BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP1/19

Credit risk mitigation: Eligibility of financial collateral

January 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP1/19

Credit risk mitigation: Eligibility of financial collateral

January 2019

By responding to this consultation, you provide personal data to the Bank of England. This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the response itself.

The response will be assessed to inform our work as a regulator and central bank, both in the public interest and in the exercise of our official authority. We may use your details to contact you to clarify any aspects of your response.

The consultation paper will explain if responses will be shared with other organisations (for example, the Financial Conduct Authority). If this is the case, the other organisation will also review the responses and may also contact you to clarify aspects of your response. We will retain all responses for the period that is relevant to supporting ongoing regulatory policy developments and reviews. However, all personal data will be redacted from the responses within five years of receipt. To find out more about how we deal with your personal data, your rights or to get in touch please visit bankofengland.co.uk/legal/privacy.

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank's functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England receives a request for disclosure of this information, we will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England.

Responses are requested by Wednesday 10 April 2019.

Please address any comments or enquiries to:
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP1_19@bankofengland.co.uk

Contents

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' 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).

1.2 This CP is relevant to UK banks, building societies and PRA-designated UK investment firms that are subject to the 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.

1.3 The CP proposes adding a new chapter to SS17/13.[1]

Background

1.4 The PRA has been reviewing firm practice in the capitalisation of certain kinds of secured financing transactions including non-recourse loans; that is, loans where the lender does not have full recourse to the assets of the beneficial borrower. In the course of this review the PRA observed a variety of approaches in the capitalisation of secured financing transactions and has concerns in a number of areas. Feedback is being provided directly to firms as part of established supervisory processes.

1.5 On one issue – the eligibility of financial collateral where there is a correlation between the collateral value and the credit quality of the obligor – the PRA considers it necessary to issue further guidance on its expectations of firms through a revision to an SS. This is because the PRA observed practices by some firms which may have resulted in collateral being recognised as eligible for credit risk mitigation (CRM) purposes when it should not have been.

1.6 The criteria for recognising collateral as eligible for CRM purposes are set out in CRR Part Three, Title II, Chapter 4 (Credit risk mitigation). Where the collateral is financial collateral, these criteria include that 'the credit quality of the obligor and the value of the collateral shall not have a material positive correlation' (CRR Article 207(2)).

1.7 In relation to non-recourse loans, in some cases a significant fall in the value of the financial collateral can itself bring about the default of the obligor. As such the creditworthiness of the obligor can depend materially on the value of the financial collateral. The risk mitigation provided by such collateral may be compromised and Article 207(2) is relevant. In the PRA's view the CRR is clear on this point. However the PRA has identified some variability in how firms interpret and apply the Article 207(2) requirement.

1.8 The PRA considers it necessary to clarify both how Article 207(2) applies in such circumstances, and the PRA's expectations of how firms should treat collateral with a material positive correlation for CRM purposes.

1 In February 2018, CP6/18 'Credit risk mitigation: Eligibility of guarantees as unfunded credit protection' proposed adding a Chapter 7 to SS17/13, so this CP proposes adding Chapter 8, subject to the outcome of CP6/18.

Responses and next steps

1.9 This consultation closes on Wednesday 10 April 2019. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP1_19@bankofengland.co.uk.

1.10 The proposals in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

2 Proposals

2.1 Article 207(2) requires that 'the credit quality of the obligor and the value of the collateral shall not have a material positive correlation'. Any financial collateral asset whose value has a material positive correlation with the obligor's credit quality is not eligible, as it cannot be relied upon to mitigate loss at the point of default.

2.2 In determining whether a financial collateral asset satisfies the requirement in Article 207(2), firms must 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. In each case the firm should consider whether the relevant characteristics might 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.

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

2.4 When modelling the effect of collateral under internal approaches such as the Advanced Internal Ratings Based approach and the Internal Model Method, collateral that has a material positive correlation as described in paragraph 2.3 should not be recognised. The PRA's proposed expectations in this regard are set out in paragraph 8.6 of the Appendix.

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.[2] 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:

2 Section 2L of FSMA.

- 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,[3] insurance objective[4] (if applicable), and secondary competition objective;[5]

- 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;[6] 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.[7]

3.3 The PRA is also required by the Equality Act 2010[8] 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 PRA considers the proposals provide additional clarity to ensure that capital relief from financial collateral is obtained only where the collateral can be relied on to provide an effective mitigant in the event of default.

3.5 The proposals do not impose new benefits and costs, but will help ensure that the benefits and costs associated with the CRR rules in question will be better realised. Those benefits include:

- enhanced safety and soundness of any affected firm as firms would recognise financial collateral for CRM purposes only when eligibility requirements are met;

- reduced 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, improve consistency among firms in how they recognise financial collateral for CRM purposes, and ensure that capital requirements are more in line with risk.

3.6 The proposals will help ensure that firms bear the intended costs of CRR compliance. The PRA has observed practices by some firms which may have resulted in collateral being recognised as eligible for credit risk mitigation (CRM) purposes when it should not have been. The risk-weighted assets of these firms may therefore increase as a result of this clarification,

3 Section 2B of FSMA.
4 Section 2C of FSMA.
5 Section 2H(1) of FSMA.
6 Section 2H(2) and 3B of FSMA.
7 Section 30B of the Bank of England Act 1998.
8 Section 149.

with correspondingly higher capital requirements. This could have a negative impact on lending. However, the PRA estimates that the overall impact on capital requirements and lending would be of limited significance.

Compatibility with the PRA's objectives

3.7 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 financial collateral 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 that they are, or may be, exposed to.

3.8 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 financial collateral only where appropriate. The PRA considers that a more consistent interpretation of the requirements will level the playing field amongst firms by ensuring that no firm claims undue capital relief from financial collateral.

Regulatory principles

3.9 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 financial collateral. The PRA has considered the burden on firms and estimates that the overall impact on firms as a result of these proposals is small in the context of their total capital requirements.

(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 financial collateral 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 of inconsistent interpretation of CRR Article 207(2) in relation to transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets. The PRA considers that setting out expectations in an SS is the most suitable way to provide greater clarity.

Impact on mutuals

3.10 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

3.11 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.[9] The PRA has considered these in relation to these proposals. Of particular relevance is the impact on competition, which has been considered in paragraph 3.8.

Equality and diversity

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

9 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Appendix

Draft amendments to Supervisory Statement 17/13 'Credit risk mitigation'

The text below is all new and has not been underlined.

…

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), firms must 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. In each case the firm should consider whether the relevant characteristics might 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 assets to which the firm has legal recourse), to meet the definition of material positive correlation as per Article 207(2).

8.5. We provide 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.