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Legal actRegulation (EU) No 575/2013 (CRR)

TopicCredit risk

Article199

Paragraph2

COM Delegated or Implementing Acts/RTS/ITS/GLs/RecommendationsNot applicable

Article/Paragraphn/a

Type of submitterCredit institution

Subject matterIPRE and Property Collateral for Credit Risk Mitigation

Question

When assessing the eligibility of immovable property collateral for the purposes of credit risk mitigation (CRM), how should institutions interpret the interaction between the definition of income-producing real estate (IPRE) exposures in Article 4(75b) CRR and the conditions set out in Article 199(2) CRR for recognising immovable property as eligible collateral under the IRB approach?

In particular, can immovable property collateral be recognised for CRM purposes under Article 199(2) in situations where an exposure is classified as IPRE under Article 4(75b), where repayment of the exposure is supported by diversified rental income streams across multiple properties or tenants, such that the repayment of the facility does not materially depend on the performance or cash flows of any single underlying property?

Background on the question

Article 4(75b) CRR defines an IPRE exposure as one where “where the fulfilment of the credit obligations related to the exposure materially depends on the cash flows generated by those immovable properties securing that exposure”, using the plural form and focusing on the exposure’s overall dependence on property-generated cash flows.

By contrast, Article 199(2)(b) CRR sets out a condition for recognising immovable property as eligible collateral for CRM under the IRB approach, referring to the singular form and requiring that “the risk of the borrower does not materially depend upon the performance of the underlying property or project” and that repayment does not materially depend on cash flows generated by “the underlying property serving as collateral”.

The existence of these two similar but not identical definitions -one referring to dependence on the cash flows generated by “those immovable properties” and the other focusing on dependence on the performance or cash flows of an individual “property or project”—indicates that the CRR allows for situations in which an exposure is categorised as IPRE while the immovable property collateral nonetheless remains eligible for CRM. Otherwise, the CRR would have included IPRE as a specific exclusion from CRM.

This interpretation appears consistent with the risk-weight calibration for IPRE exposures under the Standardised Approach, where IPRE exposures with lower exposure-to-value (ETV) ratios attract lower risk weights than higher-ETV IPRE exposures or unsecured exposures to the same obligors.

Further support for this interpretation can be found in section 3.8.9 paragraph 210 of the EBA Policy Advice on the Basel II reforms: Credit Risk Standardised Approach and IRB Approach (EBA-Op-2019-09a), which states that the assessment of material dependence on property cash flows should focus on whether the servicing of a loan materially depends on the cash flows stemming from the property securing the loan, and that it is irrelevant whether other sources of income derive from other real estate properties or from different types of investments. This is highlighted as particularly relevant for larger real estate companies with diversified portfolios of properties.

Based on this, an institution may interpret that, where rental income is diversified across multiple tenants or properties, and no single property or tenancy is critical to debt service, the repayment capacity of the borrower does not materially depend on the performance or cash flows of any individual property. In such circumstances, immovable property collateral could remain eligible for CRM under Article 199(2), even if the exposure is classified as IPRE under Article 4(75b).

In this regard “multiple tenants” refers to where there are separate units within a (large) property (for example a shopping centre or retail park) so each one of those units is essentially considered a separate property.

The institution also notes that Article 147(11) CRR3 mandates the EBA to develop RTS addressing, inter alia, the determination of the IPRE category, including specifying which exposures secured by immovable property may or shall be categorised as IPRE, which may further clarify this interaction.

Does the EBA consider that, under the current CRR framework, the recognition of immovable property collateral for CRM purposes under Article 199(2) is strictly linked to the IPRE definition in Article 4(75b).

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Final answer

In case of pools of eligible funded credit protection for an exposure treated under the IRB Approach, Article 231 CRR requires sequential recognition of the individual types of collateral in the pool, and after each step reducing the remaining value of the unsecured exposure by the adjusted value of the collateral recognised in that step, using the volatility adjustments pursuant to Article 230(2) CRR. For a pool of eligible immovable properties received as collateral for the same IRB exposure, this requires sequential recognition of these immovable properties, and after each step reducing the remaining value of the unsecured exposure by the property value of the recognised immovable property adjusted with a volatility adjustment of 40% according to Table 1 of Article 230(2) CRR.

The calculation required by Article 231 CRR effectively treats each immovable property in the collateral pool as securing a part of the exposure equal to the volatility-adjusted property value of this immovable property. If repayment of the amount of the part treated as secured by one of the immovable properties would materially depend on cash flows generated by this immovable property, these cash flows would not be available for repayment of other parts of the exposure. Consequently, meeting the condition in Article 199(2)(b) CRR for each of the immovable properties in the collateral pool requires that repayment of the total amount recognised as secured by immovable properties under Article 231 CRR does not materially depend on the total cash flows generated by the immovable properties in this collateral pool.

The term “immovable property collateral” in Article 199(1)(a) CRR, which is the basis for applying paragraphs 2 to 4 of this Article, makes clear that in Article 199 (2) of the CRR the term “property” refers to the property that actually serves as collateral for the exposure (e.g. as specified by contract and e.g. recorded in an official register) but not to individual rental units within that immovable property such as a shopping centre or an apartment building where these individual rental units are not separately pledged as collateral for an exposure that can be independently enforced. If not separately pledged, it is not the individual rental units within a property (which may have different tenants or not) that are separately and independently securing an exposure but only the property as a whole. Therefore, even where a property has multiple rental units and a diversified structure of tenants so that the cash flows generated by the property do not materially depend on a specific tenant, but the repayment of the exposure secured by that property still materially depends on overall cash flow generated by the property stemming from all tenants together, the collateral still does not meet the condition in Article 199 (2) (b) CRR.

Even if each unit is separately pledged as collateral that can be independently enforced, this does not make a difference for Article 199(2)(b) CRR, because still a material dependency of the part secured by one of these units on cash flows generated by this unit means these cash flows are not available for parts secured by other units; thus it still remains necessary to assess whether repayment of the total amount recognised as secured by these units does not materially depend on the total cash flows generated across these units. Articles 199(3) and 199(4) CRR specify the

conditions for derogating the provisions in Article 199(2)(b) CRR for immovable properties for which the risk of the borrower materially depends upon the performance of the underlying property or project.

Status

Final Q&A

Answer prepared by

Answer prepared by the EBA.
