

Chapter 4

The IRB approach

4.10 The IRB approach: Credit risk mitigation

Application

- 4.10.1 **G** ■ BIPRU 4.10 applies to all *exposures* treated under the *IRB approach*.

Purpose

- 4.10.2 **G** ■ BIPRU 4.10 sets out modifications to ■ BIPRU 5 (Credit risk mitigation) for those *exposures* for which the *IRB approach* is being used.

General

- 4.10.3 **R** A firm using the *IRB approach*, but not using its own estimates of *LGD* and *conversion factors*, may recognise *credit risk mitigation* in accordance with ■ BIPRU 5 as modified by ■ BIPRU 4.10 in the calculation of *risk weighted exposure amounts* for the purposes of the calculation of the *credit risk capital component* or as relevant *expected loss* amounts for the purposes of the calculation in ■ GENPRU 2.2.191 R to ■ GENPRU 2.2.193 R or ■ GENPRU 2.2.236 R.

[Note: BCD Article 91 (as it applies to the *IRB approach*)]

- 4.10.4 **R**
- (1) Where the requirements of ■ BIPRU 5.2.2 R - ■ BIPRU 5.2.8 R are met the calculation of *risk weighted exposure amounts*, and, as relevant, *expected loss* amounts, may be modified in accordance with ■ BIPRU 5 as modified by ■ BIPRU 4.10.
 - (2) No *exposure* in respect of which *credit risk mitigation* is obtained must produce a higher *risk weighted exposure amount* or *expected loss* amount than an otherwise identical *exposure* in respect of which there is no *credit risk mitigation*.
 - (3) Where the *risk weighted exposure amount* already takes account of credit protection under the *IRB approach* the calculation of the credit protection must not be further recognised under ■ BIPRU 5 or ■ BIPRU 4.10.
 - (4) Subject to ■ BIPRU 5.2.8 R (Maturity mismatches), ■ BIPRU 5.2.9 R (Combinations of credit risk mitigation in the standardised approach) and ■ BIPRU 5.7.27 R to ■ BIPRU 5.7.28 R (Basket credit risk mitigation techniques), where the *CRM eligibility conditions* and the *CRM minimum requirements* are satisfied, the calculation of *risk weighted exposure amounts* and *expected loss* amounts under the *IRB approach* may be modified in accordance with the provisions of ■ BIPRU 5 and

■ BIPRU 4.10 that deal with calculating the effects of credit risk mitigation.

[Note: BCD Article 93 and Annex VIII Part 3 point 1(as they apply to the *IRB approach*)]

Eligibility of funded credit protection: General

- 4.10.5 **R** In addition to the collateral set out in ■ BIPRU 5.3.1 R to ■ BIPRU 5.3.2 R, ■ BIPRU 5.4.1 R to ■ BIPRU 5.4.8 R and ■ BIPRU 5.6.1 R (Eligibility of funded credit protection) the provisions of ■ BIPRU 4.10.6 R - ■ BIPRU 4.10.11R (Eligibility of real estate collateral), ■ BIPRU 4.10.14 R (Eligibility: receivables), ■ BIPRU 4.10.16 R (Eligibility: other physical collateral), and ■ BIPRU 4.10.19 R (Eligibility: leasing), apply where a *firm* calculates *risk weighted exposure amounts* and *expected loss* amounts under the *IRB approach*.

[Note: BCD Annex VIII Part 1 point 12]

Real estate collateral: Types of eligible collateral: General

- 4.10.6 **R**
- (1) Residential real estate property which is or will be occupied or let by the owner or the beneficial owner in the case of personal investment companies and commercial real estate property, that is offices and other commercial premises, may be recognised as eligible collateral where the conditions set out in the remaining provisions of this paragraph are met.
 - (2) The value of the property must not materially depend upon the credit quality of the obligor. This requirement does not preclude situations where purely macro-economic factors affect both the value of the property and the performance of the borrower.
 - (3) The risk of the borrower must not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility must not materially depend on any cash flow generated by the underlying property serving as collateral.

[Note: BCD Annex VIII Part 1 point 13]

- 4.10.7 **R** The condition in ■ BIPRU 4.10.6 R (3) does not apply to *exposures* secured by residential real estate property situated within the *United Kingdom*.

[Note: BCD Annex VIII Part 1 point 16 (part)]

- 4.10.8 **G**
- (1) The *FCA* may only disapply the condition in ■ BIPRU 4.10.6 R (3) if it has evidence that the *UK* market is well-developed and long-established with loss-rates which are sufficiently low to justify such action.
 - (2) If the evidence were to change so that the action was no longer justified the *appropriate regulator* would expect to revoke ■ BIPRU 4.10.7 R.

[Note: BCD Annex VIII Part 1 point 16]

4.10.9 **R** (1) The condition in ■ BIPRU 4.10.6 R (3) does not apply for *exposures* secured by residential real estate property situated outside the *UK*.

(2) [deleted]

4.10.10 **R** (1) The condition in ■ BIPRU 4.10.6 R (3) does not apply for commercial real estate property situated outside the *UK*.

(2) [deleted]

Real estate collateral: Types of eligible collateral: Finnish housing legislation

4.10.11 **R** [deleted]

4.10.12 **R** [deleted]

Real estate collateral: Minimum requirements for recognition

4.10.13 **R** For the recognition of real estate collateral: the minimum requirements in ■ BIPRU 3.4.64 R - ■ BIPRU 3.4.73 R must be met with the following adjustments:

(1) those provisions apply to all real estate collateral eligible under ■ BIPRU 4.10; and

(2) the minimum frequency of valuation as referred to in ■ BIPRU 3.4.66 R is once every year for commercial real estate.

[Note: BCD Annex VIII Part 2 point 8 (as it applies to the *IRB approach*)]

Receivables: Types of eligible collateral

4.10.14 **R** Amounts receivable linked to a commercial transaction or transactions with an original maturity of less than or equal to one year may be recognised as eligible collateral. Eligible receivables do not include those associated with *securitisations*, sub-participations or credit derivatives or amounts owed by affiliated parties.

[Note: BCD Annex VIII Part 1 point 20]

Receivables: Minimum requirements for recognition

4.10.15 **R** (1) For the recognition of receivables as collateral the requirements in this paragraph must be met.

(2) The legal mechanism by which the collateral is provided must be robust and effective and ensure that the lender has clear rights over the proceeds.

(3) A *firm* must take all steps necessary to fulfil local requirements in respect of the enforceability of security interests. There must be a framework which allows the lender to have a first priority claim over the collateral subject to any claims of preferential creditors provided for in applicable insolvency law.

- (4) A *firm* must have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions.
- (5) The collateral arrangements must be properly documented, with a clear and robust procedure for the timely collection of collateral. A *firm's* procedures must ensure that any legal conditions required for declaring the default of the borrower and timely collection of collateral are observed. In the event of the obligor's financial distress or default, a *firm* must have legal authority to sell or assign the receivables to other parties without consent of the receivables obligors.
- (6) A *firm* must have a sound process for determining the credit risk associated with the receivables. Such a process must include, among other things, analyses of the obligor's business and industry and the types of customers with whom the obligor does business. Where a *firm* relies on the obligor to ascertain the credit risk of the customers, the *firm* must review the obligor's credit practices to ascertain their soundness and credibility.
- (7) The margin between the amount of the *exposure* and the value of the receivables must reflect all appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an individual obligor, and potential concentration risk within the *firm's* total *exposures* beyond that controlled by the *firm's* general methodology. A *firm* must maintain a continuous monitoring process appropriate to the receivables. Additionally, compliance with loan covenants, Environmental restrictions, and other legal requirements must be reviewed on a regular basis.
- (8) The receivables pledged by an obligor must be diversified and not be unduly correlated with the obligor. Where there is material positive correlation, the attendant risks must be taken into account in the setting of margins for the collateral pool as a whole.
- (9) Receivables from affiliates of the obligor (including *subsidiary undertakings* and employees) must not be recognised as risk mitigants.
- (10) A *firm* must have a documented process for collecting receivable payments in distressed situations. The requisite facilities for collection must be in place, even when the *firm* normally looks to the obligor for collections.

[Note: BCD Annex VIII Part 2 point 9]

Other physical collateral: Types of eligible collateral

4.10.16

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A *firm* may recognise as eligible collateral a physical item of a type other than those types indicated in ■ BIPRU 4.10.6 R - ■ BIPRU 4.10.8R (Eligibility of real estate collateral) if its *IRB permission* provides that the *firm* may treat collateral of that type as eligible and if the *firm* is able to demonstrate the following:

- (1) the existence of liquid markets for disposal of the collateral in an expeditious and economically efficient manner;

4.10.17

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- (2) the existence of well-established, publicly available market prices for the collateral; and
- (3) there is no evidence that the net prices it receives when collateral is realised deviates significantly from the market prices referred to in (b).

[Note: BCD Annex VIII Part 1 point 21]

If a *firm* wishes to recognise other types of collateral in accordance with ■ BIPRU 4.10.16 R (whether as part of its application for an *IRB permission* or under a variation of its *IRB permission*) it should demonstrate to the *appropriate regulator* how the criteria in ■ BIPRU 4.10.16 R (1) - ■ BIPRU 4.10.16 R (3) have been met with respect to that type of collateral.

Other physical collateral: Minimum requirements for recognition

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- (1) If a type of other physical collateral referred to in ■ BIPRU 4.10.16 R is potentially eligible under a *firm's IRB permission* a *firm* must only recognise it as eligible if the minimum requirements in (2) to (10) are met.
- (2) The collateral arrangement must be legally effective and enforceable in all relevant jurisdictions and must enable the *firm* to realise the value of the property within a reasonable timeframe.
- (3) With the sole exception of permissible prior claims referred to in ■ BIPRU 4.10.15 R (3), only first liens on, or charges over, collateral must be permissible. As such, the *firm* must have priority over all other lenders to the realised proceeds of the collateral.
- (4) The value of the property must be monitored on a frequent basis and at a minimum once every year. More frequent monitoring must be carried out where the market is subject to significant changes in conditions.
- (5) The loan agreement (or other agreement documenting the *exposure*) must include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation.
- (6) The types of physical collateral accepted by the *firm* and policies and practices in respect of the appropriate amount of each type of collateral relative to the *exposure* amount must be clearly documented in internal credit policies and procedures available for examination.
- (7) The *firm's* credit policies with regard to the transaction structure must address appropriate collateral requirements relative to the *exposure* amount, the ability to liquidate the collateral readily, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility or a proxy of the volatility of the value of the collateral.

- (8) Both initial valuation and revaluation must take fully into account any deterioration or obsolescence of the collateral. Particular attention must be paid in valuation and revaluation to the effects of the passage of time on fashion- or date-sensitive collateral.
- (9) The *firm* must have the right to inspect the property physically. It must have policies and procedures addressing its exercise of the right to physical inspection.
- (10) The *firm* must have procedures to monitor that the property taken as protection is adequately insured against damage.

[Note: BCD Annex VIII Part 2 point 10]

Leasing: Types of eligible transactions and conditions of eligibility

4.10.19

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- (1) Where the requirements set out in this paragraph are met, *exposures* arising from transactions whereby a *firm* leases property to a third party must be treated the same as loans collateralised by the type of property leased.
- (2) For the *exposures* arising from leasing transactions to be treated as collateralised by the type of property leased, the following conditions must be met:
 - (a) the conditions set out or referred to in ■ BIPRU 4.10.13 R or ■ BIPRU 4.10.18 R as appropriate for the recognition as collateral of the type of property leased are met;
 - (b) there is robust risk management on the part of the lessor with respect to the use to which the leased asset is put, its age, and planned duration of its use, including appropriate monitoring of the value of the security;
 - (c) there is in place a robust legal framework establishing the lessor's legal ownership of the asset and its ability to exercise its rights as owner in a timely fashion; and
 - (d) where this has not already been ascertained in calculating the *LGD* level, the difference between value of the unamortised amount and the market value of the security must not be so large as to overstate the *credit risk mitigation* attributed to the leased assets.

[Note: BCD Annex VIII Part 1 point 22 and Part 2 point 11]

Calculating risk-weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Introduction

4.10.20

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■ BIPRU 4.10.21 R - ■ BIPRU 4.10.37 R and ■ BIPRU 4.10.49 R set out how the calculation of *risk weighted exposure amounts* and *expected loss* amounts under ■ BIPRU 4.1 - ■ BIPRU 4.9 may be modified to take into account *credit risk mitigation* that meets the *CRM eligibility conditions* and the *CRM minimum requirements*.

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Valuation: Receivables

4.10.21 **R** The value of receivables for the purpose of calculating the effect of *credit risk mitigation* must be the amount receivable.

[Note: BCD Annex VIII Part 3 point 66]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Valuation: Other physical collateral

4.10.22 **R** Physical collateral recognised as eligible as described in **■ BIPRU 4.10.16 R** must be valued for the purpose of calculating the effect of *credit risk mitigation* at its market value. Market value is the estimated amount for which the property would exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction.

[Note: BCD Annex VIII Part 3 point 67]

Calculating risk weighted exposure amounts and expected loss amounts: General treatment

4.10.23 **R** **■ BIPRU 4.10.24 R** - **■ BIPRU 4.10.28R** apply to collateral in the form of real estate collateral, receivables, other physical collateral and leasing permitted by **■ BIPRU 4.10** and *exposures* secured by such collateral.

4.10.24 **R** LGD* (the effective *loss given default*) calculated as set out in **■ BIPRU 4.10.25 R** - **■ BIPRU 4.10.28 R** must be taken as the *LGD*.

[Note: BCD Annex VIII Part 3 point 68]

4.10.25 **R** Where the ratio of the value of the collateral (C) to the *exposure* value (E) is below a threshold level of C* (the required minimum collateralisation level for the *exposure*) as laid down in **■ BIPRU 4.10.28 R**, LGD* must be the *LGD* laid down in the other sections of **■ BIPRU 4** for uncollateralised *exposures* to the counterparty. For this purpose, the *exposure* value of items listed in **■ BIPRU 4.4.37 R** to **■ BIPRU 4.4.39 R** and **■ BIPRU 4.8.29 R** must be calculated using a *conversion factor* or percentage of 100% rather than the *conversion factors* or percentages indicated in those rules.

[Note: BCD Annex VIII Part 3 point 69]

4.10.26 **R** Where the ratio of the value of the collateral to the *exposure* value exceeds a second, higher threshold level of C** (i.e. the required level of collateralisation to receive full *LGD* recognition) as laid down in **■ BIPRU 4.10.28 R**, LGD* must be that prescribed in that table.

[Note: BCD Annex VIII Part 3 point 70]

4.10.27 **R** Where the required level of collateralisation C** is not achieved in respect of the *exposure* as a whole, the *exposure* must be considered to be two

exposures - that part in respect of which the required level of collateralisation C** is achieved and the remainder.

[Note: BCD Annex VIII Part 3 point 71]

4.10.28 **R** Table: Minimum LGD for secured portion of exposures

This table belongs to ■ BIPRU 4.10.24 R - ■ BIPRU 4.10.27 R

| | LGD* for senior claims or contingent claims | LGD* for subordinated claims or contingent claims | Required minimum collateralisation level of the exposure (C*) | Required minimum collateralisation level of the exposure (C**) |
|--|---|---|---|--|
| Receivables | 35% | 65% | 0% | 125% |
| Residential real estate/ commercial real estate | 35% | 65% | 30% | 140% |
| Other collateral | 40% | 70% | 30% | 140% |

[Note: BCD Annex VIII Part 3 point 72 (part)]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Alternative treatment for real estate collateral

4.10.29 **R** [deleted]

Calculating risk weighted exposure amounts and expected loss amounts: Mixed pools of collateral

- 4.10.30** **R**
- (1) Where:
 - (a) *risk weighted exposure amounts* and *expected loss* amounts are calculated under the *IRB approach*; and
 - (b) an *exposure* is collateralised by both financial collateral and other eligible collateral;

LGD* to be taken as the *LGD* for the purposes of the *IRB approach* must be calculated in accordance with this *rule*.
 - (2) A *firm* must subdivide the volatility-adjusted value of the *exposure* (i.e. the value after the application of the volatility adjustment as set out in ■ BIPRU 5.4.28 R (Volatility adjustments under the financial collateral comprehensive method) into parts each covered by only one type of collateral. That is, the *firm* must divide the *exposure* into the part covered by eligible financial collateral, the part covered by receivables, the parts covered by commercial real estate property collateral and/or residential real estate property collateral, the part covered by other eligible collateral, and the unsecured part, as relevant.

- (3) LGD* for each part of *exposure* must be calculated separately in accordance with the relevant provisions of ■ BIPRU 5 (Credit risk mitigation) and ■ BIPRU 4.10.

[Note: BCD Annex VIII Part 3 points 76 to 78]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Financial collateral simple method

- 4.10.31 **R** The *financial collateral simple method* must not be used under the *IRB approach*.

[Note: BCD Annex VIII Part 3 point 24 (part)]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Master netting agreements

- 4.10.32 **R**
- (1) This *rule* sets out how the calculations under ■ BIPRU 5.6.11 R (Using the supervisory volatility adjustments or the own estimates volatility adjustments approaches to master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions) must be modified under the *IRB approach*.
 - (2) Where *risk weighted exposure amounts* and *expected loss* amounts are calculated under the *IRB approach*, E is the *exposure* value for each separate *exposure* under the agreement referred to in the provisions listed in (1) that would apply in the absence of the credit protection.

[Note: BCD Annex VIII Part 3 point 11 (as it applies to the *IRB approach*)]

- 4.10.33 **R**
- (1) This *rule* sets out how the calculations under ■ BIPRU 5.6.24 R (Using the internal models approach to master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing transactions and/or other capital market driven transactions) must be modified under the *IRB approach*.
 - (2) Where *risk weighted exposure amounts* and *expected loss* amounts are calculated under the *IRB approach* E is the *exposure* value for each separate *exposure* under the agreement referred to in the provisions listed in (1) that would apply in the absence of the credit protection.

[Note: BCD Annex VIII Part 3 point 20 (as it applies to the *IRB approach*)]

- 4.10.34 **R**
- (1) This *rule* sets out how the calculations under ■ BIPRU 5.6.29 R (Calculating risk-weighted exposure amounts and expected loss amounts for master netting agreements covering repurchase transactions and/or securities or commodities lending or borrowing

transactions and/or other capital market driven transactions) must be modified under the *IRB approach*.

- (2) E* must be taken as the *exposure* value of the *exposure* to the counterparty arising from the transactions subject to the master netting agreement referred to in the provisions listed in (1) for the purposes of ■ BIPRU 4.

[Note: BCD Annex VIII Part 3 point 23 (as it applies to the *IRB approach*)]

Calculating risk weighted exposure amounts and expected loss amounts for funded credit risk mitigation: Other modifications of the rules on credit risk mitigation: Financial collateral comprehensive method

- 4.10.35 **R** (1) This *rule* sets out how the calculations under ■ BIPRU 5.4.28 R (Calculating adjusted values under the financial collateral comprehensive method) must be modified under the *IRB approach*.
- (2) E as referred to in the provisions listed in (1) is the *exposure* value as would be determined under the *IRB approach* if the *exposure* was not collateralised. For this purpose, where a *firm* calculates *risk weighted exposure amounts* under the *IRB approach*, the *exposure* value of the items listed in ■ BIPRU 4.4.37 R to ■ BIPRU 4.4.39 R, ■ BIPRU 4.4.45 R, ■ BIPRU 4.6.44 R (3) and ■ BIPRU 4.8.29 R must be calculated using a *conversion factor* of 100% rather than the *conversion factors* or percentages indicated in those provisions.
- 4.10.36 **R** (1) This *rule* sets out the calculation of *risk weighted exposure amounts* and *expected loss* amounts under the *financial collateral comprehensive method* for a *firm* using the *IRB approach*.
- (2) LGD* (the effective *loss given default*) calculated as set out in this paragraph must be taken as the *LGD* for the purposes of ■ BIPRU 4.
- (3) $LGD^* = LGD \times (E^*/E)$ where:
- (a) *LGD* is the *loss given default* that would apply to the *exposure* under the *IRB approach* if the *exposure* was not collateralised;
- (b) E is the *exposure* value as calculated under ■ BIPRU 4; and
- (c) E* is as calculated under ■ BIPRU 5.4.28 R (3) (Calculation of adjusted values under the financial collateral comprehensive method).
- [Note: BCD Annex VIII Part 3 point 61]
- 4.10.37 **R** (1) In the case of a *firm* using the *IRB approach* to calculate *risk weighted exposure amounts* and *expected loss* amounts, the *persons* in (2) are added to the list in ■ BIPRU 5.4.64 R (Definition of core market participant).
- (2) The *persons* referred to in (1) are other financial companies (including insurance companies) *exposures* to which do not have a credit assessment by an *eligible ECAI* and are internally rated as having a *probability of default* equivalent to that associated with the credit

assessments of *ECAs* that are associated with *credit quality step 2* or above under the *rules* for the *risk weighting* of *exposures* under the *standardised approach* to credit risk.

[Note: BCD Annex VIII Part 3 point 58(h) (as it applies to the *IRB approach*)]

Unfunded credit protection: Eligibility of providers

4.10.38

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(1) In the case of a *firm* using the *IRB approach* in calculating *risk weighted exposure amounts* and *expected loss amounts*, the *persons* in (2) are added to the list in ■ BIPRU 5.7.1 R (List of eligible providers of unfunded credit protection).

(2) The *persons* referred to in (1) are other corporate entities, including *parent undertakings*, *subsidiary undertakings* and affiliate corporate entities of the *firm*, that do not have a credit assessment by an *eligible ECAI* and are internally rated as having a *probability of default* equivalent to that associated with the credit assessments of *ECAs* that are associated with *credit quality step 2* or above under the *rules* for the *risk weighting* of *exposures* under the *standardised approach* to credit risk.

[Note: BCD Annex VIII Part 1 point 26(g)(ii)]

4.10.39

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Where *risk weighted exposure amounts* and *expected loss amounts* are calculated under the *IRB approach*, to be eligible a guarantor must be internally rated by a *firm* in accordance with the provisions of the *minimum IRB standards*.

[Note: BCD Annex VIII Part 1 point 27]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Introduction

4.10.40

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■ BIPRU 4.10.41 R to ■ BIPRU 4.10.48 R set out the minimum requirements:

- (1) assessing the effect of guarantees and credit derivatives for:
 - (a) *exposures* in the *sovereign, institution and corporate IRB exposure class* where the *advanced IRB approach* is being used to calculate *LGDs*; and
 - (b) *retail exposures*; and
- (2) additionally, in the case of *retail exposure* guarantees, to the assignment of *exposures* to grades or pools, and the estimation of *PD*.

[Note: BCD Annex VII Part 4 point 97]

4.10.41

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The requirements in ■ BIPRU 4.10.40 R (2) and ■ BIPRU 4.10.42 R - ■ BIPRU 4.10.48 R do not apply to guarantees provided by *institutions*, central governments, *central banks* and other *corporate* entities which meet the requirements in ■ BIPRU 5.7.1 R (7) if the *firm* has received approval under ■ BIPRU 4.2 to apply

the *standardised approach* for exposures to such entities. In this case the requirements of ■ BIPRU 5 (credit risk mitigation) apply.

[Note: BCD Annex VII Part 4 point 96]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Eligible guarantors and guarantees

4.10.42 **R** A *firm* must have clearly specified criteria for the types of guarantors it recognises for the calculation of *risk weighted exposure amounts*.

[Note: Annex VII Part 4 point 98]

4.10.43 **R** For recognised guarantors the same requirements as for obligors as set out in ■ BIPRU 4.3.43 R - ■ BIPRU 4.3.48 R (Assignment to grades and pools), ■ BIPRU 4.4.11 R - ■ BIPRU 4.4.18 R and ■ BIPRU 4.4.51 R (Assignment of exposures and rating systems), ■ BIPRU 4.5.6 R (Assignment of exposures) and ■ BIPRU 4.6.11 R and ■ BIPRU 4.6.14 R (Assignment of exposures and rating systems) apply.

[Note: BCD Annex VII Part 4 point 99]

4.10.44 **R** The guarantee must be evidenced in writing, non-cancellable on the part of the guarantor, in force until the obligation is satisfied in full (to the extent of the amount and tenor of the guarantee) and legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgement. Guarantees prescribing conditions under which the guarantor may not be obliged to perform (conditional guarantees) may be recognised if the *IRB permission* permits this. A *firm* must (in the case of a *firm* with an *IRB permission* that permits conditional guarantees) be able to demonstrate to the *appropriate regulator* that the assignment criteria adequately address any potential reduction in the risk mitigation effect.

[Note: BCD Annex VII Part 4 point 100]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Adjustment criteria

4.10.45 **R** A *firm* must have clearly specified criteria for adjusting grades, pools or *LGD* estimates, and in the case of *retail exposures* and eligible purchased receivables, the process of allocating *exposures* to grades or pools, to reflect the impact of guarantees for the calculation of *risk weighted exposure amounts*. These criteria must comply with the minimum requirements referred to in ■ BIPRU 4.10.43 R.

[Note: BCD Annex VII Part 4 point 101]

4.10.46 **R** The criteria in ■ BIPRU 4.10.45 R must be plausible and intuitive. They must address the guarantor's ability and willingness to perform under the guarantee, the likely timing of any payments from the guarantor, the degree to which the guarantor's ability to perform under the guarantee is correlated with the obligor's ability to repay, and the extent to which residual risk to the obligor remains.

[Note: BCD Annex VII Part 4 point 102]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Credit derivatives

4.10.47 **R** The minimum requirements for guarantees set out in ■ BIPRU 4.10 also apply for single name credit derivatives. In relation to a mismatch between the underlying obligation and the reference obligation of the credit derivative or the obligation used for determining whether a credit event has occurred the requirements set out under ■ BIPRU 5.7.14 R (Mismatches and credit derivatives) apply. For *retail exposures* and eligible purchased receivables, this paragraph applies to the process of allocating *exposures* to grades or pools.

[Note: BCD Annex VII Part 4 point 103]

4.10.48 **R** The criteria applied by ■ BIPRU 4.10.47 R must address the payout structure of the credit derivative and conservatively assess the impact this has on the level and timing of recoveries. A *firm* must consider the extent to which other forms of residual risk remain.

[Note: BCD Annex VII Part 4 point 104]

Unfunded credit protection: Minimum requirements for assessing the effect of guarantees and credit derivatives: Calculating risk weighted exposure amounts and expected loss amounts

- 4.10.49** **R**
- (1) This *rule* relates to the calculation of *risk-weighted exposure amounts* and *expected loss* amounts in the case of *unfunded credit protection*.
 - (2) ■ BIPRU 5.7.21 R (Tranching) applies for the purpose in (1).
 - (3) The provisions in (4) replace those in ■ BIPRU 5.7.22 R to ■ BIPRU 5.7.25 R (Calculating risk weighted exposure amounts under the standardised approach in the case of unfunded credit protection).
 - (4) For the covered portion of the *exposure* value E (based on the adjusted value of the credit protection G_A), the *PD* for the purposes of ■ BIPRU 4 may be the *PD* of the protection provider, or a *PD* between that of the borrower and that of the guarantor if a full substitution is deemed not to be warranted. In the case of subordinated *exposures* and non-subordinated unfunded protection, the *LGD* to be applied for the purposes of ■ BIPRU 4 may be that associated with senior claims.
 - (5) For any uncovered portion of the *exposure* value E the *PD* must be that of the borrower and the *LGD* must be that of the underlying *exposure*.
 - (6) G_A is the value of G^* as calculated under ■ BIPRU 5.7.17 R (Valuation of unfunded credit protection) further adjusted for any maturity mismatch as laid down in ■ BIPRU 4.10.51 R (Maturity mismatches).
 - (7) E is the *exposure* value as related to the following rules:
 ■ BIPRU 4.4.38 R, ■ BIPRU 4.4.39 R, ■ BIPRU 4.4.71 R to ■ BIPRU 4.4.78 R, ■ BIPRU 4.7.7 R, ■ BIPRU 4.8.28 R, ■ BIPRU 4.8.29 R and ■ BIPRU 4.9.9 R. For this purpose, the *exposure* value of the items referred to in ■ BIPRU 4.4.37 R to ■ BIPRU 4.4.39 R and ■ BIPRU 4.8.29 R must be

calculated using a *conversion factor* or percentage of 100% rather than the *conversion factors* or percentages indicated in those rules.

[Note: BCD Annex VIII Part 3 points 90 to 92]

Maturity mismatches

- 4.10.50 **R** In addition to ■ BIPRU 5.8.2 R, where there is a maturity mismatch the credit protection must not be recognised where the *exposure* is a short term *exposure* specified in the *firm's IRB permission* as being subject to a one-day floor rather than a one-year floor in respect of the maturity value (M) under ■ BIPRU 4.4.68 R.

[Note: BCD Annex VIII Part 4 point 2(b)]

- 4.10.51 **R** G_A as calculated under ■ BIPRU 5.8.11 R is then taken as the value of the protection for the purposes of calculating the effects of *unfunded credit protection* under the *IRB approach*.

[Note: BCD Annex VIII Part 4 point 8 (part)]