Chapter 4

Capital resources

4.2C Credit risk mitigation

Application

4.2C.1 R This section applies to a *firm* carrying on any *home financing* connected to *regulated mortgage contracts* or *home financing* and *home financing administration* connected to *regulated mortgage contracts* see MIPRU 4.2.23 R where it applies credit risk mitigation to the calculation of its *risk weighted exposure amounts* under MIPRU 4.2A (Credit risk capital requirement).

Purpose

4.2C.2 G MIPRU 4.2C sets out the provisions a *firm* should comply with when calculating *risk weighted exposure amounts* for calculating the *credit risk capital requirement* under MIPRU 4.2.23 R.

Organisation

4.2C.2A G This section is organised as follows:

(1) High-level principles (MIPRU 4.2C.5 R to MIPRU 4.2C.9 R)

(2) Minimum operational requirements (MIPRU 4.2C.10 R to MIPRU 4.2C.15 R)

(3) Eligibility (MIPRU 4.2C.16 R)

(4) Calculating the effects of credit risk mitigation (MIPRU 4.2C.17 R to MIPRU 4.2C.31 G)

(5) Sovereign guarantees (MIPRU 4.2C.32 R)

(6) Combinations of credit risk mitigation (MIPRU 4.2C.33 R to MIPRU 4.2C.34 R)

4.2C.3 R

4.2C.4 R

High-level principles

4.2C.5 R A *firm* may recognise credit risk mitigation under this section in calculating *risk weighted exposure amounts* for calculating the *credit risk capital requirement*.

4.2C.6 R

(1) If a *firm* transfers part of the risk of a loan in one or more *tranches*, MIPRU 4.2BA (Securitisation) applies.

(2) Materiality thresholds below which no payment shall be made by the provider of credit protection 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.

4.2C.7 R The technique used to provide credit protection, together with the actions and steps taken and procedures and policies implemented by a *firm*, must result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.

4.2C.8 R

(1) A *firm* must not recognise credit protection as eligible until it has conducted an adequate legal review confirming that the credit protection arrangements are legally effective and enforceable in all relevant jurisdictions, in accordance with MIPRU 4.2C.7 R.

(2) A *firm* must conduct further legal reviews as necessary, to ensure continuing enforceability and effectiveness.

4.2C.9 R A *firm* must take steps to ensure the effectiveness of the credit protection arrangement and to address related risks.

Minimum requirements: operational

4.2C.10 R

(1) A *firm* must satisfy the *FCA* that it has adequate risk management processes to control the risks to which it may be exposed as a result of carrying out *credit risk mitigation*.

(2) These 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.

4.2C.11 R A *firm* must:

(1) satisfy the *FCA* that it has systems to manage risks arising from its use of credit protection; and

(2) demonstrate how its strategy on the use of credit protection interacts with the *firm's* management of its overall risk profile.

4.2C.12 R Even where a *firm* recognises credit risk mitigation when calculating *risk weighted exposure amounts*, it must:

(1) continue to undertake full credit-risk assessment of the underlying *exposure*; and

(2) demonstrate to the *FCA* the fulfilment of the requirement in (1).

Minimum requirements: effectiveness

4.2C.13 R For credit protection to be recognised, the following conditions must be met:

(1) it 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 which is outside the direct control of the lender to fulfil and which:

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

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

(c) could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original borrower 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.

4.2C.14 G A clause that allows the protection provider unilaterally to cancel the contract after a reasonable period due to non-payment of premiums and other monies due under the contract will not normally indicate non-compliance with MIPRU 4.2C.13R (3)(a). The reason is that payment of such monies is within the control of the *firm*.

4.2C.15 R For a guarantee, including those in the form of mortgage indemnity products, to be recognised, the following conditions must be met in addition to those in MIPRU 4.2C.13 R:

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

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

(3) for credit protection covering residential mortgage loans, the requirement in MIPRU 4.2C.13R (3)(c) and in this *rule* have only to be satisfied within 24 months;

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

(5) unless (6) applies, the guarantee must cover all types of payments the borrower is expected to make in respect of the claim, such as principal, interest payments and fees; 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.

Eligibility

4.2C.16 R For *unfunded credit protection*:

(1) to be eligible for recognition:

(a) the party giving the undertaking must be sufficiently reliable; and

(b) the protection agreement must be 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) protection must be provided by central governments or *central banks*.

Calculating the effects of credit risk mitigation

4.2C.17 R The calculation of *risk weighted exposure amounts* may be modified in accordance with this section where a *firm* has complied with MIPRU 4.2C.7 R to MIPRU 4.2C.16 R.

4.2C.18 R No *exposure* for which credit risk mitigation is obtained may produce a higher *risk weighted exposure amount* than an otherwise identical *exposure* for which there is no credit risk mitigation.

4.2C.19 R Where the *risk weighted exposure amount* already takes account of credit protection, the calculation of the credit protection must not be further recognised under MIPRU 4.2C (Credit risk mitigation).

Valuation

4.2C.20 R The value of *unfunded credit protection* is the amount that the protection provider has undertaken to pay in the event of the default of, or non-payment by, the borrower or on the occurrence of other specified credit events.

Currency mismatches

4.2C.21 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 HFX as follows:

$G^* = G \times (1\text{-}HFX)$

where:

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

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

(3) HFX is the volatility adjustment for any currency mismatch between the credit protection and the underlying obligation.

4.2C.22 R For the purpose of MIPRU 4.2C.21 R, HFX is set at 10%.

4.2C.23 R For the purpose of MIPRU 4.2C.21 R, where there is no currency mismatch:

G* = G

Maturity mismatches

4.2C.24 R (1) In calculating *risk weighted exposure amounts*, a maturity mismatch occurs where the residual maturity of the credit protection is less than that of the protected *exposure*.

(2) Protection of less than three months residual maturity, the maturity of which is less than the maturity of the underlying *exposure*, must not be recognised.

4.2C.25 R Where there is a maturity mismatch the credit protection must not be recognised if the original maturity of the protection is less than one year.

4.2C.26 R (1) Subject to a maximum of five years, the effective maturity of the underlying *exposure* is the longest possible remaining time before the borrower is scheduled to fulfil its obligations.

(2) Unless MIPRU 4.2C.27 R applies, the maturity of the credit protection is the length of time to the earliest date at which the protection may terminate or be terminated.

4.2C.27 R (1) Where there is an option to terminate the protection which is at the discretion of the protection seller, the maturity of the protection must be taken to be the length of time to the earliest date at which that option may be exercised.

(2) Where there is an option to terminate the protection which is at the discretion of the protection buyer and the terms of the arrangement at the origination of the protection contain a positive incentive for the *firm* to call the transaction before contractual maturity, the maturity of the protection must be taken to be the length of time to the earliest date at which that option may be exercised; otherwise such an option may be considered not to affect the maturity of the protection.

4.2C.28 R (1) The maturity of the credit protection and that of the *exposure* must be reflected in the adjusted value of the credit protection according to the following formula:

GA = G* x (t-t*)/(T-t*)

where:

(a) G* is the amount of the protection adjusted for any currency mismatch;

(b) GA is G* adjusted for any maturity mismatch;

(c) t is the number of years remaining to the maturity date of the credit protection calculated in accordance with MIPRU 4.2C.27 R to MIPRU 4.2C.28 R, or the value of T, whichever is the lower;

(d) T is the number of years remaining to the maturity date of the *exposure* calculated in accordance with MIPRU 4.2C.27 R to MIPRU 4.2C.28 R, or five years, whichever is the lower; and

(e) t* is 0.25.

(2) GA is then taken as the value of the credit protection for the purposes of MIPRU 4.2C.6 R, MIPRU 4.2C.21 R to MIPRU 4.2C.23 R and MIPRU 4.2C.29 R to MIPRU 4.2C.31 G.

Full protection

4.2C.29 R Under MIPRU 4.2A.9 R, MIPRU 4.2A.12 R, MIPRU 4.2A.17A R and MIPRU 4.2A.17B R, g is the *risk weight* to be assigned to an *exposure*, the *exposure* value (E) of which is fully protected by *unfunded credit protection* (GA), where:

(1) g is the *risk weight* of *exposures* to the protection provider;

(2) GA is the value of G* as calculated under MIPRU 4.2C.22 R further adjusted for any maturity mismatch under MIPRU 4.2C.24 R to MIPRU 4.2C.28 R; and

(3) E is the *exposure* value according to MIPRU 4.2A.6 R.

Partial protection: equal seniority

4.2C.30 R (1) Proportional regulatory capital relief is afforded if:

(a) the protected amount is less than the *exposure* value; and

(b) the protected and unprotected portions are of equal seniority, i.e. the *firm* and the protection provider share losses on a pro-rata basis.

(2) Under MIPRU 4.2A.9 R, MIPRU 4.2A.12 R, MIPRU 4.2A.17A R and MIPRU 4.2A.17B R, *risk weighted exposure amounts* must be calculated in accordance with the following formula:

(E-GA) x r + GA x g

where:

(a) E is the *exposure* value according to MIPRU 4.2A.6 R;

(b) GA is the value of G* as calculated under MIPRU 4.2C.21 R further adjusted for any maturity mismatch under MIPRU 4.2C.24 R to MIPRU 4.2C.28 R;

(c) r is the *risk weight* of *exposures* to the borrower; and

(d) g is the *risk weight* of *exposures* to the protection provider.

4.2C.31 G Where the protected and unprotected portions of the *exposure* are not of equal seniority, MIPRU 4.2C.6 R applies.

Sovereign guarantees

4.2C.32 R A *firm* may assign a *risk weight* of 0% to *exposures* or parts of *exposures* guaranteed by the *UK* government or its *central bank* if the following conditions are met:

(1) the guarantee is denominated in the domestic currency of the borrower; and

(2) the *exposure* is funded in that currency.

Combinations of credit risk mitigation

4.2C.33 R Where a *firm* calculating *risk weighted exposure amounts* has more than one form of credit risk mitigation covering a single *exposure*:

(1) it must divide the *exposure* into parts covered by each type of credit risk mitigation; and

(2) the *risk weighted exposure amount* for each portion must be calculated separately in accordance with MIPRU 4.2A (Credit risk capital requirement).

4.2C.34 R When credit protection provided by a single protection provider has differing maturities, a similar approach to that described in MIPRU 4.2C.33 R must be applied.