

Content of question – Specialised lending exposures

Piece of law	Decree No. 123/2007 Coll. (as amended) (hereinafter the "Decree")
Provision	<ul style="list-style-type: none">• Annex 11/3/c)• Annex 12/2/d)
Question	<p>In case a liable entity uses the IRB approach to determining the investment portfolio's credit risk capital requirements, is it obliged to assign specialised lending exposures to a separate subcategory of corporate exposures, which would rule out using a model designed for general corporate exposures? Which procedure should the liable entity follow in the event that some of the criteria listed in Annex 11/3/c) to the Decree are not met (for example, the obligor is a member of a broader consolidated group with diversified incomes, or the asset is financed by more banks and the liable entity in question exercises significant control neither over the financed asset nor over the revenue generated by the financed asset, or perhaps the obligor runs more projects)?</p> <p>In case a liable entity uses the Standardised Approach, does it also need to apply some kind of specific treatment to specialised lending exposures?</p>
Answer	<p>Specialised lending exposures form a separate subcategory of corporate exposures due to their specific nature, which makes them distinguished from general corporate exposures. Official Information of the Czech National Bank of 18 July 2007 – Specialised Lending Exposures When Calculating the Capital Requirement for Credit Risk – provides a more detailed description of the classical types of specialised lending exposures.</p> <p>Annex 11/3/c) to the Decree sets out three basic criteria for specialised lending exposures, the most important of these being the fact that the primary source of repayment of the obligor's liability is the revenue generated by the financed assets, rather than the debtor's separate capacity for broader commercial activities. In other words, the borrower (usually a separate legal entity known generally as an SPV - <i>special purpose vehicle</i>), whose revenues are not diversified and depend essentially on only one asset (or one set of assets). The fulfilment of the other criteria is to be assessed in terms of their nature.</p> <p>The purpose of the exclusion of specialised lending exposures into a separate subcategory is the fact that their specific nature also requires specific risk management practices. The risk of specialised lending exposures is generally perceived as larger than that of general commercial exposures precisely because the obligor's income is not diversified and it is dependent on the asset in question. Risk management under the IRB Approach includes, first of all, a correct assignment of the internal rating grade, a correct determination of the probability of default (PD) and the risk weight, since a model designed for general corporate exposures would not produce accurate results and could not reflect the high specificity of specialised lending exposures. Moreover, it includes the necessity of performing additional activities associated with the management of this portfolio's risks, which is made possible precisely by its segregation (the application of specific procedures for approval, as well as for the ongoing risk measurement and monitoring which must follow, for internal reporting, for reflecting the specific factors which affect stress-testing, for the measurement and monitoring of the concentration risk of these exposures etc). It also includes the necessity to reflect the relevant risks in the in the allocation of internal capital.</p>

In the event that the obligor (SPV) is a unit – a legal entity – earmarked for the

given asset (such as its construction or operation), but it is a member of a broader consolidated group in which diversified activities prevail, and the liable entity exercises reasonable control over its activities (for example, a guarantee issued by the parent company exists) so that, if necessary, it will be possible for the liable entity to collect its receivable from some additional (diversified) incomes of the group as well, the liable entity may use a model designed for general corporate exposures to determine the resulting internal rating. In this case, principles for the assessment of such specialised lending exposures' obligors must be included in the liable entity's internal procedures and must be applied in a consistent manner. The rules for the recognition of credit risk mitigation are not affected. However, in case the liable entity controls only the SPV in question the income of which is fully dependent on the profitability of the given asset, it is also necessary to treat the obligor as a specialised lending exposure when the rating is being determined. (It can be, for example, as asset which is being let to the parent company, where the rent is derived from the amount of the profit obtained by operating this asset.)

Since the basic criterion for specialised lending exposures, i.e. that the revenues are not diversified, is crucial in their assignment according to the Decree, it cannot be bypassed, for example, by a situation where the given liable entity does not finance an overwhelming bulk of this asset (for example, the client has sufficient own resources or there are some other banks involved in the financing) or does not contractually ensure a significant degree of control over the financed assets and the income generated by these assets. The absolute amount of the credit risk which the liable entity is exposed to may be limited, but this does not alter the essential characteristics of this exposure and, for example, it still holds that determining the internal rating by applying a model designed for general corporate exposures would produce incorrect results.

Another problematic case may be a situation where a borrower (SPV) runs more projects. This particular issue is addressed in the Official Information of the Czech National Bank of 18 July 2007 – Specialised Lending Exposures When Calculating the Capital Requirement for Credit Risk (see section II.2), see also http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/legislation/provisions_and_official_information/v_2007_18_23207530_en.pdf

Although there is no really accurate rule for the assignment procedure, it is essential that the liable entity carefully assesses the degree of diversification of the projects and the capacity to replace the income generated by the obligor's assets with other incomes of the obligor. The principles set out in the Official Information imply that a specialised lending exposure would be an exposure that roughly corresponds to at least 70% of the obligor's income.

If the Standardised Approach to calculating the capital requirement for credit risk in the investment portfolio is used, specialised lending exposures as such are not segregated with respect to the capital requirement calculation, as long as the exposures in question do not fall, for example, into the class of exposures secured by real estate. However, a liable entity applying the Standardised Approach is not exempt from the obligation to follow the general principles for risk management set out in Art. 24 of the Decree et seq. The risk management system, pursuant to Art. 24/2, corresponds to the character, scope and complexity of activities and their associated risks. Consequently, and, in particular, when the liable entity has a concentrated position in exposures meeting the criteria for specialised lending exposures, the Czech National Bank expects the liable entity to devote appropriate attention to the management of their risks, which would mean, above all, that the liable entity is effectively able to identify such exposures in its portfolios.

The Czech National Bank also expects that liable entities also reflect the higher risks of specialised lending exposures in their internal capital allocation, including the risks associated with the relevant phase of the business cycle that are not fully covered by the minimum capital requirements as set out in Pillar 1.

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Further information for the recipient of the answer: The answer reflects views of the staff members of the Czech National Bank. A court of law, or possibly the Bank Board of the Czech National Bank, may take a different point of view. However, a liable entity's practices that adhere to the answer will be considered, within the limits of the answer and its assumptions, to be in harmony with legal regulations, unless the inapplicability of the answer to the case in question follows from circumstances particular to the case.