

PRA CONSULTS ON INTERPRETATION OF ELIGIBILITY CRITERIA FOR UNFUNDED CREDIT RISK MITIGATION

The PRA has issued a consultation (CP6/18) on proposed changes to Supervisory Statement 17/13 on credit risk mitigation, in relation to the eligibility of guarantees as unfunded credit protection under the Capital Requirements Regulation (CRR).

Of particular note, the PRA sets out its view that a guarantor should be contractually obliged to pay out "within days" of the obligor's failure to pay, with some limited exceptions. This could potentially have a significant impact on the use of insurance as credit risk mitigation for capital purposes.

Background to the PRA consultation

Firms may use funded or unfunded credit risk mitigation (CRM) techniques to reduce the credit risk associated with an exposure. Firms are permitted to recognise some forms of CRM when calculating their own funds requirements under CRR, provided that relevant eligibility criteria are met.

The PRA is consulting on amendments to SS17/13 to include new guidance about its expectations on the eligibility criteria for the recognition of guarantees as unfunded credit protection under the "substitution approach" set out in Part Three, Title II, Chapter 4 of CRR.

What is the PRA proposing?

The PRA has set out its proposed interpretations of and expectations in relation to several of these eligibility criteria, as summarised below.

Legally effective and enforceable in all relevant jurisdictions

The PRA states that at a minimum, it would expect firms to satisfy themselves that the guarantee is enforceable under its governing law and in the jurisdiction where the guarantor is incorporated. Practical ease of enforcement should be considered and the PRA would expect an independent legal opinion to consider the eligibility criteria.

Clearly defined and incontrovertible

The PRA interprets "incontrovertible" to mean that the wording of the guarantee should be clear and unambiguous, and leave no practical scope for

Summary

- PRA consultation on guidance on eligibility criteria for guarantees to be recognised as credit protection under Part Three, Title II, Chapter 4 CRR
- PRA sets out proposed expectations and interpretation of eligibility criteria
- Interpretation of requirement to pay out in a timely manner as meaning "within days, but not weeks" may impact existing unfunded credit protection, including insurance products which typically have longer pay out periods
- Consultation closes on 16 May 2018
- Once finalised, amendments to SS17/13 will be effective immediately upon publication

the guarantor to dispute, contest, challenge or otherwise seek to be released from, or reduce, their liability. The PRA states that firms should consider the terms of the guarantee itself, the remedies under applicable law and whether there are scenarios in which the guarantor could successfully reduce or be released from liability.

Contractual requirement to pay out in a timely manner

Articles 213(1)(c)(iii) and 215(1)(a) CRR require that the guarantor should be required to pay "in a timely manner". The PRA considers this requirement to mean that the payout should be "within days, but not weeks or months" of the obligor's failure to make payment when due, except where:

- the guarantee covers residential mortgage loans (in this case CRR specifically allows a 24 month pay out period);
- where provisional payments are made under guarantees provided by mutual guarantee schemes or by public sector bodies; or
- where CRM is applied in respect of a securitisation position in the different context of CRR Part Three, Title II, Chapter 5.

This may have significant implications, particularly for insurance and other similar risk transfer products that are used as unfunded credit protection, where longer pay out periods are common (e.g. 90, 120 or 180 days).

Adjustment of guarantee value to reflect limited coverage where certain types of payment are excluded

The PRA's view is that "limited coverage" refers to a quantifiable portion of the exposure and "certain types of payment" refer to different sums that an obligor may be required to pay such as principal, interest or margin payments. Therefore, where for example a guarantee covers non-payment of principal but excludes interest payments, the PRA expects that this limited coverage will be reflected in the calculation of the value of the unfunded credit protection.

Conversely therefore, this requirement would not allow for adjustment of the guarantee value to reflect exclusion of certain types of risks, such as nuclear risks, which would instead render the guarantee ineligible for recognition as CRM under CRR.

Scope of the consultation

The PRA notes that CRR does not define the term "guarantee" and so guarantees may take many forms. However, only those that meet the relevant criteria will be eligible as unfunded CRM under Part Three, Title II, Chapter 4 of CRR.

The PRA states that the proposed amendments to SS17/13 are relevant for firms applying the standardised approach or foundation internal ratings based approach to exposures, but not for firms applying the advanced internal ratings approach (**AIRB**) for the recognition of guarantees under Part Three, Title II, Chapter 3 CRR, which is outside the scope of the current consultation.

However, the draft SS17/13 states that it applies to other parts of the CRR that cross-reference Part Three, Title II, Chapter 4 (including some provisions of Chapter 3) and so firms may need to analyse carefully the extent to which this consultation may impact them. In addition, even if some firms conclude that the proposed SS17/13 does not formally apply to them, the consultation does

"The PRA considers that the requirement for the guarantor to be obliged, contractually, to pay out 'in a timely manner' means that the pay out should be made without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment..."

[PRA Consultation Paper CP6/18](#)

nevertheless raise a question about the extent to which the PRA's views (such as in relation to the "timely manner" requirement) may have broader implications.

Timing and next steps

The PRA is inviting feedback on the proposals set out in CP6/18, which is open for responses until 16 May 2018. The PRA specifically asks for feedback on the nature of and impact of the proposals on firms' existing CRM practices.

The PRA will then consider the responses received, before publishing a final revised version of SS17/13. As a Supervisory Statement, the updated version would be effective immediately upon publication, affording firms little, if any, grace period. In addition, as the proposed amendments to SS17/13 are framed as a clarification of the PRA's interpretation of existing rules under CRR, the final updated Supervisory Statement would be relevant for both existing and new unfunded credit protection.

Therefore, firms should consider whether or not their current CRM arrangements are consistent with the PRA's proposals. The PRA notes that where firms identify that they use CRM in a way that may not meet the PRA's expectations, they should discuss this with their usual supervisory contact.

Since the outcome of the consultation and final positions that the PRA may adopt are not yet clear, it may be premature for firms to take pre-emptive action at this stage. Nevertheless firms may decide to conduct some contingency planning or take transitional steps, to ensure they are well prepared for the eventual outcome of the consultation.

Firms should also consider to what extent the consultation may impact their CRM arrangements going forward.

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