



# Single Rulebook Q&A

<b>Question ID</b>	2021_5677
<b>Status</b>	Final Q&A
<b>Legal act</b>	Regulation (EU) No 575/2013 (CRR)
<b>Topic</b>	Credit risk
<b>Article</b>	161
<b>Paragraph</b>	3
<b>Subparagraph</b>	-
<b>COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations</b>	EBA/GL/2020/05 - Guidelines on credit risk mitigation for institutions applying the IRB approach with own estimates of LGDs
<b>Article/Paragraph</b>	paragraph 38, point (c)
<b>Date of submission</b>	07/01/2021
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<b>Disclose name of institution / entity</b>	Yes
<b>Name of institution / submitter</b>	BaFin
<b>Country of incorporation / residence</b>	Germany
<b>Type of submitter</b>	Competent authority
<b>Subject matter</b>	Allocation of direct costs associated with the realisation of funded credit protection in case of partial coverage of an exposure by unfunded credit protection
<b>Question</b>	Does paragraph 38(c) of the EBA/GL/2020/05 require the allocation of direct costs associated with the realisation of the funded credit protection to the

	part of the exposure that is covered by the funded credit protection?
<b>Background on the question</b>	<p>According to point (c) of paragraph 38 of the Guidelines on credit risk mitigation for institutions applying the IRB approach with own estimates of LGDs (EBA/GL/2020/05) in the case of an exposure that, apart from partial coverage through unfunded credit protection, also benefits from funded credit protection the direct costs associated with the realisation of such funded credit protection should be allocated to the “guaranteed part of the exposure”. Paragraph 38 of said Guidelines deals with the case where unfunded credit protection only covers part but not all of an exposure and inter alia specifies how institutions that use the „substitution of risk parameters approach“ or the „substitution of risk weight approach“ should allocate cash flows, indirect costs and direct costs for the purposes of calculating the realised LGD. In this regard, point (a) inter alia stipulates that cash flows received from the guarantor should be allocated to the guaranteed part and cash flows that are associated with funded credit protection should be allocated to the part of the exposure that is covered by this funded credit protection. Point (c) of that paragraph provides clarifications on the allocation of direct costs. According to the provisions of this point, direct costs that are directly linked to the exercising of the unfunded credit protection should be allocated to the part of the exposure that is covered by the unfunded credit protection. Where exposures, apart from the partial coverage through unfunded credit protection, also benefit from funded credit protection, the direct costs associated with the realisation of such funded credit protection should, however, be allocated to the “guaranteed part of the exposure”. This appears to be inconsistent with the approach taken under point (a) of that paragraph according to which the cash flows associated with funded credit protection should be allocated to the part of the exposure that is covered by this funded credit protection.</p>
<b>EBA answer</b>	<p>Paragraph 38 of the Guidelines on credit risk mitigation for institutions applying the IRB Approach with own estimates of LGDs (EBA/GL/2020/05) refers to cases where institutions use the substitution of risk parameters approach (defined in paragraph 31(a)(ii) of the same Guidelines) or the substitution of risk weight approach (defined in paragraph 31(b) of the same Guidelines) and cases where the unfunded credit protection (UFCP) only covers part but not all of an exposure, including when the exposure may benefit also from funded credit protection (FCP).</p> <p>The paragraph specifies how institutions should allocate cash flows (point a)), indirect costs (point b)) and direct costs (point (c)) to the guaranteed/unguaranteed parts of the exposure (i.e. to the part of exposure covered or not by UFCP) for the purposes of calculating realised LGDs.</p>

	<p>In case of exposures covered by both UFCP and FCP, the guidelines provide guidance on how institutions should allocate the cash flow and costs associated with the realisation of the FCP to the part of the exposure which is covered by UFCP and the one which is not. In this context, paragraph 38(c) requires the direct costs associated with the realisation of the FCP to be allocated in accordance with paragraph 46. Paragraph 46 clarifies that institutions should allocate multiple credit risk mitigation techniques to the different parts of the exposure consistently with the internal recovery and collection process. As a result, in case of exposures covered by both UFCP and FCP, this allocation determines whether the FCP overlaps with the UFCP and, therefore, for the purposes of paragraph 38(c), whether the direct costs associated to the FCP will be allocated to the guaranteed part of the exposure or to the unguaranteed part.</p> <p>In other words, both paragraph 38(a) and paragraph 38(c) imply respectively that the cash flows and direct costs associated with the realisation of the FCP should be allocated to the part of the exposure that is covered by this FCP. However, in accordance with paragraph 46 the allocation of the FCP to different parts of the exposures will ultimately determine whether these cash flows and costs will be allocated to the guaranteed (i.e. covered by UFCP) or unguaranteed (i.e. not covered by UFCP) part of the exposure.</p>
<b>Link</b>	<a href="https://www.eba.europa.eu/single-rule-book-qa/qna/view/publicId/2021_5677">https://www.eba.europa.eu/single-rule-book-qa/qna/view/publicId/2021_5677</a>

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