ITFA POSITION PAPER

21st February 2022

Executive Summary

1. Credit risk insurance is a vital instrument for banks' risk and capital management and for facilitating lending to the real economy. It is particularly used by European banks as they operate in a more intermediated financial system.
2. Banks only use the strongest insurers with sound capital bases, whose own risk management practices are in turn supported by the well-established distribution mechanism of reinsurance. The implementation of Solvency II has had a positive effect on the recovery rate for insureds. This means that banks are well protected as policyholders.
3. Credit risk insurance, a specialist product line, is not a major component of the overall activity of multi-line insurers (based on premium, limits, claims), which means that any transfer of credit risk from banks to these insurers will not create contagion or aggravate systemic risk.
4. Industry expert Oliver Wyman estimates that Loss Given Default (LGD) for credit risk insurance used as a credit risk mitigation should not be higher than 10-30%. The current level of 45% Foundation LGD proposed by the BCBS December 2017 on the finalisation of Basel 3 is inappropriate and will constrain wider bank risk distribution. This will in turn inhibit insurers' diversification of their portfolios which would negatively impact insurers' appetite for offering cover, thereby putting at risk approximately EUR 600bn of lending to the real economy.
5. ITFA therefore strongly welcomes the recognition by the European Commission in its proposal to revise the CRR2 that the issue of insurance for credit risk deserves further attention.
6. Ideally, the prudential treatment of credit insurance should be addressed in the legislative text of the Capital Requirements Regulation (CRR) itself. Nonetheless, the industry understands that regulators and supervisors are in favour of the proposed evaluation process as described in Article 506 of the revised CRR.
7. There are nonetheless a number of areas where this evaluation process should be improved, namely:
    - ✓ The European Insurance and Occupational Pensions Authority (EIOPA) should be involved in the evaluation process.
    - ✓ In the interest of legal certainty and to promote market standardisation, the proposed evaluation should in particular clarify the eligibility criteria mentioned in Article 506 as well as their scope of application in a manner that ensures consistency with insurance law, regulation and practice.
    - ✓ The proposed timetable of 31 December 2026 for the assessment is far too long and, assuming CRR3 is effective on 1st January 2025, it could trigger a period of up to two years with an effective 45% Foundation LGD before it comes back down with all the negative (and possibly irreversible) consequences on banks' RWAs, adverse selection for insurers and lower lending to the real economy.

8. ITFA believes the proposed evaluation process should confirm an LGD of 15% to 20% for Unsecured Insured Exposures and an LGD of 10% to 15% for Secured Insured Exposures (or 15% if we must have only one single parameter).
9. ITFA only addresses here the capital treatment of private credit insurance when used by banks as a credit risk mitigant to manage risks of any asset class exposure (corporate, specialised lending, etc). Importantly, ITFA would like to point out that this paper does not deal with export credit agency (ECA) insurance, nor does it focus on the other important topics related to CRR3 and their consequences on trade finance. On the treatment of credit insurance in the context of synthetic securitisation, ITFA is supportive of the position and proposal of IACPM.
10. Lastly, ITFA is grateful for the new additions to Article 181. If we understand correctly what is intended, beyond a substitution and a modelled approach, there could be a third way where the LGD of an insured exposure is risk-driven and reflective of the credit insurance product itself.

About ITFA

11. ITFA is an association of financial institutions who are engaged in supporting trade and distributing trade-related risk across the industry. Founded in 1999, it brings together over 260 members, mainly banks and insurers from all over the world.
12. Expanding from its original focus on the purchase and discounting of simple but robust payment instruments, such as negotiable instruments and letters of credit, the forfaiting industry has embraced new instruments and created new structures for risk mitigation, becoming a prominent part of both international and local supply chain finance. In this context, ITFA acts as a valuable forum for its members to interact and transact business together in a profitable and safe manner.
13. You can find more information on ITFA and its members here. ITFA is registered in the Transparency Register of the EU under registration number 659141434941-88.

The Ask

14. In the last 15 years ITFA member banks, in line with the general market trend, have become active users of credit insurance to provide unfunded credit protection (UFCP). These insurance policies are issued by major international insurance groups with financial strength ratings of A- or better. The policies operate according to the same principles as guarantees under Basel and in Europe the CRR but are not specifically referenced as such in Basel/CRR. This is despite the fact that their effective role is acknowledged by regulators including the European Banking Authority (EBA)[1].
15. The EBA, in its Opinion of March 2020[2] did not adequately reflect the benefits of risk mitigation through credit insurance. ITFA and other trade associations (such as IACPM, ICISA, LMA, IUA) have

[1] BCBIS, FAQ6, QIS3, October 2002; EBA, Single Rulebook Q&A 2014_768, 2014, and also Section 4 page 38, paragraph 15 of the EBA's Final report on Guidelines EBA/GL/2020/05.

[2] Opinion by the EBA on the treatment of credit insurance in the prudential framework, March 2020 (to which ITFA replied in March 2021).

commissioned studies and gathered hard data that was not available to the EBA at the time of issuing the Opinion. Since the time the Opinion was issued, ITFA has been able to gather significant evidence to support the merits of revisiting this issue and recognizing the specificities of credit insurance in the future regulatory framework.

16. ITFA wants to make sure that credit insurance, a credit risk mitigation technique supported by the current prudential regulatory framework and mainly used by the European banks, can continue to play an important role when enabling the banking sector to finance the real economy in the future.

Recommendations to improve the CRR proposal

17. Against the backdrop of a 45% Foundation LGD applied to credit risk insurance, ITFA welcomes the recognition by the European Commission in its proposal to revise the CRR2 that the issue of insurance for credit risk deserves further attention (Article 506 of the revised CRR).

18. ITFA and its members also appreciate and value the dialogue they have had on the important issue of credit insurance with the European regulators and certain of their stakeholders (ie Member States and/or their Ministries of Finance). They hope that, through these exchanges, they can contribute to the creation of a robust, sound and fair regulatory framework that appropriately reflects the risks and associated prudential framework for credit insurance.

19. Ideally ITFA would like to see the issue already addressed in a clear change to the provisions in the Level 1 text but the proposed evaluation process offers a best second option for the industry.

20. In particular, ITFA welcomes the proposed structured dialogue with the EBA and the European Commission established by Article 506 on the use of credit insurance as a credit risk mitigation technique, and will work with the EBA to address the particular characteristics of the credit insurance product in the eligibility criteria and risk parameters.

21. ITFA nonetheless believes that Article 506 of the revised CRR requires further clarification in five aspects:

- ✓ While the text of the Article rightly suggests that the European Commission would be empowered to adopt a Delegated Act to adjust the regulatory capital treatment for credit insurance as a risk mitigator, the explanatory text of the CRR more generally refers to empowering the European Commission to adopt legislation. ITFA believes the text should be unambiguous and refer to a Delegated Act in the explanatory text as well.

- ✓ ITFA believes it is critical that EIOPA should be involved in the assessment. EIOPA regulates the EU insurance market and can provide insight into the risk profile associated with exposure to insurance undertakings. They can best explain how the Solvency II insurance prudential framework protects policy holders. Finally, EIOPA may have useful data on insurer default.

- ✓ The proposed evaluation should in particular clarify the eligibility criteria mentioned in Article 506 as well as their scope of application. This eligibility should be clearly and explicitly tailored to the credit insurance product, including a definition of credit insurance that appropriately reflects both the principles currently applied in banks' use of credit insurance and currently accepted criteria for credit risk mitigation. However, we are supportive of adding eligibility criteria on protection providers (minimum external rating, submission to Solvency II regulations or equivalent) in order to create a consensus and level of comfort that allows for the right LGD to be adopted.

- ✓ Existing credit insurance contracts should benefit from transitional arrangements to avoid any disruptions to the existing capital relief from banks' exposures to insurance undertakings through credit insurance. A detailed proposition of such transitional arrangements has been included in the annexed mark-up.
- ✓ The proposed timetable of 31 December 2026 for the assessment, as set out in Article 506, is far too long. Any possible new regime should be introduced in parallel with the implementation of the revised CRR. We would advocate a report by 30th June 2024 and a decision by the Commission by 31st December 2024, which would allow for one year's leeway versus the current timetable. Please refer to our mark-up annexed to this paper.

22. In light of the new Article 181, we look forward to working with the EBA in defining appropriate LGDs for insured exposures both under a substitution approach and under a modelled approach based on the banks' recovery track-record and pooled claim data. With representatives from the whole industry (insurers, banks and brokers), ITFA is ideally positioned to coordinate the data gathering exercise required for the EBA report. We would also contend that both approaches should yield the same result as the combined contractual recourse is intrinsically linked to the product itself.

Further background on the market and proportionate risk weightings

23. The credit risk insurance industry plays a significant role in financing the real economy. Especially in Europe, credit risk insurance policies, which are currently CRR compliant, provide unfunded credit protection and are widely used for risk mitigation and capital management.
24. For European banks, credit risk insurance is the second most important portfolio management tool for SMEs and corporate loans, as well as structured finance. This is evidenced by ITFA/IACPM's joint surveys dated November 2019 and December 2021
25. Claims performance is of the highest quality. Credit risk insurance has proved to be a well- functioning insurance class in line with the expectations of all parties. As mentioned in previous papers, over $3.6bn of claims were paid by insurers between 2007 and 2020 (included) across 563 claims. 100% of claims made by regulated financial entities in 2018, 2019 and 2020 were paid in full.
26. The prescribed Foundation LGD at 45% does not enable a distinction to be made between a direct credit risk on an insurer and that resulting from holding a credit risk insurance policy. Indeed, it does not take into account the fundamental elements of credit risk insurance:

- ✓ The super-senior status of the product linked to the seniority that a policy holder has over other creditors under the legal and regulatory framework of European Solvency II, i.e. a privileged position as creditor and access to designated capital. The policy holders benefiting from credit risk insurance have therefore a status which puts them in a better position than unsecured loan creditors.
- ✓ The combined recourse which an Insured Lender has on the insurer as policy holder and on the Borrower through the Facility documentation. This gives the insured dual contractual rights which are discrete, independent and parallel and can be pursued concurrently.
- ✓ The Basel III framework does not accurately reflect the reality that in a case of default the counterparty has recourse to both the insurer and the borrower (including the physical security) which are available to banks at all times. This principle is clearly established through the agreed standard policies between the contracting parties.

27. The consequence of not recognizing the difference between holding an insurance policy and taking a direct risk on an insurance company will be to reduce the efficiency of credit risk insurance as an unfunded credit protection and will impact its viability thus resulting in lower lending capacity or less favourable pricing to companies, importers or exporters.
28. There is no basis risk i.e. no discrepancy between the cover and underlying risk.
29. This is further reinforced by the incentives which align the interests between the bank and insurer, reduce possible moral hazard and are embedded in the design of credit insurance. For example:

- ✓ To reinforce a bank's prudence and vigilance when entering into underlying transactions, a minimum of 5-20% (but often much more) of exposure usually remains uninsured and retained by the bank.
- ✓ The insurance cover is typically undisclosed to the obligor (borrower), further aligning the interests between bank and insurer.

30. The super-senior status of Insurance is a widely recognised component of the rationale for banks' treatment of credit risk insurance exposure as materially different from unsecured loan exposure to borrowers.
31. A recent KPMG report[3] provides empirical evidence and demonstrates how this priority status, as well as the other enhanced capital requirements introduced by the Solvency II regime, have in practice positively impacted the policy holder position in insurer insolvencies. In particular, there has been a marked decrease in both the number and size of insurance undertaking insolvencies; and for all concluded insolvencies all policy holder claims were paid in full in every case.
32. Credit risk insurance is not a major component of the overall activity of multi-line insurers, which means that any transfer of credit risk from banks to these insurers will not create contagion or aggravate systemic risk.

[3] KPMG Insurance Insolvency Study – 25th February 2020.

33. Credit risk insurance is a very small part of a much wider spectrum of traditional insurance activities that generate stable cash flows and are less dependent on the economic cycle and less inter-correlated than bank activities. In fact, credit risk insurance represents on average less than 2% of overall gross written premium - the most common measurement of insurance portfolios (source: survey carried out on behalf of ITFA in April 2020).

34. Reinsurance, through which a proportion of the risk is borne by other regulated multi-line insurers (50% by gross written premium and reserves, according to Oliver Wyman[4]), further dilutes the risk and ensures adequate capital to pay claims.

35. The same study by Oliver Wyman on current European regulatory framework and finalization of Basel III standards and the role of credit risk insurance concludes that LGDs between 11.25% and 30% better reflect the real risk profile for insured transaction banking assets as opposed to the currently proposed 45% under the finalized Basel III framework.

36. We believe that this analysis by Oliver Wyman is very much in line with the ITFA proposals of an LGD of 15% to 20% for Unsecured Insured Exposures and an LGD of 10% to 15% for Secured Insured Exposures (ie exposures for which the banks benefits from a collateral – FCP - and also from a credit insurance policy - UFCP). These figures are backed by industry experience, seem reasonable and rest upon sound, evidence-based arguments.

37. ITFA believes that the arguments of the super-senior status of insurance and the combined recourse as well as the value of risk mitigation via insurance strongly support the case for the European Commission to recognise the need for appropriate regulatory recognition in its transposition of Final Basel III into the new EU CRR.

[4] Oliver Wyman report to Marsh dated 24th May 2019 on the impact on credit insurance from finalised Basel 3 framework.

Annex

Art 506 CRR Credit risk – credit insurance	
European Commission proposal	**Industry suggested drafting**
By 31 December 2026, EBA shall report to the Commission on the eligibility and use of policy insurance as credit risk mitigation techniques and on the appropriateness of the associated risk parameters referred to in Part Three, Title II, Chapter 3 and 4. Based on the report by EBA, the Commission shall be empowered to amend this Regulation by adopting a delegated act, where appropriate, in accordance with Article 462, to amend the treatment applicable to credit insurance referred to in Part Three, Title II.';	By ~~31 December 2026~~**[OP please insert date = 12 months after the entry into force of this amending Regulation]**, EBA**, in consultation with EIOPA,** shall report to the European Commission on the eligibility and use of policy insurance as credit risk mitigation techniques and on the appropriateness of the associated risk parameters referred to in Part Three, Title II, Chapter 3 and 4. Based on the report by EBA, the European Commission shall be empowered to amend this Regulation by adopting a delegated act, where appropriate, in accordance with Article 462, to amend the treatment applicable to credit insurance referred to in Part Three, Title II.'; **Until the Delegated Act is applicable, transitional arrangements for credit insurance policies would apply as follows:** **By way of derogation from articles 236 (1a) and 236a (2), as far as credit insurance policies are concerned, the LGD applicable to the protection provider shall be the applicable protection provider's LGD provided for in Article 161(1), multiplied by the following factors:** **(a) 30 % during the period from 1 January 2025 to 31 December 2028;** **(b) 70 % during the period from 1 January 2029 to 31 December 2030;** **(c) 80 % during the period from 1 January 2031.**

Justification

Regarding EIOPA, we believe that they have valuable data on insurer default that will be useful to share with the EBA in arriving at adequate parameters.

Regarding timing, we do not think that the topic of credit insurance is so complex as to warrant such a long delay for the EBA report. We also believe that transitional arrangements are necessary in the absence of grandfathering as credit insurance applies to loans with significant tenors.