Content of question:

Question 1:
In which manner shall a liable entity, which has received the competent authority's approval to use the Standardised Approach as part of the IRB Approach for selected exposure classes pursuant to Article 100 of the Decree, state, in the Report on Capital Adequacy (code DISIFE20, or KISIFE20) submitted to the CNB, an exposure to an obligor secured by unfunded credit protection under such circumstances that the liable entity applies the IRB Approach to the obligor's exposure class and the Standardised Approach to the protection provider's exposure class?
Question 2:
In which manner shall a liable entity proceed for reporting purposes in the opposite case, i.e. where the Standardised Approach is applied to the exposure and the IRB Approach is relevant to its protection?

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Approved by: **Pavel Vacek**
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Piece of law	**Decree No. 123/2007 Coll. (hereinafter the "Decree")**
Provision	**Article 100** **Annex 16, III, 4, e)**
Explanation	It can be generally stated that if there is an exposure within the IRB Approach secured by unfunded credit protection in full or in part the so-called substitution treatment can be applied to the exposure in relation to its PD, as it is possible, pursuant to Annex 16, III, 4, e), to apply to the secured part of the exposure the PD value of the protection provider or a PD value that is lower than the PD value of the obligor but not falling below the PD value of the protection provider. It means that the liable entity must know the PD values of the obligor and the protection provider. Question 1: It follows from the essence of the issue that the above procedure is not relevant to a situation where the liable entity applies the Standardised Approach to the protection provider and, therefore, does not know its PD. In such cases the liable entity shall state this secured exposure firstly in the corresponding part of the Report on Capital Adequacy referring to the IRB Approach (data fields DIS20_80 to DIS20_87) in the "gross exposure amount" column, but, additionally, it shall transfer this secured exposure to the part of the report referring to the Standardised Approach as part of the IRB Approach (data fields DIS20_70 to DIS20_72) where this "transferred" exposure shall be included in the appropriate category corresponding to the protection provider after the substitution effect of the protection is reflected.

	An exception to the above procedure in the part of the report referring to the IRB Approach is the Internal Models Approach for equity exposures where the exposure amount is not stated. For completeness's sake let us note that in the case of exposures reported in their gross amount under the IRB Approach (this applies to most exposures, with some exceptions - see Annex 13, IV to the Decree) it is necessary to take account of any existing value adjustments before the exposure amount is transferred to the Standardised Approach. For the purpose of calculating the capital requirement the liable entity applies to the "transferred" exposure a treatment which would be applicable to a direct exposure to the protection provider (i.e. when going over to the Standardised Approach the calculation of the capital requirement is based on the net exposure amount, where value adjustments are taken into account, expected credit loss amounts are not calculated, and even any existing value adjustments to this "transferred " exposure are not taken into account in the so-called test of expected credit losses versus value adjustments pursuant to Articles 57 and 62 of the Decree, or, analogically, Articles 67 and 72 of the Decree). In the event of a default of the protection provider without the protection being replaced by another the exposure shall only be stated as an unsecured exposure in the data fields referring to the IRB Approach. The above referred data fields relate to an individual basis; in the case of a consolidated basis the data fields are analogical. Question 2: In opposite cases where the Standardised Approach is applied to the exposure and the IRB Approach is relevant to its protection the procedure is analogical. It can be stated in general that the fact of an exposure being transferred to the protection provider's exposure class, including the change of the approach (the IRB Approach being changed to the Standardised Approach or vice versa), for the purposes of reporting and calculating the capital requirement has no connection with managing the exposure in the internal processes of the liable entity. This exposure shall continue to be an exposure to the original obligor and be treated accordingly for the purpose of internal management. Additionally, it is necessary to bear in mind that the exposure described in the question will e.g. appear in the part of the report referring to the IRB, but the capital requirement for the exposure will be calculated in the part referring to the STA as part of the IRB and vice versa. This will affect the comparison of the original (input) and risk-weighted (output) exposures in the corresponding parts of the report.

Schematic examples:

1)
A corporate exposure in an amount of CZK 100,000 is fully secured by a state guarantee. The liable entity applies the IRB Approach to corporate exposures and the Standardised Approach to sovereign exposures.

The part of the report referring to the IRB Approach

	EBD1602-PD assigned to the borrower/pool grade	EBD 1620 Gross exposure amount	EBD 1603 Exposure after recognising the substitution effect of protection
On-balance sheet corporate exposure	1%	100	-

The part of the report referring to the STA Approach as part of the IRB Approach

	EBD 1594 – Gross exposure amount	EBD 1595 – Value adjustments to exposures and provisions to off-balance sheet items	EBD 1596 – Net exposure amount	EBD 1597 Exposure after recognising the substitution effect of protection
On-balance sheet exposure to central governments and central banks	-	-	-	100

2)
A corporate exposure in an amount of CZK 100,000 is fully secured by a state guarantee. The liable entity applies the IRB Approach to corporate exposures and the Standardised Approach to sovereign exposures. Allowances in an amount of CZK 5,000 have been established for the exposure.

The part of the report referring to the IRB Approach

	EBD1602-PD assigned to the borrower/pool grade	EBD 1620 Gross exposure amount	EBD 1603 Exposure after recognising the substitution effect of protection
On-balance sheet corporate exposure	100%	100	-

The part of the report referring to the STA Approach as part of the IRB Approach

	EBD 1594 – Gross exposure amount	EBD 1595 – Value adjustments to exposures and provisions to off-balance sheet items	EBD 1596 – Net exposure amount	EBD 1597 Exposure after recognising the substitution effect of protection
On-balance sheet exposure to central governments and central banks	-	-	-	95