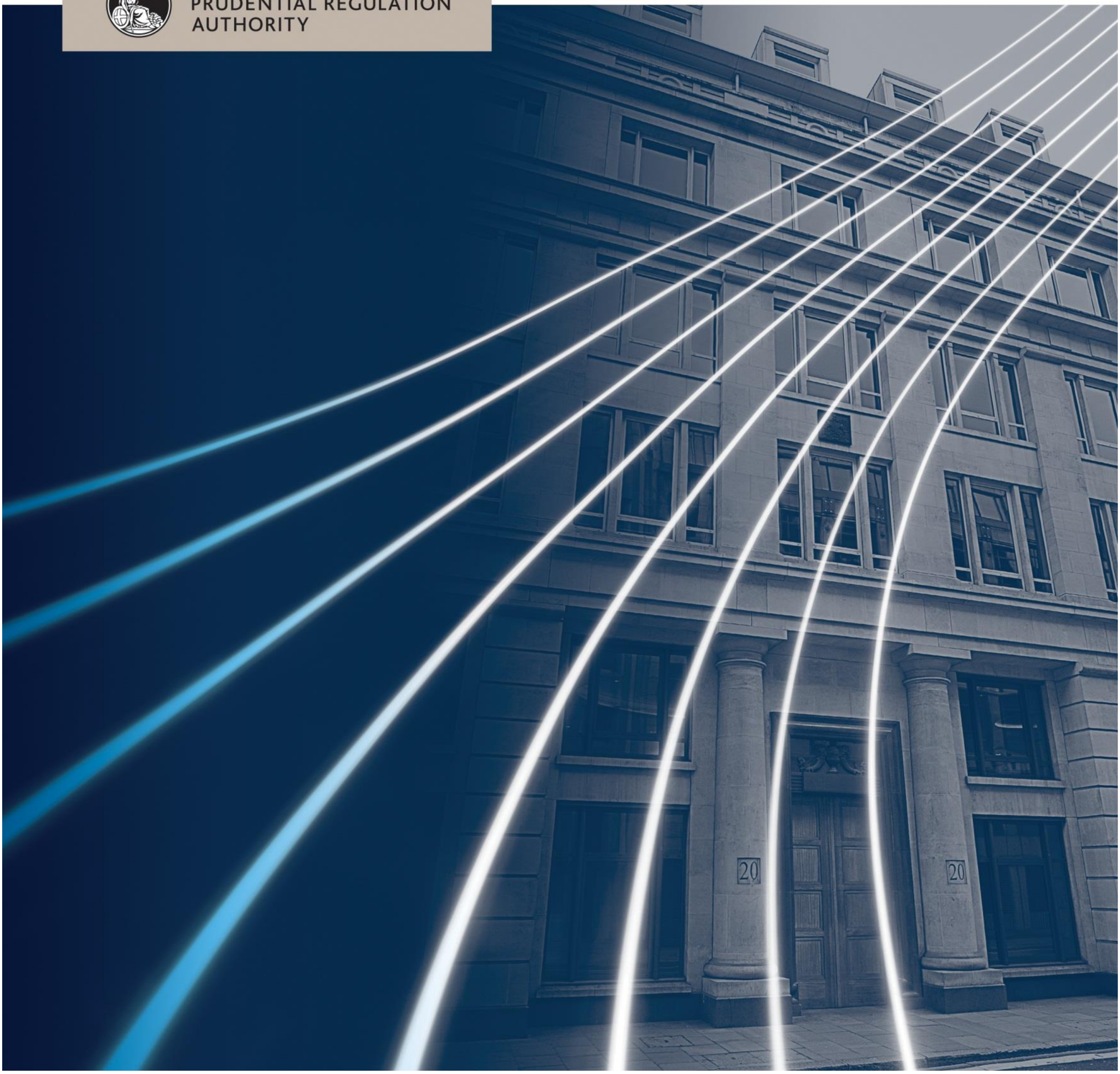
Policy Statement | PS14/19

Credit risk mitigation: Eligibility of financial collateral

July 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 1/19 'Credit risk mitigation: Eligibility of financial collateral'.[1] It contains the updated Supervisory Statement (SS) 17/13 'Credit risk mitigation' (Appendix).

1.2 This PS is relevant to UK banks, building societies and PRA-designated UK investment firms that are subject to the Capital Requirements Regulation (575/2013) (CRR). It is not relevant to UK branches of firms in other European Economic Area (EEA) countries and non-EEA countries, or to insurance firms.

Background

1.3 In CP1/19 the PRA consulted on clarifications to expectations regarding the eligibility of financial collateral as funded credit protection under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the CRR.

1.4 The PRA received three responses to the CP. Respondents generally welcomed the PRA's clarifications regarding the eligibility of financial collateral. However, respondents raised some specific concerns regarding the impact of the proposals on certain types of transactions. Some respondents also requested further clarification on certain aspects of the proposals. The PRA's feedback to these responses, and final policy decisions, are set out in Chapter 2.

Changes to draft policy

1.5 Following consideration of responses, the PRA has made a number of minor changes to the draft policy as set out in the CP. These changes clarify:

- that where the obligor and the collateral issuer share the same country this does not necessarily imply there is a material positive correlation;
- what assets the PRA would consider relevant when it refers to 'all of the assets to which the lender has legal recourse'; and
- how the PRA's expectations apply when firms have recourse to a financial collateral asset that is an index instrument.

1.6 Further details on these changes are set out in Chapter 2.

1.7 The PRA considers that the changes will not have a significant impact on firms (including mutuals) and will not have a significantly different impact on mutuals than for other firms. As a result, the cost benefit analysis has not been updated in respect of these changes.

Implementation

1.8 The changes to SS17/13 will be effective on publication of this PS. If firms have concerns about their ability to comply with these expectations, they should get in touch with their usual supervisory contacts.

1 January 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-mitigation-eligibility-of-financial-collateral.

1.9 The policy set out in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that the proposals will not be affected in the event that the UK leaves the EU with no implementation period in place.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practices, and must publish feedback to the representations in such manner as it thinks fit.[2]

2.2 The feedback set out in this chapter has been grouped by the subject of the responses in three sections:

- CRR requirements on correlated collateral;
- material positive correlation in transactions with limited recourse; and
- other comments.

CRR requirements on correlated collateral

2.3 The CRR requires that in order for financial collateral to be an eligible credit risk mitigant 'the credit quality of the obligor and the value of the collateral shall not have a material positive correlation'.[3] The PRA proposed that in making this determination firms are expected to consider characteristics of the obligor, the transaction and the collateral, and it proposed some types of characteristics that may be relevant. The PRA also proposed to clarify 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.

Relevant characteristics to determining material positive correlation

2.4 Respondents agreed that a number of characteristics must be considered to determine whether there is a material positive correlation between the credit quality of the obligor and the value of the collateral, such as geographic location, business model, and legal connectedness. They also agreed that the absence of a legal connection between the collateral issuer and the obligor does not preclude the possibility of a material positive correlation.

2.5 Respondents elaborated on a number of transaction specific features that may be relevant to determining material positive correlation such as over-collateralisation, deleverage triggers, close out features, margining arrangements and parental guarantees. The section below on 'Material positive correlation in transactions with limited recourse' considers this further in paragraphs 2.15 to 2.18 of this PS, and the PRA has clarified in SS17/13 the circumstances in which parental guarantees are relevant to the determination of material positive correlation.

Correlation where the obligor and the collateral issuer share the same country

2.6 One respondent said that where the collateral issuer and the obligor share the same country, this should not necessarily imply material positive correlation. In such a case, this respondent said they would also consider other characteristics in order to determine whether there is a material positive correlation.

2 Sections 2L and 2N of FSMA.
3 CRR Article 207(2).

2.7 The PRA considers that correlations that might arise due to the obligor and the collateral issuer sharing the same country are relevant in determining whether there is a material positive correlation. But that does not mean a determination of material positive correlation necessarily follows in such a case. For the avoidance of doubt, the PRA has clarified this in the SS. The PRA has also clarified that firms should consider relevant characteristics both in isolation and in combination with other relevant characteristics in determining whether there is a material positive correlation.

Covered bonds

2.8 One respondent noted that a deterioration in economic conditions in a particular country would reduce both the value of that country's government bonds and the credit quality of its banks as the quality of their loan books suffered greater impairment. They noted this correlation could be relevant to covered bonds. They requested confirmation that firms would not be expected to exclude covered bonds as eligible collateral against exposures to banks because of such general correlation.

2.9 In relation to firms' own issues of covered bonds, the PRA notes that according to the second paragraph of CRR Article 207(2) "the obligor's own issues of covered bonds falling within the terms of Article 129 qualify as eligible collateral when they are posted as collateral for a repurchase transaction, provided that they comply with the condition set out in the first subparagraph". Where a firm wishes to recognise covered bonds as collateral in other circumstances (for example covered bonds that are not own issued), these must also comply with the conditions set out in Article 207(2), as required under Article 207(1). The PRA considers this to be clear and has decided to publish no further clarification.

Material positive correlation in transactions with limited recourse

2.10 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 trigger the default of the obligor. The PRA proposed 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) should meet the definition of material positive correlation as per Article 207(2). As a result the PRA proposed that firms should not 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.

Lack of risk sensitivity

2.11 Where there is material positive correlation as described in Article 207(2), the collateral is ineligible as funded credit protection under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the CRR. One respondent agreed that the benefits of collateralisation should not be double counted – first in the credit rating to determine the risk weight, and second in the exposure value – but they argued it is not risk sensitive to treat the transaction as unsecured, as this ignores the level of over-collateralisation and other potential risk-reducing features. Two other respondents made similar points.

2.12 The PRA notes that for transactions where there is a material positive correlation as described in Article 207(2), risk-weighted assets do not vary with some features of the transaction like the level of over-collateralisation. This reflects the relatively simple nature of the Pillar 1 credit risk mitigation framework. The PRA considers this outcome to be better than a position where differences in interpretation of Article 207(2) can be a major driver of variation in firms' capital requirements on transactions with limited recourse; this may have resulted in capital requirements for some firms that were too low relative to the risk. The PRA considers that even where collateral on transactions with limited recourse is not eligible under Article 207(2), the collateral is to an extent reflected in the corporate risk weight; for example under standardised approaches a 100% risk weight might apply to special purpose entities (SPEs), the same as for a (BBB-rated or unrated) broader commercial enterprise.

Conservatism compared with treatment of economically similar transactions

2.13 Two respondents argued that applying a 100% risk weight is conservative compared to the CRR treatment of certain other transactions with limited recourse. They argued that securitisation positions with underlying assets having a standardised risk weight of 100% can receive a risk weight of 15% under the standardised approach to securitisation, even where the loan-to-value ratio (LTV) is higher than that of a typical non-recourse margin loan. Similarly, a specialised lending exposure might receive a risk weight of 50% if its maturity is less than 2.5 years.

2.14 The PRA considers that the risk characteristics of a given transaction will depend on a number of factors, and the examples of transactions provided by respondents are likely to have quite different risk characteristics from the types of limited recourse transactions that will be affected by the proposals in CP1/19. Securitisations are transactions where credit risk is tranched, and the securitised assets are typically diversified. Where a firm has recourse to a diversified pool of collateral, this would not be affected by the proposals in CP1/19. The 50% slotting risk weight assumes the exposure is slotted in to the highest quality slot; if assets are highly illiquid that is an indicator of the ‘weak’ category, which attracts a 250% risk weight. The highest quality slot also requires that asset value and liquidity are relatively insensitive to economic cycles, which might not be the case for example where the asset is an equity, as is frequently the case for non-recourse margin loans.

Over-collateralisation and risk-reducing features of collateral agreements

2.15 The PRA proposed that firms should not 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, regardless of the level of collateralisation or margin agreements. Respondents suggested that, especially for non-recourse transactions, transaction specific features such as over-collateralisation, deleverage triggers, close out features, and margining arrangements are relevant to whether there is material positive correlation. Two respondents argued that firms should be able to take account of such features when determining if there is a material positive correlation under Article 207(2). One respondent said that because of these features they do not consider the existence of material positive correlation to be a relevant consideration in transactions with limited recourse.

2.16 While the PRA agrees that such features can reduce the risks of secured lending, the PRA notes that these may not be sufficient to prevent loss especially when the fall in collateral value is rapid and there is no recourse to the ultimate borrower. Significant over-collateralisation with a single collateral asset can reduce risk, but unless the lender has recourse to other assets they remain exposed to a significant and rapid fall in the value of that asset. Margin agreements may provide the lender recourse to additional assets in certain circumstances, but until the lender is provided with recourse to those assets they remain exposed to changes in the value of the collateral that they do have recourse to. For these reasons the PRA considers that over-collateralisation, margin agreements and similar risk reducing features are not relevant to the determination of material positive correlation on non-recourse loans collateralised by a single asset or group of materially positively correlated assets.

Guarantees

2.17 Two respondents argued that parental guarantees and other forms of credit support can help mitigate the risk of loss on non-recourse transactions.

2.18 The PRA considers that where a firm's exposure is subject to a legally enforceable guarantee provided by a third party, this may broaden the scope of assets to which a firm has legal recourse. The PRA has clarified that where the SS refers to the total value of all of the assets to which the lender has legal recourse, this would include assets of a third party where that third party has provided a legally enforceable guarantee, in addition to collateral posted by the obligor and the unencumbered assets of the obligor (if the lender has a general recourse to the obligor).

High quality collateral

2.19 One respondent noted that, while they consider the PRA's proposals to have been motivated by non-recourse transactions secured by equity, the principles are equally applicable to non-recourse transactions with debt collateral. They suggested the PRA consults again and considers clarifying the intended scope of the policy regarding debt collateral. Three respondents discussed look-through approaches, where the risk weight is determined by the underlying collateral rather than the risk weight of the direct obligor. This could allow non-recourse exposures collateralised by high quality assets to receive a lower risk weight than the risk weight of the direct obligor. One firm argued that for firms using Internal Ratings Based (IRB) approaches such a methodology is possible or even required by the provisions of Article 170(1)(a), which require firms to ensure that rating systems "take into account obligor and transaction characteristics". They also compared a look-through approach to the approach that can be taken for equity investments in funds and for exposures subject to a guarantee.

2.20 The PRA confirms that the expectations set out in paragraph 8.4 of the SS apply to any financial collateral asset on transactions with limited recourse whose value has a material positive correlation with the total value of all of the assets to which the lender has legal recourse. For such transactions, regardless of the quality of the collateral, the value of the collateral and the borrower's creditworthiness are mutually dependent.

2.21 The PRA notes a look-through approach for financial collateral is not available under the credit risk mitigation framework of the CRR, except in certain circumstances where firms are using the financial collateral simple method (which is in general not available to firms that also make use of the financial collateral comprehensive method). Even where firms use the financial collateral simple method, eligibility requirements for financial collateral including those under Article 207(2) would still apply. For IRB firms the PRA notes the requirement in Article 170(1)(a) that firms take into account obligor as well as transaction characteristics.

Index instruments

2.22 One respondent noted the PRA expects 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. They said they understand that an index instrument is not deemed a single asset for the purpose of this statement and the constituent parts of the index would need to be assessed for the existence of material positive correlation if the PRA's proposals remain unchanged.

2.23 The PRA agrees with the view that index instruments should, for the purposes of assessing material positive correlation for transactions with limited recourse, be considered as a collection of the underlying financial assets. The PRA has clarified that for the purposes of paragraph 8.4 of the SS, 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.

Capitalisation using market risk approaches

2.24 One respondent considered that it may be appropriate to use internal risk transfer techniques and capitalise some of the risk in the trading book rather than the banking book. They argued that in certain restricted circumstances firms are able to capitalise the risk using a market risk approach. While the credit risk risk-weighted assets would continue to be treated in the banking book, they argued material positive correlation would be assessed as nil on the basis that there is no recourse to the borrower.

2.25 The PRA does not offer any comment here on the appropriateness of an internal risk transfer approach, but firms will need to ensure that any such arrangements are compliant with the CRR, including in particular Article 106. However as the respondent noted, credit risk capital requirements would still apply in this case. Therefore, the rules regarding capitalisation of credit risk, including credit risk mitigation, will continue to be relevant. This includes Article 207(2). Paragraph 8.4 of the SS clarifies how Article 207(2) should be applied in the context of transactions where there is no general recourse to the borrower. In particular, in the context of transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets, the PRA considers 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 to meet the definition of material positive correlation as per Article 207(2). A firm should not determine that there is no material positive correlation simply on the basis that recourse is restricted only to specified assets with no recourse to the borrower generally.

2.26 Another respondent suggested a market risk approach could alternatively be used as the basis for a Pillar 2 charge, if the PRA were worried that certain risks are not adequately captured in Pillar 1.

2.27 The PRA considers that the risk of correlated collateral is capitalised on a mandatory basis in the CRR Pillar 1 rules by not allowing firms to recognise collateral where the credit quality of the obligor and the value of the collateral have a material positive correlation.

Other comments

Impact on UK structured lending market

2.28 One respondent noted that UK markets are an international centre of excellence for structured lending solutions, including types of limited recourse lending, such as margin loans, the capital requirement for which may increase due to the proposals in CP1/19. They noted the PRA's guidance will make the required provision of an independent legal opinion in relation to the effectiveness of the credit risk mitigation benefit of financial collateral more difficult until the PRA's intentions are clarified. They said this will disrupt the UK's internationally important non-recourse and limited recourse loan markets, at least temporarily.

2.29 The PRA has observed a variety of approaches in the capitalisation of secured financing transactions. Some firms, including firms with significant levels of non-recourse lending business, already determine capital requirements on these transactions in accordance with the proposed expectations. The PRA considers these proposals will improve consistency by bringing all firms in to line with the CRR and with the practice already adopted by some firms.

Implementation

2.30 One respondent suggested that alternatives to the proposed policy should be considered and further consulted on. They said a change in regulatory treatment would be significant and merits additional consultation to ensure there are no unintended consequences. Another respondent said they believe the subject would merit a more in-depth dialogue between the industry and the PRA, and would also benefit from discussion at international level, before an approach is finalised for an individual jurisdiction. A further respondent requested that firms are given appropriate time to implement any changes once the PRA has finalised its stance, rather than changes applying with immediate effect.

2.31 After careful consideration, the PRA does not consider that the issues raised by the responses to CP1/19 or the subsequent changes to the policy explained in this PS are of such magnitude as to warrant a further consultation. Nor does the PRA consider that the impact of the policy is of such magnitude to warrant a delay in implementation. Because some firms already determine capital requirements on transactions with limited recourse in accordance with the proposed expectations, the PRA considers it would put them at a competitive disadvantage to delay implementation. Where firms have concerns about their ability to meet the expectations in the SS, they should get in touch with their usual supervisory contacts.

Appendix

SS17/13 'Credit risk mitigation', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-mitigation-ss.