Chapter 5

Credit risk mitigation

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5.7 Unfunded credit protection

Eligibility

5.7.1 R The following parties may be recognised as eligible providers of *unfunded credit protection*:

(1) central governments and *central banks*;

(2) regional governments or local authorities;

(3) multilateral development banks;

(4) international organisations exposures which are assigned a 0% *risk weight* under the *standardised approach*;

(5) public sector entities, *claims* on which are treated as claims on *institutions* or central governments under the *standardised approach*;

(6) institutions;

(7) other corporate entities, including *parent undertakings*, *subsidiary undertakings* and affiliate corporate entities of the *firm*, that have a credit assessment by an *eligible ECAI* associated with *credit quality step* 2 or above under the *rules* for the *risk weighting* of *exposures* to *corporates* under the *standardised approach*.

[**Note**: *BCD* Annex VIII Part 1 point 26]

Types of credit derivatives

5.7.2 R The following types of credit derivatives, and instruments that may be composed of such credit derivatives or that are economically effectively similar, may be recognised as eligible;

(1) credit default swaps;

(2) total return swaps; and

(3) credit linked notes to the extent of their cash funding.

[**Note**: *BCD* Annex VIII Part 1 point 30]

5.7.3 R Where a *firm* buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection must not be recognised as eligible.

[**Note**: *BCD* Annex VIII Part 1 point 31]

Internal hedges

5.7.4 R When a *firm* conducts an internal hedge using a credit derivative – i.e. hedges the credit risk of an *exposure* in the *non-trading book* with a credit derivative booked in the *trading book* – in order for the protection to be recognised as eligible for the purposes of BIPRU 4.10 or BIPRU 5 the credit risk transferred to the *trading book* must be transferred out to a third party or parties. In such circumstances, subject to the compliance of such transfer with the requirements for the recognition of *credit risk mitigation* set out in BIPRU 4.10 or BIPRU 5, the *rules* for the calculation of *risk weighted exposure amounts* and *expected loss* amounts where *unfunded credit protection* is acquired set out in BIPRU 4.10 or BIPRU 5 must be applied.

[**Note**: *BCD* Annex VIII Part 1 point 32]

Minimum requirements: General

5.7.5 R BIPRU 5.7.6 R to BIPRU 5.7.10 R deal with requirements common to guarantees and credit derivatives.

5.7.6 R Subject to BIPRU 5.7.9 R, for the credit protection deriving from a guarantee or credit derivative to be recognised the following conditions must be met:

(1) the credit protection must be direct;

(2) the extent of the credit protection must be clearly defined and incontrovertible;

(3) the credit protection contract must not contain any clause, the fulfilment of which is outside the direct control of the lender, that:

  (a) would allow the protection provider unilaterally to cancel the protection;

  (b) would increase the effective cost of protection as a result of deteriorating credit quality of the protected *exposure*;

  (c) could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due; or

  (d) could allow the maturity of the credit protection to be reduced by the protection provider; and

(4) it must be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

[**Note**: *BCD* Annex VIII Part 2 point 14]

5.7.7 G For the purposes of BIPRU 5.7.6 R (3)(a), payment of premiums and other monies due under the contract is within the control of the *lending firm*. So a clause that allows the protection provider unilaterally to cancel the contract after a reasonable period due to non payment of such monies will not mean that the condition in that *rule* is not met.

Minimum requirements: Operational requirements

5.7.8 R A *firm* must be able to satisfy the *appropriate regulator* that it has systems in place to manage potential concentration of risk arising from the *firm*'s use of guarantees and credit derivatives. The *firm* must be able to demonstrate how its strategy in respect of its use of credit derivatives and guarantees interacts with its management of its overall risk profile.

[**Note**: *BCD* Annex VIII Part 2 point 15]

Minimum requirements: Sovereign and other public sector counter-guarantees

5.7.9 R Where an *exposure* is protected by a guarantee which is counter-guaranteed by a central government or *central bank*, a regional government or local authority or a *public sector entity* claims on which are treated as claims on the central government in whose jurisdiction they are established under the *standardised approach*, a *multilateral development bank* or an *international organisation*,to which a 0% *risk weight* is assigned under or by virtue of the *standardised approach*, or a *public sector entity*, claims on which are treated as claims on *credit institutions* under the *standardised approach*, the *exposure* may be treated as protected by a guarantee provided by the entity in question provided the following conditions are satisfied:

(1) the counter-guarantee covers all credit risk elements of the claim;

(2) both the original guarantee and the counter-guarantee meet the requirements for guarantees set out in BIPRU 5.7.6 R, BIPRU 5.7.8 R and BIPRU 5.7.11 R, except that the counter-guarantee need not be direct; and

(3) the *firm* is able to satisfy the *appropriate regulator* that the cover is robust and that nothing in the historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct guarantee by the entity in question.

[**Note**: *BCD* Annex VIII Part 2 point 16]

5.7.10 R The treatment of BIPRU 5.7.9 R applies, also, to an *exposure* which is not counter-guaranteed by an entity listed in that *rule* if the *exposure*'s counter-guarantee is in its turn directly guaranteed by one of the listed entities and the conditions listed in BIPRU 5.7.9 R are satisfied.

[**Note**: *BCD* Annex VIII Part 2 point 17]

Additional requirements for guarantees

5.7.11 R For a guarantee to be recognised the following conditions must also be met:

(1) on the qualifying default of and/or non-payment by the counterparty, the *lending firm* must have the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided;

(2) payment by the guarantor must not be subject to the *lending firm* first having to pursue the obligor;

(3) in the case of *unfunded credit protection* covering residential mortgage loans, the requirements in BIPRU 5.7.6 R (3)(c) and in this *rule* have only to be satisfied within 24 months;

(4) the guarantee must be an explicitly documented obligation assumed by the guarantor;

(5) subject to (6), the guarantee must cover all types of payments the obligor is expected to make in respect of the claim; and

(6) where certain types of payment are excluded from the guarantee, the recognised value of the guarantee must be adjusted to reflect the limited coverage.

[**Note**: *BCD* Annex VIII Part 2 point 18]

5.7.12 R In the case of guarantees provided in the context of mutual guarantee schemes recognised for these purposes by another EEA *competent authority* under a *CRD implementation measure* with respect to point 19 of Part 2 of Annex VIII of the *Banking Consolidation Directive* or provided by or counter-guaranteed by entities referred to in BIPRU 5.7.9 R, the requirements in BIPRU 5.7.11 R (1) – (3) will be satisfied where either of the following conditions are met:

(1) the *lending firm* has the right to obtain in a timely manner a provisional payment by the guarantor calculated to represent a robust estimate of the amount of the economic *loss*, including losses resulting from the non-payment of interest and other types of payment which the borrower is obliged to make, likely to be incurred by the *lending firm* proportional to the coverage of the guarantee; or

(2) the *lending firm* is able to demonstrate to the *appropriate regulator* that the loss-protecting effects of the guarantee, including losses resulting from the non-payment of interest and other types of payments which the borrower is obliged to make, justify such treatment.

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

Additional requirements for credit derivatives

5.7.13 R For a credit derivative to be met the following conditions must also be met.

(1) Subject to (2), the credit events specified under the credit derivative must at a minimum include:

(a) the failure to pay the amounts due under the terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with or shorter than the grace period in the underlying obligation);

(b) the bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

(c) the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. value adjustment or other similar debit to the profit and loss account).

(2) Where the credit events specified under the credit derivative do not include restructuring of the underlying obligation as described in (1)(c), the credit protection may nonetheless be recognised subject to a reduction in the recognised value as specified in BIPRU 5.7.16 R.

(3) In the case of credit derivatives allowing for cash settlement a robust valuation process must be in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit-event valuations of the underlying obligation.

(4) If the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.

(5) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection provider. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.

[**Note**: *BCD* Annex VIII Part 2 point 20]

5.7.14 R A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for the purposes of determining cash settlement value or the deliverable obligation) or between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible only if the following conditions are met:

(1) the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be, ranks pari passu with or is junior to the underlying obligation; and

(2) the underlying obligation and the reference obligation or the obligation used for purposes of determining whether a credit event has occurred, as the case may be, share the same obligor (i.e., the same legal entity) and there are in place legally enforceable cross-default or cross-acceleration clauses.

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

Unfunded credit protection: Valuation

5.7.15 R BIPRU 5.7.16 R to BIPRU 5.7.19 R set out the provisions applying to the valuation of *unfunded credit protection*.

5.7.16 R (1) The value of *unfunded credit protection* (G) is the amount that the protection provider has undertaken to pay in the event of the default or non-payment of the borrower or on the occurrence of other specified credit events.

(2) In the case of credit derivatives which do not include as a credit event restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that result in a credit loss event (e.g. value adjustment, the making of a value adjustment or other similar debit to the profit and loss account):

(a) where the amount that the protection provider has undertaken to pay is not higher than the *exposure* value, the value of the credit protection calculated under (1) must be reduced by 40%; or

(b) where the amount that the protection provider has undertaken to pay is higher than the *exposure* value, the value of the credit protection must be no higher than 60% of the *exposure* value.

[**Note**: *BCD* Annex VIII Part 3 point 83]

5.7.17 R Where *unfunded credit protection* is denominated in a currency different from that in which the *exposure* is denominated (a currency mismatch) the value of the credit protection must be reduced by the application of a volatility adjustment H_{FX} as follows:

$G^* = G \times (1-H_{FX})$

where:

(1) G is the nominal amount of the credit protection;

(2) G^* is G adjusted for any *foreign currency* risk; and

(3) H_{fx} is the volatility adjustment for any currency mismatch between the credit protection and the underlying obligation.

[**Note**: *BCD* Annex VIII Part 3 point 84 (part)]

5.7.18 R Where there is no currency mismatch:

$G^* = G$

[**Note**: *BCD* Annex VIII Part 3 point 84 (part)]

5.7.19 R The volatility adjustments to be applied for any currency mismatch may be calculated based on the *supervisory volatility adjustments approach* or the *own estimates of volatility adjustments approach* as set out in BIPRU 5.4.30 R to BIPRU 5.4.65 R.

[**Note**: *BCD* Annex VIII Part 3 point 85]

Calculating risk weighted exposure amounts and expected loss amounts

5.7.20 R BIPRU 5.7.21 R to BIPRU 5.7.28 R set out the provisions applying to the calculation of *risk weighted exposure amounts*.

Calculating risk weighted exposure amounts: Partial protection – tranching

5.7.21 R Where a *firm* transfers a part of the risk of a loan in one or more *tranches*, BIPRU 9 applies. Materiality thresholds on payments below which no payment shall be made in the event of loss are considered to be equivalent to retained first loss positions and to give rise to a *tranched* transfer of risk.

[**Note**: *BCD* Annex VIII Part 3 point 86]

Calculating risk-weighted exposure amounts : The standardised approach

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5.7.22 R BIPRU 5.7.23 R to BIPRU 5.7.25 R set out the provisions applying to the calculation of *risk weighted exposure amounts* under the *standardised approach* in the case of *unfunded credit protection*.

Calculating risk weighted exposure amounts: standardised approach: Full protection

5.7.23 R For the purposes of BIPRU 3.2.20 R to BIPRU 3.2.26 R, g shall be the *risk weight* to be assigned to an *exposure*, the *exposure* value (E) of which is fully protected by *unfunded credit protection* (G_A), where:

(1) g is the *risk weight* of *exposures* to the protection provider as specified under the *standardised approach*;

(2) G_A is the value of G^* as calculated under BIPRU 5.7.17 R further adjusted for any maturity mismatch as laid down in BIPRU 5.8; and

(3) E is the *exposure* value according to BIPRU 3.2.1 R to BIPRU 3.2.3 R and BIPRU 13; for this purpose the *exposure* value of an off-balance sheet item listed in BIPRU 3.7.2 R shall be 100% of its value rather than the *exposure* value indicated in BIPRU 3.2.1 R.

[**Note**: *BCD* Annex VIII Part 3 point 87]

Calculating risk weighted exposure amounts: Standardised approach: Partial protection – equal seniority

5.7.24 R Where the protected amount is less than the *exposure* value and the protected and unprotected portions are of equal seniority – i.e. the *firm* and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief is afforded. For the purposes of BIPRU 3.2.20 R to BIPRU 3.2.26 R *risk weighted exposure amounts* must be calculated in accordance with the following formula:

$(E-G_A) \text{ x } r + G_A \text{ x } g$

where:

(1) E is the *exposure* value; according to BIPRU 3.2.1 R to BIPRU 3.2.3 R and BIPRU 13; for this purpose, the *exposure* value of an off-balance sheet item listed in BIPRU 3.7.2 R shall be 100% of its value rather than the *exposure* value indicated in BIPRU 3.2.1 R;

(2) G_A is the value of G^* as calculated under BIPRU 5.7.17 R further adjusted for any maturity mismatch as laid down in BIPRU 5.8;

(3) r is the *risk weight* of *exposures* to the obligor as specified under the *standardised approach*; and

(4) g is the *risk weight* of *exposures* to the protection provider as specified under the *standardised approach*.

[**Note**: *BCD* Annex VIII Part 3 point 88]

Calculating risk weighted exposure amounts: standardised approach: Sovereign guarantees

5.7.25 R A *firm* may apply the treatment provided for in BIPRU 3.4.5 R to BIPRU 3.4.7 R to *exposures* or parts of *exposures* guaranteed by the central government or *central bank*, where the guarantee is denominated in the domestic currency of the borrower and the *exposure* is funded in that currency.

[**Note**: *BCD* Annex VIII Part 3 point 89]

Calculating risk-weighted exposure amounts and expected loss amounts: Basket CRM techniques

5.7.26 R BIPRU 5.7.27 R to BIPRU 5.7.28 R set out the provisions applying to the calculation of *risk weighted exposure amount* and *expected loss* amounts where basket *credit risk mitigation* techniques are used.

First-to-default credit derivatives

5.7.27 R Where a *firm* obtains credit protection for a number of *exposures* under terms that the first default among the *exposures* will trigger payment and that this credit event will terminate the contract, the *firm* may modify the calculation of the *risk weighted exposure amount* and, as relevant, the *expected loss* amount of the *exposure* which would in the absence of the credit protection produce the lowest *risk weighted exposure amount* under the *standardised approach* or the *IRB approach* as appropriate in accordance with BIPRU 4.10 or BIPRU 5, but only if the *exposure* value is less than or equal to the value of the credit protection.

[**Note**: *BCD* Annex VIII Part 6 point 1]

Nth-to-default credit derivatives

5.7.28 R Where the nth default among the *exposures* triggers payment under the credit protection provided by a credit derivative, a *firm* purchasing the protection may only recognise the protection for the calculation of *risk weighted exposure amounts* and, as relevant, *expected loss* amounts if protection has also been obtained for defaults 1 to n-1 or when n-1 defaults have already occurred. In such cases the methodology must follow that set out in BIPRU 5.7.27 R for first-to-default derivatives appropriately modified for nth-to-default products.

[**Note**: *BCD* Annex VIII Part 6 point 2]