

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Text with EEA relevance)

PART THREE

CAPITAL REQUIREMENTS

TITLE II

CAPITAL REQUIREMENTS FOR CREDIT RISK

CHAPTER 4

Credit risk mitigation

Section 3

Requirements

Sub-Section 1

Funded credit protection

Article 205

Requirements for on-balance sheet netting agreements other than master netting agreements referred to in Article 206

On-balance sheet netting agreements other than master netting agreements referred to in Article 206 shall qualify as an eligible form of credit risk mitigation where all the following conditions are met:

- (a) those agreements are legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;
- (b) institutions are able to determine at any time the assets and liabilities that are subject to those agreements;
- (c) institutions monitor and control the risks associated with the termination of the credit protection on an ongoing basis;
- (d) institutions monitor and control the relevant exposures on a net basis and do so on an ongoing basis.

Article 206

Requirements for master netting agreements covering repurchase transactions or securities or commodities lending or borrowing transactions or other capital market driven transactions

Master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transactions or other capital market driven transactions shall qualify as an eligible form of credit risk mitigation where the collateral provided under those agreements meets all the requirements laid down in Article 207(2) to (4) and where all the following conditions are met:

- (a) they are legally effective and enforceable in all relevant jurisdictions, including in the event of the bankruptcy or insolvency of the counterparty;
- (b) they give the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon the event of default, including in the event of the bankruptcy or insolvency of the counterparty;
- (c) they provide for the netting of gains and losses on transactions closed out under an agreement so that a single net amount is owed by one party to the other.

Article 207

Requirements for financial collateral

1 Under all approaches and methods, financial collateral and gold shall qualify as eligible collateral where all the requirements laid down in paragraphs 2 to 4 are met.

2 The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. Where the value of the collateral is reduced significantly, this shall not alone imply a significant deterioration of the credit quality of the obligor. Where the credit quality of the obligor becomes critical, this shall not alone imply a significant reduction in the value of the collateral.

Securities issued by the obligor, or any related group entity, shall not qualify as eligible collateral. This notwithstanding, the obligor's own issues of covered bonds falling within the terms of Article 129 qualify as eligible collateral when they are posted as collateral for a repurchase transaction, provided that they comply with the condition set out in the first subparagraph.

3 Institutions shall fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of the collateral arrangements under the law applicable to their interest in the collateral.

Institutions shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions. They shall re-conduct such review as necessary to ensure continuing enforceability.

- 4 Institutions shall fulfil all the following operational requirements:
- a they shall properly document the collateral arrangements and have in place clear and robust procedures for the timely liquidation of collateral;

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- b they shall use robust procedures and processes to control risks arising from the use of collateral, including risks of failed or reduced credit protection, valuation risks, risks associated with the termination of the credit protection, concentration risk arising from the use of collateral and the interaction with the institution's overall risk profile;
- c they shall have in place documented policies and practices concerning the types and amounts of collateral accepted;
- d they shall calculate the market value of the collateral, and revalue it accordingly, at least once every six months and whenever they have reason to believe that a significant decrease in the market value of the collateral has occurred;
- e where the collateral is held by a third party, they shall take reasonable steps to ensure that the third party segregates the collateral from its own assets;
- f they shall ensure that they devote sufficient resources to the orderly operation of margin agreements with OTC derivatives and securities-financing counterparties, as measured by the timeliness and accuracy of their outgoing margin calls and response time to incoming margin calls;
- g they shall have in place collateral management policies to control, monitor and report the following:
 - (i) the risks to which margin agreements expose them;
 - (ii) the concentration risk to particular types of collateral assets;
 - (iii) the reuse of collateral including the potential liquidity shortfalls resulting from the reuse of collateral received from counterparties;
 - (iv) the surrender of rights on collateral posted to counterparties.

5 In addition to meeting all the requirements set out in paragraphs 2 to 4, for financial collateral to qualify as eligible collateral under the Financial Collateral Simple Method the residual maturity of the protection shall be at least as long as the residual maturity of the exposure.

Article 208

Requirements for immovable property collateral

- 1 Immovable property shall qualify as eligible collateral only where all the requirements laid down in paragraphs 2 to 5 are met.
- 2 The following requirements on legal certainty shall be met:
- a a mortgage or charge is enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement and shall be properly filed on a timely basis;
 - b all legal requirements for establishing the pledge have been fulfilled;
 - c the protection agreement and the legal process underpinning it enable the institution to realise the value of the protection within a reasonable timeframe.
- 3 The following requirements on monitoring of property values and on property valuation shall be met:
- a institutions monitor the value of the property on a frequent basis and at a minimum once every year for commercial immovable property and once every three years for residential real estate. Institutions carry out more frequent monitoring where the market is subject to significant changes in conditions;

- b the property valuation is reviewed when information available to institutions indicates that the value of the property may have declined materially relative to general market prices and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. For loans exceeding EUR 3 million or 5 % of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years.

Institutions may use statistical methods to monitor the value of the property and to identify property that needs revaluation.

4 Institutions shall clearly document the types of residential and commercial immovable property they accept and their lending policies in this regard.

5 Institutions shall have in place procedures to monitor that the property taken as credit protection is adequately insured against the risk of damage.

Article 209

Requirements for receivables

1 Receivables shall qualify as eligible collateral where all the requirements laid down in paragraphs 2 and 3 are met.

2 The following requirements on legal certainty shall be met:

- a the legal mechanism by which the collateral is provided to a lending institution shall be robust and effective and ensure that that institution has clear rights over the collateral including the right to the proceeds from the sale of the collateral;
- b institutions shall take all steps necessary to fulfil local requirements in respect of the enforceability of security interest. Lending institutions shall have a first priority claim over the collateral although such claims may still be subject to the claims of preferential creditors provided for in legislative provisions;
- c institutions shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions;
- d institutions shall properly document their collateral arrangements and shall have in place clear and robust procedures for the timely collection of collateral;
- e institutions shall have in place procedures that ensure that any legal conditions required for declaring the default of a borrower and timely collection of collateral are observed;
- f in the event of a borrower's financial distress or default, institutions shall have legal authority to sell or assign the receivables to other parties without consent of the receivables obligors.

3 The following requirements on risk management shall be met:

- a an institution shall have in place a sound process for determining the credit risk associated with the receivables. Such a process shall include analyses of a borrower's business and industry and the types of customers with whom that borrower does business. Where the institution relies on its borrowers to ascertain the credit risk of the customers, the institution shall review the borrowers' credit practices to ascertain their soundness and credibility;
- b the difference between the amount of the exposure and the value of the receivables shall reflect all appropriate factors, including the cost of collection, concentration within the receivables pool pledged by an individual borrower, and potential concentration risk within the institution's total exposures beyond that controlled by the institution's general

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- methodology. Institutions shall maintain a continuous monitoring process appropriate to the receivables. They shall also review, on a regular basis, compliance with loan covenants, environmental restrictions, and other legal requirements;
- c receivables pledged by a borrower shall be diversified and not be unduly correlated with that borrower. Where there is material positive correlation, institutions shall take into account the attendant risks in the setting of margins for the collateral pool as a whole;
 - d institutions shall not use receivables from affiliates of a borrower, including subsidiaries and employees, as eligible credit protection;
 - e institution shall have in place a documented process for collecting receivable payments in distressed situations. Institutions shall have in place the requisite facilities for collection even when they normally rely on their borrowers for collections.

Article 210

Requirements for other physical collateral

Physical collateral other than immovable property collateral shall qualify as eligible collateral under the IRB Approach where all the following conditions are met:

- (a) the collateral arrangement under which the physical collateral is provided to an institution shall be legally effective and enforceable in all relevant jurisdictions and shall enable that institution to realise the value of the collateral within a reasonable timeframe;
- (b) with the sole exception of permissible first priority claims referred to in Article 209(2) (b), only first liens on, or charges over, collateral shall qualify as eligible collateral and an institution shall have priority over all other lenders to the realised proceeds of the collateral;
- (c) institutions shall monitor the value of the collateral on a frequent basis and at least once every year. Institutions shall carry out more frequent monitoring where the market is subject to significant changes in conditions;
- (d) the loan agreement shall include detailed descriptions of the collateral as well as detailed specifications of the manner and frequency of revaluation;
- (e) institutions shall clearly document in internal credit policies and procedures available for examination the types of physical collateral they accept and the policies and practices they have in place in respect of the appropriate amount of each type of collateral relative to the exposure amount;
- (f) institutions' credit policies with regard to the transaction structure shall address the following:
 - (i) appropriate collateral requirements relative to the exposure amount;
 - (ii) the ability to liquidate the collateral readily;
 - (iii) the ability to establish objectively a price or market value;
 - (iv) the frequency with which the value can readily be obtained, including a professional appraisal or valuation;
 - (v) the volatility or a proxy of the volatility of the value of the collateral.

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- (g) when conducting valuation and revaluation, institutions shall take fully into account any deterioration or obsolescence of the collateral, paying particular attention to the effects of the passage of time on fashion- or date-sensitive collateral;
- (h) institutions shall have the right to physically inspect the collateral. They shall also have in place policies and procedures addressing their exercise of the right to physical inspection;
- (i) the collateral taken as protection shall be adequately insured against the risk of damage and institutions shall have in place procedures to monitor this.

Article 211

Requirements for treating lease exposures as collateralised

Institutions shall treat exposures arising from leasing transactions as collateralised by the type of property leased, where all the following conditions are met:

- (a) the conditions set out in Article 208 or 210, as applicable, for the type of property leased to qualify as eligible collateral are met;
- (b) the lessor has in place robust risk management with respect to the use to which the leased asset is put, its location, its age and the planned duration of its use, including appropriate monitoring of the value of the security;
- (c) the lessor has legal ownership of the asset and is able to exercise its rights as owner in a timely fashion;
- (d) where this has not already been ascertained in calculating the LGD level, the difference between the value of the unamortised amount and the market value of the security is not so large as to overstate the credit risk mitigation attributed to the leased assets.

Article 212

Requirements for other funded credit protection

1 Cash on deposit with, or cash assimilated instruments held by, a third party institution shall be eligible for the treatment set out in Article 232(1), where all the following conditions are met:

- a the borrower's claim against the third party institution is openly pledged or assigned to the lending institution and such pledge or assignment is legally effective and enforceable in all relevant jurisdictions and is unconditional and irrevocable;
- b the third party institution is notified of the pledge or assignment;
- c as a result of the notification, the third party institution is able to make payments solely to the lending institution or to other parties only with the lending institution's prior consent.

2 Life insurance policies pledged to the lending institution shall qualify as eligible collateral where all the following conditions are met:

- a the life insurance policy is openly pledged or assigned to the lending institution;
- b the company providing the life insurance is notified of the pledge or assignment and, as a result of the notification, may not pay amounts payable under the contract without the prior consent of the lending institution;

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- c the lending institution has the right to cancel the policy and receive the surrender value in the event of the default of the borrower;
- d the lending institution is informed of any non-payments under the policy by the policyholder;
- e the credit protection is provided for the maturity of the loan. Where this is not possible because the insurance relationship ends before the loan relationship expires, the institution shall ensure that the amount deriving from the insurance contract serves the institution as security until the end of the duration of the credit agreement;
- f the pledge or assignment is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement;
- g the surrender value is declared by the company providing the life insurance and is non-reducible;
- h the surrender value is to be paid by the company providing the life insurance in a timely manner upon request;
- i the surrender value shall not be requested without the prior consent of the institution;
- j the company providing the life insurance is subject to Directive 2009/138/EC or is subject to supervision by a competent authority of a third country which applies supervisory and regulatory arrangements at least equivalent to those applied in the Union.

Sub-Section 2

Unfunded credit protection and credit linked notes

Article 213

Requirements common to guarantees and credit derivatives

1 Subject to Article 214(1), credit protection deriving from a guarantee or credit derivative shall qualify as eligible unfunded credit protection where all the following conditions are met:

- a the credit protection is direct;
- b the extent of the credit protection is clearly defined and incontrovertible;
- c the credit protection contract does not contain any clause, the fulfilment of which is outside the direct control of the lender, that:
 - (i) would allow the protection provider to cancel the protection unilaterally;
 - (ii) would increase the effective cost of protection as a result of a deterioration in the credit quality of the protected exposure;
 - (iii) could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due, or when the leasing contract has expired for the purposes of recognising guaranteed residual value under Articles 134(7) and 166(4);
 - (iv) could allow the maturity of the credit protection to be reduced by the protection provider;
- d the credit protection contract is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

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2 An institution shall demonstrate to competent authorities that it has in place systems to manage potential concentration of risk arising from its use of guarantees and credit derivatives. An institution shall be able to demonstrate to the satisfaction of the competent authorities how its strategy in respect of its use of credit derivatives and guarantees interacts with its management of its overall risk profile.

3 An institution shall fulfil any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of its unfunded credit protection under the law applicable to its interest in the credit protection.

An institution shall have conducted sufficient legal review confirming the enforceability of the unfunded credit protection in all relevant jurisdictions. It shall repeat such review as necessary to ensure continuing enforceability.

Article 214

Sovereign and other public sector counter-guarantees

1 Institutions may treat the exposures referred to in paragraph 2 as protected by a guarantee provided by the entities listed in that paragraph, provided all the following conditions are satisfied:

- a the counter-guarantee covers all credit risk elements of the claim;
- b both the original guarantee and the counter-guarantee meet the requirements for guarantees set out in Articles 213 and 215(1), except that the counter-guarantee need not be direct;
- c the cover is robust and nothing in the historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct guarantee by the entity in question.

2 The treatment set out in paragraph 1 shall apply to exposures protected by a guarantee which is counter-guaranteed by any of the following entities:

- a a central government or central bank;
- b a regional government or local authority;
- c a public sector entity, claims on which are treated as claims on the central government in accordance with Article 116(4);
- d a multilateral development bank or an international organisation, to which a 0 % risk weight is assigned under or by virtue of Articles 117(2) and 118 respectively;
- e a public sector entity, claims on which are treated in accordance with Article 116(1) and (2).

3 Institutions shall apply the treatment set out in paragraph 1 also to an exposure which is not counter-guaranteed by any entity listed in paragraph 2 where that exposure's counter-guarantee is in turn directly guaranteed by one of those entities and the conditions listed in paragraph 1 are satisfied.

Article 215

Additional requirements for guarantees

1 Guarantees shall qualify as eligible unfunded credit protection where all the conditions in Article 213 and all the following conditions are met:

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- a on the qualifying default of or non-payment by the counterparty, the lending institution has the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided and the payment by the guarantor shall not be subject to the lending institution first having to pursue the obligor;

In the case of unfunded credit protection covering residential mortgage loans, the requirements in Article 213(1)(c)(iii) and in the first subparagraph of this point have only to be satisfied within 24 months;

- b the guarantee is an explicitly documented obligation assumed by the guarantor;
- c either of the following conditions is met:
 - (i) the guarantee covers all types of payments the obligor is expected to make in respect of the claim;
 - (ii) where certain types of payment are excluded from the guarantee, the lending institution has adjusted the value of the guarantee to reflect the limited coverage.

2 In the case of guarantees provided in the context of mutual guarantee schemes or provided by or counter-guaranteed by entities listed in Article 214(2), the requirements in point (a) of paragraph 1 of this Article shall be considered to be satisfied where either of the following conditions is met:

- a the lending institution has the right to obtain in a timely manner a provisional payment by the guarantor that meets both the following conditions:
 - (i) it represents a robust estimate of the amount of the loss, including losses resulting from the non-payment of interest and other types of payment which the borrower is obliged to make, that the lending institution is likely to incur;
 - (ii) it is proportional to the coverage of the guarantee;
- b the lending institution can demonstrate to the satisfaction of the competent authorities that the effects of the guarantee, which shall also cover losses resulting from the non-payment of interest and other types of payments which the borrower is obliged to make, justify such treatment.

Article 216

Additional requirements for credit derivatives

1 Credit derivative shall qualify as eligible unfunded credit protection where all the conditions in Article 213 and all the following conditions are met:

- a the credit events specified in the credit derivative contract include:
 - (i) the failure to pay the amounts due under the terms of the underlying obligation that are in effect at the time of such failure, with a grace period that is equal to or shorter than the grace period in the underlying obligation;
 - (ii) the bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events;
 - (iii) the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event;
- b where credit derivatives allow for cash settlement:

- (i) institutions have in place a robust valuation process in order to estimate loss reliably;
- (ii) there is a clearly specified period for obtaining post-credit-event valuations of the underlying obligation;
- c where the protection purchaser's right and ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation provide that any required consent to such transfer shall not be unreasonably withheld;
- d the identity of the parties responsible for determining whether a credit event has occurred is clearly defined;
- e the determination of the credit event is not the sole responsibility of the protection provider;
- f the protection buyer has the right or ability to inform the protection provider of the occurrence of a credit event.

Where the credit events do not include restructuring of the underlying obligation as described in point (a)(iii), the credit protection may nonetheless be eligible subject to a reduction in the value as specified in Article 233(2);

2 A mismatch between the underlying obligation and the reference obligation under the credit derivative or between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible only where both the following conditions are met:

- a the reference obligation or the obligation used for the purpose of determining whether a credit event has occurred, as the case may be, ranks *pari passu* with or is junior to the underlying obligation;
- b the underlying obligation and the reference obligation or the obligation used for the purpose of determining whether a credit event has occurred, as the case may be, share the same obligor and legally enforceable cross-default or cross-acceleration clauses are in place.

Article 217

Requirements to qualify for the treatment set out in Article 153(3)

1 To be eligible for the treatment set out in Article 153(3), credit protection deriving from a guarantee or credit derivative shall meet the following conditions:

- a the underlying obligation is to one of the following exposures:
 - (i) a corporate exposure as referred to in Article 147, excluding insurance and reinsurance undertakings;
 - (ii) an exposure to a regional government, local authority or public sector entity which is not treated as an exposure to a central government or a central bank in accordance with Article 147;
 - (iii) an exposure to an SME, classified as a retail exposure in accordance with Article 147(5);
- b the underlying obligors are not members of the same group as the protection provider;
- c the exposure is hedged by one of the following instruments:
 - (i) single-name unfunded credit derivatives or single-name guarantees;

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- (ii) first-to-default basket products;
 - (iii) nth-to-default basket products;
- d the credit protection meets the requirements set out in Articles 213, 215 and 216, as applicable;
 - e the risk weight that is associated with the exposure prior to the application of the treatment set out in Article 153(3), does not already factor in any aspect of the credit protection;
 - f an institution has the right and expectation to receive payment from the protection provider without having to take legal action in order to pursue the counterparty for payment. To the extent possible, the institution shall take steps to satisfy itself that the protection provider is willing to pay promptly should a credit event occur;
 - g the purchased credit protection absorbs all credit losses incurred on the hedged portion of an exposure that arise due to the occurrence of credit events outlined in the contract;
 - h where the payout structure of the credit protection provides for physical settlement, there is legal certainty with respect to the deliverability of a loan, bond, or contingent liability;
 - i where an institution intends to deliver an obligation other than the underlying exposure, it shall ensure that the deliverable obligation is sufficiently liquid so that the institution would have the ability to purchase it for delivery in accordance with the contract;
 - j the terms and conditions of credit protection arrangements are legally confirmed in writing by both the protection provider and the institution;
 - k institutions have in place a process to detect excessive correlation between the creditworthiness of a protection provider and the obligor of the underlying exposure due to their performance being dependent on common factors beyond the systematic risk factor;
 - l in the case of protection against dilution risk, the seller of purchased receivables is not a member of the same group as the protection provider.
- 2 For the purpose of point (c)(ii) of paragraph 1, institutions shall apply the treatment set out in Article 153(3) to the asset within the basket with the lowest risk-weighted exposure amount.
- 3 For the purpose of point (c)(iii) of paragraph 1, the protection obtained is only eligible for consideration under this framework where eligible (n-1)th default protection has also been obtained or where (n-1) of the assets within the basket has or have already defaulted. Where this is the case, institutions shall apply the treatment set out in Article 153(3) to the asset within the basket with the lowest risk-weighted exposure amount.