

Draft Guidelines on Credit Risk Mitigation (CRM) for institutions applying the IRB approach with own estimates of LGDs

EBA Public hearing

Paris, 15 April 2019

GL on CRM in the context of IRB roadmap

Prioritisation	Regulatory products	Current status
Phase 1: Assessment methodology	RTS on IRB assessment methodology	Finalised and awaiting COM ✓
Phase 2: Definition of default	RTS on materiality threshold	Finalised and in force ✓
	GL on default of an obligor	Finalised and in force ✓
Phase 3: Risk parameters	GL on PD estimation, LGD estimation and the treatment of defaulted exposures	Finalised and in force ✓
	RTS on economic downturn GL on LGD downturn estimation	Finalised and awaiting COM ✓ Finalised ✓
Phase 4: Credit risk mitigation	RTS on conditional guarantees RTS on liquid assets RTS on master netting agreements	Postponed – broader considerations on CRM framework necessary
	<u>New initiative:</u> Report on CRM under SA and F-IRB GL on CRM under A-IRB	Finalised ✓ Consultation stage

Background – why do we need the guidelines?

- The GLs are developed in response to industry's feedback, as well as the analysis carried out by the EBA in the context of the CRM report, which outlined the complexity of the current CRR on the CRM framework:
 - Significant variability in the practices
 - Necessity to clarify the requirements and their applicability under different approaches

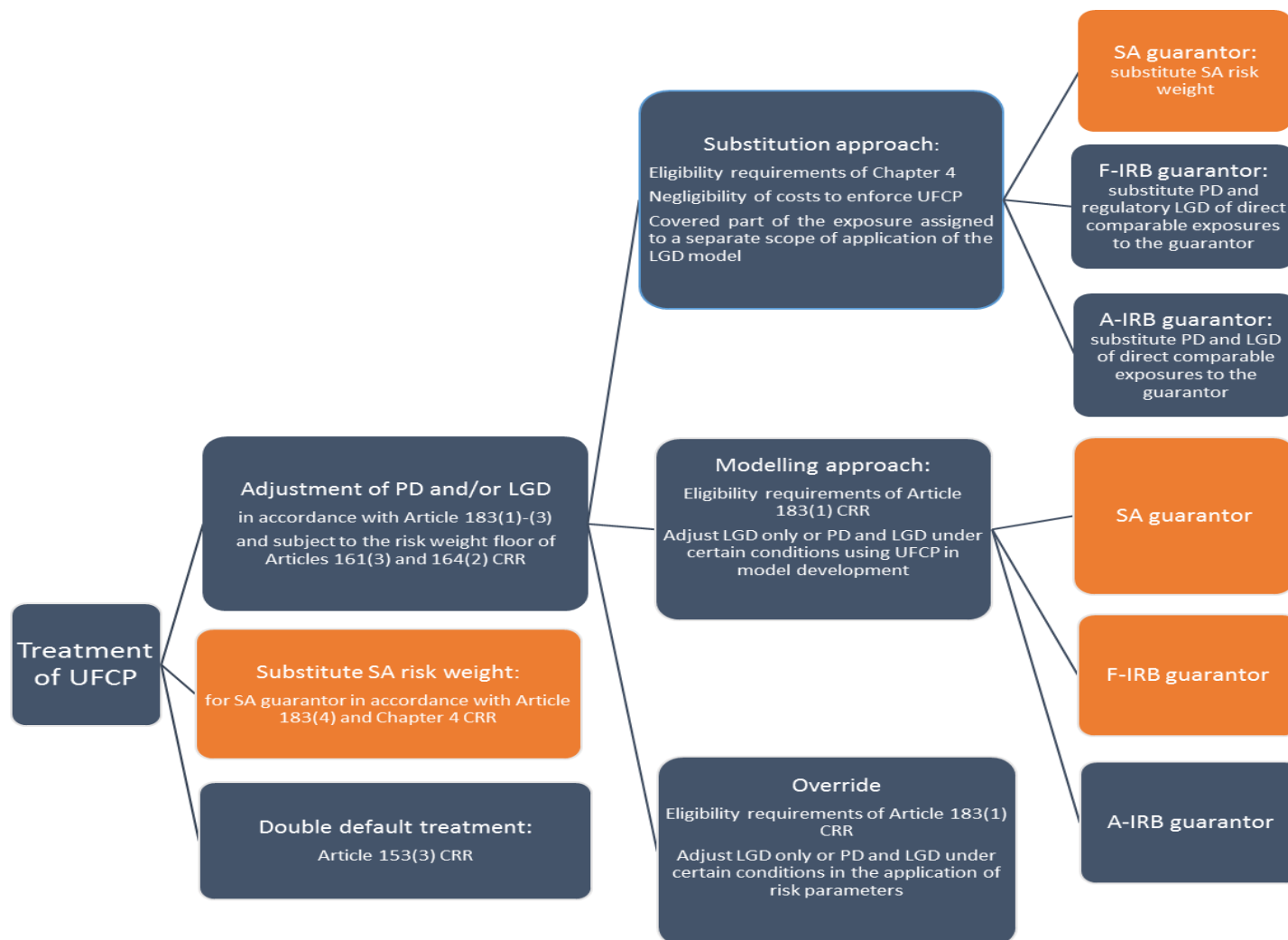
- The Guidelines on CRM under the Advanced IRB Approach (A-IRB) complement the CRM report which was focused on the Standardised Approach (SA) and the Foundation IRB Approach (F-IRB).

- The Guidelines on CRM complement the Guidelines on the PD and LGD estimation and the treatment of defaulted exposures.

Interactions with Basel III standards

- **The final Basel III framework** introduces certain adjustments to the treatment and eligibility criteria of CRM techniques for all approaches:
 - Non-eligibility of conditional guarantees and nth-to-default derivatives
 - Adjustments to the eligibility of immovable properties with junior liens
 - Recognition of the effects of unfunded credit protection (UFCP) though the use of the approach which would be applied to direct exposures to the protection provider
 - Deletion of double-default formula
- **Treatment of the Basel III reform in the GL on CRM**
 - All provisions in the GL on CRM are consistent with the current CRR
 - Any elements related to the Basel reform or which could lead to inconsistencies with the final Basel III standards are out of the scope of the GL
 - Aspects related to the Basel reform will be addressed in the EBA's response to the Call for Advice from the Commission with regard to Basel III implementation

Treatment UFCP: Basel III related issues



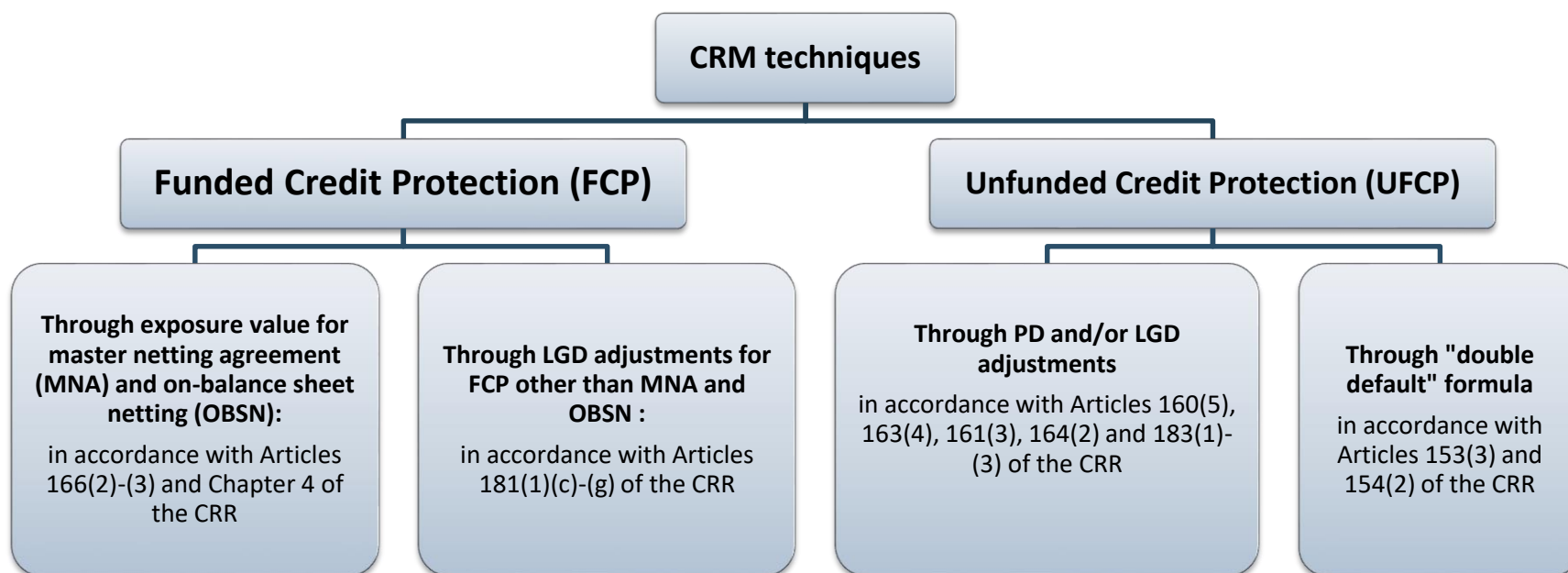
Structure of the Guidelines

The Guidelines are split into three main sections:

1. **General provisions**, aimed at clarifying the applicability of the current CRR requirements to the A-IRB Approach; clarifications include different forms of CRM, namely funded credit protection (FCP) and unfunded credit protection (UFCP)
2. **Eligibility requirements**, providing detailed guidance on the eligibility requirements for FCP and UFCP under A-IRB Approach.
3. **Effects of credit risk mitigation**, providing detailed guidance on how institutions could recognise the effects of eligible FCP and UFCP in the risk parameters; clarifications include also the treatment of ineligible credit protection.

General provisions

Overview of CRM techniques for A-IRB Approach



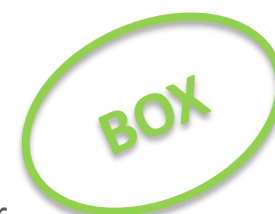
General provisions

- Main clarifications regarding **applicability of requirements**:
 - ▶ **Article 108**: under A-IRB Approach CRM recognised in accordance with Chapter 3, under F-IRB Approach in accordance with Chapter 4
 - ▶ Requirements for A-IRB Approach: **160(5), 161(3), 164(2)-(3)**
 - ▶ Requirements **not** applicable under A-IRB Approach: **160(4), 161(1)**
- The term collateral in Article 181(1) is understood as FCP other than netting.
 - ▶ FCP other than netting: Article 181(1)
 - ▶ FCP MNA and OBSN: Article 166(2) and (3)
 - ▶ UFCP: Article 183
- **On-balance sheet netting (OBSN) and master netting agreements (MNA)** should be recognised only through exposure value and according to both eligibility and treatment requirements of Chapter 4.
- **Credit insurance** may be treated in accordance with Article 183 as a guarantee or credit derivative, where it effectively functions in an equivalent manner (the definition of UFCP has to be met).

Eligibility requirements

Eligibility requirements for funded credit protection

- **Mapping to legal certainty and collateral valuation requirements of Chapter 4**
 - **Legal certainty** – the collateral is legally effective and legally enforceable in all relevant jurisdictions, giving the institution the right to liquidate or repossess the collateral in a reasonable timeframe, also in the event of the default, bankruptcy or insolvency of the obligor
 - **Valuation** – the rules governing the revaluation of the collateral, including methods and frequency of the monitoring of the value of the collateral, are consistent for each type of collateral
- **Written legal opinion** to verify enforceability and legal effectiveness of each type of collateral and in all relevant jurisdictions
 - ▶ Relevant jurisdictions for physical movable collateral:
 - Place of incorporation of the institution and the obligor
 - Law governing the collateral agreement
 - Place of registration of collateral or incorporation of the owner
 - Jurisdictions where the collateral could move during the lifetime of the loan



Eligibility requirements for unfunded credit protection

- **Written legal opinion** to verify enforceability and legal effectiveness of each type of unfunded credit protection and in all relevant jurisdictions
 - single legal opinion may support multiple credit protection arrangements where the legal opinion relates to the same applicable law
 - legal opinion relating to any substantive variation to the terms of the contract
 - legal counsel may be an employee of the institution

- **Defaulted guarantor** is ineligible

Effects of credit risk mitigation

Effects of credit risk mitigation - FCP

The EBA Guidelines on PD and LGD estimation and the treatment of defaulted exposures already provide guidance on the recognition of collateral in LGD models and hence less focus is given to that topic in the GL on CRM. In the context of FCP the GL on CRM provide additional clarifications on the treatment of OBSN and MNA.

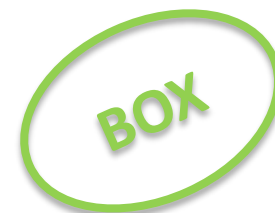
■ How to recognise OBSN and MNA in exposure value and avoid double counting?

$$LGD^* = LGD \cdot \frac{E^*}{E}$$

where:

- *LGD is an own estimate, where in risk quantification realized LGD is computed based on the adjusted exposure value, internal cash flows based on netting are not taken into account*
- *E* is computed in accordance with Chapter 4 CRR*
- *E is a gross exposure value in accordance with Article 166 CRR as if not collateralized*

► Risk weighted exposure amounts are computed based on LGD* and E*



Methods for the recognition of UFCP

1) Adjustment of PD and LGD according to 160(5), 161(3) and 164(2) according to the criteria of 183(2) and (3)

- Modelling approach
 - ▶ adjustment of LGD (including LGD in-default and EL_{BE})
 - ▶ under certain conditions both PD and LGD (never sole adjustment of PD)
- Substitution approach
 - ▶ both PD and LGD parameters should be substituted
 - ▶ subject to eligibility requirements of Chapter 4
- Override
 - ▶ for individual cases in the application of the model

Risk weight floor applies in all cases

Methods for the recognition of UFCP - cont.

2) Substitution of the risk weight with the risk weight of the guarantor in accordance with Article 183(4)

- In the case direct exposures to the guarantor are treated under the SA
- Subject to eligibility criteria specified in Article 183(4)

3) Double default formula in accordance with Articles 161(4), 164(3), 153(3) and 154(2)

- Subject to eligibility criteria specified in Articles 202 and 217

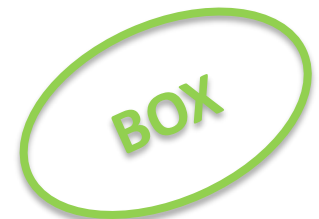
Optionality in the use of methods

■ General requirement for the use of substitution approach

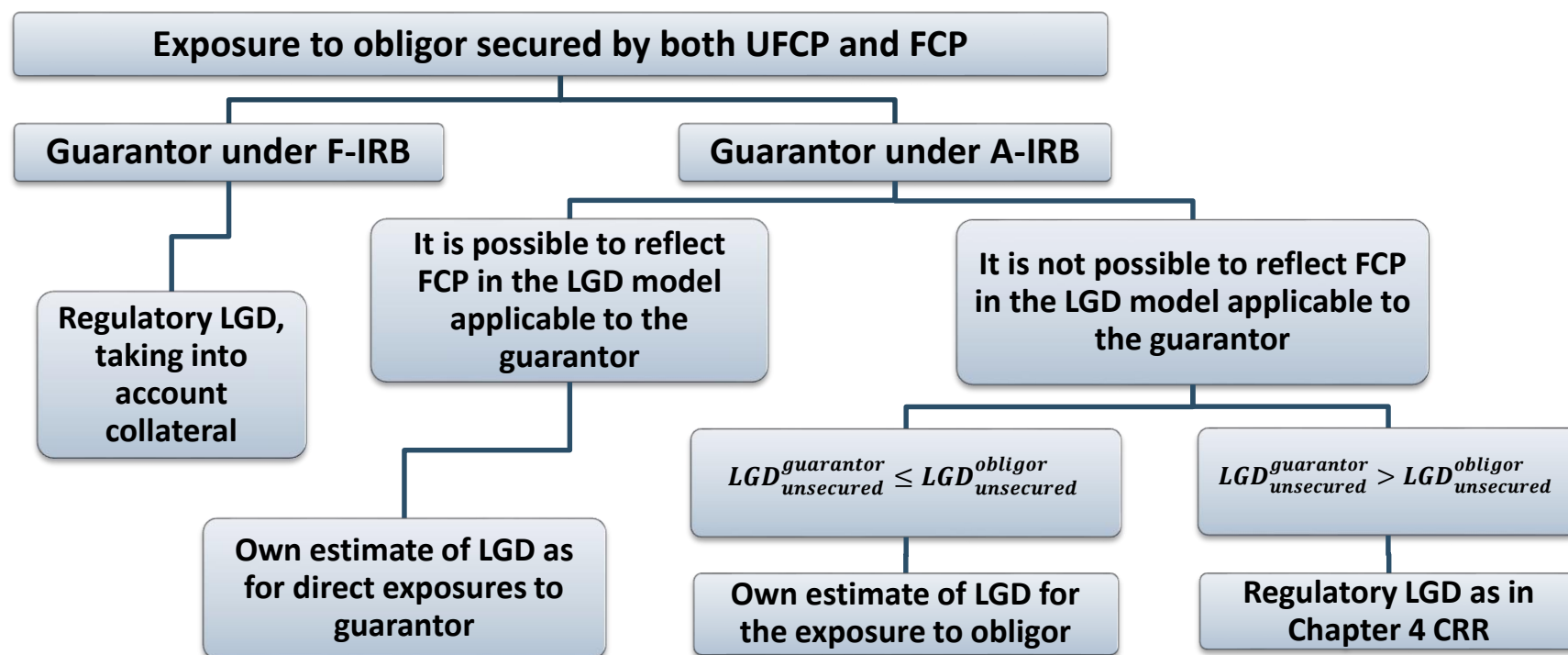
- clear policies on the scope of application of the substitution approach and methods to derive parameters applicable to comparable direct exposure to the guarantor
- separate scope of application of the LGD model for the guaranteed part of the exposure to which substitution approach is not applied
- all data relevant for PD and LGD estimation should be stored in the institution's reference data set
- PD of the obligor must be estimated; no need to estimate LGD

■ Selected application issues

- allocation cash flows and costs in case of partial guarantees
- multiple CRM techniques covering the same exposure
- backtesting of the substitution approach
 - ▶ based on EL rather than PD and LGD separately



Hierarchy of methods for deriving LGD adequate to comparable direct exposure to the protection provider, for exposures secured by UFCP and FCP
– both for substitution and for the risk weight floor:

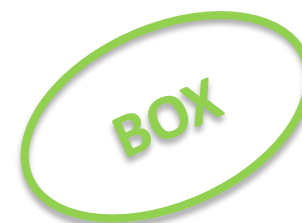


Other issues under consideration

■ Recognition of portfolio guarantees under A-IRB Approach

- Is portfolio guarantee eligible form of collateral?
 - ▶ Various possible structures of the guarantee
 1. Losses covered if above a threshold
 2. Losses covered up to a threshold
 3. Complex structure combining more than one threshold
 - ▶ Article 234 CRR not applicable
 - ▶ Definition of securitisation in accordance with point (61) of Article 4(1) CRR

- Is it possible to adequately reflect portfolio guarantee in LGD model?
 - ▶ Is sufficient data available?
 - ▶ How to allocate the portfolio effect to individual facilities?
 - ▶ How to reflect the effect of downturn conditions?



Expected timelines

■ Expected timelines for finalising the Guidelines

- Publication of the Consultation Paper – 25 February 2019
- End of the consultation period – 25 May 2019
- Analysis of responses – Q3 / Q4 2019 (tentative)
- Final Guidelines – Q4 2019 / Q1 2020 (tentative)

■ Expected timelines for implementation of the Guidelines

- Implementation date aligned with the timelines for the IRB roadmap in order to avoid multiple changes in the rating systems where possible
- Final implementation deadline including supervisory approval where necessary (together with other changes based on IRB roadmap) – end 2020 (currently envisaged)



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