MEMO

DANISH FINANCIAL
SUPERVISORY AUTHORITY

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Maturity

Maturity for particular exposures under the IRB approach

For institutions that have permission to use their own estimates of LGD and CF for corporate, institution, and sovereign exposures, the institution must calculate the maturity for each exposure within these asset classes, according to Article 162 in the CRR-regulation[1].

Two questions have been asked in the EBA's Q&A system (Q&A 686 & 687), which are particularly relevant to the institutions' calculation of maturity. Hence, the Danish FSA will elaborate on the interpretation of the provisions for calculating the maturity for a number of exposures, both with respect to pillar 1 and pillar 2.

1. Pillar 1

The FSA has become aware of the occurrence of exposures that formally expire at a given point in time, but where the general business procedure is to automatically rollover such exposures, which means that the effective maturity is longer than the contractual maturity.

Because of the responses to Q&A 686 & 687, institutions must in pillar 1, however, only base the maturity on the contractual maturity for these exposures, when calculating the maturity according to Article 162(2) in the CRR and thus not take into account that the effective maturity is longer.

Furthermore, it is the FSA's assessment that the responses to the Q&A's imply that for exposures with a fixed time for counterparty renegotiation, which also include a possibility for the institution to terminate the exposure, the institution must only base the maturity on the time for renegotiation, when calculating the maturity according to Article 162(2) in the CRR.

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[1] REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

According to Article 162(2)(a) in the CRR the maturity for instruments with known future cash flows, must be calculated as stated in the formula in (a).

The FSA is of the opinion that if the institution has an early termination clause, which involves certain covenants for the counterparty, and there is no maturity date or date for renegotiation specified then the future cash flow for the exposure is unknown. Thus, the maturity cannot be calculated as stated in Article 162(2)(a) in the CRR.

On this basis, the FSA's opinion is that calculation of the maturity for these exposures must be according to Article 162(2)(f) in the CRR. It follows that: "For any other instrument than those mentioned in this paragraph or when an institution is not in a position to calculate M as set out in (a), M shall be the maximum remaining time (in years) that the obligor is permitted to take to fully discharge its contractual obligations, where M shall be at least 1 year".

The FSA is of the opinion that the maximum remaining time the counterparty has to discharge all of its contractual obligations, is the remaining time of the maturity initially agreed upon. The maximum amount of time before the counterparty must meet its obligations or the maximum residual maturity is according to the FSA's opinion the remaining time of the maturity initially agreed upon, disregarding the early termination clause, unless this relates to a specified time for renegotiation, cf. section regarding renegotiation.

For exposures without an initially agreed upon maturity, it is also the FSA's opinion that it is not possible to calculate the maturity stated in the formula in Article 162(2)(a) in the CRR, because the expiry date of the exposure is unknown and therefore no predictable repayment program can be made.

Hence, exposures without an initially agreed upon maturity, must be calculated according to Article 162(2)(f) in the CRR. Since the maturity for exposures without an initially agreed upon maturity is unknown, it is the FSA's opinion that the maturity should be set at the maximum value, which is 5 years.

Regarding these exposures, it is likewise possible to take account of a possible specified time for renegotiation, cf. section regarding renegotiation.

2. Pillar 2

The FSA's assessment is that the applied approach under pillar 1, which is a result of the response to Q&A 686 & 687, might lead to a too short maturity for certain exposures. Hence, the risk is underestimated for these exposures under pillar 1.

As described above the FSA has become aware of the occurrence of exposures that formally expire at a given point in time, but where the general business procedure is to automatically rollover such exposures, which means that the effective maturity is longer than the contractual maturity.

Likewise, it is the FSA's opinion that an institution, in many cases, will not use the opportunity of terminating the exposure in a renegotiation even though they have this opportunity.

Hence, it is the FSA's assessment that it might be relevant taking into account that the effective maturity for these exposures under pillar 2 often might be longer than calculated under pillar 1. However, it is the FSA's assessment that a distinction between exposures to creditworthy and less creditworthy customers should be made.

Regarding less creditworthy customers, it is often not possible for the institution to renew the agreement or utilize the early termination clause by renegotiation, without realizing a loss.

Hence, it is the FSA's assessment that the institution under pillar 2 must take account of, whether it is necessary to allocate more capital equivalent to using the maximum maturity of 5 years for less creditworthy customers.

Regarding creditworthy customers, an institution would probably not utilize its early termination clause at renegotiation or expiry of the contract. Hence, it is the FSA's assessment that institutions under pillar 2 must address, whether it is relevant to determine the maturity as the remaining time of the maturity initially agreed upon, disregarding the early termination clause. For exposures without an initially agreed upon maturity, the maturity should be set to the maximum value, which is 5 years.

However, it is the FSA's assessment that an institution regarding creditworthy customers can take account of the early termination clause, if the institution can demonstrate that the early termination possibility is actively used. By active use, the FSA understands demonstrated use of the early termination clause significantly for a longer period.

Based on a specific and individual assessment in each institution, the FSA will assess in the regular supervision, whether the institution has taken account of the risk related to these exposures. In the assessment, the FSA will also take account of other add-ons under pillar 2 that the institution has made for these exposures.

3. Fixed maturity of 2.5 years

According to Article 162(4) in the CRR, an IRB institution that has permission to use their own estimates of LGD and CF, may choose to set the maturity to 2.5 years for certain corporate exposures instead of calculating the maturity according to Article 162(2) in the CRR.

The FSA is aware that a number of corporate exposures in general have a longer maturity than 2.5 years, particularly with respect to corporate exposures in mortgage credit institutions. The FSA assesses that it is not a reflection of the actual risk, if the institutions consistently set the maturity to 2.5 years based on the provision in the CRR.

Hence, as a general rule the FSA expects that institutions for corporate exposures with a fixed maturity above 2.5 years, do not use the possibility to set the maturity to 2.5 years, but instead set the maturity according to Article 162(2) in the CRR.

If an institution nevertheless chooses to set the maturity to 2.5 years, the FSA expects that the institution under pillar 2 takes account of, whether the calculation under pillar 1 underestimates the actual risk. If this is the case, the institution must allocate adequate capital equivalent to the underestimation under pillar 2.

Based on a specific and individual assessment in each institution, the FSA will assess in the regular supervision, whether the institution under pillar 2 has taken account of this risk if the institution sets the maturity to 2.5 years in pillar 1. In the assessment, the FSA will also take account of other capital allocated under pillar 2 that the institution has made for these exposures.