ALLEN & OVERY

Capital Requirements Directive IV Framework
Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives

Allen & Overy Client Briefing Paper 6 | January 2014

CRD IV Framework: *Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV[1] (**CRD IV**) and the Capital Requirements Regulation[2] (**CRR**), replacing the Banking Consolidation Directive[3] (**BCD**) and the Capital Adequacy Directive.[4] 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.

[1] 2013/36/EU.
[2] Regulation 575/2013.
[3] 2006/48/EU.
[4] 2006/49/EU.

NOTE: In relation to the topics discussed in this briefing, the CRR contains a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects.

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

Background and Scope

The recast BCD introduced a revised framework for the recognition of credit risk mitigation (**CRM**), including explicit recognition of credit derivatives and guarantees as mitigants of regulatory capital requirements. This framework remains largely unchanged by the introduction of CRD IV and the CRR.

This briefing deals with the banking book treatment of guarantees and credit derivatives as mitigants of credit risk – ie which reduce the risk weight of (and, therefore, the regulatory capital held against) the assets covered by the guarantee or credit derivative. In broad terms, this is achieved by substituting the risk weight (or in the case of the Internal Ratings Based approach (**IRB Approach**), the probability of default (**PD**) and/or loss given default (**LGD**)) of the protection provider for that of the underlying exposure.

Sources

CRR (*Regulation 575/2013*): Articles 108, 160-161, 183, 192-194, 201-204, 213-217, 233-241 and 247.

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**).

© Allen & Overy LLP 2014

Background and Scope (continued)

This briefing deals with unfunded CRM. Funded CRM (collateral – including credit-linked notes) is dealt with in Client Briefing 5 (*Collateral: Funded credit risk mitigation in the Banking Book*).

For credit derivatives which tranche credit risk, the securitisation rules are also relevant – see Client Briefing 7 (*The Securitisation Framework*).

Background and key changes

Article 108 recognises the use of eligible CRM for exposures risk-weighted under the standardised approach (the **Standardised Approach**) and IRB Approach. Article 247 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. As the key provisions dealing with credit risk mitigation are set in the CRR (which is directly applicable in the UK by virtue of being a regulation), they will not be transposed into UK legislation.

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.
- It is unclear whether the historic UK practice of recognising insurance as eligible for unfunded CRM is sustainable under the CRR.
- Central counterparties are included as eligible providers of unfunded CRM.
- For corporate providers of unfunded CRM, the requirement for a minimum rating of credit quality step 3 or above in order to be an eligible provider has been removed.
- Certain technical changes have been made to the calculation of the haircut for currency mismatch.

Requirements

The requirements split into:

- eligibility conditions – conditions for guarantees and credit derivatives to be eligible for CRM;
- recognition – the effect of CRM; and
- haircuts – the effect of mismatches on CRM.

Eligibility

To be eligible, protection must be (1) a credit derivative or guarantee, (2) which is provided by an eligible protection provider, and (3) which satisfies certain preconditions to recognition.

Instruments eligible for unfunded CRM

Only guarantees and credit derivatives (including total return swaps (**TRS**), credit linked notes (**CLNs**) and economically equivalent instruments) are recognised as unfunded CRM (Article 204 CRR).

Strictly, insurance remains outside the scope of the CRM regime. This is not a change on the face of the legislation. However, in the UK firms have sought to recognise credit insurance as unfunded CRM in certain circumstances, following guidance from the FSA that insurance may be eligible[5] (which in turn reflected guidance provided by the Basel Committee as part of the QIS on Basel II implementation). The guidance has not been adopted by the PRA or FCA. Given the CRR is maximum harmonisation, and does not include insurance as eligible unfunded CRM, it is unclear whether this treatment is sustainable following CRR implementation. However, firms on the IRB Approach (see below) may be able to recognise benefits from insurance in respect of exposures by reason of a lowering of the LGD in respect of insured exposures[6]. Insurance may also be used to mitigate the operational risk charge.

Who may provide guarantees and credit derivatives?

The following are eligible to provide credit protection (Articles 203 and 204 CRR):

- sovereign entities, PSEs, banks (including MDBs), central counterparties and investment firms; and
- other rated entities[7].

The Accord continues to state that special purpose vehicles (**SPVs**) may not provide protection under guarantees or credit derivatives unless the guarantee or credit derivative is funded or collateralised. This is not reflected in the CRR, but is expected to remain regulatory policy.

Preconditions to recognition (all approaches)

The preconditions to recognition of guarantees comprise certain requirements which are common to both guarantees and credit derivatives ((a) below), additional requirements specific to guarantees ((b) below) and additional requirements specific to credit derivatives ((c) below).

(a) Preconditions to recognition of guarantees and credit derivatives

Article 194 of the CRR sets out certain operational requirements applicable to the recognition of credit risk mitigation. These include requirements that:

- the counterparty be eligible;
- the guarantee or credit derivative be legally effective and enforceable in all relevant jurisdictions; and
- the firm has systems in place to manage potential concentration of risk arising from the use of guarantees and credit derivatives.

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 (Article 194(1) CRR). Article 194(1) of the CRR introduces a new requirement to "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 [legally effective and enforceable] condition". In

[5] See http://www.fsa.gov.uk/pubs/international/bipru5.pdf.

[6] We have been advised by a UK IRB bank that this is its internal approach.

[7] For IRB firms, an internal (rather than external CRA rating) is sufficient. In addition, there are additional conditions to allowing insurance companies and export credit agencies with an internal rating of CQS 3 to be eligible for the treatment set out in Article 153(3) CRR – see Article 202 CRR.

© Allen & Overy LLP 2014

light of amendments introduced by the CRR, and the European Banking Authority (**EBA**)'s guidance in this respect in its Single Rulebook Q&A, 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[8]. 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).

Further requirements apply to banks that adopt the internal ratings based approach (**IRB Banks**) (Article 183 CRR). These include formal requirements that any guarantee or credit derivative be evidenced in writing, non-cancellable on the part of the protection provider, in force until the obligation is satisfied in full (to the amount and tenor of the guaranteed credit derivative), and legally enforceable against the protection provider in a jurisdiction where the guarantor has assets to attach and enforce a judgment[9]. IRB banks are allowed to recognise conditional credit protection, subject to the permission of the competent authority and regulatory technical standards to be produced
in 2014.

Other conditions

A guarantee or credit derivative must (Article 213 CRR):

- be a direct claim;
- be clearly defined and "incontrovertible"[10];
- not contain clauses whose fulfilment is outside the firm's direct control which:
  - allow the provider to cancel protection unilaterally[11];
  - increase the cost of protection as a result of deteriorating credit quality of the protected exposure;
  - could prevent the provider from being obliged to pay out in a timely manner[12] in the event that the obligor under the protected exposure defaults; or
  - allow the provider to reduce the maturity of the protection; and
- be legally effective and enforceable in all relevant jurisdictions at the time it is entered into.

Additional requirements apply in respect of counter-guaranteed exposures (Articles 214 and 215(2) CRR).

Where there is a maturity mismatch (ie the duration of the credit protection is shorter than that of the underlying exposure), credit protection of less than one year's original maturity will not be recognised (Article 237 CRR).

(b) Additional preconditions to recognition of guarantees

The following additional requirements apply to a guarantee (Article 215 CRR):

- on default by the borrower, the firm may pursue the guarantor for any monies outstanding under the underlying documentation in a timely manner, without first having to pursue the obligor;
- the guarantee must be an explicitly documented obligation of the guarantor;
- the guarantee must cover all types of payments the borrower is expected to make under the

[8] Article 194(1) CRR.
[9] Although it may be inferred from the fact that these requirements only apply to IRB firms that the same requirements should not apply to Standardised firms, it should be borne in mind that there is considerable overlap between these requirements and the baseline guarantee requirements set out above.

[10] This term appears in the CRD. It is undefined. It is not intended to cover enforceability (see below).
[11] The provider's standard early termination rights under the ISDA Master Agreement are allowed and will not breach this requirement.
[12] In the case of protection on residential mortgages, the requirements for timely payment are specified to be 24 months – BIPRU 5.7.11R (3).

underlying documentation (including future interest). Where a guarantee covers the payment of principal only, interest and other uncovered amounts are treated as uncovered.

Conditional guarantees may be recognised for IRB firms where their IRB permission permits this.

(c) Additional preconditions to recognition of credit derivatives

The following additional requirements apply to a credit derivative (Article 216 CRR)[13]:

- the specified credit events must at a minimum include:
  - bankruptcy, insolvency, or inability to pay debts;
  - failure to pay (NB: the grace period for any failure to pay must be no longer than the grace period of the underlying exposure)[14]; and
  - restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event – ie a loss appearing in the profit and loss account of the firm. Where the restructuring definition does not appear or does not comply with the above, then there is a haircut of 40% (see Article 233(2) CRR)[15];
- if there is to be cash settlement, there must be a robust valuation process and a clearly defined period for obtaining post credit-event valuations of the underlying[16];
- where there is to be physical settlement, the underlying must provide that consent to its transfer may not be unreasonably withheld;
- any determination as to whether a credit event has occurred must not be the sole responsibility of the protection seller: the protection buyer must have the right to notify a credit event; and
- the protection buyer must have the right to notify the seller of the occurrence of a credit event.

If there is an asset mismatch[17] either for the purpose of determining default or for the purpose of calculating cash settlement value:

- the reference obligation (the deliverable obligation under the credit default swap (**CDS**)) must be *pari passu* with or junior to the underlying obligation (the exposure being hedged); and
- the obligations must be obligations of the same obligor and have cross-default or cross-acceleration clauses.

Recognition

General

Subject to haircuts (reduction in the level of protection recognised) for (1) maturity mismatch (see below), (2) currency mismatch (see below), and (3) the absence of restructuring for credit

[13] Although there is no explicit guidance on this point, a TRS should be capable of satisfying this pre-condition notwithstanding that the credit events are not listed, but where the TRS is not funded, consider whether the provider is obliged to pay out in a timely manner in the event that the obligor defaults. This should be the case if the firm is entitled to put/physically settle the asset upon a default in respect of the protected exposure.

[14] If the grace period of the underlying exposure is less than three Local Business Days (as defined in the ISDA Master Agreement), the definition of "Grace Period" in the 2003 ISDA Credit Derivatives Definitions should be amended so that the Grace Period of the credit derivative does not exceed the grace period of the underlying exposure (ie by deleting Section 1.12(a)(ii) and (iii) of the 2003 ISDA Credit Derivatives Definitions in their entirety and amending Section 1.12(a)(i) so that the grace period matches the grace period with respect to payments under the relevant obligation). To address counterparty concerns, firms might also want to consider including a Cure Event so that, in the event that a Failure to Pay Credit Event has occurred, such Failure to Pay Credit Event will be deemed to not have occurred and the Conditions to Settlement of such Failure to Pay Credit Event will be deemed to have not been satisfied in relation to the defaulted reference obligation if the Failure to Pay Credit Event in respect of the defaulted reference obligation is cured on or before the relevant date on which the loss has been verified.

[15] While there has been some argument that the 2003 ISDA Credit Derivatives Definitions should be amended by (a) a specific reference or adjustment to the profit and loss account and (b) the definition of Section 4.7(b)(iii), we think this should not be required, but firms need to be confident that any restructuring which may lead to an adjustment (including provisioning) to the profit and loss account is captured. Consideration should be given to the timing and method for determining any loss to ensure this is consistent with internal accounting practices.

[16] Firms should consider whether the cash settlement mechanics under Section 7 of the 2003 ISDA Credit Derivatives Definitions are sufficient for these purposes or if they should follow a full work-out period instead.

[17] Credit derivatives are often bought to hedge a mismatched asset. Thus a firm may have made a loan to a borrower, but instead buys a CDS whose deliverable obligation is (or includes) a bond issued by the same borrower instead of the loan. If the borrower defaults, if it defaults on the bonds as well as the private firm loan, and the bond and loan are *pari passu* (or the bond is junior to the loan) then the firm is effectively hedged. In addition, it is easier for the firm to deliver a bond than transfer a loan, and the markets for bond CDSs are more liquid, and hence it is cheaper to buy protection on a bond than a loan.

© Allen & Overy LLP 2014

derivatives referred to above, recognition of guarantees and credit derivatives works as follows:

Standardised Approach

The risk weight of the guarantor or protection provider is substituted for that associated with underlying exposure.

Where the protection purchased is less than the exposure amount, then the protection is recognised (after haircuts) on a *pro rata* basis.

Example: A bank buys £60 of protection from a 20% weighted protection provider on an underlying loan of £100 weighted at 100%. Assuming no currency or maturity mismatch, the bank will be required to risk weight £60 at 20% (the protected portion) and £40 at 100%.

IRB Approach

There are two approaches to recognising guarantees and credit derivatives in the IRB approach: Foundation IRB approach (**FIRB approach**) for firms using the value of LGD provided by the supervisor; and Advanced IRB approach (**AIRB approach**) for firms using their own internal estimates of LGD. For an overview of LGD and PD see Client Briefing 4 (*Internal Ratings Based Approach to Credit Risk in the Banking Book*).

Under the IRB approach, the treatment of guarantees and credit derivatives closely follows that under the Standardised approach. For the covered portion of the exposure, the risk weight is derived by using the PD appropriate to the protection provider's borrower grade (or some grade between the borrower and the protection provider's borrower grade if the firm believes a full substitution treatment is not warranted).

The firm may replace the LGD of the underlying exposure with that of the credit protection, taking into account seniority and any collateralisation of a guaranteed commitment. Any unprotected portion of the exposure is assigned the risk weight associated with the borrower.

A firm using the Advanced IRB approach may reflect the risk mitigating effect of guarantees and credit derivatives through adjusting either the PD or LGD estimates (Articles 160-161 CRR). The adjusted risk weight must not be less than that of a comparable direct exposure to the guarantor or the provider. There are further detailed requirements where the firm's own estimates of LGD are used.

Baskets

In respect of first-to-default credit protection, Article 240 of the CRR provides for protection to be applied (both in the Standardised and IRB approaches) to the lowest risk weighted asset(s) in the basket, up to the value of the protection received.

In respect of nth-to-default protection, Article 241 of the CRR provides that protection may only be recognised where protection is already in existence in respect of defaults 1 to n-1, or where those exposures have already defaulted.

Haircuts

General

The term "haircut" refers to a reduction in the amount of the value of protection recognised in respect of the underlying exposure.

Example: A firm has a sterling-denominated loan exposure whose maturity is five years, and buys credit protection on the loan denominated in euros and with a maturity of four years. The firm has residual credit risk on the borrower arising from:

- a maturity mismatch – if the borrower defaults in year five then the firm is unhedged; and
- currency mismatch – if the borrower defaults in year three, but sterling has appreciated against the euro by 20%, then the firm is unhedged as to 20% of the par value of the loan.

The CRD provides for these risks by applying a reduction in the value of the protection recognised to take account of them.

Tranching and materiality thresholds

A materiality threshold (an amount of loss below which protection is not recognised) does not give rise to a haircut. However, to the extent that a

guarantee or credit derivative tranches risk in the underlying protected exposure(s), including by means of materiality thresholds (ie thresholds below which protection does not apply), then the regime for synthetic securitisations will apply. Securitisations are discussed in Client Briefing 7 (*The Securitisation Framework*).

Currency mismatch

The currency mismatch rules provide for a haircut to take account of currency volatility where there is a mismatch between the currency of the underlying exposure and that of the protection.

The rules setting the amount of the currency haircut are derived from the collateral rules (Article 233 CRR). These give two options:

- the supervisory volatility adjustments approach, assuming a 10-day liquidation period[18]: in broad terms this gives a haircut of 8%; and
- the own estimate volatility adjustment approach: this gives haircuts based on internal models.

In each case, the haircut is subject to scaling up, dependent on the frequency of revaluation of the exposure.

Maturity mismatch

There are special rules governing the situation if the residual maturity of the credit protection is less than that of the protected exposure.

Determining maturity

For these purposes a protected exposure is deemed at any time to have a maximum maturity of five years (Article 238(1) CRR).

The maturity of the credit protection is the earliest time at which the protection may be terminated either automatically or by the protection seller. Where there is an option for a firm which is a protection buyer to terminate and the terms of the arrangement at origination contain a "positive incentive" for the firm to terminate before maturity, the maturity date is the earliest date on which the option may be exercised. There is no guidance as to what constitutes a positive incentive for these purposes.

[18] This is a change from the pre-CRR position, under which the liquidation period was not set in this way.

Haircut for maturity mismatch

Maturity mismatched credit protection with a residual maturity of less than three months will not be recognised[19]. In addition, for IRB banks, credit protection is not recognised where there is a maturity mismatch in relation to any underlying exposure whose maturity is treated as subject to a one-day floor (Article 237(2) CRR).

All other maturity mismatched credit protection is scaled back in accordance with a formula (Article 239 CRR) which (in essence) provides for the proportion of credit protection recognised to be reduced by a percentage equal to (a) the maturity of the credit protection LESS three months; divided by (b) the maturity of the underlying exposure (subject to the five year maximum) LESS three months.

Example: A bank has a loan exposure of £100 from a borrower (with a risk weighting of 100%) with a bullet amortisation in six years. It has purchased a sterling-denominated credit derivative from a bank (with a risk weighting of 20%) covering principal and interest, with a maturity of four years.

By virtue of the five year maximum, the loan is deemed to have a five year maturity. The haircut applicable to the protection received is:
£100* [(4-.25)/(5-.25)], or £79.

The exposure is therefore risk weighted at £79 at 20%, and £21 at 100%.

[19] In addition, credit protection in respect of certain exposures of IRB firms with a deemed maturity floor of one day will not be recognised where there is a maturity mismatch.

© Allen & Overy LLP 2014

EBA technical standards

The CRR mandates that various technical standards shall be produced. In connection with unfunded CRM, the following technical standards shall be produced:

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
Article 183 (*Requirements for assessing the effect of guarantees and credit derivatives for exposures to corporates, institutions and central governments and central banks where own estimates of LGD are used and retail exposures)*	Draft regulatory technical standards to specify the conditions according to which competent authorities may permit conditional guarantees to be recognised.	31 December 2014.	None to date.
Article 194 *(Principles governing the eligibility of credit risk mitigation techniques)*	Draft regulatory technical standard to specify what constitutes sufficiently liquid assets and when asset values can be considered as sufficiently stable for the purpose of paragraph 3.	30 September 2014.	None to date.

National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 183 (*Requirements for assessing the effect of guarantees and credit derivatives for exposures to corporates, institutions and central governments and central banks where own estimates of LGD are used and retail exposures*)	A competent authority may allow a firm in its IRB Permission to recognise conditional guarantees as eligible for the purposes of assessing the effect of these guarantees in the firm's calculation of own LGDs.	In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).
Article 202 (*Eligibility of protection providers under the IRB Approach which qualify for the treatment set out in Article 153(3)*)	An institution may use institutions, insurance and reinsurance undertakings and export credit agencies as eligible providers of unfunded credit protection which qualify for the treatment set out in Article 153(3) where they meet certain conditions.	In respect of PRA authorised firms, the PRA Supervisory Statement (at 2.1 – Eligibility of protection providers under all approaches) provides that the PRA does not consider there to be any financial institution of the type identified in Article 119(5) of the CRR. Accordingly, the PRA has no list of such providers to publish.
Article 237 (*Maturity mismatch*)	A competent authority may specify in an IRB firm's permission short term exposures subject to a one-day floor rather than a one-year floor in respect of the maturity value to be calculated in accordance with Article 162 (*Maturity*).	In respect of FCA authorised firms, the FCA indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).

Further reading

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

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 7 (*The Securitisation Framework*)

© Allen & Overy LLP 2014

Contacts

Bob Penn
Partner
Tel +44 20 3088 2582
bob.penn@allenovery.com

Etay Katz
Partner
Tel +44 20 3088 3823
etay.katz@allenovery.com

Damian Carolan
Partner
Tel +44 20 3088 2495
damian.carolan@allenovery.com

FOR MORE INFORMATION, PLEASE CONTACT:

London

Allen & Overy LLP
One Bishops Square
London
E1 6AD
United Kingdom

Tel +44 20 3088 0000
Fax +44 20 3088 0088

GLOBAL PRESENCE

Allen & Overy is an international legal practice with approximately 5,150 people, including some 525 partners, working in 43 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

Abu Dhabi
Amsterdam
Antwerp
Athens (representative office)
Bangkok
Beijing
Belfast
Bratislava
Brussels
Bucharest (associated office)
Budapest
Casablanca
Doha
Dubai
Düsseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Istanbul
Jakarta (associated office)
London
Luxembourg
Madrid
Mannheim
Milan
Moscow
Munich
New York
Paris
Perth
Prague
Riyadh (associated office)
Rome
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Warsaw
Washington, D.C.
Yangon

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.

© Allen & Overy LLP 2014 I BS:6431410.2