CP16/22 – Implementation of the Basel 3.1 standards: Credit risk mitigation

Chapter 5 of CP16/22

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Content

Overview

5.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards for credit risk mitigation (CRM), and to amend the PRA's expectations in respect of CRM. The proposals set out in this chapter are relevant to firms using the standardised approach (SA) and the internal ratings based (IRB) approach to credit risk. The proposals relating to the 'financial collateral comprehensive method' (FCCM) volatility adjustments are also relevant to firms using the standardised approach to counterparty credit risk (SA-CCR).

5.2 The proposals in this chapter would:

- complement HM Treasury's (HMT) proposed revocation of certain Capital Requirements Regulation (CRR) articles;
- introduce a new Credit Risk Mitigation (CRR) Part of the PRA Rulebook;
- insert an additional provision into the Counterparty Credit Risk (CRR) Part of the PRA Rulebook;
- amend Supervisory Statement (SS)17/13 'Credit risk mitigation' (Appendix 15); and
- amend SS12/13 'Counterparty credit risk' (Appendix 17).

5.3 CRM is a series of techniques used by a firm to reduce the credit risk associated with an exposure or exposures that the firm continues to hold. The CRR allows firms to reflect two forms of eligible CRM in their risk-weighted assets (RWA):

- funded credit protection (FCP): a type of CRM that reflects financial or non-financial collateral held against an exposure, which the firm can retain or liquidate in case of the default of a borrower or counterparty. It also includes the use of on-balance sheet netting and master netting agreements (MNA); and
- unfunded credit protection (UFCP): a type of CRM that reflects the promise from a third party to pay when a borrower or counterparty defaults.

5.4 Throughout this chapter, the PRA refers to the following CRM methods outlined in Table 1 below:

Table 1: CRM methods referenced in this chapter

CRM method	Description
On-balance sheet netting	A method for recognising on-balance sheet netting under all approaches to credit risk, which the PRA proposes to restrict to recognition through exposure value only.
Financial collateral simple method (FCSM)	A method for recognising financial collateral, which can only be used by firms applying the SA.
Financial collateral comprehensive method (FCCM)	A method for recognising financial collateral, which the PRA proposes would only be available for (a) exposures that give rise to credit risk (other than derivatives) under all credit risk approaches, and (b) exposures that do not give rise to credit risk under the SA only.[1] Firms are currently able to model the volatility adjustments used within this method if they have permission from the PRA; however, the PRA proposes to withdraw this option.
Foundation collateral method	A proposed new method for recognising financial and non-financial collateral, which the PRA proposes to introduce for firms using the foundation internal ratings based (FIRB) approach and which would replace existing similar methods.
Other funded credit protection (OFCP) method	A bespoke method for recognising other funded credit protection under the SA and the FIRB approach, which the PRA proposes to retain.
LGD modelling collateral method	A method for firms using the advanced internal ratings based (AIRB) approach to recognise the effects of financial and non-financial collateral in loss given default (LGD) estimates.
Securities financing transactions value-at-risk (SFT VaR) method (previously known as the ‘internal models approach for master netting agreements’)	A method for calculating the exposure value of SFTs, which firms may apply subject to PRA permission. The method currently applies to exposures covered by MNAs only; however, the PRA proposes to extend it to also cover single transactions.

Internal models method (IMM)	A method for modelling exposure value for derivatives and SFTs in accordance with counterparty credit risk requirements.[2]
Risk weight substitution method	A method that involves substituting the risk weight of the exposure with that of the protection provider to reflect the effect of UFCP, which the PRA proposes would be applied to all exposures subject to the SA, and to exposures subject to the FIRB and AIRB approaches where comparable direct exposures to the protection provider[3] would be subject to the SA. The PRA proposes to extend this method to exposures subject to the slotting approach in certain circumstances.
Parameter substitution method	A method that involves substituting probabilities of default (PDs) and, optionally, FIRB LGD values, of the exposure with those of the protection provider to reflect the effect of UFCP. This method is applied by firms using the FIRB and AIRB approaches where they are not applying the risk weight substitution method or, for AIRB approaches, the LGD adjustment method.
LGD adjustment method	A method that involves firms making adjustments to modelled LGD values to reflect the effect of UFCP. The PRA proposes to restrict this approach to exposures subject to the AIRB approach where comparable direct exposures to the protection provider are also subject to the AIRB approach.
Obligor grade adjustment	A method for reflecting the effect of protection arrangements in IRB PD models, by making adjustments to obligor grades, which is not considered to be a CRM method (see Chapter 4 – Credit risk – internal ratings based approach).
PD adjustment	A method of adjusting PD estimates under the FIRB and the AIRB approaches to reflect CRM, which the PRA proposes to withdraw.
Double default approach	A method for recognising the effect of UFCP in the IRB risk weight formula, which the PRA proposes to withdraw.

5.5 The Basel Committee on Banking Supervision (BCBS) identified the following weaknesses in the existing Basel standards, including, in relation to CRM:

- unnecessary complexity in the framework that could result in excessive variability in RWAs;[4] and
- the ability of firms to use internal estimates under the SA, which is contrary to one of the BCBS's principles for revising the SA.[5]

5.6 To enhance the clarity and consistency of the CRM framework, and to address these weaknesses, the Basel 3.1 standards introduce a number of material changes impacting the treatment of FCP and UFCP under both the SA and the IRB approach.

5.7 The PRA supports the changes to the CRM framework that are set out in the Basel 3.1 standards. The PRA considers that the changes would improve the robustness, consistency and comparability of the use of CRM across firms and therefore proposes a number of changes to the CRM framework that are consistent with the Basel 3.1 standards.

5.8 The PRA considers that CRM is a complex part of the RWA framework, and therefore proposes certain additional amendments which the PRA considers would reduce complexity, improve coherence, and provide greater clarity to firms regarding the availability of CRM methods.

5.9 The PRA sets out a number of proposals relating to FCP in this chapter that are consistent with the Basel 3.1 standards. Key proposals include:

- under the SA, removal of certain methods for calculating the effects of FCP and amendments to the methods that remain available;
- under the FIRB approach, amendments to existing methods for calculating the effects of FCP, including new supervisory LGD values and collateral volatility adjustments; and
- under the AIRB approach, a new technique for calculating the effects of FCP where firms lack sufficient data.

5.10 The PRA also sets out a number of proposals relating to UFCP in this chapter that are consistent with the Basel 3.1 standards. Key proposals include:

- restrictions on existing methods where firms adjust PDs and/or obligor grades in IRB models; and
- new restrictions on recognising and modelling UFCP which would depend on the credit risk approach applicable to comparable direct exposures to the protection provider.

5.11 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[6]

5.12 In this chapter, the PRA has set out details of its proposals where it proposes substantive changes to requirements and expectations relative to the existing approach. The PRA also proposes to make a number of other amendments in order to enhance the clarity and coherence of the framework. This includes consolidating some existing PRA rules into new Rulebook Parts. To the extent that the PRA does not propose to amend the existing approach, existing requirements and expectations would continue to apply.[7]

Methods for recognising CRM

5.13 This section sets out the PRA's proposals relating to the availability of methods for recognising CRM. Further proposals relating to the application of the CRM methods themselves are set out in subsequent sections.

Overview

5.14 As set out in the chapter overview, the Basel 3.1 standards introduce a number of material changes to the CRM framework in order to reduce excessive variability of RWAs.

5.15 The PRA proposes to introduce three frameworks of methods for recognising CRM based on the nature of the credit protection and the credit risk approach applied to the exposures. The first framework would cover recognition of FCP for exposures that give rise to counterparty credit risk, the second framework would cover recognition of FCP for exposures that do not give rise to counterparty credit risk, and the final framework would cover recognition of UFCP.

5.16 The most significant changes proposed by the PRA relating to the availability of methods for recognising CRM include:

- withdrawal of the option to use own-estimate volatility adjustments in the FCCM for firms using all credit risk approaches (FCCM with use of supervisory volatility adjustments would remain available);

- restricting the use of the internal models approach for master netting agreements to firms using the FIRB and AIRB approaches and extending this approach to cover single transactions, in addition to the existing scope of transactions subject to MNAs (renamed as the 'SFT VaR method');
- introduction of a new integrated approach to collateral recognition for firms using the FIRB approach, which would incorporate and update existing methods for recognising financial and non-financial collateral (the foundation collateral method);
- introduction of new restrictions on the availability of methods for recognising the effect of UFCP, based on the credit risk approach that would be applied to comparable exposures to the protection provider, as well as the credit risk approach that applies to the exposure itself; and
- withdrawal of the 'double default' approach for recognising the effect of UFCP in the IRB approach.

5.17 The PRA proposes to clarify that firms may choose to disregard CRM across all credit risk approaches and CRM methods.

5.18 The application of CRM methods by firms using the IRB approach is subject to risk weight floors as specified in the Basel 3.1 standards. Further details of the PRA's proposals relating to these floors are set out in Chapter 4.

5.19 The PRA proposes to introduce a rule requiring firms which would recognise both FCP and UFCP in respect of the same exposure to do so in an appropriate manner that is consistent with the frameworks for recognising FCP and UFCP that are set out in this chapter.

5.20 The PRA proposes to clarify in the Credit Risk Mitigation (CRR) Part that the review that firms are required to undertake to confirm the legal effectiveness and enforceability of CRM must be repeated as necessary to help ensure ongoing enforceability.

Funded credit protection: exposures that give rise to counterparty credit risk

5.21 The PRA considers that the existing interaction between the requirements in the Credit risk mitigation chapter of the CRR, the Counterparty credit risk chapter of the CRR, and the Counterparty Credit Risk (CRR) Part is excessively complex. This can lead to uncertainty as to which methods are available to firms, resulting in the inconsistent application of methods across firms. It can also result in opportunities for firms to 'cherry-pick' methods in order to reduce RWAs.

5.22 With the aim of simplifying the framework, the PRA proposes the following framework of methods for FCP recognition for exposures that give rise to counterparty credit risk (the proposed framework is summarised in Chart 1 below):

- for derivative exposures, the PRA proposes to retain existing methods with no changes (regardless of the approach to credit risk used). Derivative exposures would continue to be subject to the requirements currently set out in the Counterparty credit risk chapter of the CRR and the Counterparty Credit Risk (CRR) Part;
- for SFTs and any other exposures within the scope of an IMM permission, FCP would only be recognised in accordance with the IMM (regardless of the approach to credit risk used);
- the internal models approach for master netting agreements would be renamed the 'SFT VaR method'.[8] For exposures within the scope of an SFT VaR method permission, FCP would only be recognised in accordance with that method. The SFT VaR method would not be available where firms are applying the SA as set out in paragraph 5.25;
- for all other exposures that give rise to counterparty credit risk and that are subject to the SA, FCP would be recognised by either adjusting risk weights in accordance with the FCSM or by adjusting exposure values in accordance with the FCCM. Firms using the FCSM would not be permitted to recognise MNAs and would instead treat each exposure subject to a MNA as a single transaction; and
- for all other exposures that give rise to counterparty credit risk that are subject to the IRB approach, FCP would be recognised by adjusting exposure values in line with the FCCM.

Use of own-estimate volatility adjustments within FCCM

5.23 The PRA proposes to withdraw the use of own-estimate volatility adjustments within FCCM for all firms, which would align with the Basel 3.1 standards. The PRA proposes that all firms using FCCM instead use specified supervisory volatility adjustments.

5.24 For exposures subject to the SA, the proposed withdrawal of own-estimate volatility adjustments is intended to eliminate this aspect of modelling from the SA credit risk framework. This is because the PRA considers firms using the SA generally find it challenging to develop robust own-estimate volatility adjustment models within the FCCM. For exposures subject to the IRB approach, the PRA does not consider it necessary to retain own-estimate volatility adjustments within FCCM, because of its proposals relating to the SFT VaR method that are set out below.

SFT VaR method

5.25 The PRA proposes that the SFT VaR method would not be available for exposures subject to the SA, because the PRA considers that firms using the SA generally find it challenging to develop robust SFT VaR method models. The PRA does not propose any changes to the availability of the IMM, which would align with the Basel 3.1 standards.

5.26 The PRA proposes to extend the SFT VaR method to also cover single transactions, to align with the Basel 3.1 standards, in order to replace the use of own-estimate volatility adjustments within FCCM for firms using the IRB approach.

Recognition in exposure value and risk weights

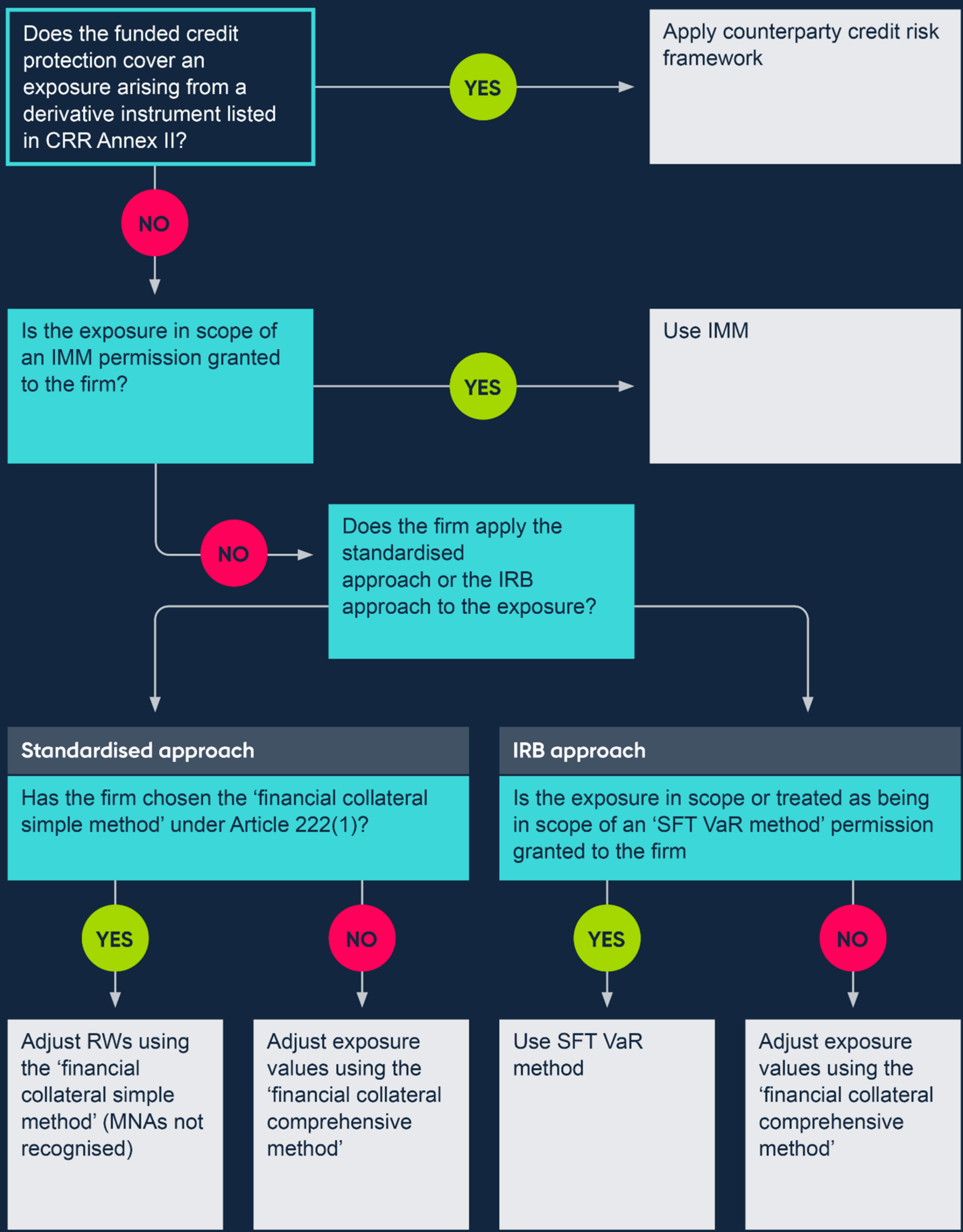
5.27 The PRA considers that the overall effect of the proposals in this section would be that, with the exception of firms applying the FCSM, firms would only be able to recognise FCP for exposures that give rise to counterparty credit risk through adjustments to the exposure value. This would represent a change to the existing position, where firms can recognise FCP through adjustments to LGD in some circumstances, including through AIRB models.

5.28 The PRA considers that adjusting the exposure value is generally the most appropriate mechanism for recognising FCP where exposures give rise to counterparty credit risk. But the PRA also considers that it is appropriate for firms using the SA to continue to be able to use the FCSM to adjust risk weights for such exposures. Firms would need to make a single choice between the FCSM and the FCCM for all exposures on SA, as explained in paragraph 5.33.

Summary of proposed framework

5.29 The proposed framework for recognition of FCP on exposures that give rise to counterparty credit risk is outlined in the chart below:

Chart 1: Summary of the proposed framework for recognition of FCP on exposures that give rise to counterparty credit risk



Question 33: Do you have any comments on the PRA's proposals for recognising FCP for exposures that give rise to counterparty credit risk?

Funded credit protection: exposures that do not give rise to counterparty credit risk

5.30 The PRA considers that there is currently excessive complexity in the CRM framework for recognition of FCP in respect of exposures that do not give rise to counterparty credit risk (eg secured loans).

5.31 The PRA proposes that, in order to simplify the framework, the following methods would apply where firms choose to recognise CRM for exposures that do not give rise to counterparty credit risk (the proposed framework is summarised visually in Chart 2 below):

- on-balance sheet netting would be recognised through adjustments to exposure value only under the SA and IRB approach. The PRA proposes to clarify the mechanics of how on-balance sheet netting impacts exposure value calculations;
- for exposures subject to the SA:
  - financial collateral would be recognised by either adjusting risk weights in accordance with the FCSM or by adjusting exposure values in accordance with the FCCM. Firms would be required to make a single choice between the FCSM and the FCCM for all exposures subject to the SA, as explained in paragraph 5.33 of this section;
  - non-financial collateral would continue to not be recognised in the CRM framework, however certain SA risk weights would continue to reflect the existence of non-financial collateral (eg the SA risk weights for immovable property); and
  - collateral that is currently classed as OFCP would continue to be recognised under a standalone method. The PRA proposes to refer to this as the 'OFCP method';
- for exposures subject to the FIRB approach:
  - financial and non-financial collateral would be recognised by an integrated method for adjusting LGD values known as the 'foundation collateral method'. This method would align with the FCCM for financial collateral and replace existing foundation LGD values for non-financial collateral. Further details about the PRA's proposals for the foundation collateral method is set out in 'Funded credit protection' section; and
  - collateral in the form of OFCP would be recognised using the OFCP method;
- for exposures subject to the AIRB approach, firms would continue to reflect financial and non-financial collateral using the LGD modelling collateral method. Use of alternative CRM methods to recognise financial and non-financial collateral, such as

those available for exposures subject to the SA or the FIRB approach, would not be permitted; and

- for exposures subject to the slotting approach, collateral would not be recognised via the CRM framework but would instead continue to be reflected in the assignment of exposures to slotting categories.

Use of own-estimate volatility adjustments in the FCCM

5.32 The PRA proposes to withdraw the option for firms to use own-estimate volatility adjustments in the FCCM for exposures that do not give rise to counterparty credit risk, in line with the approach for exposures that give rise to counterparty credit risk set out above. The PRA does not propose, however, to introduce any alternatives for modelling volatility adjustments in the FCCM for exposures not subject to counterparty credit risk under either the SA or the FIRB approach. This would align with the Basel 3.1 standards, and reflects the complexity of modelling in this area. The FCCM with use of supervisory volatility adjustments would remain available.

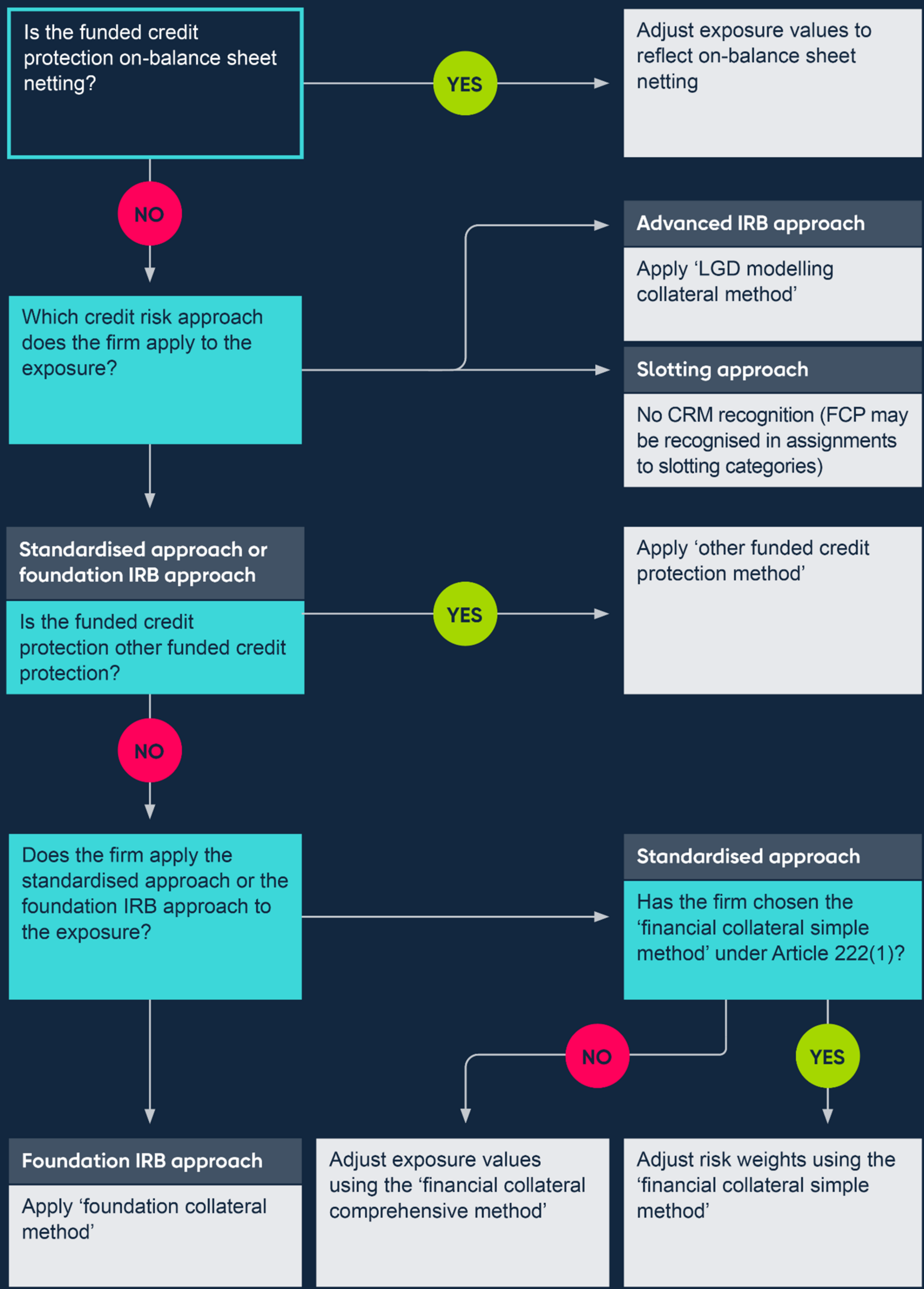
Use of the FCSM and the FCCM

5.33 The PRA proposes to continue to permit firms using the SA to make a choice between either applying the FCSM or the FCCM for all exposures. The PRA also proposes to clarify that firms with IRB permissions that use the SA for certain exposures would also be required to make a choice between these two methods for all exposures subject to the SA.

Summary of proposed framework

5.34 The PRA considers that the proposals in this section would bring clarity to the framework and would reduce 'cherry-picking' opportunities. The proposed framework for recognition of FCP on exposures that do not give rise to counterparty credit risk is outlined in the chart below:

Chart 2: Summary of the proposed framework for recognition of FCP on exposures that do not give rise to counterparty credit risk



Question 34: Do you have any comments on the PRA's proposals for recognising FCP for exposures that do not give rise to counterparty credit risk?

Unfunded credit protection

5.35 The PRA proposes to introduce the following framework of methods for recognising UFCP (the proposed framework is summarised visually in Chart 3 below):

- for exposures subject to the SA, UFCP would continue to be recognised by the 'risk weight substitution method';
- for exposures subject to the FIRB approach:
  - if a comparable direct exposure to the protection provider would be subject to the SA, UFCP would be recognised by the 'risk weight substitution method'; and
  - if a comparable direct exposure to the protection provider would be subject to the FIRB approach or the AIRB approach, UFCP would be recognised by the 'parameter substitution method' (PD substitution plus optional FIRB LGD substitution as further detailed in the 'Unfunded credit protection' section of this chapter);
- for exposures subject to the AIRB approach:
  - if a comparable direct exposure to the protection provider would be subject to the SA, UFCP would be recognised by the 'risk weight substitution method';
  - if a comparable direct exposure to the protection provider would be subject to the FIRB approach, UFCP would be recognised by the 'parameter substitution method' as set out above; and
  - if a comparable direct exposure to the protection provider would be subject to the AIRB approach, UFCP would either be recognised by:
    - the 'LGD adjustment method', where firms make adjustments to modelled LGD values to reflect the credit protection; or
    - the 'parameter substitution method' as set out above; and
- for exposures subject to the slotting approach, the PRA proposes to introduce recognition of UFCP using the 'risk weight substitution method' in certain circumstances.

Consistency in use of method

5.36 In order to reduce 'cherry-picking' opportunities, the PRA also proposes that where firms have a choice of UFCP methods, they would be required to apply the same method to all guarantees and credit derivatives of a particular type. The PRA proposes that firms would be required to have a documented policy in place to determine which UFCP method applies to each type of guarantee or credit derivative.

Dependency on the credit risk approach used for the protection provider

5.37 The PRA considers it appropriate that the proposals link the availability of UFCP methods to the credit risk approach that would apply to a comparable direct exposure to the protection provider, because it considers that it can be challenging for firms to model the impact of credit protection provided by an entity where the PRA considers that they are unable to model direct exposures to that entity. The PRA is seeking, through its proposals, to provide greater clarity on which CRM methods are available in cases where a comparable direct exposure to a protection provider is subject to a different credit risk approach than approach applied to the exposure on which the credit protection has been received.

Risk weight substitution method

5.38 The PRA considers that its proposals for the methods available for UFCP recognition would not result in any change for exposures currently subject to the SA, as firms already use the risk weight substitution method for these exposures.

5.39 The PRA proposes, however, to extend the use of the risk weight substitution method to exposures subject to the slotting approach in certain circumstances. Firms would only be able to use this method in respect of exposures that benefit from UFCP that meet the CRM eligibility criteria. Certain other indirect support, such as guarantees of cash flows, would continue to be reflected as part of the assignment of exposures to slotting categories subject to restrictions to prevent double counting (see Chapter 4 for further details).

Interaction of methods for recognising UFCP

5.40 The PRA proposes to withdraw a CRM technique that allows firms using the IRB approach to make adjustments to PD estimates. However, PD substitution would still be permitted. The PRA considers these proposals are justified as there is currently considerable complexity in how PD adjustments interact with both LGD adjustments and adjustments to obligor grades in IRB models. The PRA considers that the current complexity on these interactions could result in unwarranted variation in RWAs, as firms are able to take different approaches.

5.41 However, as set out in Chapter 4, ‘Probability of default (PD) estimation’ section, the PRA proposes to continue to permit firms to make adjustments to obligor grades in the IRB models themselves to reflect documented support arrangements. Such adjustments, which would not fall within the scope of the CRM framework, would enable firms to continue to reflect such support arrangements in PD estimates where a full PD substitution is not warranted.

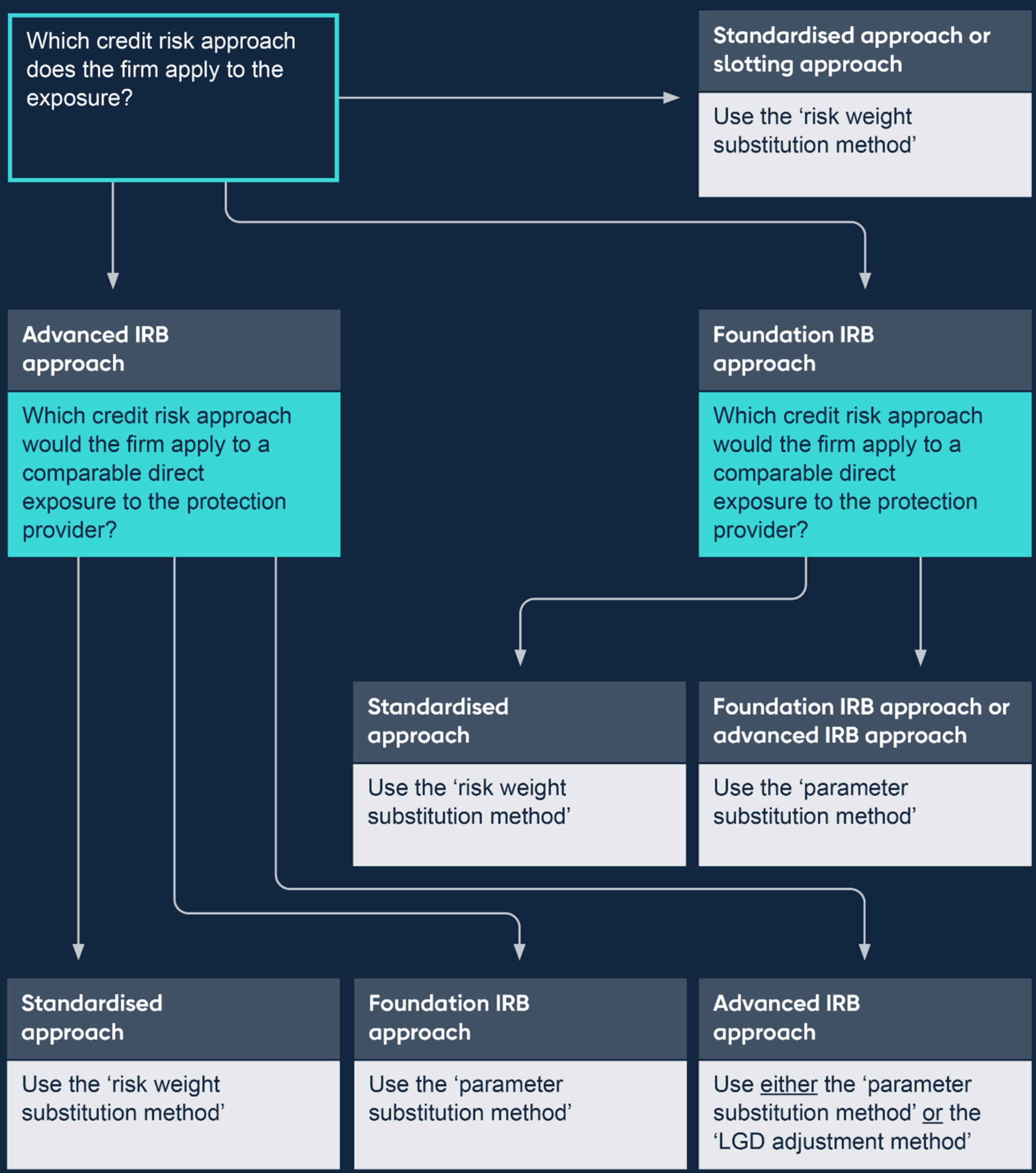
5.42 Where an exposure is subject to the AIRB approach and a comparable direct exposure to the protection provider would also be subject to the AIRB approach, the PRA proposes that firms would be able to: (a) continue to recognise UFCP through adjustments to LGD models (the ‘LGD adjustment method’), or (b) alternatively apply the parameter substitution method, which would align with the Basel 3.1 standards. The PRA considers that this proposal would provide an alternative recognition method for firms that are unable to model the effect of the credit protection.

5.43 The PRA proposes to withdraw the ‘double default’ approach for recognising credit protection, which would align with the Basel 3.1 standards. The PRA considers that it is appropriate to withdraw this approach in order to reduce unnecessary complexity and risk weight variability in the CRM framework.

5.44 The PRA proposes to introduce a number of further restrictions on how the various CRM methods and modelling techniques interact. Further details are set out in the ‘Unfunded credit protection’ section of this chapter.

5.45 The proposed framework for recognition of UFCP is outlined in the chart below:

Chart 3: Summary of the proposed framework for recognition of UFCP



Question 35: Do you have any comments on the PRA's proposals for recognising UFCP?

PRA objectives analysis

5.46 The PRA considers that the proposals set out in this section would advance its primary objective of safety and soundness. Limiting opportunities for firms to use internal modelling approaches that are not sufficiently robust should reduce the potential for firms to achieve RWA reductions in respect of CRM that are not commensurate with the CRM's risk-mitigating effect. Reducing the number of options in the CRM framework would result in more consistent and comparable CRM approaches being applied across firms which should, in turn, improve the consistency, comparability, and credibility of RWAs across firms.

5.47 The proposals set out this section may result in changes to RWAs for some firms that currently use CRM modelling approaches that the PRA proposes to remove. The impact of these proposed changes depends on the conservatism of a firm's modelled RWAs compared to RWAs calculated under the proposed remaining approaches. The PRA considers there would be some overall increase in RWAs due to the proposed restrictions on modelling, but that this would be likely to vary materially across firms and across exposure and transaction types, since RWAs would decrease in some cases. The PRA considers that such changes to RWAs would be consistent with its primary objective, as the proposals would help ensure that the risks to which firms are exposed are prudently capitalised.

5.48 The PRA considers that the proposals set out in this section would advance the PRA's secondary objective of facilitating effective competition. The proposed restrictions would have the effect of narrowing the gap in RWAs between firms using the IRB approach and firms using the SA, resulting in a more level playing field across firms.

'Have regards' analysis

5.49 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section are broadly aligned with the Basel 3.1 standards. There is some potential ambiguity regarding the availability of CRM methods in the Basel 3.1 standards, and the PRA has sought to propose an implementation of the standards that would reduce unwarranted variation in risk weights and minimise uncertainty for firms.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA has not identified any adverse impact on the competitiveness of the UK arising from the proposals set out in this section. While there is some uncertainty regarding the approach that may be taken by other regulators, the PRA expects that proposals of a broadly similar nature are likely to be adopted in most major jurisdictions.

3. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers that the proposals set out in this section would support sustainable growth. Providing greater clarity and certainty on the interaction of CRM methods and the approaches to modelling credit risk may provide firms with more confidence to engage in economic activities. Restricting the availability of CRM methods may cause increases in RWAs in some circumstances; however, if RWAs do increase, this may benefit sustainable growth to the extent that RWAs are currently too low relative to risk.

4. Transparency (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that its proposals to clarify available CRM methods would contribute to the transparency of regulatory activities. Providing more clarity on the available CRM methods and their application should make it easier for firms and other stakeholders to understand and apply the PRA's regulatory framework.

5. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section would be a proportionate response to deficiencies in the existing CRM framework that have been identified by the BCBS and the PRA. The PRA considers its proposals to be proportionate as they simplify the CRM framework, while retaining a range of methods for the recognition of CRM which should limit the impact of the proposed restrictions. This is because firms would have alternative methods available to recognise CRM, and benefit from RWA reductions where appropriate.

Funded credit protection

5.50 This section sets out a number of proposed changes to the following aspects of the FCP framework:

- the FCCM;
- SFT VaR method permissions;
- the foundation collateral method;
- treatment of trading book instruments used as collateral for SFTs;
- minor changes relating to eligible forms of collateral;
- minor changes relating to collateral eligibility requirements; and
- minor changes relating to the treatment of FCP in RWA calculations.

5.51 The proposed availability of FCP methods is set out in the 'Methods for recognising CRM' section of this chapter.

The financial collateral comprehensive method

Changes to the FCCM volatility adjustments

5.52 The PRA proposes a series of changes to the FCCM supervisory volatility adjustments.[9] The PRA considers these proposed changes are relevant for firms applying the foundation collateral method, the alternative methodology in the LGD modelling collateral method, and for firms calculating LGD input floors, because the FCCM supervisory volatility adjustments are used as inputs in each of these cases.[10]

5.53 The PRA proposes to make the volatility adjustments that currently apply under the CRR more risk-sensitive. The size of the existing volatility adjustments depends on the type of collateral, the credit quality step, and the residual maturity of the collateral.[11] The existing volatility adjustments are scaled using a prescribed formula when a liquidation period[12] other than 10 days is prescribed. A five-day liquidation period is prescribed for repurchase transactions (with certain exceptions) and securities lending and borrowing, while a 20-day liquidation period is prescribed for secured lending transactions.[13]

5.54 The PRA considers that the proposed changes to volatility adjustments is unlikely to have a material impact on overall RWAs. However, as an illustration, where the PRA proposes that residual maturity buckets would be split in two, with decreased volatility adjustments for shorter maturities and maintained or increased adjustments for longer maturities, the PRA considers that the effect would be to make the volatility adjustments increase more smoothly as maturity increases while the overall level of calibration would remain broadly unchanged. In this way, the PRA is seeking to introduce more risk-sensitivity, rather than to increase or decrease the conservatism of the calibration.

5.55 The PRA does not propose changes to volatility adjustments applicable to debt securities that are issued by central governments and central banks, or for collateral that are securitisation positions. In respect of debt securities issued by entities other than central governments and central banks, the PRA proposes changes to volatility adjustments that are set out in Table 2 below:

Table 2: Volatility adjustments for debt securities

Credit quality step (CQS)	Maturity (*m*)	Current	Proposed
CQS 1	$m \leq$ one year	1%	1%
	One year < $m \leq$ three years	4%	3%
	Three years < $m \leq$ five years	4%	4%
	Five years < $m \leq$ ten years	8%	6%
	m > ten years	8%	12%
CQS 2-3	$m \leq$ one year	2%	2%
	One year < $m \leq$ three years	6%	4%
	Three years < $m \leq$ five years	6%	6%
	Five years < $m \leq$ ten years	12%	12%
	m > ten years	12%	20%

5.56 The PRA also proposes changes to the volatility adjustments for equities and convertible bonds as set out in Table 3 below:

Table 3: Volatility adjustments for equities and convertible bonds

Exposure	Current	Proposed
Main index equities (including convertible bonds)	15%	20%
Other equities and convertible bonds listed on a recognised exchange	25%	30%

5.57 The PRA proposes that the volatility adjustments in both Tables 2 and 3 above would apply to exposures with a 10-day liquidation period, and that the volatility adjustments required for five-day and 20-day liquidation periods would be scaled accordingly.

5.58 The PRA does not propose to amend the existing approach where the liquidation periods used are brought in line with those set out in the Counterparty credit risk chapter of the CRR in certain circumstances.

5.59 The PRA proposes to clarify that in instances where an equity investment in a collective investment undertaking (CIU) is used as collateral, and the firm would apply the look-through approach to calculating the risk weight for a direct exposure to the CIU, the applicable volatility adjustment would be a weighted average of the volatility adjustments applicable to the CIU's exposures.

5.60 Firms can currently apply a 0% volatility adjustment when certain conditions are met. The PRA proposes to specify additionally that the 0% volatility adjustment would only be applied where firms have an unfettered, enforceable right to immediately seize and liquidate collateral following default. This would align with the Basel 3.1 standards. The PRA proposes this additional restriction because it considers that application of a 0% volatility adjustment is imprudent where a firm does not have a legal right to immediately seize and liquidate the collateral.

Changes to the FCCM formula for SFTs subject to eligible MNAs

5.61 Firms using the FCCM can currently apply a formula that allows them to reflect the effect of eligible MNAs across multiple SFTs, rather than treating each SFT as an individual collateralised transaction. The Basel 3.1 standards introduce a revised formula that aims to increase risk-sensitivity and better account for diversification and correlation.

5.62 Aligning with the Basel 3.1 standards, the PRA proposes to implement the following revised formula:

$$E^* = \max\left\{0, \left[\sum_i E_i - \sum_j C_j + 0.4 \cdot E_{net} + 0.6 \cdot \frac{E_{gross}}{\sqrt{N}} + \sum_k \left|E_k^{fx}\right| \cdot H_k^{fx}\right]\right\}$$

where:

- E^* is the exposure value of the exposures subject to the MNA after CRM;
- i is the index that denotes all separate securities, commodities or cash positions under the agreement, that are either lent, sold with an agreement to repurchase, or posted by the institution to the counterparty;
- j is the index that denotes all separate securities, commodities or cash positions under the agreement that are either borrowed, purchased with an agreement to resell, or held by the institution;
- k is the index that denotes all separate currencies in which any securities, commodities or cash positions under the agreement are denominated;
- E_i is the exposure value of a given security, commodity, or cash position i, that is either lent, sold with an agreement to repurchase or posted to the counterparty under the agreement that would apply in the absence of the credit protection. This calculation would exclude securities or commodities where: (i) the net position is negative; and (ii) the securities or commodities are not eligible CRM;
- C_j is the value of a given security, commodity, or cash position j that is either borrowed, purchased with an agreement to resell, or held by the institution under the agreement. This calculation would exclude securities or commodities where: (i) the net position is negative; and (ii) the securities or commodities are not eligible CRM;
- E_k^{fx} is the net position (positive or negative) in a given currency k other than the settlement currency of the agreement;
- H_k^{fx} is the foreign exchange volatility adjustment for currency k;
- E_{net} is the net exposure of the agreement, calculated as follows:

$$E_{net} = \left| \sum_{m=1} E_m^{SEC} \cdot H_m^{SEC} \right|$$

where:

- E_m^{SEC} is the net position (positive or negative) in a given group of securities m, or a given type of commodities m, under the agreement; and

- H_m^{SEC} is the volatility adjustment appropriate to a given group of securities m, or a given type of commodities m; and
- E_{gross} is the gross exposure of the agreement, calculated as follows:

$$E_{gross} = \sum_{m=1} E_m^{SEC} \cdot \left|H_m^{SEC}\right|$$

and

- N is the number of distinct groups of the same securities and distinct types of the same commodities under the MNA (except that groups and types where the value E_m^{SEC} is less than one tenth of the value of the largest E_m^{SEC} in the netting set are not included the count).

5.63 The PRA proposes to limit eligibility of MNAs under the FCCM to those MNAs that would allow for the prompt liquidation or set-off of collateral upon the event of default, to align with the Basel 3.1 standards. As a result, firms would not be able to use this formula in respect of MNAs that do not meet this criterion. The PRA considers that this proposal would increase the robustness of the regulatory framework.

5.64 Both the existing and proposed revised formulae effectively contain three components:

a) the current exposure;

b) an add-on to reflect potential price changes of the securities covered by the MNA; and

c) an add-on to reflect any currency mismatches of the securities covered by the MNA.

5.65 The proposed revised formula would effectively change the second component from being calculated entirely on a gross basis, to being partially calculated on a net basis and partially calculated on a gross basis. The gross element would be adjusted based on the number of material security issuances covered by the MNA. The PRA considers that the proposed revised formula would result in a more risk-sensitive approach for these transactions and risks, as it would allow some recognition of both netting and diversification.

5.66 The PRA proposes to clarify that where firms post ineligible collateral, this would be reflected in the same way as any other posted collateral, with a 30% volatility adjustment applied. The PRA proposes that where firms receive ineligible collateral, this would be disregarded within the FCCM formula.

SFT VaR method permissions

5.67 For firms using the IRB approach, the PRA proposes to make a number of changes relating to SFT VaR method permissions:

a) to provide that SFT VaR method permissions may be granted where firms 'materially comply', instead of fully comply with the conditions, in line with the proposed changes to the IRB approach (see Chapter 4);

b) to introduce a requirement in the Credit Risk Mitigation (CRR) Part that firms wishing to use the SFT VaR method by virtue of an internal models approach (IMA) permission must first notify the PRA, and to clarify that in such cases firms may only apply the SFT VaR method for products within the scope of the IMA permission;

c) to introduce a requirement in the Credit Risk Mitigation (CRR) Part that firms wishing to make material extensions and changes to SFT VaR method permissions would need to seek the prior approval of the PRA, except where the SFT VaR method is used solely by virtue of an IMA permission in which case pre-notification would be required;

d) to introduce an expectation that all other changes would need to be post-notified to the PRA on a quarterly basis;

e) to make a number of changes to its expectations regarding the classification of extensions and changes to SFT VaR method permissions (see Appendix 17);

f) to require that firms using the SFT VaR method, but which do not meet the requirements for using that method, notify the PRA and either submit a remediation plan to address the non-compliance in a timely manner or demonstrate to the PRA that the effect of the non-compliance is immaterial (see the Credit Risk Mitigation (CRR) Part); and

g) to make a number of further related changes to its expectations regarding SFT VaR method permissions and SFT VaR method annual attestations (see Appendix 17).

5.68 The PRA considers that these proposed changes to the SFT VaR method permission process would deliver a more coherent regulatory framework, provide greater clarity to firms on the processes relating to SFT VaR method permissions and increase alignment with the IRB permissions framework.

5.69 The PRA also proposes to introduce three new requirements relating to the SFT VaR method, namely:

- a requirement that ineligible collateral received should be excluded from the calculation of net current exposure and from the VaR calculations within the SFT VaR method, in line with the proposed approach under the FCCM;
- that MNAs would only be recognised where they allow for the prompt liquidation or set-off of collateral upon the event of default in line with the proposed approach under the FCCM; and
- an additional qualitative standard that firms' systems for managing risks arising from transactions covered by eligible MNAs are conceptually sound and implemented with integrity.

The foundation collateral method

5.70 As noted above, the PRA proposes to introduce a revised methodology known as the foundation collateral method, which would be available to firms using the FIRB approach. The PRA considers that its proposed specification of this method is also relevant to firms using the 'LGD modelling collateral method' (see Chapter 4, section 'Loss given default (LGD) estimation') and firms calculating LGD input floors (see Chapter 4, section 'Input floors') because the PRA proposes that both of these would make use of the foundation collateral method formulae.

5.71 The proposal would combine existing approaches for financial and non-financial collateral into a single formula for cases where the firm recognises a single type of collateral, and a further formula where the firm recognises multiple types of collateral.

5.72 The PRA proposes that the following formula would be used where a firm recognises a single type of collateral:

$$\mathrm{LGD}^* = \mathrm{LGD}_U \cdot \frac{E_U}{E \cdot (1 + H_E)} + \mathrm{LGD}_S \cdot \frac{E_S}{E \cdot (1 + H_E)}$$

where:

- LGD^* is the LGD applicable to a collateralised transaction;
- LGD_U is the FIRB unsecured LGD applicable to the exposures;
- LGD_S is the foundation collateral method secured LGD applicable to the collateral type (as set out in Table 4 below);
- E is the current value of the exposure after the effect of on balance sheet netting;
- E_U is the value of unsecured exposure calculated as follows:

$$E_U = E \cdot (1 + H_E) - E_S$$

- E_S is the current value of the collateral after the application of the applicable volatility adjustment (H_C);
- H_C is the volatility adjustment applied to the collateral (as defined in the FCCM for financial collateral and in the foundation collateral method for non-financial collateral – see Table 4 below); and
- H_E is the volatility adjustment applicable to the exposure.

5.73 The PRA proposes that, where a firm receives multiple types of collateral for a single exposure, it would apply a formula that would have the effect of repeatedly applying the formula for a single type of collateral in line with the Basel 3.1 standards. The effect of the proposed formula would be to divide each exposure into portions reflecting each type of recognised collateral as well as an unsecured portion where applicable. In line with the proposed formula for recognising a single type of collateral, the total adjusted value of the secured portions of the exposure would be capped at the adjusted total value of the exposure ($E (1 + H_E)$). The proposed formula for multiple types of collateral would be specified as follows:

$$\mathrm{LGD}^* = \mathrm{LGD}_U \cdot \left(\frac{E_U}{E \cdot (1 + H_E)}\right) + \sum_i \mathrm{LGD}_{S_i} \cdot \left(\frac{E_{S_i}}{E \cdot (1 + H_E)}\right)$$

where:

- i is the index of all the separate types of collateral obtained for that exposure;
- LGD_{S_i} is the foundation collateral method secured LGD applicable to the collateral of type i;
- E_{S_i} is the current value of the collateral of type i received after the application of the volatility adjustment applicable for the type of collateral (H_C) (as set out in Table 4 below);
- E_S is the current value of the collateral received after the application of volatility and maturity mismatch adjustments;
- H_C for the first piece of collateral recognised by the firm (where i = 1), the following definition would apply:

$$E_{S_1} = \min\{C_1, E \cdot (1 + H_E)\}$$

- for all subsequent pieces of collateral recognised by the firm (where i ≥ 2), the following definition would apply:

$$E_{S_i} = \min\left\{C_i, E \cdot (1 + H_E) - \sum_{k=1}^{i-1} E_{S_k}\right\}$$

- k is the index that denotes all separate values of the index ;
- E_U is the value of unsecured exposure calculated as follows:

$$E_U = E \cdot (1 + H_E) - \sum_i E_{S_i}$$

and

- all other terms are as defined in the previous formula for when a firm recognises a single type of collateral.

5.74 The proposed formulae would require firms to split secured exposures into one or more secured parts (one for each recognised type of collateral) based on volatility-adjusted collateral values, and a further unsecured part (in cases where the total volatility-adjusted value of the collateral is less than the value of the exposure). The formulae would then require firms to apply prescribed LGD values to the secured and unsecured parts.

5.75 The PRA considers that the Basel 3.1 standards do not specify a specific treatment where an item of collateral is held against multiple facilities. The PRA proposes to require firms to sub-divide such collateral into one or more portions prior to allocating these portions to specific facilities in order to prevent the effect of such collateral from being double counted. The PRA does not propose requirements or expectations regarding how firms allocate such collateral to specific facilities.

5.76 Firms applying the FCCM are currently required to 'gross up' exposure values for securities lent or posted by applying a volatility adjustment (H_E) to the value of the exposure. The PRA proposes to retain this approach in the foundation collateral method and extend its application to non-financial assets lent or posted in line with the Basel 3.1 standards.

5.77 Firms applying the FIRB approach are currently subject to minimum collateralisation requirements which need to be met to recognise the effect of non-financial collateral in the FIRB approach for a given exposure. As a result, collateral below the minimum levels cannot be recognised even where it has a risk-mitigating effect. The PRA proposes to remove these minimum collateralisation levels in order to enhance the risk-sensitivity of the framework in line with the Basel 3.1 standards.

5.78 Firms applying the FIRB approach are also currently subject to separate minimum collateralisation requirements that are needed for an exposure to be treated as fully collateralised. Where these minimum requirements are not met, the exposure is divided into a secured and unsecured part in an analogous way to the proposed new foundation collateral method formulae. The PRA considers that it is therefore unnecessary to retain these minimum collateralisation requirements as they are effectively superseded, so the PRA proposes to remove them.

5.79 The PRA proposes to make a number of revisions to secured LGD values and volatility adjustments in line with the Basel 3.1 standards. The PRA has set out a comparison of the existing regime and its proposals in Table 4 below. For this purpose, the PRA has calculated the effective volatility adjustment which is implied by the existing minimum collateralisation requirements so that a meaningful comparison can be made.

Table 4: Proposed changes to supervisory LGD values, required minimum levels of collateral, and volatility adjustments under FIRB

Type of collateral	Proposed secured LGD	Current secured LGD (senior exposures)	Current secured LGD (subordinated exposures)	Proposed volatility adjustment	Effective volatility adjustment (existing regime)
Eligible financial collateral	0%	0%	0%	Same volatility adjustments as used for the FCCM	Same volatility adjustments as currently used for the FCCM
Eligible receivables	20%	35%	65%	40%	20%
Eligible residential real estate / commercial real estate	20%	35%	65%	40%	28.6%
Other eligible physical collateral	25%	40%	70%	40%	28.6%

5.80 The proposed changes set out in Table 4 would increase volatility adjustments and reduce secured LGDs for all non-financial collateral types. The PRA considers that the overall effect of the proposals would increase the risk-sensitivity of the framework.

5.81 As set out in Table 4, firms currently apply different secured LGDs for senior and subordinated exposures. The PRA proposes that secured LGDs would no longer depend on the degree of subordination of the exposure and that the degree of subordination would continue to be reflected in the unsecured LGD applied to any unsecured part of the exposure. The PRA considers this to be an appropriate way to reflect the effects of subordination in LGD estimates.

Treatment of trading book instruments used as collateral for SFTs in the trading book

5.82 Firms applying the Counterparty credit risk chapter of the CRR to SFTs in the trading book are currently permitted to use a wider range of collateral than set out in the Credit risk mitigation chapter of the CRR. In particular, firms may treat all financial instruments and commodities that are eligible to be included in the trading book as eligible collateral, even if the firm does not currently trade them. The PRA considers that this diverges from the existing Basel standards, which only extend eligibility to instruments that are actually in the trading book.

5.83 The PRA considers that the existing approach in the CRR is likely to be imprudent, as it can result in collateral being recognised as eligible that the PRA considers firms would not always be able to liquidate in practice. The PRA therefore proposes to limit this treatment to financial instruments and commodities that are in the trading book, in line with the existing Basel standards.

Eligible forms of collateral

5.84 The PRA proposes the following series of minor changes to eligible forms of collateral:

a) to clarify that all firms may apply on-balance sheet netting where there is a currency mismatch between the exposure and collateral, subject to the application of the applicable volatility adjustment, in line with the Basel 3.1 standards;

b) firms are currently able to treat investment firms as institutions when determining whether financial collateral is eligible. The PRA proposes to replace this approach by amending the eligibility criteria such that collateral issued by financial institutions which are risk-weighted as institutions under the SA would be treated in the same way as collateral issued by institutions. The PRA considers that this would result in a more consistent framework for collateral recognition and would result in entities only being treated as institutions where they are subject to comparable prudential regimes;

c) for firms using the FIRB approach, the PRA proposes to implement new provisions on the recognition of general security agreements that are set out in the Basel 3.1 standards. These would explicitly clarify that firms may recognise collateral that is covered by a general security agreement or other forms of floating charge;

d) for firms using the SA or the FIRB approach, the PRA proposes to restrict the scope of cash assimilated instruments that can be recognised as eligible collateral to only those issued by the lending institution, in line with the Basel 3.1 standards. The PRA considers that cash assimilated instruments issued by entities other than the lending institution do not typically have the same CRM properties as cash deposits; and

e) for firms using the FIRB approach, the PRA proposes to limit the eligibility of receivables to those where repayment would be funded by the commercial or financial flows relating to the underlying assets of the counterparty, in line with the Basel 3.1 standards.

Collateral eligibility requirements

5.85 In respect of collateral eligibility requirements that apply to firms using the SA or the FIRB approach, the PRA proposes that firms may treat collateral associated with undrawn facilities, but which has not yet been received by the firm, as eligible where it otherwise satisfies all other eligibility requirements, and where drawing on the facility would be conditional on the prior or simultaneous purchase or receipt of the collateral by the firm.

5.86 In respect of collateral eligibility requirements which would apply to firms using the FIRB approach (and in some cases indirectly to firms using the AIRB approach as set out in paragraph 5.87 of this section), the PRA proposes the following minor changes:

a) to introduce two additional collateral management requirements for real estate and other physical collateral. The PRA proposes that firms would be required to monitor the extent of any permissible prior claims on an ongoing basis, and to monitor the risk of environmental liability in respect of the collateral. The PRA considers these proposed requirements would help ensure firms manage the risk that collateral valuations do not fully reflect these risks. Both proposed requirements would align with the Basel 3.1 standards;

b) to introduce a requirement that property valuations should be reviewed when a ‘default event’ occurs, in line with the Basel 3.1 standards, in order to provide for sufficiently robust valuations;[14]

c) to align with the Basel 3.1 standards by requiring that other non-financial collateral would only be eligible under the FIRB approach where the periodic revaluation process includes physical inspection of the collateral;

d) to simplify the existing process for derogating from a collateral eligibility requirement for real estate that requires that the risk of the borrower does not materially depend upon the performance of the underlying property or project. The PRA proposes to replace the existing derogations with a rule that applies this eligibility requirement to commercial real estate but not residential real estate;

e) to clarify that the valuations of real estate and other non-financial collateral required to meet eligibility criteria under the FIRB approach would need to be undertaken by qualified professionals. This would align with the Basel 3.1 standards;

f) to clarify that the legal review confirming the enforceability of collateral arrangements for receivables would need to be undertaken on an ongoing basis where necessary to confirm continuing enforceability;

g) to further specify the eligibility requirements for receivables relating to monitoring, to align with the Basel 3.1 standards (including in relation to the type of information that would need to be monitored and the monitoring of concentration limits); and

h) to introduce additional eligibility requirements for financial receivables linked to commercial transactions such that repayment would need to occur through commercial or financial flows relating to the underlying assets of the obligor.

5.87 The proposed changes set out in paragraphs 5.85 and 5.86 could also impact firms using the AIRB approach to the extent that they are required to establish internal processes that are generally consistent with those that apply under the FIRB approach in order to recognise collateral under the LGD modelling collateral method.

Treatment of FCP in RWA calculations

5.88 The PRA proposes the following minor changes to RWA calculations:[15]

a) firms using the SA and applying the FCSM must currently meet a number of conditions in order to apply a 0% risk weight floor for SFTs, to align with the conditions for applying a 0% volatility adjustment under FCCM. The PRA proposes that its proposed additional condition relating to the ability of the firm to immediately seize and liquidate the collateral in the event of the bankruptcy or insolvency of the counterparty, as outlined in the ‘Changes to the FCCM volatility adjustments’ sub-section, would also apply to firms applying a 0% risk weight floor under the FCSM. This would align with the Basel 3.1 standards;

b) for firms using the IRB approach, the PRA proposes to clarify that the same collateral eligibility criteria apply under the SFT VaR method as apply under the FCCM, which would align with the Basel 3.1 standards;

c) for firms using the FIRB approach, to remove references to mortgage lending value which the PRA considers to be not relevant in the UK, and to clarify the treatment of prior claims in immovable property valuation;

d) for firms using the FIRB approach, the PRA proposes to introduce an option for firms to value other physical collateral at less than its market value (the existing requirements state that other physical collateral must be valued at its market value);

e) firms using the FIRB approach are currently permitted to apply a 50% risk weight for parts of certain exposures collateralised by real estate as an alternative CRM treatment. The PRA proposes to remove this treatment, which would not align with the Basel 3.1 standards, because it does not consider it to reflect the risk or be prudentially justified;

f) for firms using the SA or the FIRB approach and applying the OFCP method, the PRA proposes a minor clarification regarding the application of the OFCP risk weight treatment for eligible cash assimilated instruments;

g) for firms using the SA or the FIRB approach and applying the OFCP method, the CRR sets out risk weights for exposures collateralised by the current surrender value of life insurance policies pledged to the lender. This involves mapping the applicable risk weights in the SA for exposures to the entity providing the life insurance. The PRA proposes to update the mapping to reflect the proposed changes to SA risk weights set out in Chapter 3 – Credit risk – Standardised approach, while retaining the existing OFCP method capital treatment;[16]

h) the PRA proposes to explicitly align the risk weight calculation under the OFCP method for collateral treated as guarantees with the risk weight treatment applied to guarantees. The eligibility criteria for OFCP recognition would, however, remain unchanged (and would not depend on the credit risk treatment for comparable direct exposures to the guarantor); and

i) the PRA also proposes to make a small number of minor changes to the approach for reflecting maturity mismatches in the CRM framework that are applicable to UFCP and FCP.

Question 36: Do you have any comments on the PRA's proposals for FCP?

PRA objectives analysis

5.89 The PRA considers that the proposals set out in this section would increase the consistency, robustness, and risk-sensitivity of the FCP treatment in the CRM framework, thereby advancing its primary objective of safety and soundness. The proposed changes to volatility adjustments and supervisory LGDs in the FCCM would result in a prudent and risk-sensitive calibration of risk weights. The PRA considers that the proposed foundation collateral method formula would be more transparent than the current approach and would enhance comparability across firms, advancing the PRA's primary objective of safety and soundness. The PRA considers that the proposed revised LGD values and volatility adjustments in this method would provide a greater incentive to firms to take collateral that mitigates risks, while also maintaining prudent levels of RWAs to reflect remaining risks. The PRA considers that this would contribute to the safety and soundness of firms.

5.90 The PRA considers that the impact of the proposals set out in this section on firms' RWAs would be mixed. The proposed changes to the FCCM volatility adjustments should reduce RWAs for exposures with collateral of shorter maturities, and the proposed changes to the FCCM formula for SFTs with MNAs should result in lower RWAs to the extent that it better takes account of diversification. The proposal to remove the minimum collateralisation requirement for firms applying the FIRB approach to recognise the effect of non-financial collateral should allow greater recognition of collateral and result in a potential reduction in RWAs. The proposed lower LGD values for secured exposures under the foundation collateral method should also reduce RWAs. The changes to the recognition of trading book instruments as collateral for trading book SFTs may increase RWAs in cases where previously recognised collateral can no longer be recognised. Overall, the PRA considers that the net impact of the different proposals in this section would likely result in a slight reduction in aggregate RWAs; however, the PRA considers the impacts would differ across firms, as well as across different exposures and transactions.

5.91 The PRA considers that its proposals would facilitate effective competition between firms by reducing excessive variability in RWAs and providing greater consistency and comparability of RWAs and approaches across firms. For some transactions, compared to the existing framework, the proposals may favour firms using the IRB approach relative to the SA, whereas for others the proposals may favour firms applying the SA. The PRA also considers that the effect on competition between firms applying the FIRB approach and firms applying the AIRB approach would be broadly neutral.

'Have regards' analysis

5.92 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed changes in this section are broadly aligned with the Basel 3.1 standards. The PRA considers that some aspects of the Basel 3.1 standards are open to interpretation, and has therefore made proposals that it considers would implement the Basel 3.1 standards in line with its statutory objectives and 'have regards'.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers its proposals relating to the FCCM and the foundation collateral method to be broadly aligned with those expected to be introduced by other jurisdictions. The PRA also considers that the proposed clarifications to the existing approaches would support the UK's relative standing. The PRA considers that while the proposed changes to the recognition of trading book instruments as collateral for SFTs in the trading book would align with existing international standards, other jurisdictions may not implement this approach. The PRA considers that this could negatively impact the UK's relative standing; however, it does not consider the impact of this to be material.

3. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals relating to the FCCM and the foundation collateral method would impact RWAs, but should not significantly impact operational costs. The proposed changes to the recognition of trading book instruments used as collateral for SFTs in the trading book may increase firms' operational costs, because firms would have to monitor trading book composition on an ongoing basis in order to confirm CRM eligibility. The proposed new volatility adjustments, the proposed new formula for SFTs with MNAs within the FCCM, and the proposed revised secured LGD values for non-financial collateral would be considered by the PRA to reduce RWAs. Overall, the PRA considers that its proposals are proportionate because, while they may increase firm's operational costs to some degree, the PRA considers the proposals to result in RWAs that better reflect risks.

4. Finance for the real economy (FSMA CRR rules):

- The PRA considers that its proposals relating to the FCCM would be unlikely to have a material impact on finance for the real economy. The PRA considers that the improved recognition of netting and collateral diversification in the proposed revised formula for SFTs with MNAs within the FCCM would support provision of financing by firms in the market for repurchase agreements. The proposed revised volatility adjustments and secured LGD values that would apply under the foundation collateral method may have a positive impact on firms' willingness to lend for certain types of transactions that use non-financial collateral. The proposed changes to collateral eligibility for SFTs in the trading book would increase RWAs for certain SFTs, but the PRA does not consider that this would materially impact finance for the real economy.

Unfunded credit protection

5.93 This section sets out the PRA's detailed proposals relating to the following aspects of the UFCP framework:

- eligibility criteria for recognising UFCP;
- application of UFCP methods, including the formulae to be applied; and
- other proposals relating to UFCP.

5.94 The proposed availability of the UFCP methods themselves is set out in the section 'Methods for recognising CRM' of this chapter.

Eligibility criteria for recognising UFCP

General principles for UFCP recognition

5.95 Currently, the eligibility criteria for UFCP generally depends on whether a firm uses either, (a) the SA or the FIRB approach, or (b) the AIRB approach. The PRA proposes to instead define eligibility criteria for UFCP that depend on the CRM method that is being used. This is because the PRA considers that it would be appropriate for all firms to be subject to the same UFCP eligibility criteria when they employ a given UFCP methodology.

Conditional and unconditional guarantees

5.96 UFCP can currently only be recognised if it is considered 'unconditional' (ie it does not contain any clause outside the direct control of the lender that would make the credit protection ineffective), with the exception that firms using the AIRB approach can recognise conditional guarantees with PRA permission.

5.97 Under the Basel 3.1 standards, firms can no longer recognise conditional guarantees as CRM under the AIRB approach. The BCBS decided to remove recognition of conditional guarantees because it considered that firms were unable to model the risk-mitigating effect of such guarantees in a robust manner. The PRA shares these concerns, and therefore proposes that recognition of conditional guarantees would not be permitted under all CRM methods.

5.98 Firms can currently recognise a range of credit derivatives as CRM, including basket credit derivatives such as '1st to default' credit derivatives and '2nd to default' credit derivatives. The ability to recognise basket credit derivatives as CRM is not included in the Basel 3.1 standards with the exception of '1st to default' credit derivatives, which may be recognised by firms using the AIRB approach only. These restrictions on recognition reflect the BCBS and PRA's concerns regarding the challenges firms have had in accurately including the risk-mitigating effect of basket credit derivatives in non-modelled approaches and in robustly modelling '2nd to default' and higher-order basket credit derivatives.

5.99 The PRA proposes to prohibit firms from recognising basket credit derivatives in the CRM framework with the exception of '1st to default' credit derivatives, which firms would only be able to recognise where they are using the 'LGD adjustment method'. This would align with the Basel 3.1 standards by allowing firms to recognise '1st to default' credit derivatives only where they are applying a modelled CRM approach.

5.100 Currently, UFCP can generally only be recognised where it is direct. However, firms can exceptionally recognise indirect credit protection where a counter-guarantee provided by a sovereign or quasi-sovereign is in place.

5.101 The Basel 3.1 standards restrict the eligibility of indirect counter-guarantees to those provided by sovereign entities only. The PRA considers that, in general, indirect credit protection arrangements such as counter-guarantees are less likely to be effective than direct credit protection arrangements, and that this risk is greater for such arrangements when provided by non-central government and non-central bank counter-guarantors compared to central government and central bank counter-guarantors. The PRA therefore proposes to restrict the eligibility of indirect counter-guarantees to those provided by central governments and central banks only. However, the PRA proposes that firms would still be able to treat counter-guarantees provided by other guarantors as eligible where they are further guaranteed by a central government or a central bank.

5.102 In general, firms are only able to recognise guarantees in the CRM framework where they have the right to pursue the guarantor in a timely manner for monies due under the guarantee agreement. The CRR does, however, allow firms to apply alternative criteria for guarantees provided in the context of mutual guarantees schemes, or when provided by, or counter-guaranteed by, an entity that can provide eligible counter-guarantees. The effect of these alternative criteria is that such guarantees may be eligible where a provisional payment has been made under the guarantee, or the firm can demonstrate to the PRA that the effect of the guarantee makes an alternative treatment appropriate.

5.103 The PRA proposes to continue to align the eligibility criteria for recognising such guarantees with the list of entities eligible to provide counter-guarantees. As a result, the alternative criteria would only be available for guarantees provided in the context of mutual guarantee schemes, and guarantees that are either provided by, or counter-guaranteed by, a central government or central bank. The PRA considers that this is appropriate to reflect the prudential risk relating to non-timely payment of guarantees by entities other than central governments and central banks.

5.104 The PRA also proposes to make the following minor changes to the criteria for recognising UFCP:

- to introduce an explicit requirement that UFCP would only be eligible if it does not contain any clause which would allow the protection provider to change the credit protection unilaterally to the detriment of the lender. The PRA does not consider this would be a significant change to existing requirements;

- to clarify in the eligibility criteria for guarantees that it would be permissible for the guarantor to either make a lump sum payment or assume the future obligations of the counterparty in the event of a valid claim on the guarantee; and
- to clarify in its expectations that credit insurance (including mortgage indemnity products) can be treated as eligible UFCP where the eligibility criteria are met, and that such credit insurance would be treated as a guarantee or a credit derivative depending on whether the credit insurance effectively functions like a guarantee or a credit derivative respectively.

Application of UFCP Methods

Risk weight substitution method: revised formula

5.105 The PRA proposes to introduce a revised formula for calculating risk weights for firms using the risk weight substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the risk weight that would apply in the absence of credit protection for any part of the exposure not covered by UFCP (calculated using the SA or the IRB approach, as appropriate); and

b) the risk weight that would apply to a comparable direct exposure to the protection provider under the SA for the part of the exposure covered by UFCP.

5.106 The PRA also proposes to introduce a formula for calculating the expected loss (EL) when applying the IRB approach and using the risk weight substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the EL that would apply in the absence of credit protection for any part of the exposure not covered by UFCP; and

b) specific provisions relating to the part of the exposure covered by UFCP.

5.107 The PRA's proposed EL formula is designed to ensure that the amount of EL calculated aligns with specific provisions for the guaranteed part of the exposure and that these net-off in the 'expected loss – provisions' ('EL – P') calculation used to calculate capital resources for firms applying the IRB approach (see Chapter 4). The PRA considers that this calculation would best align risk weights calculated under the risk weight substitution method across the SA and the IRB approach.

5.108 The PRA considers that the revised risk weight and EL formula would provide greater clarity as to how firms should calculate risk weights and ELs when using the risk weight substitution method and applying the IRB approach.

Parameter substitution method: revised formula

5.109 The PRA proposes to introduce a revised formula for calculating risk weights for firms using the parameter substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the risk weight that would apply in the absence of credit protection for any part of the exposure not covered by UFCP; and

b) a revised risk weight calculated using the PD and risk weight function of the protection provider, and either the LGD applicable to the exposure (as if there was no UFCP) or the FIRB approach LGD applicable to the protection provider, for the part of the exposure covered by UFCP.

5.110 The PRA also proposes to introduce an analogous formula for the calculation of EL under the parameter substitution method. The PRA considers that the revised risk weight and EL formulae would provide greater clarity as to how firms should calculate risk weights and ELs under the parameter substitution method.

5.111 Firms applying the parameter substitution method and substituting the PD of the exposure with the PD of the protection provider currently apply the IRB risk weight formula that is applicable to the exposure in accordance with the CRR. This is a different approach to that in the Basel 3.1 standards, where the IRB risk weight formula relevant to the protection provider is instead applied for the protected part of the exposure.

5.112 The PRA considers that the approach set out in the Basel 3.1 standards is more logical because the purpose of PD substitution is to replace the risk of obligor default with the risk of guarantor default, and the Basel 3.1 standards reflect this in full. In contrast, the PRA considers the existing CRR approach is somewhat inconsistent because it combines the risk weight function formula of the exposure with the PD of the guarantor.

5.113 The PRA therefore proposes that firms using the parameter substitution method would apply the IRB risk weight formula relevant to the protection provider for the protected part of the exposure.

Parameter substitution method: LGD for the part of an exposure covered by UFCP

5.114 Firms using the parameter substitution method can choose to substitute the LGD associated with the guarantee as well as substituting the PD. As set out in the 'Methods for recognising CRM' section of this chapter, firms would be able to choose to use the parameter substitution method where the exposure is subject to the AIRB approach and a comparable direct exposure to the guarantor would also be subject to the AIRB approach. The PRA therefore considers it necessary to clarify whether the LGD of the comparable direct exposure to the guarantor which firms may substitute for the LGD of the exposure should be calculated under the FIRB approach or the AIRB approach.

5.115 The PRA proposes to clarify that the LGD of the comparable direct exposure to the guarantor would be calculated under the FIRB approach. The PRA considers that this would be more appropriate, given that the parameter substitution method is intended to be a non-modelled CRM technique, and because it considers that substitution of modelled LGDs under this method could result in insufficiently robust outcomes. The PRA recognises that a consequence of this proposal is that firms using the parameter substitution method would not be able to substitute LGDs for retail guarantors; however, the PRA does not expect that this would have a material impact.

LGD adjustment method: combining with adjustments to obligor grades

5.116 The PRA considers that there is some ambiguity in both the CRR and the Basel 3.1 standards regarding whether firms can combine the LGD adjustment method with adjustments to obligor grades (see Chapter 4).

5.117 The PRA considers that it is challenging for firms to simultaneously apply the LGD adjustment method and to reflect the impact of a guarantee through adjustments to obligor grades without double counting. The PRA therefore proposes to clarify that where firms recognise guarantees using the LGD adjustment method, they would not also be able to reflect the effect of the guarantee by adjusting obligor grades (see Chapter 4).

Other proposals relating to UFCP

Risk weight substitution of sovereign guarantees

5.118 Firms using the risk weight substitution method are currently able to apply a preferential sovereign risk weight treatment to exposures guaranteed or part-guaranteed by a central government or central bank, where the guarantee is denominated in the domestic currency of the obligor and the exposure is funded in that currency. The PRA proposes to change the criteria for applying preferential risk weights by introducing a requirement that the guarantee must be denominated in the domestic currency of the central government or central bank providing the guarantee, rather than in that of the obligor.

5.119 The PRA proposes this change because it considers that it would better reflect the purpose of the concessionary risk weight treatment and because the proposed change would align with the Basel 3.1 standards.

Credit derivative eligibility

5.120 The PRA proposes to extend certain existing expectations relating to guarantee eligibility to cover credit derivative eligibility, where the expectation in question relates to a requirement that applies equally to guarantees and credit derivatives. The PRA considers that this change would enhance the consistency and coherence of the regulatory framework (see Appendix 15).

Residual risks

5.121 The PRA proposes to withdraw an existing expectation that firms should consider residual risks arising from UFCP through adjustments to PDs, and instead proposes to set an expectation that these should be reflected in Pillar 2. The PRA considers that this change is necessary in order to align its expectations on residual risks with its proposed changes to CRM methods that are set out in this chapter.

Maturity mismatch treatment

5.122 As noted in the 'Funded credit protection' section, the PRA proposes to make a small number of minor changes to the approach for reflecting maturity mismatches in the CRM framework that are applicable to UFCP and FCP.

> **Question 37: Do you have any comments on the PRA's proposals for UFCP?**

PRA objectives analysis

5.123 The PRA considers that the proposals set out in this section would advance its primary objective of safety and soundness. The proposals to prohibit recognition of conditional guarantees and restrict recognition of basket credit derivatives should improve firm safety and soundness given BCBS findings that such UFCP has not consistently had the desired risk-mitigating effect. The PRA considers that its proposals relating to the application of UFCP methods would advance its safety and soundness objective through better reflection of UFCP in RWAs, including that risk-mitigating effect of UFCP should not be double counted.

5.124 The PRA considers that the proposed restrictions on UFCP eligibility, including the proposals to remove the recognition of conditional guarantees, restrict recognition of basket credit derivatives, and restrict the eligible providers of counter-guarantees, would result in RWA increases for firms currently reflecting these types of UFCP in their risk weights. The PRA considers that the proposals set out in this section would collectively represent a tightening of requirements for impacted firms because they would limit the circumstances in which firms would be permitted to recognise UFCP. The PRA considers that any increase in RWAs would be justified, as set out above.

5.125 The PRA considers the proposals set out in this section would advance its secondary objective to facilitate effective competition by simplifying the framework and addressing existing deficiencies in IRB modelling. The PRA considers the proposals would enable firms using the SA to compete more effectively with firms using the IRB approach, to the extent that addressing deficiencies in IRB modelling results in increased IRB RWAs.

'Have regards' analysis

5.126 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section are broadly aligned with the Basel 3.1 standards. The PRA considers that some aspects of the Basel 3.1 standards are open to interpretation and has therefore made proposals that it considers implement the Basel 3.1 standards in line with its statutory objectives and 'have regards'.

2. Competitiveness (HMT recommendation letter) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that the proposals in this section would be unlikely to materially impact UK competitiveness. The PRA considers that its proposals relating to UFCP eligibility are aligned with those that are expected to be adopted by other jurisdictions, but considers that there is some uncertainty as to how its other proposals relating to UFCP would compare to the approaches taken by other jurisdictions. The PRA considers that the overall impact of any such variations is uncertain, as they would potentially lead to higher RWAs relative to other jurisdictions for some exposures, while leading to lower RWAs for others. Overall, the PRA considers the impact on firms to be broadly neutral, with a range of uncertainty around that, and therefore invites firms to provide responses on the overall impact of the PRA's proposals.

3. Sustainable growth (FSMA regulatory principles) and sustainable real economy financing (FSMA CRR rules):

- The PRA does not expect that the proposals in this section would have a significant impact on sustainable growth. The PRA considers, however, that some of the proposals may increase RWAs for certain exposures (eg where currently eligible UFCP would be treated as ineligible), and that this may have an impact on firms' willingness undertake particular types of lending. The PRA considers, however, that its proposals would support sustainable growth by improving the robustness and clarity of the CRM framework.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section would be a proportionate response to deficiencies in IRB modelling that have been identified by the BCBS and the PRA. The PRA considers that its proposals would result in a more risk-sensitive framework that would better align RWAs with risks.
- The PRA recognises that the proposal that firms using the parameter substitution method would apply the IRB risk weight formula relevant to the protection provider for the protected part of the exposure may slightly increase the operational burden on firms. This is because they would need to start calculating maturity (M) for retail exposures where they recognise UFCP provided by non-retail guarantors. The PRA considers, however, that its proposal is proportionate given that it considers that it would result in a more robust and coherent regulatory framework.

1. Throughout this document and the PRA's proposals, 'SFT' means a repurchase transaction, a securities or commodities lending or borrowing transaction, or a margin lending transaction.

2. The Counterparty credit risk chapter of the CRR and the Counterparty Credit Risk (CRR) Part of the PRA Rulebook.

3. A 'comparable direct exposure to the protection provider' means a direct exposure to the protection provider of the same type and with the same characteristics as the exposure to the obligor in the absence of any UFCP.

4. **Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches**.

5. 'Principle 4: The standardised approach should not rely on internal modelled approaches to set capital charges. The capital charge should be based on easily verifiable and objective variables set by regulators. The process should not require supervisory approval.' (BCBS **'Revisions to the Standardised Approach for credit risk Consultative Document'**, March 2015).

6. See Chapter 2 – Scope and levels of application, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.

7. The PRA expects all permissions granted under CRR Articles 199(6), 221(1) and 221(2) to be saved by HMT for firms implementing the Basel 3.1 standards. This would result in permissions granted under CRR Articles 199(6), 221(1) and 221(2) being deemed to be permissions under Articles 199(6), 221(1) and 221(2) of the Credit Risk Mitigation (CCR) Part. For TCR firms see paragraph 2.26 of Chapter 2.

8. This is also currently referred to as 'Repo VaR' in PRA Supervisory Statement 12/13 '**Counterparty credit risk**', April 2013.

9. Volatility adjustments are applied to the market value of collateral to take account of price volatility when valuing collateral under the FCCM.

10. The FCCM formulae also include foreign exchange volatility adjustments, which the PRA does not propose to change.

11. The credit quality steps relate to external credit ratings as referred to in Chapter 3 – Credit risk – Standardised approach.

12. The liquidation period is the period of time over which exposure or collateral values are assumed to move before the firm can close out the transaction.

13. The proposed changes would also impact the SA-CCR approach.

14. Firms using the SA are currently subject to these validation requirements; however, the PRA proposes that these requirements would only be applicable to firms using the FIRB approach as it is proposed that firms applying the SA would use origination loan to value to calculate RWAs. Firms using the AIRB approach may also be affected due to the requirement to establish valuation standards that are generally consistent with the FIRB approach where collateral is recognised in LGD estimates.

15. See Appendix 15 and the Credit Risk Mitigation (CRR) Part for further details.

16. The proposed changes to the mapping relate to exposures to unrated corporates where the PRA proposes new risk weights of 65% and 135% and to exposures to institutions that qualify for credit quality step 1, where the PRA proposes a new risk weight of 30%. While exposures to providers of life assurance would not generally be

treated as exposures to institutions under the Standardised approach chapter of the CRR and the Credit Risk: Standardised Approach (CCR) Part of the PRA Rulebook, the PRA proposes to update the OFCP method mapping to reflect the possibility of this new risk weight being assigned for completeness.

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- CP16/22 - Appendix 15: Draft amendments to Supervisory Statement SS17/13 'Credit Risk Mitigation' (PDF 1.5MB)
- Appendix 17: Draft amendments to Supervisory Statement SS12/13 – Counterparty credit risk (PDF 1.5MB)

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