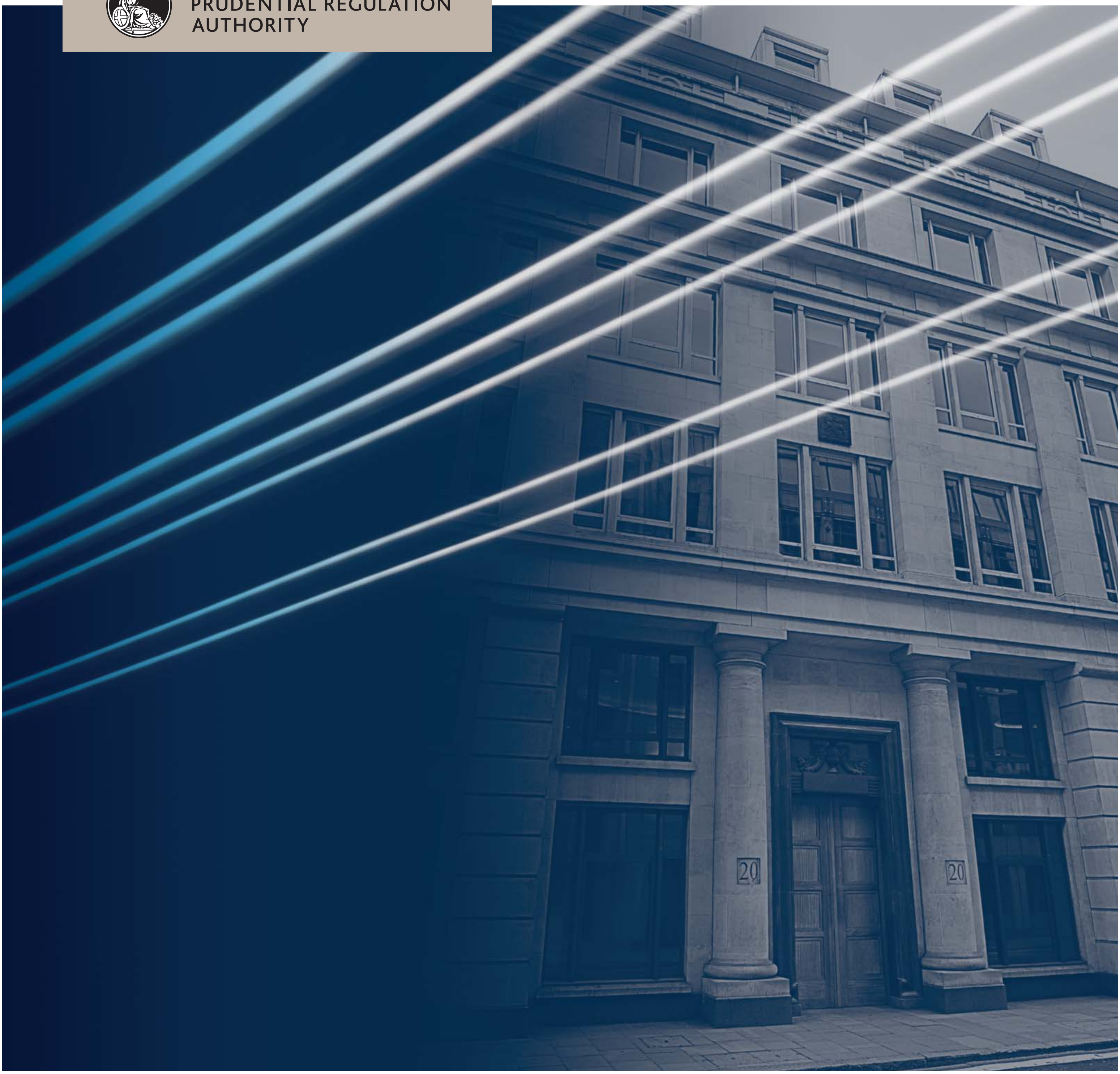
Supervisory Statement | SS17/13

Credit risk mitigation

December 2013

(Last updated on 12 December 2014)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

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28 April 2017 - this document has been updated, see
http://www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss1713update.aspx

1 Introduction

1.1 This supervisory statement is aimed at firms to which CRD IV applies.

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 MIFID 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% volatility 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 volatility 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.

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.