

## Chapter 5

# Credit risk mitigation

## 5.2 The central principles of credit risk mitigation

**5.2.1** **R** A firm using the *standardised approach* may recognise *credit risk mitigation* in accordance with ■ BIPRU 5 in the calculation of *risk weighted exposure amounts* for the purposes of the calculation of the *credit risk capital component*.

[Note: BCD Article 91]

**5.2.2** **R** The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by a *lending firm* must be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.

[Note: BCD Article 92(1)]

**5.2.3** **R** (1) A firm must not recognise credit protection as eligible until it has conducted sufficient legal review confirming that the credit protection arrangements are legally effective and enforceable in all relevant jurisdictions in accordance with ■ BIPRU 5.2.2 R.

(2) A firm must re-conduct legal reviews as necessary to ensure continuing enforceability and effectiveness.

**5.2.4** **R** A *lending firm* must take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

[Note: BCD Article 92(2)]

### Funded credit protection

**5.2.5** **R** In the case of *funded credit protection*:

(1) to be eligible for recognition the assets relied upon must be sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate *risk weighted exposure amounts* and to the degree of recognition allowed; eligibility is limited to the assets set out in the *CRM eligibility conditions*; and

(2) the *lending firm* must have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy of the obligor – or other credit

event set out in the transaction documentation – and, where applicable, of the custodian holding the collateral; the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor must not be undue.

[Note: BCD Article 92(3) and (4)]

### Treatment of credit linked notes

- 5.2.6 **G** A credit linked note should be treated, to the extent of its cash funding, as *funded credit protection*. Therefore the conditions in ■ BIPRU 5 regulating the eligibility of protection providers for *unfunded credit protection* do not apply. However the other provisions about the requirements for the recognition of *unfunded credit protection* do apply.

### Unfunded credit protection

- 5.2.7 **R** In the case of *unfunded credit protection*:
- (1) to be eligible for recognition the party giving the undertaking must be sufficiently reliable, and the protection agreement legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate *risk weighted exposure amounts* and to the degree of recognition allowed; and
  - (2) eligibility is limited to the protection providers and types of protection agreement set out in the *CRM eligibility conditions*.
- [Note: BCD Article 92(5)]

### Minimum requirements

- 5.2.8 **R** The minimum requirements set out in BIPRU 5 must be complied with.
- [Note: BCD Article 92(6)]
- 5.2.9 **R** A *firm* must be able to satisfy the *appropriate regulator* that it has adequate risk management processes to control the risks to which the *firm* may be exposed as a result of carrying out *credit risk mitigation*. Those processes must include appropriate stress tests and scenario analyses relating to those risks, including residual risk and the risks relating to the intrinsic value of the *credit risk mitigation*.
- [Note: BCD Annex VIII Part 2 point 1]
- 5.2.10 **R** Notwithstanding the presence of *credit risk mitigation* taken into account for the purposes of calculating *risk weighted exposure amounts* and as relevant *expected loss* amounts, a *firm* must continue to undertake full credit risk assessment of the underlying *exposure* and must be in a position to demonstrate to the *appropriate regulator* the fulfilment of this requirement. In the case of *repurchase transactions* and/or *securities or commodities lending or borrowing transactions* the underlying *exposure* must, for the purposes of this *rule* only, be deemed to be the net amount of the *exposure*.
- [Note: BCD Annex VIII Part 2 point 2]

**Calculating the effects of the credit risk mitigation**

- 5.2.11 **R** Where the requirements of ■ BIPRU 5.2.2 R to ■ BIPRU 5.2.8 R are met the calculation of *risk weighted exposure amounts*, may be modified in accordance with ■ BIPRU 5.  
[Note: BCD Article 93(1)]
- 5.2.12 **R** No *exposure* in respect of which *credit risk mitigation* is obtained may produce a higher *risk weighted exposure amount* than an otherwise identical *exposure* in respect of which there is no *credit risk mitigation*.  
[Note: BCD Article 93(2)]
- 5.2.13 **R** Where the *risk weighted exposure amount* already takes account of credit protection under the *standardised approach* the calculation of the credit protection must not be further recognised under ■ BIPRU 5.  
[Note: BCD Article 93(3)]
- 5.2.14 **R** Subject to ■ BIPRU 5.8, ■ BIPRU 5.9 and ■ BIPRU 5.7.27 R to ■ BIPRU 5.7.28 R, where the *CRM eligibility conditions* and the *CRM minimum requirements* are satisfied, the calculation of *risk weighted exposure amounts* under the *standardised approach* may be modified in accordance with the provisions of ■ BIPRU 5.  
[Note: BCD Annex VIII Part 3 point 1]
- 5.2.15 **R** Cash, *securities* or *commodities* purchased, borrowed or received under a *repurchase transaction* or *securities or commodities lending or borrowing transaction* must be treated as collateral.  
[Note: BCD Annex VIII Part 3 point 2]