 2006/48 EC relating to the taking up and pursuit of the business of credit institutions. .

ii. Expected losses from risk weighted exposure amount using the Internal Ratings Based approach to credit risk

Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

iii. IRB value adjustments

Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

iv. Additional deductions

Where the Authorised Person forms part of a financial conglomerate, participations and/ or other instruments held in insurance schemes, reinsurance schemes and insurance holding companies are to be deducted.

v. Additional capital requirement

Additional capital requirement - in the case where half of the total of items (i) to (iv) above exceed total tier two capital (Upper Tier Two Capital + Lower Tier Two Capital), the amount by which tier two capital is exceeded should be taken as a deduction from own funds.

7.1.3 *Tier Three Capital*

Tier three capital is composed of Interim Trading Book Profits and Losses. Any profits or losses which the Authorised Person makes with respect to trading book business which includes any foreseeable charges and dividends and which has not been included in the Income Statement.

7.1.4 *Restrictions on Own Funds*

a. Non-core tier one capital is to be **less than 50%** of total tier one capital after deductions;

b. Total tier two capital **must at all times be less** than total tier one capital after deductions;

c. Lower tier two capital **must at all times be less than 50%** of total tier one capital after deductions; and

d. Total tier two capital after deductions and tier three capital must **at all times be less than 200%** of total tier one capital after deductions

Authorised Persons must ensure that the above conditions are met at all times. Should the Authorised Person be in breach of any of the above conditions, the MFSA is to be immediately notified.

7.1.4 *The Return*

Sheet 4 – (Own Funds) of the Return, which calculates the Authorised Person's own funds is fully automated and does not require any form of manual intervention in the case where the Standardised Approach to credit/counterparty risk is used by the Authorised Person.

The Authorised Person is to ensure that items 1.0 – 3.0 in the section "OWN FUNDS WARNINGS", section of Sheet 4 are in order. This ensures that any of the restrictions listed in Rule 7.1.4 have not been exceeded. Where the restrictions on Own Funds have been exceeded, the Authorised Person should inform the MFSA of the action to be taken to reduce this exposure.

7.2 *Risk Components*

7.2.1 *Non Trading Book Business Risk Component:*

This category is made up of the credit/counterparty risk component.

7.2.1.1 *Credit/Counterparty Risk Component*

Being the possibility of a loss occurring due to:

i. the failure of a debtor of a Authorised Person to meet its contractual debt obligations; or

ii. the loss in value of any other asset (excluding derivatives which are exclusively dealt with in the sections on trading book business and commodities instruments – risk component) which forms part of the Authorised Person's balance sheet except for: (a) intangible assets including goodwill; (b) cash in hand and at bank; (c) those financial instruments which fall within the category of trading book business; and (d) commodity positions.

(A) Measuring the Credit/Counterparty Risk

The credit/ counterparty risk can be measured through any one of the following three methods: (i) the Standardised Approach, (ii) the Foundation Internal Ratings Based Approach (FIRB) or the (iii) the Advanced Internal Ratings Based Approach (AIRB).

The Standardised Approach calculates the credit risk component by applying a broad category of risk weights to non-trading book business asset exposures.

N.B. These Rules and the Return cater for the Standardised Approach. The FIRB and the AIRB approaches are based on the Authorised Person's assessments of the risks to which it is exposed. It is strongly recommended that MFSA's guidance is sought prior to adopting these alternative methods, which methods are to be approved by the MFSA.

(B) Credit/ Counterparty Risk applying the Standardised Approach

The computation of the credit/counterparty risk component using the standardised approach is calculated as follows:

i. identify the exposure value of the asset item – i.e. the balance sheet value of that particular asset;

ii. assign each exposure to one of the exposure classes defined in (C) below;

iii. calculate the risk weighted exposure amounts by multiplying the exposure value by an applicable risk weight;

iv. add the total risk weighted exposure amounts; and

v. the credit/counterparty risk capital component is 8% of the total risk weighted exposure amounts.

(C) Exposure classes

The non-trading book business asset exposures of Authorised Persons are to be categorised within one of the 8 exposure classes which are explained further on in this Rule.

A number of these Exposure Classes apply the Credit Quality Steps Approach ('CQSA'). In terms of CQSA, the individual risk weighting of non-trading book asset exposures is to be assigned a risk weighting depending on their credit quality assessment rating.

Steps to use the CQSA:

i. Check whether the relevant non-trading book business asset exposure is rated by one of the following rating agencies: Fitch Rating, Moody's, and Standard and Poor's;

ii. Obtain from the rating agency the rating of the relevant non-trading book business asset exposure;

iii. Apply the following mapping table to categorise the non-trading book business asset exposure in one of the credit quality steps:

Credit Quality Step	Fitch's assessment	Moody's assessment	S&P assessment
1	AAA to AA-	Aaa to Aa3	AAA to AA-
2	A+ to A-	A1 to A3	A+ to A-
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-

Credit Quality Step	Fitch's assessment	Moody's assessment	S&P assessment
5	B+ to B-	B1 to B3	B+ to B-
6	CCC+ and below	Caal and below	CCC+ and below

iv. the risk weighting assigned to the non-trading book business asset exposure will vary depending on the type of exposure class and the credit quality step assigned.

Exposure – Class 1
Tangible Assets such as land, building, office furniture.

Risk Weighting: The risk weight to be applied is 100%.

Exposure – Class 2
Claims or contingent claims on central governments or central banks such as Government Bonds or T-bills.

Risk Weighting:

a. Exposures to EEA States
Exposures to EEA states' central governments and central banks denominated in the national currency of the borrower should be assigned a 0% risk weight.

b. Applying the CQSA
Use the CQSA where the non-trading book business asset exposure is rated by one of the rating agencies mentioned in C (iii) above. The following risk weightings will apply depending on the credit quality step category within which the relevant non-trading book business asset exposure falls.

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

c. Other Class 2 exposures

Other exposures are to be allocated a risk weight of 100%.

Exposure – Class 3
Amounts receivable from EEA Financial Services Licensed Entities such as accruals and debt securities

Risk Weighting:

a. Exposures to debt securities redeemable after three months
Applying the CQSA: Use the CQSA where the exposure to debt securities issued by EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

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

Unrated exposures which fall within this category are to be allocated a risk weight of 50%.

b. Exposures to debt securities redeemable before three months
Applying the CQSA: Use the CQSA where the exposure to debt securities issued by EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

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

Unrated exposures which fall within this category are to be allocated a risk weight of 20%.

c. Other Class 3 exposures
Amounts which fall within this category and are due within three months are to be assigned a risk weight of 20%.

Other amounts due should be assigned a risk weight of 50%.

Exposure – Class 4
Amounts receivable from Corporates/ other Entities other than EEA Financial Services Licensed Entities

Risk Weighting:

a. Applying the CQSA:
Use the CQSA where the exposure to debt securities issued by corporates other than EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

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

b. Other Class 4 exposures
Other exposures including which fall within this category are to be allocated a risk weight of 100%.

Exposure – Class 5
Investments in collective investment schemes

Risk Weighting:

a. High Risk Collective Investment Schemes:
Investments in units of Collective Investment Schemes which have the majority of their portfolio invested in high risk instruments such as derivatives should be allocated a risk weight of 150%.

b. Other Collective Investment Schemes:
Investments in other collective investment schemes should be allocated a risk weight of 100%.

Exposure – Class 6
Shares

Risk Weighting:

a. Shares traded on a EU Regulated Market or the Regulated Market of a developed financial centre
The risk weight to be applied is 100%.

b. Other Shares (including investments in Venture Capital Firms private equity investments)
The risk weight to be applied is 150%.

c. Investments in connected companies.
The risk weight to be applied is 100%.

Exposure – Class 7
Amounts receivable from Government Bodies and Local Authorities

Risk Weighting:

Amounts due within three months are to be assigned a risk weight of 20%. Other amounts due should be assigned a risk weight of 50%.

Exposure – Class 8
Other Balance Sheet Items such as Prepayments and accrued income; amounts due from group or connected companies; amounts due from collective investment schemes; and other debtors

Risk Weighting:

The risk weight to be applied is 100%.

Credit/Counterparty Risk - Steps to be followed in the Return
In the Input Sheet of the Return:

i. identify those assets which qualify as non-trading book business asset exposure;

ii. categorise the non-trading book business asset exposure under one of the Exposure Classes referred to above;

iii. input a description of the relevant non-trading book business asset exposure;

iv. input the 'balance sheet value' and the 'market value' of the non-trading book business asset exposure in the adjacent columns

v. qualify the asset as a non-trading book business asset exposure by choosing letter 'N' from the drop down list which is available in the column titled 'Held with trading intent?';

vi. where the risk weighting of the non-trading book business asset exposure is determined through the CQSA, depending on the category of asset, choose the applicable option from the drop down list which is available in the column titled 'Credit Quality Assessment';

vii. the return will automatically compute the credit risk component in sheet 5.

7.2.2 <u>*Trading Book Business Risk Component:*</u>

This category is made up of four risk components: (i) the position risk component; (ii) the settlement risk component; (iii) the counterparty risk component; and (iv) free deliveries.

7.2.2.1 *Position Risk*

The position risk component is defined as the risk of losses in on and off balance sheet investments in financial instruments, which qualify as trading book business, arising from the movement in market prices. For the purpose of the calculation of position risk, financial instruments are categorised under one of the following titles: (i) Traded Debt Instruments; (ii) Traded Equities; (iii) Collective Investment Schemes; and (iv) Derivatives.

N.B. These Rules and the Return provide for the calculation of the position risk component of all types of financial instruments except for derivatives. As it is generally the exception that Authorised Persons invest in derivatives, MFSA has taken the approach that the calculation of the risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in derivatives should contact the MFSA for guidance as to how the derivatives related position risk component should be catered for in their Return.

(A) Measuring the Position Risk Component

The methodology for measuring the position risk component varies depending on the type of financial instrument. The following explains the manner in which the position risk component is calculated.

(B) Traded Debt Instruments / Traded Equities

The calculation of the position risk component for Traded Debt Instruments, and Traded Equity is based on two factors being:

i. the specific risk factor which is the risk of a price change in the instruments due to risks inherent to its Issuer; and

ii. the general risk factor being the risk of a price change in the instruments due to a change in the level of interest rates in the case of a traded debt instrument or a broad equity market movement unrelated to specific attributes of individual securities in the case of equity.

<u>*Traded Debt Instruments: Specific Risk*</u>

The specific risk factor of the position risk component of a traded debt instrument is equivalent to the market value of the debt instrument multiplied by the applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

a. the classification of the debt instrument;

b. the rating of the debt instrument (if any) – for an explanation of how to establish the rating of a Debt Instrument, please refer to the explanation of the CQSA in point ((C)) of Rule 7.2.1.1; and

c. the number of months to maturity.

In order to calculate the specific risk for the position risk component of traded debt instruments, the following classifications/position risk weightings apply:

Traded Debt Instrument Classifications	**Rating Credit Quality Steps**	**Number of months to maturity**	**Risk Weights**
CATEGORY 1 Debt instruments issued by the central governments or *centralbanks* - same as credit risk - class 2 exposure however, falling within the definition of trading book business	**CQS 1 or 0% Risk Weight**	**Any**	**0%**
	CQS 2 or 3	**0 - 6 Months**	**0.25%**
		6 – 24 Months	**1%**
		Over 24 Months	**1.6%**
	CQS 4 or 5	**Any**	**8%**
	CQS 6	**Any**	**12%**
CATEGORY 2 Debt instruments issued by EEA Financial Services Licensed Entities - same as credit risk – class 3 exposure however, falling within the definition of trading book business	**CQS 1 or 2 or 3**	**0 - 6 Months**	**0.25%**
		6 – 24 Months	**1%**
		Over 24 Months	**1.6%**
	CQS 4	**Any**	**8%**
	CQS 5 or 6	**Any**	**12%**

Traded Debt Instrument Classifications	Rating Credit Quality Steps	Number of months to maturity	Risk Weights
CATEGORY 3 Other debt instruments being – Debt instruments issued by Corporates /other entities other than EEA Financial Services Licensed Entities– class 4 exposure however, falling within the definition of trading book business Debt instruments which show a particular risk due to insufficient solvency of the issuer which fall within any of the above categories are to be included the maximum weighting.	**CQS 1 or 2**	**0 - 6 Months**	**0.25%**
		6 – 24 Months	**1%**
		Over 24 Months	**1.6%**
	CQS 3 or 4	**Any**	**8%**
	CQS 5 or 6	**Any**	**12%**

Traded Debt Instruments: General Risk

The general risk factor of the position risk component of a traded debt instrument is equivalent to the market value of the debt instrument multiplied by the applicable position risk weighting, which weighting depends on: (a) the coupon rate; (b) the number of months to maturity; and (c) the zone within which the said debt instrument falls. Traded debt instruments are categorised into three zones depending on the time to maturity of each particular instrument. The scope of this categorisation is to net any opposite positions (long and short) within the same zone.

The table in the following page outlines the applicable general position risk weighting of debt instruments which qualify as trading book business:

Zone	Maturity Band		Weighting
	Coupon which is less than 3%	**Coupon which is 3% or more**	
One	0 to 1 month	0 to 1 month	0.00%
	Over 1 month and less than or equal to 3 months	Over 1 month and less than or equal to 3 months	0.20%
	Over 3 months and less than or equal to 6 months	Over 3 months and less than or equal to 6 months	0.40%
	Over 6 months but less than or equal to 12 months	Over 6 months but less than or equal to 12 months	0.70%
Two	Over 12 months but less than or equal to 23 months	Over 12 months but less than or equal to 24 months	1.25%
	Over 23 months but less than or equal 34 months	Over 24 months but less than or equal 36 months	1.75%
	Over 34 months but less than or equal to 43 months	Over 36 months but less than or equal to 48 months	2.25%
Three	Over 43 months but less than or equal to 52 months	Over 48 months but less than or equal to 60 months	2.75%
	Over 52 months but less than or equal to 68 months	Over 60 months but less than or equal to 84 months	3.25%
	Over 68 months but less than or equal 88 months	Over 84 months but less than or equal 120 months	3.75%

Zone	Maturity Band		Weighting
	Coupon which is less than 3%	Coupon which is 3% or more	
	Over 88 months but less than or equal 112 months	Over 120 months but less than or equal 180 months	4.50%
	Over 127 months but less than or equal to 144 months	Over 180 months but less than or equal to 240 months	5.25%
	Over 144 months but less than or equal to 240 months	Over 240 months	6.00%
	Over 240 months		8.00%

Traded Debt Instruments: Specific Risk and General Risk of the Position Risk Component – Steps to be followed in the Return

In the Input Sheet of the Return:

a. identify those financial instruments which fall within the traded debt instruments category and which qualify as trading book business asset exposures;

b. input a description in section 3 (d) of the relevant trading book business asset exposure;

c. input the 'balance sheet value' and the 'market value' of the trading book business asset exposure in the adjacent columns;

d. qualify the asset as a trading book business asset exposure by choosing 'YES' from the drop down list which is available in the column titled 'Held with trading intent?';

e. input the number of months to maturity in the adjacent column;

f. where the risk weighting of the trading book business asset exposure is determined through the CQSA, depending on the category of asset, choose the applicable option from the drop down list which is available in the column titled 'Credit Quality Assessment';

g. input the coupon rate in the final column;

h. the return will automatically compute both the specific and general risk for traded debt instruments in Sheet 6 and Sheet 7 respectively.

Equity: Specific Risk

The specific risk factor of the position risk component of an equity instrument is equivalent to the overall gross position in equity instruments multiplied by the applicable risk weighting. The overall gross position is defined as the summation of the market values of all long and short positions in equity instruments. In order to establish the risk weighting, the following should be taken into consideration:

- the classification of the equity instrument into either: (a) shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre; and (b) Other Shares (including investments in venture capital firms and private equity investments);

- the applicable risk weighting of the equity instrument, is 2% for equity instruments which fall within classification (a) of the above first bullet point and 4% for equity instruments falling within classification (b) of the above first bullet point.

Equity: General Risk

The general risk factor of the position risk component of an equity instrument is equivalent to the overall net position of the equity instrument multiplied by 8%. The overall net position is defined as long positions less short positions in equity instruments. Equity instruments which are classified as: (a) shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre and (b) Other Shares (including investments in venture capital firms and private equity investments) are both assigned a risk weight of 8%.

Equity: Position Risk Component – Steps to be followed in the Return

In the Input Sheet of the Return:

a. identify those financial instruments which fall with the equity instruments category and which qualify as trading book business asset exposures;

b. input a description in Section 3(d) of the relevant trading book business asset exposure;

c. input the ‘balance sheet value’ and the ‘market value’ of the trading book business asset exposure in the adjacent columns;

d. qualify the asset as a trading book business asset exposure by choosing letter ‘Y’ from the drop down list which is available in the column titled ‘Held with trading intent?’;

e. the Return will automatically compute both the specific and general risk for traded debt instruments in Sheet 8.

Collective Investment Schemes: Specific and General Risk

The specific and general risk factor of the position risk component in the case of collective investment schemes is combined. In this case, the position risk component is the equivalent of the market value of the units in the collective investment scheme multiplied by the applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

- the classification of the financial instrument into: (a) investments in high risk collective investment schemes; and (b) other collective investment schemes;

- the applicable risk weighting of the financial instrument, is 16% for collective investment schemes which fall within classification (b) of the above bullet point and 32% for collective investment schemes falling within classification (a) of the above bullet point.

Collective Investment Schemes: Risk Component - Steps to be followed in the Return

In the Input Sheet of the Return:

a. identify those investments in collective investment schemes which qualify as trading book business asset exposures;

b. input a description of the relevant trading book business asset exposure;

c. input the ‘balance sheet value’ and the ‘market value’ of the trading book business asset exposure in the adjacent columns;

d. qualify the asset as a trading book business asset exposure by choosing letter ‘Y’ from the drop down list which is available in the column titled ‘Held with trading intent?’;

e. the Return will automatically compute the position risk component for collective investment schemes in Sheet 9.

7.2.2.2 *Settlement Risk – Cash Against Documents*

For the purpose these rules, cash against documents transactions shall mean transactions where the purchaser takes ownership of the financial instrument the moment cash is handed over to the seller (delivery versus payment).

Settlement risk is the risk that the Authorised Person's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

(A) Measuring the Settlement Risk Component

The Settlement Risk Component is the equivalent of the difference between the agreed settlement price and the current market value of a financial instrument which qualifies as trading book business and whose payment is unsettled after its due delivery date, multiplied by the relevant risk weight. The applicable risk weights are outlined in the following table:

Number of working days after the due settlement date	Risk Weight
5-15	**8%**
16 - 30	**50%**
31 – 45	**75%**
46 or more	**100%**

(B) Settlement Risk Component – Steps to be followed in the Return

In the Input Sheet of the Return:

Debtors – Unsettled Securities transactions - cash against documents

i. identify those financial instruments which have been delivered by the Authorised Person and which qualified as trading book business but for which payment is still due after delivery date;

ii. identify the cash amounts which have been settled by the Authorised Person in respect of undelivered financial instruments and which qualified as trading book business/cash against documents;

iii. categorise in the section 3 (e) (i) of the input sheet the unsettled securities transactions, identified in (i) and (ii) above, under one of the available headings, which headings reflect the headings in the above table;

iv. enter the balance sheet value of the amount due to the Authorised Person and in the adjacent column include the current market value.

v. the Return will automatically compute the relevant settlement risk component in Sheet 10.

7.2.2.3 *Counterparty Risk Component*

For the purpose of these Rules, counterparty risk is the amount of capital which the Authorised Person must hold against exposures in financial derivative instruments and credit derivatives (which can be defined as a contract between two parties that allows for the use of a derivative instrument to transfer credit risk from one party to another).

N.B. These Rules and the Return do not cater for the calculation of the trading book business Counterparty Risk Component. As it is generally the exception that Authorised Persons invest in derivatives, the MFSA has taken the approach that the calculation of the counter party risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in derivatives should contact the MFSA for guidance as to how the counterparty risk component should be calculated and catered for in the Return.

7.2.2.4 *Free Deliveries*

For the purpose these Rules, free deliveries transactions shall mean non delivery versus payment transactions in financial instruments.

Free Deliveries caters for the risk that the Authorised Person has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

(A) Measuring Free Deliveries

Both where: (i) financial instruments which fall within the definition of trading book business were delivered by the Authorised Person prior to receiving payment, or (ii) where the Authorised Person has paid for the financial instruments which fall within the definition of trading book business; the applicable free deliveries risk factor is calculated as follows:

Multiply the market value of the financial instrument by the applicable discount factor as detailed in the following table:

Period	Risk Discount Factor
Up to first payment/ delivery leg	0%
From first payment/ delivery leg to four days after second payment/ delivery leg	8%
From five business day post payment/ delivery leg until extinction of transaction	100%

(B) Free Deliveries - Steps to be followed in the Return

In the Input Sheet of the Return:

Debtors – Unsettled securities transactions – free deliveries

i. identify those financial instruments which have been delivered by the Authorised Person and which qualified as trading book business/free deliveries but for which payment is still due after delivery date;

ii. identify the cash amounts which have been settled by the Authorised Person in respect of undelivered financial instruments which qualified as trading book business/free deliveries;

iii. categorise in the section 3 (e) (ii) of the input sheet the unsettled securities transactions, identified in (i) and (ii) above, under one of the available headings, which headings reflect the heading in the above table;

iv. enter the balance sheet value of the amount due to the Authorised Person and for debtors classified under (ii) above, in the adjacent column, include the current market value;

v. the Return will automatically compute the relevant free deliveries risk component in Sheet 11.

7.2.3 *Commodities Instruments - Risk Component*

Commodities Risk is the risk component required to cover the Authorised Person's risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market including commodity derivatives.

Some traditional examples of commodities include grains, gold, beef, oil and natural gas. More recently, the definition has been expanded to include: (a) financial products such as foreign currencies and indices, and (b) cell phone minutes and bandwidth.

(A) Measuring the Commodities Instruments - Risk Component:

Steps to measure the Commodities Risk Component:

i. identify the commodity positions;

ii. express each position in terms of the standard unit of measurement of the commodity concerned (for example barrels of oil) ;

iii. calculate the individual commodity risk for each commodity position by summing 15% of the net position (long – short) of standard unit of measurement;

iv. multiply the result as per (iii) by the spot price of the commodity;

v. calculate the individual commodity risk for each commodity position by summing 3% of the gross position (long + short) of standard unit of measurement;

vi. multiply the result in as per (v) by the spot price of the commodity;

vii. add the resulting figure as per (iv) and (vi) above to obtain the risk component for each individual position;

viii. the Commodities instruments - risk component is equivalent to the result of the sum of each individual position.

(B) An Authorised Person's commodities instruments - risk component calculation shall include the following items:

i. forwards, futures, contracts for differences, synthetic futures and options on a single commodity;

ii. a commitment to buy or sell a single commodity at an average of spot prices prevailing over some future period;

iii. forwards, futures contracts for differences, synthetic futures and options on a commodity index; and

iv. commodity swaps.

(C) Commodities Instruments – Risk Component - the Return

N.B. The Return does not cater for the Commodities Instruments - Risk Component. As Authorised Persons rarely invest in commodities or commodity derivatives, risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in commodities or commodity derivatives should contact the MFSA for guidance as to how the commodities instruments - risk component should be catered for in the Return.

7.2.4 *Large Exposures Risk Component*

The purpose of the large exposure requirement is to ensure that a firm manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements. A large exposure may be in the form of a loan to a single borrower, or it may arise across many transactions involving different types of financial instruments with several counterparties.

A large exposure means the exposure to: (a) an individual counterparty; (b) connected counterparties; or (c) a group of connected clients (all three terms are defined in point (A) below).

Condition regarding Individual Large Exposures
Authorised Persons are to adopt policies within which exposures to any class of the above-mentioned categories of counterparties do not exceed 25% of their Own Funds and/ or 20% in the case of an Associate Company.

The Large Exposures Risk Component shall be the equivalent of the summation of the amount which is in excess of the above-mentioned limits.

Condition regarding Total Individual Large Exposure
Authorised Persons are to adopt policies wherein the total of individual exposures exceeding 10% of Own Funds are not to exceed 800% of their Own Funds. Authorised Persons shall monitor and control their large exposures to ensure that the total large exposures does not exceed this limit.

(A) Types of Counterparties

Individual Counterparties

An individual counterparty may be either a natural or a legal person. Examples of counterparties include:

i. the client which includes governments, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses and non-profit making bodies and individual clients;

ii. where the Authorised Person is providing a guarantee, the person guaranteed;

iii. for a derivatives contract, the person with whom the contract was made; and

iv. the company in which a Authorised Person acquires shares which are traded on a regulated market either as principal or on behalf of clients.

Groups of Connected clients
A group of connected clients is defined as one of the following either:

i. two or more persons who unless proved otherwise constitute a single risk because one of them is the parent undertaking of the other/s; or

ii. two or more persons who do not have the relationship as defined in (a) but who are regarding as constituting a single risk because they are so interconnected that if a member where to encounter financial difficulties the other members are likely to face repayment difficulties. Relationships between individual counterparties which might be considered to constitute a single risk for the purposes of the definition of group of connected clients include: schemes in the same group; companies whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure; companies having common directors or management; and counterparties linked by cross guarantees.

Connected counterparties
For the purpose of the calculation of large exposure risk component, connected counterparty means another person ('P') to whom the Authorised Person has an exposure and who fulfils at least one of the following conditions:

i. P is closely related to the Authorised Person; or

ii. P is an associate of the firm; or

iii. the same persons significantly influence the governing body of P and the Authorised Person; or

iv. the Authorised Person has an exposure to P that was not incurred for the clear commercial advantage of the Authorised Person and which is not on an arm's length basis.

(B) Measuring the Large Exposures Risk Component / The Return

i. classify the Authorised Person's exposures under one of the categories of counterparties mentioned in (A) above. By way of example, classify a company in which the Authorised Person has an investment as either an individual counterparty; or a connected counterparty; or a group of connected clients;

ii. report in sheet 12 all the Authorised Person's individual counterparty exposures which exceed 10% of own funds;

iii. the Return will automatically calculate the large exposures risk component in Sheet 12.

(C) Large Exposures - Exempt Exposures

The following exposures are fully or partially exempt from the calculation of the individual and total large exposure calculation:

	Exempt Exposures	**Proportion Exempt**
i.	asset items constituting claims on central governments or central banks which, unsecured, would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	**100%**
ii.	asset items constituting claims on international organisations or multilateral development banks which, unsecured, would be assigned a 0% risk weight under Credit/Counterparty Risk Calculation;	**100%**
iii.	asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	**100%**
iv.	other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the	

	Exempt Exposures	Proportion Exempt
	exposure is attributable or by which it is guaranteed would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	**100%**
v.	asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;	**100%**
vi.	asset items and other exposures secured to the satisfaction of the MFSA, by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, member states' regional governments, local authorities or public sector entities , which securities constitute claims on their issuer which would receive 0% risk weighting under the Standardised Approach to credit/counterparty risk;	**100%**
vii.	asset items and other exposures secured, to the satisfaction of the MFSA, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution;	**100%**
viii.	asset claims and other exposures secured to the satisfaction of the MFSA, by collateral in the form of certificates of deposits issued by the lending credit institution or by a credit institution which is the parent undertaking or subsidiary of the lending credit institution and lodged with either of them;	**100%**
ix.	asset items constituting claims on and other exposures to credit institutions or investment firms, with a maturity of one year or less, but not forming part of their Own Funds;	**100%**
x.	trade bills avalised by a prime credit institution with a maturity of twelve months or less;	**100%**
xi.	covered bonds as defined under the Standardised Approach to Credit/Counterparty Risk;	**100%**

Exempt Exposures		Proportion Exempt
xii.	holdings in the insurance and reinsurance companies up to 40% of the own funds of the Authorised Person acquiring such a holding;	**100%**
xiii.	exposures to prime credit institutions with a maturity of over one year but not more than three years;	**80%**
xiv.	exposures to prime institutions of over three years' maturity in the form of debt instruments issued by a prime institution provided such instruments are effectively negotiable in a professional market and are subject to a daily quotation on that market;	**50%**
xv.	asset items constituting claims on EEA states regional government and local authorities where such claims receive a zero risk weight under the standardised approach to credit/counterparty risk.	**100%**
xvi.	asset items constituting claims on EEA States, Regional Governments and Local Authorities where such claims receive a 20% risk weight under the standardised approach to credit risk.	**80%**

(D) General

Authorised Persons shall not deliberately avoid the additional capital requirements that would otherwise exceed 25% of their Own Funds or 20% of their Own Funds in the case of an associate company, by temporarily transferring the exposures in question to another company, whether within the same group or not, and/or by undertaking artificial transactions to close out the exposure and create a new exposure. Authorised Persons shall maintain systems which ensure that any transfer which has this effect is immediately reported to the MFSA

7.2.4 *Foreign Exchange Risk Component*

Foreign Exchange Risk is the risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

N.B. These Rules and the Return provide for the calculation of the Foreign Exchange Risk component of all types of asset exposures except for derivatives. As Authorised Persons rarely invest in derivatives, MFSA has taken the approach that for the purpose of the Return, the calculation of the risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons which undertake transactions in derivatives should contact the MFSA for guidance as to how the derivatives related foreign exchange risk component should be calculated and catered for in the Return.

(A) *To calculate its foreign exchange risk component which will form part of the applicable capital resources requirement, an Authorised Person shall identify the foreign currencies to which it is exposed and then calculate the open currency position by:*

i. calculating the net (long/short) open currency position in each foreign currency to which the Authorised Person is exposed;

ii. converting each net open position into its base currency equivalent at current spot rates;

iii. summing all short net positions and summing all long net positions and selecting the larger sum; and

iv. multiplying the sum of the net open currency position in base currency equivalent by 8%.

(B) *An Authorised Person's foreign exchange risk component calculation shall include the following items regardless whether they are trading book business positions or non-trading book business positions or commodity positions:*

i. all financial instruments which are denominated in a foreign currency;

ii. all spot positions in foreign currency (including accrued interest); and

iii. other assets/liabilities including gold positions.

(C) *Foreign Exchange Risk Component - Steps to be followed in the Return*

i. identify those asset exposures denominated in a currency other than the currency in which the financial statements are prepared;

ii. categorise these exposures in sheet 13 of the Return under one of the available sub-headings. Input the forex exposure in each currency under one of the available columns;

iii. in section 3 of sheet 13 input the exchange rate converting the foreign currency to reporting currency;

iv. the Return will automatically compute the relevant foreign exchange risk component in Sheet 13.

7.2.6 *Operational Risk Capital Requirement*

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

The operational risk capital requirement ("ORCR") for a Authorised Person is an amount calculated in accordance with one of the following methods:

i. The Basic Indicator Approach ('BIA');

ii. The Standardised Measurement Approach ('SMA'); and

iii. The Advanced Measurement Approach ('AMA').

N.B. These Rules cater for the Basic Indicator Approach. An explanation on how to apply the SMA and the AMA approaches and the applicable qualifying criteria to use both methods will be provided by the MFSA upon request.

(A) The ORCR as calculated by the BIA is equivalent to 15% of the relevant indicator which is defined hereunder:

i. The relevant indicator is defined as the three year average of the sum of the Authorised Person's (a) net interest income; and (b) net non-interest income.

ii. The three year average must be calculated on the basis of the last three yearly observations at the end of the financial year. Where audited figures are not available, business estimates may be used.

iii. If the sum of (a) and (b) above is negative or equal to zero, this figure must be excluded from both the numerator and denominator when calculating the three year average. The relevant indicator shall be calculated as the sum of positive figures divided by the number of positive figures.

iv. The relevant indicator shall be expressed as the sum of elements listed hereunder. Each element must be included in the sum with a positive or negative sign.

a. Interest receivable and similar income

b. Interest payable and similar charges

c. Income from shares and other variable/fixed-yield securities

d. Commissions/fees receivable

e. Commissions/fees payable

f. Net profit or net loss on financial operations

g. Other operating income

v. Considerations prior to calculating the Relevant Indicator

a. For the purpose of the above calculation, any income from a participation held in an undertaking of the Authorised Person, is not to be included in the relevant indicator calculations, thereby ensuring that intra-group dividends and other intra-group income flows are not double counted;

b. Furthermore, any income received under an operating lease, should be included as gross income less depreciation and not as gross rental income;

c. The relevant indicator must be calculated before the deduction of any provisions and operating expenses;

d. Operating expenses shall include fees paid for outsourcing services rendered by third parties. These third parties should not be **(i)** a parent or subsidiary of the Authorised Person or **(ii)** a subsidiary of a parent company which is also the parent of the Authorised Person. Expenditure on the outsourcing of services rendered by third parties will reduce the relevant indicator if such expenditure is incurred by: **[i]** a company licensed in terms of the Investment Services Act, 1994 or **[ii]** an Authorised Person under these Rules. **Outsourcing** may be defined as a Authorised Person's use of a third party to perform activities on a continuing basis that would normally be undertaken by the Authorised Person now or in future;

e. The following elements shall **not** be used in the calculation of the relevant indicator:

– Realised profits/losses from the sale of non-trading book items;

– Income from extraordinary or irregular items; and

– Income derived from insurance.

f. When revaluations of trading items forms part of the income statement, such revaluations could be included in the calculation of the relevant income indicator.

(B) Operational Risk - the Return

N.B. The Return does not cater for the Operational Risk Component. MFSA decided that for the purpose of the Return, the calculation of the operational risk component may be catered for on a case by case basis. Authorised Persons should contact the MFSA for guidance as to how the operational risk component should be catered for in the Return.