

MIPRU Chapter 4 Simplification: Feedback on CP14/28 and final rules

March 2015



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In this Policy Statement we report on the main issues arising from Consultation Paper 14/28 *MIPRU Simplification* and publish the final rules.

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Abbreviations used in this paper

ASTL	Association of Short Term Lenders
BCBS	Basel Committee on Banking Supervision
BCD	Banking Consolidation Directive
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BTL	Buy-to-let
CML	Council of Mortgage Lenders
CP	Consultation Paper CP14/28 MIPRU Simplification (December 2014)
CRD	Capital Requirements Directive (EU Directive 2013/36/EU), which forms part of the CRD IV legislative package
CRD IV	CRR and CRD
CRR	Capital Requirements Regulation (EU Regulation 575/2013), which forms part of the CRD IV legislative package
Deposit-takers	Banks and building societies
FCA	Financial Conduct Authority
FSA	Financial Services Authority
IMLA	Intermediary Mortgage Lenders Association
LTV	Loan-to-value
MCD	Mortgage Credit Directive
MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
MIPRU 4	Chapter 4 of MIPRU
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** On 8 December 2014 we published a Consultation Paper (CP)¹ proposing changes to our Handbook of rules and guidance to simplify the provisions for calculating capital requirements for non-bank lenders (NBLs) engaged primarily in residential mortgage lending. These provisions are in the Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU), specifically chapter 4 of that sourcebook (MIPRU 4).
- 1.2** The provisions currently in MIPRU 4 cross-refer to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU), which contains complex and detailed rules derived from European legislation², designed primarily for banks and building societies (collectively termed 'deposit-takers' here) and their broader lending activities. NBLs have a different business model to most deposit-takers so many of the provisions in BIPRU are redundant for them or overly detailed, and our predecessor organisation, the Financial Services Authority (FSA), recognised this. It made a commitment in the Policy Statement³ (PS12/16) on the Mortgage Market Review⁴ (MMR), published in October 2012, to explore how the relevant provisions in BIPRU might be both simplified and incorporated in a standalone version of MIPRU 4.
- 1.3** In this Policy Statement (PS), we summarise the feedback we received to the proposals contained in the CP and give our responses. We also set out the final rules, which will come into effect on 26 April 2015.

Who does this affect?

- 1.4** The rules set out in this PS apply to NBLs that undertake home financing and/or home finance administration (with assets on the balance sheet) that is connected to regulated mortgage contracts.

¹ www.fca.org.uk/static/documents/consultation-papers/cp14-28.pdf

² In the form of the Banking Consolidation Directive (BCD, eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32006L0048) which has since been replaced by CRD IV (ec.europa.eu/finance/bank/regcapital/legislation-in-force/index_en.htm#maincontentSec1) which also covers investment firms.

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

⁴ www.fca.org.uk/firms/firm-types/mortgage-brokers-and-home-finance-lenders/mortgage-market-review

Is this of interest to consumers?

- 1.5** The current provisions in BIPRU are difficult to understand for potential new entrants to the NBL sector without a background in those capital requirements and could therefore act as a barrier. Simplifying them may encourage smaller firms to enter the sector as the new provisions in MIPRU 4 should be easier to understand and comply with, which would offer consumers more choice (and potentially a better deal through increased competition in the sector).

Context

Revision of MIPRU 4 arising from the MMR

- 1.6** As part of the MMR the FSA decided that the existing prudential requirements for lending by NBLs, primarily in the area of residential mortgages given their business model, did not appropriately reflect the inherent risks. The FSA therefore decided to revise the relevant requirements in MIPRU to reflect this.
- 1.7** This led to the first phase of the revision of MIPRU 4, introducing for NBLs the credit risk capital requirements for mortgage and other lending as they were then in BIPRU for deposit-takers, via cross-references to BIPRU. (Since the implementation of CRD IV on 1 January 2015, for deposit-takers the provisions in BIPRU relating to capital requirements have been superseded by those in CRD IV and the PRA rules, but are very largely the same as those derived from the BCD that appear in BIPRU, especially for the calculation of credit risk capital requirements.)
- 1.8** The provisions arising from the first phase came into force on 26 April 2014 and form the current version of MIPRU 4 which 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.⁵
- 1.9** The FSA made a commitment in PS12/16 to consider how the provisions in the current version of MIPRU 4 might be made more accessible for NBLs. That is, it said it would simplify the content of and the language used in those provisions, while maintaining the underlying policy position. The CP and this PS deliver that second phase, i.e. simplifying the relevant provisions from BIPRU (including removing those that are not relevant to NBLs) and incorporating them in a standalone version of MIPRU 4.

Consultation

- 1.10** In December 2014 we consulted on the changes needed to the Handbook to make the relevant provisions more accessible.
- 1.11** We asked for written feedback on our draft rules by 19 January 2015, intending to implement the simplified provisions on 26 April 2015. Implementation of the simplified provisions by that date will make all NBLs subject to the same provisions in MIPRU 4 from then onwards (including those that had been granted the modification by consent).
- 1.12** In our CP we also encouraged stakeholders to give us their views to help inform any future approaches to two specific issues:

⁵ It should be noted, however, that we granted smaller NBLs a modification of MIPRU 4 by consent (www.fca.org.uk/firms/being-regulated/waiver/waiver-by-consent/mipru-4). This effectively delays for them the implementation of the MIPRU 4 rules that cross-refer to BIPRU rules until the modification expires on 25 April 2015, so those NBLs remain subject to the version of MIPRU 4 that applied before 26 April 2014.

- whether the introduction of more risk-sensitive capital requirements for exposures falling outside the exposure classes in MIPRU 4 should be considered; and
- whether multiple risk weights, related to loan-to-value (LTV) bands, should be assigned to the secured portion of an exposure to a residential mortgage to enhance the risk-sensitivity of the capital requirements.

FCA objectives

- 1.13** The adoption of the simplified provisions will advance our objective of promoting effective competition. Simplifying the provisions in MIPRU 4 for calculating capital requirements will make it easier for potential entrants to the NBL sector to understand the standards required of them and to calculate their capital requirements more accurately.
- 1.14** The simplified provisions will very largely maintain the current, underlying policy position, in line with the objectives of the MMR, and broadly maintain the level playing-field with deposit-takers undertaking similar lending business (given they have subsequently become subject to CRD IV). There are, however, a limited number of policy revisions to the provisions currently in MIPRU 4; these will enhance accessibility, but we believe that these do not represent significant changes to the related BIPRU provisions to which NBLs are currently subject.

Cost benefit analysis

- 1.15** The final rules set out in Appendix 1 to this PS do not differ significantly from the draft rules on which we consulted. In the CP we stated that our proposals contain only small policy revisions that will have no material adverse impact on the market for NBLs and that we believed these proposed changes will give rise only to costs of minimal significance. We considered that any such costs will be outweighed by the benefits that simpler and more accessible rules will bring. No new evidence or analysis has come to light in the consultation to lead us to change our view.

Compatibility statement

- 1.16** We consider that the statement of compatibility with our objectives and general duties published in Annex 3 to the CP remains valid, as the final rules set out in Appendix 1 to this PS do not differ significantly from the draft rules on which we consulted in our CP.

Equality and diversity considerations

- 1.17** The simplified provisions, both rules and guidance, are a straightforward clarification and rationalisation of existing prudential provisions, and therefore we conclude there are no equality or diversity implications.

Summary of feedback and our responses

- 1.18** We asked for written feedback on our CP, including the discussion chapter, and received responses from three trade bodies for the mortgage sector, based on their discussions with their members. Two respondents, the Council of Mortgage Lenders (CML) and the Intermediary Mortgage Lenders Association (IMLA), submitted a joint response that addressed the four questions posed in the CP, with additional comments on relevant, wider issues. The third respondent, the Association of Short Term Lenders (ASTL), did not respond to the specific questions posed in the CP, and presented broader views on the impact of the capital requirements derived from BIPRU.

- 1.19** The respondents welcomed the proposals to simplify the provisions in MIPRU 4 and make it a standalone chapter. The following comments were made in the joint CML/IMLA response in relation to the specific questions in the CP.
- It is important to maintain a level playing-field between the NBLs subject to MIPRU 4 and deposit-takers subject to BIPRU where they undertake the same business (e.g. lending for residential mortgages).
 - The opportunity for NBLs to undertake overseas lending and use funded credit risk mitigation should not be limited.
 - For the points raised in the discussion chapter, the introduction of greater risk-sensitivity would be supported by the respondents, whether for exposure classes not currently within the scope of MIPRU 4 or for residential mortgages, subject to appropriate caveats.
- 1.20** We have considered these comments, and do not believe that it is necessary to revise the proposals as they were presented in the CP. We have, however, both clarified the term 'exposure' and ensured consistency with new requirements elsewhere in MIPRU as a result of the implementation of the Mortgage Credit Directive (MCD); these are detailed below in Chapter 2, and we have corrected the few, minor errors that appeared in the draft instrument in the CP.

Next steps

What do NBLs need to do next?

- 1.21** All NBLs, both those currently subject to the version of MIPRU 4 that cross-refers to BIPRU and those that used the modification, should review the changes to the Handbook set out in Appendix 1 to establish how the revised rules will affect their business and any changes that may need to be made to comply with them.

What will we do?

- 1.22** The Handbook changes set out in Appendix 1 will come into force on 26 April 2015. The comments from respondents on the two further issues raised in the discussion chapter of our CP will be considered in any future policy review of MIPRU 4 (but they are not part of this current simplification exercise).

2. Summary of feedback and our responses

- 2.1** In this chapter we summarise the feedback received on the questions in the CP, set out our responses to this feedback, and highlight one policy clarification and a revision of one provision to ensure consistency with another part of MIPRU.

Secured portion of exposures to residential mortgages

- 2.2** For the purposes of BIPRU, the UK exercised a national discretion in the European legislation for the purposes of assessing the portion of an exposure to a residential mortgage on a property in the UK that could be treated as 'secured' and thereby receive a lower risk weight of 35%.⁶
- 2.3** The use of this 'opt-out' effectively allows the relevant portions of exposures to residential mortgages for buy-to-let (BTL) and investment properties to be considered as secured and thereby receive a risk weight of 35%. 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 every portion of such an exposure up to a threshold of the value of the property.
- 2.4** As the provisions in MIPRU 4 currently stand they currently incorporate this opt-out via the cross-references to BIPRU. We proposed in the CP that the link to sufficiently low loss rates should be broken in the equivalent provisions in a revised, standalone MIPRU 4. This would simplify those provisions and recognise the lesser risk that NBLs pose to financial stability, relative to deposit-takers.
- 2.5** In the consultation we asked:

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?*

⁶ BIPRU 3.4.61 R and BIPRU 3.4.62 G

- 2.6** In their joint response, the CML and IMLA welcomed the proposal to remove the reference to loss rates for NBLs subject to MIPRU 4, particularly in relation to their BTL exposures. However, the response also pointed out that the treatments for lenders subject to the proposed version of MIPRU 4 and those subject to BIPRU might diverge if loss rates for this market were to change in future.
- 2.7** The specific issue raised concerns about the potential for deposit-takers regulated by the PRA and now subject to CRD IV to see the national discretion revoked in the light of increased loss rates. The borrower's ability to repay the debt from sources other than an appreciation of the value of the property or cashflows generated by it would then become the sole basis on which the lender could treat a portion of the exposure as secured and consequently be able to assign a risk weight of 35% to that portion of the exposure.
- 2.8** This would contrast with the position of NBLs subject to the simplified version of MIPRU 4, where an appreciation of the value of the property or cashflows generated by it would still be a factor in the lender's assessment of the borrower's ability to service the debt (in addition to any other income streams they might have). The PRA-regulated lenders might therefore be perceived to be at a relative disadvantage to NBLs subject to MIPRU 4.

Our response

Our rationale for this change is to remove some uncertainty for NBLs as to whether, or under what conditions, we might revoke the preferential risk weight. We believe that omitting this condition from MIPRU 4 will be beneficial for NBLs, which are not subject to prudential regulatory standards driven by European legislation, as they will have greater certainty over the risk weights that will apply in future to exposures secured on residential property. If market conditions or European legislation in this area change materially we shall address this in conjunction with the PRA.

Policy revisions

- 2.9** In the CP we proposed some minor revisions to the policy positions in BIPRU, e.g. that relating to lending for overseas mortgages on residential properties, such that the underlying, overall policy position in the simplified version of MIPRU 4 will be very largely the same as that in BIPRU. We considered these revisions both necessary and desirable to simplify the resulting provisions in MIPRU 4 and achieve a clean break with BIPRU.
- 2.10** In the consultation we asked:
- Q2: *Do you agree that the proposed policy changes (set out in Table 2 [of the CP]) are justified and will have an immaterial impact on NBLs given their business model and lending profiles?***
- 2.11** The CML and IMLA, in their joint response, agreed that the proposed revisions would have a limited impact on the business models of NBLs as they currently exist. However, the response raised two points in relation to the opportunity for NBLs, firstly, to undertake overseas lending as a result of changing their business model and, secondly, to use funded credit risk mitigation

techniques for risk management purposes. The response acknowledged that the current level of overseas lending is minimal and that NBLs do not currently use funded risk mitigation techniques, but wished to retain the option for NBLs to undertake them.

Our response

We have not precluded NBLs from undertaking either activity, but have had to offset the objective of simplifying the rules against both losing some risk sensitivity and covering all potential business activities that an NBL might undertake. Overseas lending is explicitly covered in the simplified provisions (with a risk weight of 75% for lending on residential property located overseas, and one of 100% otherwise, except where an exposure is past due). NBLs may use funded credit risk mitigation techniques for risk management purposes or to obtain regulatory capital relief, but the latter will be subject to an NBL applying for a waiver and being granted it.

More generally, we highlighted in the CP that NBLs will retain the opportunity to apply for waivers where the NBL can satisfy us that the thresholds for rule waivers or modifications are met under FSMA. This might be the case for those NBLs that undertake a wider range of lending activities, similar to those of deposit-takers, and that have appropriate systems and controls in place to identify and adequately manage the credit risk that arises.

Discussion points

2.12 We raised the following two topics in the discussion chapter of the CP, and wished to hear views from the industry. Our response in both cases is that the views received will be considered in any potential future policy review of MIPRU 4.

Risk weights for other items

2.13 In the CP we raised the matter for discussion by the industry of introducing more risk-sensitive risk weights for exposures falling outside the exposure classes contained in MIPRU 4. At present, and also in the simplified version of MIPRU 4 that will be implemented on 26 April 2015, any such exposure will be assigned a flat-rate capital requirement of 1% of the exposure value, rather than a risk weight determined by the nature and riskiness of the exposure.

2.14 In the consultation we asked:

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?*

2.15 The joint response from the CML and IMLA supported the use of a more risk-sensitive approach for the exposures considered here, i.e. those falling outside the exposure classes detailed in MIPRU 4. It cautioned, however, that a phased approach would be appropriate to spread any additional administrative burden for NBLs should additional exposure classes with associated risk weights be introduced in future.

Risk weights based on loan-to-value for residential mortgages

- 2.16** In the CP we raised the matter of introducing more risk-sensitive risk weights for residential mortgages, based on the LTV of those exposures. A series of fixed risk weights currently applies to the various portions of such an exposure (secured – 35%, unsecured – 75%, remainder – 100%). We wanted the industry's views on potentially varying the overall risk weight for the secured portion, with exposures with lower LTVs being assigned lower risk weights.
- 2.17** In the consultation we asked:

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?*

- 2.18** The joint response from the CML and IMLA supported the use of a more risk-sensitive approach, based on LTV, for assigning risk weights to the secured portion of an exposure to a residential mortgage and associated capital requirements. However, the response highlighted the need to retain consistency with the capital requirements for deposit-takers for the same type of lending, so the potential for capital requirements for NBLs to be lower than those for deposit-takers is minimised.

Further points

- 2.19** The joint response from the CML and IMLA raised a couple of other points in relation to:
- i.** the periodic revaluation required for larger residential mortgages where they exceed £2.5mn or 5% of the capital resources of an NBL (whichever is the higher) at least every three years⁷; and
 - ii.** the current work by the Basel Committee on Banking Supervision (BCBS) on revising the standardised approach for credit risk.⁸

i. Periodic revaluation of larger loans

- 2.20** The joint response proposed that, instead of the requirement to revalue residential properties that represent those larger exposures of the NBL, a risk weight of 100% should be applied to such exposures, that being in line with the requirements for commercial mortgages. We are not adopting that proposal for a number of reasons.
- 2.21** Most importantly, and from the perspective of providing incentives for better risk management, knowing the value of the property allows the lender to assess the recoverability of the loan and reduce the size of any potential losses associated with the default of a borrower. Where the value of the property falls towards the outstanding exposure this requirement allows the lender to take appropriate steps in good time to enhance the likelihood of recovering the full outstanding amount of the loan (e.g. through forbearance), or to make appropriate provisions against potential default.
- 2.22** Individual exposures to residential mortgages for NBLs, given their business model, are generally larger relative to their overall size than those of deposit-takers and their portfolios do not have

⁷ MIPRU 4.2F.14 R(1)(e)

⁸ *Revisions to the standardised approach for credit risk – consultative document*, (December 2014): www.bis.org/bcbs/publ/d307.htm

as much granularity. The regular, individual monitoring by NBLs of larger exposures in the form of residential mortgages is an appropriate risk management requirement to prevent the default of those exposures which may have a disproportionate impact on the viability of an NBL.

2.23 The capital requirements generated by adopting a single risk weight of 100% for all portions of an exposure (i.e. secured, unsecured, remainder) would provide more capital than the current requirements up to a certain LTV. However, if the borrower defaults, those capital requirements would fully protect the lender only for a small increase in LTVs beyond the protection afforded by the current requirements.

2.24 (It should also be noted that the independent valuer that is required can be in-house, and off-site valuations, as explicitly referred to in MIPRU 4.2F.26 G(2) [see the relevant policy clarification below], can also be used.)

ii. Revision of the standardised approach for credit risk

2.25 One of the aspects of the review by the BCBS is the risk weights that might be applied to exposures to residential mortgages where those properties will be used to generate income to service the debt, e.g. for BTL properties. The BCBS is proposing that these exposures may be classified as specialised lending falling within the corporate exposure category where certain conditions are met. If this were to be the case, such BTL exposures would attract a risk weight of up to 120%, rather than the lower risk weights that would apply to the secured and unsecured portions of such exposures where they are eligible to be considered as residential real estate exposures. The joint response from the CML and IMLA was against any categorisation of BTL exposures as specialised lending and the associated requirement to assign higher risk weights.

2.26 We are monitoring the development of these proposals as the work of the BCBS progresses, alongside our colleagues at the PRA, and that will inform any potential, future review of the MIPRU regime.

Errata and policy clarifications

2.27 We have corrected minor errors that appeared in the provisions as published in the CP. Additionally, we have made two minor revisions to the provisions as they appeared in the CP to clarify them and enhance consistency with other provisions in MIPRU and the Handbook Glossary.

- We have revised rule MIPRU 4.2A.6 R to clarify the policy and ensure that it is consistent with the definition of 'exposure' that appears in the Glossary, i.e. it covers liabilities in addition to assets, except where another rule requires the level of the exposure to be determined in a different, context-appropriate manner (e.g. for lifetime mortgages via MIPRU 4.2F.7 R).
- We have introduced a second limb to MIPRU 4.2F.26 G to acknowledge explicitly the option for NBLs to undertake off-site valuations. This ensures consistency with the provisions introduced in MIPRU 1.3.3 G(2) as part of the implementation of the MCD.

Annex 1

List of respondents

We received two responses to the CP from three respondents, one response being a joint submission, as listed below. (There were no respondents requesting confidentiality.)

The Council of Mortgage Lenders and the Intermediary Mortgage Lenders Association (joint response)

The Association of Short Term Lenders

Appendix 1

Made rules (legal instrument)

**PRUDENTIAL SOURCEBOOK FOR MORTGAGE AND HOME FINANCE FIRMS,
AND INSURANCE INTERMEDIARIES (AMENDMENT) 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 26 April 2015.

Amendments to the FCA Handbook

- D. The Glossary of definitions 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 Prudential Sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (Amendment) Instrument 2015.

By order of the Board of the Financial Conduct Authority
24 March 2015

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 ...

- (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:

- ...
- (2) ... ; or
- (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.

credit enhancement

- (1) (in accordance with...

	(2)	<u>(in MIPRU) a contractual arrangement which improves the credit quality of a <i>securitisation position</i> in relation to what it would have been if the enhancement had not been provided, including the enhancement provided by more junior <i>tranches</i> in the <i>securitisation</i> and other types of credit protection.</u>
<i>credit quality step</i>	(1)	<u>(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).</u>
	(2)	<u>(in MIPRU) a credit quality step in a credit quality assessment scale, as set out in MIPRU 4.2E (Use of external credit assessments).</u>
<i>credit risk capital requirement</i>	(1)	<u>(for a BIPRU firm) the part of the <i>capital</i>...</u>
	(2)	<u>(for a firm carrying on any <i>home financing</i> connected to <i>regulated mortgage contracts</i> or <i>home financing and home financing administration</i> connected to <i>regulated mortgage contracts</i>) the part of the <i>capital resources requirement</i> in respect of credit risk, calculated in accordance with MIPRU 4.2A (Credit risk capital requirement).</u>
<i>CRM eligibility conditions</i>	...	
	(2)	<u>... ; or</u>
	(3)	<u>(for the purpose of MIPRU), MIPRU 4.2C.16R.</u>
<i>default</i>	(1)	<u>(in relation to the <i>IRB approach</i> ...</u>
	(2)	<u>(in MIPRU) for any credit obligation a borrower has with a <i>firm</i>, an event where:</u> <ul style="list-style-type: none"> (a) <u>the borrower is past the contractual payment due date by more than 90 days; and</u> (b) <u>the <i>firm</i> reasonably considers that the borrower is unlikely to pay or otherwise fulfil its credit obligations to the <i>firm</i>.</u>
<i>ECAI</i>	(1)	<u>(except in MIPRU) an external credit assessment institution, as defined in article 4(1)(98) of the <i>EU CRR</i>.</u>
	(2)	<u>(in MIPRU) an external credit assessment institution.</u>
<i>eligible ECAI</i>		an <i>ECAI</i> :

- (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...
- (c) ... ; or
- (d) (in MIPRU) an ECAI listed in the table in MIPRU 4.2E.14R.
- exposure*
- (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*
- (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*.

<i>risk weight</i>	<p>(1) (in relation to an <i>exposure</i> for the purposes of <i>BIPRU</i>) a degree of risk expressed as a percentage assigned to that <i>exposure</i> in accordance with:</p> <p style="margin-left: 20px;">(a) whichever is applicable of the <i>standardised approach</i> to credit risk and the <i>IRB approach</i>, including (in relation to a <i>securitisation position</i>) under <i>BIPRU</i> 9 (Securitisation); or</p> <p style="margin-left: 20px;">(b) (for a firm to which <i>MIPRU</i> 4 applies), <i>MIPRU</i> 4.2A.10R to <i>MIPRU</i> 4.2A.13R.</p> <p>(2) <u>(for an <i>exposure</i> under <i>MIPRU</i>) a degree of risk expressed as a percentage assigned to that <i>exposure</i> in accordance with <i>MIPRU</i> 4.2A.10R to <i>MIPRU</i> 4.2A.12R, and <i>MIPRU</i> 4.2A.17R.</u></p>
<i>risk weighted exposure amounts</i>	<p>(1) (in relation to an <i>exposure</i> for the purposes of <i>BIPRU</i>) the value of an <i>exposure</i> for the purposes of the calculation of (in the case of a <i>BIPRU</i> firm) the <i>credit risk capital component</i> or (in the case of a firm to which <i>MIPRU</i> 4 applies) the <i>credit risk capital requirement</i> under <i>MIPRU</i> 4.2A.4R, in both cases after application of a <i>risk weight</i>.</p> <p>(2) <u>(for an <i>exposure</i> under <i>MIPRU</i>) the <i>credit risk capital requirement</i> under <i>MIPRU</i> 4.2A.4R after application of a <i>risk weight</i>.</u></p>
<i>securitisation position</i>	<p>(1) (in <i>GENPRU</i>, <u><i>MIPRU</i></u> and <i>BIPRU</i>)...</p> <p style="margin-left: 20px;">...</p> <p>...</p>
<i>securitisation special purpose entity</i>	<p>(1) (in accordance with Article 4(44) of the <i>Banking Consolidation Directive</i> (Definitions)...</p> <p>(2) <u>(in <i>MIPRU</i>) a corporation, trust or other entity that has the following characteristics:</u></p> <p style="margin-left: 20px;">(a) <u>it is organised for carrying on a <i>securitisation</i> or <i>securitisations</i> (within the meaning of paragraph (2) of the definition of <i>securitisation</i>);</u></p> <p style="margin-left: 20px;">(b) <u>its activities are limited to those appropriate to accomplishing such <i>securitisation</i> or <i>securitisations</i>; and</u></p> <p style="margin-left: 20px;">(c) <u>its structure is intended to isolate its obligations from those of the <i>originator</i>.</u></p>

<i>securitised exposure</i>	(for the purposes of <i>BIPRU</i> and <i>MIPRU</i>) an <i>exposure</i> ...
<i>traditional securitisation</i>	(in accordance with Article 4(37) of the <i>Banking Consolidation Directive</i> (Definitions) and for the purpose of <i>BIPRU</i> and <i>MIPRU</i>) a <i>securitisation</i> ...
	...
<i>tranche</i>	(in accordance with Article 4(39) of the <i>Banking Consolidation Directive</i> (Definitions) and in relation to a <i>securitisation</i> within the meaning of paragraph (2) of the definition of <i>securitisation</i> and for the purposes of <i>BIPRU</i> and <i>MIPRU</i>) a contractually...
<i>unfunded credit protection</i>	...
	(3) <u>(in <i>MIPRU</i>) a way of mitigating credit risk where the reduction of credit risk on the <i>exposure</i> of an <i>undertaking</i> (the borrower) 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.</u>

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 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 The ~~capital resources requirement~~ capital resources requirement for a firm carrying on any home financing which is connected 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:

(1) ...

- (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 ~~EU~~ fund positions subject to MIPRU 4.2A.4R.

4.2A Credit risk capital requirement

- 4.2A.1 R This section applies to a *firm* carrying on any home financing connected to regulated mortgage contracts or home financing and home financing administration connected to regulated mortgage contracts to which (see MIPRU 4.2.23R) applies.
- 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.3R 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 CIU fund position entered into;

...

(3) have not been deducted from the ~~firm's capital resources~~ 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 4.2.15E to MIPRU 4.2.17E.

4.2A.6 R ~~Unless a rule requires otherwise, the~~ The exposure value of an asset ~~item~~ or liability 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 <i>BIPRU 3.2</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.3R</i> and <i>MIPRU 4.2C.3R</i>
All provisions of <i>BIPRU 3.2</i>	All references to <i>capital resources</i> in <i>BIPRU 3.2</i> are replaced by references to capital resources calculated under <i>MIPRU 4.4</i>
<i>BIPRU 3.2.14G</i>	The last two sentences do not apply
<i>BIPRU 3.2.38R</i>	The references to <i>BIPRU 14</i> , <i>BIPRU 13.3.13R</i> and <i>BIPRU 13.8.8R</i> (Exposure to a central counterparty) do not apply
<i>BIPRU 3.2.10R</i> and <i>BIPRU 3.2.19G</i>	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.10A 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.10B 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.17A 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 ECAs where these are available, in

accordance with MIPRU 4.2E (Use of external credit assessments).

- 4.2A.17B 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 (Credit risk mitigation).
- 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 5 rules referenced within these provisions. [deleted]~~

MIPRU 4.2B (Securitisation) is deleted in its entirety. The deleted text is not shown.

After MIPRU 4.2B (deleted) insert the following new section. The text is not underlined.

4.2BA Securitisation

Application

- 4.2BA.1 R This section applies to a *firm* carrying on any *home financing* connected to *regulated mortgage contracts* or *home financing* and *home financing administration* connected to *regulated mortgage contracts* (see MIPRU 4.2.23R).

Purpose

- 4.2BA.2 R A *firm* must calculate the *risk weighted exposure amounts* for the *securitisation positions* it holds under MIPRU 4.2BA.31R to MIPRU 4.2BA.53R.
- 4.2BA.3 G Where a *firm* has transferred significant credit risk associated with *securitised exposures* which it has originated under MIPRU 4.2BA.5R (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 4.2BA.5R to MIPRU 4.2BA.8R)
 - (2) Systems and controls

(MIPRU 4.2BA.9R to MIPRU 4.2BA.16R)

- (3) Structural features
(MIPRU 4.2BA.17R to MIPRU 4.2BA.22R)
- (4) Implied future support
(MIPRU 4.2BA.23R to MIPRU 4.2BA.30R)
- (5) Calculation of risk weighted exposure amounts
(MIPRU 4.2BA.31R to MIPRU 4.2BA.53R)
- (6) Disclosure to investors
(MIPRU 4.2BA.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 (e.g. residential mortgages) originated by the *firm* are eligible.
 - (4) Effective credit-risk transfer: the *securitisation* mechanism (e.g. 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; or

- (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 exclude, for example, structures such as master trusts, synthetic securitisations and asset-backed commercial paper programmes. Financial derivatives (e.g. 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 R A *firm* must consider at least the following situations to determine whether there may be a breach of the prohibition against implied future support in *MIPRU* 4.2BA.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.26R(1) is permitted.

(2) The support described in *MIPRU* 4.2BA.26R(2) is not permitted.

(3) The support described in *MIPRU* 4.2BA.26R(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* 4.2BA.5R(6) provided that:
- (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* this implies that the *firm* may be likely to provide future support to its *securitisations*, thus failing to achieve a significant transfer of risk. The *FCA* 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 (Credit risk

mitigation) 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 ECAIs*, a *firm* must:
- (1) nominate one or more of the *eligible ECAIs*;
 - (2) use the credit assessments of *nominated ECAIs* 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 ECAIs* to determine the *risk weight* for the position 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 4.2BA.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%
Resecuritisation positions	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:

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

4.2BA.48 G It is sufficient for the purposes of *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 (1) 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.53R for a conversion factor of 50% or 0% are met.

(2) 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 (1) 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.

(2) 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 the following conditions are met:

- (1) the conditions for a conversion factor of 50% in *MIPRU* 4.2BA.52R are met;
- (2) the liquidity facility is unconditionally cancellable; and
- (3) 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) information necessary to conduct comprehensive and well-informed stress tests on the cashflows and collateral values supporting the *securitisation exposures*.

Amend the following as shown.

4.2C Credit risk mitigation

Application

4.2C.1 This section applies to a *firm carrying on any home financing connected to regulated mortgage contracts or home financing and home financing administration connected to regulated mortgage contracts to which* (see *MIPRU 4.2.23R*) ~~applies where that firm wishes to apply credit risk mitigation~~ it applies credit risk mitigation to the calculation of its *risk weighted exposure amounts* under *MIPRU 4.2A (Credit risk capital requirement)*.

Purpose

4.2C.2 G ~~The purpose of MIPRU 4.2C is to set~~ 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 4.2C.5R to MIPRU 4.2C.9R)
- (2) Minimum operational requirements
(MIPRU 4.2C.10R to MIPRU 4.2C.15R)
- (3) Eligibility
(MIPRU 4.2C.16R)
- (4) Calculating the effects of credit risk mitigation
(MIPRU 4.2C.17R to MIPRU 4.2C.31R)
- (5) Sovereign guarantees
(MIPRU 4.2C.32R)
- (6) Combinations of credit risk mitigation
(MIPRU 4.2C.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.5AG</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 to BIPRU 3.2.26R</i> " are replaced by the words " <i>MIPRU 4.2A.8R to MIPRU 4.2A.11R and MIPRU 4.2A.14G</i> ".
<i>BIPRU 5.7.24R(1)</i>	This <i>rule</i> is amended to read as follows: " <i>E is the exposure value according to MIPRU 4.2A.5AG and BIPRU 3.2.3R.</i> "
<i>BIPRU 5.7.27R</i>	The references to <i>BIPRU 4.10</i> and the <i>IRB approach</i> do not apply
<i>BIPRU 5.8.8R and 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 (Securitisation) 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 an adequate 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 satisfy the FCA that it has adequate risk management processes to control the risks to which 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:
- (1) satisfy the FCA 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 Even where a firm recognises credit risk mitigation when calculating risk weighted exposure amounts, it must:
- (1) continue to undertake full credit-risk assessment of the underlying exposure; and
- (2) demonstrate to the FCA 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 and which:
- (a) would allow the protection provider unilaterally to cancel the protection; or
- (b) would increase the effective cost of protection as a result of deteriorating credit quality of the protected exposure; or
- (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 A clause that allows the protection provider unilaterally to cancel the contract after a reasonable period due to non-payment of premiums and other monies due under the contract will not normally indicate non-compliance with MIPRU 4.2C.13R(3)(a). The reason is that payment of such monies is within the control of the firm.

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 requirement 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) unless (6) applies, the guarantee must cover all types of payments the borrower is expected to make in respect of the claim, such as principal, interest payments and 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 (Credit risk mitigation)*.

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.21R, H_{FX} is set at 10%.

4.2C.23 R For the purpose of MIPRU 4.2C.21R, 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 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) Unless MIPRU 4.2C.27R applies, 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 is 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) Proportional regulatory capital relief is afforded if:
- (a) the protected amount is less than the *exposure* value; and
 - (b) the protected and unprotected portions are of equal seniority, i.e. the *firm* and the protection provider share losses on a pro-rata basis.
- (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 (Liquidity resources requirements), which remains unchanged, insert the following new sections. The text 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 programme 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.11 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.12 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.13 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.14R.
- 4.2E.14 R Table: Exposures for which a credit assessment by a nominated ECAI is available
This table belongs to *MIPRU* 4.2E.13R.

		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	BBBH to BBBL	BBH to BBL	BH to BL	CCCH and below

4.2F Exposures and risk weights

Application

- 4.2F.1 R This section applies to a *firm carrying on any home financing connected to regulated mortgage contracts or home financing and home financing administration connected to regulated mortgage contracts* (see *MIPRU 4.2.23R*).

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 will 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 will 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:

$$\text{exposure amount} = P \frac{(1 + i)^T}{(1 + d)^T}$$

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 judgment 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 (i.e. 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:
- (1) 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) as well as the standards in *MIPRU* 4.2F.27R to *MIPRU* 4.2F.29R; and
 - (2) the requirement to use reliable standards of valuation of residential property is not limited to on-site inspections where it is possible to demonstrate that any risks posed have been adequately assessed through the overall collateral management process.
- 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

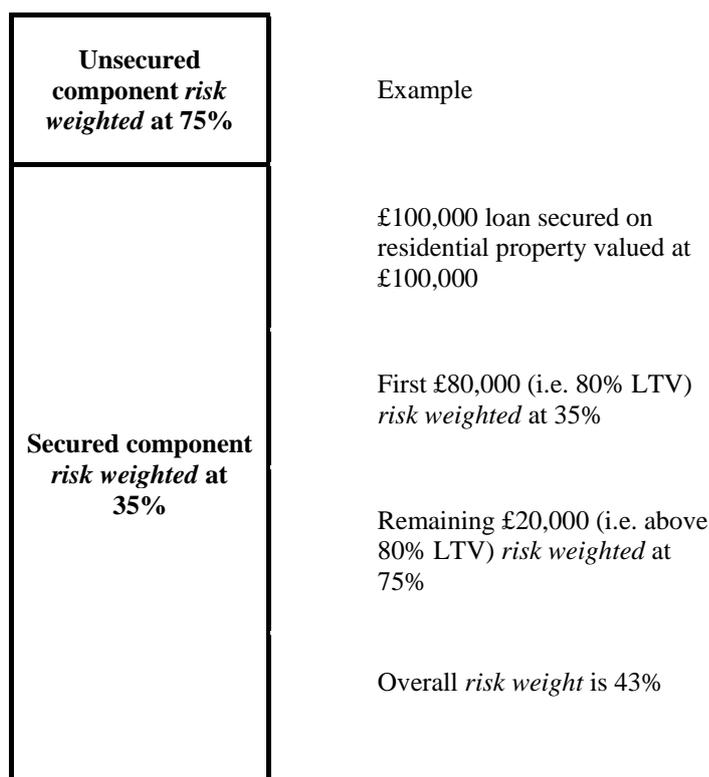
- 4.2F.30 R A *firm* may not treat an *exposure* as fully and completely secured by residential property located in the *United Kingdom* for *MIPRU* 4.2F.4R (residential mortgages) or *MIPRU* 4.2F.9R (property leasing transactions)

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) A diagrammatic illustration of the example in (1).



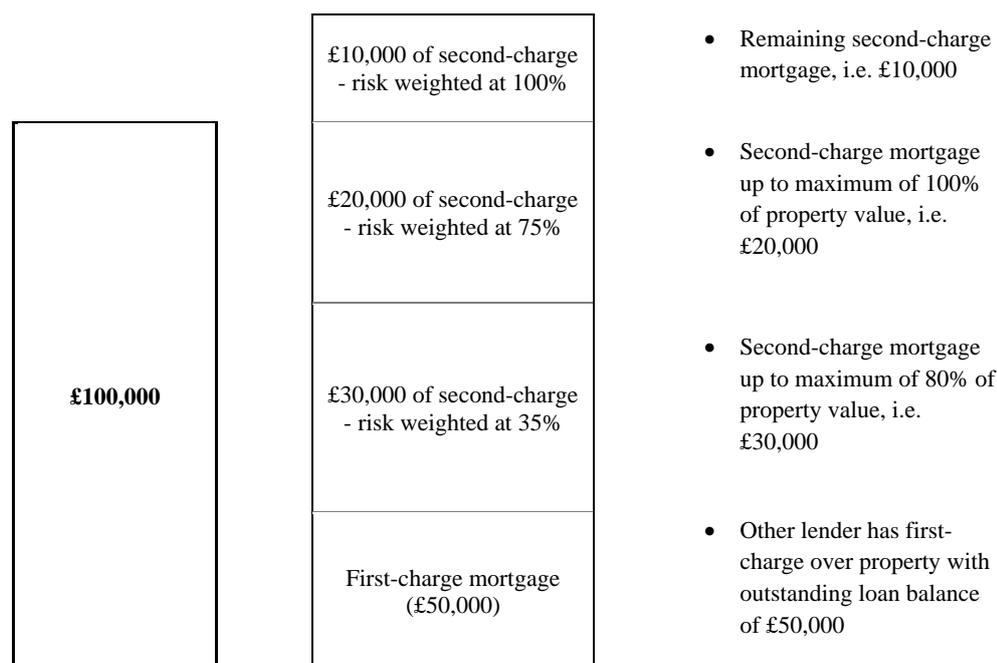
(3) The same approach applies to *exposures* described in *MIPRU* 4.2F.9R. On inception, a *risk weight* of 35% should be applied to the first 80% of the principal/"purchase price" outstanding, with a *risk weight* of 75% being applied to the remainder of the principal *exposure*.

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 will 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, then 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).
- (2) A diagrammatic illustration of the example in (1)

Property value	Exposure and risk weightings	Example
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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.6AR (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.47R* 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* in 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 method in *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 (Credit risk mitigation).

- 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:

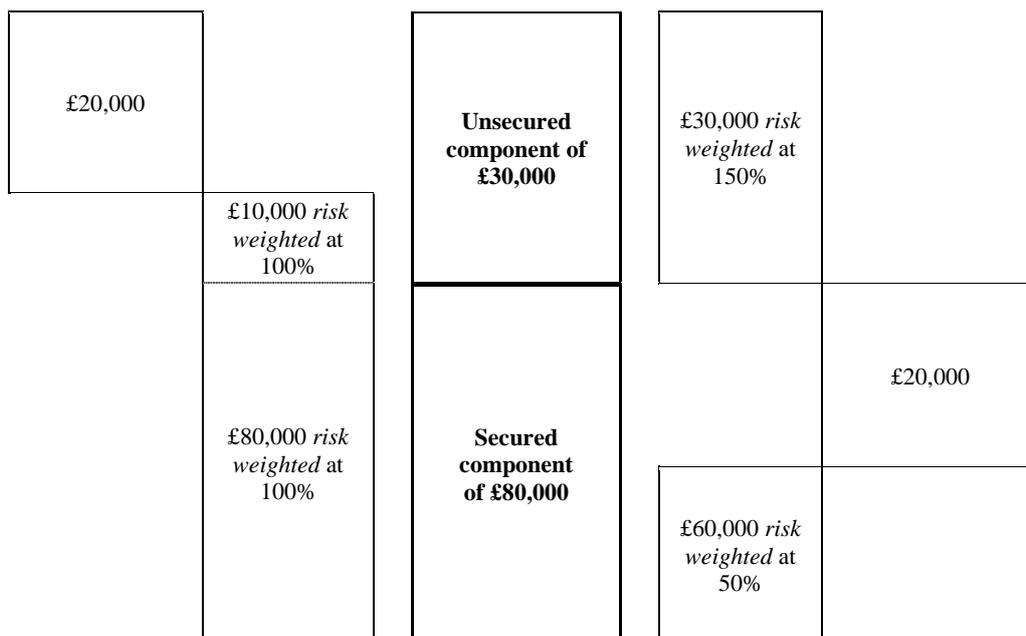
- (a) Value adjustment of £20,000 taken on £30,000 unsecured *exposure*.
- (b) Value adjustment exceeds 20%, so the *firm* should *risk weight* the remaining £10,000 unsecured *exposure* at 100% (as per *MIPRU* 4.2F.55R).
- (c) The *risk weight* to be applied to the secured *exposure* of £80,000 is 100% (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).

(3) A diagrammatic illustration of how (1) and (2) operate is as follows:

Value adjustment applied to <u>unsecured</u> component (<i>MIPRU</i> 4.2F.51R)	Risk weightings	Exposure	Risk weightings	Value adjustment to <u>secured</u> component (<i>MIPRU</i> 4.2F.55R)
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