



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP6/18

# Credit risk mitigation: Eligibility of guarantees as unfunded credit protection

February 2018





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Responses are requested by Wednesday 16 May 2018.

**Please address any comments or enquiries to:**

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## 1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed changes to Supervisory Statement (SS) 17/13 'Credit risk mitigation'<sup>1</sup> to clarify expectations regarding the eligibility of guarantees as unfunded credit protection under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the Capital Requirements Regulation (575/2013) (CRR).

1.2 The proposals extend to any contract or other documented obligation that purports to be a guarantee for the purpose of achieving unfunded credit protection under CRR Part Three, Title II, Chapter 4.

1.3 The CP is relevant to all firms bound by the CRR.

### Background

1.4 Credit risk mitigation (CRM) is a technique used by firms to reduce the credit risk associated with an exposure. Firms may, for sound risk management reasons, wish to use techniques to mitigate credit risk irrespective of any particular capital treatment. The CRR allows firms to recognise some forms of CRM in the calculation of their capital requirements.

1.5 CRM can be funded or unfunded. One of the ways unfunded credit protection can be achieved is through a guarantee. That can be achieved through the obligation of a third party to pay out in the event of non-payment or default of a credit obligor.

1.6 In order to be eligible as a guarantee for CRM under the CRR, strict eligibility criteria must be met. The PRA has identified that some firms are unclear on what contracts or other documented obligations are eligible to be treated as guarantees for CRM under the CRR. The PRA considers that additional clarity is needed to ensure that capital relief from guarantees is obtained only where the risk has been effectively transferred to the guarantor.

### Responses and next steps

1.7 This consultation closes on Wednesday 16 May 2018. The PRA invites feedback on the proposals set out in this consultation. In particular, the PRA seeks feedback on the nature of firms' existing guarantee arrangements for CRM, the impact of the proposals on firms' existing CRM practices, and any other issues arising as a result of the proposals. Please address any comments or enquiries to CP6\_18@bankofengland.co.uk.

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1 April 2017: [www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-mitigation-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-mitigation-ss).

## 2 Proposals

2.1 CRR Part Three, Title II, Chapter 4 (Credit risk mitigation) sets out the criteria that a guarantee must meet to be eligible for CRM.<sup>1</sup> These criteria include that the guarantee must be:

- Legally effective and enforceable in all relevant jurisdictions and supported by an independent, written and reasoned legal opinion.
- Clearly defined and incontrovertible.
- Without any clauses, the fulfilment of which is outside the direct control of the lender, that could render the contract ineligible for CRM. This includes any clauses that could prevent the guarantor from being obliged to pay out in a timely manner in the event where the original obligor fails to make any payments due.
- Covering all types of payments the obligor is expected to make; or where certain types of payment are excluded from the guarantee, the lending institution has adjusted the value of the guarantee to reflect the limited coverage.

2.2 The CRR outlines two approaches for the recognition of guarantees in capital requirements for credit risk. The first is the substitution approach, and is set out in CRR Part Three, Title II, Chapter 4. It is the only approach available to exposures on the standardised approach (SA) and foundation internal ratings based approach (FIRB), and is the subject of the proposed amendments to SS17/13 in this CP. The second is an adjustment of probability of default (PD) and loss given default (LGD) for firms on the advanced internal ratings based approach (AIRB). Requirements for AIRB are different. For example, CRR requires that firms have permission from their supervisor to apply AIRB, and the PD and LGD must take account of both the ability and the willingness of the guarantor to perform. This second approach is set out in CRR Part Three, Title II, Chapter 3 (Internal ratings based approach), and is outside the scope of this CP and the proposed amendments to SS17/13.

2.3 The PRA proposes amendments to SS17/13 to provide guidance on its expectations on the eligibility criteria for the recognition of guarantees as set out in CRR Part Three, Title II, Chapter 4 (summarised in paragraph 2.1 above). The proposals are outlined below.

### Legally effective and enforceable

2.4 The guarantee must be legally effective and enforceable in all relevant jurisdictions. The PRA would expect that, at a minimum, this will require the firm to satisfy itself that the guarantee is enforceable under its governing law, and in the jurisdiction where the guarantor is incorporated, but could well include other jurisdictions where enforcement action may be taken. The practical ease of enforcement should also be considered. As part of considering its effectiveness, the PRA would expect an independent legal opinion to consider the eligibility criteria.

### Clearly defined and incontrovertible

2.5 The PRA considers that incontrovertibility is important because a guarantee which can be disputed, and which is not robust, does not effectively transfer credit risk. Having considered other official language versions of the CRR, the PRA interprets 'incontrovertible' to mean that the wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, and challenge or otherwise seek to be released from, or reduce, their liability. When satisfying themselves that a guarantee is 'incontrovertible', the PRA would expect firms to

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<sup>1</sup> CRR Articles 194, 213 and 215.



consider the terms of the guarantee itself, the remedies available under the law that applies to that guarantee, and whether there are scenarios in which the guarantor could in practice successfully seek to reduce or be released from liability under the guarantee.

### **Without any clauses that will render the guarantee ineligible for CRM**

2.6 Some types of clauses will render a guarantee ineligible. These are set out in CRR Article 213(1)(c). The requirement that a guarantee must not contain a clause that prevents the guarantor from being obliged to pay out in a timely manner would be expected to be read with the further condition that the firm must have the right to pursue, in a timely manner, the guarantor for any monies due under the guarantee, and that payment shall not be subject to the firm first having to pursue the defaulting obligor for recovery. The PRA would expect firms to review existing agreements to ensure that they do not contain such clauses, or clauses that could be construed this way.

### **Pay out in a timely manner**

2.7 The PRA considers that the requirement for the guarantor to be obliged, contractually, to pay out ‘in a timely manner’ means that the pay out should be made without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due under the claim in respect of which the protection is provided. In reaching this view, the PRA has considered other uses of this phrase in CRR Part Three, Title II, Chapter 4, the phrase used in other official language versions of the CRR, the timeliness of settlement of credit derivative contracts once an event of default has been declared, and market practice for guarantees and other forms of eligible funded credit protection. Rights to liquidate or retain assets, or terminate and close out transactions, for example, are typically exercisable immediately on an event of default. The only exceptions to the timeliness requirement described in the Appendix (that pay out should occur without delay, ie within days) are as follows:

- for guarantees covering residential mortgage loans, where the CRR specifically provides that the protection may pay out within 24 months (CRR Article 215(1)(a));
- where provisional payments are made under guarantees provided by mutual guarantee schemes or by public sector bodies (CRR Article 215(2)); and
- where CRR Part Three, Title II, Chapter 4 is applied in respect of a securitisation position in the different context of CRR Part Three, Title II, Chapter 5 (Securitisation).

### **Exclusion of certain types of payments and limited coverage**

2.8 The PRA has considered what ‘certain types of payment’ and ‘limited coverage’ mean in the context of CRR Article 215(1)(c).<sup>1</sup> The Article sets out two scenarios:

- (i) the underlying contract and the guarantee mirror each other in terms of liability so if the underlying obligor is not obliged to pay the firm, there is no non-payment of the guarantee; and
- (ii) ‘certain types of payment’ can be excluded from the guarantee, but the value of the guarantee is then adjusted by the firm to reflect the ‘limited coverage’.

2.9 CRR Article 235 sets out how risk weighted assets should be calculated under the SA when unfunded credit protection under CRR Part Three, Title II, Chapter 4 is used. Under this approach,

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<sup>1</sup> CRR Article 215(1)(c) is based on paragraph 190(c) of Basel II.

the adjusted value of the unfunded credit protection,  $G_{A}$ , must be calculated. This is derived by taking  $G$ , the nominal amount of the credit protection,<sup>1</sup> and adjusting for foreign exchange risk, currency mismatch and maturity mismatch. Under the SA approach (Article 235), the firm applies the risk weight of the guarantor to the amount of the credit protection  $G_{A}$ , and the risk weight of the obligor to any remaining portion.

2.10 The PRA considers that, in the context of CRR Article 215(1)(c), 'limited coverage' refers to a quantifiable portion of the exposure. The 'certain types of payment' refer to different sums the obligor may be required to pay to the firm under the contract, such as the principal, interest, margin payments, fees and charges. For example, it contemplates a guarantor guaranteeing non-payment of principal, but not interest payments due by the obligor, or both principal and interest payments, but not fees or other charges. The PRA proposes that limited coverage of a guarantee would be reflected in firms' calculation of the value of unfunded credit protection ( $G$ ) under CRR Articles 233 and 235.

## Pillar 2

2.11 The proposals in this CP relate to the eligibility of guarantees as CRM in Pillar 1 of a firm's capital requirements. Guarantees that do not meet these expectations should not be recognised in Pillar 1.

2.12 That does not preclude the possibility that additional capital under Pillar 2 may be appropriate. The use of Pillar 2 to address residual risks is contemplated in paragraphs 767-769 of Basel II, and Articles 80 and 98(1)(c) of the Capital Requirements Directive (2013/36), which specifically require the competent authorities to ensure that risks that flow from the use of CRM techniques are addressed.

2.13 Guidelines issued by the European Banking Authority on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process<sup>2</sup> require competent authorities to assess the level and quality of guarantees that would mitigate losses where credit events occur, including those not eligible for CRM techniques, for own funds calculations. These requirements are reflected in paragraph 5.5 of SS31/15 'The Internal Capital Adequacy Assessment Process and the Supervisory Review and Evaluation Process'<sup>3</sup> which states that '[T]he SREP will also consider...the robustness, suitability and manner of application of policies and procedures implemented by firms for the management of the residual risk associated with the use of credit risk mitigation techniques'.

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1 CRR Article 233 states that 'the value of unfunded credit protection ( $G$ ) shall be the amount that the protection provider has undertaken to pay in the event of the default or non-payment of the borrower or on the occurrence of other specified credit events'.

2 December 2014: [www.eba.europa.eu/-/eba-publishes-final-guidelines-on-srep-methodologies-and-processes](http://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-srep-methodologies-and-processes).

3 December 2017: [www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss).

### 3 The PRA's statutory obligations

3.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to consult when setting its general policies and practices.<sup>1</sup> In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.<sup>2</sup>

3.3 The PRA is also required by the Equality Act 2010<sup>3</sup> to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

#### Cost benefit analysis

3.4 The proposals in this CP clarify the PRA's expectations for firms to satisfy the eligibility requirements for the recognition of guarantees as set out in CRR Part Three, Title II, Chapter 4.

3.5 The PRA has identified that some firms are unclear on what contracts or other documented obligations are eligible to be treated as guarantees for CRM under the CRR. The PRA considers the proposals provide additional clarity to ensure that capital relief from guarantees is obtained only where the risk has been effectively transferred to the guarantor and that capital is available where firms face losses on a timely basis.

3.6 The PRA considers that the benefits of the proposals include:

- enhanced safety and soundness of any affected firm as firms would recognise guarantees for CRM purposes only when eligibility requirements are met;
- the minimisation of the adverse effects of a failure of a PRA-regulated firm on the UK financial system, as failed firms would hold more capital because they would not have claimed more favourable treatment than requirements permit; and
- increased consistency and transparency with the PRA's supervisory approach as clarifying requirements will improve transparency of the CRM framework and improve consistency among firms in how they recognise guarantees for CRM purposes.

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<sup>1</sup> Section 2L of FSMA.

<sup>2</sup> Section 30B of the Bank of England Act 1998.

<sup>3</sup> Section 149.

3.7 The PRA recognises that there may be firms currently recognising guarantees, or that are planning to recognise guarantees under the CRM framework, which would not meet the expectations proposed in this CP. These firms would then have higher risk weighted assets than they are anticipating, and correspondingly higher capital requirements. This could have a negative impact on lending and growth aspirations. However, the PRA estimates that the overall impact on capital requirements and lending would be of minimal significance.

### **Compatibility with the PRA's objectives**

3.8 The PRA considers that the proposals in this CP advance its general objective to promote the safety and soundness of the firms it regulates by clarifying the PRA's expectations on the eligibility requirements for the recognition of guarantees as set out in CRR Part Three, Title II, Chapter 4. This is aimed at ensuring that the level of capital firms are expected to maintain is adequate in relation to the risks they are, or may be, exposed to.

3.9 When discharging its general functions in a way that advances its objectives, the PRA has, as a secondary objective, a duty, as far as reasonably possible, to act in a way that facilitates effective competition in markets for services provided by PRA-regulated firms carrying on regulated activities. The PRA's proposals should facilitate a more consistent interpretation of the requirements and ensure that firms claim capital relief from guarantees only where appropriate. The PRA considers a more consistent interpretation of the requirements will level the playing field amongst firms using the SA and FIRB and ensure that no firm claims capital relief from guarantees as a result of an interpretation of the CRR requirements that is not shared by other firms.

### **Regulatory principles**

3.10 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. Three principles are of particular relevance.

- (i) The principle that a burden should be proportionate to the benefits which are expected to result from the imposition of that burden. The PRA considers that the main benefit of the proposals in this CP is that they promote the safety and soundness of PRA regulated firms by clarifying the PRA's expectations on eligibility requirements for the recognition of guarantees. The PRA has considered the burden on firms and estimates that the overall impact on firms as a result of these proposals is small.
- (ii) The principle that the PRA should use its resources in the most efficient and economic way. Clarifying the PRA's supervisory expectations in respect of certain conditions for the eligibility of guarantees would result in better and more efficient engagement between the PRA and users of the CRM framework.
- (iii) The principle that the PRA should exercise its functions as transparently as possible. The PRA is aware that some firms find requirements on the eligibility of guarantees for the purposes of CRM unclear. The PRA considers that setting out expectations in an SS is the most suitable way to provide greater clarity.

### **Impact on mutuals**

3.11 The proposals in this CP would only apply to firms subject to the CRR. Some mutual societies are subject to the CRR, and for those firms, the impact of the proposals would be no different than for other authorised firms.

### **HM Treasury recommendation letter**

3.12 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.<sup>1</sup> The PRA has considered these in relation to these proposals. Of particular relevance is the impact on competition, which has been considered in paragraph 3.9.

### **Equality and diversity**

3.13 The PRA does not consider that the proposals give rise to equality and diversity implications.

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<sup>1</sup> Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at [www.bankofengland.co.uk/about/Pages/people/prapeople.aspx](http://www.bankofengland.co.uk/about/Pages/people/prapeople.aspx).

## **Appendix: Draft amendments to Supervisory Statement 17/13 ‘Credit risk mitigation’**

This Appendix outlines proposed amendments to Supervisory Statement (SS) 17/13 ‘Credit risk mitigation’ to add a new chapter ‘7 Eligibility of guarantees as unfunded credit protection’. The text is all new and is not underlined.

### **7 Eligibility of guarantees as unfunded credit protection**

7.1 This chapter is relevant to any contract or other documented obligation which purport to be guarantees for the purpose of achieving unfunded credit protection under CRR Part Three, Title II, Chapter 4 (Credit risk mitigation). It is also relevant for other parts of the CRR and any other legislation that cross-refers to CRR Part Three, Title II, Chapter 4. This includes, for example, CRR Part Four (Large Exposures) and CRR Part Three, Title II, Chapter 5 (Securitisation) and the double default framework for the internal ratings based approach (IRB) in CRR Articles 153(3), 202 and 217. It is not relevant for insurers seeking guidance on the eligibility criteria for guarantees in Article 215 of Commission Delegated Regulation (EU) 2015/35.

7.2 The requirements for guarantees are set out in CRR Part Three, Title II, Chapter 4.<sup>1</sup> ‘Guarantee’ is not defined in the CRR. While guarantees can take many forms and be governed by different laws, only those that meet the strict criteria set out in the CRR are eligible for unfunded CRM.

#### **Legally effective and enforceable**

7.3 CRR Articles 194(1), 213(1)(d) and 213(3) require that the guarantee must be legally effective and enforceable in all relevant jurisdictions. The PRA expects that, at a minimum, this will require the firm to satisfy itself that the guarantee is enforceable under its governing law, and in the jurisdiction where the guarantor is incorporated, but could well include other jurisdictions where enforcement action may be taken. The practical ease of enforcement should also be considered. CRR Article 194(1) requires that the guarantee be supported by an independent, written and reasoned legal opinion. As part of considering the guarantee’s effectiveness, the PRA expects the independent legal opinion to consider the eligibility criteria.

#### **Clearly defined and incontrovertible**

7.4 CRR Article 213(1)(b) requires that the extent of the guarantee must be clearly defined and incontrovertible. The PRA interprets ‘incontrovertible’ to mean that the wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, challenge or otherwise seek to be released from, or reduce, their liability. When satisfying themselves that a guarantee is ‘incontrovertible’, firms should consider the terms of the guarantee itself, the remedies available under the law that applies to that guarantee, and whether there are scenarios in which the guarantor could in practice successfully seek to reduce or be released from liability under the guarantee.

#### **Without any clauses that will render the guarantee ineligible for CRM**

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<sup>1</sup> CRR Articles 194, 213 and 215.

7.5 Under CRR Article 213(1)(c), some types of clauses will render a guarantee ineligible. The prohibition on the guarantee containing a clause that prevents the guarantor from being obliged to pay out in a timely manner should be read with the further condition that the firm must have the right to pursue, in a timely manner, the guarantor for any monies due under the guarantee, and that payment shall not be subject to the firm first having to pursue the defaulting obligor for recovery. The PRA expects firms to review agreements to ensure that they do not contain such clauses.

### **Pay out in a timely manner**

7.6 CRR Article 215(1)(a) requires that the guarantor be obliged, contractually, to pay out 'in a timely manner'. The PRA considers this requirement means that pay out should be without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due under the claim in respect of which the protection is provided. The only exceptions to this timeliness requirement described in this chapter (that pay out must occur without delay, ie within days) are as follows:

- (a) for guarantees covering residential mortgage loans, where the CRR specifically provides that the protection may pay out within 24 months (CRR Article 215(1)(a));
- (b) where provisional payments are made under guarantees provided by mutual guarantee schemes or by public sector bodies (CRR Article 215(2)); and
- (c) where CRR Part Three, Title II, Chapter 4 (Credit risk mitigation) is applied in respect of a securitisation position in the different context of CRR Part Three, Title II, Chapter 5 (Securitisation).

### **Exclusion of certain types of payments and limited coverage**

7.7 CRR Article 215(1)(c) requires that the guarantee must cover all types of payments the obligor is expected to make to the firm or, where certain types of payment are excluded from the guarantee, the firm has adjusted the value of the guarantee to reflect the limited coverage. The PRA has considered what 'certain types of payment' and 'limited coverage' mean in the context of CRR Article 215(1)(c). It takes the view that, in the context of CRR Article 215(1)(c) 'limited coverage' refers to a quantifiable portion of the exposure. The 'certain types of payment' refer to different sums the obligor may be required to pay to the firm under the contract, such as the principal, interest, margin payments, fees and charges. For example, it contemplates a guarantor guaranteeing non-payment of principal, but not interest payments due by the obligor, or both principal and interest payments, but not fees or other charges. The PRA expects that limited coverage of a guarantee will be reflected in firms' calculation of the value of unfunded credit protection under CRR Articles 233 and 235.

## **Pillar 2**

7.8 The expectations set out in this chapter relate to the eligibility of guarantees as CRM in Pillar 1 of a firm's capital requirements. Guarantees that do not meet these expectations should not be recognised in Pillar 1.

7.9 That does not preclude the possibility that additional capital under Pillar 2 may be appropriate. The use of Pillar 2 to address residual risks is contemplated in Basel II<sup>1</sup>, and Articles 80

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<sup>1</sup> Paragraphs 767-769.

and 98(1)(c) of the Capital Requirements Directive (2013/36) specifically requires the competent authorities to ensure that risks which flow from the use of CRM techniques are addressed.

7.10 The PRA expects firms' use of guarantees for achieving unfunded credit protection under CRR Part Three, Title II, Chapter 4 to be consistent with the expectations set out in this chapter of the SS. Where firms use CRM in a way that might not meet the PRA's expectations, they should discuss this with their usual supervisory contact.