

Question ID

2025_7470

Legal act

Regulation (EU) No 575/2013 (CRR)

Topic

Credit risk

Article

207

Paragraph

2

Subparagraph

2

COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations

Not applicable

Article/Paragraph

Not applicable

Type of submitter

Credit institution

Subject matter

Eligibility as collateral under article 207(2) of secured notes designed specifically to remove any material positive correlation between the value of the note and the credit quality of its issuer.

Question

Entity A issues a secured note designed specifically to remove any material positive correlation between the value of the note and the credit quality of its issuer (entity A). The note is secured by assets uncorrelated to entity A. In legal structure I, entity A deposits the assets with a third-party custodian trust account, pledged to the note holders. In a variant legal structure II, entity A sells the assets to a SPV, which has been setup by entity A for that sole purpose; the SPV then issues a guarantee to the noteholders, backed by the assets it holds.

Bank B enters into a reverse repo with entity A, where it lends cash to entity A and receives the secured note as collateral.

From bank B's perspective, does such secured note qualify as eligible collateral under CRR article 207(2) when:

- the secured note is secured by the assets held in a third party custodian trust account, pledged to the noteholders (legal structure I)?
 - the secured note is guaranteed by a SPV holding the assets (variant legal structure II)?
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Background on the question

For a security received as collateral to effectively reduce (Counterparty) Credit Risk RWAs, the CRR requires in particular that its value is not materially positively correlated with the credit quality of the obligor/counterparty ('Wrong Way Risk').

These requirements are laid out under:

- Chapter 4, Title II, Part THREE (Credit Risk Mitigation for Credit Risk RWAs), article 207
- Chapter 6, Title II, Part THREE (Counterparty Credit Risk RWAs), article 291

CRR article 207(2) 1st sub-paragraph provides that in order to be eligible as collateral, a financial asset must not be materially positively correlated with the credit quality of the obligor.

CRR article 207(2) 2nd sub-paragraph adds that no securities issued by the obligor or any related group entity can qualify as eligible collateral, with the exception of covered bonds falling within the terms of Article 129 when they are posted as collateral for a repurchase transaction.

CRR article 291(5) requires institution to apply a specific treatment when both 1) Specific Wrong Way Risk (S-WWR) has been identified and 2) the counterparty and the issuer of the underlying of the transaction are legally linked.

Financial institutions have recently developed and issued so-called secured notes (e.g. EMTN-S), designed specifically to retain value in the event of the issuer defaulting by removing the material positive correlation feature of standard unsecured notes. Article 207(2) remains unchanged since CRR was first published in the EU OJ in 2013 while these products were only developed in the last few years.

Usually, a financial institution will setup a bankruptcy remote third-party custodian trust account or SPV for that sole purpose and then transfer to it a pool of assets uncorrelated to the credit quality of the financial institution, for a value in excess of the repayment obligations under the note. In the case of a third-party custodian trust account, the assets are pledged to the benefit of the noteholders. In the case of the SPV, it provides a guarantee to the noteholders ensuring payment of the note backed by the pool of assets.

Submission date

28/05/2025

Final publishing date

Final answer

Under both legal structures I and II, a note issued by the counterparty of a repurchase transaction is not eligible as collateral due to the explicit prohibition in the second sub-paragraph of Article 207(2) of the CRR. This provision states that securities issued by the obligor, or any related group entity, do not qualify as eligible collateral – unless the security qualifies as a covered bond that meets all the conditions set out in that sub-paragraph, along with all other applicable eligibility requirements.

Furthermore, the credit protection backing the note – whether funded (under legal structure I) or unfunded (under legal structure II) is also not eligible as standalone credit risk mitigation:

- Under legal structure I, where assets are pledged to the noteholders, an individual noteholder in general does not have a right to separately liquidate those assets. They cannot influence whether, or when, an insolvency manager decides to liquidate the pledged assets, and must instead wait for the outcome of the issuer's insolvency proceedings. This process is only recognized as providing sufficient protection under the specific legal framework governing regulated covered bonds. As consequence, such pledged assets do not meet the eligibility requirement in Article 194(4) CRR, because a noteholder typically does not have a right to individually liquidate or to retain, in a timely manner, the assets covering the note in the event of the default, insolvency or bankruptcy of the note issuer.
- Under legal structure II, in the case of a guarantee issued by an SPV to the noteholders – intended to ensure payment of the note backed by a pool of assets – individual noteholders in general cannot exercise the guarantee directly. It is only enforceable by the insolvency manager of the note issuer. Furthermore, the payment obligation under the guarantee is directed to the issuer, rather than to the noteholders themselves. As a result, the credit protection provided by such a guarantee is not considered direct guarantee of the exposure within the meaning of Article 213(1)(a) of the CRR. Consequently, this type of guarantee does not meet the eligibility criteria set out in the CRR.

Status

Final Q&A

Answer prepared by

Answer prepared by the EBA.
