afme/
Finance for Europe

Association for Financial Markets in Europe

Consultation response

PRA CP1/19

Credit risk mitigation: Eligibility of financial collateral

10 April 2019

Introduction

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Prudential Regulation Authority's (PRA's) consultation paper on Credit risk mitigation: Eligibility of financial collateral. AFME agrees with the PRA's expectations in relation to determinants of material positive correlation, emphasising however that the existence of positive correlation should not in itself imply that there is material positive correlation. We also highlight additional factors that are relevant and should be taken into account when determining whether any positive correlation is "material".

In relation to the treatment of non and limited recourse transactions, we recognise that the CRR does not directly address risks specific to these transactions. However, we believe the PRA's proposed approach which results in non and limited recourse transactions being treated as unsecured credit exposures is unduly conservative. The approach lacks risk sensitivity and is inconsistent with the definition of MPC, which states that a firm must consider the characteristics of the obligor, transaction and collateral and goes beyond the CRR. As such, we have provided suggestions of alternative approaches within our response for the PRA's consideration.

Given the potentially significant impact of a change in treatment, we believe that it is important to understand the impact of changes and ensure that an approach that is decided on i) is equally applicable to firms using modelled and non-modelled approaches, ii) does not contradict historical evidence of the benefits of collateral even in non-recourse transactions, and iii) retains the required risk-sensitivity in order to promote effective risk management. As such, we would request a further consultation be issued once the PRA has considered industry feedback and we provide greater details of relevant considerations in the feedback that follows. We note that CP1/19 was prompted in part by the PRA's work on equity margin transactions (i.e. similar to Steinhoff) but the principles are equally applicable to non- or limited-recourse transactions with debt underlyings. As part of the re-consultation it may be appropriate to consider clarifying the intended scope of the policy.

Industry Comments

The consultation deals with two elements of eligibility of financial collateral for the purposes of credit risk mitigation: CRR requirements on correlated collateral; and material positive correlation in transactions with limited recourse.

CRR requirements on correlated collateral

The first element relates to determinants that should be taken into consideration in assessing the existence of 'a material positive correlation' (MPC) for the purposes of satisfying the requirements for a financial collateral asset in CRR Article 207(2). In particular, a firm must consider the characteristics of the (i) obligor; (ii) the transaction; and (iii) the collateral. In specifying the characteristics, the consultation specifies that the absence of a legal connection between the issuer of the collateral and the obligor does not preclude the possibility of material positive correlation.

AFME agrees that the characteristics of the obligor, collateral and transaction are important determinants of MPC and with the PRA's view that the absence of legal connectedness alone does not preclude the possibility of material positive correlation. A number of factors such as business model dependencies, correlations that might arise where the obligor and the collateral issuer share the same country (i.e. general wrong way risk), and any other factors must also be considered in determining MPC. However, whilst these factors might give rise to positive correlation, the level of correlation must be assessed on a transaction by transaction basis, as a factor that indicates MPC for one transaction does not necessitate MPC for another. For instance, where the obligor and collateral issuer share the same country, whilst indicating positive correlation, this alone should not imply that this is material positive correlation in the context of the transaction, as the entities may be operating in different sectors. As such, firms should make their own assessment on the degree of MPC based on a number of relevant factors applicable to each transaction.

Additional factors that are relevant for determining whether any positive correlation is "material" and should therefore be taken into account include transaction specific features such as over-collateralisation, deleverage triggers, close out features, margining arrangements etc.

As an illustrative example, a transaction exhibiting positive correlation that is supported by liquid and eligible collateral that materially over-collateralises the exposure value should not be viewed as having MPC. This follows, as a reduction in the value of the collateral does not immediately imply deterioration in the credit worthiness of the counterparty whilst the exposure remains significantly over-collateralised.

It is recognised that in all cases firms should be able to articulate clearly to the PRA the rationale for their judgements in respect of material positive correlation both as part of their ongoing supervisory dialogue and as part of the firm's SREP evaluation.

Material positive correlation in transactions with limited recourse

The second element relates to transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets. It is the PRA's view that for these transactions, a fall in the value of the financial collateral assets may itself sometimes trigger the default of the obligor. In order to guard against this risk, the PRA has assessed that any financial collateral asset whose value has positive correlation with the total value of all of the assets to which the lender has legal recourse (including collateral posted by the obligor and any other assets to which the firm has legal recourse), to meet the definition of material positive correlation as per CRR Article 207(2).

In the example provided in paragraph 8.5.(i) of the consultation paper, it states that the PRA expects firms not to recognise as eligible collateral on any non-recourse margin loan collateral assets that consist of a single asset, or group of materially positively correlated assets. We understand that an index instrument is not deemed a single asset for the purpose of this statement and the constituent parts of the index would need to be assessed for the existence of MPC if the PRA's proposals remain unchanged.

It should be noted, however, that we do not consider the existence of MPC as a relevant consideration in non and limited recourse transactions. As such, in the remainder of this paper we outline existing prudent credit risk management practices that help mitigate risks associated with non and limited recourse transactions, the factors we believe relevant in assessing risks associated with such transactions and suggestions for alternative approaches for the PRA's consideration. However, we believe it necessary that any proposal should be consulted on and the impacts of proposals fully considered before any new approach is mandated.

Prudent credit risk management

Lending firms typically manage their credit risk exposure for any transaction by including safeguards and explicit risk mitigation features within any contractual arrangements, in order to protect themselves against losses arising from non-payment or default. Such features tend to be especially relevant when a firm lends on a limited recourse (or non-recourse) basis or lends against single assets.

The underlying risk on non and limited recourse margin loans is primarily driven by the pledged collateral and not the fundamental credit quality of the borrower. Therefore, ignoring the collateral from a risk perspective would be inconsistent with the risk profile of non and limited recourse margin loans.

Additionally, given the fact that the borrower SPV generally does not have any material assets beyond the pledged collateral, the credit quality or rating of the direct borrower cannot be assessed using traditional credit risk metrics and instead the risk analysis focuses primarily on the collateral.

Factors considered in such analysis include but are not limited to leverage of the underlying obligor, collateral valuation considerations, country and industry specific risks, market volatility of the collateral provided, historical analysis of gaps in the collateral values or large price declines in a short period of time, debt profile and capital structure of the issuer of the collateral, shareholder register, normal and stressed trading liquidity, and macro-economic backdrop.

This collateral risk analysis is used in determining transaction specific features that ensure prudent risk management. Additional transactional features ensure that the firm minimises any losses it may incur upon default of the obligor. Such features include (and are not limited to):

- Very low LTVs for such arrangements (i.e. significant over-collateralisation, taking into account the value of collateral under a potential stressed exit)
- Margin triggers payable in cash
- LTV triggers which immediately close out the trades
- Margin triggers linked to the market liquidity (trade volumes) of collateral
- Qualitative mitigants such as parental guarantees and other forms of credit support.

It should be noted that the above structural features are typically included specifically to minimise the correlation between the obligor default and the resulting loss suffered by the lending firm.

For example, a non or limited recourse loan supported by single asset liquid and eligible collateral that materially over-collateralizes the exposure and benefits from additional risk mitigating factors such as daily cash margining and LTV close-out triggers should not be viewed as having MPC. In this case, a reduction in the value of the collateral does not immediately and alone imply deterioration in the creditworthiness of the counterparty so long as it remains materially over-collateralized which daily margining would ensure. Furthermore, in the event of a larger decline in the value of the collateral asset, the LTV close-out trigger would permit the lender to terminate the loan and liquidate the collateral in a prompt and timely manner and thus limit the potential loss.

Considerations for limited recourse transactions

Value of financial collateral vs default of the obligor

By definition, financing under a limited or non-recourse transaction is de-linked from the credit-worthiness of the obligor as the lender cannot pursue the obligor in case of a shortfall upon default of the obligor. Therefore, the key consideration when capitalising such transactions should be the extent of collateral coverage and impact of reduction in the value of the collateral rather than the correlation with the creditworthiness of the obligor.

Risk Sensitivity and harmonised implementation

It is our view that the PRA's expectation for "firms not to recognise as eligible collateral on any non-recourse margin loan collateral assets that consist of a single asset, or group of materially positively correlated assets." is overly simplistic and non-risk sensitive. As such, we have suggested a more targeted alternative approach that we outline below.

In considering the appropriate treatment however, it should be noted the PRA's proposals are super-equivalent to the CRR and international requirements. In turn, the alternative approach put forward by industry also goes beyond existing requirements. As such, when considering these approaches, it is important to consider the implications on an international level playing field and whether a more harmonised approach is required internationally, rather than first-mover disadvantage adding to existing headwinds faced by the UK.

Alternative Approaches

Capitalisation of Gap Risk for transactions with limited recourse

The CRR level 1 text does not specifically address the situation where, although an exposure is to one particular obligor (e.g. an SPE), the bank with that exposure has limited or no economic or legal recourse to that entity and instead would seek to recover any losses on default by liquidating the collateral to which the bank does have legal and economic recourse.

If an obligor has no economic substance other than its collateral, it follows that its economic exposure is directly related to the underlying collateral value rather than the obligor's credit-worthiness (i.e. losses would arise from a drop in collateral value below the loan amount upon close out of the trade).

The CRR does not specify a treatment for non-recourse financing. However, the market risk part of the PRA rulebook specifies, within the "Instruments for which no treatment specified" chapter that "where the a firm has a position in a financial instrument for which no treatment has been specified in the CRR, it must calculate its own funds requirement for that position by applying the more appropriate rules relating to positions that are specified in the CRR, if doing so is prudent and appropriate, and if the position is sufficiently similar to those covered by the relevant rules."[1] As such, we have taken this principle and considered the most appropriate rules for capturing the risks associated with collateral value in non and limited recourse transactions and have identified approaches that can be applied to capture the risk of these transactions.

As noted earlier, the primary risk for the lender on margin/equity lending transactions is the risk of substantial fall in value of the collateral with any residual value being insufficient to avoid losses on any unpaid loan – otherwise known as "gap risk." Economically, this is similar to the firm writing an out-of-the-money written put option with a prepaid strike. These transactions can therefore be capitalised as an out-of-the-money written put option. Acknowledging that the firm's Pillar 1 charges do not sufficiently capture the gap risk inherent in the transaction (e.g. the risk of jump to default of the collateral), this can be addressed through the market risk capital framework, either via the standardised approach, or the IMA approach where available.

We note that the CRR permits the transfer of internal risks between the banking book to trading book under Article 106 and therefore this approach can be applied consistently to relevant banking book and trading book exposures. Where the risk is not captured under Pillar 1, it should be addressed through Pillar 2 or other appropriate measures (e.g. hedging of gap risk on a portfolio basis) where material, and its adequacy assessed as part of the SREP review.

This approach would allow for a more targeted approach than discounting all collateral in limited recourse transactions as eligible credit risk mitigation and retain risk sensitivity in the capital framework.

A Look-through Approach for transactions exhibiting MPC

Arguably, the current CRR text also does not adequately address the risks faced by the firm where it is exposed to a transaction which exhibits MPC. Such transactions are currently treated as uncollateralised credit exposures, as the credit risk mitigation provided is considered ineligible.

One pragmatic approach to address this deficiency is to consider the economic exposure to be to the underlying collateral, rather than to the obligor, thereby recognising a more accurate risk profile of the arrangement.

For IRB firms we believe that such an approach is possible, even required, by the provisions of Article 170(1)(a) which requires firms to ensure that rating systems "take into account obligor and transaction characteristics".

Where the obligor and collateral are materially correlated, it follows that the appropriate parameters to assign to that obligor are driven by the credit characteristics of the collateral. Conservatively, the

[1] http://www.prarulebook.co.uk/rulebook/Content/Chapter/211447/22-02-2019

obligor can be assigned the PD and LGD of the collateral, though there will likely be a case for assigning a better PD or LGD to reflect overcollateralisation.

For a standardised bank we believe that common sense would permit a similar approach, whereby a non-recourse exposure to an unrated SPV should be treated as an exposure to its underlying instrument(s). Such an approach is supported by the approach adopted in analogous situations:

- CRR1 permits, and CRR2 requires, exposures to funds to be treated as exposures to the underlying instruments
- CRR1 considers the underlying assets for securitisations and specialised lending exposures even where the SPV itself is unrated
- Where an exposure is secured on collateral, or benefits from a collateralised guarantee, the exposure is assigned the risk weight of the collateral where that is lower than that of primary obligor, and Article 3 permits a more conservative capitalisation approach (so that where the collateral has a higher risk weight than the obligor it would be conservative to apply the collateral risk weight in circumstances where the obligor has no other economic substance.)

Having determined that the credit characteristics of an arrangement where MPC is present are driven by the amount and characteristics of the collateral, the next step is to determine the approach for risk weighting the exposure. For a standardised bank without any sophisticated model approvals the risk weight could, as noted above, be driven by the risk weight attributable to the collateral. For an IRB bank the risk weight could be driven by the credit characteristics as determined by Article 170(1)(a).

However, a more sophisticated approach, where a bank has the appropriate model permissions and where the exposure is managed as part of trading book activity, is to consider the exposure as a market risk exposure and therefore capitalise using market risk and gap risk models. This is also in line with the approach suggested for non-recourse and limited recourse arrangements above.

Conclusion

The assessment of MPC should be based on the unique characteristics of the obligor, the transaction and the collateral in concluding on the correlation present.

We believe the PRA's proposals highlight the need for a tailored treatment for non and limited recourse transactions that is not explicit in the current capital framework. However, it is our view that correlation between the obligor and collateral is not a relevant factor for assessing the eligibility of collateral for non and limited recourse transactions, as the lender cannot pursue the obligor in case of a shortfall upon default of the obligor, and the focus should therefore be on the characteristics and value of the collateral in order to understand the potential loss to the firm under a default scenario.

It is our view that any revised treatment for limited / non-recourse transactions should retain an appropriate level of risk sensitivity, which the PRA's proposals lack through a super-equivalent blanket ban on recognising collateral in these transactions as eligible, which is also inconsistent with the principle of assessing all relevant characteristics for the assessment of MPC.

As such, we have put forward alternative approaches for the PRA's consideration, including a gap risk approach, a look-through approach, and the use of Pillar 2 add-ons or other appropriate measures where the risk is material and cannot be captured through look-through or a gap risk approach. The adequacy of capital in all instances can be assessed as part of a firm's SREP evaluation.

We have developed our proposals to address what we believe to be the PRA's core concern of a collateral shortfall and have sought to leverage existing approaches / principles that can be supported by the CRR to facilitate a consistent and coherent framework. Nevertheless, we believe a change in regulatory treatment would be significant and merits additional consultation to ensure there are no unintended consequences e.g. the scope of the revised treatment captures transactions other than equity margin loans, which we understand to be the PRA's focus, and that the impact of any approach is well understood before it is mandated.

AFME and its members are available to engage further with the PRA on this topic as required.

Kind Regards,

Director, Prudential Regulation

Sahir Akbar

sahir.akbar@afme.eu

+44 (0)20 3838 2732

Director, Prudential Regulation

Constance Usherwood

constance.usherwood@afme.eu

+44 (0)20 3838 2719

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

Information about AFME and its activities is available on the Association's website: **www.afme.eu**