

Financial Conduct Authority



Consultation Paper

CP14/28**

MIPRU Simplification

December 2014



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We are asking for comments on this Consultation Paper by 19 January 2015.

You can send them to us using the form on our website at:
www.fca.org.uk/your-fca/documents/consultation-papers/cp14-28-response-form

Or in writing to:

John Carroll
Policy, Risk and Research Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 1906
Email: cp14-28@fca.org.uk

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You can download this Consultation Paper from our website: www.fca.org.uk. Or contact our order line for paper copies: 0845 608 2372.

Abbreviations used in this paper

AIFMD	Alternative Investment Fund Managers Directive
BCD	Banking Consolidation Directive
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BTL	Buy-to-let
CIU	Collective Investment Undertakings
CP	Consultation Paper
CP11/31	Mortgage Market Review: Proposed package of reforms (December 2011)
CRD	Capital Requirements Directive (EU Directive 2013/36/EU), which forms part of the CRD IV legislative package
CRD IV	The CRR and the CRD
CRR	Capital Requirements Regulation (EU Regulation 575/2013), which forms part of the CRD IV legislative package
Deposit-takers	Banks and building societies
EEA	European Economic Area
FCA	Financial Conduct Authority
FSA	Financial Services Authority
LTV	Loan-to-value
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
MLAR	Mortgage Lenders & Administrators Return
MMR	Mortgage Market Review
NBLs	Non-bank lenders
PRA	Prudential Regulation Authority
PS	Policy Statement
PS12/16	Mortgage Market Review: Responsible Lending (October 2012)

1. Overview

Introduction

- 1.1** We are consulting on the changes we propose to our Handbook to make it simpler for certain mortgage firms to calculate their capital requirements. These are firms that undertake home financing and/or home finance administration (with assets on the balance sheet) that is connected to regulated mortgage contracts, termed 'non-bank lenders' (NBLs). They are subject to the provisions located in chapter 4 of the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU).

Why are we revising the existing rules and guidance again?

- 1.2** As part of the Mortgage Market Review¹ (MMR), our predecessor regulator, the Financial Services Authority (FSA), decided that the existing prudential capital requirements for lending by NBLs, primarily in the area of residential mortgages given their business model, did not appropriately reflect the inherent risks. So the FSA decided to revise those requirements to reflect this.
- 1.3** This led to the first phase of the revision of chapter 4 of MIPRU (MIPRU 4) – introducing for NBLs the same credit risk capital requirements for mortgage lending used by banks and building societies (deposit-takers) in the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). These provisions came into force on 26 April 2014 and form the current version of MIPRU 4 which largely cross-refers to the prudential provisions contained in BIPRU for the standardised approach to credit risk (chapter 3), credit risk mitigation (chapter 5) and securitisation (chapter 9). NBLs are therefore currently subject to the same provisions in these areas as BIPRU firms.
- 1.4** Those chapters in BIPRU contain complex and detailed rules, as they are derived from European legislation², which was designed for deposit-takers and their broader lending activities. NBLs have a different business model to deposit-takers so many of these provisions are redundant. The Policy Statement³ (PS12/16) on the MMR, published in October 2012, recognised this with an obligation for the FSA to '*continue to explore whether and how the same policy requirements could be delivered through a simplified, stand-alone set of rules in MIPRU (without cross-reference [to BIPRU]) in a way that makes them more accessible to non-bank lenders*'.
- 1.5** To address this commitment and make our rules and guidance simpler, we are proposing a revised and simplified stand-alone version of the relevant provisions in MIPRU 4, omitting all

¹ www.fca.org.uk/firms/firm-types/mortgage-brokers-and-home-finance-lenders/mortgage-market-review

² In the form of the Banking Consolidation Directive (<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32006L0048>) which has since been replaced by CRD IV (<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32006L0048>)

³ www.fca.org.uk/your-fca/documents/fsa-ps-12-16-mortgage-market-review

references to BIPRU, whilst seeking to maintain the existing, underlying policy and capital requirements as far as possible. This means we need to propose minor changes that are necessary to make the standalone provisions in MIPRU 4 more accessible to NBLs by revising or removing the more complex and detailed provisions in BIPRU.

Is this of interest to consumers?

- 1.6** The current provisions in BIPRU are difficult to understand for new entrants without a background in those capital adequacy requirements and they may therefore act as a barrier. Simplifying them may encourage smaller firms to enter the NBL sector as the provisions should be easier to understand and comply with, which would offer consumers more choice (and potentially a better deal).

Timeline

- 1.7** We granted smaller NBLs a modification of MIPRU 4 by consent⁴. This effectively delays the implementation of the MIPRU 4 rules that cross-refer to BIPRU rules until 26 April 2015. The NBLs that used the modification remain subject to the version of MIPRU 4 that applied prior to 26 April 2014. The modification by consent, which gave us more time to consider how to make the rules more accessible for such firms, will expire on 25 April 2015. We want to implement the revised provisions by then so we can make all NBLs subject to the same simplified provisions in MIPRU 4 from 26 April 2015 onwards.

Second phase changes

- 1.8** The sections in MIPRU 4 that we propose revising would remain largely the same in content as those in BIPRU, but we have taken this opportunity to reorder them to allow more straightforward navigation through the provisions, and have also provided a roadmap at the start of lengthier sections for that purpose. We have removed all cross-references to BIPRU, and the changes in moving to the proposed, second phase version of MIPRU 4 from the first phase of its revision are summarised in Table 1.

⁴ www.fca.org.uk/firms/being-regulated/waiver/waiver-by-consent/mipru-4

Table 1: Proposed changes to MIPRU 4

Section	Title	Second phase revisions and proposals
4.2	Capital resources requirements	No material changes
4.2A	Credit risk capital requirement	Removal of cross-references to BIPRU and incorporation of provisions from BIPRU 3
4.2B	Securitisation	Deleted, replaced by 4.2BA
4.2BA	Securitisation	New, replaces 4.2B, and has been simplified whilst reflecting provisions in BIPRU 9
4.2C	Credit risk mitigation	Removal of cross-references to BIPRU and incorporation of provisions from BIPRU 5
4.2D	Liquidity	Remains the same, no change
4.2E	Use of external credit assessments	New, reflects provisions in BIPRU 3
4.2F	Exposures and risk weights	New, reflects provisions in BIPRU 3

- 1.9** There is a substantial change in the form of the proposed provisions for MIPRU 4 for the section covering securitisation, in MIPRU 4.2BA, when compared to what appears in BIPRU. We have sought to simplify the underlying language and structure that appears in chapter 9 of BIPRU, removing complex language and making it more compact, so it is more intelligible to NBLs.
- 1.10** Section MIPRU 4.2F will reflect modified capital requirements in a couple of cases, namely in relation to mortgages for residential and commercial properties overseas. We propose introducing a single risk weight for each of these exposure classes, but removing the lengthy and complex provisions in BIPRU that might require a firm to assess the overseas regulatory regime for credit risk in order to derive a risk weight. Annex 1 contains the proposed simplified provision in relation to overseas residential mortgages, alongside the comparable ones from BIPRU, as an example of the trade-off being made here.
- 1.11** Overall, these proposed changes should not have significant impacts for the generally larger NBLs that have not taken up the modification and are therefore moving from the current cross-referenced provisions to the proposed ones, based on their pared-down business model relative to deposit-takers.
- 1.12** We appreciate, however, that those NBLs that have not used the modification will face a second change to MIPRU 4 within a short time. Offsetting this is the benefit that those firms currently subject to the cross-referenced provisions should also find it easier to navigate the simpler articulation of the provisions we propose in the revised MIPRU 4; the capital requirements will remain essentially unchanged.
- 1.13** NBLs will retain the opportunity to apply to the FCA for waivers where they believe that provisions in BIPRU, which have been superseded by the proposed revised provisions in MIPRU 4, are more appropriate for their business activities.

Cost benefit analysis

- 1.14** The simplification of the provisions will help NBLs to understand better the Handbook provisions in MIPRU 4, and thereby promote their compliance with them. It should therefore be beneficial for NBLs as they will require less specialist knowledge to understand the simplified provisions

proposed for MIPRU 4 than is required to understand the complex and lengthy provisions in BIPRU, and potentially lead to reduced costs in their compliance function.

- 1.15** The proposals also mirror the exposure classes as they appear in the reporting requirements that come into force in the revised version of MLAR⁵ that NBLs will be subject to from 1 January 2015. Any costs incurred as a result of moving to the revised reporting requirements will not, therefore, be increased by us introducing a second revised version of MIPRU 4 and the proposed exposure classes.
- 1.16** Additionally, supervisors will benefit from having a simpler set of provisions, both in terms of their interactions with the NBLs they supervise and in assessing the compliance of NBLs with the underlying provisions.
- 1.17** For some NBLs these beneficial effects may be offset, however, by proposals that might result in an increase in capital requirements for lending related to mortgages for residential and commercial properties overseas. These proposals, and others, are outlined in Chapter 2, but the activities in these areas fall outside the normal business model of NBLs, plus the new provisions will only apply to mortgage lending originated on or after 26 April 2014. We believe, therefore, that any potential increase in costs will be of minimal significance.
- 1.18** So we believe that our proposals contain only small policy changes that will have no material adverse impact on the market for NBLs and may potentially give rise only to costs of minimal significance that are outweighed by the benefits that more simple and accessible rules will bring.

Equality and diversity considerations

- 1.19** PS 12/16 stated that:

'[the] MMR proposes the introduction of a new prudential regime for non-deposit taking mortgage lenders, which is based on the relevant parts of BIPRU. Respondents to CP11/31⁶ did not raise any equality or diversity concerns about these prudential requirements. An initial assessment was completed prior to consultation and as no new issues were raised we have concluded there are no equality or diversity implications.'

- 1.20** As our proposals here are a straightforward clarification and reduction of the existing prudential provisions as referred to above, we conclude there are no further equality or diversity implications.

What do you need to do next

- 1.21** We want to know what you think of our proposals to simplify these provisions in MIPRU 4 and would welcome comments by 19 January 2015. We recognise that the consultation period is shorter than the three-month period that would normally be the case, but the proposed changes to MIPRU 4 should be welcome to NBLs as they reduce the complexity and volume of the provisions. We also believe that a shorter consultation period will not impact on our

⁵ 'Mortgage Lenders & Administrators Return', <http://fshandbook.info/FS/html/FCA/SUP/16/Annex19A>

⁶ <http://www.fca.org.uk/your-fca/documents/consultation-papers/fsa-cp11-31>

objectives in a negative manner, as the goal in simplifying the provisions has been to make them more accessible to NBLs, and the proposed provisions very largely maintain the existing policy position. Finally, adopting this consultation period will allow the revised provisions to be implemented by 26 April 2015 so that all NBLs become subject to the same provisions from that date.

How?

- 1.22** Use the online response form on our website or write to us at the address on page 2.

What will we do?

- 1.23** We will consider your feedback and publish our final rules and guidance in a Policy Statement in March 2015, in time for implementation of the revised provisions on 26 April 2015.

2. Revisions and policy change proposals

Objectives

- 2.1** As outlined in PS12/16, our overarching objectives in the simplification of the provisions in MIPRU 4 have been *'to help make the rules more accessible and not to change the impact or application of the risk-based capital requirements derived from applying the relevant BIPRU rules as consulted on in CP11/31'*.
- 2.2** Simplifying MIPRU 4 consists of two strands:
- (i)** revising the language and format to remove complexity and keep the underlying policy identical to that in BIPRU; and
 - (ii)** proposing to make the provisions more accessible, but where that necessarily entails some change in the existing BIPRU policy.

Below we outline one case of a revision in (i) above where the underlying policy remains the same, but there is a significant change in style in how the provisions are formulated, and we also detail the proposed policy changes under (ii) above that we believe are necessary to achieve the objectives of the simplification exercise.

- 2.3** We suggest that the proposed revised provisions in MIPRU 4 (set out in Appendix 1) very largely achieve the first of the objectives above, i.e. we have simplified the language and structure of MIPRU 4 wherever possible to enhance accessibility. However, there are some limited exceptions where we consider it is both necessary and desirable to propose changes to policy, leading to changes in the provisions, such as that relating to lending for mortgages on residential properties overseas.
- 2.4** These proposals reflect the differences in business models between NBLs (subject to MIPRU) and deposit-takers (subject to BIPRU), whilst also contributing to the objective of simplifying the resulting provisions in MIPRU and achieving a clean break with BIPRU. In this CP we are consulting on both (i) the revisions we have made to the structure of – and language in – MIPRU 4 and (ii) the proposed policy changes outlined below.

Revisions

- 2.5** We are proposing recasting the existing provisions on risk weights for residential buy-to-let and investment properties where the provisions in BIPRU, which NBLs without the modification are currently subject to, are derived from the BCD.
- 2.6** In identifying the secured part of an exposure in the form of a mortgage on a residential property there is a provision in BIPRU⁷ that requires that:
- 'the risk of the borrower does not materially depend upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the loan does not materially depend on any cashflow generated by the underlying property serving as collateral'.*
- 2.7** For the purposes of BIPRU, we have exercised a national discretion available in the BCD, effectively an 'opt-out', to dis-apply this provision for 'exposures fully and completely secured by mortgages on residential property which is situated within the United Kingdom'⁸. Our use of this opt-out is based on previous evidence of the well-developed and long-established residential real estate market present in the UK with loss rates which are sufficiently low to justify such treatment.
- 2.8** In addition to owner-occupied properties, the use of this 'opt-out' allows exposures to residential buy-to-let (BTL) and investment properties in the UK to be treated as fully secured under BIPRU. Those exposures may then be assigned a risk weight of 35% for that part of the exposure up to a maximum loan-to-value (LTV) of 80%. However, BIPRU states that if loss rates for the residential real estate market are not sufficiently low the regulator may be obliged to revoke the opt-out, which would result in a risk weight of 75% being assigned to any part of such an exposure up to a threshold of the value of the property (above which the marginal risk weight is 100%).
- 2.9** We are now proposing that the simplified version of MIPRU 4 effectively replicates the outcome of the policy contained in BIPRU, i.e. that part of an exposure in the form of a mortgage on a residential property in the UK (whether owner-occupied, BTL or for investment) that is below the threshold of an LTV of 80% may be considered as secured and thereby qualify for a risk weight of 35% (assuming all other conditions are met).
- 2.10** If the opt-out in BIPRU were not mirrored in the proposed provisions in MIPRU 4⁹, the secured part of an exposure to residential BTL and investment properties could not be assigned a risk weight of 35% where there was a dependence on the property itself to generate sufficient cashflows to repay the underlying exposure. This would result in that part of the exposure up to the value of the property being considered as an unsecured exposure and assigned a risk weight of 75% and any remaining part of the exposure in excess of the value of the property being assigned a risk weight of 100%.
- 2.11** We are proposing that the effect of the opt-out in BIPRU is replicated in the simplified provisions in MIPRU 4, which will maintain the level playing field between NBLs and deposit-takers with such exposures in the UK. Unlike in BIPRU, we do not propose to complicate matters by making any explicit link to there being sufficiently low loss rates or by keeping a rule that gives us the ability to revoke the treatment according to loss rates. We would, however, welcome comments

⁷ BIPRU 3.4.60 R(3)

⁸ BIPRU 3.4.61 R

⁹ Achieved by omitting any provisions from the revised MIPRU 4 that are the equivalent of BIPRU 3.4.60 R(3) and BIPRU 3.4.61 R

on what effect there might be on NBLs and the residential BTL and property investment markets if we were not to replicate the opt-out that appears in BIPRU for deposit-takers, and that is therefore currently in place for NBLs without the modification. We would also welcome comments on whether any explicit link to there being sufficiently low loss rates can be removed for NBLs (as such firms are not bound by the requirements of EU legislation).

Q1: If we keep the opportunity to consider some part of exposures to residential BTL or investment properties in the UK as being secured, do you agree with our proposal not to include any reference to sufficiently low loss rates in the rules? If you disagree, why is that?

Policy change proposals

2.12 We set out in Table 2 the proposed changes from the current provisions in MIPRU 4 (as cross-referenced to BIPRU) at a high level, with the supporting rationale. (These are generally ordered as they appear in the proposed version of MIPRU 4.)

Table 2: Proposed policy changes

Policy issue	Detail [and existing BIPRU rule references]	Proposal [and proposed MIPRU rule references]
1. Exposure classes	There are currently sixteen exposure classes to which firms must assign their exposures. [BIPRU 3.2.9 R]	We propose reducing the number of exposure classes to five, covering mortgages secured on real estate (both residential and commercial), securitisation positions, exposures to funds, other loans and past due items, as this will align with the simpler business model of NBLs. This mirrors the exposure classes referred to in both MIPRU 4.2.23 R (where 'loans' covers all mortgages and other loans) and the reporting requirements that will appear in MLAR from 1 January 2015. [MIPRU 4.2A.6 R]
2. Other items	This exposure class is currently included to capture all exposures falling outside the other exposure classes. [BIPRU 3.2.9 R(16)]	We propose further discussion about capturing any exposures that are currently out of scope of the revised proposals (see chapter 3), where they do not fall under the five proposed exposure classes as they may give rise to risk that is not adequately captured by the proposed provisions, including appropriate capital requirements. [MIPRU 4.2.23 R and 4.2A.6 R]

Policy issue	Detail [and existing BIPRU rule references]	Proposal [and proposed MIPRU rule references]
3. Other loans	This exposure class is not in BIPRU, but is picked up through the use of a default risk weight of 100%. [BIPRU 3.2.24 R]	We propose introducing this as a separate exposure class with a single risk weight of 100% to reflect the greater risk associated with (i) the part of any exposure secured on a residential property that exceeds the value of the property and (ii) any other unsecured loan. It is already in MLAR. [MIPRU 4.2A.6 R(2)]
4. CIU positions	This exposure class is currently included. [BIPRU 3.2.9 R(15)]	We propose retaining this exposure class given the potential for regulatory arbitrage as firms may use such pooled investments to hold lending assets rather than directly on the balance sheet (as outlined in CP11/31), but changing the designation of this exposure class to 'funds' further to the implementation of the AIFMD. This exposure class covers positions in both collective investment schemes and alternative investment funds and is therefore a broader definition than CIU and in our view better achieves the policy objective of capturing any pooled investments in loans. [MIPRU 4.2A.6 R(4)]
5. Credit risk mitigation – volatility adjustment for currency mismatches	Firms may choose an approach to assess the appropriate volatility adjustment where an underlying exposure and the associated credit protection are denominated in different currencies. [BIPRU 5]	We propose introducing a single volatility adjustment of 10% as it will be easier for an NBL to use should it have currency mismatches in this area, although we do not expect this to be widely used given the NBL business model (unlike deposit-takers which employ a wider variety of credit risk mitigation techniques). We have set this value based on the existing range of supervisory adjustments in BIPRU. [MIPRU 4.2C.22 R]
6. Residential mortgages – monitoring of value	An independent valuer must periodically review a property valuation where it exceeds the lower of €3m or 5% of the capital resources of the firm. [BIPRU 3.4.66 R(1)(e)]	We propose keeping this requirement for higher-value properties, to reflect the greater risk associated with them, but converting the figure of €3m to £2.5m as this lending by NBLs should be primarily based in the UK. [MIPRU 4.2F.14 R(1)(e)]

Policy issue	Detail [and existing BIPRU rule references]	Proposal [and proposed MIPRU rule references]
7. Residential mortgages – overseas properties	For a residential mortgage in an EEA state or third country, BIPRU requires an assessment of the overseas regulatory regime to allow the exposure to qualify for a risk weight of 35%. [BIPRU 3.4.83 R to 3.4.85 R]	We propose introducing a single risk weight of 75% to cover both secured and unsecured portions of such residential mortgages (equal to that for the unsecured portion of a domestic residential mortgage). The use of a single risk weight will remove the requirement to assess the overseas regulatory regime. [MIPRU 4.2F.36 R]
8. Commercial mortgages – overseas properties	For a commercial mortgage in an EEA state, BIPRU has significant requirements in respect of the overseas regulatory regime to allow the exposure to qualify for the local risk weight. [BIPRU 3.4.90 R to 3.4.94 R]	We propose introducing a single risk weight of 100%, the same as for domestic commercial mortgages. The use of a single risk weight will remove the requirement to assess the overseas regulatory regime. [MIPRU 4.2F.37 R]
9. Credit risk mitigation - funded	Firms may use credit protection in this form to obtain regulatory capital relief. [BIPRU 5.2.5 R]	We propose to remove these provisions as there is no evidence that NBLs use this form of credit protection.

- 2.13** Issues 7 and 8 in Table 2 require particular consideration because the proposed policy changes relate to lending for residential and commercial mortgages on overseas properties.
- 2.14** In this context ‘overseas lending’ will cover lending by a UK-based NBL or its overseas branch to a borrower based either in the UK or overseas for the purposes of taking out a mortgage on a property that is physically located outside the UK: it is this last condition on the domicile of the property itself that determines the ‘overseas’ nature of such lending.
- 2.15** The proposal to introduce single, revised risk weights for both of the above exposure classes may result in increased capital requirements for some NBLs that undertake lending on overseas properties. However, the impact should be marginal as the changes would only apply to overseas lending of this kind, which itself should be a small proportion of NBLs’ total lending given their business model, and limited to those exposures originated on or after 26 April 2014. Taken together, these exposures should only be a very small proportion of total exposures for NBLs. We believe that these two proposed changes should not have a material impact – if any – on the capital requirements for those NBLs currently subject to the provisions in BIPRU, i.e. those not subject to the modification by consent, given the simpler business model of NBLs relative to that of deposit-takers.
- 2.16** Overall, considering the policy proposals outlined in Table 2 in the round, we believe that the proposed policy changes do not represent significant changes to the related BIPRU provisions that NBLs not using the modification are subject to in the current version of MIPRU 4. For example, NBLs are unlikely to have ‘other loans’ that are rated (outside those exposures arising from securitisations and positions in funds) so applying differentiated risk weights to this exposure class would introduce unnecessary complexity (issue 3 in Table 2).

Conclusion

- 2.17** Our view is that the proposed policy changes, overall, will not have a disproportionate impact on NBLs on a standalone basis or relative to firms subject to BIPRU, and they will very largely maintain the alignment of capital requirements for NBLs with those for deposit-takers undertaking comparable lending activities. An NBL may apply to us, however, for a waiver from the proposed provision(s) in MIPRU 4 where it believes that the detailed provision(s) in BIPRU which we propose to remove may be more appropriate to its individual business.

Q2: Do you agree that the proposed policy changes (set out in Table 2) are justified and will have an immaterial impact on NBLs given their business model and lending profiles?

3. Discussion chapter

Background

- 3.1 In reviewing the provisions in MIPRU 4 we have identified two issues where we invite further comments from the industry. These are outlined below, with references to the relevant BIPRU and existing and proposed MIPRU 4 provisions as appropriate.

Other items

- 3.2 ***(BIPRU 3.2.9 R(16), MIPRU 4.2.23 R and 4.2A.6A R)***
This exposure class appears in BIPRU and includes tangible items, cash items in the process of collection and forward purchases. These items have associated risk weights that are then converted into a capital requirement by multiplying them by the figure of 8%: under MIPRU 4 these items would have a flat-rate capital requirement of 1%. However, the alternative of introducing risk weights based on the riskiness of these assets would both introduce more risk-sensitivity and maintain consistency with the capital requirements that deposit-takers are subject to.

Q3: Is the application of more risk-sensitive capital requirements (than the flat rate of 1%), for exposures falling outside the exposure classes identified in MIPRU 4.2A.6A R, an area appropriate for future consideration?

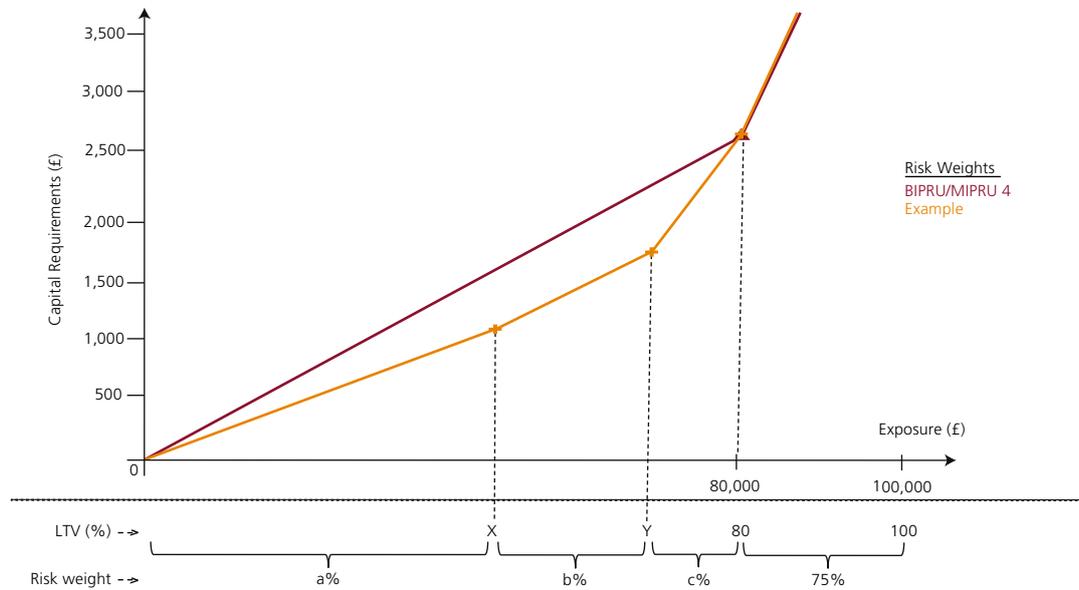
Loan-to-value bandings for capital requirements

- 3.3 ***(BIPRU 3.4.56 R and 3.4.58 R, MIPRU 4.2F.4 R and 4.2F.9 R)***
The splitting of exposures to residential mortgages in BIPRU into secured, unsecured and 'other' parts that attract different risk weights goes some way to reflecting the different risks posed to an NBL by those loans. The proposed changes to MIPRU 4 retain these three categories, but introducing more risk-sensitivity into the risk weights applied to residential mortgages might be achieved through using a more graduated set of risk weights for the secured part of the exposure. Differentiated risk weights could be assigned on a marginal basis to the part of the exposure associated with specific 'LTV bands', such as in the hypothetical example in Table 3 below.

Table 3: Example of risk weights differentiated by LTV

LTV band ==>		0% to X%	X% to Y%	Y% to 80%	80% to 100%	>100%
		Secured			Unsecured	Other
Risk weights	BIPRU & MIPRU 4	35%			75%	100%
	Example	a%	b%	c%	75%	100%

3.4 The application of these differentiated risk weights is illustrated in Chart 1 below, where the value of the residential property is £100,000.

Chart 1: Capital requirements arising from risk weights differentiated by LTV

3.5 In this example, up to the point at which the LTV equals 80% of the property value, the LTV bands and associated risk weights are derived in order to introduce more risk-sensitivity through differentiated risk weights than those used under BIPRU/the proposed MIPRU 4; this recognises that, in general, lower LTVs represent lower risk to a lender and this, in turn, delivers lower capital requirements for the secured part. For exposures exceeding an LTV of 80%, i.e. the part of the exposure that is not secured, the capital requirements across BIPRU/MIPRU 4 and this hypothetical set of risk weights are the same, where the maroon and orange lines in Chart 1 run together. (If any such proposal were adopted it would need to be calibrated to ensure that capital requirements were appropriate for this category of exposures.)

Q4: Is the use of differentiated risk weights, based on LTV and that would reduce capital requirements for exposures to loans secured on residential property, an area appropriate for future consideration?

Annex 1

Examples of simplified requirements

Current	Proposed	Comment
<p>BIPRU 3.4.83 R</p> <p>EXAMPLE – Overseas residential mortgages</p> <p>A firm may only treat an exposure as fully and completely secured by residential property situated in another EEA State for the purposes of BIPRU 3.4.56 R or BIPRU 3.4.58 R if it would be treated as fully and completely secured by the relevant CRD implementation measures in that EEA State implementing points 45 and 47 of Part 1 of Annex VI of the Banking Consolidation Directive.</p>	<p>MIPRU 4.2F.36 R</p>	<p>A single risk weight of 75% will cover both secured and unsecured portions of a mortgage on a residential property overseas (equal to that for the unsecured portion of a domestic mortgage). NBLs will not be required to assess the equivalency of the regulatory regimes for third countries.</p>
<p>BIPRU 3.4.84 R</p> <p>For the purposes of BIPRU 3.4.56 R or BIPRU 3.4.58 R, a firm may only treat an exposure as fully and completely secured by residential property situated in the territory of a third-country competent authority that is listed as equivalent for credit risk in BIPRU 8 Annex 6 R if it would be treated as fully and completely secured under the applicable requirements of that third-country competent authority (including any applicable loan-to-value ceiling).</p>		
<p>BIPRU 3.4.85 R</p> <p>For the purposes of BIPRU 3.4.56 R or BIPRU 3.4.58 R, where the residential property in question is situated in the territory of a third-country competent authority that is not listed as equivalent for credit risk in BIPRU 8 Annex 3 R:</p> <p>(a) a firm must not treat an exposure as fully and completely secured by the residential property in question unless the value of the property exceeds the exposures by a substantial margin, which must be at least 20%;</p> <p>(b) the firm must apply a risk weight of 50% to the exposure.</p>		

Annex 2

List of questions

- Q1:** If we keep the opportunity to consider some part of exposures to residential BTL or investment properties in the UK as being secured, do you agree with our proposal not to include any reference to sufficiently low loss rates in the rules? If you disagree, why is that?
- Q2:** Do you agree that the proposed policy changes (set out in Table 2) are justified and will have an immaterial impact on NBLs given their business model and lending profiles?
- Q3:** Is the application of more risk-sensitive capital requirements (than the flat rate of 1%), for exposures falling outside the exposure classes capital requirements derived from risk weights identified in MIPRU 4.2A.6A R, an area appropriate for future consideration?
- Q4:** Is the use of differentiated risk weights, based on LTV and that would reduce capital requirements for exposures to loans secured on residential property, an area appropriate for future consideration?

Annex 3

Compatibility statement

Introduction and statement of purpose

1. This Annex sets out how the proposals to simplify the MIPRU capital requirements satisfy the requirements in section 138I of FSMA.
2. When consulting on new rules, we are required by FSMA to include an explanation of why we believe making the proposed rules is compatible with our strategic objective of ensuring that the relevant markets function well, advances one or more of our operational objectives, and has regard to the statutory principles in section 3B of FSMA.
3. This Annex also sets out our view of how the proposed rules are compatible with the duty on us to carry out our general functions (which include rule-making) in a way that promotes effective competition in the interests of consumers (section 1B(4) of FSMA). This duty applies insofar as promoting competition is compatible with advancing either or both of our consumer protection and integrity objectives.
4. This Annex must be read in conjunction with the rest of the consultation paper as confirmation that we meet our statutory duties and objectives.

Compatibility with our objectives and general duties

5. In discharging our general functions, our duty is, as far as is reasonably possible, to act in a way that is compatible with our strategic objective, i.e. to ensure that the relevant markets function well, and to advance one or more of our operational objectives.
6. Our proposed simplification of MIPRU, as set out in this CP and the draft Handbook text that accompanies it, aims primarily to meet our market integrity and consumer protection objectives by creating a simpler prudential framework tailored to the business model of NBLs. The simplification of the rules will allow NBLs to understand the rules with greater ease and less specialist knowledge. This (as mentioned in paragraph 1.14) could potentially lead to reduced costs in their compliance function making their business more cost effective and competitive. We do not believe that competition will be adversely impacted.

Integrity objective

7. This objective requires us to protect and enhance the integrity of the UK financial system. MIPRU simplification should enable firms to be better placed to comply with the capital requirements meaning they are less likely to leave the market in a disorderly manner and thereby reduce the likelihood of market disruption arising from their failure.

Consumer protection objective

8. This objective requires us to secure an appropriate degree of protection for consumers. If MIPRU simplification were to help avert a firm failure this would directly benefit consumers.

Competition objective

9. Making MIPRU 4 simpler may reduce a barrier to entry in the NBL sector and give consumers more choice, without reducing the protections they enjoy under the current rules as the policy will remain very largely the same. It should not result in any adverse impacts on competition in the market.

Compatibility with the need to have due regard to the principles of good regulation

10. Section 1B(5) of FSMA requires that, in carrying out our general functions, we have regard to the principles of good regulation. In formulating these proposals, we have had regard to the following relevant principles set out in Section 3B of FSMA.

Need to use resources in the most efficient and economic way

11. The timeline for implementation is intended to ensure that the new rules come into effect on 26 April 2015. This is the expiry date of the modification granted to smaller firms whereby they remain subject to the version of MIPRU 4 that applied prior to 26 April 2014.
12. This timing is therefore the most effective and proportionate and should help to keep down the implementation costs for us and for firms, as it means we will not need to consider whether to extend the modification or require smaller firms to comply with the more complex provisions introduced on 26 April 2014.

Principle that a burden or restriction imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected

13. Our proposals contain only small policy changes that should have no material adverse effect on the market and may potentially give rise only to costs of minimal significance that are outweighed by the benefits of simpler and more accessible rules.

14. Our overall approach to MIPRU simplification has sought not to change current policy where possible. In this way we have demonstrated and exercised proportionality.

Responsibilities of those who manage the affairs of authorised persons

15. MIPRU simplification means it should be easier for firms to comply with the capital requirements.

Desirability of exercising our functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons

16. MIPRU simplification only applies to NBLs, and the capital rules are designed to recognise the different types of exposures that might exist in the sector.

Principle that we should exercise our functions as transparently as possible

17. We have engaged with firms throughout this process to simplify the provisions in MIPRU including our timeline for this consultation process.

Expected effect on mutual societies

18. Under section 138K of FSMA, where we are proposing to make rules that would apply both to authorised persons which are mutual societies and other authorised persons we must prepare a statement setting out whether or not in our opinion the proposed rules apply to mutual societies and authorised firms in a different manner.
19. Our proposed rules would apply to firms that carry on home financing in connection with regulated mortgage contracts (see MIPRU 4.1.1R, 4.1.4R and 4.2.23R), which we refer to as non-bank lenders (NBLs). Most types of mutual societies that carry on home financing, however, are excluded from MIPRU, e.g. credit unions, friendly societies and building societies, but it is possible that other types of mutual society might become subject to our proposed rules depending on the activities they are carrying out. In that case the rules would apply in the same way as to any other authorised firm.

Equality and diversity

20. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.
21. As we stated in paragraph 1.20 of the CP, our proposals are a straightforward clarification and reduction of existing prudential provisions, and therefore we conclude there are no equality or diversity implications.

Appendix 1

Draft Handbook text

SIMPLIFICATION OF CAPITAL REQUIREMENTS RULES AND GUIDANCE INSTRUMENT 2015

Powers exercised

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
 - (2) section 137T (General supplementary powers); and
 - (3) section 139A(1) (Power of the FCA to give guidance).
- B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [XX April 2015].

Amendments to the Handbook

- D. The Glossary of definitions (Glossary) is amended in accordance with Annex A to this instrument.
- E. The Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Simplification of Capital Requirements Rules and Guidance Instrument 2015.

By order of the Board of the Financial Conduct Authority
[date]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

residual risk (in *MIPRU*) the risk that credit risk mitigation techniques used by the *firm* prove less effective than expected.

Amend the following definitions as shown.

capital resources ...

(B) In the FCA Handbook

...

(4) ... (1) on the assumption that it is a *BIPRU firm* of the same category as the relevant firm; or

(5) (for a firm carrying on any home financing connected to regulated mortgage contracts or home financing and home financing administration connected to regulated mortgage contracts) capital resources calculated under MIPRU 4.2.23R.

capital resources requirement an amount of *capital resources* that:

...

(3) a firm carrying on any home financing connected to regulated mortgage contracts, or home financing and home financing administration connected to regulated mortgage contracts, must hold under MIPRU 4.2.23R.

clean-up call option (1) (for the purposes of *BIPRU* 9...

(2) (for the purposes of MIPRU and for a securitisation) a contractual option for the originator to repurchase or extinguish the securitisation positions before all of the underlying exposures have been repaid, when the amount of outstanding exposures falls below a specified level.

<i>credit enhancement</i>	<p>(1) (in accordance with...</p> <p>(2) <u>(in MIPRU) a contractual arrangement which improves the credit quality of a securitisation position in relation to what it would have been if the enhancement had not been provided, including the enhancement provided by more junior tranches in the securitisation and other types of credit protection.</u></p>
<i>credit quality step</i>	<p>(1) (except in MIPRU) a credit quality step in a <i>credit quality assessment scale</i> as set out in BIPRU 3.4 (Risk weights under the standardised approach to credit risk) and BIPRU 9 (Securitisation).</p> <p>(2) <u>(in MIPRU) a credit quality step in a credit quality assessment scale, as set out in MIPRU 4.2E.</u></p>
<i>credit risk capital requirement</i>	<p>(1) <u>(for a BIPRU firm) the part of the capital...</u></p> <p>(2) <u>(for a firm carrying on any home financing connected to regulated mortgage contracts or home financing and home financing administration connected to regulated mortgage contracts) the part of the capital resources requirement in respect of credit risk, calculated in accordance with MIPRU 4.2A.</u></p>
<i>CRM eligibility conditions</i>	<p>...</p> <p>(3) <u>(for the purpose of MIPRU), MIPRU 4.2C.16R.</u></p>
<i>default</i>	<p>(1) (in relation to the <i>IRB approach</i> ...</p> <p>(2) <u>(in MIPRU) for any credit obligation a borrower has with a firm, an event where:</u></p> <p style="margin-left: 2em;">(a) <u>the borrower is past the contractual payment due date by more than 90 days; and</u></p> <p style="margin-left: 2em;">(b) <u>the firm reasonably considers that the borrower is unlikely to pay or otherwise fulfil its credit obligations to the firm.</u></p>
<i>ECAI</i>	<p>...</p> <p>(B) In the FCA Handbook:</p> <p style="margin-left: 2em;">(1) <u>(except in MIPRU) an external credit assessment institution, as defined in article 4(1)(98) of the EU CRR.</u></p>

- eligible ECAI* ...
- (2) (in MIPRU) an external credit assessment institution.
- (B) In the FCA Handbook:
an *ECAI*:
- (a) (for *exposure risk weighting* purposes other than those in (b) or (d)) recognised by...
- (b) (for *securitisation risk weighting* purposes except under MIPRU 4.2BA) recognised by...
- ...
- (d) (in MIPRU) an ECAI listed in the table in MIPRU 4.2E.15R.
- exposure* ...
- (B) In the FCA Handbook
- (1) (in relation to a *firm* but subject to (2) and ~~(3)~~ (6)) the maximum loss which the firm might suffer if:
- ...
- (2) (in accordance with Article 77 of the *Banking Consolidation Directive* and for the purposes of the calculation of the *credit risk capital component* and the *counterparty risk capital component* (including *BIPRU 3* (Standardised credit risk), *BIPRU 4* (The IRB approach), *BIPRU 5* (Credit risk mitigation), *BIPRU 9* (Securitisation) ~~or for the purposes of the calculation of the credit risk capital requirement in MIPRU 4.2 (Capital resources requirement)~~) an asset or off-balance sheet item.
- ...
- (6) (in MIPRU) an asset or liability.
- nominated ECAI* ...
- (c) (for paragraph (d) of the definition of an *eligible ECAI* (in MIPRU)) an *eligible ECAI* nominated by a *firm* in accordance with MIPRU 4.2E for calculating its *risk weighted exposure amounts*.
- originator* ...

- (B) ...
- (1) (in *GENPRU* (except *GENPRU* 3), *MIPRU* and *BIPRU* (except *BIPRU* 12)) (in accordance with Article 4(41) of the *Banking Consolidation Directive* (Definitions) and in relation to a *securitisation* within the meaning of paragraph (2) of the definition of *securitisation*) either of the following:

...

...

rated position (for the purposes of *MIPRU* and *BIPRU* 9 (Securitisation), in accordance with Part 1 of Annex IX of the *Banking Consolidation Directive* (Securitisation definitions) and in relation to a *securitisation position*) describes a *securitisation position* which has an eligible credit assessment by an *eligible ECAI*.

risk weight ...

- (B) In the *FCA Handbook*:
- (1) (in relation to an *exposure* for the purposes of *BIPRU*) a degree of risk expressed as a percentage assigned to that *exposure* in accordance with:
- (a) whichever is applicable of the *standardised approach* to credit risk and the *IRB approach*, including (in relation to a *securitisation position*) under *BIPRU* 9 (Securitisation); ~~or~~
- (b) ~~(for a firm to which *MIPRU* 4 applies), *MIPRU* 4.2A.10R to *MIPRU* 4.2A.13R.~~
- (2) (for an *exposure* under *MIPRU*) a degree of risk expressed as a percentage assigned to that *exposure* in accordance with *MIPRU* 4.2A.10R to *MIPRU* 4.2A.12R, and *MIPRU* 4.2A.17R.

risk weighted exposure amounts ...

- (B) In the *FCA Handbook*:
- (1) (in relation to an *exposure* for the purposes of *BIPRU*) the value of an *exposure* for the purposes of the calculation of ~~(in the case of a *BIPRU* firm) the credit risk capital component or (in the case of a firm to which *MIPRU* 4 applies) the credit risk capital requirement under *MIPRU*~~

~~4.2A.4R, in both cases~~ after application of a *risk weight*.

- (2) (for an *exposure* under *MIPRU*) the *credit risk capital requirement* under *MIPRU* 4.2A.4R after application of a *risk weight*.

securitisation position

...

(B) In the FCA Handbook:

- (1) (in *GENPRU*, *MIPRU* and *BIPRU*)...

...

...

securitisation special purpose entity

...

(B) In the FCA Handbook:

- (1) (in accordance with Article 4(44) of the *Banking Consolidation Directive* (Definitions)...

- (2) (in *MIPRU*) a corporation, trust or other entity that has the following characteristics:

(a) it is organised for carrying on a *securitisation* or *securitisations* (within the meaning of paragraph (2) of the definition of *securitisation*);

(b) its activities are limited to those appropriate to accomplishing such *securitisation* or *securitisations*; and

(c) its structure is intended to isolate its obligations from those of the *originator*.

securitised exposure

...

(B) In the FCA Handbook:

(for the purposes of *BIPRU* and *MIPRU*) an *exposure*...

traditional securitisation

(in accordance with Article 4(37) of the *Banking Consolidation Directive* (Definitions) and for the purpose of *BIPRU* and *MIPRU*) a *securitisation*...

...

tranche (1) (in accordance with Article 4(39) of the *Banking Consolidation Directive* (Definitions) and in relation to a *securitisation* within the meaning of paragraph (2) of the definition of securitisation and for the purposes of *BIPRU* and *MIPRU*) a contractually...

unfunded credit protection ...

(3) (in *MIPRU*) a way of mitigating credit risk where the reduction of credit risk on the *exposure* of an *undertaking* derives from the enforceable obligation of a third party to pay an amount in the event of the default of the borrower or on the occurrence of other specified events.

Annex B

Amendments to the Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

4 Capital resources

4.1 Application and purpose

...

Purpose

4.1.14 G This chapter:

- (1) ~~amplifies *threshold condition 4* (Adequate resources) by providing that sets out that a *firm* must meet, on a continuing basis, a basic solvency requirement and a minimum ~~capital resources requirement~~. capital resources requirement (see COND 2.4 (Appropriate resources))~~; and
- (2) ~~This chapter also amplifies *Principle 4* which requires a *firm* to maintain adequate financial resources by setting out capital requirements for a *firm* according to the *regulated activity* or activities regulated activities it carries on.~~

...

4.2 Capital resources requirements

~~Applicable guidance within BIPRU~~

4.2.-1 G ~~Unless otherwise specified, where *MIPRU 4.2* to *MIPRU 4.2D* refers to a *guidance* provision contained in *BIPRU*, a *firm* should regard that *guidance* provision as applying to it in the same way that that provision applies to a *BIPRU firm*. [deleted]~~

...

4.2.23 R (1) ~~The ~~capital resources requirement~~ capital resources requirement for a *firm* carrying on any *home financing* which is connect to *regulated mortgage contracts*, or *home financing* and *home finance administration* which is connected to *regulated mortgage contracts* (and no other *regulated activity*), is the higher of:~~

...

- (2) the sum of:
- (a) the ~~credit risk capital requirement~~ credit risk capital requirement calculated in accordance with *MIPRU 4.2A*; and
 - (b) 1% of:
 - ...
 - (ii) intangible assets (see Note 1 in the table in *MIPRU 4.4.4R*) plus loans, *securitisation positions* and ~~CHU~~ fund positions subject to *MIPRU 4.2A.4R*.

4.2A Credit risk capital requirement

...

4.2A.2 G ~~The purpose of *MIPRU 4.2A* is to~~ sets out how a firm should calculate its credit risk capital requirement.

- (1) ~~set out how a firm should calculate its credit risk capital requirement; and~~
- (2) ~~set out how a firm should calculate its risk weighted exposure amounts for exposures on its balance sheet, and~~
- (3) ~~identify which provisions of *BIPRU 3* will apply to a firm, in addition to the provisions of *MIPRU 4.2A*, to enable it to make those calculations.~~

4.2A.3 G A firm may use credit risk mitigation to reduce the credit risk associated with an exposure. The firm should refer to *BIPRU 5* (as amended by *MIPRU 4.2C*) with regard to the effect of credit risk mitigation on the calculation of to determine the effect of credit risk mitigation on its risk weighted exposure amounts.

Calculation of credit risk capital requirement

4.2A.4 R ~~The credit risk capital requirement~~ credit risk capital requirement of a firm is 8% of the total of its *risk weighted exposure amounts* for exposures that:

...

- (2) derive from:
 - ...
 - (c) a *€IU fund* position entered into;
 - ...
- (3) have not been deducted from the *firm's* capital resources under *MIPRU 4.4.4R* or *MIPRU 4.2BA*;
- ...

4.2A.4A R Loans, securitisation positions and fund positions entered into before 26 April 2014 are excluded from the credit risk capital requirement calculation.

...

4.2A.5A G ~~The arrangements excluded from the credit risk capital requirement~~ credit risk capital requirement include:

- (1) a loan acquired by a *firm* on or after 26 April 2014 if that loan was made before 26 April 2014;

...

4.2A.5B G A firm may exclude loans or home reversion plans entered into before 26 April 2014 where they meet the conditions in MIPRU 4.2.14R, applied in accordance with MIPRU 4.2.15 E to MIPRU 4.2.17 E.

4.2A.6 R The *exposure* value of an asset ~~item~~ held on the balance sheet of a firm must be its balance sheet value.

Exposure classes

4.2A.6A R A firm must assign each exposure to one of the following exposure classes:

- (1) loans or contingent loans secured on real estate property;
- (2) other loans;
- (3) securitisation positions;

(4) exposures in the form of funds; or

(5) past due items.

4.2A.7 R ~~When calculating risk weighted exposure amounts, a firm must comply with BIPRU 3.2.3R, BIPRU 3.2.9R to BIPRU 3.2.19G, and BIPRU 3.2.38R in the same way that these provisions apply to a BIPRU firm, except to the extent that a provision is modified or excluded in the table in MIPRU 4.2A.8R. [deleted]~~

4.2A.8 R ~~This table belongs to MIPRU 4.2A.7R... [deleted]~~

BIPRU provision	Adjustment
All provisions of BIPRU 3.2	A reference to a provision of BIPRU 3, BIPRU 5 or BIPRU 9 must be read in conjunction with MIPRU 4.2A.8R, MIPRU 4.2B.3R and MIPRU 4.2C.3R
All provisions of BIPRU 3.2	All references to capital resources in BIPRU 3.2 are replaced by references to capital resources calculated under MIPRU 4.4
BIPRU 3.2.14G	The last two sentences do not apply
BIPRU 3.2.38R	The references to BIPRU 14, BIPRU 13.3.13R and BIPRU 13.8.8R (Exposure to a central counterparty) do not apply
BIPRU 3.2.10R and BIPRU 3.2.19G	The references to €1m are replaced by references to £1m.

Risk weights

4.2A.9 R For the purposes of applying a *risk weight*, the *exposure* value must be multiplied by the *risk weight* determined in accordance with MIPRU 4.2A.10R, MIPRU 4.2A.10AR, MIPRU 4.2A.10BR, MIPRU 4.2A.11R, MIPRU 4.2A.12R or MIPRU 4.2A.13R MIPRU 4.2A.17R, unless it is deducted from capital resources under MIPRU 4.4.4R or MIPRU 4.2BA.

4.2A.10 R To calculate *risk weighted exposure amounts* on *exposures* secured by mortgages on residential property, *risk weights* must be applied to all such *exposures*, ~~unless deducted from capital resources calculated under MIPRU 4.4,~~ in accordance with BIPRU 3.4.56R to BIPRU 3.4.88G MIPRU 4.2F.4R to MIPRU 4.2F.10G.

- 4.2A.10 A R To calculate *risk weighted exposure amounts* on exposures secured by mortgages on commercial property, *risk weights* must be applied to all such *exposures* in accordance with *MIPRU 4.2F.37R*.
- 4.2A.10 B R To calculate *risk weighted exposure amounts* on other loans, *risk weights* must be applied to all such *exposures* in accordance with *MIPRU 4.2F.38R*.
- 4.2A.11 R To calculate *risk weighted exposure amounts* on exposures in *CIUs funds*, *risk weights* must be applied to all such *exposures*, ~~unless deducted from capital resources under *MIPRU 4.4*~~, in accordance with ~~*BIPRU 3.4.114R*~~ to *BIPRU 3.4.125R* *MIPRU 4.2F.39R* to *MIPRU 4.2F.49R*.
- 4.2A.12 R ~~*Risk weighted exposure amounts*~~ To calculate *risk weighted exposure amounts* for securitised exposures, *risk weights* must be calculated in accordance with *MIPRU 4.2BA (Securitisation)*.
- 4.2A.13 R ~~To calculate *risk weighted exposure amounts* on exposures other than those provided for in *MIPRU 4.2A.10R* to *MIPRU 4.2A.12R*, *risk weights* must be applied to all such exposures, unless deducted from capital resources calculated under *MIPRU 4.4*, in accordance with *BIPRU 3.5.5G* as though that provision were a rule. [deleted]~~
- 4.2A.14 G ~~Rather than *risk weighting exposures* individually under *MIPRU 4.2A.13R*, a firm should apply a single *risk weight* to all exposures in each *exposure class*. [deleted]~~
- 4.2A.15 R ~~If a firm calculates *risk weighted exposure amounts* under *MIPRU 4.2A.13R* and is directed by *BIPRU 3.5.5G* to the "normal rules", it must, in the calculation of those *risk weighted exposure amounts*, comply with *BIPRU 3.4* in the same way that that section applies to a *BIPRU firm*. [deleted]~~
- 4.2A.16 R ~~*Exposures* must be assigned a *risk weight* of 100% if *MIPRU 4.2A.10R* to *MIPRU 4.2A.13R* do not set out a calculation for *risk weighted exposure amounts* applicable to that *exposure*. [deleted]~~
- 4.2A.17 R A firm must apply ~~*BIPRU 3.4.96R*~~ ~~to *BIPRU 3.4.102R*~~ *MIPRU 4.2F.50R* to *MIPRU 4.2F.55R* to all past items due items.
- 4.2A.17 A R (1) The application of *risk weights* must be based on the *exposure class* to which the *exposure* is assigned and, to the extent specified in *MIPRU 4.2BA* and *MIPRU 4.2F (Exposures and risk weights)*, its credit quality.
- (2) Credit quality must be determined by reference to solicited credit

assessments of eligible ECAIs where these are available, in accordance with MIPRU 4.2E (Use of external credit assessments).

4.2A.17 R Where an *exposure* is subject to credit risk mitigation, the *risk weighted exposure amount* applicable to that item may be modified in accordance with MIPRU 4.2C.

4.2A.18 G ~~A firm may apply BIPRU 3.5.6G and BIPRU 3.5.7G to exposures. MIPRU 4.2C sets out the amendments to the BIPRU 5Rules referenced within these provisions. [deleted]~~

MIPRU 4.2B Securitisation is deleted in its entirety, and the following text is inserted after MIPRU 4.2A. The entire text is new and not underlined.

4.2BA Securitisation

Application

4.2BA.1 R This section applies to a *firm* to which MIPRU 4.2.23R applies.

Purpose

4.2BA.2 R A *firm* must calculate the *risk weighted exposure amounts* for the *securitisation positions* it holds under MIPRU 4.2.BA.31R to MIPRU 4.2BA.53R.

4.2BA.3 G Where a *firm* has transferred significant credit risk associated with *securitised exposures* it has originated under MIPRU 4.2BA.5R (the high-level principles) and has complied with other applicable requirements in this section, it may exclude those *securitised exposures* from the calculation of its *risk weighted exposure amounts* and *expected loss amounts*.

Organisation

4.2BA.4 G This section is organised as follows.

- (1) High-level principles
(MIPRU 4.2.BA.5R to MIPRU 4.2BA.8R)
- (2) Systems and controls
(MIPRU 4.2.BA.9R to MIPRU 4.2BA.16R)
- (3) Structural features

(MIPRU 4.2.BA.17R to MIPRU 4.2BA.22R)

- (4) Implied future support
(MIPRU 4.2.BA.23R to MIPRU 4.2BA.30R)
- (5) Calculation of risk weighted exposure amounts
(MIPRU 4.2.BA.31R to MIPRU 4.2BA.53R)
- (6) Disclosure to investors
(MIPRU 4.2.BA.54R)

High level principles

- 4.2BA.5 R
- (1) Economic substance – the risk management and capital treatment of a *securitisation* must be determined on the basis of its economic substance and not its legal form.
 - (2) Eligible structures – only standalone *traditional securitisations* are eligible.
 - (3) Eligible underlying assets - term assets (eg, residential mortgages) originated by the *firm* are eligible.
 - (4) Effective credit-risk transfer - the *securitisation* mechanism (eg, true sale) must effectively transfer the risks of the *securitised exposures* to the holders of the *securitisation positions*, except those risks that remain adequately covered by the *firm's* capital. The securities issued must not represent payment obligations of the *firm*.
 - (5) Significant credit risk transfer - the proportion of risk transferred must be commensurate with, or exceed, the proportion by which *risk weighted exposure amounts* are reduced.
 - (6) Implied future support – a *firm* must not provide any support (direct or indirect) to investors in the *securitisation* beyond the *firm's* contractual obligations, with a view to reducing potential or actual losses, unless permitted in MIPRU 4.2BA.27R.
 - (7) Maximum regulatory capital – the maximum regulatory capital requirement for retained *securitisation exposures* is the lowest of:
 - (a) the regulatory *capital resources requirement* plus expected losses for the *securitised exposures* before entering into the *securitisation*;

- (b) the *capital resources requirement* from the application of a *risk weight* of 1250% to the retained *securitisation positions*; or
- (c) deduction of the retained *securitisation positions* from capital resources.

4.2BA.6 G Eligible structures would exclude, for example, structures such as master trusts, synthetic securitisations and asset-backed commercial paper programmes. Financial derivatives (eg, interest-rate swaps) used to structure the *securitisation* should be with third-party counterparties, not the *firm* or connected entities.

4.2BA.7 G Eligible underlying assets would exclude, for example, assets purchased from third-party entities, those arising from re-securitisations and any revolving *exposures* such as credit cards.

4.2BA.8 G Further provisions on implied future support are contained in *MIPRU 4.2BA.23R* to *MIPRU 4.2BA.30R*.

Systems and controls

4.2BA.9 R Policies and procedures – a *firm* must evaluate and address all risks, including reputational risks, through appropriate policies and procedures, to ensure in particular that the economic substance of the transaction is fully reflected in risk assessments and management decisions.

4.2BA.10 R Monitoring – a *firm* must continuously monitor risks that it may be subject to when it has excluded the *securitised exposures* from its calculation of *risk weighted exposure amounts*.

4.2BA.11 R Exposure quality - a *firm* must consider the impact that *securitisation* has on the quality of the remaining *exposures* it holds and the capital planning implications.

4.2BA.12 R Stress testing - the *firm* must carry out regular stress testing which takes into account:

- (1) the *firm-wide* impact of *securitisation* activities and *exposures* in stressed market conditions; and
- (2) the implications for other sources of risk including, but not limited to, credit risk, concentration risk, counterparty risk, market risk, liquidity risk and reputational risk.

- 4.2BA.13 G Stress testing of *securitisation* activities should take into account both existing *securitisations* and pipeline transactions, as there is a risk that the latter would not be completed in a stressed market scenario.
- 4.2BA.14 G The frequency and extent of the stress testing should be determined by the materiality of the *firm's securitisation* activities. A *firm* should have procedures in place to assess and respond to the stress testing results.
- 4.2BA.15 R (1) Credit-granting – a *firm* must apply the same sound and well-defined criteria used under SYSC 7.1.9R for credit-granting in respect of *exposures* held on the balance sheet to *exposures* to be *securitised*.
- (2) These criteria must include the processes for approving and, where relevant, amending, renewing and re-financing credits.
- 4.2BA.16 R Legal opinions - legal opinions obtained in the context of *securitisation* transactions must be reviewed by an independent legal adviser periodically, or when there is a change in law (including case law) or any applicable rules that may affect the opinion.

Structural features

- 4.2BA.17 R The transferee must be a *securitisation special purpose entity*.
- 4.2BA.18 R A *firm* must not maintain effective or indirect control over the transferred *exposures*.
- 4.2BA.19 G For the purposes of MIPRU 4.2BA.18R, a *firm* will be considered to have maintained effective control over the transferred *exposures* if:
- (1) it has the right to repurchase previously transferred *exposures* to realise their benefits; or
- (2) it is required to re-assume any previously transferred risk.
- 4.2BA.20 G For the purposes of MIPRU 4.2BA.18R, the *originator's* retention of servicing rights or obligations in respect of the *exposures* does not, of itself, constitute indirect control of the *exposures*.
- 4.2BA.21 R A *clean-up call option* must satisfy all of the following conditions:
- (1) it must be exercisable at the discretion of the *firm*;
- (2) it must only be exercised when 10% or less of the original value of

the *exposures* securitised remains unamortised;

- (3) it must not be structured so that allocating losses to *credit enhancement* positions or other positions held by investors can be avoided; and
- (4) it must not otherwise be structured to provide *credit enhancement*.

4.2BA.22 R The *credit enhancement* documentation must not contain clauses that require *securitisation positions* to be improved by the *firm* in response to a deterioration in the credit quality of the *securitised exposures*, including:

- (1) altering the credit quality of the underlying *exposures*; or
- (2) increasing the yield payable to investors in the *securitisation positions*.

Implied future support

4.2BA.23 R The *securitisation* documentation must make clear, where applicable, that any repurchase of *securitised exposures* or *securitisation positions* by the *firm* beyond its contractual obligations is not mandatory and may only be made at fair market value.

4.2BA.24 R In general, any such repurchase must be subject to the *firm's* credit-granting process, which should be adequate to ensure that the repurchase does not provide support.

4.2BA.25 R If a *firm* repurchases *securitised exposures* or *securitisation positions*, it must:

- (1) be able to demonstrate that it has adequately considered the following:
 - (a) the price of the repurchase;
 - (b) the *firm's* capital and liquidity position before and after repurchase;
 - (c) the performance of the *securitised exposures*; and
 - (d) the performance of the *securitisation positions*;
- (2) have concluded, taking into account the factors in (1) and any other relevant information that the repurchase is not structured to

provide support; and

- (3) keep adequate records of the considerations and conclusions under (1) and (2).

4.2BA.26 G A *firm* will need to consider the following potential situations to determine whether there may be a breach of the prohibition against implied future support in *MIPRU* 4.2.BA.5R(6):

- (1) support given under a contractual obligation;
- (2) support which is not provided for under the contractual documentation for the *securitisation*; and
- (3) support given under the contractual documentation for the *securitisation* which the *firm* is entitled, but not obliged, to give.

4.2BA.27 R

- (1) The support described in *MIPRU* 4.2BA.26G(1) is permitted.
- (2) The support described in *MIPRU* 4.2BA.26G(2) is not permitted.
- (3) The support described in *MIPRU* 4.2BA.26G(3) is permitted if the following conditions are met:
 - (a) contractual and marketing documents of the *securitisation* expressly envisage and allow for the possibility of the *firm* providing such support;
 - (b) the nature of any support that the *firm* may give is precisely described in the contractual and marketing documents of the *securitisation*;
 - (c) both the *firm* and a *person*, whose only information comes from the marketing documents, must be able to ascertain at the time of the *securitisation* the maximum amount of support that can be given in future;
 - (d) an assessment has been made by the *firm* of significant risk transfer, that must include the maximum possible contractual support; and
 - (e) the *firm's* capital resources and *capital resources requirement* are adjusted at the time of the *securitisation* on the basis that the *firm* has provided support to the

maximum amount possible, whether by an immediate deduction from capital resources or appropriate *risk weighting*.

- 4.2BA.28 G A waiver of the right to future margin income will not breach the prohibition against implied future support in *MIPRU* 4.2.BA.5R(6) provided:
- (1) the degree of support that can be given can be defined precisely by reference to the contractual documentation for the *securitisation*, even if the amount of support may not be ascertainable in absolute monetary terms; and
 - (2) no adjustment to the *firm's capital resources* or *capital resources requirement* is required, as a *firm* should not include future margin income in its income or *capital resources*.
- 4.2BA.29 G If a *firm* is found to have provided support to a *securitisation* that implies that the *firm* may be likely to provide future support to its *securitisations*, thus failing to achieve a significant transfer of risk. The *appropriate regulator* will consider taking appropriate measures to reflect this increased expectation after any instance of support is found.
- 4.2BA.30 R If a *firm* is found to have provided support to a *securitisation* it will be required to:
- (1) hold capital resources against all of the *securitised exposures* associated with the *securitisation* transaction as if they had not been securitised; and
 - (2) disclose publicly in a timely fashion:
 - (a) where it has provided such support; and
 - (b) the regulatory capital impact of doing so.

Calculation of risk weighted exposure amounts

- 4.2BA.31 R The *risk weighted exposure amount* equals the on-balance sheet *exposure* value multiplied by the *risk weight* associated with the *credit quality step* with which the credit assessment of that *exposure* value is associated.
- 4.2BA.32 R Where there is an *exposure* to different *tranches* in a *securitisation*, the *exposure* to each *tranche* must be considered as a separate *securitisation position*.

- 4.2BA.33 R The providers of credit protection to *securitisation positions* must be treated as holding positions in the *securitisation*.
- 4.2BA.34 R *Securitisation positions* include *exposures* to a *securitisation* arising from interest rate or currency derivative contracts.
- 4.2BA.35 R The *ECAI* rating of a *securitisation position* must, at a minimum, comply with the following:
- (1) there must be no mismatch between the types of payments reflected in the credit assessment and the types of payment to which the *firm* is entitled under the contract giving rise to the *securitisation position* in question;
 - (2) the rating must be publicly available to the market; and
 - (3) the rating must not be based, or partly based, on support provided by the *firm* itself.
- 4.2BA.36 G Credit assessments may only be treated as publicly available under *MIPRU* 4.2BA.35R(2) if they have been published in a publicly accessible forum and they are included in the *ECAI*'s transition matrix; a rating that is only made available to a limited number of entities may not be treated as publicly available;.
- 4.2BA.37 G *MIPRU* 4.2BA.35R(3) refers, for example, to situations where a *firm* holds *securitisation positions* which receive a lower *risk weight* by virtue of credit protection provided by the *firm* itself acting in a different capacity in the *securitisation* transaction.
- 4.2BA.38 R The assessment of whether a *firm* is providing unfunded support to its *securitisation positions* must take into account the economic substance of that support in the context of the overall transaction and any circumstances in which the *firm* could become exposed to a higher credit risk in the absence of that support. In this case the *firm* must consider the relevant position as if it were not rated and must apply the relevant treatment for unrated positions.

Multiple credit assessments for a rated position

- 4.2BA.39 R Where a *rated position* has credit assessments from two *nominated ECAIs*, the *firm* must use the less favourable credit assessment.
- 4.2BA.40 R Where a *rated position* has more than two *nominated ECAI* credit assessments, the two most favourable credit assessments must be used. If the two most favourable credit assessments are different, the less

favourable of the two must be used.

- 4.2BA.41 R Where eligible credit protection under *MIPRU 4.2C* is provided directly to the *securitisation special purpose entity* and that protection is reflected in the credit assessment of a position by a *nominated ECAI*, the *risk weight* associated with that credit assessment may be used. Where the credit protection is not provided to the *securitisation special purpose entity* but provided directly to a *securitisation position*, the credit assessment must not be recognised.

Minimum operational requirements

- 4.2BA.42 R A *firm* must attribute to an unrated *position* an inferred rating equivalent to the rating of those *rated positions* (the reference positions) which are the most senior positions and are, in all respects, subordinate to the unrated *securitisation position* in question when the following minimum operational requirements are satisfied:
- (1) the reference positions must be subordinate in all respects to the unrated *securitisation position*;
 - (2) the maturity of the reference positions must be equal to or longer than that of the unrated position in question; and
 - (3) on an ongoing basis, any inferred rating must be updated to reflect any changes in the credit assessment of the reference positions.
- 4.2BA.43 R Where publicly available credit assessments for *securitisation positions* are available from *eligible ECAs*, a *firm* must:
- (1) nominate one or more of the *eligible ECAs*,
 - (2) use the credit assessments of *nominated ECAs* in the calculation of its *risk weighted exposure* amounts under this section; and
 - (3) apply those credit assessments consistently in respect of its *rated positions*.
- 4.2BA.44 R Where a *firm* holds a *rated position* it must use the credit assessment from the *nominated ECAs* to determine the *risk weight* for the position using:
- (1) the table in *MIPRU 4.2E.15R* to determine the *credit quality step* associated with that credit assessment; and
 - (2) the table in *MIPRU 4.2BA.45R* to determine the *risk weight* to be

applied to the *rated position*, based on the associated *credit quality step*.

- 4.2BA.45 R Table: Rated positions in securitisations for which a credit assessment by a nominated ECAI is available

This table belongs to *MIPRU 4.2BA.44R*.

Credit quality step	1	2	3	4	Other credit quality steps
<i>Securitisation positions</i>	20%	50%	100%	350%	1250%
<i>Resecuritisation positions</i>	40%	100%	225%	650%	1250%

Concentration ratio approach for unrated securitisation positions

- 4.2BA.46 R When calculating its *risk weighted exposure amount* for *securitised positions*, subject to satisfying the conditions in *MIPRU 4.2BA.47R*, a *firm* may apply the weighted-average *risk weight* that would be applied to the *securitised exposures* multiplied by a concentration ratio.

- 4.2BA.47 R The use of the concentration ratio approach for unrated *securitisation positions* is only permitted where all the following conditions are met:

- (1) the concentration ratio is equal to the sum of the nominal amounts of all the *tranches* divided by the sum of the nominal amounts of the *tranches* junior to, or equal to, the *tranche* in which the position is held, including that *tranche* itself;
- (2) where the resulting *risk weight* for a *securitisation position* is lower than any *risk weight* applicable to a more senior *tranche* then that higher *risk weight* must be applied to the *securitisation position*;
- (3) the composition of the pool of *securitised exposures* is known at all times;
- (4) the *firm* must be able, at all times, to calculate accurately the *risk weighted exposure amounts* of the pool of *securitised exposures* based on its knowledge of the composition of the pool;
- (5) any change to the composition of the pool of *securitised*

exposures during the life of the transaction that would lead to an increase in the total *risk weighted exposure amount* of the pool, using the *risk weights* specified in *MIPRU 4.2F* (Exposures and risk weights), is either:

- (i) prohibited by the documentation; or
- (ii) included in the *firm's* calculation of its *capital resources*.

4.2BA.48 G It is sufficient for *MIPRU 4.2BA.47R(4)* for the composition of the pool of *securitised exposures* to be reported to the *firm* at least daily through information service providers, secure websites or other appropriate sources.

4.2BA.49 R Where the *firm* is unable to determine the *risk weights* that would be applied to the *securitised exposures*, it must apply a *risk weight* of 1250%.

Conversion factor for unrated liquidity facilities

4.2BA.50 R A conversion factor of 100% must be applied to the nominal amount of unrated liquidity facilities unless the conditions in *MIPRU 4.2BA.51R* or *MIPRU 4.2BA.52R* for a conversion factor of 50% or 0% are met. The *risk weight* to be applied is the highest *risk weight* that would be applied to any of the *securitised exposures* by a *firm* holding those *exposures*.

4.2BA.51 R A conversion factor of 50% may be applied to the nominal amount of an unrated liquidity facility where all the conditions in *MIPRU 4.2BA.52R* are met. The *risk weight* to be applied is the highest *risk weight* that would be applied to any of the *securitised exposures* by a *firm* holding those *exposures*.

4.2BA.52 R The conditions for the application of a conversion factor of 50% are:

- (1) the liquidity facility documentation must clearly identify and limit the circumstances under which the facility may be drawn;
- (2) it must not be possible for the facility to be drawn so as to provide credit support by covering losses already incurred at the time of drawdown, for example by providing liquidity for *exposures* in default at the time of drawdown or by acquiring assets at more than fair value;
- (3) the facility must not be used to provide permanent or regular funding for the *securitisation*;

- (4) repayment of drawdowns on the facility must not be subordinated to the claims of investors, other than to claims arising in respect of interest rate or currency derivative contracts, fees or other such payments, nor be subject to waiver or deferral;
- (5) it must not be possible for the facility to be drawn after all applicable *credit enhancements* from which the liquidity facility would benefit are exhausted; and
- (6) the facility must include a provision that results in an automatic reduction in the amount that can be drawn by the amount of *exposures* that are in *default*.

4.2BA.53 R A conversion factor of 0% may be applied to the nominal amount of an unrated liquidity facility where, in addition to meeting the conditions for a conversion factor of 50%, the liquidity facility is unconditionally cancellable and repayment of any drawings on the facility are senior to any other claims on the cashflows arising from the *securitised exposures*.

Disclosure to investors

4.2BA.54 R A *firm* must ensure that investors have access to all materially relevant data determined as at the date of the *securitisation* and, where appropriate due to the nature of the *securitisation*, thereafter. These data must include:

- (1) the credit quality, performance, cashflows and supporting collateral of the *securitisation exposures*; and
- (2) such information as is necessary to conduct comprehensive and well-informed stress-tests on the cashflows and collateral values supporting the *securitisation exposures*.

In this section, underlining again indicates new text and striking through again indicates deleted text, unless otherwise stated.

4.2C Credit risk mitigation

...

Purpose

4.2C.2 G The purpose of *MIPRU* 4.2C is to sets out ~~which~~ the provisions of ~~*BIPRU*~~

~~5 a firm should comply with in the recognition of credit risk mitigation in the calculation of when calculating risk weighted exposure amounts for the purposes of the calculation of calculating the credit risk capital requirement credit risk capital requirement under MIPRU 4.2.23R.~~

Organisation

4.2C.2A G This section is organised as follows.

- (1) High-level principles
(MIPRU 4.2.C.5R to MIPRU 4.2C.9R)
- (2) Minimum operational requirements
(MIPRU 4.2.C.10R to MIPRU 4.2C.15R)
- (3) Eligibility
(MIPRU 4.2.C.16R to MIPRU 4.2BA.19R)
- (4) Calculating the effects of credit risk mitigation
(MIPRU 4.2.C.17R to MIPRU 4.2BA.31R)
- (5) Sovereign guarantees
(MIPRU 4.2.C.32R)
- (6) Combinations of credit risk mitigation
(MIPRU 4.2.C.33R to MIPRU 4.2C.34R)

General

4.2C.3 R ~~A firm that wishes to recognise credit risk mitigation in the calculation of risk weighted exposure amounts, must comply with BIPRU 5 in the same way that that section applies to a BIPRU firm, except to the extent that a provision of BIPRU 5 is modified or excluded in the table in MIPRU 4.2C.4R. [deleted]~~

4.2C.4 R This table belongs to ~~MIPRU 4.2C.3R~~
[deleted]

BIPRU provision	Adjustment
All provisions of <i>BIPRU 5</i>	A reference to a provision of <i>BIPRU 3</i> , <i>BIPRU 5</i> or <i>BIPRU 9</i> must be read in conjunction with <i>MIPRU 4.2A.8R</i>, <i>MIPRU 4.2B.4R</i> and <i>MIPRU 4.2C.4R</i>
<i>BIPRU 5.1</i>	This section does not apply

<i>BIPRU 5.3.2R</i>	The words "without prejudice to <i>BIPRU 5.6.1R</i> " do not apply
<i>BIPRU 5.4.1R</i>	This rule does not apply
<i>BIPRU 5.4.8R</i>	This rule does not apply
<i>BIPRU 5.4.16R</i>	This rule does not apply
<i>BIPRU 5.4.18R</i>	The second sentence of this <i>rule</i> does not apply The words " <i>BIPRU 5.4.19R</i> to <i>BIPRU 5.4.21R</i> " are replaced by the words " <i>BIPRU 5.4.21R</i> "
<i>BIPRU 5.4.19R</i>	This <i>rule</i> does not apply
<i>BIPRU 5.4.20R</i>	This <i>rule</i> does not apply
<i>BIPRU 5.4.22R</i>	The reference to <i>BIPRU 5.4.20R</i> does not apply
<i>BIPRU 5.4.23R</i> to <i>BIPRU 5.4.66R</i>	These provisions do not apply. A <i>firm</i> must only use the <i>financial collateral simple method</i>
<i>BIPRU 5.6</i>	This section does not apply
<i>BIPRU 5.7.4R</i>	This <i>rule</i> does not apply
<i>BIPRU 5.7.12R</i>	This <i>rule</i> does not apply
<i>BIPRU 5.7.19R</i>	This <i>rule</i> does not apply
<i>BIPRU 5.7.23R</i>	The words " <i>BIPRU 3.2.20R</i> to <i>BIPRU 3.2.26R</i> " are replaced by the words " <i>MIPRU 4.2A.8R</i> to <i>MIPRU 4.2A.11R</i> and <i>MIPRU 4.2A.14G</i> "
<i>BIPRU 5.7.23R(3)</i>	The first clause of this <i>rule</i> is amended to read as follows: "E is the <i>exposure</i> value according to <i>MIPRU 4.2A.5A G</i> and <i>BIPRU 3.2.3R</i> ;" The second clause of this <i>rule</i> does not apply
<i>BIPRU 5.7.24R</i>	The words " <i>BIPRU 3.2.20R</i> to <i>BIPRU 3.2.26R</i> " are replaced by the words " <i>MIPRU 4.2A.8R</i> to <i>MIPRU 4.2A.11R</i> and <i>MIPRU 4.2A.14G</i> ".
<i>BIPRU 5.7.24R(1)</i>	This <i>rule</i> is amended to read as follows: "E is the <i>exposure</i> value according to <i>MIPRU 4.2A.5A G</i> and <i>BIPRU 3.2.3R</i> ."
<i>BIPRU</i>	The references to <i>BIPRU 4.10</i> and the <i>IRB approach</i>

<i>5.7.27R</i>	do not apply
<i>BIPRU 5.8.8R</i> and <i>BIPRU 5.8.9R</i>	These <i>rules</i> do not apply

High-level principles

- 4.2C.5 R *A firm may recognise credit risk mitigation under this section in calculating risk weighted exposure amounts for calculating the credit risk capital requirement.*
- 4.2C.6 R (1) *If a firm transfers part of the risk of a loan in one or more tranches, MIPRU 4.2BA applies.*
- (2) *Materiality thresholds below which no payment shall be made by the provider of credit protection in the event of loss are considered to be equivalent to retained first-loss positions and to give rise to a tranching transfer of risk.*
- 4.2C.7 R *The technique used to provide credit protection, together with the actions and steps taken and procedures and policies implemented by a firm, must result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.*
- 4.2C.8 R (1) *A firm must not recognise credit protection as eligible until it has conducted sufficient legal review confirming that the credit protection arrangements are legally effective and enforceable in all relevant jurisdictions, in accordance with MIPRU 4.2C.7R.*
- (2) *A firm must conduct further legal reviews as necessary, to ensure continuing enforceability and effectiveness.*
- 4.2C.9 R *A firm must take steps to ensure the effectiveness of the credit protection arrangement and to address related risks.*

Minimum requirements - operational

- 4.2C.10 R (1) *A firm must be able to satisfy the appropriate regulator that it has adequate risk management processes to control the risks it may be exposed as a result of carrying out credit risk mitigation.*
- (2) *These processes must include appropriate stress tests and scenario analyses relating to those risks, including residual risk and the risks relating to the intrinsic value of the credit risk mitigation.*

- 4.2C.11 R A firm must be able to:
- (1) satisfy the appropriate regulator that it has systems to manage risks arising from its use of credit protection; and
 - (2) demonstrate how its strategy on the use of credit protection interacts with the firm's management of its overall risk profile.

- 4.2C.12 R Notwithstanding the presence of credit risk mitigation considered for the purposes of calculating risk weighted exposure amounts, a firm must:
- (1) continue to undertake full credit-risk assessment of the underlying exposure; and
 - (2) be in a position to demonstrate to the appropriate regulator the fulfilment of the requirement in (1).

Minimum requirements - effectiveness

- 4.2C.13 R For credit protection to be recognised, the following conditions must be met:
- (1) it must be direct;
 - (2) the extent of the credit protection must be clearly defined and incontrovertible;
 - (3) the credit protection contract must not contain any clause which is outside the direct control of the lender to fulfil that:
 - (a) would allow the protection provider unilaterally to cancel the protection;
 - (b) would increase the effective cost of protection as a result of deteriorating credit quality of the protected exposure;
 - (c) could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original borrower fails to make any payments due; or
 - (d) could allow the maturity of the credit protection to be reduced by the protection provider; and
 - (4) it must be legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

4.2C.14 G Under MIPRU 4.2C.13R(3)(a), payment of premiums and other monies due under the contract is within the control of the *firm*. So a clause that allows the protection provider unilaterally to cancel the contract after a reasonable period due to non-payment of such monies will not mean that the condition in that *rule* is not met.

4.2C.15 R For a guarantee, including those in the form of mortgage indemnity products, to be recognised, the following conditions must be met in addition to those in MIPRU 4.2C.13R:

- (1) on the qualifying default of and/or non-payment by the borrower, the *firm* must have the right to pursue, in a timely manner, the guarantor for any monies due under the claim for which the protection is provided;
- (2) payment by the guarantor must not be subject to the *firm* first having to pursue the borrower;
- (3) for credit protection covering residential mortgage loans, the requirements in MIPRU 4.2C.13R(3)(c) and in this *rule* have only to be satisfied within 24 months;
- (4) the guarantee must contain an explicitly documented obligation assumed by the guarantor;
- (5) subject to (6), the guarantee must cover all types of payments the borrower is expected to make in respect of the claim, such as principal, interest payments, fees; and
- (6) where certain types of payment are excluded from the guarantee, the recognised value of the guarantee must be adjusted to reflect the limited coverage.

Eligibility

4.2C.16 R For *unfunded credit protection*:

- (1) to be eligible for recognition:
 - (a) the party giving the undertaking must be sufficiently reliable; and
 - (b) the protection agreement must be legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved, having regard to the approach used to calculate *risk*

weighted exposure amounts and to the degree of recognition allowed; and

- (2) protection must be provided by central governments or central banks.

Calculating the effects of credit risk mitigation

- 4.2C.17 R The calculation of *risk weighted exposure amounts* may be modified in accordance with this section where a *firm* has complied with *MIPRU 4.2C.7R* to *MIPRU 4.2C.16R*.
- 4.2C.18 R No *exposure* for which credit risk mitigation is obtained may produce a higher *risk weighted exposure amount* than an otherwise identical *exposure* for which there is no credit risk mitigation.
- 4.2C.19 R Where the *risk weighted exposure amount* already takes account of credit protection, the calculation of the credit protection must not be further recognised under *MIPRU 4.2C*.

Valuation

- 4.2C.20 R The value of *unfunded credit protection* is the amount that the protection provider has undertaken to pay in the event of the default of, or non-payment by, the borrower or on the occurrence of other specified credit events.

Currency mismatches

- 4.2C.21 R Where *unfunded credit protection* is denominated in a currency different from that in which the *exposure* is denominated (a currency mismatch) the value of the credit protection must be reduced by the application of a volatility adjustment H_{FX} as follows:
$$G^* = G \times (1 - H_{FX})$$
where:
- (1) G is the nominal amount of the credit protection;
 - (2) G^* is G adjusted for any *foreign currency risk*; and
 - (3) H_{FX} is the volatility adjustment for any currency mismatch between the credit protection and the underlying obligation.
- 4.2C.22 R For the purpose of *MIPRU 4.2C.22R*, H_{FX} is set at 10%.

4.2C.23 R For the purpose of *MIPRU 4.2C.22R*, where there is no currency mismatch:
 $G^* = G$

Maturity mismatches

4.2C.24 R (1) In calculating *risk weighted exposure amounts*, a maturity mismatch occurs when where the residual maturity of the credit protection is less than that of the protected *exposure*.

(2) Protection of less than three months residual maturity, the maturity of which is less than the maturity of the underlying *exposure*, must not be recognised.

4.2C.25 R Where there is a maturity mismatch the credit protection must not be recognised if the original maturity of the protection is less than one year.

4.2C.26 R (1) Subject to a maximum of five years, the effective maturity of the underlying *exposure* is the longest possible remaining time before the borrower is scheduled to fulfil its obligations.

(2) Subject to *MIPRU 4.2C.27R*, the maturity of the credit protection is the length of time to the earliest date at which the protection may terminate or be terminated.

4.2C.27 R (1) Where there is an option to terminate the protection which is at the discretion of the protection seller, the maturity of the protection must be taken to be the length of time to the earliest date at which that option may be exercised.

(2) Where there is an option to terminate the protection which is at the discretion of the protection buyer and the terms of the arrangement at the origination of the protection contain a positive incentive for the *firm* to call the transaction before contractual maturity, the maturity of the protection must be taken to be the length of time to the earliest date at which that option may be exercised; otherwise such an option may be considered not to affect the maturity of the protection.

4.2C.28 R (1) The maturity of the credit protection and that of the *exposure* must be reflected in the adjusted value of the credit protection according to the following formula:

$$G_A = G^* \times (t-t^*) / (T-t^*)$$

where:

(a) G^* is the amount of the protection adjusted for any currency

mismatch;

- (b) G_A is G^* adjusted for any maturity mismatch;
- (c) t is the number of years remaining to the maturity date of the credit protection calculated in accordance with *MIPRU* 4.2C.27R to *MIPRU* 4.2C.28R, or the value of T , whichever is the lower;
- (d) T is the number of years remaining to the maturity date of the *exposure* calculated in accordance with *MIPRU* 4.2C.27R to *MIPRU* 4.2C.28R, or five years, whichever is the lower; and
- (e) t^* is 0.25.

- (2) G_A is then taken as the value of the credit protection for the purposes of *MIPRU* 4.2C.6R, *MIPRU* 4.2C.21R to *MIPRU* 4.2C.23R and *MIPRU* 4.2C.29R to *MIPRU* 4.2C.31R.

Full protection

4.2C.29 R Under *MIPRU* 4.2A.9R, *MIPRU* 4.2A.12R, *MIPRU* 4.2A.17AR and *MIPRU* 4.2A.17BR, g shall be the *risk weight* to be assigned to an *exposure*, the *exposure* value (E) of which is fully protected by *unfunded credit protection* (G_A), where:

- (1) g is the *risk weight* of *exposures* to the protection provider;
- (2) G_A is the value of G^* as calculated under *MIPRU* 4.2C.22R further adjusted for any maturity mismatch under *MIPRU* 4.2C.24R to *MIPRU* 4.2C.28R; and
- (3) E is the *exposure* value according to *MIPRU* 4.2A.6R.

Partial protection - equal seniority

- 4.2C.30 R (1) If the protected amount is less than the *exposure* value and the protected and unprotected portions are of equal seniority, ie, the *firm* and the protection provider share losses on a pro-rata basis, proportional regulatory capital relief is afforded.
- (2) Under *MIPRU* 4.2A.9R, *MIPRU* 4.2A.12R, *MIPRU* 4.2A.17AR and *MIPRU* 4.2A.17BR, *risk weighted exposure amounts* must be calculated in accordance with the following formula:
 $(E - G_A) \times r + G_A \times g$

where:

- (a) E is the *exposure* value according to *MIPRU 4.2A.6R*;
- (b) G_A is the value of G^* as calculated under *MIPRU 4.2C.21R* further adjusted for any maturity mismatch under *MIPRU 4.2C.24R* to *MIPRU 4.2C.28R*;
- (c) r is the *risk weight of exposures* to the borrower; and
- (d) g is the *risk weight of exposures* to the protection provider.

4.2C.31 G Where the protected and unprotected portions of the *exposure* are not of equal seniority, *MIPRU 4.2C.6R* applies.

Sovereign guarantees

4.2C.32 R A *firm* may assign a *risk weight* of 0% to *exposures* or parts of *exposures* guaranteed by the *UK* government or its *central bank* if the following conditions are met:

- (1) the *guarantee* is denominated in the domestic currency of the borrower; and
- (2) the *exposure* is funded in that currency.

Combinations of credit risk mitigation

4.2C.33 R Where a *firm* calculating *risk weighted exposure amounts* has more than one form of credit risk mitigation covering a single *exposure*:

- (1) it must divide the *exposure* into parts covered by each type of credit risk mitigation; and
- (2) the *risk weighted exposure amount* for each portion must be calculated separately in accordance with *MIPRU 4.2A* (Credit risk capital requirement).

4.2C.34 R When credit protection provided by a single protection provider has differing maturities, a similar approach to that described in *MIPRU 4.2C.33R* must be applied.

After MIPRU 4.2D, which remains unchanged, insert the following section. In section 4.2E the entire text is new and is not underlined.

4.2E Use of external credit assessments

- 4.2E.1 R For the calculation of *risk weighted exposure amounts*, a *firm* must use solicited credit assessments from *ECAIs* in the following manner:
- (1) consistently and in accordance with this section; and
 - (2) not selectively.

Treatment

- 4.2E.2 R A *firm* must nominate one or more *eligible ECAIs* to be used for the determination of *risk weights* to be assigned to on-balance sheet items.
- 4.2E.3 R A *firm* must only use a *nominated ECAI's* credit assessments that take into account all amounts of both principal and interest owed to it.
- 4.2E.4 R A *firm* which uses the credit assessments produced by a *nominated ECAI* must do so in a continuous and consistent way over time.
- 4.2E.5 R A *firm* which uses the credit assessments produced by a *nominated ECAI* for a certain *exposure* class must use those credit assessments consistently for all *exposures* belonging to that class.
- 4.2E.6 R If only one credit assessment is available from a *nominated ECAI* for a rated item, that credit assessment must be used to determine the *risk weight* for that item.
- 4.2E.7 R If two credit assessments are available from *nominated ECAIs* and the two correspond to different *risk weights* for a rated item, the higher *risk weight* must be applied.
- 4.2E.8 R
- (1) If more than two credit assessments are available from *nominated ECAIs* for a rated item, the two assessments generating the two lowest *risk weights* must be referred to.
 - (2) If the two lowest *risk weights* are different, the higher *risk weight* must be assigned.
 - (3) If the two lowest *risk weights* are the same, that *risk weight* must be assigned.

Issuer and issue credit assessment

- 4.2E.9 R Where a credit assessment exists for a specific issuing program or facility to which the item constituting the *exposure* belongs, this credit assessment must be used to determine the *risk weight* to be assigned to that item.
- 4.2E.10 R Where no directly applicable credit assessment exists for a certain item but a general credit assessment exists for the issuer, that general credit

assessment must be used where it produces either of the following:

- (1) a higher *risk weight* than would otherwise be the case;
- (2) a lower *risk weight* and the *exposure* in question ranks as equally senior or senior in all respects to senior unsecured *exposures* of that issuer, as relevant.

4.2E.12 R Credit assessments for issuers within a *group* cannot be used as the credit assessment of another issuer within the same *group*.

Domestic and foreign currency items

4.2E.13 R A credit assessment that refers to an item denominated in the borrower's domestic currency cannot be used to derive a *risk weight* for another *exposure* on that same borrower that is denominated in a foreign currency.

Mapping of credit assessments of nominated ECAIs to credit quality steps

4.2E.14 R *Exposures* for which a credit assessment by a *nominated ECAI* is available must be assigned a *credit quality step* according to the table in *MIPRU 4.2E.15R*.

4.2E.15 R Table: Exposures for which a credit assessment by a nominated ECAI is available
This table belongs to *MIPRU 4.2E.14R*.

		Credit quality step					
		1	2	3	4	5	6
Credit assessment	Fitch	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	CCC + and below
	Moody's	Aaa to Aa3	A1 to A3	Baa1 to Baa3	Ba1 to Ba3	B1 to B3	Caa1 and below
	S&P	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	CCC + and below
	DBRS	AAA to AAL	AH to AL	BBB H to BBBL	BBH to BBL	BH to BL	CCC H and below

Part 5

After MIPRU 4.2E insert the following section. In this Part the entire text is new and is not underlined.

4.2F Exposures and risk weights

Application

4.2F.1 R This section applies to a firm to which *MIPRU* 4.2.23R applies.

Purpose

4.2F.2 R *MIPRU* 4.2F sets out the risk weights that a *firm* should apply to *exposures* in the form of loans secured on real estate property, other loans, *exposures* in the form of funds, and past due items, when calculating *risk weighted exposure amounts* for calculating the *credit risk capital requirement* under *MIPRU* 4.2.23R.

Organisation

4.2F.3 G This section is broadly organised according to the type of exposure class.

- (1) Exposures secured by mortgages on residential property (*MIPRU* 4.2F.4R to *MIPRU* 4.2F.36R)
- (2) Exposures secured by mortgages on commercial property (*MIPRU* 4.2F.37R)
- (3) Exposures to other loans (*MIPRU* 4.2F.38R)
- (4) Exposures to funds (*MIPRU* 4.2F.39R to *MIPRU* 4.2F.49R)
- (5) Exposures to past due items (*MIPRU* 4.2F.50R to *MIPRU* 4.2F.56G)

Exposures secured by mortgages on residential property

4.2F.4 R Without prejudice to *MIPRU* 4.2F.36R, an *exposure* or any part of an *exposure* must be assigned a *risk weight* of 35% where:

- (1) the *exposure* is fully and completely secured, to the satisfaction of the *firm*, by mortgages on residential property; and
- (2) the residential property is, or shall be, occupied or let by the owner or the beneficial owner in the case of personal investment

companies.

- 4.2F.5 R Without prejudice to *MIPRU* 4.2F.36R, an *exposure*, or any part of an *exposure*, must be assigned a *risk weight* of 75% where:
- (1) the *exposure* arises from a mortgage on residential property up to a limit of 100% of the value of the property which is not fully and completely secured, to the satisfaction of the *firm*, by that mortgage; and
 - (2) the residential property is, or shall be, occupied or let by the owner or the beneficial owner in the case of personal investment companies.

- 4.2F.6 R An *exposure* or any part of an *exposure* must be assigned a *risk weight* of 100% where the *exposure* arises from a mortgage on residential property that exceeds the value of the available collateral, as assessed in accordance with *MIPRU* 4.2F.29R.

Exposures secured by mortgages on residential property: lifetime mortgages

- 4.2F.7 R (1) A *firm* must not treat a *lifetime mortgage* as an *exposure* fully and completely secured on residential property for the purposes of *MIPRU* 4.2F.4R unless the amount of the *exposure* is calculated according to the following formula:
exposure amount =

$$P \frac{(1 + i)^T}{(1 + d)^T}$$

where:

- (a) *P* is the current outstanding balance on the *lifetime mortgage*;
 - (b) *i* is the interest rate charged on the *lifetime mortgage*, which for the purposes of this calculation must not be lower than the discount rate referred to in (c);
 - (c) *d* is the discount rate which is the risk-free rate as represented by the yield on 10-year *UK* government bonds; and
 - (d) *T* is the projected number of years to maturity of the *exposure*.
- (2) Notwithstanding (1)(c), a *firm* may calculate an annual average

discount rate, provided there is no obvious bias in its calculation and it is consistent in its approach.

- 4.2F.8 G (1) For the purposes of *MIPRU* 4.2F.7R(2), a *firm* may use the FTSE UK gilt 10-year yield index which the Council of Mortgage Lenders makes available to its members.
- (2) If a *firm* offers a variable interest rate on a *lifetime mortgage*, it should calculate an average interest rate in a way which is consistent with the calculation of the discount rate.
- (3) To determine the projected number of years to maturity of the *exposure*, a *firm* may use the standard mortality tables published by the Institute of Actuaries or the Faculty of Actuaries.
- (4) For internal risk management purposes, the *firm* should use factual data or seek actuarial advice to determine how the information in these tables may be adjusted to take account of regional and other relevant variations.

Exposures secured by property leasing transactions

- 4.2F.9 R Without prejudice to *MIPRU* 4.2F.36R, an *exposure*, or any part of an *exposure*, to a tenant under a property leasing transaction must be assigned a *risk weight* of 35% where:
- (1) the transaction concerns residential property;
- (2) under the transaction, the *firm* is the lessor and the tenant has an option to purchase; and
- (3) the *firm* is satisfied that the *exposure* is fully and completely secured by its ownership of the property.

- 4.2F.10 G An Ijara mortgage is an example of an *exposure* described in *MIPRU* 4.2F.9R.

Conditions for mortgages

- 4.2F.11 R (1) In exercising its judgement under *MIPRU* 4.2F.4R to *MIPRU* 4.2F.9R, a *firm* may be satisfied only if the conditions in (2) to (6) are met.
- (2) (a) The value of the property does not materially depend upon the credit quality of the borrower.

- (b) The condition in (a) does not preclude situations where purely macroeconomic factors affect both the value of the property and the performance of the borrower.
- (3) The minimum requirements about:
 - (a) legal certainty in *MIPRU* 4.2F.12R;
 - (b) monitoring of property values in *MIPRU* 4.2F.14R;
 - (c) documentation in *MIPRU* 4.2F.20R; and
 - (d) insurance in *MIPRU* 4.2F.21R are met.
- (4) The valuation provisions in *MIPRU* 4.2F.26R to *MIPRU* 4.2F.29R are met.
- (5) The value of the property exceeds the *exposures* by a substantial margin, as set out in *MIPRU* 4.2F.29R.

Legal certainty

- 4.2F.12 R The requirements about legal certainty referred to in *MIPRU* 4.2F.11R(3)(a) are as follows:
- (1) the mortgage or charge must be enforceable in all relevant jurisdictions which are relevant at the time of conclusion of the credit agreement, and the mortgage or charge must have been properly filed on a timely basis;
 - (2) the arrangements must reflect a perfected lien (ie, all legal requirements for establishing the pledge must have been fulfilled); and
 - (3) the protection agreement and the legal process underpinning it must enable the *firm* to realise the value of the protection within a reasonable timeframe.
- 4.2F.13 G The term ‘protection agreement’ in *MIPRU* 4.2F.12R(3) refers to the contract or deed by which the mortgage or charge is established.

Monitoring of property values

- 4.2F.14 R (1) The requirements about monitoring of property values referred to in *MIPRU* 4.2F.11R(3)(b) are as follows:

- (a) the value of the property must be monitored on a frequent basis and, at a minimum, once every three years;
- (b) more frequent monitoring must be carried out where the market is subject to significant changes in conditions;
- (c) statistical methods may be used to monitor the value of the property and to identify property that needs revaluation;
- (d) the property valuation must be reviewed promptly by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices; and
- (e) for loans exceeding the higher of £2.5 million or 5% of the *capital resources* of the *firm*, the property valuation must be reviewed by an independent valuer at least every three years.

(2) In (1), 'independent valuer' means a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

- 4.2F.15 G A property will need to be revalued over time to ensure that the original purchase price does not overstate the degree of security provided by the property. Ijara providers should undertake revaluations in the same way as providers of conventional mortgages.
- 4.2F.16 G For *MIPRU* 4.2F.14R(1)(a), the monitoring of property values should be an ongoing part of risk managing and tracking the portfolio. The requirement to monitor property values does not include the physical assessment of each property in the portfolio.
- 4.2F.17 G For *MIPRU* 4.2F.14R(1)(d) and (e), the review of a property valuation is more in-depth than the normal monitoring process required by *MIPRU* 4.2F.14R(1)(a). This requirement is likely to include a review of the property value on an individual *exposure* basis. Where an *exposure* is secured by multiple properties, the review can be undertaken at the level of the *exposure*, rather than at the level of each individual property.
- 4.2F.18 G The review of property values required by *MIPRU* 4.2F.14R(1)(e) may lead to an amendment of the value assigned to the property under *MIPRU* 4.2F.29R.

- 4.2F.19 G For *MIPRU* 4.2F.14R(2), necessary qualifications need not be professional qualifications but the *firm* should be able to demonstrate that the person has the necessary ability and experience to undertake the review.

Documentation

- 4.2F.20 R The requirements in *MIPRU* 4.2F.11R(3)(c) are that the types of residential real estate accepted by the *firm* and its lending policies in this regard must be clearly documented.

Insurance

- 4.2F.21 R The requirements about insurance in *MIPRU* 4.2F.11R(3)(d) are that the *firm* must have procedures to monitor that the property taken as protection is adequately insured against damage.
- 4.2F.22 G For *MIPRU* 4.2F.21R, a *firm* should, as a minimum, ensure that it is a requirement of each loan that the property taken as collateral must have adequate buildings insurance at all times, which should be reviewed when any new loan is extended against the property.
- 4.2F.23 G A *firm* may deal with the risk that insurance on properties taken as protection may be inadequate by taking out insurance at the level of the portfolio.

Valuation rules

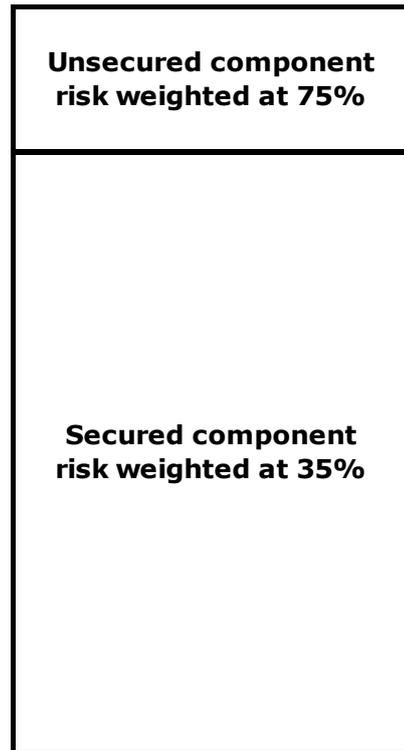
- 4.2F.24 G The valuation provisions in *MIPRU* 4.2F.11R(4) are set out in *MIPRU* 4.2F.25R to *MIPRU* 4.2F.29R.
- 4.2F.25 R The property must be valued by an independent valuer at or less than the market value using reliable standards for the valuation of residential property.
- 4.2F.26 G For *MIPRU* 4.2F.25R, reliable standards for the valuation of residential property include internationally recognised valuation standards, in particular those developed by the International Valuation Standards Committee (IVSC), the European Group of Valuers' Associations (EGoVA) or the Royal Institution of Chartered Surveyors (RICS).
- 4.2F.27 R (1) Market value means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing, where the parties had each acted knowledgeably, prudently and without compulsion.

- (2) The market value must be documented in a transparent and clear manner.
- 4.2F.28 R (1) Mortgage lending value means the value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, and the current use and alternative appropriate uses of the property.
- (2) Speculative elements must not be taken into account in the assessment of the mortgage lending value.
- (3) The mortgage lending value must be documented in a transparent and clear manner.
- 4.2F.29 R The value of the collateral must be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under *MIPRU* 4.2F.11R(3)(b) and *MIPRU* 4.2F.14R and to take account of any prior claims on the property, such as a first-charge mortgage from another lender.

Treatment of secured and unsecured portions of residential mortgages

- 4.2F.30 R A *firm* may not treat an *exposure* as fully and completely secured by residential property located in the *United Kingdom* for *MIPRU* 4.2F.4R(residential mortgages) or *MIPRU* 4.2F.9R(property leasing transactions) unless either of the following is 80% or less of the value of the residential property on which it is secured:
- (1) the amount of the *exposure*;
- (2) the secured part of the *exposure* in *MIPRU* 4.2F.4R or *MIPRU* 4.2F.9R.
- 4.2F.31 G (1) The application of *MIPRU* 4.2F.30R may be illustrated by an example. If a *firm* has a mortgage *exposure* of £100,000 secured on residential property in the *United Kingdom* that satisfies the criteria listed in *MIPRU* 4.2F.4R to *MIPRU* 4.2F.29R and the value of that property is £100,000, then £80,000 of that *exposure* may be treated as fully and completely secured and *risk weighted* at 35%. The remaining £20,000 should be *risk weighted* at 75%. A diagrammatic illustration of this example is in (2).

(2)



EXAMPLE

- £100,000 loan secured on residential property valued at £100,000
- First £80,000 (i.e. 80% LTV) risk weighted at 35%
- Remaining £20,000 (i.e. above 80% LTV) risk weighted at 75%
- Overall risk weight is 43%

(3) The same approach applies to *exposures* described in *MIPRU 4.2F.9R*. On inception, a *risk weight* of 35% should be applied to the first 80% of the principal/"purchase price" outstanding, with a *risk weight* of 75% being applied to the remainder of the principal *exposure*.

4.2F.32 G If a *firm* has more than one *exposure* secured on the same property they should be aggregated and treated as if they were a single *exposure* secured on the property for the purposes of *MIPRU 4.2F.4R*, *MIPRU 4.2F.9R* and *MIPRU 4.2F.30R*.

4.2F.33 R If a *firm* has an *exposure* arising through a second-charge mortgage secured on the same property as a first-charge loan from a different *firm*, the *exposure*, taking into account the first-charge mortgage, must be split into the following components and *risk weighted* as follows, after taking into account the seniority of the first-charge loan:

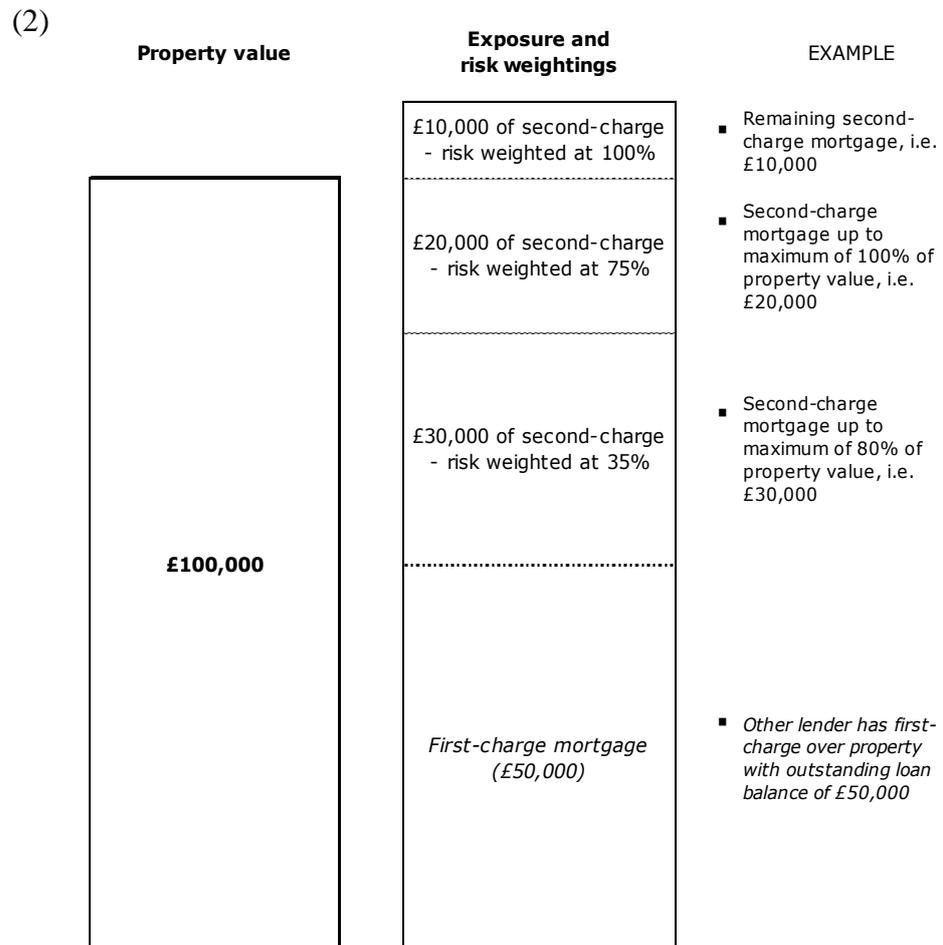
(1) the amount of the *exposure* or any part of the *exposure*, up to a limit of 80% of the value of the residential property, must be assigned a *risk weight* of 35% where:

- (a) the *exposure* is fully and completely secured, to the satisfaction of the *firm*, by a mortgage on residential property; and
- (b) the residential property is, or shall be, occupied or let by

the owner, or the beneficial owner in the case of personal investment companies; and

- (2) the amount of the same *exposure* that is unsecured, above 80% of the value of the residential property up to a limit of 100% of the value of the residential property, must be assigned a *risk weight* of 75%; and
- (3) any remaining part of the *exposure*, above 100% of the value of the property, must be assigned a *risk weight* of 100%.

4.2F.34 G (1) The application of *MIPRU* 4.2F.33R may be illustrated by an example. Where a first-charge mortgage *exposure* of £50,000 from another lender is secured on residential property in the *United Kingdom* that satisfies the criteria in *MIPRU* 4.2F.4R to *MIPRU* 4.2F.29R and the value of that property is £100,000. A *firm* with a second-charge mortgage of £60,000 on the same property may treat £30,000 of that *exposure* as fully and completely secured and *risk weight* it at 35%, treat a further £20,000 as unsecured and *risk weight* it at 75%, and *risk weight* the remaining £10,000 at 100%. A diagrammatic illustration of this example is in (2).



4.2F.35 G If an *exposure* is secured on property that is used partly for residential purposes under *MIPRU* 4.2F.4R and partly for commercial purposes (such as a farm, public house, guest house or shop) it may be treated as secured by residential real estate if the *firm* can demonstrate that:

- (1) the property's main use is, or will be, residential; and
- (2) the value of the property is not significantly affected by its commercial use.

4.2F.36 R *Exposures* to residential property situated in an *EEA State* or a *third-country* must be assigned a *risk weight* of 75% up to a limit of 100% of the value of the property.

Exposures secured by mortgages on commercial property

4.2F.37 R *Exposures*, or any part of an *exposure*, secured by mortgages on offices or other commercial premises must be assigned a *risk weight* of 100% where the *exposure*:

- (1) cannot properly be considered to fall within any other standardised credit risk *exposure* class specified in *MIPRU* 4.2A.6A R(Exposure classes); or
- (2) does not qualify for a lower *risk weight* under this section.

Exposures to other loans

4.2F.38 R *Exposures* to other loans must be assigned a *risk weight* of 100%.

Exposures to funds

4.2F.39 R Except where a different *risk weight* is assigned to *exposures* in the form of *funds* by *MIPRU* 4.2F.40R, *MIPRU* 4.2F.42R or *MIPRU* 4.2F.45R, these *exposures* must be assigned a *risk weight* of 100%.

4.2F.40 R *Exposures* in the form of *funds* for which a credit assessment by a *nominated ECAI* is available must be assigned a *risk weight* using:

- (1) the table in *MIPRU* 4.2E.14R to determine the *credit quality step* associated with that credit assessment; and
- (2) the table in *MIPRU* 4.2F.41R to determine the *risk weight* to be applied to the *rated position*, based on the associated *credit quality step*.

- 4.2F.41 R Table: Exposures in the form of funds for which a credit assessment by a nominated ECAI is available
This table belongs to *MIPRU* 4.2F.40R.

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

- 4.2F.42 R Where a *firm* considers that a position in a *fund* is associated with particularly high risks, it must assign that position a *risk weight* of 150%.
- 4.2F.43 G A *firm* should consider a *fund* as being high risk where there is no external credit assessment from an *eligible ECAI* and where the *fund* has specific features (such as high levels of leverage or lack of transparency).
- 4.2F.44 G Other examples of high-risk *funds* are:
- (1) those in which a substantial element of the *fund's* property is made up of items that would attract a *risk weight* of over 100%; and
 - (2) those whose mandate (as referred to in *MIPRU* 4.2F.46R) would permit it to invest in a substantial amount of items that would attract a *risk weight* of over 100%.
- 4.2F.45 R If the eligibility criteria in *MIPRU* 4.2F.46R are met, a *firm* must decide whether to:
- (1) assign a 100% *risk weight* to its *exposures* in *funds*, as required by *MIPRU* 4.2F.39R; or
 - (2) determine the *risk weight* for an exposure in *funds*, as set out in *MIPRU* 4.2F.48R to *MIPRU* 4.2F.48R
- 4.2F.46 R The eligibility criteria in *MIPRU* 4.2F.45R are:
- (1) the *fund's* prospectus or equivalent document includes:
 - (a) the categories of assets in which the *fund* is authorised to invest; and
 - (b) if investment limits apply, the relative limits and the methodologies to calculate them; and
 - (2) the business of the *fund* is reported on at least an annual basis to enable an assessment to be made of the assets and liabilities, income

and operations over the reporting period.

- 4.2F.47 R Where a *firm* is not aware of the underlying *exposures* of a *fund*, it may calculate an average *risk weight* for the *fund* the following manner:
- (1) it will be assumed that the *fund* first invests, to the maximum extent allowed under its mandate, in the *exposure* classes attracting the highest *capital resources requirement*; and
 - (2) then continues making investments in descending order until the maximum total investment limit is reached.
- 4.2F.48 R A *firm* may rely on a third party to calculate and report, in accordance with the methods in *MIPRU* 4.2F.46R to *MIPRU* 4.2F.47R, a *risk weight* for the *fund*, provided that the correctness of the calculation and report is adequately ensured.
- 4.2F.49 R *Exposures* in the form of funds that are not past due items, that have been assigned a *risk weight* of 150% or greater, and for which value adjustments have been established, may be assigned a *risk weight* of:
- (1) 100% if value adjustments are no less than 20% of the *exposure* value gross of value adjustments; or
 - (2) 50%, if value adjustments are no less than 50% of the *exposure* value gross of value adjustments.

Exposures to past due items

- 4.2F.50 R *Exposures* must be treated as past due in their entirety where any payment due is past its contractual date by more than 90 days.

Exposures to past due item: treatment of secured part of mortgages on residential property

- 4.2F.51 R Where value adjustments are taken against the secured part of an *exposure* secured by a mortgage on residential property and that is past due, the secured part net of value adjustments must be assigned a *risk weight* of:
- (1) 100% if value adjustments are less than 20% of the secured part of the *exposure* gross of value adjustments; or
 - (2) 50% if value adjustments are no less than 20% of the secured part of the *exposure* gross of value adjustments.

- 4.2F.52 G A *firm* may treat the secured part of an *exposure* covered by a mortgage indemnity product that meets the relevant eligibility criteria for credit risk mitigation as secured for the purposes of *MIPRU* 4.2F.51R.

Exposures to past due items: treatment of secured part of other exposures

- 4.2F.53 R For the purpose of defining the secured part of a past due item other than *exposures* secured on residential property, credit protection must be eligible for credit risk mitigation purposes under *MIPRU* 4.2C.

- 4.2F.54 G
- (1) For *MIPRU* 4.2F.53R, the secured part of a past due item is dealt with under *MIPRU* 4.2C (Credit risk mitigation).
 - (2) The *risk weight* to be applied to the secured part is determined under *MIPRU* 4.2C.6R, and *MIPRU* 4.2C.29R to *MIPRU* 4.2C.30R.
 - (3) The *risk weight* of the unsecured part of the past due item is determined in accordance with *MIPRU* 4.2F.55R.

Treatment of unsecured part – all exposures

- 4.2F.55 R The unsecured part of any past due item, net of any value adjustments taken against the unsecured part, must be assigned a *risk weight* of:
- (1) 150% if value adjustments are less than 20% of the unsecured part of the *exposure* gross of value adjustments; or
 - (2) 100% if value adjustments are no less than 20% of the unsecured part of the *exposure* gross of value adjustments.

Example - mortgages on residential property

- 4.2F.56 G The application of value adjustments to either the secured or the unsecured component of an *exposure* secured on residential property may be illustrated on the basis of a £110,000 loan on a property valued at £100,000, where £80,000 of the loan is secured, £30,000 of the exposure is unsecured and a value adjustment of £20,000 is taken.

- (1) Value adjustment applied to unsecured component
 - (a) Value adjustment of £20,000 taken on £30,000 unsecured *exposure*.
 - (b) Value adjustment exceeds 20%, so the firm should risk weight the remaining £10,000 unsecured *exposure* at 100%

(as per *MIPRU* 4.2F.55R).

(c) The *risk weight* to be applied to the secured *exposure* of £80,000 is 100% (as per *MIPRU* 4.2F.51R).

(2) Value adjustment applied to secured component

(a) Value adjustment of £20,000 taken on £80,000 secured *exposure*.

(b) Value adjustment exceeds 20%, so the firm should *risk weight* the remaining £60,000 secured *exposure* at 50% (as per *MIPRU* 4.2F.51R).

(c) The *risk weight* to be applied to the unsecured *exposure* of £30,000 is 150% (as per *MIPRU* 4.2F.55R).

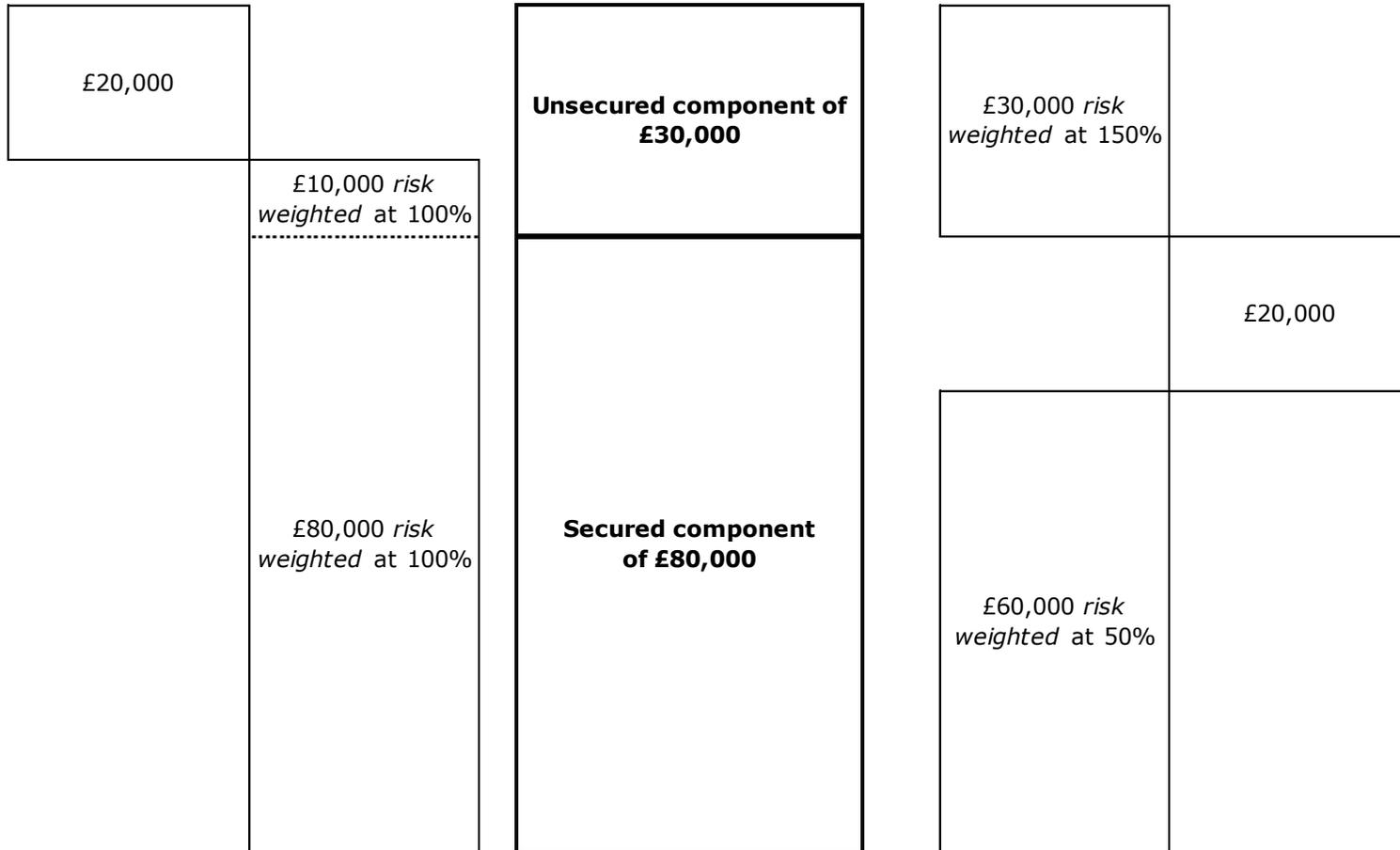
**Value adjustment
applied to
unsecured
component
(MIPRU 4.2F.51R)**

Risk weightings

Exposure

Risk weightings

**Value adjustment
to secured
component
(MIPRU 4.2F.55R)**



Financial Conduct Authority



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25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
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