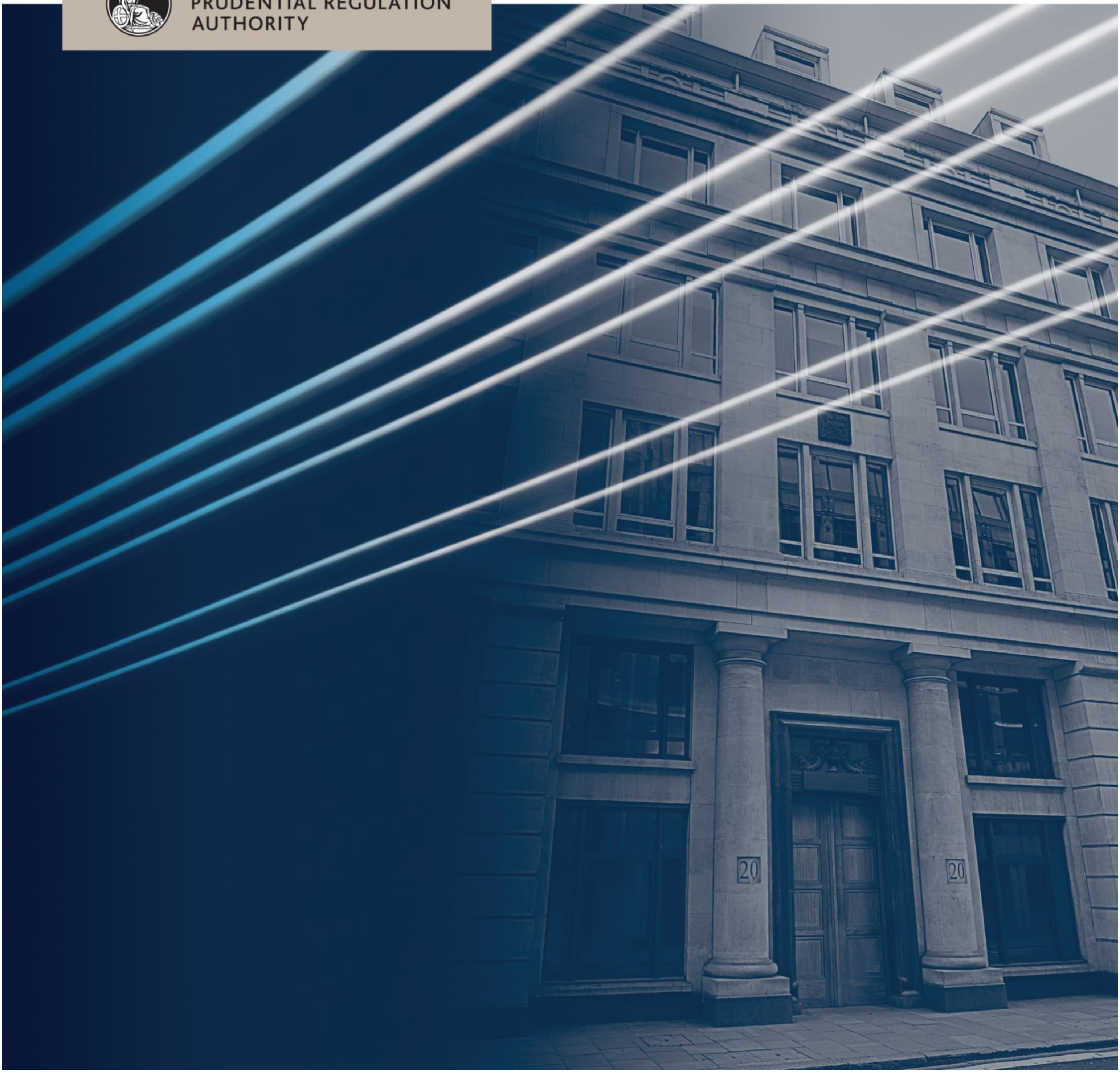
Supervisory Statement | SS17/13

Credit risk mitigation

March 2019

(Updating April 2017)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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PRUDENTIAL REGULATION
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March 2019

(Updating April 2017)

Effective from 13 September 2019

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

7.1 This chapter is relevant to any firm that is intending to treat an arrangement as a guarantee qualifying as 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. ‘Guarantee’ is not defined 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 are eligible as unfunded credit risk mitigation.

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. CRR Article 194(2) requires that firms take all appropriate steps to ensure effectiveness of the guarantee. The PRA expects firms to consider the practical ease of enforcement of the guarantee.

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 and the remedies available under the law that applies to that guarantee.

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

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.

Exclusion of certain types of payments and limited coverage

7.6 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, 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). 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 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.

Risks arising from eligible guarantee arrangements

7.7 CRR Article 194(8) requires that a firm 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) requires that a firm 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 intended to qualify as credit risk mitigation, the PRA expects firms to identify risks arising from guarantee arrangements. This would include identifying the risk of non-fulfilment by the firm of an obligation or term, in connection with the guarantee 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 guarantor. Firms are expected to have adequate risk management processes in place to control these risks.

Residual risks

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.

Pillar 2

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

7.10 That does not preclude the possibility that additional capital under Pillar 2 may be appropriate where a guarantee is eligible under Pillar 1. The use of Pillar 2 to address residual risks is contemplated in Basel II[3], 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)',[4] the SREP will specifically consider firms' management of residual risk from 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.

3 Paragraphs 767-769.
4 https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

Annex - SS17/13 updates

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

March 2019

13 March

This SS was updated following publication of Policy Statement 8/19 'Credit risk mitigation: Eligibility of guarantees as unfunded credit protection',[1] 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). These updated expectations are set out in Chapter 7 of this SS and take effect from Friday 13 September 2019.

This SS was also updated to simplify the formatting and aid readability, including sequential numbering of footnotes, the updating of hyperlinks to reflect the location on the Bank of England's website, and to make hyperlinks more easily identifiable.

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/2018/credit-risk-mitigation-eligibility-of-guarantees.
2 https://www.bankofengland.co.uk/prudential-regulation/publication/2016/implementation-of-mifid-2-part-2.