A response to the

The PRA's CP16/22

Chapter 5

Credit Risk Mitigation

Key messages

Flow charts and CRM clarification: The industry welcomes the flow charts that have been included within the consultation by way of summaries of the new framework. To enhance this further, we ask that article references are included within each box of the flow chart for ease of referencing the relevant section of the PRA rulebook The principle stating that "no transaction in which credit risk mitigation (CRM) techniques are used shall receive a higher capital requirement than an otherwise identical transaction where such techniques are not used" has been removed. Although this could be implied in the proposal as firms may choose to disregard CRM across all credit risk approaches and CRM methods, we believe that clearly stating this principle is useful.

Impact on UK repo business: The current proposal appears to allow as eligible collateral any financial instruments and commodities that are actually included in the trading book i.e., on the balance sheet. In addition to creating significant operational challenge the industry believes the proposal would run counter to the principle of trading book and have a detrimental impact to the sub-investment grade liquidity market. The industry proposes to align the eligibility to the firm's capability to trade the instrument.

Recognising Covered Bond as FCP: The introduction of definition of "CRR Covered Bonds" has significantly restricted the scope of covered bonds that can be used as eligible collateral. Industry proposed to remove the reference to "CRR Covered Bonds" and allow the recognition of "Covered Bonds" eligible for the preferential treatment seta out in Article 129(4,5). Also, the industry proposed to expand the recognition of own issued securities to instruments that provide the same effective mitigations as covered bonds do.

Cross-recognition under UFCP: Permit RW substitution using the RW applicable to the guarantor rather than a standardised risk weight. This would allow the RW to be calculated using IRB parameters and the guarantor's RW function, for example including the application of multipliers such as the AVC charge where relevant to the guarantor. For the purpose of the output floor calculation, RW substitution should use a standardised RW calculation of the IRB guarantor. This approach is consistent with the Basel framework.

The ability to use the RWA applicable to the guarantor rather than the standardised risk weight of the obligor is also relevant for parental guarantees, which is an integral part of banks' client management framework for global banking business. It is important for global clients that we are able to provide banking facilities to their global subsidiaries in a way that reflects the credit quality of the client group.

Question 33: Do you have any comments on the PRA's proposals for recognising FCP exposures that give rise to CCR?

Correlation

Recommendation 5.1

- Paragraph 8.4 of SS17/13 should recognise that negatively correlated collateral assets may be recognised as eligible collateral.

Rationale

The current supervisory approach to the implementation of Article 207(2) has reduced the possibility to apply economically effective FCP to certain exposures which results in highly conservative treatment of these structures compared to their economic risks.

According to Supervisory Statement SS17/13 section 8.4 in relation to transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets the PRA considers that 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), would meet the definition of material positive correlation set out in Article 207(2) of the Credit Risk Mitigation (CRR) Part.

This paragraph would capture also transactions which actually have negative or no correlation present in the overall structure (e.g. covered calls or collar financing structures) as the value of the collateral and the value of the derivative exposure to the obligor will move in line and as such the assessment of material positive correlation for limited recourse trades should not be assessed solely between the value of the collateral asset and all assets to which a firm has legal recourse to but should also consider the correlation against the value of the exposure. For transactions such as covered calls, a decline in the value of the collateral asset will still cover the exposure to the obligor as this will have reduced in direct proportion to the collateral. Any losses incurred by a firm would reflect ineffective market risk hedging rather than counterparty credit risk.

Proposal

We recommend that paragraph 8.4 of Supervisory Statement SS17/13 should include the following sentence at the end: "This notwithstanding, when the collateral assets are negatively correlated or where there is no correlation with the value of the transaction they may be recognised as eligible collateral".

Question 34: Do you have any comments on the PRA's proposals for recognising FCP exposures that do not give rise to counterparty credit risk?

Consequential impacts of reducing the scope of Articles to specific approaches

Recommendation 5.2

- The PRA should:
  - Clarify that statistical valuation models are permitted for valuation purposes under the SA for exposures secured by property.
  - Clarify whether insurance against damage is required under the Standardised approach for exposures secured by property.

Rationale

The scope of Article 208 has been reduced to the "Foundation Collateral Method". We understand that this will also be applicable under LGD Modelling Collateral Method on a generally consistent basis as set out in Article 169A (2)(b). Firms not using this method will need to refer to newly inserted real estate exposure articles (Article A124A to Article 124I).

Whilst we can see that some of the Article 208 requirements have been replicated (e.g., the requirement for a legally enforceable charge in Article 124A) a number of requirements in Article 208 appear to be missing. The following clarifications are sought for banks not using the Foundation Collateral Method:

- Is the use of statistical methods for valuation permitted (still contained Art 208 for the Foundation Collateral Method).
- The requirement to monitor the property is insured against the risk of damage is not in the new Articles Art 124A to Art 124I. This seems an oversight as we would expect that this to be a requirement under all approaches.

Proposal

We propose that the requirement for insurance against damage an explicit requirement under the Standardised approach for exposures secured by property be included, and ask the PRA to clarify whether statistical valuation models are permitted under the Standardised approach for exposures secured by property.

Drafting error in Article 230

Recommendation 5.3

Fix drafting error in Article 230.

Rationale

We have identified a drafting error in Article 230 where in paragraph 1 the definition of ES contains some misalignment of reference between the volatility adjustment for any currency mismatch and the volatility adjustment applicable for the type of collateral.

Proposal

We believe that the definition of E_S in Article 230 paragraph 1 should read as follows:
E_S = the current value of the collateral received after the application of:
(a) the volatility adjustment applicable for the type of collateral (H_C) as specified in paragraph 2;
(b) a volatility adjustment for any currency mismatches between the exposure and the collateral (H_{fx}) in accordance with Articles 224 to 227;
(c) an adjustment for any maturity mismatches calculated in accordance with Section 5

Capital market-driven transactions

Recommendation 5.4

- Article 224(2)(c) should be amended to ensure the correct types of SFTs are captured within the 'capital market-driven transaction' definition.

Rationale

In Article 224(2)(c), the following changes have been made:

The calculation of volatility adjustments in accordance with paragraph 1 shall be subject to the following conditions:

> (a) for secured lending transactions the liquidation period shall be 20 business days;
> (b) for repurchase transactions, except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities, and securities lending or borrowing transactions the liquidation period shall be five business days;
> (c) for ~~other~~ capital market-driven transactions for which no liquidation period is set out in point (a) or (b), the liquidation period shall be 10 business days.

The cross-reference in point (c) to point (a) implies that 'secured lending transactions' are 'capital market-driven transactions'. However, this is not the case as the definition of 'capital market-driven transactions' states that there must be daily margining whilst the definition of 'secured lending transaction' states that there is no daily margining for such transactions. A secured lending transaction is therefore not a capital market-driven transaction. The definitions in the Credit Risk Mitigation (CRR) Part are as follows:

- capital market-driven transaction means a transaction giving rise to an exposure secured by collateral which confers on the institution the right to receive margin at least daily
- secured lending transaction means any transaction giving rise to an exposure secured by collateral which does not include a provision conferring upon the institution the right to receive margin at least daily.

The removal of the word 'other' could also be problematic depending on how the PRA decides to address the erroneous cross-reference to point (a) in point (c).

Daily margined repurchase transactions and securities lending or borrowing transactions are a subset of capital market-driven transactions.

If the cross reference to (b) is maintained, this recognises that repurchase transactions and securities lending or borrowing transactions are 'capital market-driven transactions' and therefore that daily margining for these transactions is required to apply a 5-day liquidation period.

If the cross-reference to (b) is also removed, then the word ‘other’ would need to remain. If it is removed, a distinction is drawn between repurchase transactions and securities lending or borrowing transactions, and capital market-driven transactions, meaning that repurchase transactions and securities lending or borrowing transactions without daily margining would be captured in point (b) and a 5-day liquidation period would be incorrectly applied.

Proposal

We therefore propose either of the following changes:

(c) for capital market-driven transactions <u>for which no liquidation period is set out in point (b),</u> the liquidation period shall be 10 business days.
Or
(c) for <u>other</u> capital market-driven transactions the liquidation period shall be 10 business days.

<u>Funded credit protection under the Slotting Approach</u>

Recommendation 5.5

- PRA should:
  - confirm On Balance Sheet Netting, a type of FCP, is an eligible CRM approach for slotting exposure, and
  - reversion to Standardised approach is acceptable for slotting exposure where cash collateralisation is present, but no netting agreement is in place.

Rationale

The CP states that for exposure subject to the slotting approach, collateral would not be recognised via the CRM framework but would instead continue to be reflected in the assignment of exposures to slotting categories. This is confirmed further in the FCP Chart 2. This has been interpreted as meaning that there are no cases in which funded credit protection can be recognised outside the scope of the slotting assignment process, potentially meaning that the lowest risk weight a 100% cash collateralised transaction under the slotting approach could receive is 50% / 70% (depend on the maturity of the exposure).

Proposal

A 50% / 70% risk weight is very punitive for a cash collateralised transaction. It is proposed that either the reference to FCP not being an eligible CRM approach for slotting be removed or specific reference be made to how cash collateral be treated under the slotting approach.

Question 35: Do you have any comments on the PRA's proposals for recognising UFCP?

Eligibility of protection providers for slotted exposures

Recommendation 5.6

- The PRA should confirm that all IRB risk weighted corporates should be eligible protection providers in the Risk-Weight Substitution Method when used for slotted exposures.

Rationale

We welcome the extension of the Risk-Weight Substitution Method to exposures subject to the slotting approach (CP paragraph 5.39). However, we believe a further change is needed in relation to the eligible protection providers to whom this method can be applied, to ensure unfunded credit protection can be adequately taken into account for slotted exposures. For firms using the Risk-Weight Substitution Method, Article 201(1)(g) in the draft PRA rulebook states that corporates are only eligible protection providers if they are ECAI-rated. Meanwhile, for firms using the Parameter Substitution Method, Article 201(2) states that corporates rated under the firm's IRB approach are also eligible. This means that, where a firm rates a corporate guarantor under their IRB approach, this guarantor is eligible if guaranteeing a non-slotted IRB exposure, but is ineligible if guaranteeing a slotted exposures. This is counterintuitive, because in both cases the guarantor is the same entity subject to the same rating process, and in both cases is guaranteeing an IRB exposure (slotting is an IRB approach).

Proposal

We recommend amending Article 201(2), such that for an exposure where an institution calculates risk-weighted exposure amounts and expected loss amounts using the *Parameter Substitution Method*, <u>or the *Risk-Weight Substitution Method* for exposures that use the *Slotting Approach*</u>, the institution may use as eligible providers of unfunded credit protection other corporate entities that are internally rated by the institution in accordance with the provisions of the Credit Risk: Internal Ratings Based Approach (CRR) Part Articles 169 to 191. This would make guarantor eligibility for slotted exposures consistent with guarantor eligibility for other IRB exposures.

Question 36: Do you have any comments on the PRA's proposals for recognising FCP?

Collateral recognition in trading book SFTs

Recommendation 5.7

- The PRA should establish specific criteria so firms can determine which the collateral can be effectively traded upon default of a client.

Rationale

Article 299A in replacing Article 299(2)(c) requires that for securities financing transactions booked in the trading book, any financial instrument and commodities can be recognised as eligible providing it is included in the trading book. A conservative reading of the new article would mean that the relevant financial instrument must be carried as outright inventory on the trading book over the life of the SFT for it to be deemed as eligible collateral.

We acknowledge the PRA wants to address a legitimate concern of preventing firms considering any collateral received as eligible on the basis it is tradeable despite not having the capabilities to trade it. We believe however the proposal goes far beyond its intended objective with detrimental impact to the sub-investment grade or unrated collateral financing market (or thinly traded investment grade market), which is a perfectly functioning and important market, with consequential impact to the financing and liquidity of that market.

The proposal creates also significant operational challenges as firms are required to monitor their inventory on a daily basis before and after entering into a repo transaction. As trading inventory changes all the time this could create an inconsistent treatment to the same instrument as its eligibility would depend on being present in the inventory at a specific point in time. It could also bring perverse actions such as traders might choose not to dispose of assets due to capital implications of a repo collateralised with that same asset.

When a firm enters into an SFT transaction for the purposes of market making in SFT markets (trading related SFTs) under which it receives securities as collateral this collateral remains off of the balance sheet of the firm with respect to the SFT itself as the firm is obligated to return the bonds (and performance) back to the counterparty and as such it is not included in the trading book market risk calculations as the firm has no market risk against the security.

To require a firm to have the collateral in its trading book in order for the securities to be considered eligible collateral would run counter to the principles of the trading book as the firm would actively need to also purchase an inventory position in the securities for which we would presume a need to hold throughout the life of the SFT to ensure the collateral remains eligible and as such this would fail the trading book entry criteria with respect to trading intent as there is now an intent to hold.

This requirement would also introduce significant market risk for the firms undertaking the SFTs which would require significant RWA to be calculated against these risks.

The concerns flagged in the CP that a firm may not be able to liquidate the securities in practice could instead be addressed via the following considerations:

1) Firms must assess the market liquidity of the security received as collateral under an SFT to demonstrate that there is a sufficient depth of market to exit the position. This assessment is already performed as part of the MPOR requirements for increasing liquidation periods for more illiquid collateral which adjust the volatility adjustments applied to reflect the amount of time it would take the firm to exit the position. Even illiquid collateral with a 20-day liquidation period is capable of being traded, albeit at a

possible discounted price for which the higher volatility adjustment already captures this potential loss on default risk to the firm.

2) A firm must have the capability to trade the particular underlying position in the relevant markets i.e. the firm must have a trading desk, with the market knowledge, authority, operational and risk infrastructure, such that it can actively sell the position if required.

3) A firm must have the capability to risk manage the position within its trading book in line with the trading book entry requirements if upon enforcement following a default it did have to recognise the security in inventory. Broadly however we would expect to be able to exit the security in the market during close-out of the SFT.

We believe the draft implies a deviation from Basel standards where in CRE 55.2 provides that "In the trading book, for repo-style transactions, all instruments, which are included in the trading book, may be used as eligible collateral", which does not necessarily imply the instrument has to be in the trading book inventory at the time it is received as collateral.

We recommend that in order for the instruments to be eligible to be included in the trading book, institutions must ensure that they are able to meet the trading book entry requirements for the instrument set out in the Trading Book (CRR) section of the PRA Rulebook. In this context the firm must ensure it has appropriate market access to sell the instrument and the relevant infrastructure and risk management capabilities to manage the market risk of the instrument during any period between close out of the SFT and sale of the collateral.

Proposal

We believe the existing provision focusing on eligibility for inclusion in the trading book to be appropriate, rather than a requirement for the asset to be in inventory and suggest a reversion to the following requirement:

> "When calculating risk weighted exposure amounts for counterparty credit risk of securities financing transactions booked in the trading book, an institution may recognise as eligible collateral any financial instruments and commodities that are **eligible to be** included in the trading book"

Transactions in scope of Article 299A

Recommendation 5.8

Maintain the inclusion of Margin Lending Transaction in the scope of Article 299A.

Rationale

Article 299A has been updated to include securities financing transactions (SFTs). SFTs are defined in the Capital Requirement Regulations (as on shored into UK Law) as a *"repurchase transaction, a securities or commodities lending or borrowing transaction, or a margin lending transaction"*. Current CRR Article 299(2)(c) only refers to "repurchase transactions, or commodities lending or borrowing transactions" while Basel refers to *"Repo-style transactions"* which does not included margin lending.

The industry welcomes the adoption of the terminology of "securities financing transactions" as this ensures that margin lending transactions that meet the Trading Book eligibility rules will come into the scope of Article 299A.

Traditional Margin Lending transactions are booked in the banking book (e.g. Lombard Lending products where clients can borrow cash against a pool of equity assets – these typically have infrequent margin calls) however other Margin Lending transactions, which meet the requirement of the Trading Book (e.g. Margin Lending transactions under a Prime Brokerage Margin Agreement), share the same economic risks as repurchase transactions or securities or commodities lending or borrowing transactions. Furthermore, from a client's perspective they represent analogous products to the extent that clients will often switch positions between them. Therefore, it is logical that, when provided as collateral, Trading Book margin lending transactions should result in a consistent regulatory outcome when compared to repurchase transactions and securities or commodities lending or borrowing transactions that are also booked in the Trading Book.

The existing criteria in Article 299(2)(c) (and those proposed in Article 299A) requiring positions to be eligible for the Trading Book will ensure only Margin Lending transactions that are economically similar to repurchase (or securities or commodities lending or borrowing) transactions will be brought into scope; banking book margin loans will remain out of scope of Article 299A.

Proposal

We recommend the retention of the wording of Article 299A, as originally proposed in CP 16/22, and maintain the scope of this article to SFTs.

Furthermore, on this basis we recommend that the 5-day liquidation period that is currently afforded to repurchase transaction in Article 224(2)(a) is applied more broadly to Securities Financing Transactions.

Material Positive Correlation treatment of own issued bonds

Recommendation 5.9

We recommend that the PRA consider broadening the wording for the scope of own issued securities which can still be eligible collateral under Article 207(2) to any securities which do not economically have material positive correlation in line with the principles of SS17/13.

Rationale

According to Article 207(2) an eligible financial collateral must not have its value materially positively correlated with the quality of the obligor. The article refers to securities issued by the obligor, or any other related group entity, as collateral that have material positive correlation. A derogation from this requirement is applied to "Covered Bonds" eligible for the preferential treatment seta out in Article 129(4,5) when collateral is posted in a repurchase transactions providing they comply with the material positive correlation conditions in the firs subparagraph of Article 207(2).

The preferential treatment in article 129 is applied to "CRR covered Bonds", which have been defined by the PRA in Article 4(1)(128A) as bonds issued by a credit institution which:

> (a) has its registered office in the UK; and
> (b) is subject by law to special public supervision designed to protect bondholders and in particular protection under which
>> (i) sums deriving from the issue of the bond must be invested in conformity with the law in assets.
>> (ii) during the whole period of validity of the bond, those sums are capable of covering claims attaching to the bond; and
>> (ii) in the event of failure of the issuer, those sums would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

The reference to "CRR Covered Bonds" has significantly restricted the scope of covered bonds that can be used as eligible collateral and it introduced a more restrictive requirement than the Basel requirement in CRE 20.33, which only states that covered bonds must be subject by law to special public supervision designed to protect bond holders.

The key provisions of section 8 of SS17/13 on Credit Risk Mitigation require firms to consider the characteristics of the transaction, collateral and obligor to determine in a robust manner whether there is any material positive correlation present in the transaction which would result in the collateral not providing an effective mitigant to loss at the point of default of the obligor.

Examples of own issued securities which may still provide an effective mitigant include:

- Covered bonds (including those issued in third countries not meeting the definition of CRR Covered Bonds and hence the preferential risk weight treatment in Article 129)
- Securities backed by third party (e.g. sovereign guarantees)
- Other structural features which segregate a specific pool of assets for the benefit of the security holder which will not be available to other creditors of the obligor following a default

As such restricting the scope of own issued securities to only "CRR covered bonds" eligible for the preferential risk weight treatment in Article 129 is counterintuitive to the SS provisions to assess whether or not material positive correlation is present and therefore it would make sense to amend the CRR to present a broader requirement in line with the SS requirements.

Proposal

We believe the following amendments to Article 207(2) and the introduction of new paragraph within supervisory statement SS17/13 will address this issue as outlined below:

> **Article 207(2) –** "The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. 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.
>
> Securities issued by the obligor, or any related group entity will generally not qualify as eligible collateral. This notwithstanding, the institution may use the obligor's own issues of securities as eligible collateral subject to a detailed assessment of the characteristics of the obligor, the transaction and the collateral

evidencing that there is no material positive correlation such that the collateral can still be relied upon to mitigate loss at the point of default."

SS17/13 – New point 8.3A – Where a financial collateral asset is an own issued covered bond, the assessment of material positive correlation shall specifically consider the following requirements:

- The asset pool must be in line with Article 129(1)
- Any immovable property collateral must be valued in line with the requirements of Article 208 and 229(1)
- The institution must receive portfolio information in line with Article 129(7)
- The covered bond must be subject to law which is designed to protect the bond holders in an event of the default of the obligor.

CIU collateral

Recommendation 5.10

- A simple look-through approach (LTA) should be allowed instead of a mandate-based approach (MBA).

Rationale

PRA's intention is to align with Basel but currently, the calculation of the LTA by the mandated thresholds, effectively applies a MBA in addition to the LTA, which means most CIUs have little value as a form of collateral.

We appreciate PRA efforts to clarify the treatment of CIUs as collateral post the industry raising this issue post implementation of the UK CRR 2 as per CP16/22 5.59. However, there is existing UK CRR2 drafting and new proposed drafting under the UK B3.1, which will practically restrict banks' ability to use the look-through approach (LTA).

There are various references in Articles 132, 197, 198 that go beyond the LTA requirements and require firms to align it to the funds' mandated thresholds to confirm the assets which the CIU is permitted to invest in. It is clear from an assessment of mandates that even the most widely-traded CIUs, such as ETFs on indices, give the fund manager a lot of latitude to invest in assets outside the index, enter into financing transactions or use derivatives, meaning that look-through conditions cannot be met in practice. For example, many bond funds may state that they may invest in non-investment grade securities up to x%. However, a CIU mandate typically includes conservative thresholds (i.e. to avoid having to update mandates, to mitigate for volatility as well as allow the fund manager latitude to invest) while in actual practice such investments may be significantly lower than the cap. This means that, having to restrict the calculation of the LTA by the mandated thresholds, effectively applies a (MBA) in addition to the LTA, means that most CIUs have little value as a form of collateral. The problematic language is underlined: 'institutions may use units or shares in that CIU as collateral to an amount equal to the value of the eligible assets held by that CIU <u>under the assumption that that CIU or any of its underlying CIUs have invested in non-eligible assets to the maximum extent allowed under their respective mandates</u>'.

In case helpful, we include worked examples to illustrate the issue:

- **Example (1), practically unable to qualify**: Many equity funds state that they invest in US equities or global equities however without a specific x% in main index stocks in the mandate. These, therefore, would become 100% ineligible even though on an LTA basis they may be invested primarily in main index equities and eligible for these proportions.

- **Example (2), practically the LTA calculation becomes MBA**: If a CIU has 100 of assets and as per mandate can have maximum 40% in ineligible (non-sovereign, non-investment grade) bonds, then currently, firms take 60% of the CIU collateral as eligible. However, under LTA if actually 80 assets are in eligible bonds and 20 in non-investment grade then firms are currently still restricted to take only 60% and not 80% as eligible.

- **Example (3)**: mandate unjustifiably forces derecognition: the mandates of many equity index funds permit the fund manager to use derivatives to replicate the index when it may not be possible or practical to purchase all of the securities in proportion to their weighting in the index. Since Article 197(5) and Article 198(1) restrict the use of derivatives to hedging rather than for performance purposes, these funds are treated as ineligible even when the fund does not actually use derivatives for performance purposes.

The PRA's intention as stated in CP16/22 paragraph 5.59 is to allow firms to apply a look-through approach for CIUs held as collateral, however a pure look-through approach is not possible and/or severely restricted to a practical MBA application of the rules. Therefore, the proposed update by the PRA to Article 224(5) cannot be applied by firms in practice.

Proposal

We therefore propose that the PRA amends Article 197/198 to allow firms to use a simple look-through approach, aligning with Basel standards. Under Basel standards, UCITS/mutual funds are eligible collateral where a price for the units is publicly quoted daily and the UCITS/mutual fund is limited to investing in the eligible instruments. For such UCITS/mutual funds, firms can apply a look-through approach, and use weighted average haircuts of the underlying instruments, where they meet the look-through conditions for equity investments in funds in RBC 25.8(5)(a). These simply require that "**the bank is able to look through the fund to its individual components and there is sufficient and frequent information, verified by an independent third party, provided to the bank regarding the fund's composition**".

We believe the PRA's intention to allow a look-through approach which can be applied in practice by firms could be achieved by amending Article 197(6) and Article 198(2) as follows:

> Article 197(6): For the purposes of paragraph 5, where a CIU ('the original CIU') or any of its underlying CIUs are not limited to investing in instruments that are eligible under paragraphs 1 and 4, institutions may use units or shares in that CIU as collateral to an amount equal to the value of the eligible assets held by that CIU ~~under the assumption that that CIU or any of its underlying CIUs have invested in non-eligible assets to the maximum extent allowed under their respective mandates.~~
>
> Article 198(2): Where the CIU or any underlying CIU are not limited to investing in instruments that are eligible for recognition under Article 197(1) and (4) and the items mentioned in point (a) of paragraph 1 of this Article, institutions may use units or shares in that CIU as collateral to an amount equal to the value of

the eligible assets held by that CIU ~~under the assumption that that CIU or any of its underlying CIUs have invested in non-eligible assets to the maximum extent allowed under their respective mandates~~.

Immovable property collateral valuation

Recommendation 5.11

- Article 208 should include automated valuation model (AVM) validations as acceptable.

Rationale

Article 208 introduced the requirements for institutions to review the property valuation in the event that a default is considered to have occurred and that the review is carried out by an independent qualified valuer. We believe that for firms using the Foundation collateral method or the LGD modelling approach for retail mortgages the use of Automated Valuation Models (AVMs) (where AVMs utilise valuation data from Physical valuations and are validated / monitored against physical valuations), would meet the requirement of chapter 5 (Articles 208(3) (a) and (b) and 229).

Proposal

We propose to re-draft point (b) of paragraph 3 in Article 208 as follows (with edited text shown on Bold):

> (b) the institution ensures the property valuation is reviewed in the event that a default, as set out in Credit Risk: Internal Ratings Based Approach (CRR) Part Article 178, is considered to have occurred with regard to the obligor or when information available to the institution indicates that the value of the property may have declined materially relative to general market prices, and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process; **or where a review cannot be carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation, a new valuation is obtained from an independent source such as an Automated Valuation Model, with the valuation being updated where the new valuation results in a lower value**. For loans exceeding £2.6 million or 5% of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years.

Scaling of supervisory volatility adjustments

Recommendation 5.12

- the volatility adjustment formula to reflect longer or shorted liquidation period of collateral should be added Article 224(2).

Rationale

When a collateral has a shorted or longer liquidation period than the ones set in Article 224(2), the volatility adjustment is scaled up or down in accordance with the formula provided in Article 225(2)(c) referring to the “own estimate volatility adjustment under the Financial Collateral Comprehensive Method”, which the proposal has deleted.

Proposal

We recommend that the formula for scaling up or down the volatility adjustment previously included in Article 225(2)(c) should be added within Article 224(2).

Equities traded on a recognised exchange

Recommendation 5.13

- Article 224 Table 3 should be amended to align with the amended text in Article 224(4).

Rationale

The text of Article 224(4) has been amended as follows:

> For non-eligible securities ~~or for~~ and commodities lent or sold under ~~repurchase transactions or~~ securities ~~or commodities lending or borrowing~~ financing transactions, the institution shall apply the same volatility adjustment ~~is the same~~ as ~~for non-~~ it would for equities which are not equities included in a main index equities ~~listed~~ or traded on a recognised exchange.

We note that Table 3 of Article 224 has not been similarly amended and still refers to 'Other Equities or Convertible Bonds listed on a recognised exchange'.

Proposal

We recommend changing Table 3 to read 'Other Equities or Convertible Bonds ~~listed~~ traded on a recognised exchange' to align with Article 224(4).

Securities or commodities lending or borrowing transactions

Recommendation 5.14

- A definition of '*securities or commodities borrowing or lending transaction'* should be provided.

Rationale

Unlike other types of SFT transactions, the CRR does not contain a definition of '*securities or commodities borrowing or lending transaction*'. We believe the updates currently being made to the Credit Risk Mitigation (CRR) Part of the PRA Rulebook presents a good opportunity for the PRA to address this omission.

Proposal

The PRA could align with the FCA Glossary definition of 'securities or commodities lending or borrowing transaction' which refers to the following definition in Article 3(7) of the UK version of the *Securities Financing Transactions Regulation* (SFTR) (Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012):

'securities or commodities lending' or 'securities or commodities borrowing' means a transaction by which a counterparty transfers securities or commodities subject to a commitment that the borrower will return equivalent securities or commodities on a future date or when requested to do so by the transferor, that transaction being considered as securities or commodities lending for the counterparty transferring the securities or commodities and being considered as securities or commodities borrowing for the counterparty to which they are transferred.

Financial Collateral Comprehensive Method for Master Netting Agreements calculation

Following are recommendations to Article 220 the Financial Collateral Comprehensive Method for Master Netting Agreements.

These are being proposed to address issues with the current draft that result in unexpected, and we think unwanted outcomes from the calculation, and a deviation from BCBS CRE22.65. Also to improve the readability of this article.

We have summarised the issues into the following three items:.

PRA Art. 220
Example.xlsx

1. Group of securities vs. index that denotes separate securities, commodities, cash

Recommendation 5.15

- The concept of 'group of securities' should be used consistently.

Rationale

Art. 220(2)(a) introduces the calculation of a net position in each group of securities, where 'group of securities' is defined in Art. 220(5) as ''group of securities' means securities which are issued by the same entity, have the same issue date, the same maturity, are subject to the same terms and conditions, and are subject to the same liquidation periods as indicated in Article 224.'

However, this concept of group of securities is not then used consistently in the subsequent parts of the article.

Instead in Art. 220(3) the sum of the exposure (E) and collateral (C) is over index i and j respectively which is redefined as ' … all separate securities, commodities or cash positions under the master netting agreement …'.

We do not see a reason why the summation in part (3) would be different from that presented in part (2) using the definition in part (5).

Proposal:

Reword Art. 220(3) to:

> 'i = the index that denotes all separate **groups of** securities, **separate** commodities or cash positions under the master netting agreement, …'
> 'Ei = the exposure value of a given **group of** securities, **separate** commodity …' and

2. Signage of net position Enet in Art. 220(3)

Recommendation 5.16

- the definition of Esecm should be re-worded to ensure it is always a positive value

Rationale

Enet is defined in Art. 220(3) as 'the net exposure of the master netting agreement, calculated as follows: Enet = $\left| \sum_m \text{Esecm} \cdot \text{Hsecm} \right|$

Where:

> Esecm = the net position (positive or negative) in a given group of securities …
> Hsecm = the volatility adjustment appropriate to a given group of securities … . The sign of Hsecm shall be determined as follows: (a) it shall have a positive sign where the group of securities or commodities m, is lent or sold … (b) it shall have a negative sign where the group of securities or commodities m, is borrowed, purchased …

As a result, both Esecm and Hsecm will have a negative sign when the net group of securities is net borrowed or purchased, and as a result, the product of the two will always have a positive sign and all elements in the summation will be positive resulting in no netting between them (i.e. Enet would give the same value as calculated for Egross).

This is inconsistent with the definition of net exposure in BCBS CRE22.65(6) where Es (the BCBS equivalent of the PRA Esecm) is defined as:

> 'Es is the net current value of each security issuance under the netting set (always a positive value)'

Proposal

Reword the definition of Esecm in Art. 220(3) to be consistent with CRE22.65(6) to always show a positive sign 'Esecm = the **absolute value of the** net position **(positive or negative)** in a given group of securities …

3. Interaction between Art. 220(2)(c) and Art. 220(3)

Recommendation 5.17

- the exclusion of net ineligible collateral for volatility adjustments should be confirmed.

Rationale

Art. 220(2)(c) describes the application of the volatility adjustment which is represented as Hsecm in Art. 220(3). Part (2) notes that the calculation should exclude ineligible net collateral defined as groups of securities or types of commodities where:

> '(i) the net position calculated in point (a) of paragraph 2 is negative, and
> (ii) the securities or commodities either (A) are not included in the lists of eligible collateral … or (B) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207.'

However, in the calculation of the volatility adjustment for the collateral in part (3), Esecm, which is a component of Enet and Egross as part of E* given in part (3) makes no note of this exclusions.

While there is a reference to point (c) of paragraph 2 in the definition of Hsecm in paragraph 3 it is unclear whether, and how, the exclusions are expected to be applied in this part. Additionally the exclusion of ineligible securities is not mentioned in either component of the foreign exchange volatility adjustment (Efxk nor Hfxk) but would be expected to be treated consistently in this part.

Proposal

Reword Article 220(3) to reference the exclusion of net ineligible collateral for volatility adjustments as follows:

> Efxk = the net position in a given currency k other than the settlement currency of the master netting agreement as calculated under point (b) of paragraph 2 **and the exclusion of ineligible net collateral in accordance with point (c) of paragraph 2**.
> Esecm = the net position in a given group of securities … calculated in accordance with point (a) of paragraph 2 **and the exclusion of ineligible net collateral in accordance with point (c) of paragraph 2.**
> Hsecm = the volatility adjustment appropriate to a given group of securities, or a given type of commodities m, ~~**determined in accordance with point (c) of paragraph 2**~~.

To avoid duplication, similarly, reference the exclusion criteria of net ineligible collateral set out in point (c) of paragraph 2 in the definitions of Ei and Cj in paragraph 3 as follows:
Ei = the exposure value …. Subject to **the exclusion of ineligible net collateral in accordance with point (c) of paragraph 2.** ~~Article 299 of CRR and Counterparty Credit Risk (CRR) Part Article 299A, this calculation should exclude securities or commodities where:~~

> ~~(a) the net position calculated in point (a) of paragraph 2 is negative; and~~
> ~~(b) the securities or commodities either:~~
> ~~(i) are not included in the lists of eligible collateral set out in Articles 197 and 198; or~~
> ~~(ii) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207;~~

Cj = the value …. Subject to **the exclusion of ineligible net collateral in accordance with point (c) of paragraph 2.** ~~Article 299 of CRR and Counterparty Credit Risk (CRR) Part Article 299A, this calculation should exclude securities or commodities where:~~

> ~~(a) the net position calculated in point (a) of paragraph 2 is negative; and~~

~~(b) the securities or commodities either:~~
~~(i) are not included in the lists of eligible collateral set out in Articles 197 and 198; or~~
~~(ii) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207;~~

Question 37: Do you have any comments on the PRA's proposals for UFCP?

RW substitution

Recommendation 5.18

- IRB parameter RW substitution should be permitted where IRB banks have underlying standardised exposures/portfolios.

Rationale

As set out in both the Appendix 1 [Part three : Unfunded Credit Protection covering an exposure] and in Article 235 and 235A, a standardised risk weight substitution is proposed to be used when the exposure to the obligor is on standardised approach, irrespective of whether the IRB approach is normally applied to the guarantor.

We do not believe this is consistent with Basel 3.1 requirements as set out in CRE22.70 and CRE32.23.

Specifically, our reading of CRE22.70, which refers to risk weights more generally, is that this relates to the use of the risk weight function of the guarantor and resulting risk weight. This allows for cross approach recognition of unfunded credit protection, where the risk parameters of an internally rated guarantor may be used when it guarantees an exposure subject to the standardised approach. Furthermore CRE 22.79 refers to 'The protected portion is assigned the risk weight of the protection provider. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.' This again does not explicitly refer to any standardised risk weight that would be applicable to an IRB guarantor.

Similarly, the legacy EU CRR did not explicitly address this scenario. Although EU guidance has covered the reverse scenario of a standardised guarantor for an IRB exposure. The historical lack of clarity is also implied by the EBA in its 2019 Policy Advice on Basel III reforms - Credit Risk.pdf (europa.eu) as it recommended: 'Clarification should be provided that in this case the RW should be calculated based on the RW function applicable to the protection provider rather than that applicable to the original obligor.'

It is our view that the PRA should allow IRB firms to substitute an IRB risk weight for a standardised risk weight where the underlying exposure is on standardised and the guarantor is on IRB. This approach will ensure a more risk sensitive approach and importantly enable firms to meet the overarching CRM requirement where the risk weight derived from application of CRM is not greater than that for a comparable direct exposure to CRM protection provider.

In addition, the ability to take account of parental guarantees is an integral part of our client management framework for global banking business. It is important for global clients that we are able to provide banking facilities to their global subsidiaries in a way that reflects the credit quality of the client group.

Providing banking facilities to subsidiaries is an integral part of global business for banks. This will also allow us to take account of parental support where a different risk weight approach is used between the parent (IRB) and the subsidiaries (standardised) where UFCP is being used in respect of a parental guarantee rather than making an obligor grade adjustment for other forms of parental support (such as documented support arrangements).

This approach is also consistent with existing practice amongst some of our members who use internal frameworks reflect unfunded CRM provided by a parent that is on the IRB approach to a subsidiary that is on the standardised approach. Or, alternatively, in situations where IRB member banks have permission to use the standardised approach for certain types/portfolios of exposures, but the guarantor is on IRB. Some members have relied on their own interpretations while some also sought and received bilateral clarification/guidance on the treatment in this scenario from the PRA as far back as 2013 post the publication of the legacy EU. This is subject to the PRA being aware of such practises but not subject to formal approval in the same way IRB permissions are.

Proposal

Permit risk weight substitution using the risk weight applicable to the guarantor rather than a standardised risk weight. This would allow the risk weight to be calculated using IRB parameters and the guarantor's risk weight function, for example including the application of multipliers such as the AVC charge where relevant for the guarantor. It will also allow us to take account of parental guarantees where a different risk weight approach is used between the parent (IRB) and the subsidiaries (standardised) [where the obligor grade adjustment is not being utilised].

We would also recommend amending Article 201(2) to read as follows: "In addition to the parties in paragraph 1, corporate entities that are internally rated by the institution in accordance with the provisions of the Credit Risk: Internal Ratings Based Approach (CRR) Part Articles 169 to 191, shall be eligible protection providers of unfunded credit protection.

For the purpose of the output floor calculation, the risk weight substitution should however involve substituting using standardised risk weights.

Additional requirement for eligibility of UFCP

Recommendation 5.19

PRA to delete this new requirement, or to apply it only to new protection arrangements from 1/1/2025.

Rationale

In paragraph 5.104 of the CP the PRA proposes introducing an explicit requirement that UFCP is only eligible if it does not contain any clause which would allow the protection provider to change the credit protection unilaterally to the detriment of the lender. This requirement is included in the draft rulebook in article 213.1(c)(i) replacing the current requirement that there should be no clause outside the direct control of the lender that allows the protection provider to cancel the protection unilaterally.

Current operational checks cover the specific requirements and will not specifically include the proposed wording of “change the protection in a way that would adversely impact the institution”. This means that where unfunded credit protection is deemed to be eligible and is used in the capital calculation and reporting that evidence won’t be held against of compliance against the revised wording.

Proposal

While taken in isolation, the proposed change is a reasonable thing to require of the UFCP there are already a number of eligibility criteria and it is not clear what value this further clause would add. Given the PRA states in paragraph 5.104 that this is not a significant change and that it is a divergence from the BCBS standards this new requirement should be removed. If the additional criteria is to be applied, it should be grandfathered in such that evidence of compliance is not required for existing UFCP arrangements. This would avoid the operational complexity of specifically obtaining information just for this additional requirement.

Expected Loss calculation

Recommendation 5.20

- PRA should confirm how such exposures should be reported.

Rationale

The PRA proposes to introduce a formula for calculating the expected loss (EL) when applying the IRB approach and using the risk weight substitution method. The CP includes a formula for calculating the expected loss (“EL”) for such an exposure in such a way that it nets-off the EL – provisions part of the calculation for the protected part of the exposure.

Proposal

Where the protected part of the exposure is to be treated under the Standardised Approach there would be no need to calculate EL and so it would be helpful to understand how this rule aligns with the expected loss calculations and treatment of provisions and how they should be reflected in regulatory capital reporting.

Unfunded Credit Protection reporting inconsistency

Recommendation 5.21

- The PRA should follow the Basel 3.1 approach: to risk weight the unprotected part of the transaction according to the underlying counterparty, and the protected part of the transaction according to the protection provider.

Rationale

As well as being consistent with Basel, risk weighting the unprotected part of the transaction according to the underlying counterparty, and the protected part of the transaction according to the protection provider is consistent with current reporting processes. The PRA's proposal to deviate from this is not without cost as existing reporting processes and systems will have to be modified to implement it. There seems to be no benefit to the change, as overall RWAs will be unchanged, and it seems to be a change for change's sake.

In addition, there may be unintended consequences for reporting. The Basel approach is consistent with the reporting of inflows and outflows for mitigation on reporting templates, whereby the risk weightings of exposures reported for an exposure class are always calculated under the rules for that exposure class. Under the CP's proposal, the risk weighting reported will often bear no relation to the weighting of the risk party. For example, for transactions with 150% weighted corporate counterparties and 20% weighted institutions as protection providers:

- The unmitigated exposure to the 150% weighted corporate exposure might be reported with a very low risk weight on the corporates template (an example is set out below – the first table illustrates that such an exposure could be reported as 26.5% risk weighted)
- The mitigated exposure to the 20% weighted institution might be reported with a very high-risk weight on the institutions template (the second table of the example below illustrates that such an exposure could be reported as 143.5% risk weighted)

Very large part protected	RW%	Obligation	Mitigation risk transfer	Post-mitigation	RWA
Obligor	150%	100	-95	5	7.5
Protection provider	20%		95	95	19.0
		100			26.5
Weighted average	26.5%				

Very small part protected	RW%	Obligation	Mitigation risk transfer	Post-mitigation	RWA
Obligor	150%	100	-5	95	142.5
Protection provider	20%		5	5	1.0
		100			143.5
Weighted average	143.5%				

Furthermore, in rows 0140-0280 of the CAP 07.00 reporting template and in columns a to ac of the UKB CR5 disclosure template, mitigated exposures will rarely exactly match one of the prescribed risk weightings.

It is not at all obvious that the PRA's proposal is a better way to report the risk weighting of mitigated exposures.

Proposal

The Basel 3.1 approach should be followed without amendment, with the unprotected part of the transaction being risk weighted according to the underlying counterparty, and the protected part of the transaction according to the protection provider.

Other General Observations

Applicability of Funded Credit Protection to IMM

Recommendation 5.22

The reference of the non-applicability of the CRM section to IMM, LGD collateral modelling methos or LGD adjustment method in article 191A(4) should be amended.

Rationale

According to Article 191A(4) “Articles 192 to 239 do not apply to an institution using the IMM, the LGD Modelling Collateral Method or the LGD Adjustment Method or to an institution taking into account funded credit protection covering an exposure arising from a derivative instrument”

We believe this may be confusing as certain articles within the CRM section will apply under these approaches. For example, under the IMM approach, Article 285(7) cross refers to the CRM section for Supervisory Volatility Adjustments. Furthermore, the CRM section will also continue to be relevant for the LGD Collateral Modelling Method under the Advanced IRB approach to the extent set out in Article 166A, which requires ‘general consistency’

Proposal

We recommend to reword Article 191A(4) as follows:

> “Articles 192 to 239 do not apply to an institution using the IMM, the LGD Modelling Collateral Method or the LGD Adjustment Method or to an institution taking into account funded credit protection covering an exposure arising from a derivative instrument, *except where set out in Articles 169A, Article 183 (3), Article 276 and Article 285(7).*”.

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