Single Rulebook Q&A

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Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Large exposures
Article	399, 401, 403
Paragraph	-
Subparagraph	-
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	Not applicable
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Disclose name of institution / entity	No
Type of submitter	Other
Subject matter	Mandatory substitution approach according to Article 403 CRR when applying either the Financial Collateral Comprehensive Method (FCCM) or, in the case of securities financing transactions (SFTs) the Internal Model Method (IMM) or master netting agreements to calculate the exposure value.
Question	Question 1: Has the mandatory substitution approach according to Article 403 CRR to be applied when an institution uses the FCCM? If yes, what is the amount that the institution shall assign to the protection provider/collateral issuer? Question 2: In the case of exposures arising from SFTs referred to in Article 401(2) second paragraph CRR, has the mandatory substitution approach according to Article 403 CRR to be applied when an institution applies master netting agreements, together with either the FCCM or IMM as referred to in Articles 220 CRR and 221 CRR? If yes, what is the exposure amount that shall be assigned to the collateral issuer? Question 3: Also regarding exposures arising from SFTs, has the mandatory substitution

	approach according to Article 403 CRR to be applied when an institution applies IMM as referred to in Section 6 of Chapter 6 of Title II of Part Three CRR? If yes, what is the exposure amount that shall be assigned to the collateral issuer? Question 4: Does an institution have to use a credit risk mitigation technique for large exposure purposes when it has used it for calculating own funds requirements, or can an institution renounce, for large exposure purposes, applying a credit risk mitigation that it has used for calculating own funds requirements? Question 5: Does an institution also have to apply the substitution approach, for large exposure purposes, in those cases where the collateral is not taken into account for calculating own funds requirements?
Background on the question	In the case of financial collateral, for large exposure purposes, with the exception of institutions using the FCSM, institutions have to use the FCCM according to Article 401(2) CRR, regardless of the method used for calculating the own funds requirements for credit risk. In relation to SFTs, Article 401(2) CRR permits the institutions allowed to use the methods referred to in Section 4 of Chapter 4 of Title II of Part Three CRR (among others master netting agreements in accordance with Articles 220 and 221 CRR) and Section 6 of Chapter 6 of Title II of Part Three CRR (i.e. internal model methods –IMM- for counterparty credit risk) to apply those methods for calculating the exposure values of such transactions. According to Article 401(4) CRR, when an institution reduces an exposure to a client, the institution, in the manner set out in Article 403 CRR, shall treat the portion of the exposure by which the exposure to the client has been reduced as having been incurred for the protection provider rather than for the client. Then, Article 403(1)(b) CRR describes how the mandatory substitution applies in the case of financial collateral: an institution has to treat the portion of the exposure collateralised by the market value of recognised collateral as exposure to the third party (collateral issuer) rather than to the client, provided that the exposure is secured by collateral and provided that the collateralised portion of the exposure would be assigned a risk weight that is equal to or lower than the risk weight of the unsecured exposure to the client under Chapter 2 of Title II of Part Three CRR. However, it is not clear how the substitution has to be applied when an institution uses the FCCM, the IMM (for SFTs) or master netting agreements, since the wording of Article 403(1)(b) CRRII and the third subparagraph of Article 403(1) CRRII seems to be still tailored to the FCSM: - The condition to apply the substitution approach as set out in Article 403(1)(b) CRR (“provided that the collateralised portion of the exposure would be assigned a risk weight that is equal to or lower than the risk weight of the unsecured exposure to the

client under Chapter 2 of Title II of Part Three") is clearly tailored for the FCSM. Indeed, applying this condition to the FCCM would mean that the substitution is no longer mandatory when the risk weight of the collateral issuer is higher than the risk weight of the client, which does not make sense from a prudential point of view. - In Article 403(1)(b) CRR, the amount of the exposure to be assigned to the collateral issuer is the market value of the collateral, which is the value of the collateral used in the FCSM according to Article 222(2) CRR. The amount of the collateral used in the FCCM is the volatility-adjusted value of the collateral defined in Article 223(2) CRR. - The third subparagraph of Article 403(1)(b) CRR II still restricts the scope of substitution to where an institution uses the FCSM since, except in two applicable cases (for more details, see EBA Q&A 2014_793) where partial application is permitted, an institution is required to opt for either the FCCM or the treatment set out in Article 403(1)(b) of the CRR. And yet, Article 401(4) CRR refers to Article 403 CRR (the substitution approach), in such a manner, that an institution, when it reduces an exposure to a client using an eligible credit risk mitigation technique in accordance with Article 399(1) CRR shall treat the part of the exposure by which the exposure to the client has been reduced as having been incurred for the protection provider rather than for the client. Therefore, it is not clear from the wording of Article 401(4) CRR, referring to Article 403 CRR ("in the manner set out in Article 403"), together with the wording of Article 403(1)(b) CRR (which is clearly tailored for the FCSM) if the substitution approach is mandatory in the case of an institution using the FCCM or using the IMM (in the case of SFTs), or using master netting agreements together with FCCM, or using IMM for master netting agreements (in the case of SFTs), and whether it is necessary to reassign the secured part of the exposure towards the client as exposure towards the protection provider/collateral issuer. Can you clarify the situation, since the Basel text is however clear at least for the FCCM: the substitution approach shall apply to banks using the FCCM, according to the third bullet point of paragraph 42. Regarding IMM for SFTs, it should be noted that there is no exposure reduction via an eligible credit risk mitigation technique as referred to in Article 401(4) CRR. IMM is a method to directly calculate the exposure. There is no separate calculation of the amount to be deducted from the exposure when recognizing the collateral. However, collaterals are used. So the question arises, shall the substitution approach apply in this case? If yes, which amount shall the institution assign to the collateral issuer? A further question arises when a bank applies master netting agreements in the case of SFTs, using either the fully adjusted exposure value determined in accordance with Article 220 CRR (FCCM) or in accordance with Article 221 CRR (IMM). Does the substitution approach have to be applied to all collateral in a netting set or only to the net position if this is secured by collateral? Netting is one eligible form of credit risk mitigation regulated in Part Three, Title II, Chapter 4. However, one feature distinguishing netting from conventional credit risk mitigation techniques is the offsetting of positions that cancel each other out. In

	conventional credit risk mitigation techniques, the default risk of an exposure to a counterparty is reduced by financial collateral or a guarantee provided by a third party. The institution nevertheless retains an open position of the original value vis-à-vis the counterparty. In netting, by contrast, opposite positions of the bank and a counterparty are set off against one another. After that, only one position (the net position) remains. This means that the offsetting of positions which occurs in netting does not result in the default risk of the netted position being fully or partially replaced by the default risk of a third party. Does this mean that a substitution has not taken place as the secured amount is efficiently reduced and no additional exposure stemming from the CRM technique arises? Two questions remain: According to Article 399(1) CRR, an institution shall use a credit risk mitigation technique in the calculation of an exposure where it has used that technique to calculate capital requirements for credit risk in accordance with Title II of Part Three. Does this sentence mean that, under the large exposure framework, an institution cannot renounce to a credit risk mitigation technique it has used under the solvency framework? And what about the other way around? Is it allowed that an institution uses collateral to reduce the exposure amount only for the purposes of large exposures but not for calculating its capital requirements? Has the substitution approach according to Article 403 CRR to be applied in such cases?
Final answer	Question 1: Article 399(1) of Regulation (EU) No 575/2013 requires an institution that has used a credit risk mitigation technique to calculate own funds requirements for credit risk to also use that technique in the calculation of exposures under the large exposure rules. Further, Article 401(2) of that Regulation mandates the use of the Financial Collateral Comprehensive Method (FCCM) when institutions use the fully adjusted exposure value (E*) for calculating the value of exposures for the purposes of Article 395(1) of that Regulation, with two exceptions1. Finally, Article 401(4) of that Regulation specifies that when an institution reduces an exposure to a client using an eligible credit risk mitigation technique for the purpose of large exposure calculations, the institution must use the substitution approach. Based on the combined reading of the above provisions, when an institution applies the FCCM, it should apply the substitution approach. In that case, the amount that the institution is required to assign to the collateral issuer is the value of the collateral (issued by that issuer) that is recognised as reducing the exposure to the client for the purpose of calculating own funds requirements. This value is determined as the difference between the exposure amount calculated without recognising that collateral and the exposure amount recognising that collateral, in accordance with Article 223 of that Regulation.

Question 2:

For exposures arising from SFTs included in a master netting agreement, an institution that applies the approaches set out in Article 220 or Article 221 of Regulation (EU) No 575/2013 to calculate the exposure value has to apply the substitution approach for the same reasons stated in the response to Question 1.

Under these approaches, for each eligible collateral securing an exposure arising from SFTs included in a master netting agreement, the portion of the exposure to be assigned to the third party (i.e. collateral issuer) rather than to the client is the value of that collateral recognised as reducing the exposure to the client for the purpose of calculating own funds requirements. This value is determined as the difference between the exposure amount calculated without recognising that collateral (all other things being equal) and the exposure amount calculated recognising that collateral (all other things being equal).

Question 3:

Yes, when an institution uses the approach set out in Section 6 of Chapter 6 of Title II of Part Three of Regulation (EU) No 575/2013 (i.e. the IMM) to calculate the own funds requirement for counterparty credit risk for those exposures, the substitution approach is applicable to those exposures.

Under this approach, for each eligible collateral securing an exposure arising from SFTs included in a master netting agreement, the portion of the exposure to be assigned to the third party (i.e. collateral issuer) rather than to the client is the value of that collateral recognised as reducing the exposure to the client for the purpose of calculating own funds requirements. This value is determined as the difference between the exposure amount calculated without recognising that collateral (all other things being equal) and the exposure amount calculated recognising that collateral (all other things being equal).

Question 4:

Article 399(1) of Regulation (EU) No 575/2013 requires an institution that has used a credit risk mitigation technique to calculate own funds requirements for credit risk to also use that technique in the calculation of exposures under the large exposure rules. Therefore, the only situation in which an institution would be allowed to not recognise the use of a credit risk mitigation technique under large exposure rules, is when it would not

	recognise it when calculating own funds requirements for credit risk. Question 5: No. Based on the combined reading of Articles 399(1) and 403(1) of Regulation (EU) No 575/2013, an institution is only required to apply the substitution approach where it has used a credit mitigation technique to calculate own funds requirements for credit risk. **Disclaimer:** The answers clarify provisions already contained in the applicable legislation. They do not extend in any way the rights and obligations deriving from such legislation nor do they introduce any additional requirements for the concerned operators and competent authorities. The answers are merely intended to assist natural or legal persons, including competent authorities and Union institutions and bodies in clarifying the application or implementation of the relevant legal provisions. Only the Court of Justice of the European Union is competent to authoritatively interpret Union law. The views expressed in the internal Commission Decision cannot prejudge the position that the European Commission might take before the Union and national courts.
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