Legal Alert

Possibilities of mitigating credit risk May 2007

By virtue of Banking Supervision Commission resolution of 13 March 2007 (No. 1/2007), banks can apply credit risk mitigation techniques, which lead to a reduction in the level of capital requirements.

Introduction

Starting from April 2007, banks are obliged to observe:

- the amended provisions of the Banking Law concerning capital requirements
- the provisions the Banking Supervision Commission resolution of 13 March 2007 (No. 1/2007) concerning the scope of, and detailed principles for, the determination of capital requirements with respect to particular types of risk.

The purpose of the above regulations is to implement the provisions of the New Capital Accord (NCA) and the Capital Requirements Directive (CRD).

Consequences

The regulations that have been introduced stipulate, among other things, minimum capital requirements for banks, calculated in relation to credit, market and operating risk.

In most cases, the new regulations increase the level of capital requirements for banks in their banking operations.

However, pursuant to Banking Supervision Commission Resolution No. 1/2007, when calculating their capital requirements with regard to credit risk, banks may take into account, among other factors, **credit risk mitigation techniques**, in accordance with Appendix 17 of the resolution.

In practice, applying credit risk mitigation techniques allows banks to reduce risk deriving from credit exposures, which leads to a **reduction in the level of capital requirements.**

The most important credit risk mitigation techniques include:

- Collateral
- On-balance sheet netting
- Guarantees
- Credit derivatives.

Implementation of the new solutions

It is likely that the greatest source of problems for banks when they are implementing the new solutions provided for by the NCA and CRD will be the identification of "recognised collaterals", that is assessing and determining whether collaterals applied by banks for particular credit exposures qualify as "recognised collaterals" within the meaning of Banking Supervision Commission Resolution No. 1/2007, and therefore lead to the anticipated reduction of credit risk.

Mitigation of credit risk may only occur when the collaterals applied by banks meet, among other criteria, the requirements of **legal certainty**, i.e. when the banks have obtained – in accordance with Appendix 17 – "legal opinions confirming the practicability of credit risk security agreements in all the appropriate jurisdictions".

Banks will therefore be obliged to prepare such opinions and review and assess the collaterals they apply.

Further assistance

Please contact Przemysław Cichulski for detailed information concerning the matters referred to above.

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