

# ALLEN & OVERY



## Capital Requirements Directive IV Framework *Collateral: Funded Credit Risk Mitigation in the Banking Book*

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# CRD IV Framework: *Collateral: Funded Credit Risk Mitigation in the Banking Book*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV<sup>1</sup> (**CRD IV**) and the Capital Requirements Regulation<sup>2</sup> (**CRR**), replacing the Banking Consolidation Directive<sup>3</sup> and the Capital Adequacy Directive.<sup>4</sup> The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be relevant to the in-house lawyer.

This briefing is for general guidance only and does not constitute definitive advice.

**NOTE: This briefing paper is based on information available as at 17 January 2014.**

<sup>1</sup> 2013/36/EU.

<sup>2</sup> Regulation 575/2013.

<sup>3</sup> 2006/48/EU.

<sup>4</sup> 2006/49/EU.

## Background and Scope

The CRR includes a framework for the recognition of credit risk mitigation (**CRM**).

This briefing paper deals with the banking book treatment of collateral as funded credit protection. The main techniques of funded credit protection are collateral and netting. Collateral is provided where an institution with an exposure holds cash, gold or certain other high quality highly liquid securities as collateral for the exposure. The funding can be provided by the entity on whose behalf the exposure has been incurred or by a guarantor or by means of a third party charge.

Where an institution has permission to adopt an advanced internal ratings based (**AIRB**) approach in relation to an exposure, modified credit risk mitigation requirements apply. The modified AIRB requirements for credit risk mitigation are beyond the scope of this briefing paper.<sup>5</sup>

## Sources

CRR (*Regulation 575/2013*): Articles 192-241.

[UK Financial Conduct Authority \(FCA\) Policy Statement \(PS13/10\) CRD IV for Investment Firms \(December 2013\)](#) (the **FCA Policy Statement**).

[UK Prudential Regulation Authority \(PRA\) Policy Statement \(PS7/13\) Strengthening capital standards: implementing CRD IV, feedback and final rules \(December 2013\)](#) (the **PRA Policy Statement**).

[PRA Supervisory Statement \(SS17/13\) Credit risk mitigation \(December 2013\)](#) (the **PRA Supervisory Statement in respect of Credit Risk Mitigation**).

<sup>5</sup> Under Chapter 3 (*Internal Ratings Based Approach*) of Title II (*Capital Requirements for Credit Risk*), see Article 108(2) CRR.

## Background and Scope (continued)

Unfunded credit risk mitigation is covered in Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*) in this series.

Article 108 of the CRR recognises the use of eligible CRM for exposures risk-weighted under the Standardised approach (the **Standardised Approach**) and the Internal Ratings Based approach (**IRB Approach**). Article 247 of the CRR recognises the use of eligible CRM in respect of securitisation positions. In order to be eligible, CRM must meet the requirements of Chapter 4, Title II of Part 3 of the CRR.

# Key changes

Key changes arising under CRR are as follows:

- The key change introduced by the CRR in respect of credit risk mitigation (both funded and unfunded) is a new obligation for institutions to obtain formal legal opinions in order to satisfy the existing requirement for credit protection to be legally effective and enforceable in all relevant jurisdictions.
- Material changes to the detail of the requirements in respect of collateral as funded credit protection include the following:
  - Additional operational requirements are introduced in respect of collateral management – see ‘minimum requirements for the recognition of eligible financial collateral’ below.
  - Securitisation positions that are not re-securitisation positions, associated with credit quality step 3 or above are now included as eligible collateral under all approaches and methods – see ‘eligibility’ below.
  - Technical changes to the calculation of the liquidation period for the purposes of the supervisory volatility adjustments. A daily margin call right is required in order for a transaction to qualify as a ‘capital markets transaction’ rather than a ‘secured lending transaction’ and so benefit from a 10 day (rather than 20 day) liquidation period for the purposes of the supervisory volatility adjustments.
- Additional eligibility requirements apply in respect of the recognition, as collateral, of units or shares in collective investment undertakings that invest in eligible collateral classes. The application of the eligibility requirements to collective investment undertakings that invest in other collective investment undertakings (ie funds of funds) is also clarified. See ‘eligibility’ below.
- The requirements to recognise residential property as immovable property collateral and to recognise other physical collateral (ie physical collateral other than immovable property) on the IRB Approach have been strengthened in certain respects. The basis on which the market value of other physical collateral (ie physical collateral other than immovable property) is to be estimated has also changed slightly. See ‘eligibility’ below.

- Though relevant to funded credit protection in general rather than to the focus of this briefing (collateral as funded credit protection), we note that on-balance sheet netting now appears to be limited to loans and deposits of a lending institution that are denominated in the same currency.<sup>6</sup>
- In line with the overall trend in the CRR, the number of discretions available to national competent authorities in respect of collateral as

<sup>6</sup> Article 219 CRR.

funded credit protection has been reduced – see ‘national discretions and UK implementation’ below. In particular, flowing from changes to the Standardised Approach (see Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*) in this series) the European Banking Authority (**EBA**) and other European Supervisory Authorities (rather than national competent authorities) are now responsible for recognising eligible credit assessment institutions, and mapping the ratings issued by them to the credit quality steps that underpin collateral eligibility – see ‘eligibility’ below.

# The requirements

## Central principles

### Legal certainty

An institution must not recognise credit protection as eligible until it has conducted sufficient legal review confirming that the credit protection arrangements are legally effective and enforceable in all relevant jurisdictions.<sup>7</sup>

Although opinions have long been required in connection with the use of contractual netting to reduce counterparty credit risk exposure in respect of derivatives and repo-style transactions,<sup>8</sup> institutions have not, in a credit risk mitigation context, typically obtained formal legal opinions from external counsel as to the legal effectiveness and enforceability of their credit protection arrangements. They have, instead, relied upon a broad range of measures (eg internal legal review, opinions on analogous scenarios, individual experience, market practice) to support their conclusions. In light of amendments introduced by the CRR, and the EBA’s guidance in this respect in its Single Rulebook Q&A,<sup>9</sup> it appears that

institutions must now obtain legal opinions in order to satisfy the CRR requirement for credit protection to be legally effective and enforceable in all relevant jurisdictions.<sup>10</sup> The EBA indicates that, as long as it is ‘independent, written and reasoned’, an opinion may be provided by an internal legal counsel (rather than external legal counsel), however, internal legal counsel appetite for this role and market practice in this respect is yet to be established. Market practice also remains to be established as to the extent to which generic opinions for particular types of transactions as opposed to transaction-specific opinions will be relied upon. The EBA guidance indicates that where ‘an institution engages in the same type of transaction, with counterparties located in the same jurisdiction and uses the same credit risk mitigation technique’, it can rely on the same opinion (eg a generic opinion relating to a master netting agreement covering all relevant jurisdictions).

In relation to financial collateral, an institution must re-conduct legal reviews as necessary to ensure continuing enforceability and effectiveness.<sup>11</sup>

<sup>7</sup> Article 194(1) CRR.

<sup>8</sup> Under Articles 295-298 CRR.

<sup>9</sup> The second sub-paragraph of Article 194(1) provides that: “the lending institution shall provide, upon request of the competent authority, the most recent version of the independent, written and

reasoned legal opinion or opinions that is used to establish whether its credit protection arrangement or arrangements meet the condition laid down in the first sub-paragraph”. The EBA has commented on this provision at question [2013\\_23](#) of its Single Rulebook Q&A.

<sup>10</sup> Article 194(1) CRR.

<sup>11</sup> Article 207(3) CRR. An institution will need to adopt a policy on the frequency with which it will re-conduct legal reviews and the form that

## Eligibility

To be eligible for recognition, the assets relied upon must be sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved. Eligibility is limited to the assets set out in the CRM eligibility conditions (see ‘eligibility’ below).<sup>12</sup> The EBA is tasked with preparing Regulatory Technical Standards (**RTS**) as to what constitutes sufficient liquidity and stability in this context<sup>13</sup> – see ‘technical standards and lists’ below.

In assessing the degree of certainty that the credit protection provides, account is taken of the degree of recognition allowed (ie the amount of the “haircut” applied).<sup>14</sup>

The institution must have the right to liquidate and retain, in a timely manner, the assets from which the protection derives. This right must be exercisable on the default or insolvency of the obligor (or any other credit event set out in the transaction documentation). If the collateral is held by a custodian, insolvency of the custodian must not adversely affect the rights of the institution.<sup>15</sup>

There must not be a correlation between the value of the assets relied upon for protection and the credit quality of the obligor that is ‘too high’.<sup>16</sup> Article 207(2) of the CRR provides further (new, but not particularly enlightening) gloss as to what constitutes a material positive correlation in relation to financial collateral.<sup>17</sup>

## Other minimum requirements

An institution must be able to demonstrate to the competent authority that it has adequate risk management processes to control the risks the

will take. The frequency and form of the review may depend on the type of protections and the nature of the collateral.

<sup>12</sup> Article 194(3) CRR.

<sup>13</sup> Article 194(10) CRR.

<sup>14</sup> Article 194(3) CRR.

<sup>15</sup> Article 194(4) CRR.

<sup>16</sup> Article 194(4) CRR. As the debt securities of corporates are now eligible as collateral, it has to be made clear that a corporate cannot use its own debt securities (or the debt securities of an affiliate) to provide CRM.

<sup>17</sup> Where the value of the collateral is reduced significantly, this shall not alone imply a significant deterioration of the credit quality of the obligor. Where the credit quality of the obligor becomes critical, this shall not alone imply a significant reduction in the value of the collateral.

institution may be exposed to as a result of using credit risk mitigation.<sup>18</sup>

Even where an institution holds collateral as a risk mitigant, it must still undertake a full credit risk assessment of the underlying exposure and be able to demonstrate to the competent authority that it has done this.<sup>19</sup>

Cash, securities or commodities purchased, borrowed or received under a repurchase transaction or securities or commodities lending or borrowing transaction must be treated as collateral.<sup>20</sup>

## Double counting

Sometimes, the exposure calculation for an instrument itself allows netting and/or collateral to be taken into account. This is seen mainly in relation to derivative and repo-style transactions, covered bonds, and exposures secured by mortgages on immovable property. Where this is the case, an institution is not able to double-count the effect of the CRM by also using the CRM methods.<sup>21</sup>

## Eligibility

Whether a particular kind of financial collateral is eligible for recognition as a credit risk mitigant depends on whether the institution is using the Standardised Approach or the IRB Approach.<sup>22</sup> Eligibility also depends on whether the institution is using the simple method or the comprehensive method.<sup>23</sup>

The following is a summary of the forms of financial collateral that are eligible collateral under all approaches and methods.<sup>24</sup> This is only a summary. There are a number of detailed requirements in relation to eligible collateral.

<sup>18</sup> Article 194(8) CRR.

<sup>19</sup> Article 194(9) CRR.

<sup>20</sup> Article 193(4) CRR.

<sup>21</sup> Article 193(2) CRR.

<sup>22</sup> Article 199 CRR.

<sup>23</sup> Article 198 CRR. By way of example, equities listed on a recognised or designated investment exchange are eligible under the comprehensive method but not under the simple method.

<sup>24</sup> Article 197 CRR.

- Cash on deposit with, or cash assimilated instruments (that is, certificates of deposit (**CDs**)) held by, the lending firm.
- Debt securities issued by central governments or central banks associated with credit quality steps (**CQS**) 4 or above.
- Debt securities issued by other institutions (ie banks, building societies and MiFID investment firms)<sup>25</sup> associated with CQS 3 or above (unrated debt securities issued by other institutions may also be eligible subject to the satisfaction of specified conditions, including that the securities are listed on a ‘recognised exchange’).
- Debt securities issued by other entities (ie corporates) associated with CQS 3 or above.
- Debt securities with a short-term credit assessment associated with CQS 3 or above.
- Equities or convertible bonds that are included in a ‘main index’.
- Gold.
- Securitisation positions that are not re-securitisation positions, associated with CQS 3 or above. (This is a new eligible asset class under the CRR).
- Units or shares, that are subject to a daily public price quote, in collective investment undertakings (**CIUs**) if, and to the extent that, the CIU invests in the eligible financial collateral classes above. The CRR introduces an additional requirement that, in order for its units or shares to constitute eligible financial collateral for this purpose, a CIU must comply with the requirements that would need to be satisfied in order for an institution to benefit from a ‘look through’ or ‘average risk weight’ risk weighting approach in relation to exposures to that CIU on the standardised approach (ie EU – or equivalent – management supervision, and certain operational requirements). The CRR also clarifies that units or shares in CIUs that invest in other CIUs (ie

funds of funds) can qualify, provided that the eligibility requirements are met in relation to the underlying CIU.

The CQS are those specified in the Standardised Approach. Under the Standardised Approach, the EBA will publish a list of registered<sup>26</sup> ratings agencies and central banks issuing credit ratings, together referred to as eligible credit assessment institutions (**ECAIs**) and the EBA, European Insurance and Occupational Pensions Authority (**EIOPA**), and the European Securities and Markets Authority (**ESMA**) will develop Implementing Technical Standards (**ITS**) mapping the CQS levels across to the ratings provided by the ECAIs which are required to be submitted to the European Commission by 1 July 2014.<sup>27</sup> In the UK, the PRA has confirmed that the existing mapping, as set out in the supervisory statement that will accompany the PRA Rulebook, will continue to apply until it is superseded by the mapping that will be adopted by the European Commission.<sup>28</sup> This represents a change from the pre-CRR position under which ECAI recognition and credit quality mapping were the prerogative of national competent authorities. Annex 2 to this briefing paper contains an extract from the existing CQS mapping table, as set out in the supervisory statement that will accompany the PRA Rulebook.

Investments in credit-linked notes (**CLNs**) issued by the lending institution may also be treated as cash collateral on all approaches and methods; however, the CRR clarifies that this is only the case where the credit default swap embedded in the relevant CLN itself qualifies as unfunded credit protection.<sup>29</sup>

Equities and convertible bonds that are not included in a ‘main index’ but are traded on a ‘recognised exchange’ and CIUs that invest (or invest in underlying CIUs that invest) in these are, additionally, eligible under the financial collateral comprehensive method. (The additional new eligibility requirements applicable to CIUs under Article 197 of the CRR are not replicated in this context.)

<sup>26</sup> Under *Regulation 1060/2009*.

<sup>27</sup> Article 136, CRR.

<sup>28</sup> See PRA CP5/13, Appendix 2, Chapter 3 – Standardised Approach, paragraph 7, Table 3.E and proposed IFPRU 4.2.13 in FCA CP13/6.

<sup>29</sup> Article 218 CRR.

<sup>25</sup> That is investment firms as defined in Article 4(1) of the Markets in Financial Instruments Directive (*Directive 2004/39 EC*).

ESMA is tasked with preparing ITS to specify what constitutes ‘main indices’ and ‘recognised exchanges’ in the context of the eligibility requirements<sup>30</sup> – see ‘Technical standards and lists’ below.

Under the IRB Approach, immovable property collateral, receivables, other physical collateral (ie physical collateral other than immovable property) and leasing are also eligible forms of collateral subject to detailed eligibility requirements that are beyond the scope of this briefing paper. The requirements to recognise residential property as immovable property collateral and to recognise other physical collateral (ie physical collateral other than immovable property) have been strengthened somewhat by the CRR (Article 199(2) and (3) in respect of residential property, and Article 199(6) in respect of other physical collateral).<sup>31</sup> The basis on which the ‘market value’ of other physical collateral (ie physical collateral other than immovable property) is estimated has also changed slightly.<sup>32</sup>

## Minimum requirements for the recognition of eligible financial collateral

In addition to the requirements for legal certainty and low correlation (as already mentioned) the institution must comply with some operational requirements,<sup>33</sup> the last two bullets below being new requirements in the CRR:

- the collateral arrangements must be properly documented with a clear and robust procedure for the timely liquidation of collateral;
- an institution must employ robust procedures and processes to control the risks arising from

the use of collateral – for example, risks of failed or reduced credit protection, valuation risks, concentration risks and interaction with the institution's overall risk profile;

- an institution must have documented policies and practices about the types and amounts of collateral accepted;
- an institution must calculate the market value of the collateral with a minimum frequency of once every six months and whenever the institution has reason to believe there has been a significant decrease in market value;
- where the collateral is held by a third party, the institution must take reasonable steps to ensure that the third party segregates the collateral from its own assets;
- an institution must devote sufficient resources to the orderly operation of margin agreements with over-the-counter derivatives and securities-financing counterparties as measured by the timeliness and accuracy of their outgoing margin calls and response time to incoming margin calls; and
- an institution must have in place collateral management policies to control, monitor and report on: the risks to which margin agreements expose it; its concentration risk to particular types of collateral assets; its re-use of collateral including potential liquidity shortfalls resulting from the re-use of collateral received from counterparties; and the surrender of rights on collateral posted to counterparties.

## Adjusting the risk weight exposure to take account of eligible financial collateral

An institution is able to choose which of two approaches it takes to adjusting the risk weight exposure to take account of the credit risk mitigants. The first approach is the simple method. Under this approach, the risk weight attaching to the collateral item is substituted for the risk weight attaching to the underlying exposure. The comprehensive method is more sophisticated, and requires the institution to adjust the value of the exposure and

<sup>30</sup> Article 197(4) CRR.

<sup>31</sup> In relation to residential property, specific limits are imposed on the prevailing residential property market loss rates in a member state below which an institution may derogate from the requirement for borrower risk not to materially depend on the performance of an underlying property project. In relation to other physical collateral, further gloss is provided as to what constitute ‘liquid markets’ and ‘well established, publicly available market prices’ for the purposes of eligibility, specific limits are imposed on the permitted deviation of net collateral proceeds from market prices, and certain additional operational and documentary requirements apply.

<sup>32</sup> Article 229(3) CRR.

<sup>33</sup> Article 207(4) CRR.

collateral by using volatility adjustments. These volatility adjustments are also known as “haircuts”.

## The financial collateral simple method

When is this method used? The financial collateral simple method is only available to firms that use the Standardised Approach and must not be used selectively for the purpose of achieving reduced own funds requirements, or conducting regulatory arbitrage.<sup>34</sup> But firms that do use the Standardised Approach may use the financial collateral comprehensive method if they can meet the requirement for use of that method.<sup>35</sup>

Where the financial collateral simple method is used, the residual maturity of the protection must be at least as long as the residual maturity of the exposure.<sup>36</sup>

## Calculating the adjustment to risk weight exposure using the simple method

To the extent that the exposure is covered by the market value of the collateral – the risk weight attaching to the collateral is substituted for the risk weight attaching to the exposure<sup>37</sup> **BUT** the risk weight assigned to the collateralised portion must be not less than 20%.<sup>38</sup>

This requirement to assign a minimum 20% risk weight is modified in a number of cases. If the collateral takes the form of cash or cash assimilated

<sup>34</sup> Article 222(1) CRR.

<sup>35</sup> Most substantial banks in London will be using the IRB Approach. These banks will therefore be using the comprehensive method to assess the effect that holding collateral will have on their exposure risk weight. This means that each bank will have a different model for assessing what effect holding the collateral will have on risk weight. The only exception is cash in the same currency which always achieves 0% risk weight.

<sup>36</sup> Article 207(5) CRR.

<sup>37</sup> For this purpose, the credit conversion factors that operate to reduce the exposure value of off-balance sheet items under Article 111 of the CRR do not apply (ie the exposure value of off balance sheet items is 100% of their nominal value) (Article 222(3) CRR).

<sup>38</sup> Giving a minimum risk weight of 20% is a proxy for the risk of changes in market value of the collateral, which only has to be revalued once every six months.

instruments (such as certificates of deposit or bonds) in the same currency as the exposure, the exposure is given a risk weight of 0%.<sup>39</sup> In case of certain repurchase transactions and derivative transactions subject to daily marking-to-market, a risk weight of 0% or 10% can be achieved.<sup>40</sup> In relation to collateral in the form of debt securities issued by central governments, central banks and certain other public bodies eligible for a 0% risk weight, it is possible to discount the market value of the collateral by 20% as an alternative to risk weighting at 20% – in this case the collateral is given a risk weight of 0%.<sup>41</sup>

Examples of how this works in practice are set out in Annex 1 to this briefing paper.

## The financial collateral comprehensive method

Under the financial collateral comprehensive method, which is significantly more complex than the simple method, the values of both the exposure and the collateral are adjusted. The exposure is adjusted to represent possible exposure growth. An exposure could grow if, for instance, securities are lent and increase in value. The collateral is adjusted to represent potential collateral value loss due to market fluctuations. A separate adjustment is made to incorporate the risk of exchange rate changes when the collateral and the exposure are in different currencies. These price and currency volatility adjustments are often referred to as “haircuts”. After both exposure value and collateral value have been adjusted, the latter is subtracted from the former leaving the exposure after collateral. The credit risk capital requirement is calculated by multiplying the exposure after collateral by the risk weight of the exposure.

Within the financial collateral comprehensive method, an institution has a choice about how it will calculate the volatility adjustments. It can either use what are called the supervisory volatility adjustments – or it can use its own estimates of the volatility adjustments.<sup>42</sup> The choice of which

<sup>39</sup> Article 222(6)(a) CRR.

<sup>40</sup> Article 222(4) and Article 222(5) CRR.

<sup>41</sup> Article 222(6)(b) and Article 222(7) CRR.

<sup>42</sup> Article 223(6) CRR.

method it chooses can be made independently of whether the institution is using the Standardised Approach or the IRB Approach to the calculation of risk weighted exposures. But (with limited exceptions) it must use the same method across its portfolio<sup>43</sup> and – a new requirement in the CRR – must not revert to use of other methods once permission to use own estimates of the volatility adjustments has been obtained other than for ‘demonstrated good cause and subject to the permission of the competent authorities’.<sup>44</sup>

<sup>43</sup> Article 223(6) CRR.

<sup>44</sup> Article 225(1) CRR.

## Supervisory volatility adjustments

No attempt is made in this briefing paper to give details of the supervisory volatility adjustments. But, in general terms, the volatility adjustment depends on (a) the type of instrument that is being valued (b) the credit quality of the instrument and (c) the length of time to liquidation of the collateral item. The adjustments are set out in a series of tables.<sup>45</sup> Set out below is a selection of volatility adjustments to give some idea of how this works. This is not a complete table.

<sup>45</sup> Article 224(1) CRR.

ISSUER OF DEBT SECURITIES AND ASSOCIATED CQS	Residual Maturity	VOLATILITY ADJUSTMENT (%) (VARIES WITH LIQUIDATION PERIOD)		
		20 days	10 days	5 days
Central Government – CQS 1	≤ 1 year	0.707	0.5	0.354
Central Government – CQS 1	> 5 years	5.657	4.0	2.828
Banks or corporates – CQS 2-3	≤ 1 year	2.828	2.0	1.414
Banks or corporates – CQS 2-3	> 5 years	16.971	12.0	8.485

The liquidation periods for different kinds of transaction and security are specified<sup>46</sup> and are as follows:

- 20 business days – secured lending transactions. Secured lending transaction is defined as any transaction giving rise to an exposure secured by collateral which does not include a provision conferring upon the person with the exposure the right to receive margin at least daily.
- 5 business days – repos and securities borrowing and lending transactions (not relating to commodities).
- 10 business days – all other capital market-driven transactions. Capital market-driven transaction is defined as any transaction giving rise to an exposure secured by collateral which includes a

<sup>46</sup> Article 224(2) CRR.

provision conferring upon the person with the exposure the right to receive margin at least daily.

The supervisory haircut can differ significantly depending on whether the collateral has a 20, 10 or 5 day liquidation period. The length of the liquidation period depends on whether the institution has a right to receive margin at least daily. In the calculation of OTC derivatives and securities financing arrangements, where a transaction or netting set meets the criteria set out in Article 285(2), (3) and (4) of the CRR, the liquidation period is the applicable margin period of risk.<sup>47</sup> (In this respect, the CRR offers greater clarity than the Banking Consolidation Directive which referred simply to a right to receive margin ‘frequently’ (undefined)). Documenting a daily margin call right will be important for collateralised transactions.

<sup>47</sup> Article 224(2)(c) CRR.

## Own estimate of volatility

If the institution uses its own estimates for volatility adjustments – a 99th percentile one-tailed confidence interval must be used.<sup>48</sup> There are detailed qualitative and quantitative criteria that an institution's own method of estimation of volatility must meet.

## Scaling up of volatility adjustments

The supervisory volatility adjustments are scaled up if the collateral is not revalued daily. There is a

<sup>48</sup> Article 225(2)(a) CRR.

formula to deal with this. The longer the time between revaluations, the higher the volatility adjustment.<sup>49</sup> The combination of (a) having the right to receive margin payments at least daily and (b) revaluing collateral daily will result in a much lower volatility adjustment for the collateral. This incentivises institutions to implement systems that allow daily mark-to-market and documentation that reflects that and includes daily margining.

<sup>49</sup> Article 226 CRR.

# Technical standards and lists

The CRR mandates that various technical standards and lists shall be produced. In connection with funded credit risk mitigation, the following technical standards and lists shall be produced:

CRR SOURCE	TECHNICAL STANDARDS/LISTS REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA/ESMA PUBLICATIONS
Article 194(10) ( <i>Principles governing the eligibility of credit risk mitigation techniques</i> )	Regulatory technical standards to specify what constitutes sufficiently liquid assets and when asset values can be considered as sufficiently stable for the purposes of paragraph 3 of Article 194.	30 September 2014.	None to date.
Article 197(8) ( <i>Eligibility of collateral under all approaches and methods</i> )	N/A. As indicated at 'eligibility' above, ESMA is to produce implementing technical standards to specify what constitute 'main indices' and 'recognised exchanges' in the context of the eligibility requirements.	31 December 2014.	None to date. The PRA has set out the approach to be taken prior to the adoption of the ESMA implementing technical standard specifying the list of recognised exchanges in the PRA Supervisory Statement in respect of third country equivalence aspects of the credit risk provisions in CRR and recognised exchanges. See also paragraphs 7.12 and 7.13 ( <i>Recognised exchanges</i> ) of the PRA Policy Statement.

CRR SOURCE	TECHNICAL STANDARDS/LISTS REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA/ESMA PUBLICATIONS
Article 199(8) <i>(Additional eligibility for collateral under the IRB Approach)</i>	The EBA is to publish a list of types of physical collateral for which institutions can assume that the conditions referred to in points (a) and (b) of paragraph 6 of Article 199 (ie the availability of liquid markets and well-established publicly available market prices for the collateral) are met.	To be confirmed.	None to date.
Article 221 <i>(Using the internal models approach for master netting agreements)</i>	Regulatory technical standards to specify:  (a) what constitutes an immaterial portfolio (ie a portfolio which can be excluded from the application of the internal model) for the purposes of paragraph 3 of Article 221; and  (b) the criteria for determining whether an internal model is sound and implemented with integrity for the purposes of paragraphs 4 and 5 of Article 221 and master netting agreements.	31 December 2015.	None to date.

# National discretions and UK implementation

In line with the overall trend in the CRR, the number of discretions available to national competent authorities in respect of collateral as funded credit protection has been reduced. For example, competent authorities no longer have discretion to: refuse to accept the priority of domestic preferential creditors taking over an institution's claim in relation to purchased receivables<sup>50</sup> and other physical collateral;<sup>51</sup> approve the sufficiency of market liquidity for unrated debt securities issued by other institutions;<sup>52</sup> or refuse

recognition of receivables or physical collateral other than immovable physical collateral<sup>53</sup> where the applicable conditions are met. While a number of discretions continue to apply on an institution-by-institution basis (ie competent authorities have discretion as to whether to apply a particular discretion in relation to a given institution), there are no longer any discretions in respect of collateral as funded credit protection that can be exercised on a member state-by-member state basis (ie turned off or on for a member state as a whole).

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<sup>50</sup> Article 209(2)(b) CRR.

<sup>51</sup> Article 210(b) CRR.

<sup>52</sup> Article 197(4) CRR.

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<sup>53</sup> Article 199(5) and (6) CRR.

# Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)

Client Briefing 4 (*Internal Ratings Based Approach to Credit Risk in the Banking Book*)

Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)

Client Briefing 8 (*Counterparty Credit Risk*)

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# Annex 1

## Part 1

### The Simple Method

#### Risk Weights attaching to different types of Collateral

This table is a selection of the risk weights assigned to some different types of collateral. It is not comprehensive but is intended to give an indication of how CRM works under the simple method.

COLLATERAL TYPE	CREDIT QUALITY STEP			
	1	2	3	4
Debt securities of central governments and central banks	0%	20%	50%	100%
Debt securities of “banks”	20%	50%	50%	N/A
Debt securities of corporates	20%	50%	100%	N/A

#### Gold and equities as collateral

Gold is given a risk weight of 0% under the Standardised Approach.<sup>54</sup> This means that an exposure fully collateralised by gold has a risk weight of 20%. The treatment is the same as for cash in a different currency – see Example 1A below. Under the comprehensive method, the supervisory volatility adjustments (haircuts) to the market value of gold range from 10.607% to 21.213% depending on the liquidation period.

Holdings of equities<sup>55</sup> must be given a risk weight of 100% under the Standardised Approach.<sup>56</sup> This means that banks using the simple method to CRM are unlikely to derive any benefit from holding equities as collateral. The risk weight attaching to the underlying exposure would have to be in excess of 100% before the institution derived any benefit. Under the comprehensive method, the supervisory adjustments (haircuts) to the market value of

equities – assuming daily mark-to-market – range from 10.607% to 21.213% for equities listed on a main index and from 17.678% to 35.355% for equities listed on a recognised investment exchange.

<sup>54</sup> Article 134(4) CRR.

<sup>55</sup> Other than holdings of equities that fall to be deducted, or assigned a higher risk weight as significant investments in financial sector entities, qualifying holdings outside the financial sector, or items associated with particularly high risk.

<sup>56</sup> Article 133(2) CRR.

## Part 2

### The Simple Method

#### Example of Adjustments to Risk Weight

An institution has exposure of 100 to a counterparty and this exposure is risk weighted at 100% under the Standardised Approach.

**Example 1:** The counterparty provides cash collateral in the same currency and of an amount equal to the exposure. The exposure achieves a risk weight of 0%.

**Example 1A:** The counterparty provides cash collateral in a different currency. The amount in the different currency can be converted to the currency of the exposure which is equal to the amount of the exposure.

The whole exposure is covered by the value of the collateral. The risk weight attaching to cash is 0%. But, as the cash is in a different currency, the minimum risk weight to be attached to the exposure is 20% – giving a risk weight amount for the exposure of 20.

**Example 2:** The counterparty provides collateral in the form of debt securities issued by a corporate which are associated with CQS 2. The market value of the collateral is 100 (or more). The risk weight attaching to this collateral is 50%.

Check how much of the exposure is covered by the market value of the collateral. In this case it is all of it. So – substitute the risk weight that the institution would have had if it had been exposed to the collateral type for all of the exposure. Risk weight is therefore  $100 \times 50\% = 50$ .

**Example 2A:** As in Example 2 – but the market value of the collateral is 80 instead of 100.

Only 80 of the exposure is covered by the market value of the collateral. So 80 of the exposure is treated as if it were exposure to the collateral, giving a risk weight of 40 for the collateralised part of the exposure. The remainder of the exposure (20) is not collateralised and is risk weighted at 100%, giving a risk weight amount of 20 for the uncollateralised part of the exposure. Therefore, total risk weight amount for the exposure is  $40 + 20 = 60$ .

**Example 3:** As in Example 2 – but the collateral is in the form of debt securities issued by a central government (or central bank) associated with CQS 1. The market value of the collateral is 100. The risk weight associated with this collateral is 0%.

All of the exposure is collateralised by the market value of the collateral – so all of the exposure is treated as exposure to that collateral. This would give a risk weight for the exposure of 0% – except for the fact that the collateralised portion of the exposure must have a minimum risk weight of 20% (unless the collateral is cash in the currency of the exposure). So the risk weight for this exposure is 20.

**Example 3A:** As in Example 3 – but the market value of the collateral is 80.

80 of the exposure is covered by collateral. The collateral has a risk weight of 0 – but as the collateralised part of the exposure must be given a minimum risk weight of 20% – the risk weighted amount for the collateralised part of the exposure is  $80 \times 20\% = 16$ . The uncollateralised part of the exposure (20) has a risk weighted amount of 20. So the total risk weighted amount is  $20 + 16 = 36$ .

## Annex 2

Extract from the table, set out in the supervisory statement that will accompany the PRA rulebook, mapping the credit assessments of eligible credit assessment institutions to credit quality steps for the

purposes of the Standardised Approach. This table is incomplete and is provided for illustrative purposes only.

### Long Term Mapping

S&P RATING	CORPORATE	INSTITUTION (INCLUDES BANKS)		SOVEREIGN	
		Sovereign method	Credit Assessment method		
				Maturity > 3 months	Maturity 3 months or less
AAA to AA-	20%	20%	20%	20%	0%
A+ to A-	50%	50%	50%	20%	20%
BBB+ to BBB-	100%	100%	50%	20%	50%
BB+ to BB-	100%	100%	100%	50%	100%

