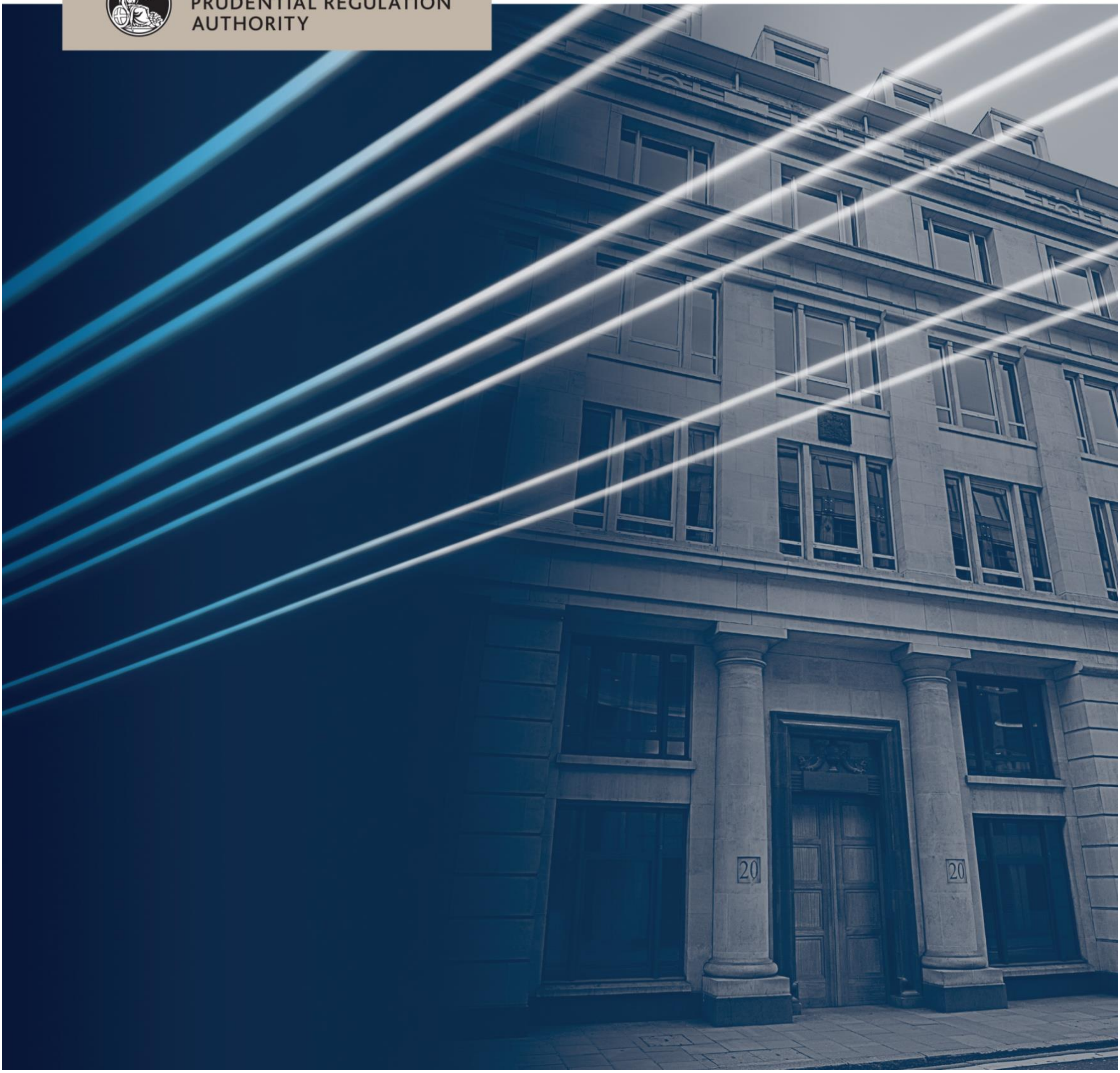
Supervisory Statement | SS17/13

Credit risk mitigation

July 2019

(Updating April 2017)

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

1 Introduction

1.1 This supervisory statement (SS) is aimed at firms to which CRD IV[1] applies.[2]

1.2 The purpose of this 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

2.1 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

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

3.2 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)

4.1 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)

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

5.1 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.

5.2 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 Capital Requirements Directive (2013/36/EU) (CRD) and Capital Requirements Regulation (575/2013) (CRR) – jointly 'CRD IV'.
2 On 28 April 2017 this SS was updated – see the annex for details.

5.3 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.

5.4 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.

5.5 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

6.1 To qualify as an eligible form of credit risk mitigation under Part Three, Title II, Chapter 4 of the CRR, netting agreements must meet a number of conditions, including the conditions 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.

6.2 The PRA does not consider that netting agreements are legally effective and enforceable where a resolution authority has the power to bail in the liabilities in question on a gross basis and netting of these liabilities will therefore not qualify as an eligible form of credit risk mitigation.

6.3 Conversely, the PRA does not expect that the legal effectiveness and enforceability of a netting agreement is affected where a resolution authority has the power to bail in the liabilities in question only on a net basis.

7 Eligibility of guarantees as unfunded credit protection

[This chapter takes effect from 13 September 2019. See the annex of the future version of SS13/17 for details.[3]]

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. It is, in particular, relevant for CRR Part Three, Title II, Chapter 4 (Credit risk mitigation) and any other parts of the CRR or other legislation that cross-refers to CRR Part Three, Title II, Chapter 4.

CRR requirements on correlated collateral

8.2 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" (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), 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.[4] 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 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 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

3 Available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-mitigation-ss.
4 Where the obligor and the collateral issuer share the same country this does not necessarily imply there is a material positive correlation.

assets to which the firm has legal recourse),[5] to meet the definition of material positive correlation as per Article 207(2).[6]

8.5 The PRA provides two examples:

(i) 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). Consequently, 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.

(ii) 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). 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, when modelling the effect of collateral under internal approaches such as the Advanced Internal Ratings Based approach and the Internal Model Method, not to recognise collateral 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, firms should apply Article 207(2) taking into account the extent of any correlation between the reference obligations in the reference portfolio and the assets of a SSPE.

5 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.

6 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.

Annex - SS17/13 updates

This annex outlines changes made to SS17/13 since its publication in December 2013.

July 2019

23 July

This SS was updated following publication of Policy Statement 14/19 ‘Credit risk mitigation: Eligibility of financial collateral’,[1] to clarify expectations regarding the eligibility of financial collateral as funded credit protection under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the Capital Requirements Regulation (575/2013) (CRR). These updated expectations are set out in Chapter 8 of this SS.

April 2017

28 April

This SS was updated following publication of PS9/17 ‘Implementation of MiFID II: Part 2’,[2] to update references in paragraph 3.1 from Markets in Financial Instruments Directive (MiFID) to MiFID II. The updates referring to MiFID II take effect from Wednesday 3 January 2018.

1 https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-mitigation-eligibility-of-financial-collateral (page 1 of 2).

2 https://www.bankofengland.co.uk/prudential-regulation/publication/2016/implementation-of-mifid-2-part-2.