Chapter 4

The IRB approach

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4.8 The IRB approach: Purchased receivables

Application

4.8.1 R ■ BIPRU 4.8 applies with respect to purchased receivables.

4.8.2 G Purchased receivables do not form an *IRB exposure class* on their own. For any purchased receivable, the provisions of the sections of ■ BIPRU 4 that deal with the *IRB exposure class* to which it belongs also apply, as modified by this section.

[**Note**: *BCD* Annex VII Part 4 point 15 (part)]

Structure of rating systems

4.8.3 R For *retail exposure* that are purchased receivables, the grouping referred to in ■ BIPRU 4.6.9 R must reflect the seller's underwriting practices and the heterogeneity of its customers.

Risk quantification: Overall requirements for estimation: General

4.8.4 G Further general material about the requirements for estimation can be found in ■ BIPRU 4.3.73 R - ■ BIPRU 4.3.94 R.

4.8.5 R The estimates for determining the risk parameters *PD*, *LGD*, *conversion factor* and *EL* must reflect all relevant information available to the purchasing *firm* regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing *firm*, or by external sources. The purchasing *firm* must evaluate any data relied upon which is provided by the seller.

[**Note**: *BCD* Annex VII Part 4 point 53]

Risk quantification: Overall requirements for estimation: Requirements specific to PD estimation

4.8.6 R With respect to ■ BIPRU 4.6.26 R (Internal and external data for PD estimation: retail exposures) a *firm* may use external and internal reference data for *PD* estimation. A *firm* must use all relevant data sources as points of comparison.

[**Note**: *BCD* Annex VII Part 4 point 69 (part)]

4.8.7 R For *corporate exposure* purchased receivables a *firm* may estimate *ELs* by obligor grade from long run averages of one-year realised *default* rates.

[**Note**: *BCD* Annex VII Part 4 point 60]

4.8.8 R If a *firm* derives long run average estimates of *PDs* and *LGDs* for *corporate exposure* purchased receivables from an estimate of *EL*, and an appropriate estimate of *PD* or *LGD*, the process for estimating total *losses* must meet the overall standards for estimation of *PD* and *LGD* set out in the *minimum IRB standards*, and the outcome must be consistent with the concept of *LGD* as set out in BIPRU 4.3.99 R.

[**Note**: *BCD* Annex VII Part 4 point 61]

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Risk quantification: Overall requirements for estimation: Requirements specific to own-LGD estimates

4.8.9 R A *firm* may use external and internal reference data for its *LGD* estimates in the case of *retail exposures* that are purchased receivables.

[**Note**: *BCD* Annex VII Part 4 point 85]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: General

4.8.10 R BIPRU 4.8.11 R - BIPRU 4.8.15 R set out minimum requirements specific to the treatment of purchased receivables under the *IRB approach*.

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Legal certainty

4.8.11 R The structure of the facility must ensure that under all foreseeable circumstances a *firm* has effective ownership and control of all cash remittances from the receivables. When the obligor makes payments directly to a seller or servicer a *firm* must verify regularly that payments are forwarded completely and within the contractually agreed terms. Servicer means an entity that manages a pool of purchased receivables or the underlying credit *exposures* on a day-to-day basis. A *firm* must have procedures to ensure that ownership over the receivables and cash receipts is protected against bankruptcy stays or legal challenges that could materially delay the lender's ability to liquidate or assign the receivables or retain control over cash receipts.

[**Note**: *BCD* Annex VII Part 4 point 105]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Effectiveness of monitoring systems

4.8.12 R

(1) A *firm* must monitor both the quality of the purchased receivables and the financial condition of the seller and servicer. In particular a *firm* must comply with the remaining provisions of this *rule*.

(2) A *firm* must assess the correlation among the quality of the purchased receivables and the financial condition of both the seller and servicer, and have in place internal policies and procedures that

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provide adequate safeguards to protect against such contingencies, including the assignment of an internal risk rating for each seller and servicer.

(3) A *firm* must have clear and effective policies and procedures for determining seller and servicer eligibility. A *firm* or its agent must conduct periodic reviews of sellers and servicers in order to verify the accuracy of reports from the seller or servicer, detect fraud or operational weaknesses, and verify the quality of the seller's credit policies and servicer's collection policies and procedures. The findings of these reviews must be documented.

(4) A *firm* must assess the characteristics of the purchased receivables pools including:

(a) over-advances;

(b) history of the seller's arrears, bad debts, and bad debt allowances;

(c) payment terms; and

(d) potential contra accounts.

(4) A *firm* must have effective policies and procedures for monitoring on an aggregate basis single-obligor concentrations both within and across purchased receivables pools.

(5) A *firm* must ensure that it receives from the servicer timely and sufficiently detailed reports of receivables ageings and dilutions to ensure compliance with the *firm*'s eligibility criteria and advancing policies governing purchased receivables, and provide an effective means with which to monitor and confirm the seller's terms of sale and dilution.

[**Note**: *BCD* Annex VII Part 4 point 106]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Effectiveness of work-out systems

4.8.13 R A *firm* must have systems and procedures for detecting deteriorations in the seller's financial condition and purchased receivables quality at an early stage, and for addressing emerging problems proactively. In particular a *firm* must have clear and effective policies, procedures, and information systems to monitor covenant violations, and clear and effective policies and procedures for initiating legal actions and dealing with problem purchased receivables.

[**Note**: *BCD* Annex VII Part 4 point 107]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Effectiveness of systems for controlling collateral, credit availability and cash

4.8.14 R A *firm* must have clear and effective policies and procedures governing the control of purchased receivables, credit, and cash. In particular, written internal policies must specify all material elements of the receivables purchase programme, including the advancing rates, eligible collateral, necessary documentation, concentration limits, and the way cash receipts are to be handled. These elements must take appropriate account of all relevant and material factors, including the seller's and servicer's financial condition, risk concentrations, and trends in the quality of the purchased receivables and the seller's customer base, and internal systems must ensure that funds are advanced only against specified supporting collateral and documentation.

[**Note**: *BCD* Annex VII Part 4 point 108]

Risk quantification: Overall requirements for estimation: Minimum requirements for purchased receivables: Compliance with the firm's internal policies and procedures

4.8.15 R A *firm* must have an effective internal process for assessing compliance with all internal policies and procedures. The process must include regular audits of all critical phases of the *firm's* receivables purchase programme, verification of the separation of duties between, firstly, the assessment of the seller and servicer and the assessment of the obligor and, secondly, between the assessment of the seller and servicer and the field audit of the seller and servicer and evaluations of back office operations, with particular focus on qualifications, experience, staffing levels, and supporting automation systems.

[**Note**: *BCD* Annex VII Part 4 point 109]

Calculation of risk-weighted asset amounts: Eligibility for different treatments: Corporate exposures

4.8.16 R For its *corporate exposure* purchased receivables a *firm* must comply with the minimum requirements set out in BIPRU 4.8.11 R - BIPRU 4.8.15 R. For *corporate exposure* purchased receivables that comply in addition with the conditions set out in BIPRU 4.8.18 R, and where it would be unduly burdensome for a *firm* to use the risk quantification standards for *corporate exposures* as set out in the *minimum IRB standards* for these receivables, the risk quantification standards for *retail exposures* as set out in the *minimum IRB standards* may be used.

[**Note**: *BCD* Annex VII Part 1 point 7]

4.8.17 R For *corporate exposure* purchased receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for *default losses*, dilution *losses*, or both, may be treated as first-loss positions under the provisions in BIPRU 9 (Securitisation) about the *IRB approach*.

[**Note**: *BCD* Annex VII Part 1 point 8]

Calculation of risk weighted asset amounts: Eligibility for different treatments: Retail exposures

4.8.18 R To be eligible for the *retail exposure* treatment purchased receivables must comply with the minimum requirements set out in BIPRU 4.8.11 R - BIPRU 4.8.15 R and the following conditions:

(1) the *firm* has purchased the receivables from unrelated, third party sellers, and its *exposure* to the obligor of the receivable does not include any *exposures* that are directly or indirectly originated by the *firm* itself;

(2) the purchased receivables must be generated on an arm's-length basis between the seller and the obligor (and as such, intercompany accounts receivables and receivables subject to contra-accounts between firms that buy and sell to each other are ineligible);

(3) the purchasing *firm* has a claim on all proceeds from the purchased receivables or a pro-rata interest in the proceeds; and

(4) the portfolio of purchased receivables is sufficiently diversified.

[**Note**: *BCD* Annex VII Part 1 point 14]

4.8.19 R With respect to *retail exposures*, for purchased receivables, refundable purchase discounts, collateral or partial guarantees that provide first-loss protection for *default losses*, dilution *losses*, or both, may be treated as first-loss positions under the provisions in BIPRU 9 (Securitisation) about the *IRB approach*.

[**Note**: *BCD* Annex VII Part 1 point 15]

4.8.20 R For hybrid pools of purchased *retail exposure* receivables where the purchasing *firm* cannot separate *exposures* secured by real estate collateral and *qualifying revolving retail exposures* from other *retail exposures*, the retail *risk weight* function producing the highest capital requirements for those *exposures* must apply.

[**Note**: *BCD* Annex VII Part 1 point 16]

Calculation of risk weighted asset amounts for dilution risk

4.8.21 R The *risk weights* for *dilution risk* for purchased receivables (both *corporate exposures* and *retail exposures*) must be calculated according to this *rule*. The *risk weights* must be calculated according to the formula in BIPRU 4.4.58 R. However, for the purposes of that formula, the total annual sales referred to in BIPRU 4.4.59 R are the weighted average by individual *exposures* of the pool. The input parameters *PD* and *LGD* and the *exposure* value must be determined under the applicable provisions of BIPRU 4 as modified by this section. M (maturity) must be 1 year. However:

(1) a *firm* need not recognise *dilution risk* if its *IRB permission* permits this; and

(2) (in the case of a *firm* with an *IRB permission* that permits the treatment of *dilution risk* in (1)) the *firm* must be able to convince the *appropriate regulator* that *dilution risk* is immaterial.

[**Note**: *BCD* Article 87(2) (part) and Annex VII Part 1 point 28]

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Calculation of risk weighted exposure amounts: PDs

4.8.22 R For purchased *corporate exposure* receivables in respect of which a *firm* cannot demonstrate that its *PD* estimates meet the *minimum IRB standards*, the *PDs* for these *exposures* must be determined according to the following methods:

(1) for senior claims on purchased *corporate exposure* receivables *PD* must be the *firm*'s estimate of *EL* divided by *LGD* for these receivables;

(2) for subordinated claims on purchased *corporate exposure* receivables *PD* must be the *firm*'s estimate of *EL*; and

(3) if a *firm* is under its *IRB permission* using the *advanced IRB approach* for *LGD* estimates for *corporate exposures* and it can decompose its *EL* estimates for purchased *corporate exposure* receivables into *PDs* and *LGDs* in a reliable manner, the *LGD* estimate may be used.

[**Note**: *BCD* Annex VII Part 2 point 3]

4.8.23 R In the case of *corporate exposures*, for *dilution risk* of purchased receivables *PD* must be set equal to *EL* estimate for *dilution risk*. If a *firm* is under its *IRB permission* using the *advanced IRB approach* for *LGD* estimates for *corporate exposures* and it can decompose its *EL* estimates for *dilution risk* of purchased *corporate exposure* receivables into *PDs* and *LGDs* in a reliable manner, the *PD* estimate may be used. A *firm* may recognise *unfunded credit protection* in the *PD* in accordance with the provisions of BIPRU 9 and BIPRU 5 as modified by BIPRU 4.10. A *firm* may recognise those *unfunded credit protection* providers set out in its *IRB permission* in addition to those indicated in the *CRM eligibility conditions*. Where a *firm's IRB permission* allows it to use its own *LGD* estimates for *dilution risk* of purchased corporate receivables, the *firm* may recognise *unfunded credit protection* by adjusting *PDs* subject to the provisions of BIPRU 4.4.43 R.

[**Note**: *BCD* Annex VII Part 2 point 7]

4.8.24 R In the case of *retail exposures*, for *dilution risk* of purchased receivables *PD* must be set equal to *EL* estimates for *dilution risk*. If a *firm* can decompose its *EL* estimates for *dilution risk* of purchased receivables into *PDs* and *LGDs* in a reliable manner, the *PD* estimate may be used.

[**Note**: *BCD* Annex VII Part 2 point 19]

Calculation of risk weighted asset amounts: LGDs: Corporate exposures

4.8.25 R The following *LGD* values apply for purchased *corporate exposure* receivables:

(1) for senior purchased *corporate exposure* receivables *exposures* where a *firm* cannot demonstrate that its *PD* estimates meet the *minimum IRB standards*, the value is 45%;

(2) for subordinated purchased *corporate exposure* receivables *exposures* where a *firm* cannot demonstrate that its *PD* estimates meet the *minimum IRB standards*, the value is 100%; and

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(3) for *dilution risk* of purchased *corporate exposure* receivables, the value is 75%.

[**Note**: *BCD* Annex VII Part 2 point 8(e) to (g)]

4.8.26 R Notwithstanding BIPRU 4.4.34 R and BIPRU 4.8.25 R, for *dilution risk* and *default* risk if a *firm* is under its *IRB permission* using the *advanced IRB approach* for *LGD* estimates for *corporate exposures* and it can decompose its *EL* estimates for purchased *corporate exposure* receivables into *PDs* and *LGDs* in a reliable manner, the *LGD* estimate for purchased *corporate exposure* receivables may be used.

[**Note**: *BCD* Annex VII Part 2 point 9]

Calculation of risk weighted asset amounts: LGDs: Retail exposures

4.8.27 R For *dilution risk* of purchased *retail exposure* receivables an *LGD* value of 75% must be used. If a *firm* can decompose its *EL* estimates for *dilution risk* of purchased receivables into *PDs* and *LGDs* in a reliable manner, the *LGD* estimate may be used.

[**Note**: *BCD* Annex VII Part 2 point 21]

Calculation of risk weighted asset amounts: Exposure value

4.8.28 R The *exposure* value for the calculation of *risk weighted exposure amounts* of purchased receivables must be the outstanding amount minus the capital requirements for *dilution risk* prior to *credit risk mitigation*.

[**Note**: *BCD* Annex VII Part 3 point 6]

4.8.29 R

(1) The *exposure* value for the items in (2) must be calculated as the committed but undrawn amount multiplied by a *conversion factor*.

(2) For undrawn purchase commitments for revolving purchased receivables that are unconditionally cancellable or that effectively provide for automatic cancellation at any time by the *firm* without prior notice, a *conversion factor* of 0% applies. To apply a *conversion factor* of 0%, a *firm* must actively monitor the financial condition of the obligor, and its internal control systems must enable it immediately to detect a deterioration in the credit quality of the obligor.

[**Note:** *BCD* Annex VII Part 3 point 9 (c)]

Calculation of expected loss amounts

4.8.30 R The *expected loss* amounts for *dilution risk* of purchased receivables must be calculated according to the following formula:

expected loss (*EL*) = *PD* × *LGD*; and

expected loss amount = *EL* × *exposure* value.

[**Note**: *BCD* Article 88(5) and Annex VII Part 1 point 35]