

The logo for the International Association of Credit Portfolio Managers (IACPM) features the acronym "IACPM" in a blue, serif font. A thin, grey, curved line arches over the letters from the left side.

International Trade and  
Forfeiting Association

***White Paper***

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Collaboration between the International Trade and Forfeiting Association and the International Association of Credit Portfolio Managers

# **Credit Insurance as a Credit Risk Mitigant to Diversify Risk under the Capital Rules**

June 2023

This paper is a collaboration between the International Trade and Forfeiting Association (“ITFA”) and the International Association of Credit Portfolio Managers (“IACPM”). ITFA is a trade association focused on global trade, forfeiting, supply chain, receivables financing, and risk mitigation thereof. Its members include banks, insurers, insurance brokers, lawyers, and others engaged in supporting global trade. The IACPM is an industry association that represents the world’s largest banks and teams within those institutions who have responsibility for the prudential management of credit portfolios, including actively controlling concentrations, adding diversification, managing the return of the portfolio relative to the risk, and applying capital to new lending. In addition, its members also include investors, insurers, and reinsurers, which participate in credit risk transfer transactions.<sup>1</sup>

## **EXECUTIVE SUMMARY**

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Capital rules encourage banks to balance their portfolios with a healthy distribution of assets across various asset classes and to maintain capital reserves to protect against economic downturns. Similarly, capital risk weight substitution rules encourage banks to seek out strong counterparties for their unfunded risk mitigation strategy. One tool that banks can use to mitigate and diversify their credit risk is credit insurance. Credit insurance is a type of insurance that protects businesses against losses due to the non-payment of trade debts by their customers. By purchasing credit insurance, banks can reduce their risk exposure to non-payment of trade debts.

Under the current US capital rules, credit insurance issued by financially strong insurers is a permitted form of eligible guarantee. However, banks generally cannot obtain meaningful capital risk weight substitution benefits from such policies because insurers are not recognized as lower-risk counterparties compared to any other corporate entities. This gives rise to a concern that US banks lack access to a risk mitigation tool that is expressly contemplated by the US capital rules and utilized by competitor banks subject to other national capital rules, at a time when US banks face increased capital requirements against an economic environment where recession indicators are growing. This paper argues that certain clarifications to the US capital rules would provide US banks with the opportunity to partner with proven, well-rated counterparties in the insurance industry to mitigate their credit risk, reduce their risk-weighted assets, and thereby increase their ability to redeploy capital to support the US economy.

This paper’s objectives are (a) to demonstrate that credit insurance can be an effective method for distributing risk among quality protection providers; and (b) to recommend clarification of the relevant capital rules that will better enable US banks to use credit insurance as a credit risk mitigant under the capital rules. The proposed clarification is meant to encourage prudent credit risk diversification within the framework of the strong capital and liquidity requirements applicable to US banks.

This paper consists of three parts. Part 1 discusses credit insurance generally, including an overview of credit insurance policies, policy characteristics, the insurers that underwrite credit insurance, and claim performance of credit insurance policies. Part 2 focuses on the credit insurance market and how credit insurance can be utilized by banks. Part 3 proposes areas of potential clarifications to the capital rules in connection with the finalization of the Basel III rules.

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## **PART 1: CREDIT INSURANCE OVERVIEW**

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### ***Credit Insurance Generally***

For purposes of this paper, the term “credit insurance” encompasses both trade credit insurance and non-payment insurance. Trade credit insurance refers to policies that protect against loss on trade finance transactions and may consist of a portfolio of receivables for a short-term tenor between 1 to 3 years. Nonpayment insurance refers to policies that protect against single exposures, such as project finance transactions, with tenors of 1 year to over 5 years.

For the avoidance of doubt, credit insurance does not refer to “wrap” policies offered by mono-line financial guaranty insurers. None of the statistics cited in this paper refer to policies issued by mono-line financial guaranty insurers. Further, credit insurance used in horizontal structures of risk transfer, like unfunded protection on tranches of synthetic securitizations, is not part of the focus of this paper.

Credit insurance has historically been used as a means of encouraging or expanding investment, especially by government export credit agencies. For example, the US Export-Import Bank has long provided support of the export of US made goods through credit insurance. As discussed throughout this white paper, the private credit insurance market has grown significantly over the past 20 years and has the potential to support a significant amount of bank transactions.

There are approximately 60 insurers participating actively in the global credit insurance market today. All of these insurance companies have investment-grade credit ratings (from either Fitch, Moody’s, or S&P) ranging from A- to AA. As noted above in the discussion of the capital regulation of insurers, such ratings require, among other things, positive operational performance as well as having significant holdings of surplus capital relative to an insurance company’s overall exposures.

Banks, in particular, use credit insurance as a portfolio management tool, and currently over a hundred billion dollars of credit insurance coverage is underwritten globally.<sup>2</sup> Further, studies have shown that credit insurance helps banks unlock additional lending capacity for trade transactions and project finance, especially for fast growing sectors such as renewal energy facilities. For example, a survey of banks conducted by ITFA and IACPM in 2020 found that the \$135 billion of credit insurance coverage facilitated \$346 billion of loans to the real economy.<sup>3</sup>

### ***Policy Characteristics***

The private credit insurance market began to expand for banks starting in the early 2000s in response to Basel II reforms as European banks required policies with clear, simple coverage terms that satisfy the requirements for an unfunded guarantee.

Today, credit insurance policies issued to banks are considered partnerships between insurers and insureds. To satisfy Basel requirements, policies cover nonpayment by the obligor for any reason whatsoever. The policies contain few exclusions or conditions, excepting matters that are clearly within the control of the insured, such as loss caused by a fraudulent act by the insured. Similarly, the policies contain minimal representations, conditions precedents, and warranties regarding essential matters relating to the insured transaction, such as the enforceability (as limited by legal opinions received by the insured) of the underlying obligations.

Insurers balance such policies with several provisions to ensure that the applicable risk is appropriately managed. One requirement generally is the minimum risk retention, which requires that the insureds retain

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<sup>2</sup> The IACPM and ITFA estimate that the private credit insurance market underwrote at least \$135 billion in coverage in 2020. <http://iacpm.org/wp-content/uploads/2022/03/IACPM-ITFA-Private-Credit-Risk-Insurance-2021-Select-High-Level-Results.pdf>.

<sup>3</sup> *Ibid.*

a minimum percentage of the exposure uninsured and unhedged. Insurers also require that insureds consult with them before agreeing to material amendments and waivers that may impact the risk particularly as to payment dates, and following claim payment, insureds are required to cooperate with insurers in pursuing recoveries. Policies covering trade credit receivables may cover up to 90% of any given loss, though any given loss is typically only a small amount of a given trade credit portfolio, and policy aggregate limits are typically equal to half or less of the overall portfolio.

Insurers and insureds in this market take similar approaches to evaluating risks. Both seek to balance their overall exposure to any given insurer or bank, as applicable, as well as aggregate exposures to the applicable sector, country, and obligor, with further internal limits across affiliates and subsidiaries of each such obligor. Both banks and insurers conduct due diligence on the other's business operations. Banks evaluate the credit ratings, financials, and industry knowledge of insurers while insurers review the performance history and credit approval operations of banks.

## **Capital Regulation of Insurers**

Insurers participating in the credit insurance market are well experienced, well-rated, and well-capitalized, as well as subject to strict regulation of their capital to ensure their capacity to honor policyholder claims.

The capital of insurers is divided into two broad categories, respectively, minimum capital and surplus capital. Minimum capital must be maintained at all times, typically only in cash or US government bonds.<sup>4</sup> Surplus capital investments are also subject to quantitative and qualitative limitations, including restrictions between admitted investments (which may be counted towards an insurer's total capital) and non-admitted investments (which may not be counted towards an insurer's total capital).<sup>5</sup> Both minimum capital and surplus capital are then subject to a risk-based capital ("RBC") assessment, which balances, among other things, the value of an insurer's assets, risk-based capital charges on their assets (with higher charges assigned to riskier investments), and policyholder obligations in the event of significant losses.<sup>6</sup> The formula for RBC assessments is devised by the National Association of Insurance Commissioners, a national body led by the respective insurance commissioners that sets out widely adopted model laws and regulations, and is rarely modified on the state level.<sup>7</sup> The results of the RBC assessment are compared to the insurer's total adjusted capital, and insurers which fail to maintain adequate RBC ratios are subject to additional regulatory scrutiny or, if necessary, a takeover of operations by the relevant state regulator.<sup>8</sup>

An insurer's investments are restricted by the distinction between permitted and non-admitted investments. Non-admitted assets are those which cannot contribute to the insurer's overall capital for RBC calculations or other regulatory purposes, as such, insurers typically limit their holdings of such assets. Permitted investments, which are included in calculating an insurer's surplus capital, range from debt securities to equities to holdings in tangible real estate, with safer and better secured investments attracting more favorable RBC treatment. Permitted investments are also subject to qualitative and quantitative limitations to prevent over-concentrations in investment strategies.<sup>9</sup> Insurers are strongly discouraged from participating in derivatives or other exotic investments. To illustrate, in New York, an insurer must file a special plan with its regulator to utilize derivatives, with any such exposure strictly limited to a small portion of the insurer's capital and subject even then to Board of Directors level supervision.<sup>10</sup> Insurers must

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<sup>4</sup> For example, see New York Insurance Law Section 1402; see also 68 N.Y. Jur. 2d Insurance § 188. We will refer to New York law for the sake of providing a specific reference point, though we would be happy to provide references to the laws of other states if helpful.

<sup>5</sup> See New York Insurance Law Section 1301 and Section 1302 (distinguishing between admitted and non-admitted assets); New York Insurance Law Sections 1403 – 1407 (imposing restrictions on such investments); 68 N.Y. Jur. 2d Insurance § 189.

<sup>6</sup> New York Insurance Law Section 1324.

<sup>7</sup> For additional background on RBC calculations, see <https://content.naic.org/cipr-topics/risk-based-capital>.

<sup>8</sup> New York Insurance Law Article 74; see also 68 N.Y. Jur. 2d Insurance § 334.

<sup>9</sup> New York Insurance Law Section 1409; see also 68 N.Y. Jur. 2d Insurance § 192.

<sup>10</sup> New York Insurance Law Section 1410; 68 N.Y. Jur. 2d Insurance § 199.

maintain surplus capital that is significantly higher than their possible exposures to policyholders in order to maintain a high credit rating, which also discourages non-admitted investments.<sup>11</sup>

Every insurer must annually report all its investments to its regulators, including a detailed listing of all assets owned by the insurer.<sup>12</sup> Every three years, insurers must submit to a market conduct examination, which includes an audit of its finances along with an examination of its conduct towards policyholders (ranging from its marketing practices to claims payment rates).<sup>13</sup> Regulators reserve the right to demand a full financial accounting from insurers at any time, and upon any sign of financial distress, regulators may seize operational control of the insurer.<sup>14</sup> This process, known as “rehabilitation,” typically involves regulators significantly restricting the insurer from taking on new risks while seeking to reinsure away as many obligations as possible, and reorienting investments in a conservative fashion, with the top priority of regulators being the protection of policyholders.<sup>15</sup>

An insurer may only issue dividends after demonstrating that it has sufficient surplus capital to honor all of its obligations, and even then, the amount of any such dividend is limited.<sup>16</sup> Insurers cannot participate in material affiliated transactions without regulatory approval.<sup>17</sup> The “control” of an insurer, which is presumed for any entity that holds 10% of the voting securities of an insurer, is closely monitored and subject to regulatory restriction.<sup>18</sup>

Insurers that are domiciled in the United Kingdom, European Union, or Bermuda are subject to the Solvency II framework. Lloyd’s of London insurers are subject to the unique rules of Lloyd’s, though ultimately, all Lloyd’s policies are backed by the full strength of the Lloyd’s market to ensure that all claims are paid when due.

### **Claims Payment Data**

As noted above, credit insurance is often seen as a partnership between banks and insurers, with a balance of risk between the parties. Insurers expect that banks will retain risk and manage losses accordingly, while banks expect that their claims will be paid when due. The performance of credit insurance can be demonstrated in an ongoing industry study of claim performance based on data provided largely by leading insurance brokers (with some data being provided by insurers joining in 2022), which found the following:<sup>19</sup>

	<b>2007 – 2020</b>	<b>2021</b>	<b>2022</b>
<b>Total claims paid to banks</b>	578	140	190
<b>Total Amount Claimed</b>	\$3,753,470,551	\$1,010,242,049	\$529,534,436
<b>Total Amount Paid</b>	\$3,633,104,370	\$1,010,242,049	\$529,534,436
<b>Compromised Claims</b>	15	0	0

Overall, 97.73% of the value of all claims were paid in full, constituting 98.35% of all claims made in total. Of the remaining “compromised” claims where insurers asserted a defense against full claim payment, which would arise when either the applicable loss was arguably not covered by the policy or where the insured failed to honor a condition of the policy, 44% of the amounts claimed were paid.

Further, 29% of the aggregate amount of claim volume referenced in the above data were made in 2021 and 2022, which is both a reflection of losses arising due to the onset of the Covid-19 pandemic and growth

<sup>11</sup> For example, see <https://ratings.moodys.com/api/rmc-documents/391814>.  
<sup>12</sup> New York Insurance Law Section 307.  
<sup>13</sup> New York Insurance Law Section 309(b).  
<sup>14</sup> New York Insurance Law Section 309(a).  
<sup>15</sup> New York Insurance Law Article 74.  
<sup>16</sup> New York Insurance Law Section 4105.  
<sup>17</sup> New York Insurance Law Section 1505.  
<sup>18</sup> New York Insurance Law Section 1501.  
<sup>19</sup> Based on data supplied by A2Z Risk Services Ltd dated April 2023.

of the market, as more policies have been issued in recent years. Demonstrating the reliability of credit insurance policy wordings and the responsiveness of the insurers participating in this market, 100% of all claims from 2021 and 2022 have been paid in full.

Notably, these claim payment rates span from the 2008 financial crisis and the more recent global economic downturn following the shutdowns due to the outbreak of Covid-19. Claim payment rates increased during these times and insurers had the capacity to honor the claim obligations. This reflects the partnership between insurers and insureds where insureds seek to prudently manage risks and insurers accept the risks understanding the resulting payment obligations. Further, in addition to the capability of insurers to meet their claims liabilities, the claim payment experience demonstrates the responsiveness of credit insurance policies to cover the contemplated risk with conditions being within the control of the insured.

## **PART 2: USE OF CREDIT INSURANCE FOR CREDIT RISK MITIGATION AND DIVERSIFICATION**

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The credit insurance market in the United States has significantly grown over the last 20 years. Part of the overall growth is due to the influx of bank driven programs, e.g., supply chain finance, receivable purchase programs, payable programs, securitizations, and other monetization programs. These programs are designed for banks and differ from “corporate” programs, where the insured is typically a corporate entity seeking to balance the credit risk of transactions with its own customers.

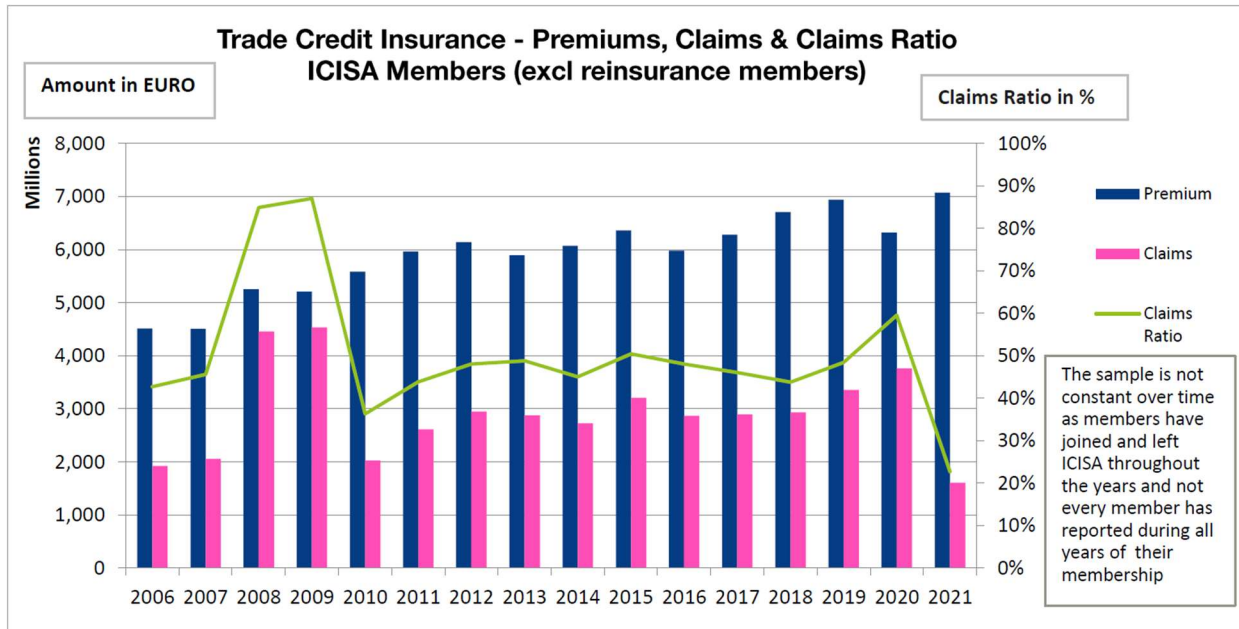
Insurers welcomed the growth and exposure to bank driven credit insurance programs that historically have performed better than corporate credit insurance programs. We briefly outline the nature of these programs in order to demonstrate the opportunity in the credit insurance market, and correspondingly, the opportunity for banks to invest in trade finance to further support the trade markets.

**Flight to Quality.** Banks and corporate entities have different priorities for their credit insurance programs, which leads to a different selection of risks, and correspondingly different loss ratios and market capacity to match.

Corporate credit insurance programs are focused on mitigating the credit risk of the corporate’s customers and fostering best practices in the corporate’s credit management practices. Purchasing credit insurance coverage on a portion of its portfolio of customers, or all their corporate customers, adds a key layer of protection that protects cashflow against non-payment of outstanding receivables. Some smaller size corporate insureds use credit insurance to outsource the credit risk function where the insured relies on the insurer for counterparty risk assessment, including the amount the insured will be able to trade with its customer. For some larger corporate insureds, credit insurance is part of a larger risk mitigation strategy such as minimizing concentration risk in a particular number of customers or geography.

Some of a corporate’s customers may not be insurable or are only partially insurable. During negotiations with the underwriter, it’s common to see a push to have these marginal risks insured under the policy. Insurers can support providing coverage to these “riskier” obligors to a certain extent, balancing premium income against the probability of loss, though as noted above, insurers must also balance their aggregate risk across obligors. The industry has been able to sustain such risks with higher industry loss ratios during the severe economic events due to the Global Financial Crisis (“**GFC**”) in 2008-09 and the COVID shutdowns in 2020. The data provided by the International Credit Insurance & Surety Association (“**ICISA**”; please see the table below) reflects the historical premiums and claims data for trade credit insurance.





By contrast, the historical loss ratios for bank business have been under 20%, which has allowed for a good diversification of insurers’ business.<sup>20</sup> Banks traditionally purchase credit insurance for credit enhancement on a monetization program as their primary motivation, with the objective of achieving a targeted financing within a current portfolio where the bank has broader relationships with the customer risk being covered, so that the bank can deepen its existing relationships while freeing up capacity for lending to other customers. Risk transfer is a by-product of such an arrangement, consequently minimizing some of the risks of adverse selection.

This approach allows positive selection for the credit insurers versus adverse selection. Rather than stretch to cover weaker obligors, bank programs typically focus on the stronger credits, focusing on program structure, reliability of the policy wording (as banks seek the “Basel” compliant wording described in Part I, whereas corporates can accept a range of exclusions that would not be acceptable to banks), and pricing to finalize the program.

This benefits the overall trade economy in two ways. First, bank-driven insurance programs simply create more capacity for banks to expand their trade finance programs, thereby expanding the amount of funds available from banks for investment and lending into the trade economy. Second, the higher quality credits underlying bank-driven insurance programs help insurers hold better diversified portfolios, which increases capacity for insurers to offer coverage to corporate programs and therefore allowing corporates to better support their customers.

It is important to note that the bulk of the US bank monetization programs that are supported by the US credit insurance market are unable to receive a substantive benefit from capital risk weight substitution due to the limitations discussed below. Therefore, the insurance market for these bank programs, while strong, remains in its infancy. If US banks, on a wholesale basis, were able to use credit insurance as a meaningful risk distribution tool, the number of US bank programs would substantially increase while maintaining the historical risk profile and loss ratios outlined above. Further, such an approach mirrors how non-US banks and credit insurers currently operate outside the United States with respect to the use of credit insurance as a meaningful risk distribution tool that provides capital risk mitigation.

<sup>20</sup> This 20% figure is an estimate based on the experience of the members of ITFA and IACPM involved in this collaboration. No industry wide study has been conducted. If useful, we would also be happy to conduct a market survey through both organizations to further supplement this data.

**Projected Exposure Shift – Credit Risk Transfer (“CRT”).**

Credit insurance plays a significant role in global trade, with one indicative study by the ICISA estimating that insurers for bank and corporate programs covered €6.35 trillion in shipments in 2020, constituting a total of 14.52% of all global trade.<sup>21</sup> As noted, insurers consider bank-driven programs to have a stronger risk profile than credit insurance provided to corporates, and therefore seek to create additional capacity for such programs. We estimate that if US domiciled banks were eligible to use credit insurance as a capital risk mitigation tool in the future, there would be a growth of \$250 billion in notional coverage amounts over a three-year period.

The anticipated credit quality of such exposures is investment grade or near investment grade risk. However, despite the high quality of these risks, which is further supported by insurance, US banks receive zero capital benefit for insurance company exposures versus other corporate exposures. Because the standardized risk weight for exposures to insurance companies under the US capital rules is the same as that for any other corporate exposure, for the same exposure amount the standardized risk weighted assets (“RWA”) amount is the same for each of these risks, regardless of the ratings provided by the external rating agencies or the internal investment grade risk assessment by the banks.

Due to this fact, the banks cannot access the benefit from credit insurance as a credit risk mitigant and risk diversification tool under the capital rules. Therefore, the bulk of the transfer will be centered on investment grade obligor risks. Even when falling below investment grade, the US banks typically will not venture too far from investment grade ratings for unsecured risk.

**RWA Calculations – Current vs. (Potential) Future.** The table below illustrates the impact of the proposed treatment under the US capital rules with respect to a \$100 million exposure. The proposed interpretation would reduce the capital amount by \$6.08 million.

	<b>Current Treatment</b>	<b>Proposed Treatment</b>
<b>Program size</b>	\$100,000,000	\$100,000,000
<b>Senior tranche</b>	Insurance coverage 95% of receivable nominal value and 5% recourse to the seller	Insurance coverage 95% of receivable nominal value and 5% recourse to the seller
<b>Insured Amount</b>	\$95,000,000	\$95,000,000
<b>Uninsured Amount</b>	\$5,000,000	\$5,000,000
<b>Risk Weight</b>	100%	20% <sup>22</sup>
<b>Risk Weighted Assets</b>	\$100,000,000	\$24,000,000
<b>Reserve Capital</b>	\$8,000,000	\$1,920,000

Extending the above to a projected \$250 billion in assets, three-year, insurance-supported asset group results in more than \$15 billion of capital savings to US banks, which could be utilized for further lending and investment to support the trade economy.

**Optimize Use of Capital.** Under the current environment, US banks over allocate capital for a particular deal thereby increasing RWA, which has a bearing on the overall Capital Adequacy Ratio. If US banks can use credit insurance as a credit risk mitigant under the capital rules, US banks will be able to optimize the use of their capital while continuing to maintain a conservative approach in managing their overall RWAs. Further, the post-pandemic shifting of supply chains has resulted in additional pressure on company cash flow, which in turn has increased the need to monetize bank programs. The ability of US banks to benefit from a better capital treatment will, therefore in turn, directly benefit US companies and their liquidity

<sup>21</sup> See <https://icisa.org/wp-content/uploads/2022/08/ICISA-Estimate-of-TCI-role-in-world-trade-June22.pdf>

<sup>22</sup> As discussed in Part 3, the risk weight applicable to an insurer under the Basel Framework could be as low as 20% in the case of a short-term exposure to a prudentially regulated insurer qualifying for a risk weight equivalent to that of a Grade A bank under the Basel Committee's revised Basel Framework.



requirements, especially in the current economic environment where costs of borrowing are substantially higher with the resulting pressure on liquidity.

**Risk Distribution Tools.** In order to manage risk effectively, credit portfolio managers rely on front-end and back-end tools. The front-end tools consist of managing a portfolio at inception through risk appetite frameworks, concentration issues, and their overall general credit assessment. The back-end tools that banks utilize are credit default swaps (“CDS”), loans sales, and synthetic on balance sheet securitization (funded and unfunded). However, these tools are becoming less viable options given the regulatory environment. Therefore, banks welcome the opportunity to utilize other risk distribution tools like credit insurance.

In contrast to other risk distribution tools, credit insurance is especially nimble and reliable. Further, as noted above, the insurance market has significant capacity for bank-driven programs, which when used, will allow banks to accept more credit risk exposure to a particular borrower and directly assist the real economy, including project financing for infrastructure projects and other transactions that support trade.

## **PART 3: SUGGESTIONS FOR CLARIFICATIONS**

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Under both the international capital standards of the Basel Committee on Banking Supervision (the “**Basel Framework**”) and the capital rules of the US federal banking agencies implementing those standards in the United States (the “**US Basel III Capital Rules**”), banks may recognize certain credit risk mitigants to reduce the capital requirements for certain credit exposures. Eligible guarantees are a form of credit risk mitigation recognized by the Basel Framework and the US Basel III Capital Rules that, if certain requirements are satisfied, permit a bank to shift the risk weight associated with a credit exposure from the original obligor to a guarantor.<sup>23</sup> If the guarantor has a lower risk weight than the original obligor, this risk-shifting treatment reduces the risk weighted asset amount associated with the credit exposure.

A credit insurance policy is economically similar to a guarantee and acts as an economic credit risk mitigant to a banking organization. In order for a credit insurance policy to qualify as an eligible guarantee, however, the policy must satisfy 10 different definitional elements,<sup>24</sup> including that the protection provider be an “eligible guarantor.”

This section analyzes the primary obstacles to applying risk-shifting treatment to credit insurance policies under the existing US Basel III Capital Rules and shows how these obstacles could be overcome with modest changes to the US Basel III Capital Rules that are consistent with the Basel Framework.<sup>25</sup> Section 3.A addresses the fact that insurers providing credit insurance policies are generally not eligible guarantors under the US Basel III Capital Rules. Section 3.B analyzes the remaining elements of the definition of an eligible guarantee, and shows that these requirements would generally be met for credit insurance policies, without changes to the existing US Basel III Capital Rules, but shows how, consistent with the Basel Framework, the US Basel III Capital Rules could be interpreted or modified to make certain insurance companies eligible guarantors. Finally, Section 3.C addresses the fact that, even if a credit insurance policy satisfied the definition of an eligible guarantee, the application of the risk-shifting approach would generally not reduce risk weighted assets for such exposures because prudentially regulated insurers are currently treated as corporate exposures under the US Basel III Capital Rules, and how this issue could be revisited as part of implementing the remaining parts of the Basel Framework in the United States as part of the so-called “Basel III Endgame.”

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<sup>23</sup> 12 C.F.R. § 217.36(b)(1) (Federal Reserve rule); 12 C.F.R. § 3.36(b)(1) (OCC rule); 12 C.F.R. § 324.36(b)(1) (FDIC rule).

<sup>24</sup> 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining “eligible guarantee”).

<sup>25</sup> As of May 2023, the US federal banking agencies are expected to soon propose changes to the US Basel III Capital Rules to implement changes to the Basel Framework finalized in 2017 and known as the “Basel III Endgame.” The revisions to the Basel Framework contained in the Basel III Endgame became effective on January 1, 2023.

## **A. Insurers as Eligible Guarantors**

The definition of eligible guarantor has two prongs, under both the US Basel III Capital Rules and the Basel Framework.<sup>26</sup> The first prong encompasses per se eligible guarantors, which under the US Basel III Capital Rules include sovereigns, multilateral development banks, depository institutions, and bank holding companies. While the US Basel III Capital Rules do not include insurance companies among per se eligible guarantors, the Basel Framework defines eligible guarantors to include “other prudentially regulated financial institutions with a lower risk weight than the counterparty” which may include insurance companies.<sup>27</sup> In implementing the Basel III Endgame, we recommend that the US federal banking agencies add insurance companies that are subject to prudential regulation and supervision, including applicable capital and liquidity requirements, to the list of per se eligible guarantors on the basis that they are prudentially regulated financial institutions that, like banking organizations, are engaged in the activity of assuming principal risk, in this case credit risk.

In addition, an insurance company could be considered an eligible guarantor under the second prong of the definition, which is available for operating entities other than the types of entities enumerated in the first prong, provided certain requirements are satisfied. Under the US Basel III Capital Rules, this prong requires among other things that, at the time of entry into the guarantee or thereafter, the protection provider must have issued and outstanding investment grade debt securities.<sup>28</sup> However, it is frequently the case that credit insurance policies are written by an operating subsidiary of the insurance group which does not itself issue debt, which precludes this prong under the current US Basel III Capital Rules.

The analogous provision in the revised Basel Framework requires “corporate entities (**or the entity’s parent company**)” to “have securities outstanding on a recognized securities exchange” in order to be considered an eligible guarantor under this prong.<sup>29, 30</sup> The key distinction is that, unlike under the current US Basel III Capital Rules, an insurance company could qualify as an eligible guarantor under the revised Basel Framework if its **parent company** has issued and outstanding securities trading on a recognized securities exchange. Alignment of the US Basel III Capital Rules with the revised Basel Framework could be achieved by allowing an insurer to satisfy the US rules’ “issued and outstanding investment grade debt securities” requirement through its parent’s issuance of debt securities, rather than applying this provision to the insurer itself.

We believe that this could be accomplished either through issuing clarifying guidance or an interpretation under the current US Basel III Rules, on the basis that the “investment grade” creditworthiness of an insurance holding company’s debt securities would inevitably reflect in part the creditworthiness of its regulated insurance operating subsidiaries. A debt security issued by a regulated parent insurance holding company of a regulated insurance company subsidiary would thus have a substantially similar effect, in terms of assessing creditworthiness for purposes of being an eligible guarantor, as the issuance of a debt security by the subsidiary itself.

In addition, in implementing the Basel III Endgame, we recommend that the US banking agencies modify the existing debt securities requirement in the US Basel III Capital Rules to explicitly include investment grade debt securities issued by the guarantor’s parent company, consistent with the revisions made in the Basel Framework.

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<sup>26</sup> 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining “eligible guarantor”).

<sup>27</sup> Basel Framework, CRE 22.76 (Basel Committee on Banking Supervision, 2023) (hereafter, “CRE XX.XX”). Footnote 11 to this provision defines prudentially regulated financial institutions to include “prudentially regulated insurance companies.”

<sup>28</sup> *Ibid.*

<sup>29</sup> CRE 22.76(3)(a)(i) (emphasis added).

<sup>30</sup> The Basel Framework would also require guarantors eligible under this prong to be “investment grade,” meaning they have adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, irrespective of the economic cycle and business conditions. CRE 22.76(3)(a). Furthermore, the creditworthiness of such investment grade guarantors must not be positively correlated with the credit risk of the exposures for which they provided guarantees. CRE 22.76(3)(a)(ii). These requirements are already incorporated into the existing US Basel III Capital Rules.

## **B. Remaining Criteria for Eligible Guarantee**

The remaining nine criteria contained in the definition of an eligible guarantee under the US Basel III Capital Rules are typically satisfied by credit insurance policies that cover trade credit exposures, as follows:<sup>31</sup>

- The first criterion requires that the guarantee be written, which is true of all credit insurance policies.
- The second criterion requires that the guarantee be unconditional. The meaning of “unconditional” is not defined in the US Basel III Capital Rules. Practically all guarantees, however, contain some conditions which do not necessarily render the guarantee ineligible, e.g., the requirement that certain specified documents be provided to the guarantor. We believe that the types of provisions contained in a typical credit insurance policy – all of which are in any event within the control of the beneficiary of the guarantee (such as submitting a claim in a particular form) – are consistent with an unconditional guarantee for the purposes of this criterion.
- The third criterion requires that the guarantee cover all or a pro rata portion of all contractual payments of the obligor on the reference exposure. In most cases, a credit insurance policy covers a pro rata portion of accounts receivable, satisfying this criterion. In cases where a credit insurance policy includes a deductible or where the amount of the policy is less than the exposure amount of the exposures it covers, this criterion would not be satisfied, but the policy would likely qualify as a securitization exposure under the US Basel III Capital Rules.<sup>32</sup>
- The fourth criterion requires that the guarantee give the beneficiary a direct claim against the protection provider. Under a typical credit insurance policy, the beneficiary would have a direct claim against the insurer for any losses covered by the policy, thereby satisfying this requirement.
- The fifth criterion requires that the guarantee not be unilaterally cancelable by the protection provider for reasons other than breach of contract by the beneficiary. A typical credit insurance policy does not contain any such cancellation provision.
- The sixth criterion requires that the guarantee be legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced. As a practical matter, a bank would conduct diligence to ensure this requirement is satisfied as part of the credit approval process prior to executing the policy.
- The seventh criterion requires the guarantee to require that the protection provider make payment to the beneficiary upon the occurrence of an obligor default on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment. A credit insurance policy covering short-term transactions typically requires payment within 15 business days after the end of a 90-day waiting period beginning on the notification of a default. Furthermore, while credit insurance policies typically require the insured bank to preserve the value of defaulted credit exposures, they do not require the bank to first take legal action against the obligor prior to making a claim under the policy. While the meaning of “timely manner” depends at least in part on the commercial context and industry custom, we believe that a credit insurance policy with customary terms would satisfy the “timely manner” criterion.

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<sup>31</sup> Each of the following elements is contained in 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining “eligible guarantee”).

<sup>32</sup> In such cases, the insurance coverage would be akin to a tranching exposure, having an attachment point equal to the deductible amount and a detachment point equal to the deductible plus the total amount of coverage under the policy. Although such a policy would not be eligible for the risk-shifting approach applicable to eligible guarantees, such policies could potentially benefit from the treatment of securitization exposures under the US Basel III Capital Rules, provided certain definitional and operational requirements were satisfied and provided similar amendments to the definition of “eligible guarantee” and “eligible guarantor” as proposed in this white paper were implemented.

- The eighth criterion requires that the guarantee does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure. The typical credit insurance policy contains no such cost adjustment mechanism.
- The ninth criterion requires that the guarantee is not provided by an affiliate of the protection purchaser. The typical credit insurer is not an affiliate of the bank seeking credit protection.

### **C. Risk Weight Applicable to Insurers**

Under the standardized approach to credit risk in the existing US Basel III Capital Rules, a credit exposure to an insurance company is considered a general corporate exposure and assigned a risk weight of 100%.<sup>33</sup> Under the Basel Framework, however, an exposure to a prudentially regulated insurance company is eligible to receive a lower risk weight (equal to the standardized risk weights for exposures to banks) if the insurance company is “subject to prudential standards and a level of supervision equivalent to those applied to banks.”<sup>34, 35</sup> Such a risk weight could be as low as 20% in the case of a short-term exposure to a low risk (i.e., Grade A) obligor.<sup>36</sup> The Basel Framework states that “[n]ational supervisors should determine whether the regulatory and supervisory framework governing securities firms and other financial institutions in their own jurisdictions is equivalent to that which is applied to banks in their own jurisdictions.”<sup>37</sup>

We recommend that, in implementing the Basel III Endgame, the US banking agencies modify the existing US Basel III Capital Rules to be consistent with the Basel Framework with respect to the standardized risk weights applicable to credit exposures to insurance companies. This could be accomplished through a provision allowing insurance companies subject to prudential supervision equivalent to banks to be treated as banks for the purposes of risk weighting of credit exposures, along with a determination by the regulators that insurance companies are subject to such prudential supervision. Such a revision would be consistent with the Basel Framework, which was developed in part by US federal banking agencies as members of the Basel Committee on Banking Supervision.<sup>38</sup>

In the case of traditional credit insurance, the original credit exposure is to the customers of a corporate client of the bank. If the insurance policy were recognized as a credit risk mitigant, the bank could obtain capital relief by, e.g., substituting the customers' risk weight (presumably 100%) with that of the insurer (which could be as low as 20% under the approach outlined above if the insurer qualifies for the lowest risk weighting applicable to banks under the Basel Committee's revised Basel Framework).

If the US Basel III Capital Rules are aligned to the revised Basel Framework as described above, banks seeking credit insurance could, consistent with international standards, achieve capital relief by substituting the insurer's risk weight in place of the risk weight assigned to its corporate clients. As explained above, alignment of the US capital rules with the revised Basel Framework furthers the US regulators' policy of maintaining US capital requirements that are consistent with the Basel Framework, and would put US banking organizations on an even playing field. In addition, this convergence would be consistent with broader policy considerations by enabling banks to protect credit exposures using an established credit insurance product, while recognizing the credit risk mitigation benefits of such a hedge in a manner consistent with economically equivalent single name risk mitigation techniques, such as traditional guarantees and credit derivatives.

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<sup>33</sup> 12 C.F.R. § 217.32(f)(1) (Federal Reserve rule); 12 C.F.R. § 3.32(f)(1) (OCC rule); 12 C.F.R. § 324.32(f)(1) (FDIC rule).

<sup>34</sup> CRE 20.40.

<sup>35</sup> Implementing statutes in other jurisdictions, including the Capital Requirements Regulation in Europe, currently allow a similar treatment of exposures to non-bank financial institutions subject to “comparable” prudential requirements. CRR Article 119.

<sup>36</sup> CRE 20.21. For purposes of this white paper, all comparisons to the Basel Framework reflect the Standardized Credit Risk Assessment Approach, applicable in jurisdictions, such as the United States, that do not allow for the use of external credit ratings in determining risk weights.

<sup>37</sup> CRE 20.40.

<sup>38</sup> The Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are all members of the BCBS. <https://www.bis.org/bcbs/membership.htm?m=3071>.

## **CONCLUSION**

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Credit insurance is a proven, reliable product offered by well-capitalized and regulated counterparties that can help banks responsibly diversify their portfolios. Such diversification, in turn, will encourage more investment, the associated risks of which will be shared by banks and insurers to the ultimate benefit of the US trade market. Clarifying the rules as suggested above would allow US banks to compete on an equal basis with their peer banks in other jurisdictions.

The authors appreciate this opportunity to outline this issue and would be happy to discuss any time should you have any questions or concerns.