ICISA
INTERNATIONAL CREDIT INSURANCE & SURETY ASSOCIATION

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ICISA Response to "*CP on Guidelines on Credit Risk Mitigation for institutions applying the IRB approach with own estimates of LGDs*"

This letter is submitted on behalf of the members of the International Credit Insurance and Surety Association (ICISA). ICISA represents the world's leading insurance undertakings that provide credit and/or suretyship insurance. With over 2 trillion EURO in trade receivables insured and billions of EURO's worth of construction, services and infrastructure guaranteed, ICISA members play a central role in facilitating trade and economic development on all five continents and practically every country in the world. A list of members of ICISA is given in Appendix II.

Members of ICISA welcome the EBA's Consultation Paper (EBA/CP/2019/01) on Credit Risk Mitigation (CRM) and the Call for Advice on the impact of the final Basel III framework. Following the EBA hearing in Paris, ICISA is appreciative of the constructive position the EBA has taken regarding Credit Insurance along with the significant accompanying evidence provided by the banking and insurance industries. ICISA wishes to re-emphasise some of the unique characteristics of Credit Insurance and as such we provide the additional clarification in this response to the Consultation Paper.

ICISA would welcome future discussions with the EBA either in relation to this Consultation or in the capacity of supporting evidence in respect of the Capital Regulations Requirement drafting.

Question 6: Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?

A. We would respectfully request the support of the European Banking Authority in amending Article 215 of the Capital Requirements Regulation (CRR) ("Additional requirements for guarantees") to reflect word for word the Bank Committee on Banking Supervision's International Convergence of Capital Measurement and Capital Standards (June 2006)[1] in order to avoid any discrepancy in the interpretation of either provision.

B. As part of Section 2.4.5 of the Call for advice to the EBA by the European Commission (Ref. Ares(2018)2374104 - 04/05/2018) and also as part of Paragraph 29a.ii of the Draft Guidelines (p.35; see also paragraph 33 which references "comparable exposure") we request that EBA should take under

[1] Equivalent to Section 22.85, p. 230 in the draft consolidated version 'The Basel Framework' as issued for consultation

consideration the qualification of the priority claim on insurance undertakings as guarantors that credit institutions (hereafter 'banks') hold as policyholders, and this compared to any other guarantor type. The exposure to credit insurance undertakings is not comparable to the bank's exposure as creditor, as policyholders are in a privileged position compared to unsecured creditors (see point 1.4 below). Therefore, we believe that banks should be allowed to recognise (depending on the jurisdiction and its respective insurance regulations) the improved LGD of its exposure as policyholder, based on the risk differentiators set forth hereafter.

Supporting Arguments:

1. Key risk differentiators that should be permitted to be taken into account in modelling the PD and LGD of banks' claims as policyholders

1.1. The fact that the (single situation) credit insurance is correlated neither with the insurers' other exposures nor with the banks' exposure to the underlying obligor[2] substantially lowers any systemic risk:

1.1.1. Regulatory and reserving requirements ensure adequate callable capital is available to pay claims to all policyholders.

1.1.2. The insurance industry's ability to absorb large losses is well tested: the figure paid by insurers during the global financial crisis – the most severe test of the single situation credit insurance product to date – was roughly EUR 2.5 billion. The losses were roughly an additional EUR 5 billion for the short-term whole turnover credit insurers. During the same period the overall insurance and Re-insurance industry (often including the same undertakings involved in single situation credit insurance for banks) handled roughly EUR 100 billion in natural catastrophe losses. Evidence of the resilience of the insurance market is also reflected in the figures from 2017: insurers paid roughly EUR 144 billion due to hurricanes and other natural catastrophes, with no recoveries expected from these losses; yet additional capital has already replaced the losses.

1.2. The banks' claims as policyholders are in a privileged position compared to unsecured creditors' claims in the unlikely event of the bankruptcy of an insurer. EU regulated and supervised insurance undertakings have minimal, if any, preferential debt. Furthermore, borrowings by insurance groups are done at the holding level, outside the regulated entity, which holds the capital and thus are structurally subordinated: the debt ratings of insurance groups are lower than the claims paying rating of an insurer, as reflected in ratings of insurers published by credit rating agencies.

1.3. Banks' claims as policyholders benefit from ring-fencing of assets to secure outstanding liabilities to policyholders at the operating insurance undertaking level; bolstered in circumstances where the insurer (guarantor) is in distress by provisioning required by insurance regulators for exposures where the

[2] As required by Section 123 of Basel III: Finalising post-crisis reforms, December 2017

insurer has a potential claim liability. This ring-fencing of assets for the benefit of banks as policyholders should be recognised by the EU in its transposition into EU legislation of the Basel III standards and the LGD should better reflect the strong regulation and supervision of the insurance sector in the EU, to acknowledge this benefit to banks as policyholders, rather than considering the banks as unsecured creditors of an insurance undertaking.

1.4. (Single situation) Credit insurance assists banks with effective credit risk transfer and reduces balance sheet volatility. Insurers and their reinsurers' regulated capital and diverse portfolios of exposures outside the banks related risks (property, energy, marine, trade, etc.) protect them from financial markets volatility and any correlation with banks' systemic risks on the liability side (as proven in 2009).

2. (single situation) credit insurance has unique advantages, particularly when compared to credit derivatives

2.1. Claims performance is within the control of the bank: a recent survey of the top 9 insurance brokers of (single situation) credit insurance for regulated banks over the period 2007-2017 reported that 97% of claims made were paid on time/in full; the remainder were "compromised" due to operational failures on the part of the insured financial institution – and yet 44% of the "compromised" amounts claimed were still paid in settlement agreements. There was never a non-payment of a claim due to an insurer's default.

2.2. The insurance claim process is much more in the control of the bank than other CRM tools , as per below:

2.3 The policy wording is already tailored to the specific exposures that the bank has and the bank has a direct relationship with the insurer, allowing communication and certainty during the claims process.

2.4 A claim can be made if the workout has not been agreed by the time the cure/claim settlement period has elapsed

2.4.1 The claims payment process is highly prescribed and includes a detailed timeframe and specifies the steps and information the bank must take or provide to successfully conclude the process.

2.4.2 The insured's rights under the contract, including damages for late payment, are protected by law and in some jurisdictions also by precedent.

2.4.3 The policy allows for active engagement by the insured bank to ensure its claim is processed in an acceptable manner.

Question 11: Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure to the guarantor? What concerns would you have about the calculation of the risk weight floor?

A. Following the public hearing on 15th of April we understand from the answers provided by the EBA that the EBA allows A-IRB banks some discretion on LGD for exposure to insurance undertakings. We would kindly request that this understanding is made more explicit in the EBA Proposed Guidance for the Estimation of the LGD. This discretion is supported by the preferential status that banks have as policyholders to insurance undertakings, where the bank purchases a guarantee in the form of a (single situation) credit insurance policy. This preferential status is different to the status of the bank as an unsecured creditor.
B. In addition to this allowance for discretion in the case of A-IRB banks, we would welcome the EBA's support to have this flexibility on LGD estimation to be considered for all banks.
C. This is also a concern that we would welcome if it would be addressed by the EBA in responding to the Call for Advice of May 2018 (Section 2.4.5), regarding the "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor".

Supporting Arguments:

3 <u>Privileged position of policyholders</u>

3.3 "The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policy holders and beneficiaries."[3]. Therefore, as stated in the Solvency II directive: "The Solvency Capital Requirement should reflect a level of eligible own funds that enables insurance and reinsurance undertakings to absorb significant losses and that gives reasonable assurance to policy holders and beneficiaries that payments will be made as they fall due." [4].

3.4 Solvency II was created with the explicit intention to continue to protect the priority ranking of policyholders as evidenced in consideration 127[5]: "It is of utmost importance that insured persons, policy holders, beneficiaries and any injured party having a direct right of action against the insurance undertaking on a claim arising from insurance operations be protected in winding-up proceedings. Member States should be provided with a choice between equivalent methods to ensure special treatment for insurance creditors, none of those methods impeding a Member State from establishing a ranking between different categories of insurance claim. Furthermore, an appropriate balance should be ensured between the protection of insurance creditors and other privileged creditors protected under the legislation of the Member State concerned."

[3] Consideration (16) of DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 (Solvency II directive)
[4] Ibidem, consideration paragraph 62
[5] Consideration 127 of DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009

3.5 This intention is reflected in Article 275 of the Solvency II directive:

"1. Member States shall ensure that insurance claims take precedence over other claims against the insurance undertaking in one or both of the following ways:

(a) with regard to assets representing the technical provisions, insurance claims shall take absolute precedence over any other claim on the insurance undertaking; or

(b) with regard to the whole of the assets of the insurance undertaking, insurance claims shall take precedence over any other claim on the insurance undertaking with the only possible exception of the following:

(i) claims by employees arising from employment contracts and employment relationships;

(ii) claims by public bodies on taxes;

(iii) claims by social security systems;

(iv) claims on assets subject to rights in rem."

3.6 Fitch Ratings, having established the value available to creditors and the approximate scale of creditors at each level of priority, applies a waterfall to determine estimated recovery ratios, based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. According to Fitch Ratings[6], the typical order of seniority of creditors at operating company level is as follows:

1. Policyholder obligations with seniority (for example, life insurance policyholders in certain jurisdictions)
2. Policyholder obligations without seniority
3. Secured debt
4. Unsecured senior debt
5. Subordinated debt
6. Hybrids

3.7 As noted in the Fitch Recovery Rating scale replicated below[7], recovery rates for policyholders could be expected to be well above the recovery rate implied by the 45% LGD floor currently prescribed for financial institutions including insurance undertakings.

3.7.1 Credit Rating agencies determine an Insurance Financial Strength (IFS) rating, which provides an indication of an insurer's capacity to pay its insurance claim and benefit obligations. An Issuer Default Rating (IDR) is also issued, which is a rating assigned to the company itself and it provides an indication of default or failure risk. The IFS serves as the initial "anchor rating" in the notching process. Depending on the regulatory regime, an operating company's IDR is normally notched at least one notch down from its IFS rating, given the average recovery assumption.

[6] Fitch Insurer Rating Criteria, 11 January 2019, p.105: https://www.fitchratings.com/site/re/10058790
[7] Fitch Insurer Rating Criteria, 11 January 2019, p.106: https://www.fitchratings.com/site/re/10058790

Fitch Recovery Rating Scale

The recovery scale is based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. As such, it is an ordinal scale and does not attempt to precisely predict a given level of recovery. While recovery ratings (RRs) are in relative terms, Fitch does employ the following recovery bands in assigning RRs.

Recovery Rating	Definition	Recovery Band (%)
RR1	Outstanding recovery prospects given default	91–100
RR2	Superior recovery prospects given default	71–90
RR3	Good recovery prospects given default	51–70
RR4	Average recovery prospects given default	31–50
RR5	Below-average recovery prospects given default	11–30
RR6	Poor recovery prospects given default	0–10

Note: Issue and obligation ratings will be notched up or down from the Issuer Default Rating (IDR) based on their RR. It is generally assumed that all of the obligations of a given entity share the same default risk, as reflected in the entity's IDR.
Source: Fitch Ratings.

Conclusion

In conclusion, in the interest of clarity and to avoid diverging interpretations, ICISA would favour EBA to advice the Commission, in its Technical Advice on the finalisation of the Basel III framework, to amend Article 215 CRR in line with Section 190a of the BCBS's International Convergence of Capital Measurement and Capital Standards.
In addition, the LGD for exposure to EU regulated and supervised insurance undertakings, and especially the 45% LGD should be reconsidered to acknowledge the explicitly protected priority ranking of the bank as policyholder under a Solvency II framework.

The credit insurance industry stands ready to work with the European Banking Authority and EIOPA and other relevant stakeholders and regulators on the appropriate/adequate regulatory and supervisory treatment of credit insurance as a Credit Risk Mitigation tool for banks including on appropriate definitions and guidelines to provide clarity on credit insurance in order to take into account its peerless features as a CRM tool.

For further information on the Credit Insurance Industry, please refer to Appendix I outlining the general supporting arguments.

Kind regards,

Robert Nijhout, Executive Director ICISA

Appendix I: General Supporting Arguments:

1. Importance to Trade

   a. Insurance support of bank lending supports international trade. This is particularly true for trade with non-OECD markets and for complex risks and lesser-known credits where other forms of credit risk mitigation may be less available. A broker of (single situation) credit insurance has confirmed that EUR 2.4 billion in coverage placed for a banking client's trade and export finance lending supported EUR 13.5 billion in contract values.[8]

   b. We estimate EUR 100 - EUR 150 billion in insured exposure supports single-transaction bank lending alone. The support available for trade and project finance as well as other lending globally is considerable: for example, up to EUR 1 billion of capacity is available per single situation credit insurance risk, for lending exposures. The insured tenor available is up to 15 years. This results in effective support for EU exporters and EU-based internationally operative companies, which has been a key component of the European economy through premium income and balance of trade effects.

   c. We estimate that 50%-70% of the bank exposures covered on an individual basis by the credit insurance market (transactional insurance) is for credit risks related to non-OECD markets: an area of financing that is thinly covered at best by other CRM tools such as credit derivatives[9].

   d. As an example of the reliance of small and medium size business (SME) on bank financing supported by (single situation) credit insurance, a SME plumbers merchant with the distributorship for other European products has a cash cycle that requires payment for product a full 2 months before cash is received from buyers. Terms to suppliers are 30 days end of month from despatch on the continent. The product is imported weekly, and orders are made up for construction industry customers where payment terms are typically 60 days end of month (and there are retentions).

   e. The business depends on credit insurance being in place, with sales made up to the level of the credit insurer's limit on each buyer, the bank financing the company's invoices and sharing in credit insurance claims. The company has variously arranged the credit insurance policy itself, attaching the bank as joint policyholder for financed debts, and has also used the bank's invoice finance facility whereby the bank buys the invoices and is the policyholder. Both solutions provide the valuable protection for the receivables asset against bad

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8 Source: Aon Risk Services; data from 2010-2017

[9] LMA estimate based on discussion with Lloyd's underwriters.

debt (non-payment within 6 months of due date) and insolvency, and enable the working capital finance to flow so that the business can thrive.

f. Depending on the outcome of the EBA Consultation, its non-affirmation of the efficacy of (single situation) credit insurance as CRM could shrink the availability of trade, export, structured credit and corporate financing from banks who have incorporated partnership with insurers in their business and risk management models.

2. <u>Important Support of Bank Lending</u>

a. Short survey done by IACPM[10] showed that bank respondents use (single situation) credit insurance to support a wide variety of lending: short-term trade finance, asset-backed lending, and project finance, all of which support investment and trade. Also of note was the use of (single situation) credit insurance for emerging market lending and for sub-investment grade corporate credits as well as investment grade credits, as other credit risk mitigation is not usually available for these exposures.
    i. The majority of IACPM respondents were banks based in EMEA, specifically Europe: removing their ability to benefit from this unique CRM would be disadvantageous.

b. During the global financial crisis (2007-2009), (single situation) credit insurance proved its worth as a credible credit risk mitigant by paying out over EUR 2.5 billion[11] in claims to banks and commercial entities. Since then banks have increasingly turned to this product to support their lending, particularly as a risk distribution tool that enables banks to increase their lending activity. Certain AIRB banks' ability to obtain regulatory capital relief on the (single situation) credit insurance product has also made it a more economically feasible, as well as an effective, risk transfer that compares favourably to other CRM tools.

c. Insurance is provided on the basis of a partnership between insurers and banks, with full disclosure by the bank of the risk to be insured, supplemented by insurers' independent underwriting and prudential management, which is in turn reinforced by insurance regulation. Insurers use their own credit risk analysis, pricing models and information sources in addition to relying on the disclosure required by insurance law to ensure that their underwriting is informed and that they are accurately assessing and managing the risk of transactions presented for their acceptance. This external validation may provide additional comfort to regulators for standardised banks using credit insurance.

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[10] Source: Intl Association of Credit Portfolio Management
[11] LMA estimate based on discussions with Lloyd's underwriters

d. The IACPM survey showed that the majority of respondents using (single situation) credit insurance deployed the substitution approach and therefore benefited from capital relief; whilst this is not the only motivation, the economic effect of using credit insurance has been cited by many bank as enabling them to lend where otherwise either (a) the risk would either be greater than the bank was willing to bear on its own or (b) the economics of the transaction would not be sufficient for the bank to provide the lending.

3. Background on (single situation) credit insurance

a. The (single situation) credit insurance product has developed, over the last 35+ years, into a sophisticated Credit Risk Mitigant (CRM), forming an important part of risk transfer for banks. The product has evolved to align with the operational requirements of banks and is recognised in other regulatory jurisdictions as an effective CRM. The private single situation credit insurance market paid to regulated financial entities over EUR 2.5 billion in claims between 2007-2017, with no claims unpaid (other than due to operational errors within the insureds' control). It supports a wide range of lending, with global exposures estimated at EUR 100 billion - EUR 150 billion, more than 50% of which relate to non-OECD credit exposures – an area poorly served by other forms of CRM.

b. The (single situation) credit insurance product covers the insured lender against non-payment for any reason, usually arising from insolvency or bankruptcy but also due to simple default on a payment when due. Policies are triggered by an insured notifying a claim. The product is a policy of indemnity, providing a specified amount of cover tailored to a specified individual risk (whilst largely uniform in principles and substance) and paying a contractually agreed amount in the event of default.

c. The policies generally include a "waiting period"; this is essentially a "standstill" agreement, mirroring best practice by the banks to first constructively address payment/credit issues with borrowers/obligors. This period enables banks to use the time to enact a cure, remedy minor delays in repayment, resolve currency shortages, etc.; allowing for the debt to be rescheduled if feasible. Simultaneously this period enables claims assessment and validation. Waiting periods are of negotiable length, typically 90-180 days.

d. Most single situation credit insurance for banks are traditionally governed by English law and are therefore subject to Section 13A of the Insurance Act 2015, which imposes a statutory requirement to pay claims "*within a reasonable time*". The law permits insurers a reasonable period to investigate and assess claims, taking into account the size and complexity involved. Where the insurer breaches this duty

the claimant is entitled to extensive remedy, including damages in addition to any sums due and related interest

4. Risk Transfer to Robust Sector used to Managing Risk:

    a. Insurance is a well-capitalised, well-regulated sector capable of managing the credit risk it underwrites without threat to the stability of the financial sector.

    b. Underwriters' risk assessment processes add underwriting rigour and challenge to banks' risk assessment.

    c. Insurers run their own pricing and risk selection models as part of their underwriting, allowing them to "model a broad range of risks and account for correlations between them, while incorporating expenses, forward-looking default probabilities, expected loss patterns and also compensate for capital costs."[12]

    d. Insurers conduct their own review of the risk, including all documentation associated with the transaction, using their own information sources as well as the information provided to them by the insured bank.

12 Swiss Re Ltd Economic Research & Consulting: "Trade Credit Insurance & Surety: taking stock after the financial crisis (October 2014)

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Appendix II: **ICISA members**

ICISA members (many of which operate in the European Union)

Member	Country
ABARCA	Portugal
AFIANZADORA LATINOAMERICANA	Argentina
ARCH RE	Ireland
ARGO SURETY	USA
ASERTA	Mexico
PT. ASKRINDO (PERSERO)	Indonesia
ASPEN RE	Switzerland
ATRADIUS	Global
AVIVA	Canada/UK
AXA	Switzerland
AXA XL	Switzerland
AXIS CAPITAL	Switzerland
BTG PACTUAL	Brazil
CESCE	Spain
CHINA NATIONAL INVESTMENT & GUARANTY CO., LTD	China
CHINA PACIFIC INSURANCE CO. LTD.	China
CHUBB	Global
CLAL CREDIT INSURANCE LTD	Israel
COFACE	Global
COSEC	Portugal
CREDENDO	Belgium/Austria
CREDIT GUARANTEE	South Africa
EULER HERMES	Global
FIANZAS Y CAUCIONES ATLAS S.A.	Mexico
THE GUARANTEE COMPANY OF NORTH AMERICA	Canada
GROUPAMA ASSURANCE-CRÉDIT & CAUTION	France
HANNOVER RE	Germany
ICIC	Israel
LIBERTY MUTUAL INSURANCE GROUP	Global
LOMBARD INSURANCE COMPANY	South Africa
MITSUI SUMITOMO	Japan
MS AMLIN	Bermuda
MUNICH RE	Germany
NATIONALE BORG	Netherlands
NAVIGATORS RE	Switzerland
PARTNER RE LTD	Switzerland
PICC PROPERTY AND CASUALTY COMPANY LIMITED	China
PING AN P&C	China
QATAR RE	Switzerland
QBE	Global
R+V RE	Germany
S2C SPA	Italy
SACE BT	Italy
SCOR GLOBAL P&C SE	France
SEOUL GUARANTEE INSURANCE COMPANY (SGI)	Korea
SID - FIRST CREDIT	Slovenia
SOMPO INTERNATIONAL	Switzerland
SOMPO JAPAN	Japan
SWISS RE	Switzerland
SWISS RE CORPORATE SOLUTIONS	Switzerland
TOKIO MARINE & NICHIDO FIRE INSURANCE	Japan
TOKIO MARINE BCC	Australia
TOKIO MARINE HCC	United Kingdom
TRAVELERS	Global
TRYG GARANTI	Denmark
ZURICH	Global