OFFICIAL INFORMATION
OF THE CZECH NATIONAL BANK

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regarding the prudential rules for banks, credit unions and investment firms

The Funding Condition in the Standardised Approach for Calculating the Capital Requirement for Credit Risk

The Czech National Bank hereby provides the following information with regard to Annexes 4 and 16 to Decree No. 123/2007 Coll., stipulating the prudential rules for banks, credit unions and investment firms (hereinafter the "Decree"):

I. Exposures to central governments and central banks in their domestic currency

Pursuant to Annex 4, 1, e) and f) of the Decree, a preferential risk weight shall be assigned to exposures to central governments and central banks denominated in their domestic currency, as long as these exposures are funded in the same currency (the funding condition). In the case of third countries the condition of equivalent regulatory and supervisory arrangements must be met as well.

II. Exposures protected by a guarantee/counter-guarantee of a central government or central bank in its domestic currency

Pursuant to Annex 16, III, 4, d) of the Decree, a preferential risk weight pursuant to Annex 4, 1, e) and f) can be assigned to exposures or their parts protected by guarantees of these central governments and central banks, as long as the guarantee is denominated in the domestic currency of the obligor (in this context the provider of the guarantee or counter-guarantee can be considered to be the obligor) and the exposure (or the part of the exposure which is protected by the given guarantee) is funded in this currency (the funding condition).

III. Compliance with the funding condition

1. The following techniques can, for example, be applied in providing justification for the use of a preferential risk weight or assessing whether the funding condition is met:
   a) if the liable entity has balance sheet claims on the central government or central bank in question it is possible to examine whether the liable entity has corresponding balance sheet liabilities in the currency of such a claim. In doing so, it is possible to take account of the total amount of balance sheet assets and balance sheet liabilities in the currency of the claim;
   b) if the liable entity has a claim on a client protected by a guarantee of the central government or central bank in question it is possible to consider the total amount of off-balance sheet assets and off-balance sheet liabilities in the currency of the guarantee received;
   c) the liable entity can also allocate the total amount of off-balance sheet liabilities to the total amount of the exposures which constitute balance sheet assets or vice versa;

d) the liable entity can allocate a particular liability to a particular exposure.

2. With respect to Article 226 of the Decree it is possible, in assessing whether the funding condition is met, to consider the total amount of assets and liabilities in the currency of any Member State.

3. The liable entity shall decide on the approach to being compliant with the funding condition, including the approach to managing the foreign exchange risk which may arise from its business operations. These approaches shall be an integral part of the strategies and procedures for ensuring the so-called internal capital, which must be maintained in an amount and structure which would adequately cover the risks to which the liable entity is or could be exposed.

4. The enclosure contains examples of approaches to the use of risk weights under the Standardised Approach.

Vice-Governor
Miroslav Singer

Banking Regulation and Supervision Department
Responsible:
Jaroslava Bauerová, tel. 22441 3365

Examples of the use of risk weights under the Standardised Approach

Example 1
A loan protected by a guarantee of a central government or central bank of a third country

Background
A loan in rupees granted to an obligor (a corporate exposure) whose registered office is in a third country, e.g. in India, which is protected by

> Alternative 1:
> a USD-denominated guarantee of the central government of the U.S.A., i.e. another state than Member States in their domestic currency, where the external rating of the central government directly implies a risk weight of 0%,
> Alternative 2:
> a guarantee or counter-guarantee of another state than Member States in their domestic currency, e.g. the central government of India, where the external rating of the central government does not directly imply a risk weight of 0%.

Which risk weight can be assigned to the given loan under alternatives 1 and 2?

Solution
Alternative 1:
Pursuant to Annex 4, 1, c) of the Decree, a risk weight of 0% can be assigned to the loan which is granted to the obligor whose registered office is in India and protected by the guarantee of the central government of the U.S.A., because this risk weight is directly implied by the external rating of the central government of the U.S.A. (Standard & Poor's external rating AAA of the debt of the central government of the U.S.A., in both the domestic currency and foreign currencies).

Alternative 2:
In case the guarantor for the loan granted to the obligor whose registered office is in India is the central government of a third country (a guarantee in the domestic currency of the given country) whose external rating does not imply a risk weight of 0% a possible approach is to examine whether the competent authority of the given country has established a more favourable risk weight for exposures to the central government and central bank denominated in the given country's domestic currency. If the competent authority has permitted to use a lower risk weight than the risk weight corresponding to the given country's external rating and there exist equivalent supervisory and regulatory arrangements in this country pursuant to Annex 4, 1, f) then such lower preferential risk weight can be applied, as long as the guarantee of the central government of the given country is denominated in the domestic currency of the obligor and the exposure to the obligor is funded in the same currency (the funding condition).

In the particular example where the claim on the obligor whose registered office is in India (the obligor does not have an external rating) is protected by the guarantee of the central government of India a risk weight of 100% must be assigned (Standard & Poor's external rating BB+ of the debt of the central government of India in the domestic currency corresponds to a risk weight of 100%). A lower risk weight than a risk weight of 100%, i.e. a preferential risk weight, can be assigned to the claim on the obligor in case the relevant competent authority has decided to assign a lower risk weight to claims on the central

government of India in the domestic currency and it has been verified that there exist supervisory and regulatory arrangements in the country equivalent to the standards set out in Directive 2006/48/EC. In addition, the funding condition must be met, i.e. the received guarantee provided by the central government of India and the exposure must be financed in the same currency (in rupees).

Example 2
A loan guaranteed by the government of the Czech Republic

Background
A loan granted to an obligor (a corporate exposure) whose registered office is in a third country protected by an insurance policy issued by Exportní garanční a pojišťovací společnost, a.s. (the Export Guarantee and Insurance Company, plc), covered by a state guarantee. The insurance product in question is, according to the opinion of the Czech National Bank, eligible as a guarantee for prudential purposes.
Which risk weight can be assigned to the given loan?

Solution
If the funding condition is met a preferential risk weight of 0% can be assigned to the loan granted to the given obligor pursuant to Annex 4, 1, e) and Annex 16, III, 4, d).

A prerequisite for the application of the methods set out in Example 1 and 2 is fulfilling the conditions stipulated by the Decree, in particular, the conditions for the eligibility of credit risk mitigation techniques, e.g. guarantees, including the conditions for reflecting the effects of these techniques.