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ITFA's RESPOSES TO PROPOSED UK BASEL REFORMS: WHAT MEMBERS SHOULD KNOW

Written by Shannon Manders and the ITFA Insurance Committee, April 2023

ITFA has issued responses to the UK's Prudential Regulation Authority (PRA) consultation on Basel 3.1 implementation, taking the lead on a submission that focuses on the recognition and treatment of credit insurance as a valuable credit risk mitigation tool, and joining forces with other industry associations on a submission outlining the implications for the bank-related provision of trade finance.

In November last year, the PRA revealed its plans for implementing Basel 3.1 capital requirements standards, which cover the amount of capital banks need to hold against the risks they take, as formulated by the Basel Committee on Banking Supervision. The reforms – the first to be designed by the PRA outside of the EU – will be live on 1 January 2025. They will apply to all bank exposures, including the entire suite of trade finance products, and the risk mitigation thereof.

ITFA, together with other trade associations, has long lobbied for a risk-aligned regulatory and capital treatment of trade finance and credit insurance. Krishnan Ramadurai, Chair of the ICC Trade Registry, and Jean-Maurice Elkouby, Chair of ITFA's Regulatory Advocacy working group and Managing Director, Credit Insurance at ING, have been at the helm of industry responses to regulators. In this interview, Jean-Maurice and Krishnan, together with Silja Calac, Chair of ITFA's Insurance Committee, provide an overview of these responses and what ITFA is hoping to achieve.

Q: In brief, what was at the core of the ICC-UK-led trade finance-focused PRA response, to which ITFA contributed?

Krishnan: The submission outlines 10 issues and recommendations, the most important of which relates to the treatment of performance guarantees and the calibration of the conversion factor (CF). The PRA proposes to apply a 50% CF to performance guarantees, while it is our belief – in light of empirical data collected by the ICC and Global Credit Data (GCD) on both performing and defaulted performance guarantees – that CF values globally should be lowered to 20% to better reflect actual default rates. I think we've put forward a strong technical case for this change to be made.

Secondly, another important issue relates to the definition of commitment for off-balance sheet items and the fact that the PRA does not propose to use National Discretion to exempt certain arrangements – i.e., allow a 0% CF – for corporates and SMEs that meet the four conditions set out by the Basel Committee in footnote 43. We recommend that the PRA adopts footnote 43 to ensure that UK banks, and the UK companies that they finance, are not at a competitive disadvantage. This is what we have in mind when we also point out to the PRA that a few key national regulators have chosen to implement the not unconditionally cancellable facilities CF of 40%, as recommended by the Basel Committee, and not 50% as proposed by the PRA. On these matters, we're simply highlighting what the Basel standards put forward.

Thirdly, and equally importantly, we look at the maturity floor for purchased receivables and query why the PRA has chosen to set a one-year maturity floor for this asset class when the Basel standards do not make any such specifications. Given that purchased receivables transactions fall within the scope of the definition of trade finance, we recommend that they too get the benefit of the maturity floor waiver.

A final, wider, point is that the PRA's proposals do not make reference to trade in services, and so we recommend that its definition of trade is broadened to include services in addition to goods.

Q: What was the crux of the ITFA-led credit insurance-focused response to the PRA?

Jean-Maurice: Together with other insurance associations, we have put forward the case that we need a nuanced regulatory regime for insurance when used as a credit risk mitigant.

Our submission aims to make the PRA aware of the vast benefits of the sector to the UK economy and for UK banks, which have become increasingly active users of credit insurance as unfunded credit protection.

We also outline that credit risk insurance is a minor component of the overall activity of multi-line insurers and therefore has limited inter-correlation with the economic cycle. We stress that the distribution of credit risk from the regulated banking industry to a non-correlated, separately regulated insurance industry serves to reduce systemic risk. This forms the basis for our recommendation that an appropriate loss given default is applied for credit insurance. We recommend that this be lower than the proposed 45% level – which would create significant unintended consequences for banks – to reflect the super-seniority of credit insurance claims.

Q: What are those unintended consequences for the banking sector? What is the scenario that ITFA is trying to avoid?

Jean-Maurice: The big risk is a wholesale revision of the capital that we need to allocate to the current stock of insurance that banks have purchased. Already, ahead of 1 January 2025, banks are starting to modify their insurance-buying habits as they prepare for this reality.

At the very least, we're hopeful for a transition period that would allow the phased-in implementation of any changes to the treatment of credit insurance to try to limit any additional volatility in the market.

Silja: Ultimately, our concern is that banks may decrease the volume of their use of credit insurance given the increased cost, which could lead to a decrease in provision of such coverage.

This scenario would be contrary to what the regulators are trying to achieve, which is for banks to find ways to reduce their risks. Regulators want banks to continue to support the real economy, but to do so in a way that does not load balance sheets with high risks. The removal of insurance as a risk mitigating solution is essentially achieving the opposite effect.

Q: What can ITFA members and the broader trade finance industry do to help the process?

Silja: It would be helpful if bank members could forward the responses to their regulatory-focused colleagues within their institutions so that they may be able to familiarise themselves with our concerns and emphasise the importance of our recommendations in their own discussions with regulators.

Krishnan: It's also important to ensure that we involve users of these instruments, predominantly corporate treasurers, so that they too may be able to provide feedback. The involvement of corporate clients has been integral to discussions at the EU level over the last year and will add weight with the UK regulator too.

Jean-Maurice: Access to quality data is essential to underpinning the industry's regulatory responses – as has been the case with the CF, as Krishnan has said. To that end, it would be incredibly beneficial for market

participants to be disciplined about collating and contributing data, either independently or through industry associations. For example, we already have insurance claims data, but perhaps we need to go one level up and demonstrate how cash flows work in the event of a default and an insurance claim.

Q: How important is industry advocacy work in influencing what happens at the regulators' decision-making table?

Krishnan: As we've seen in the EU, advocacy work is a lengthy process, and it's critical that we maintain a good dialogue and rapport with the regulators. To date, they have been very receptive to our comments and feedback – even if they may not always agree with what we have to say.

Jean-Maurice: We've learned a great deal from Afore, the advocacy group that ITFA has hired to guide us through this process. It's very complicated and you sometimes feel a bit like a pawn in a much bigger chess game – so it's really important to have the right kind of support.

In terms of insurance, I think we may have been under the radar a bit too long – we were overly concerned about not making waves. It would have been easier to speak directly to the Basel Committee, but that ship has sailed, and now, every step of the way, it becomes harder to reverse decisions. With that in mind, it's not only the dialogue that is important, but the timing thereof, and that's something we will remember for next time.