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IMPACTS OF THE BASEL II REGIME ON THE OPERATIONS OF FINANCIAL INSTITUTIONS WITH REGARD TO THE ELIGIBILITY CRITERIA OF COLLATERALS

Introduction

The primary objective of the following publication is to give a general and brief overview of the impacts of the Basel II regime on financial institutions, focusing on the correlation between the capital requirements and the credit exposure mitigation by eligible collaterals. The subject of review are banks using the IRB (Internal Rating Based) approach for the calculation of their risk weighted exposures and accordingly, their respective capital requirements. In addition we also aim to give a brief insight into the Hungarian regulatory requirements regarding the proper valuation methods for the quantification of the risk mitigating effect to be adopted by banks using IRB approach, whereby we endeavour to describe some of the primary guidelines used by the HFSA in the course of their review of credit risk mitigation.

We also introduce the so called 'funded' credit protection (such as eligible "collaterals") and 'unfunded' credit protection types eligible for the banks to mitigate the exposure value considered for the calculation of their capital requirement. The compliance of collaterals with the Basel II eligibility criteria is of a great importance for financial institutions using the Internal Rating Based (IRB) approaches as only these eligible collaterals can be used to mitigate the exposure value considered for the calculation of the capital requirement, and thereby to reduce the capital requirement.

Hereby we would like to draw your attention to the publication titled "*Eligibility and Minimum Requirements for Real Security on Real Property in the light of Basel II criteria*" whereby we endeavour to summarize certain aspects of the eligibility and minimum requirements for real security collaterals on real property under the Basel II regime. These collaterals are frequently used by the banks to mitigate the exposure value considered for the calculation of their capital requirement, and thereby to reduce the capital requirement. In our opinion borrowers being aware of such banking requirements and procedures can understand and size up the real lending value of their collaterals offered to the banks in a more realistic way, hence they can have a better understanding about the eligibility criteria of their collaterals, which fundamentals may be advantageous for the borrower during the negotiations with the lenders.

The eligibility and minimum criteria are regulated by the Government Decree 196/2007 on the Management and Capital Requirement of Credit Risk (Government Decree) implementing the respective provisions of the CRD Directives (the Capital Requirements Directives (CRD) i.e. EC Directive 2006/48 on *relating to the taking up and pursuit of the business of credit institution*s and EC Directive 2006/49 called *capital adequacy directive*). In addition to the CRD Directives,- the Government Decree,- and several other Hungarian statutory provisions related to the eligibility and minimum requirements, we have also compiled and consistently relied on the Validation Guidelines of the Hungarian Financial Services Authority's (HFSA) on the implementation, assessment and approval of IRB.

The Basel II Accord

First and foremost we aim to give a brief overview about the respective function of the Basel II accord. The accord was introduced to keep pace with the increased sophistication of lenders' operations and risk management. Lenders were able under Basel I to reduce required capital without demonstrating a decrease in the real exposures (known as regulatory capital arbitrage). Basel II was elaborated in the abovementioned EU directives. Basel II adjusted required minimum regulatory capital to the bank's real risk profile. Basel I used single risk weight to calculate a minimum level of capital for each of a limited number of asset classes, eg, mortgages, consumer lending, corporate loans, exposures to sovereigns. Lenders under Basel II use their own risk measurement models to calculate required regulatory capital. Pillar 1 of Basel II covers the calculation of risk weights to determine a basic minimum capital figure. Standardised approach, is a calculation method which provides risk weights for some asset classes meanwhile the risk weight on others are to be determined by the public credit rating assigned to the particular asset by the rating agencies.

<u>The foundation IRB approach (FIRB) is the relevant </u>method used for the calculation of the risk weighted exposure <u>reducible by the eligible collateral</u>. Regarding the exposures calculated by the interim advanced approach (AIRB) and retail, such exposures cannot be reduced by specifically eligible collaterals or only with certain material limitations). Pillar 1 also requires lenders to assess their market and operational risk and provide capital to cover such risk. Under Pillar 2, lenders are required to assess risks to their business not captured in Pillar 1, for which additional capital may be required (for example the risk caused by interest rate mismatches between assets and liabilities). Pillar 3 aims at the transparency by means of publishing information on their approach to risk management.

A brief description of the difference between the simple and the complex method (used by IRB) for the quantification of the risk mitigating effect

Banks using the IRB approach are not allowed to use the simple method. <u>When using the IRB fundamental approach the calculation of the capital requirement must always be carried out using credit risk mitigation</u>. The complex approach reduces the exposure amount by taking into account the "haircut" (volatility adjustment factor) values. Credit institutions have an option to use the value specified in the statutory regulation or they may estimate the value themselves using an internal model. The HFSA Validation Guidelines draws up precisely the difference in comparison to the simple approach; <u>namely while under the simple approach the risk mitigation tool (e.g. a real estate collateral) with its own risk weight replaces the appropriate proportion of the position to be covered, under the complex method the collateral (if it complies with the CRD eligibility criteria) may be used to reduce the exposure amount underlying the capital requirement calculation. In addition under the complex approach the exposure and the collateral may have</u>

different maturities.

Why is the method used for the calculation of the risk weighted exposure (IRB approach) relevant regarding the eligibility of the given type of collateral that may be used to mitigate credit risk?

The answer is that the recognition of collateral for the purpose of credit risk mitigation depends on whether the institution intends to apply (i) the Standardised or (ii) the IRB approach, and whether it uses a simple or complex approach to financial collateral. IRB approach enables the regulatory recognition of a wider range of funded credit protection (see below) schemes as, in addition to the financial collateral eligible in the standardised approach or unfunded credit protection, acceptable collateral may also include mortgage on real estate, mortgage on movable property (chattel mortgage), pledge on receivables, as well as financial lease.

The primary guidelines of the HFSA regarding the review of the credit risk mitigation

As a basic principle, only collaterals in compliance with CRD can be used to mitigate the exposure value considered for the calculation of the capital requirement, and thereby to reduce the capital requirement. Nevertheless, institutions will continue to have the possibility to accept, in line with Hungarian statutory regulations and their own credit policies, collateral specified in their policies but not satisfying the criteria laid down in the CRD (without mitigation of the exposure value). Irrespectively to the application (or non application) of such credit risk mitigation methods the credit institutions shall carry out the proper credit risk rating of the exposures.

Difference between 'funded' and 'unfunded' credit protection (*előre rendelkezésre bocsátott/ előre nem rendelkezésre bocsátott hitelkockázati fedezet*)

Basel II offers two forms of credit mitigation techniques, "funded" and "unfunded" credit protection. In accordance with the CRD, the Act CXII of 1996 on Credit Institutions and Financial Enterprises (Hpt.) and the Government Decree also differentiate between these two types of credit protections. Funded credit protection is a type of collateral that allows the institution to acquire the underlying asset or to seek satisfaction from the proceeds from its sale if a risk event occurs. Regarding unfunded credit protection, we talk about a risk mitigation technique where the institution may seek satisfaction from an amount paid by an independent third party. The entity providing the credit protection is more creditworthy than the primary borrower, that is the reason of the reduction in the capital.

Funded credit protection eligible by the credit institution:

1 on balance sheet netting;
2 repo-type transactions and securities or commodity lending operations implemented under standardised netting agreements;
3 **collaterals** as (i) financial collateral - including security deposit, (ii) real (*in rem*) collateral on real estate - including real estate mortgage (provided that the borrower is expected to fund 80 per cent. of the repayment from other sources, rather than the cash flows from the property itself), (iii) real (*in rem*) collateral on movable property (including chattel mortgage), (iv) financial lease, (v) collateral over receivable (including pledge on receivables) with a maturity of less than on year;
4 cash/ security deposit deposited at a non lender credit institution;
5 life insurance policy (if insurance proceeds are pledged receivables in favour of the lender)
6 securities issued by a non lender credit institution if these securities are repurchased by the issuer (for request).

Unfunded credit protection eligible by the credit institution can be (i) guarantee, (ii) suretyship, (iii) credit derivative. If a bank holds an eligible form of funded credit protection and the various legal requirements have been met, the consequences for the bank's capital adequacy position is that such credit protection may be used to reduce the exposure amount underlying the capital requirement calculation.

Discrepancies between the availability of collateral / maturity of the exposure

According to the Government Decree credit protection with less than 3 months availability is not eligible if such availability is less than the maturity of the covered exposure. The credit protection's maturity depends on various circumstances, e.g. if the party providing the credit protection can terminate such coverage unilaterally, than the availability of such credit protection shall be the earliest date upon which such termination right can be exercised.

Conclusion

Basel II creates strong correlation between capital adequacy with real risks inherent in banking business, the qualification criteria for eligible credit protection are expressively strict. New forms of credit protection has been introduced at the same time. Terms and conditions of the collateral agreements are crucial regarding the effectiveness, eligibility and the enforceability.

Bibliography and references

- *Government Decree 196/2007 on the Management and Capital Requirement of Credit Risk (Government Decree)*
- *EC Directive 2006/48 on relating to the taking up and pursuit of the business of credit institutions and EC Directive 2006/49 called capital adequacy directive)*
- *Validation Guidelines of the Hungarian Financial Services Authority's (HFSA) on the implementation, assessment and approval of IRB.*
- *Council of Mortgage Lenders: Basel II. A policy update explaining in simple terms the international capital accord, Basel II.*