Chapter 4

Capital resources

4

4.2F Exposures and risk weights

Application

4.2F.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).

Purpose

4.2F.2 R ■ MIPRU 4.2F sets out the *risk weights* that a *firm* should apply to *exposures* in the form of loans secured on real estate property, other loans, *exposures* in the form of *funds*, and past due items, when calculating *risk weighted exposure amounts* for calculating the *credit risk capital requirement* under ■ MIPRU 4.2.23 R.

Organisation

4.2F.3 G This section is broadly organised according to the type of exposure class.

(1) Exposures secured by mortgages on residential property (■ MIPRU 4.2F.4 R to ■ MIPRU 4.2F.36 R)

(2) Exposures secured by mortgages on commercial property (■ MIPRU 4.2F.37 R)

(3) Exposures to other loans (■ MIPRU 4.2F.38 R)

(4) Exposures to funds (■ MIPRU 4.2F.39 R to ■ MIPRU 4.2F.49 R)

(5) Exposures to past due items (■ MIPRU 4.2F.50 R to ■ MIPRU 4.2F.56 G)

Exposures secured by mortgages on residential property

4.2F.4 R Without prejudice to ■ MIPRU 4.2F.36 R, an *exposure* or any part of an *exposure* must be assigned a *risk weight* of 35% where:

(1) the *exposure* is fully and completely secured, to the satisfaction of the *firm*, by mortgages on residential property; and

(2) the residential property is, or will be, occupied or let by the owner or the beneficial owner in the case of personal investment companies.

4.2F.5 R Without prejudice to ■ MIPRU 4.2F.36 R, an *exposure*, or any part of an *exposure*, must be assigned a *risk weight* of 75% where:

(1) the *exposure* arises from a mortgage on residential property up to a limit of 100% of the value of the property which is not fully and completely secured, to the satisfaction of the *firm*, by that mortgage; and

(2) the residential property is, or will be, occupied or let by the owner or the beneficial owner in the case of personal investment companies.

4.2F.6 R An *exposure* or any part of an *exposure* must be assigned a *risk weight* of 100% where the *exposure* arises from a mortgage on residential property that exceeds the value of the available collateral, as assessed in accordance with ■ MIPRU 4.2F.29 R.

Exposures secured by mortgages on residential property: lifetime mortgages

4.2F.7 R (1) A *firm* must not treat a *lifetime mortgage* as an *exposure* fully and completely secured on residential property for the purposes of ■ MIPRU 4.2F.4 R unless the amount of the *exposure* is calculated according to the following formula:

$$\textit{exposure}\ \text{amount} = P\frac{(1+i)^T}{(1+d)^T}$$

where:

(a) *P* is the current outstanding balance on the *lifetime mortgage*;

(b) *i* is the interest rate charged on the *lifetime mortgage*, which for the purposes of this calculation must not be lower than the discount rate referred to in (c);

(c) *d* is the discount rate which is the risk-free rate as represented by the yield on 10-year *UK* government bonds; and

(d) *T* is the projected number of years to maturity of the *exposure*.

(2) Notwithstanding ■ MIPRU 4.2F.7R (1)(c), a *firm* may calculate an annual average discount rate, provided there is no obvious bias in its calculation and it is consistent in its approach.

4.2F.8 G (1) For the purposes of ■ MIPRU 4.2F.7R (2), a *firm* may use the FTSE *UK* gilt 10-year yield index which the Council of Mortgage Lenders makes available to its members.

(2) If a *firm* offers a variable interest rate on a *lifetime mortgage*, it should calculate an average interest rate in a way which is consistent with the calculation of the discount rate.

(3) To determine the projected number of years to maturity of the *exposure*, a *firm* may use the standard mortality tables published by the Institute of Actuaries or the Faculty of Actuaries.

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(4) For internal risk management purposes, the *firm* should use factual data or seek actuarial advice to determine how the information in these tables may be adjusted to take account of regional and other relevant variations.

Exposures secured by property leasing transactions

4.2F.9 R Without prejudice to ■ MIPRU 4.2F.36 R, an *exposure*, or any part of an *exposure*, to a tenant under a property leasing transaction must be assigned a *risk weight* of 35% where:

(1) the transaction concerns residential property;

(2) under the transaction, the *firm* is the lessor and the tenant has an option to purchase; and

(3) the *firm* is satisfied that the *exposure* is fully and completely secured by its ownership of the property.

4.2F.10 G An Ijara mortgage is an example of an *exposure* described in ■ MIPRU 4.2F.9 R.

Conditions for mortgages

4.2F.11 R (1) In exercising its judgment under ■ MIPRU 4.2F.4 R to ■ MIPRU 4.2F.9 R, a *firm* may be satisfied only if the conditions in (2) to (6) are met.

(2) (a) The value of the property does not materially depend upon the credit quality of the borrower.

(b) The condition in (a) does not preclude situations where purely macroeconomic factors affect both the value of the property and the performance of the borrower.

(3) The minimum requirements about:

(a) legal certainty in ■ MIPRU 4.2F.12 R;

(b) monitoring of property values in ■ MIPRU 4.2F.14 R;

(c) documentation in ■ MIPRU 4.2F.20 R; and

(d) insurance in ■ MIPRU 4.2F.21 R;

are met.

(4) The valuation provisions in ■ MIPRU 4.2F.26 G to ■ MIPRU 4.2F.29 R are met.

(5) The value of the property exceeds the *exposures* by a substantial margin, as set out in ■ MIPRU 4.2F.29 R.

Legal certainty

4.2F.12 R The requirements about legal certainty referred to in ■ MIPRU 4.2F.11R (3)(a) are as follows:

(1) the mortgage or charge must be enforceable in all relevant jurisdictions which are relevant at the time of conclusion of the credit

agreement, and the mortgage or charge must have been properly filed on a timely basis;

(2) the arrangements must reflect a perfected lien (i.e. all legal requirements for establishing the pledge must have been fulfilled); and

(3) the protection agreement and the legal process underpinning it must enable the *firm* to realise the value of the protection within a reasonable timeframe.

4.2F.13 G The term 'protection agreement' in ■ MIPRU 4.2F.12R (3) refers to the contract or deed by which the mortgage or charge is established.

Monitoring of property values

4.2F.14 R (1) The requirements about monitoring of property values referred to in ■ MIPRU 4.2F.11R (3)(b) are as follows:

(a) the value of the property must be monitored on a frequent basis and, at a minimum, once every three years;

(b) more frequent monitoring must be carried out where the market is subject to significant changes in conditions;

(c) statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;

(d) the property valuation must be reviewed promptly by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and

(e) for loans exceeding the higher of £2.5 million or 5% of the *capital resources* of the *firm*, the property valuation must be reviewed by an independent valuer at least every three years.

(2) In (1), 'independent valuer' means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

4.2F.15 G A property will need to be revalued over time to ensure that the original purchase price does not overstate the degree of security provided by the property. Ijara providers should undertake revaluations in the same way as providers of conventional mortgages.

4.2F.16 G For ■ MIPRU 4.2F.14R (1)(a), the monitoring of property values should be an ongoing part of risk managing and tracking the portfolio. The requirement to monitor property values does not include the physical assessment of each property in the portfolio.

4.2F.17 G For ■ MIPRU 4.2F.14R (1)(d) and ■ MIPRU 4.2F.14R (1)(e), the review of a property valuation is more in-depth than the normal monitoring process required by ■ MIPRU 4.2F.14R (1)(a). This requirement is likely to include a review of the property value on an individual *exposure* basis. Where an *exposure* is secured

by multiple properties, the review can be undertaken at the level of the *exposure*, rather than at the level of each individual property.

4.2F.18 G The review of property values required by ■ MIPRU 4.2F.14R (1)(e) may lead to an amendment of the value assigned to the property under ■ MIPRU 4.2F.29 R.

4.2F.19 G For ■ MIPRU 4.2F.14R (2), necessary qualifications need not be professional qualifications, but the *firm* should be able to demonstrate that the person has the necessary ability and experience to undertake the review.

Documentation

4.2F.20 R The requirements in ■ MIPRU 4.2F.11R (3)(c) are that the types of residential real estate accepted by the *firm* and its lending policies in this regard must be clearly documented.

Insurance

4.2F.21 R The requirements about insurance in ■ MIPRU 4.2F.11R (3)(d) are that the *firm* must have procedures to monitor that the property taken as protection is adequately insured against damage.

4.2F.22 G For ■ MIPRU 4.2F.12 R, a *firm* should, as a minimum, ensure that it is a requirement of each loan that the property taken as collateral must have adequate buildings insurance at all times, which should be reviewed when any new loan is extended against the property.

4.2F.23 G A *firm* may deal with the risk that insurance on properties taken as protection may be inadequate by taking out insurance at the level of the portfolio.

Valuation rules

4.2F.24 G The valuation provisions in ■ MIPRU 4.2F.11R (4) are set out in ■ MIPRU 4.2F.25 R to ■ MIPRU 4.2F.29 R.

4.2F.25 R The property must be valued by an independent valuer at or less than the market value using reliable standards for the valuation of residential property.

4.2F.26 G For ■ MIPRU 4.2F.25 R:

(1) reliable standards for the valuation of residential property include internationally recognised valuation standards, in particular those developed by the International Valuation Standards Committee (IVSC), the European Group of Valuers' Associations (EGoVA) or the Royal Institution of Chartered Surveyors (RICS) as well as the standards in ■ MIPRU 4.2F.27 R to ■ MIPRU 4.2F.29 R; and

(2) the requirement to use reliable standards of valuation of residential property is not limited to on-site inspections where it is possible to demonstrate that any risks posed have been adequately assessed through the overall collateral management process.

4.2F.27 R

(1) Market value means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing, where the parties had each acted knowledgeably, prudently and without compulsion.

(2) The market value must be documented in a transparent and clear manner.

4.2F.28 R

(1) Mortgage lending value means the value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, and the current use and alternative appropriate uses of the property.

(2) Speculative elements must not be taken into account in the assessment of the mortgage lending value.

(3) The mortgage lending value must be documented in a transparent and clear manner.

4.2F.29 R

The value of the collateral must be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under ■ MIPRU 4.2F.11R (3)(b) and ■ MIPRU 4.2F.14 R and to take account of any prior claims on the property, such as a first-charge mortgage from another lender.

Treatment of secured and unsecured portions of residential mortgages

4.2F.30 R

A *firm* may not treat an *exposure* as fully and completely secured by residential property located in the *United Kingdom* for ■ MIPRU 4.2F.4 R (residential mortgages) or ■ MIPRU 4.2F.9 R (property leasing transactions) unless either of the following is 80% or less of the value of the residential property on which it is secured:

(1) the amount of the *exposure*;

(2) the secured part of the exposure in ■ MIPRU 4.2F.4 R or ■ MIPRU 4.2F.9 R.

4.2F.31 G

(1) The application of ■ MIPRU 4.2F.30 R may be illustrated by an example. If a *firm* has a mortgage *exposure* of £100,000 secured on residential property in the *United Kingdom* that satisfies the criteria listed in ■ MIPRU 4.2F.4 R to ■ MIPRU 4.2F.9 R and the value of that property is £100,000, then £80,000 of that *exposure* may be treated as fully and completely secured and *risk weighted* at 35%. The remaining £20,000 should be *risk weighted* at 75%. A diagrammatic illustration of this example is in ■ MIPRU 4.2F.31G (2).

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(2) A diagrammatic illustration of the example in ■ MIPRU 4.2F.31G (1).

Unsecured component *risk weighted* **at 75%**	Example
Secured component *risk weighted* **at 35%**	£100,000 loan secured on residential property valued at £100,000 First £80,000 (i.e. 80% LTV) *risk weighted* at 35% Remaining £20,000 (i.e. above 80% LTV) *risk weighted* at 75% Overall *risk weight* is 43%

(3) The same approach applies to *exposures* described in ■ MIPRU 4.2F.9 R. On inception, a *risk weight* of 35% should be applied to the first 80% of the principal/"purchase price" outstanding, with a *risk weight* of 75% being applied to the remainder of the principal *exposure*.

4.2F.32 G If a *firm* has more than one *exposure* secured on the same property they should be aggregated and treated as if they were a single *exposure* secured on the property for the purposes of ■ MIPRU 4.2F.4 R, ■ MIPRU 4.2F.9 R and ■ MIPRU 4.2F.30 R.

4.2F.33 R If a *firm* has an *exposure* arising through a second-charge mortgage secured on the same property as a first-charge loan from a different *firm*, the *exposure*, taking into account the first-charge mortgage, must be split into the following components and *risk weighted* as follows, after taking into account the seniority of the first-charge loan:

(1) the amount of the *exposure* or any part of the *exposure*, up to a limit of 80% of the value of the residential property, must be assigned a *risk weight* of 35% where:

(a) the *exposure* is fully and completely secured, to the satisfaction of the *firm*, by a mortgage on residential property; and

(b) the residential property is, or will be, occupied or let by the owner, or the beneficial owner in the case of personal investment companies; and

(2) the amount of the same *exposure* that is unsecured, above 80% of the value of the residential property up to a limit of 100% of the value of the residential property, must be assigned a *risk weight* of 75%; and

(3) any remaining part of the *exposure*, above 100% of the value of the property, must be assigned a *risk weight* of 100%.

4.2F.34 G (1) The application of ■ MIPRU 4.2F.33 R may be illustrated by an example. Where a first-charge mortgage exposure of £50,000 from another lender is secured on residential property in the *United Kingdom* that satisfies the criteria in ■ MIPRU 4.2F.4 R to ■ MIPRU 4.2F.29 R and the value of that property is £100,000, then a *firm* with a second-charge mortgage of £60,000 on the same property may treat £30,000 of that *exposure* as fully and completely secured and *risk weight* it at 35%,

treat a further £20,000 as unsecured and *risk weight* it at 75%, and *risk weight* the remaining £10,000 at 100%. A diagrammatic illustration of this example is in (2).

(2) A diagrammatic illustration of the example in (1)

Property value	Exposure and risk weightings	Example
£100,000	£10,000 of second-charge - risk weighted at 100%	• Remaining second-charge mortgage, i.e. £10,000
	£20,000 of second-charge - risk weighted at 75%	• Second-charge mortgage up to maximum of 100% of property value, i.e. £20,000
	£30,000 of second-charge - risk weighted at 35%	• Second-charge mortgage up to maximum of 80% of property value, i.e. £30,000
	First-charge mortgage (£50,000)	• Other lender has first-charge over property with outstanding loan balance of £50,000

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4.2F.35 G If an *exposure* is secured on property that is used partly for residential purposes under ■ MIPRU 4.2F.4 R and partly for commercial purposes (such as a farm, public house, guest house or shop) it may be treated as secured by residential real estate if the *firm* can demonstrate that:

(1) the property's main use is, or will be, residential; and

(2) the value of the property is not significantly affected by its commercial use.

4.2F.36 R *Exposures* to residential property situated in a *third-country* must be assigned a *risk weight* of 75% up to a limit of 100% of the value of the property.

Exposures secured by mortgages on commercial property

4.2F.37 R *Exposures*, or any part of an *exposure*, secured by mortgages on offices or other commercial premises must be assigned a *risk weight* of 100% where the *exposure*:

(1) cannot properly be considered to fall within any other standardised credit risk *exposure* class specified in ■ MIPRU 4.2A.6A R (Exposure classes); or

(2) does not qualify for a lower *risk weight* under this section.

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Exposures to other loans

4.2F.38 R *Exposures* to other loans must be assigned a *risk weight* of 100%.

Exposures to funds

4.2F.39 R Except where a different *risk weight* is assigned to exposures in the form of *funds* by ■ MIPRU 4.2F.40 R, ■ MIPRU 4.2F.42 R or ■ MIPRU 4.2F.45 R, these exposures must be assigned a *risk weight* of 100%.

4.2F.40 R *Exposures* in the form of *funds* for which a credit assessment by a *nominated ECAI* is available must be assigned a *risk weight* using:

(1) the table in ■ MIPRU 4.2E.14 R to determine the *credit quality step* associated with that credit assessment; and

(2) the table in ■ MIPRU 4.2F.41 R to determine the *risk weight* to be applied to the *rated position*, based on the associated *credit quality step*.

4.2F.41 R Table: Exposures in the form of funds for which a credit assessment by a nominated ECAI is available

This table belongs to ■ MIPRU 4.2F.40 R.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

4.2F.42 R Where a *firm* considers that a position in a *fund* is associated with particularly high risks, it must assign that position a *risk weight* of 150%.

4.2F.43 G A *firm* should consider a *fund* as being high risk where there is no external credit assessment from an *eligible ECAI* and where the *fund* has specific features (such as high levels of leverage or lack of transparency).

4.2F.44 G Other examples of high-risk *funds* are:

(1) those in which a substantial element of the *fund's* property is made up of items that would attract a *risk weight* of over 100%; and

(2) those whose mandate (as referred to in ■ MIPRU 4.2F.46 R would permit it to invest in a substantial amount of items that would attract a *risk weight* of over 100%.

4.2F.45 R If the eligibility criteria in ■ MIPRU 4.2F.46 R are met, a *firm* must decide whether to:

(1) assign a 100% *risk weight* to its *exposures* in *funds*, as required by ■ MIPRU 4.2F.39 R; or

(2) determine the *risk weight* for an *exposure* in *funds*, as set out in ■ MIPRU 4.2F.47 R to ■ MIPRU 4.2F.48 R.

4.2F.46 R The eligibility criteria in ■ MIPRU 4.2F.45 R are:

(1) the *fund's* prospectus or equivalent document includes:

(a) the categories of assets in which the *fund* is authorised to invest; and

(b) if investment limits apply, the relative limits and the methodologies to calculate them; and

(2) the business of the *fund* is reported on at least an annual basis to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period.

4.2F.47 R Where a *firm* is not aware of the underlying *exposures* of a *fund*, it may calculate an average *risk weight* for the *fund* in the following manner:

(1) it will be assumed that the *fund* first invests, to the maximum extent allowed under its mandate, in the *exposure* classes attracting the highest *capital resources requirement*; and

(2) then continues making investments in descending order until the maximum total investment limit is reached.

4.2F.48 R A *firm* may rely on a third party to calculate and report, in accordance with the method in ■ MIPRU 4.2F.47 R, a *risk weight* for the *fund*, provided that the correctness of the calculation and report is adequately ensured.

4.2F.49 R *Exposures* in the form of funds that are not past due items, that have been assigned a *risk weight* of 150% or greater, and for which value adjustments have been established, may be assigned a *risk weight* of:

(1) 100% if value adjustments are no less than 20% of the *exposure* value gross of value adjustments; or

(2) 50%, if value adjustments are no less than 50% of the *exposure* value gross of value adjustments

Exposures to past due items

4.2F.50 R *Exposures* must be treated as past due in their entirety where any payment due is past its contractual date by more than 90 days.

Exposures to past due item: treatment of secured part of mortgages on residential property

4.2F.51 R Where value adjustments are taken against the secured part of an *exposure* secured by a mortgage on residential property and that is past due, the secured part net of value adjustments must be assigned a *risk weight* of:

(1) 100% if value adjustments are less than 20% of the secured part of the *exposure* gross of value adjustments; or

(2) 50% if value adjustments are no less than 20% of the secured part of the *exposure* gross of value adjustments.

4.2F.52 G A *firm* may treat the secured part of an *exposure* covered by a mortgage indemnity product that meets the relevant eligibility criteria for credit risk mitigation as secured for the purposes of ■ MIPRU 4.2F.51 R.

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Exposures to past due items: treatment of secured part of other exposures

4.2F.53 R For the purpose of defining the secured part of a past due item other than *exposures* secured on residential property, credit protection must be eligible for credit risk mitigation purposes under ■ MIPRU 4.2C (Credit risk mitigation).

4.2F.54 G

(1) For ■ MIPRU 4.2F.53 R, the secured part of a past due item is dealt with under ■ MIPRU 4.2C (Credit risk mitigation).

(2) The *risk weight* to be applied to the secured part is determined under ■ MIPRU 4.2C.6 R, and ■ MIPRU 4.2C.29 R to ■ MIPRU 4.2C.30 R.

(3) The *risk weight* of the unsecured part of the past due item is determined in accordance with ■ MIPRU 4.2F.55 R.

Treatment of unsecured part: all exposures

4.2F.55 R The unsecured part of any past due item, net of any value adjustments taken against the unsecured part, must be assigned a *risk weight* of:

(1) 150% if value adjustments are less than 20% of the unsecured part of the *exposure* gross of value adjustments; or

(2) 100% if value adjustments are no less than 20% of the unsecured part of the *exposure* gross of value adjustments.

Example: mortgages on residential property

4.2F.56 G The application of value adjustments to either the secured or the unsecured component of an *exposure* secured on residential property may be illustrated on the basis of a £110,000 loan on a property valued at £100,000, where £80,000 of the loan is secured, £30,000 of the exposure is unsecured and a value adjustment of £20,000 is taken.

(1) Value adjustment applied to unsecured component:

(a) Value adjustment of £20,000 taken on £30,000 unsecured *exposure*.

(b) Value adjustment exceeds 20%, so the *firm* should *risk weight* the remaining £10,000 unsecured *exposure* at 100% (as per ■ MIPRU 4.2F.55 R).

(c) The *risk weight* to be applied to the secured *exposure* of £80,000 is 100% (as per ■ MIPRU 4.2F.51 R).

(2) Value adjustment applied to secured component:

(a) Value adjustment of £20,000 taken on £80,000 secured *exposure*.

(b) Value adjustment exceeds 20%, so the *firm* should *risk weight* the remaining £60,000 secured exposure at 50% (as per ■ MIPRU 4.2F.51 R).

(c) The *risk weight* to be applied to the unsecured exposure of £30,000 is 150% (as per ■ MIPRU 4.2F.55 R).

(3) A diagrammatic illustration of how ■ MIPRU 4.2F.56G (1) and ■ MIPRU 4.2F.56G (2) operate is as follows:

Value adjustment applied to unsecured component (MIPRU 4.2F.51 R)	Risk weightings	Exposure	Risk weightings	Value adjustment to secured component (MIPRU 4.2F.55 R)
£20,000	£10,000 *risk weighted* at 100%	**Unsecured component of £30,000**	£30,000 *risk weighted* at 150%	
	£80,000 *risk weighted* at 100%	**Secured component of £80,000**	£60,000 *risk weighted* at 50%	£20,000