IUA OF LONDON
INTERNATIONAL UNDERWRITING ASSOCIATION

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European Banking Authority

Non-confidential comments submitted via the online EBA consultation portal

Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs (EBA/CP/2019/01)

We are pleased to be able to provide comments to the EBA on credit risk mitigation (CRM).

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. It exists to promote and enhance the business environment for its members.[1]

As part of our membership services, IUA operates a Political Risk and Trade Credit underwriting committee, comprising a large proportion of our members providing such insurance to financial institutions. This committee have assisted in preparing this response, though we understand that some of our member companies may also be responding to the consultation paper and may raise additional points specific to their own operations and interests.

We propose to make some general comments of principle on the operation of the non-payment credit insurance market (hereafter 'credit insurance') and CRM before addressing the specific issues outlined in the consultation paper. As we are an insurance trade association, only three of the questions (Q6, Q8 and Q11) are directly relevant to our members' insurance operations and, consequently, we will only concentrate on these areas.

General Comments

(i) EBA engagement with Insurers

Representatives from the London insurance market associations, including IUA representatives, attended the EBA hearing in Paris on 15 April 2019 and appreciated the opportunity to provide some initial comments from the floor on the recognition of credit insurance as a CRM. We would reiterate the comments made at the hearing, namely that we see value in being able to liaise more directly and in greater detail with EBA on the value and operation of the credit insurance product as the consultation process progresses. We will do this partially via this written response but would also suggest a face-to-face meeting with key EBA policy representatives.

[1] For context on our membership, the IUA's London Company Market Statistics Report outlines that overall premium income for the company market in 2017 was £26.3145bn. Gross premium written in London totalled £18.331bn while a further £7.984bn was identified as written in other locations but overseen by London operations.

(ii) Value of the credit insurance product

A key objective in our engaging with the EBA and other interested parties on CRM is to evidence the value and stability of the credit insurance product and the significant advantages it offers from a solvency, risk management and regulatory compliance perspective. Whilst acknowledging that the status and application of credit insurance is only a part of a far bigger EBA analysis of CRM, it is important nonetheless and it is crucial that the impact of any future measures takes into account all forms of CRM available to financial institutions. In Annex 1 below, we outline some headline statistics on credit insurance, which includes data on claims performance supporting our argument. We would also note that the International Credit Insurance and Surety Association (ICISA) also produce comprehensive trade credit market data, which confirm the extensive geographical scope and volume of credit insurance premium.

The recognition by the EBA[2] and BCBS that non-payment insurance can function as an effective CRM is welcomed. Accordingly, banks have increasingly turned to insurance as a risk distribution tool to support and increase their lending activities and to efficiently manage their capital. Insurers have developed products to meet these requirements, of course being cognisant of the relevant CRM related laws and regulations. The insurance is developed based on a partnership between insurers and banks[3], with full disclosure by the bank of the insured risk, supplemented by insurers' independent underwriting and prudential management. Insurers employ 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 process continues to work effectively to the benefit of all.

In short, insurers, backed by reinsurance, represent an excellent and valued source of security; highly regulated (in particular under the Solvency II Directives), with strong credit ratings, diverse risk and investment portfolios and established in jurisdictions with sound and established legal rules and where judgments can be enforced. Coupled with this is a proven claims handling and payment performance and a sophisticated, meticulous approach to risk management in the underwriting process.

Against this backdrop, a continuing concern for the insurance market is that neither the Capital Requirements Regulation (CRR), nor the Basel III text, expressly highlight credit insurance as a CRM. This creates an unnecessary and unhelpful lack of clarity, which needs to be remedied – we expand on how this might be done in our response to Q6 below.

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[2] Single Rulebook 2014_768 and the Assessment of the Current CRM framework, 19 March 2018, Para. 36, Page 15.

[3] With banks retaining a meaningful share of the risk – a key attribute of the credit insurance product, which is looked favourably upon by rating agencies in their assessments.

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(iii) Differentiating credit insurance from other CRM instruments

We strongly support the recognition of credit insurance as a separate, valid category of Unfunded Credit Protection (UCP). In addition to the advantages noted above and in Annex 1 below, there are other important indicators that differentiate credit insurance from other CRM's. These include:

1. Systemic risk: credit insurance exposures bear no correlation to insurers' exposure in other areas of their business nor with banks' exposures to their underlying obligors. Further, for the vast majority of insurers, their exposure to bank lending is a tiny proportion of their own risk portfolio. Moreover, the core business of insurers and reinsurers are far less exposed to financial risks and contagion than other CRM mechanisms.[4] This substantially limits the likelihood of systemic risk and we believe that the application of LGD floors should consider this material benefit.

2. Counterparty protection: Robust regulatory and reserving requirements ensure liquid, callable capital remains available to indemnify policyholders. Equally, in the (extremely unlikely) event of the bankruptcy of an insurer, banks' claims as policyholders are in a privileged position compared to unsecured creditors' claims.

3. Ringfenced assets: Whilst not directly secured with collateral, banks' claims as policyholders benefit from the ringfencing of assets to secure outstanding liabilities to policyholders at the insurers' operating company level; bolstered in circumstances where the obligor is in distress by provisioning required by insurance regulators for exposures where the insurer has a potential claim liability.

4. More effective balance sheet protection for banks: IFRS9 requires banks calculate forward provisions which must be made to protect its balance sheet from future volatility and exposure to assets. As insurance is an accrual-based CRM tool that is a direct match to the asset being covered, it assists banks with effective credit risk transfer, and reduces balance sheet volatility. This protection strengthens the banking sector during periods of increased volatility and downturns in the credit cycle through transfer of risk into the (re)insurance sector.

5. Global reach: A significant proportion of the bank exposures covered on an individual basis by the credit insurance market relates to emerging markets - an area of financing that is not abundantly covered by other CRM tools such as credit derivatives. Recognising the valued status of credit insurance as an UCP would help maintain this; conversely, if the value of the credit insurance product to banks is placed under threat it could negatively affect lending volumes, in particular in these markets, and, ultimately, global trade volumes.

[4] The UK Prudential Regulation Authority recently reiterated this point in its Approach to Supervision (October 2018).

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We outline some further reflections on the use of credit insurance as a contrast to credit default swaps in Annex 2 below. We also outline the advantages in comparison with other forms of guarantee in Annex 3. This is designed to support our contention that credit insurance merits its own category of CRM and/or significant differentiation within regulatory guidelines and practice.

Finally, we note that Paragraph 15 of the Draft Guidelines states that "credit insurance [can] effectively [function] like a guarantee or like a credit derivative" [emphasis added]. This, to our mind, points to the potential explicit recognition of credit insurance, which has characteristics of both of the current UCP tools, but also advantages as already noted.

Ideally, the EBA would support the amendment of the CRR to better reflect the unique benefits that credit insurance provides for banks. However, we recognise that the Regulation, as currently drafted, does not cater for a separated category of credit insurance as a CRM. Therefore, amendment to the CRR guidelines is perhaps a more realistic and achievable first step.

With this in mind, we, and other insurance industry stakeholders, would appreciate the opportunity to work with EBA, EIOPA and other stakeholders on developing a framework (including relevant definitions and guidelines) to provide further clarity on credit insurance as a separate CRM facility. This would be an important and valuable development for banks in their CRM considerations and for insurers in developing products to meet client needs.

Specific Questions

Q6: Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?

Firstly, as noted in our comments above, we would support measures to better outline the quality and status of credit insurance as a CRM, including recognising insurance as a separate UCP category.

Secondly, we would favour amending Article 215 of the CRR (additional requirements for guarantees) to reflect the explicit permission granted in Article 190(a) of the Bank Committee on Banking Supervision's International Convergence of Capital Measurement and Capital Standards: a Revised Framework for the guarantor to "step into the shoes" of the underlying obligor.[5] This ability is a core function of the credit insurance product, so EBA backing for aligning the CRR approach with the BCBS operational requirements to permit *either* one lump sum payment or assume the future payment obligations would be beneficial.

[5] Article 190(a) permits the guarantor to either make one lump sum payment or "assume the future payment obligations of the counterparty covered by the guarantee" so a single payment is not required by the BCBS in order for a guarantee to meet operational requirements.

Thirdly, we submit that the "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor"[6] should not apply for exposures of the bank as policyholder to insurance companies. This is because it is not equivalent exposure, given the priority claim on insurance companies that banks hold as policyholders (as compared to unsecured creditors). The banks should be able to recognise (depending on the jurisdiction and its respective insurance regulations) the improved LGD of its exposure as a policyholder, based on the risk differentiators noted above.

Finally, insurers' ringfencing of assets for the benefit of banks as policyholders should be recognised. For example, the 45% LGD under paragraph 70 of the Basel III: Finalising post-crisis reforms (p.66) should be modified to recognise the benefit to banks as policyholders, rather than unsecured creditors, of an insurer.

Q8: Do you agree with the proposed rules for the application of the substitution approach? Do you see any operational limitations in excluding the guaranteed part of exposure to which substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures?

We would suggest that the Draft Guidelines are unclear on this point and that further clarification would be useful. Additionally, we would raise that both Option 1 and 2 presented in paragraph 34 (and Figure 1) of the Draft Guidelines are in conflict with the normal contractual arrangements regarding the allocation of cashflows from the obligor between insurers and banks using credit insurance for UCP. The approaches presented may therefore require added consideration and we would be happy to provide added information on this if needed.

Q11: Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure towards the guarantor? What concerns would you have about the calculation of the risk weight floor?

We would argue that banks should be permitted further discretion on LGD for exposure to insurance companies. Paragraph 29a.ii of the Draft Guidelines requires that banks using the substitution approach should substitute both the PD and LGD risks parameters with the PD and LGD of a "comparable direct exposure to the guarantor". However, this should not apply where the exposure of the bank to the protection provider is as policyholder of an insurance policy, as the exposure is not comparable, as policyholders are in a privileged position compared to unsecured creditors, in the same way that depositors have preference over unsecured creditors in a bank structure. Consequently, we think a lower LGD should be considered where the bank's exposure is as policyholder.

This is also a concern that should 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

[6] As discussed in Section 2.4.5 of the Call for Advice.

under the same approach that the institution applies for direct exposures to the guarantor".

We would make a further point in relation to Paragraph 35c. of the Draft Guidelines, *"the degree to which the guarantor's ability to fulfil the contractual obligation under the unfunded credit protection agreement is correlated with the obligor's ability to repay can only result in a conservative adjustment of the grades, pools or LGD estimates."* We submit that this should beamended to address situations where the credit protection is provided by non-payment insurance, given insurers are highly regulated entities with diverse liability portfolios, stringent solvency requirements and ringfenced capital to guarantee policyholder protection, allied to low correlation risk with the default of the obligor.

Concluding remarks

In conclusion, we strongly support the view that the approach to CRM by banks needs to be clear, transparent and subject to robust regulatory scrutiny. In that sense, we welcome the EBA policy review in this area and are committed to ensuring that the regulator is fully informed from the insurance perspective and engaged with stakeholders in our industry.

Critically, we believe that there is a continuing need for the EBA to consider the value of the credit insurance product to purchasers, not only as a credit relief mechanism but also as a risk transfer mechanism in its own right, and the fundamental differences with alternative forms of guarantee which may ultimately require a bespoke regulatory approach in applying the CRR to specific forms of guarantee. As noted, we see significant benefits to insured banks in the greater engagement between the insurance and banking sectors on this point.

We would be pleased to clarify or expand upon our comments as required and look forward to further engagement with the EBA on CRM.

Yours faithfully,

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Annex 1 - Value of the credit insurance product

(i) Headline statistics

It is worth emphasising some of the attributes of the credit insurance product:

- The Berne Union notes that its members provided payment risk protection of approximately USD 2.2 trillion in 2017, equivalent to around 14% of annual world cross-border trade. The private insurers that are members of the Berne Union provided approximately 57% of this figure and 43% was provided by export credit agencies and multilateral agencies;

- According to the FCI, the receivables finance industry in 2017 funded EUR 1.7 trillion of small, medium-size and corporate business turnover across Europe. Over 45%, or EUR 778 billion, of this was insured;

- According to the International Credit Insurance and Surety Association (ICISA), EUR 2.2 trillion in coverage was provided by its members in 2014;

- A specialist insurance broker in this class, BPL Global, estimates annual premium income of about USD 2.5 billion for single-situation bank lending risks and approximately USD 300 billion of exposure (this is distinct from the portfolio numbers which are reflected in some of the figures above).

- The support available for trade and project finance, as well as other lending globally, is considerable. For example, USD 2-3 billion of credit insurance is available for a single transaction, with support available for lending exposures of up to 15 years. This results in effective support for exporters and other internationally operative companies and positive balance of trade effects;

- As per a recent association sponsored market survey of leading insurers and brokers of “transactional” or single-situation non-payment insurance show that every $1 of insurance supported on average $17 in bank facilities financing economic activity (e.g. project finance, corporate lending and trade finance)

- A large proportion – more than two-thirds - of global exposures relate to non-OECD credit exposures – an area poorly served by other CRM mechanisms. For example, the previously referenced market survey of non-payment insurance found that 26% of the support provided related to Africa, an area where banks are limited in their access to other private sector risk transfer tools;

- Private insurance also supports export credit indirectly, as well as directly. For example, of new export finance business written by official Export Credit Agencies in 2016, approximately USD 32 billion was reinsured into the private market (source: Berne Union).

It is worth emphasising the wider robustness of the private insurance sector in dealing with major exposures and claims. For instance, the recent natural catastrophe losses on the east coast of the U.S. and in California amounted to around USD 144 billion of claims (source: Swiss Re, *Sigma* No. 1/2018), which was absorbed by the industry. Compare this with the estimated USD 2.5 billion credit insurance exposure arising out of the global financial crisis in 2007-09.

(ii) Claims performance

It should be reminded that policies generally include a "waiting period". This is essentially a "standstill" agreement, mirroring best practice by the banks to first constructively address underlying issues with borrowers/obligors. This period, which is negotiable in length, but typically 90-180 days, enables banks to use the time to enact a cure, remedy minor delays in repayment, resolve currency shortages; allowing for the debt to be rescheduled if feasible. Simultaneously this period enables claims assessment and validation.

Where claims do crystallise, insurers' response has been effective and in line with client expectations. A recent market survey of the top nine brokers operating in the London market looked at single non-payment risk claims for banks and financial institutions over the period of the financial crisis from 2007 to 2018. Of the reported 486 claims made, 97% were paid in full, with the remaining 15 claims reported as 'compromised', meaning that they were not paid for the full amount (44% of the amounts claimed were paid in settlement agreements). The compromised claims were, we understand, due to the insured failing to observe policy conditions which were within their control, rather than the operation of policy exclusions, and were not contested by the policyholder in litigation or arbitration. Overall, the quantum of the claims made was USD 3.189 billion with USD 3.068 billion paid. This further evidences the value of credit insurance as a bona fide insurance product for a whole range of clients and not one solely designed to provide capital relief for certain, applicable banks. As an aside, it should also be noted that banks, as an insured, maintain a privileged position in terms of creditor claims should an insurer go insolvent. Though rarely, if ever, applied, this is another potentially important protection for policyholders and related third parties.

Annex 2 – Credit insurance vs Credit Default Swaps (CDS)

Unlike credit default swaps, non-payment insurance policies are personal contracts that rely on good faith and therefore are unlikely to be used to "manufacture defaults" as has been reported in the Financial Times with respect to the controversial Hovnanian CDS trade.

As noted in Annex 1 above, the vast majority of claims received over the period 2007-2018 were paid on time/in full; the remainder were "compromised" due to operational failures on the part of the insured financial institution – and even some of these were partially settled via agreement. Importantly, the bank has greater control over the insurance claims process than in a CDS settlement. This is because:

(i) CDS settlement only occurs once consensus has been reached (1) that a credit event has been called and has occurred and (2) as to the value of the CDS, determined through an auction process, the framework of which has to be specifically established. Only once the auction has been completed does a settlement obligation exist, at which point payment is made relatively quickly via the clearing houses.

(ii) A CDS default trigger is potentially different to that of the insurance product in a default process: a restructuring enabled via a consensual route may not result in CDS triggering until the terms of the restructuring have been agreed. This can be months or years after a non-payment insurance policy has already triggered and paid.

(iii) Depending on the structure of the company, not all entities would be covered by a CDS; the bank's specific exposure may not be covered ("basis risk")[7].

In contrast, the claims process under an insurance policy operates differently, in that:

- The policy is tailored to the specific exposure that the bank is running and the bank has a direct relationship with the insurer, allowing communication and certainty during the claims process.
- A claim can be made if the workout has not been agreed by the time the cure/claim settlement period has elapsed (although, as noted above, the preferred course is normally that the policy is restructured to follow the workout for the reasons detailed above).
- 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.
- The insured's rights under the contract, including damages for late payment, are protected by law and precedent.
- The policy allows for active engagement by the insured bank to ensure its claim is processed in an acceptable manner.

[7] See for example, Financial Times article dated 25 July 2017: – "Credit default swaps: a $10tn market that leaves few happy".

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Annex 3 – Credit insurance vs other forms of guarantee

It is important to distinguish between guarantees issued for the purposes of enhancing the credit of the borrower (those issued by parent companies or by the sovereign owners of public-sector borrowers, and bank guarantees or stand-by letters of credit issued by a borrower's bank) and guarantees managing the lender's exposure (these include unfunded risk participations, credit insurance and credit derivatives).

Credit enhancement guarantees are arranged by the borrower and issued by a guarantor with a close commercial relationship with the borrower and

(i) are specifically issued as an inducement to lending;
(ii) present a correlated credit risk between borrower and guarantor, and
(iii) on payment by the guarantor, the borrower's default is cured and its obligation to the lender is discharged.

The exposure management guarantees are arranged and paid for by the lender and

(i) are usually issued by a guarantor/insurer who regards the lender as its client, and who has no relationship with the borrower (indeed the guarantee is often silent to them);
(ii) the credit risk of the borrower and guarantor are not correlated; and
(iii) on payment by the guarantor, the borrower's default is not cured and its obligations to the lender remain unaltered.

Financial guarantees are used in the insurance market, often to good effect, particularly so in the conventional surety bond market and municipal bond market in the U.S. However, the credit insurance product is more traditional in the sense that the insurer essentially does what they are best at; namely, assessing and underwriting risks and paying claims, rather than taking on an almost quasi-banking role in essentially assuming responsibility for the lending transaction.