Draft for consultation.
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Bank of England

Prudential Regulation Authority

Appendix 15: Draft amendments to SS17/13 – Credit Risk Mitigation

Draft for consultation

Consultation Paper | CP16/122

November 2022

Draft for consultation.
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Appendix 15: Draft amendments to SS17/13 – Credit Risk Mitigation

Consultation Paper | CP16/22

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In this appendix, new text is underlined and deleted text is struck through.

…

1 Introduction

1.1 This supervisory statement (SS) is aimed at firms that are subject to the provisions of the CRR.[1] ~~to which CRD IV[2] applies.[3]~~

1.2 The purpose of this SS ~~statement~~ is to provide clarification to firms of the Prudential Regulation Authority's (PRA~~'s~~) expectations in respect of the recognition of credit risk mitigation in the calculation of certain risk-weighted exposure amounts.

~~2~~ Eligibility of protection providers under all approaches

This chapter has been deleted.

~~1.3 The PRA does not consider there to be any financial institution of the type identified in the Capital Requirements Regulation (CRR) Article 119(5). Accordingly, the PRA has no list of such providers to publish.~~

~~(CRR Articles 119(5) and 202)~~

~~3~~ Recognised exchanges

This chapter has been deleted.

~~1.4 To qualify as a recognised exchange under the CRR, an exchange must be a Markets in Financial Instruments Directive II (MIFID II) regulated market.~~

~~1.5 Prior to the end of 2013, the PRA will set out the approach to be taken prior to the adoption of the ESMA implementing technical standard specifying the list of recognised exchanges.~~

~~(CRR Articles 4(1)(72), 197(4) and (8), 198(1) and 224(1))~~

~~4~~ Conditions for applying a 0% voluntary adjustment under the Financial Collateral Comprehensive Method (FCCM)

This chapter has been deleted.

~~1.6 For the purposes of repurchase transactions and securities lending or borrowing transactions, the PRA does not consider there to be any core market participants other than those entities listed in Article 227(3) of the CRR.~~

~~(CRR Article 227)~~

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[1] The onshored and amended UK version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, referred to as the 'CRR' in this SS.

[2] ~~Capital Requirements Directive (2013/36/EU) (CRD) and Capital Requirements Regulation (575/2013) (CRR) – jointly 'CRD IV'.~~

[3] ~~On 28 April 2017 this SS was updated – see the annex for details.~~

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~~5~~ Permission to use 'own estimates of voluntary adjustments' under the FCCM

This chapter has been deleted.

~~1.7 This section sets out the PRA's expectations for granting a firm permission to use its own estimates of volatility adjustments under the FCCM, as set out in CRR Article 225.~~

~~1.8 Own estimates of volatility adjustments allow firms to model adverse changes in the market value of financial collateral received and posted against exposures arising from debt instruments, securities financing transactions (SFTs) and derivative transactions. Under the FCCM, firms that do not have permission to use own estimates of volatility adjustments shall apply the supervisory volatility adjustments as set out in CRR Article 224.~~

~~1.9 A firm that wishes to use own estimates of volatility adjustments is expected to provide the PRA with confirmation that it meets and continues to meet the requirements set out in CRR Articles 225(2) and 225(3). It is expected that the evidence supporting this confirmation should include the following:~~

- ~~for all types of financial collateral used under the FCCM, a comparison, both at point of application and at least annually thereafter, between its own estimates of volatility adjustments as calculated under CRR Article 225(2) and the supervisory volatility adjustments set out under CRR Article 224; and~~

- ~~at point of application, the impact on the own funds requirements of applying its permission to use the own estimates of volatility adjustments approach as calculated under CRR Article 225(2) instead of the supervisory volatility adjustments set out under CRR Article 224.~~

~~1.10 Under CRR Article 225, the firm's own estimates of volatility adjustments are based on 99th percentile, one-tailed Value-at-Risk number calculated over a short liquidation period, defined per type of exposures. The internal models set out in CRR Article 363(1) are based on the same measure of risk. Therefore, if the financial collateral a firm holds is included in the scope of an internal model set out under CRR Article 363(1) that the firm has been permitted to use for market risk purposes, it may re-use the same internal model for the calculation of the firm's own estimates of volatility adjustment of this financial collateral provided that the firm complies with paragraph 5.3 above.~~

~~1.11 In any other circumstances, a firm that wishes to use the firm's own estimates of volatility adjustments is expected to provide the PRA with confirmation of its compliance with the following as evidence that the conditions of CRR Article 225 are met:~~

- ~~full documentation of the methodology used to calculate its own estimates of volatility adjustments;~~

- ~~a demonstration that the unit in charge of the design and the implementation of the own estimates of volatility adjustments approach is independent from business trading units;~~

- ~~an annual programme of back-testing to assess the accuracy of its own estimates of volatility adjustments. The PRA expects back-testing to be based on a comparison of the volatility adjustments generated by the firm's internal model for all the types of financial collateral used under the FCCM with their realised values over the most recent 250 business days. If the back-testing indicates that the own estimates of volatility adjustments are underestimated, a firm is expected to take the action necessary to address the inaccuracy of its model in a reasonable timeframe, otherwise the PRA will require the firm to revert to the supervisory volatility adjustments as set out under CRR Article 224.~~

6 Netting of liabilities that may be subject to bail-in

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6.1 To qualify as an eligible form of credit risk mitigation under the Credit Risk Mitigation (CRR) Part of the PRA Rulebook ~~Part Three, Title II, Chapter 4 of the CRR~~, netting agreements must meet a number of conditions, including that those agreements must be legally effective and enforceable in all relevant jurisdictions. Firms must also obtain an independent, written and reasoned legal opinion or opinions in order to establish whether the above conditions are met.

…

7 Eligibility of guarantees and credit derivatives as unfunded credit protection

7.1 This chapter is relevant to any firm that is intending to treat an arrangement as a guarantee or credit derivative qualifying as unfunded credit protection under the Credit Risk Mitigation (CRR) Part ~~CRR Part Three, Title II, Chapter 4 (Credit risk mitigation)~~. It is also relevant to any firm subject to ~~for~~ other parts of the ~~CRR~~ PRA Rulebook, the CRR and ~~any~~ other legislation that cross-refers to relevant provisions in the ~~CRR Part Three, Title II, Chapter 4~~ Credit Risk Mitigation (CRR) Part. This includes, for example, the Large Exposures (CRR) Part of the PRA Rulebook ~~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 and credit derivatives are set out in the ~~CRR Part Three, Title II, Chapter 4~~Credit Risk Mitigation (CRR) Part. 'Guarantee' is not defined in that Part or in the CRR. While guarantees can take many forms and be governed by different laws, only those that meet the criteria set out in the ~~CRR~~ Credit Risk Mitigation (CRR) Part are eligible as unfunded credit ~~risk mitigation~~ protection.

7.2A The PRA considers that firms may treat credit insurance (including mortgage indemnity products) as credit risk mitigation provided that the credit insurance can be classified as unfunded credit protection according to the definition in CRR Article 4(1)(59). Firms should treat the credit insurance as a guarantee or a credit derivative depending on whether the credit insurance effectively functions like a guarantee, or like a credit derivative respectively.

Legally effective and enforceable (guarantees and credit derivatives)

7.3 ~~CRR~~ Articles 194(1), 213(1)(d), and 213(3) of the Credit Risk Mitigation (CRR) Part require that ~~the~~ guarantees or credit derivatives must be legally effective and enforceable in all relevant jurisdictions on an ongoing basis. The PRA expects that, at a minimum, this ~~will~~ requires a ~~the~~ firm to satisfy itself that a ~~the~~ guarantee or credit derivative is enforceable under its governing law, and in the jurisdiction where the protection provider ~~guarantor~~ is incorporated, and should also ~~but could well~~ include other relevant jurisdictions where enforcement action may be taken. ~~CRR~~ Article 194(2) of the Credit Risk Mitigation (CRR) Part requires that firms take all appropriate steps to ensure effectiveness of the guarantee or credit derivative. The PRA expects firms to consider the practical ease of enforcement of the guarantee or credit derivative.

Clearly defined and incontrovertible (guarantees and credit derivatives)

7.4 ~~CRR~~ Article 213(1)(b) of the Credit Risk Mitigation (CRR) Part requires that the extent of a ~~the~~ guarantee or credit derivative must be clearly defined and incontrovertible. The PRA interprets 'incontrovertible' to mean that the wording of the guarantee or credit derivative should be clear and unambiguous, and leave no practical scope for the ~~guarantor~~ protection provider to dispute, contest, challenge or otherwise seek to be released from, or reduce, their liability. When satisfying themselves that a guarantee or credit derivative is 'incontrovertible', firms should consider the terms of the guarantee or credit derivative itself and the remedies available under the law that applies to that guarantee or credit derivative.

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Without any clauses that will render the guarantee ineligible for credit risk mitigation (guarantees)

7.5 Under ~~CRR~~ Article 213(1)(c) of the Credit Risk Mitigation (CRR) Part, some types of clauses will render a guarantee ineligible. The PRA expects that the prohibition on a ~~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.

Exclusion of certain types of payments and limited coverage (guarantees)

7.6 ~~CRR~~ Article 215(1)(c) of the Credit Risk Mitigation (CRR) Part requires that a ~~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, that 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) of the Credit Risk Mitigation (CRR) Part. It takes the view that, in the context of ~~CRR~~ Article 215(1)(c) of the Credit Risk Mitigation (CRR) Part, '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 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 should ~~will~~ be reflected in firms' calculation of the value of unfunded credit protection under ~~CRR~~ Articles 233 ~~and~~ 235, and 236 of the Credit Risk Mitigation (CRR) Part.

Risks arising from eligible guarantee and credit derivative arrangements

7.7 ~~CRR~~ Article 194(8) of the Credit Risk Mitigation (CRR) Part requires that a firm recognising credit risk mitigation must be able to demonstrate that it has adequate risk management processes to control risks to which it may be exposed as a result of carrying out credit risk mitigation practices. Article 213(3) of the Credit Risk Mitigation (CRR) Part requires that a firm must ~~shall~~ fulfil any contractual and statutory requirements in respect of, and take all necessary steps to ensure, the enforceability of its unfunded credit protection. In relation to guarantees or credit derivatives intended to qualify as credit risk mitigation, the PRA expects firms to identify risks arising from guarantee or credit derivative arrangements. This ~~would~~ includes identifying the risk ~~of non-fulfilment by~~ that the firm does not fulfil ~~of~~ an obligation or term~~, in connection with the guarantee or credit derivative contract~~ which could render the credit protection ineffective. Examples of such obligations or terms include maintaining an uninsured percentage of the risk, paying premiums on time and disclosing material information to the protection provider ~~guarantor~~. Firms are expected to have adequate risk management processes in place to control these risks.

Residual risks

This section has been deleted.

~~7.8 For firms using the Foundation Internal Ratings Based approach to credit risk, CRR Article 236(1) states that for the covered portion of the exposure, the probability of default (PD) for the purposes of Section 4 of CRR Chapter 3 may be the PD of the guarantor, or a PD between that of the borrower and the guarantor where a full substitution of the PD is deemed not to be warranted. In considering whether a full substitution is warranted or not, the PRA expects firms to consider the risk that, although the eligibility criteria for qualifying guarantees are met, the credit protection could in practice become less effective for a reason other than the default of the guarantor and, where appropriate, adjust the PD upwards to reflect this residual risk. As part of this consideration, the PRA expects that firms consider in particular the:~~

- ~~risk, if any, that in practice the guarantor would seek to reduce or be released from liability under the guarantee, for example through lengthy settlement or disputes processes; and~~
- ~~operational risk that the firm may breach its obligations under the terms of the guarantee in a manner that might entitle the guarantor not to pay out.~~

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Pillar 2 (guarantees and credit derivatives)

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

7.10 ~~That~~ Paragraph 7.9 does not preclude the possibility that holding additional capital under Pillar 2 may be necessary ~~appropriate~~ where a guarantee or credit derivative is eligible under Pillar 1. This may be appropriate in a number of circumstances, including where there are residual risks and a firm is applying either the Risk Weight Substitution Method or the Parameter Substitution Method. ~~The use of Pillar 2 to address residual risks is contemplated in Basel II[4], and Articles 80 and 98(1)(c) of the Capital Requirements Directive (2013/36) specifically require the competent authorities to ensure that risks which flow from the use of credit risk mitigation techniques are addressed.~~ As noted in SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)',[5] the SREP will specifically consider firms' management of residual risk from the use of credit risk mitigation techniques.

~~7.11 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 credit risk mitigation in a way that might not meet the PRA's expectations, they should discuss this with their usual supervisory contact.~~

8 Eligibility of financial collateral where there is a correlation between the collateral value and the credit quality of the obligor

8.1 This chapter is relevant to any firm that wishes to recognise the effects of financial collateral under ~~CRR Part Three~~ the Credit Risk Mitigation (CRR) Part. ~~It is, in particular, relevant for CRR Part Three, Title II, Chapter 4 (Credit risk mitigation) and any~~ It is also relevant to any firm subject to other parts of the PRA Rulebook, the CRR, ~~or~~ and other legislation that cross-refers to relevant provisions in the Credit Risk Mitigation (CRR) Part. ~~CRR Part Three, Title II, Chapter 4.~~

~~CRR requirements on~~ Requirements relating to correlated collateral

8.2 In accordance with Article 207(2) of the Credit Risk Mitigation (CRR) Part, in ~~In~~ order for financial collateral to be an eligible credit risk mitigant, the ~~"the~~ credit quality of the obligor and the value of the collateral must ~~shall~~ not have a material positive correlation. ~~correlation" (CRR Article 207(2)).~~ Any financial collateral asset whose value is materially positively correlated with the obligor's credit quality is not eligible, as it cannot be relied upon to mitigate loss at the point of default.

8.3 In determining whether a financial collateral asset satisfies the requirement in Article 207(2) of the Credit Risk Mitigation (CRR) Part, the PRA expects firms to consider characteristics of the obligor, the transaction and the collateral. Relevant characteristics will vary depending on the transaction but might include legal connectedness, business model dependencies, correlations that might arise where the obligor and the collateral issuer share the same country, and any other relevant characteristics.[6] In each case the firm should consider whether the relevant characteristics might, either on their own or in combination with other relevant characteristics, give rise to a material positive correlation between obligor creditworthiness and collateral value such that the collateral might not provide effective mitigation at the point of obligor default. The PRA

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[4] ~~Paragraphs 767-769.~~

[5] July 2015, https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss

[6] Where the obligor and the collateral issuer share the same country this does not necessarily imply there is a material positive
correlation.

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considers that the absence of a legal connection between the issuer of the collateral and the obligor does not preclude the possibility of material positive correlation.

Material positive correlation in transactions with limited recourse

8.4 In the context of transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets, a fall in the value of the financial collateral assets may itself sometimes trigger the default of the obligor. The PRA considers that any financial collateral asset whose value has a material positive correlation with the total value of all of the assets to which the lender has legal recourse (including collateral posted by the obligor and any other assets to which the firm has legal recourse)~~,~~[7] would ~~to~~ meet the definition of material positive correlation set out in ~~as per~~ Article 207(2) of the Credit Risk Mitigation (CRR) Part.[8]

8.5 The PRA provides two examples:

(i) a ~~A~~ non-recourse margin loan is a margin loan made to an obligor whereby the lender has legal recourse only to the posted collateral and not to the obligor's other assets. Any individual financial collateral asset whose value is materially positively correlated with the total value of all the collateral assets on such a loan should be considered ineligible under Article 207(2) of the Credit Risk Mitigation (CRR) Part. Consequently, the PRA expects that ~~firms not to recognise as eligible collateral on any~~ non-recourse margin loan collateral assets that consist of a single asset, or group of materially positively correlated assets, should be considered to be ineligible collateral; and~~.~~

(ii) a ~~A~~ non-recourse margin loan may also be structured as a loan to a special purpose entity (SPE) whose assets consist primarily, or entirely, of the collateral posted to the lender(s). In this case any individual financial collateral asset whose value is materially positively correlated with the total value of all the SPE's assets should be considered ineligible under Article 207(2) of the Credit Risk Mitigation (CRR) Part. For the avoidance of doubt, an expectation of financial support from the SPE sponsor should not be considered an asset of the SPE for these purposes.

8.6 The PRA ~~also~~ expects firms using the advanced internal ratings based (AIRB) approach to model ~~, when modelling~~ the effect of collateral ~~under~~ using the loss given default (LGD) 'LGD Modelling Collateral Method' in accordance with Article 169A of the Credit Risk: Internal Ratings Based (CRR) Part of the PRA Rulebook, ~~internal approaches such as the Advanced Internal Ratings Based approach~~ or applying other internal modelling approaches such as the Internal Model Method (IMM) and the use of value-at-risk (VaR) models for securities financing transactions (SFTs) (SFT VaR Method models) ~~and the~~, not to recognise collateral received which has a material positive correlation as described in paragraphs 8.4 and 8.5.

8.7 Under Chapter 5 of Part Three Title II of the CRR, an originator may seek to recognise credit risk mitigation obtained in respect of a synthetic securitisation position provided by a securitisation special purpose entity (SSPE). As the originator has recourse to the reference obligations in the reference portfolio in addition to the assets of the SSPE, paragraph 8.4 may not be relevant. However, in so far as any financial collateral assets held by the SSPE are required to be eligible under ~~Chapter 4~~ the Credit Risk Mitigation (CRR) Part, firms should apply Article 207(2) of that Part, taking into account the extent of any correlation between the reference obligations in the reference portfolio and the assets of a SSPE.

9 Eligibility of non-financial collateral under the Standardised Approach

[7] This would include all of the unencumbered assets of the obligor if the lender has a general recourse to the obligor, and may
also include assets of a third party where that third party has provided a legally enforceable guarantee.

[8] Where a financial collateral asset is an index instrument, a firm may consider each constituent asset of the index as a separate financial collateral asset for the purposes of this paragraph.

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9.1 Firms using the standardised approach are not permitted to treat non-financial collateral as eligible collateral when recognising CRM in accordance with the methods set out in the Credit Risk Mitigation (CRR) Part. The PRA expects; however, that firms using the standardised approach should reflect the existence of non-financial collateral in their assignment of risk weights, where relevant, in line with the provisions of the Credit Risk: Standardised Approach (CRR) Part.

10 Obligor grade adjustment in IRB models

10.1 Firms using the internal ratings based (IRB) approach may reflect documented support arrangements by adjusting obligor grades in accordance with Article 172(1)(e) of the Credit Risk: Internal Ratings Based Approach (CRR) Part. This approach is not however available where the support arrangements are recognised by a firm using the LGD Adjustment Method as set out in Article 171(3)(b) of the Credit Risk: Internal Ratings Based Approach (CRR) Part.

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