A response to the PRA's consultation paper CP1/19

Credit risk mitigation: eligibility of Financial Collateral

April 2019

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers and facilitate innovation.

UK Finance is pleased to respond to the PRA's Consultation Paper CP1/19 on the its proposed approach to assessing the eligibility of financial collateral as funded credit protection.

The consultation is most relevant to our largest members that are active in the UK's wholesale markets that are supervised by the PRA for prudential capital and liquidity purposes, and this response represents their views and concerns and suggests alternative approaches. The UK markets are an international centre of excellence for structured lending solutions, including types of limited recourse lending, such as margin loans, the capital treatment of which may be negatively impacted by the proposals in CP 1/19.

Material positive correlation

The CP is designed to address the CRR Article 207 (2) requirement that any financial collateral which has a *material positive correlation* with the credit quality of the obligor shall be ineligible for credit risk mitigation purposes, where the obligor's solvency is materially dependent on the value of the financial collateral pledged.

General positive correlation

Our members support the PRA's requirement that in determining whether or not financial collateral is materially correlated with the credit quality of the obligor, they should consider matters such as

geographic, business model and legal connectedness. We also agree with the PRA that the absence of a legal connection between the collateral issuer and the obligor does not preclude the possibility of a material positive correlation.

We note however that CRR 207 (2) is more targeted in its proposed analysis of material correlation by stating that where either the value of the collateral or the credit quality of the obligor is reduced this shall not *alone* imply the reduction in the credit quality of the obligor or a fall in value of the collateral.

Although much has been done to attenuate the domestic bank/government bond 'doom loop' it is still likely that, for instance, a deterioration in economic conditions in a particular country would reduce both the value of that country's government bonds and the credit quality of its banks as the quality of their loan books suffered greater impairment. But we would not expect to exclude covered bonds' eligibility as collateral against exposures to banks because of such general correlation. We would appreciate confirmation that this is not the PRA's intention. We believe the inclusion of the word 'alone' in the CRR suggests that it is specific, rather than general, correlation that is the concern addressed by CRR 207 (2) and that the PRA's draft guidance introduces an unwelcome gold plating.

We believe that the determination of correlation should be the responsibility of the risk management practices and governance framework of individual firms. Potential wording to reflect this could be as follows:

> *2.2 In determining whether a financial collateral asset satisfies the requirement in Article 207(2), firms must consider characteristics of the obligor, the transaction and the collateral. Relevant characteristics will vary depending on the transaction but should be considered individually and in aggregate and might include legal connectedness, business model dependencies, correlations that might arise where the obligor and the collateral issuer are linked in some way. ~~share the same country,~~ and any other relevant characteristics.*

Double benefit

For good regulatory reasons supervisors wish to prevent lenders taking capital relief twice; once in relation to the credit rating of the obligor SPV (the credit rating of which has been assessed on the basis of its assets) and again in relation to the pledge of the same collateral by the SPV.

Double counting might also occur where a limited recourse financing has been extended by a lender to a well rated group parent company to finance that parent company's purchase of bonds issued by an operating company which it in turn pledges to the lender to support the loan. Clearly it would not be appropriate to take into account for capital calculation purposes the value of the collateral provided, as the parent company's credit would be dependent on the performance of its operating company.

Non-recourse and limited recourse loans

The proposed guidance at paragraph 2.3 excludes from recognition any financial collateral the value of which 'has a material positive correlation with the total value of all the assets to which the lender has legal recourse.'

In the case of non-recourse and limited recourse loans the PRA's focus changes from correlations between the financial collateral pledged and that of the obligor, to correlation between the financial collateral pledged and the total value of the assets to which the lender has legal recourse.

The rationale for this re-framing is unclear and in members' view, goes well beyond the presumed intention of the draft guidance which we believe is the prevention of double counting. It would render ineligible for recognition almost all single-asset financial collateral pledged to support non-recourse or limited recourse transactions. Most SPVs are not rated and have no asset other than the financial collateral pledged. So clearly the value of the financial collateral would be correlated with itself, but it does not necessarily follow that a deterioration in value of collateral drives a proportional deterioration in the credit quality of the exposure, particularly in circumstances where margining arrangements are in place and/or there is significant over-collateralisation.

In some circumstances, where the obligor has no other substance, the lender explicitly looks through the corporate entity to the value of the financial collateral as the single, only source of repayment in the event of the default of the SPV. Paragraph 2.3 appears to explicitly prevent this for a single-asset SPV because the newly introduced test is not between obligor and collateral (as in CRR 207 (2)) but between the value of an individual financial collateral asset and all assets to which the lender has legal recourse which in the case of a single-asset SPV are likely to be one and the same.

The PRA's guidance will make the required provision of an independent legal opinion in relation to the effectiveness of the credit risk mitigation benefit of financial collateral more difficult until the PRA's intentions are clarified. This will disrupt the UK's internationally important non-recourse and limited recourse loan markets, at least temporarily.

Margin loans - a specific concern?

A common type of non or limited recourse loan is the margin loan. The recent Steinhoff case, in which a loan to an individual connected with the company was secured by shares of the company, which lost value precipitously after reports of accounting irregularities, provides a cautionary tale for all securities based lending.

We believe it would be wrong to demonise all margin lending because of the Steinhoff experience. As part of prudent credit risk management, lending firms typically manage their credit risk exposure for any margin loan transaction by including safeguards and explicit risk mitigation features within any contractual arrangements. These features tend to be especially relevant when a firm lends against single assets. They ensure that the firm minimises any losses it may incur upon default of the obligor. Such features include:

- Low loans to value (LTV)s arising from significant over-collateralisation of the securities being financed
- A requirement to make a cash payment in the event of a security coverage trigger being breached
- Regular marking-to-market of the securities pool, LTV triggers which immediately close out the trades
- Margin triggers linked to the market liquidity (trade volumes) of collateral
- Qualitative mitigants such as parental guarantees and other forms of credit support.

Such structural features are typically included specifically to minimise the direct correlation between the obligor default and the resulting loss suffered by the lending firm.

For instance non-recourse margin loans on liquid equities typically have a low, circa 50% LTV at inception, with wind-down triggers set between 60%-65%. If the collateral gaps to below the level of LTV triggers and the LTV levels are not restored by the borrower, the lender would expect to realise some value for the collateral given that these are liquid equities.

Treating this transaction as unsecured lending under CP1/19 would result in a 100% risk-weight for a standardised firm (assuming e.g. that the obligor is an unrated corporate) which is significantly higher compared to other types of non-recourse transaction allowed under the CRR credit risk framework, e.g. securitisations and project financing:

Transaction	Indicative risk-weight
50% LTV under margin loan backed by liquid listed equities	100% (under PRA CP1/19)
Non-recourse senior loan to an SPV with attachment point circa 50%	15% under SEC-SA
Object financing loan with <2.5% years maturity backed by illiquid physical collateral	50% under slotting approach

Alternatives to addressing the PRA's concerns

While it is understood that the Steinhoff case resulted in collateral values dropping substantially in a short period of time and therefore resulting in credit losses, it is worth highlighting that the current Pillar 1 capital framework does not adequately consider this "gap" risk (the risk that the collateral values drops instantaneously within a very short period), despite the inclusion of the structural mitigants mentioned above.

Treatment of Gap Risk under the Market Risk framework – an alternative approach

While we acknowledge that the usual collateral framework is not appropriate for non-recourse margin lending as 'the creditworthiness of the obligor can depend materially on the value of the financial collateral', financing under a non-recourse transaction, by definition, is de-linked from the credit-worthiness of the obligor as the lender cannot pursue the obligor in case of a shortfall upon default of the obligor, even in cases where the default is not on account of insolvency of the obligor.

By analogy a firm holding a derivative position (e.g. a sold put option) on the collateral underlying, with the strike price of the option equal to the LTV of the loan is arguably exposed to the same economic loss to that which will be experienced by a firm as a result of a sudden drop in collateral value with any residual value being insufficient to avoid losses on any unpaid loan (the so called "gap risk").

So a possible alternative methodology would be to capitalise this risk of a sudden loss in value using the gap risk approach in the market risk equivalent rules if firms have the infrastructure to manage and capitalise this gap risk in their trading book.

This can be applied either via the standardised approach for options or, where IMA model permission is already available, using the 'Risk not in VaR methodology' (RNIV). However, it is worth noting that doing so would require capitalisation of the gap risk via the Pillar 1 framework, outside of the Level 1 EU text.

We note that Internal risk transfers from the banking book to the trading book are permitted under CRR Article 106 and that although the CRR does not specify a treatment for non-recourse equity financing in the trading book PRA Market Risk Rule 4.1 allows firms to apply rules by analogy where it is appropriate and prudent to do so.

Treatment of Gap Risk under the Pillar 2 framework

If the PRA is concerned about the gap risk not being adequately capitalised by Pillar 1 rules (e.g. for "jump to default" or concentration risk), this can be addressed in the Pillar 2 framework and its adequacy reviewed by the PRA under SREP. Under this approach, the PRA would retain the flexibility to assess the suitability and adequacy of each firm's approach via the SREP process, which could also take into account the market liquidity quality, perhaps by reference to HQLA categorisation.

It will be noted from the above discussion that the capitalisation of non-recourse exposures is a complex area, of which the technical issue of the interpretation of Article 207(2) is only a small part. We believe the subject merits a more in-depth dialogue between the industry and the PRA, and would also benefit from discussion at international level, before an approach is finalised for an individual jurisdiction. UK Finance would be delighted arrange this.

Responsible Executive

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