99 Bishopsgate
London EC2M 3XF
United Kingdom
Tel: +44(0)20.7710.1000 Fax: +44(0)20.7374.4460
www.lw.com

LATHAM & WATKINS

29 February 2024

ITFA International Trade & Forfaiting Association
c/o Format A AG
Wiesenstrasse 9
8008 Zürich
Switzerland

Dear Sirs

Advice with respect to Credit Insurance

1. BACKGROUND AND RELIANCE

1.1 The International Trade and Forfaiting Association ("**ITFA**") has instructed Latham & Watkins (London) LLP ("**L&W**") to prepare this letter of advice in support of its engagement with certain European regulators, including the European Banking Authority (the "**EBA**") and the Prudential Regulation Authority (the "**PRA**") in relation to the capital treatment of credit insurance as an eligible credit risk mitigation tool under its applicable Basel III implementing rules (the "**Memorandum**").

1.2 The European Parliament adopted proposed text for certain amendments to the Capital Requirements Regulation 575/2013 ("**CRR**") in November 2023 following a proposal from the European Commission ("**EC**") in October 2021 and to enact into legislation recommendations under the Basel Committee on Banking Supervision's 'Basel III: Finalising post-crisis reforms' (December 2017) ("**Basel IV**"). Such amendments included Article 506 in relation to credit insurance, which provides that the EBA, in collaboration with the European Insurance and Occupational Pensions Authority ("**EIOPA**"), must provide a report to the EC on the eligibility and use of policy insurance as credit risk mitigation techniques by 30 June 2024. Such report is to include analysis on (a) the appropriateness of the associated risk parameters (as referred to in Part Three, Title II, Chapter 3 and 4 of the CRR), (b) the effective and observed riskiness of credit risk exposures where a credit insurance is recognised as a credit risk mitigation technique and (c) the consistency of own funds requirements under the CRR with the outcomes of the analysis in (a) and (b) of the report. Based on the EBA report, the EC may put forward a legislative proposal to amend the treatment applicable to credit insurance (as referred to in Part Three, Title II of the CRR).

1.3 Prior to the adoption of the text referred to in paragraph 1.2, ITFA submitted a position paper dated 21 February 2022 (the "**ITFA Proposal**") following the EC's proposal in October 2021, in which it sought, amongst other things, a change to the prescribed Loss Given Default ("**LGD**") for private credit insurance that was more appropriate, suggesting between 15% to 20% for Unsecured Insured Exposures and 10% to 15% for Secured Insured Exposures (or 15% if only one parameter were to be applied). This was driven by the removal of the advanced internal-ratings-based (A-IRB) approach under Basel IV for certain exposures (including to large corporates and financial institutions) and therefore IRB banks having to use the foundation internal-ratings-based approach (F-IRB) where standard LGDs are prescribed. ITFA's suggested LGDs in the ITFA Proposal would comprise a reduction from the prescribed

LGD of 45% that would otherwise apply to exposures to financial sector entities (including insurers) under Basel IV.

1.4 We understand that this Memorandum will be referred to by the Insurance Committee of ITFA in its ongoing discussions with the EBA in relation to all of the aforementioned.

1.5 ITFA has requested L&W to include legal analysis with respect to the nature of credit insurance policies ("**Credit Insurance Policies**"). Our analysis is based upon an assumption that the terms of such Credit Insurance Policies would align with those set out in paragraph 2 (Key Legal Characteristics of a Credit Insurance Policy) below. L&W has not reviewed any specific transaction documentation and has not conducted any analysis (and provides no opinion with respect to) any specific credit risk mitigation transaction or structure, whether the same would meet the requirements of the CRR or not, nor whether any specific transaction documentation meets the requirements for a contract of insurance under applicable law. L&W has considered only the text of CRR and does not comment on any local law provisions of any EU member state or the UK, which may pertain to the CRR.

1.6 This Memorandum is subject to the terms and conditions of an engagement letter between L&W and ITFA, which provides that L&W's sole client is ITFA and that this Memorandum has been prepared for the sole use by ITFA for the purpose set out in paragraph 1.4. L&W has consented to ITFA publishing a copy of the final form of this Memorandum on the members' section of the ITFA website on the basis that L&W accepts no liability to any organisations or persons who are members of ITFA from time to time or to any person other than ITFA on the terms set out in the engagement letter. This Memorandum has been prepared on said agreed basis for ITFA and must not be relied upon for any other purposes than intended and no liability will be accepted by L&W for any purpose other than for which it was intended, nor for the misunderstanding of any aspect of it by any user. Furthermore, no liability will be accepted under any legislation relating to the rights of third parties in any relevant jurisdiction. Draft versions of this Memorandum may not be relied upon by any person for any purpose and must not be used or distributed by any person receiving a copy of the same. By providing this Memorandum, we do not assume any obligation to notify ITFA nor any other person of future changes in law or guidance which may affect any of the views expressed in this Memorandum.

2. KEY LEGAL CHARACTERISTICS OF A CREDIT INSURANCE POLICY

2.1 Banks use a number of techniques to mitigate the credit risks to which they are exposed in their banking book ("**Credit Risk Exposures**"). These credit risk mitigation techniques can be funded or unfunded. Funded credit protection reflects financial or non-financial collateral held by the bank in relation to a Credit Risk Exposure, which the bank can liquidate in the case of the default of a borrower or counterparty. Non-financial collateral includes guarantees from third parties, e.g. parent companies of borrowers and counterparties and also, on-balance sheet netting and master netting agreements. To the extent collateral provided under funded credit protection is liquidated, it will be applied to reduce the relevant exposure thereby reducing the amount of recourse the bank has to the defaulting borrower or counterparty. Unfunded credit protection could include the purchase by a bank of credit risk protection in the form of credit insurance, which comprises a contractual undertaking from a third-party insurer to indemnify the bank when a borrower or counterparty defaults in return for a premium. Distinct from funded credit protection, the receipt of protection payments under unfunded credit protection does not reduce the amount of recourse to the defaulting borrower or counterparty which can be pursued. Further analysis of this point appears in paragraph 3 below (Dual Recourse under a Credit Insurance Policy).

2.2 Our analysis herein specifically focusses on Credit Insurance Policies, and the position of insurance companies as issuers of Credit Insurance Policies in the EU who are regulated under

Solvency II. It may be the case that insurers outside the EU are prudentially regulated in Solvency II equivalent jurisdictions, in which case we would expect that many of the same considerations would apply to them.

2.3 A typical English law governed Credit Insurance Policy, which would be within the scope of this Memorandum would have the following characteristics:

(a) it would be issued by a Solvency II authorised insurer or insurers (each an "**Insurer**") and would comprise a contract of insurance under applicable national law;

(b) the policy terms would provide insurance coverage with respect to specified insured agreements (each an "**Insured Agreement**") comprising Credit Risk Exposures (each an "**Insured Transaction**") of the relevant insured lending institution (the "**Lender**") to the relevant obligor under the Insured Agreement (the "**Obligor**");

(c) the policy terms would specify the policy period applicable for the coverage (the "**Policy Period**");

(d) the "**Losses"** covered by the relevant Credit Insurance Policy would be defined in the policy terms, for instance: the principal amounts under the Insured Agreement, which are not received by the Lender when due and which result from a non-payment by the Obligor when due of amounts under the Insured Agreement(s) for any reason (each a "**Non-Payment**");

(e) a specified insured percentage of the Losses covered by the insurance (the "**Insured Percentage**") would be incorporated into the relevant policy terms as well as a minimum uninsured percentage retention (the "**Minimum Uninsured Percentage**") which would be retained by the Lender;

(f) a maximum financial limit of liability of the insurer would be specified in the policy terms (the "**Maximum Limit of Liability**");

(g) a specified amount or rate of premium would be payable by the Lender to the Insurer as consideration for the provision of the insurance coverage specified in the relevant Credit Insurance Policy (the "**Premium**");

(h) the insuring clause within the policy terms would contain an undertaking by the Insurer to indemnify the Lender for the Losses which the Lender incurs during the Policy Period, or Losses that relate to risks that attached during the Policy Period (as applicable for the type of cover in question), in connection with the Insured Transaction(s), which are caused by Non-Payment and that indemnification would be calculated in accordance with the policy terms, usually by reference to the actual amount of Loss suffered by the Lender multiplied by the applicable Insured Percentage;

(i) the policy terms would require the Lender to submit a written request for indemnification under the Credit Insurance Policy meeting specified requirements (each a "**Claim**"), which would usually include the completion of a proof of loss statement in the form specified and would specify timescales for completion of such documentation;

(j) the Insurer would be required to determine a Claim within a specified period of time following submission of the written documentation referred to above and to make payment of the indemnified amount promptly thereafter.

2.4 Frequently a “waiting period” or “claim assessment period” would be incorporated, which would typically commence on the date of a relevant Non-Payment and comprise a period specified in the policy terms, which allows time for any work-out processes to begin and therefore sufficient time for the ultimate Claim amount to be determined before submission of such Claim. Amongst the key characteristics of such Credit Insurance Policies is, therefore, that the Insurer undertakes to pay a claim amount calculated by reference to the actual Losses suffered by the Lender upon the occurrence of an event, namely a Non-Payment, which is uncertain as to occurrence or magnitude, in return for the payment of a premium.

2.5 Assuming that such contract meets the requirements under applicable national law for a contract of insurance[1], such contract would comprise non-life insurance activities (as classified in Solvency II) falling within the applicable class of non-life insurance for regulatory purposes. The provision of the indemnity under the policy terms is fundamental to the contract’s classification and its legal characteristics noting that the ability to make a claim, and indeed the quantum of such claim amount, is directly linked to the actual Losses suffered by the Lender and the requirement for a Non-Payment to have occurred.

2.6 As described above under the insuring clause, it can be seen that such policy terms create separate directly enforceable contractual rights and obligations as between the Insurer and the Lender. Subject to the contractual requirements for making a Claim, as described above, and any other terms and conditions of the policy, the Insurer undertakes to pay the indemnity directly to the Lender for the Insured Percentage of the Loss suffered up to the Maximum Limit of Liability applied.

3. DUAL RECOURSE UNDER A CREDIT INSURANCE POLICY

3.1 The ITFA Proposal contained a description of the fundamental elements of credit insurance, which included the fact that an insured Lender holding a Credit Insurance Policy would have dual contractual rights to make recovery of the debt, one through the underlying loan documentation against the defaulting borrower and the other by submitting a claim against the relevant insurer under the Credit Insurance Policy. Neither the purchase of credit insurance nor the receipt of claim payments under credit insurance interfere with the bank’s rights under the Insured Agreement either by reducing the amount of recourse the bank has to the defaulting borrower or counterparty or by extinguishing the rights of the bank to the defaulting borrower or counterparty under the Insured Agreement.

3.2 As described in paragraph 2 (Key Legal Characteristics of a Credit Insurance Policy), a Credit Insurance Policy creates a directly enforceable contract as between the Insurer and the Lender, which is separate to the Insured Agreement for which it provides credit protection. In particular, such transaction requires the Insurer to pay an amount that is calculated by reference to the actual loss suffered by the Lender, adjusted for amounts received on account of that loss, however described. A key feature of a Credit Insurance Policy is the indemnity nature of the payment obligation provided by the Insurer, which is triggered by the occurrence of the relevant Non-Payment and is a primary obligation to pay the loss amount sustained by the Lender (subject to the contractual requirements described in paragraph 2).

3.3 Under the terms of a Credit Insurance Policy it would be typical for there to be an application of funds provision which specifies how amounts received by the Lender from a defaulting

---

1 Solvency II does not provide a standardised definition of a contract of insurance, although it does provide the classes into which contracts should be allocated for the purposes of the authorisation regime. Consequently, it is left to national law to determine the legal definition of contract of insurance to which the Solvency II regime applies. L&W has not provided any analysis as to whether any particular Credit Insurance Policy meets the applicable definition of a contract of insurance and makes the assumption that any Credit Insurance Policy within scope of this Memorandum does so.

Borrower, both before and after the payment of a Claim by the Insurer, are to be applied. Prior to payment of a Claim, such amounts would usually be applied in accordance with the terms of the Insured Agreement and after payment of the Claim they would usually be shared by the Insurer and the Lender after deducting costs of recovery on a *pari passu* basis reflecting the claim amount paid by the Insurer as a proportion of the amount of Loss suffered. Such clauses help to demonstrate that the effect of payment of a Claim under the Credit Insurance Policy does not serve to extinguish the underlying debt due from the Borrower to the Lender under the Insured Agreement as they expressly contemplate the contractual rights which the Insurer and the Lender have with respect to any recoveries made.

3.4 A Credit Insurance Policy, which is capable of providing unfunded credit mitigation under CRR must meet certain requirements as to its contractual terms. Amongst these requirements is that the terms do not require the Lender to seek recovery from the Borrower as a pre-condition to the indemnity obligation of the Insurer under the Credit Insurance Policy. Consequently, although the Lender does have specified notification and loss mitigation responsibilities under the Credit Insurance Policy following the occurrence of a Non-Payment, the Lender may both claim under the relevant credit mitigation contract and continue to exercise its rights under the Insured Agreement, subject to any subrogation or assignment of rights provisions that apply.

3.5 Under English law, an equitable remedy of subrogation would be expected to result from the payment of a Claim by the Insurer. A detailed analysis of subrogation is beyond the scope of this Memorandum, but in principle it provides a party who pays an indemnity or discharges a debt for another to succeed to the rights of the recipient of the indemnity or the creditor of the debt. In an insurance context, subrogation would give the Insurer a right to require the exercise of the Lender's rights of recovery from relevant third parties owing amounts to the Lender at the Insurer's request, but only to the extent of the Claim payment. Typically for a Credit Insurance Policy, the policy terms contain explicit provisions addressing how contractual subrogation applies following payment of a Claim including imposing an obligation upon the Lender to execute all documentation necessary to enable the pursuit of such rights, as well as the right to take assignment of the Lender's rights of recovery where requested and if legally permitted.

3.6 Conceptually the common law rights of subrogation (and such explicit contractual terms creating similar arrangements) avoid the Lender recovering its loss twice (once from the Insurer and once from the Borrower under the Insured Agreement) and is linked to the principle of unjust enrichment. It does this by allocating the benefit of relevant third-party claims to the Insurer so that it might reimburse its own loss up to the value of the indemnity paid by it under the unfunded credit mitigation contract. However, subrogation (or the explicit contractual terms referred to above) only apply after the indemnity has been paid and it can be seen from the above description that the effect of the payment of that indemnity does not discharge the underlying obligation arising from the Insured Agreement – rather it moves the right of recovery from the Lender to the Insurer to the extent of the indemnity paid.

3.7 It can be seen from the analysis above that the effecting of a Credit Insurance Policy does not replace the obligations of the defaulting Borrower under an Insured Agreement. Rather they would constitute a separate contractual arrangement which, whilst referencing the Insured Agreement, does not have the legal effect of amending or limiting recovery under the Insured Agreement with respect to unrecovered losses but, rather, creates an additional set of contractual rights and obligations as between the Insurer and the Lender, providing the Lender with an independent legal remedy for its covered losses from the Insurer. These would then be subject to the specified provisions described above, including how any rights of recovery under the Insured Agreement may be exercised, and for whose benefit, after the Insurer has made a relevant payment.

4. PROVIDERS OF CREDIT INSURANCE

4.1 Directive 2009/138/EC on the taking up and pursuit of the business of Insurance and Reinsurance (the "**Solvency II Directive**") as supplemented by EU regulation and implemented through national implementing legislation (together referred to in this Memorandum as "**Solvency II**"), provides a maximum harmonising regime for the authorisation and prudential regulation of insurance undertakings within the European Union.

4.2 Solvency II contains a general principle of authorisation (Article 14) providing that the conduct of direct insurance is subject to prior authorisation from the supervisory authorities in the applicable Member State, being for non-life insurance the Member State where the insurer covering the risk has its head office.

4.3 Solvency II applies to direct non-life insurance undertakings established in a Member State of the EU conducting activities falling with the specified classes set out in Part A of Annex I to the Solvency II Directive, save for limited exceptions, such as certain small-scale insurers, which are out of scope of this Memorandum. Such activities would include the provision of contracts of insurance, which are Credit Insurance Policies.

4.4 Solvency II provides a robust prudential regulatory regime for insurers across the EU, which includes detailed requirements for the calculation and maintenance of technical provisions to cover insurance liabilities (such as expected losses) and additional regulatory capital (as a buffer to support unexpected liabilities). In simple terms, Solvency II insurers are required to hold assets to cover the value of their liabilities and to maintain a certain level of additional assets as a capital buffer. In relation to liabilities, insurers must hold technical provisions, which are calculated as the best estimate of liabilities plus a regulatory risk margin component, which represents the amount that the insurer would need to pay to another insurer on an arm's length basis to transfer those liabilities to it.

4.5 The regulatory capital buffer is calculated using the insurer's basic own funds, essentially the insurer's assets minus its liabilities with a further deduction of assets that are not admissible for regulatory purposes. These basic own funds are then characterised into tiers of capital that reflect their ability to absorb losses and allow the insurer to continue to operate on a going concern basis. The own funds which meet the requirements for these tiers of capital are referred to as eligible own funds and only this quality of capital can be used to cover the regulatory capital requirements of the insurer.

4.6 The core regulatory capital requirement is the Solvency Capital Requirement ("**SCR**"), which is calculated by determining the amount by which the insurer's basic own funds could fall during the course of a 12 month period and yet the insurer would still meet its liabilities to a confidence level of 99.5% over that period. There are detailed provisions specifying how such SCR is to be calculated and it must be calculated either using the standard formula set out in the regime or through an internal model which has been subject to regulatory scrutiny and prior approval. Additionally, there is a minimum capital requirement ("**MCR**"), which acts as a floor for the regulatory capital that a Solvency II insurer must hold. Failure to meet the SCR or the MCR will trigger regulatory intervention by the relevant supervisory authority aimed at restoring the financial condition of the relevant entity, including through the implementation of capital management plans which insurers are expected to have in place.

4.7 The providers of Credit Insurance Policies that are authorised Solvency II insurers are therefore subject to robust regulatory capital requirements and a robust regime of regulation, which also includes substantial requirements as to internal risk and governance functions and framework, compliance monitoring, regular regulatory reporting and oversight and a system of public disclosure.

4.8 Solvency II also includes a regime for insurers and insurance branches situated in the EU that are in financial difficulties (Title IV of the Solvency II Directive). These include (a) where a relevant insurer faces reorganisation measures taken by a competent authority aimed at preserving or restoring the financial condition of that undertaking or (b) winding up proceedings. The regime lays down the foundation for the principle that home state law and procedure should apply in these circumstances to Solvency II insurance companies and that there should be mutual recognition of such law and procedure throughout the EU.

4.9 In addition to the mutual recognition framework described above, Solvency II requires EU Member States to ensure that "insurance claims"[2] take precedence over other claims against the insurance undertaking in certain specified ways. Member States have discretion over which (or both) of the specified methods should apply as follows:

(a) for assets representing the technical provisions, insurance claims take absolute precedence over any other claim on the insurance undertaking;

(b) with regard to the whole of the assets of the insurance undertaking, insurance claims take precedence over any other claim on the insurance undertaking with the possible exception of specified categories including employment claims, tax claims by public bodies, social security claims, winding up expenses and claims on assets subject to *rights in rem* (essentially legal rights in relation to specific property, such as security rights over that property).

4.10 The actual scope of the applicable provisions for a particular insurer are therefore a matter of national law, but in principle the Solvency II framework does require that the creditors of Solvency II insurers holding insurance claims are afforded statutory priority for those claims over other creditors and/or claims (subject to those specified exceptions that may be adopted). Under Solvency II, "insurance claim" is defined to include an amount which is owed by an insurance undertaking to insured persons, policyholders and beneficiaries having a direct right of action against the insurance undertaking and which arises from an insurance contract or from specified operations regulated as insurance, in direct insurance business (i.e. not reinsurance). The claims of Lenders under Credit Insurance Policies issued by Solvency II insurance undertakings as part of their regulated insurance business would be expected to fall within the scope of such claims and hence would benefit from the statutory priority regime. However, we do not suggest that all credit risk mitigation arrangements will necessarily give rise to insurance claims and hence benefit from such statutory priority regime, as that will depend on the factual analysis of a particular arrangement.

5. CONCLUSION

5.1 In conclusion:

(a) Credit Insurance Policies provide Lenders with direct indemnity protection and afford dual recourse rights in respect of the covered losses. The purchase of credit insurance and the receipt of claim payments under credit insurance do not interfere with the bank's rights under the Insured Agreement either by reducing the amount of recourse the bank has to the defaulting borrower or counterparty or by extinguishing the rights of the bank to the defaulting borrower or counterparty under the Insured Agreement;

[2] "Insurance claims" are defined within the Solvency II Directive but are the subject of local implementation under national law in the relevant jurisdiction.

(b) the requirements of the Solvency II regime differentiate Solvency II insurers from other types of corporate debtors by materially reducing the risk of non-recovery of claims from such regulated entities in light of the robust regulatory framework provided;

(c) creditors with claims under products which are insurance policies, or which derive from operations regulated as insurance business (such as Lenders who are insureds under Credit Insurance Policies) enjoy a beneficial statutory priority regime, which provides further protection in the event that a Solvency II insurer does end up in financial difficulties.

Latham & Watkins (London) LLP