Mr. Sam Woods
Deputy Governor for Prudential Regulation
and Chief Executive Officer of the Prudential Regulation Authority
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA
United Kingdom

16 May 2018

RE: Credit Risk Mitigation: Eligibility of Guarantees as Unfunded Credit Protection

Dear Mr. Woods,

The International Chamber of Commerce ("ICC") Banking Commission, the International Trade and Forfaiting Association ("ITFA"), the Institute of International Finance ("IIF") and ") and BAFT (Bankers Association for Finance and Trade), (collectively, the "Associations"), welcome the opportunity to respond to the Prudential Regulation Authority ("PRA") '*Credit Risk Mitigation: Eligibility of Guarantees as Unfunded Credit Protection'* consultation paper (the "Consultation" or the "consultative document")[1]. We appreciate the continued constructive, substantive and informed dialogue that has evolved over years of ongoing engagement on these and other issues with the PRA.

The Associations represent members active in the fields of international banking, trade finance and insurance across the globe. As such, the following observations are submitted with an eye toward the wider economic, trade and development context within which credit risk mitigation ("CRM") products are provided to the international community, along with the importance of those products to downstream businesses and consumers.

Clarifying expectations regarding the eligibility of guarantees as unfunded credit protection is a significant development. The recognition by the PRA that firms may, for sound risk management reasons, wish to use techniques to mitigate credit risk is important in the context of ensuring adequate funding mechanisms are available to support the real economy. Indeed, CRM solutions are closely linked to the supply of global trade and commerce through traditional trade finance instruments, insurance and re-insurance products, and various types of guarantees issued by export credit agencies ("ECA") and multilateral development banks ("MDB") or through inter-bank risk distribution techniques.

We are concerned, however, that certain aspects of the Consultation may inhibit or reduce the use of these products, stymying much needed capital adequacy in an area of importance to development and global growth. Though we recognize this consultation is limited to PRA regulated firms, we have a wider concern for the macro-global implications of setting standards for CRM products that could have knock-on implications concerning how they are used in a cross-border context. There exists an inter-dependant "eco-system" amongst the banks and providers of CRM (who, in some cases, are banks themselves) which effects capacity, pricing and availability to corporates of all sizes and, ultimately, consumers.

[1] Consultation Paper | CP6/18 Credit risk mitigation: Eligibility of guarantees as unfunded credit protection, February 2018

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We strongly believe that reform in this area should take into account the global implications of credit risk mitigation as a financial tool in order to avoid unintended consequences for the supply of international financial services. However, if the PRA does go ahead with converting the proposals set out in the consultation paper into regulation, then it is recommended that the PRA provide the market with a reasonable transition period to adopt the revised standards and include grandfathering of existing transactions covered by CRM techniques which have been entered in good faith.

We stand ready to assist further in this regard and we look forward to following up accordingly as the discussions on these issues progress. Please contact us should you have any questions.

Very truly yours,

Olivier Paul
Head of Policy,
ICC Banking Commission

Tod Burwell
President and Chief Executive Officer,
BAFT

Sean Edwards
Chairman,
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Andres Portilla
Managing Director, Regulatory Affairs,
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Credit Risk Mitigation: Eligibility of Guarantees as Unfunded Credit Protection

1. Background

The use of CRM can take many forms and can include adjusting the cost of credit according to the credit strength of the borrower, reducing the amount of credit available to higher risk applicants, purchasing credit insurance, or increasing the portfolio mix of borrowers. A bank will use CRM to mitigate a range of risk related concerns including (i) country risk if the buyer is an importer based in a country outside the jurisdiction of the seller; (ii) industry sector concentration issues; (iii) risk appetite issues; and (iv) portfolio management issues. It is increasingly important for real-economy business lines around the world and, in particular, for trade and export finance.

Regulated financial institutions – primarily banks – still provide the majority of trade finance today, including documentary letters of credit, documentary collections, standby and guarantee products, receivables finance and supply chain loans, and/or risk mitigation solutions derived from these various instruments.[2] Trade Credit Insurance ("TCI") and Non-Payment Insurance (NPI) policies are often used by banks to manage and mitigate credit risk exposures at a transaction and portfolio level on recourse and non-recourse receivable finance ("R-RF, NR-RF") transactions, export-import and domestic trade loans and payables financing as part of supply chain solutions. The use of a CRM product like insurance to cover fifty percent of the exposure on a receivables financing transaction, for example, can reduce the overall risk weighted assets ("RWA") applied by thirty nine percent, allowing in many cases for the prioritization of the transaction to the benefit of clients requiring the financing.[3]
In addition, insurance generally as a CRM tool assists banks with effective credit risk transfer and reduces balance sheet volatility. This protection serves to strengthen the banking sector during periods of increased instability and downturns in the credit cycle through transfer of risk into the insurance and reinsurance communities, while insurers/reinsurers' regulated capital and diverse portfolios of exposures in turn protect them from market volatility and/or any correlation on the liability side.

Insurance is provided on the basis of a partnership between insurers and banks, with full disclosure by the bank of the risk to be insured supplemented by insurers' independent underwriting and prudential management, which is in turn reinforced by insurance regulation. Insurers use their own credit risk analysis, pricing models and information sources in

[2] The linkages between trade and the creation of economic value are well-established, and after a difficult post-crisis environment where these connections were called into question, we are seeing nascent signs of recovery, with trade regaining its long-held position as a driver of global GDP growth. There is also growing appreciation of the linkage between trade financing (including traditional trade finance, fast-growing supply chain finance, receivable finance and the risk mitigation capabilities of each) and the successful conduct of cross-border trade. While market sizing is a difficult exercise, conservative estimates quoted in a January 2014 report of The Committee on the Global Financial System ("CGFS"), '*Trade Finance: developments and issues*', suggest that bank-intermediated trade finance is at about 40% of total merchandise trade globally by value, when inter-firm credit and open account transactions (*e.g.* Supply Chain loans, Recourse & Non-Recourse Receivable Finance) are included in the estimates. With annual merchandise trade approaching US$20 trillion, the importance and impact of trade finance is easily appreciated.

[3] A USD1mil receivable finance transaction for a corporate customer with an estimated Probability of Default (PD) of 0.63%, Loss-given-default (LGD) of 45%, Maturity (M) of 6 months when uninsured will consume risk-weighted assets of USD560,407. When insurance is bought from a highly rated counterparty with a PD of 0.07%, LGD: 45%, M: 6months to cover 50% of the exposure then the RWA consumed will reduce by 39% to USD339,625.

addition to relying on the disclosure required by insurance law to ensure that their underwriting is informed and that they are accurately assessing the risk of transactions presented for their acceptance.

It is in this context that considerations of regulatory treatment and capital adequacy requirements linked to CRM products should be viewed with a clear focus on the development and economic impact of these requirements, and with an eye toward the risk-aligned treatment by regulatory authorities. There is a continuing need to safely and adequately mitigate risk in the context of certain financial product lines in order to ensure their availability and affordability to downstream customers. We believe, however, that certain aspects of the consultative document could inhibit the effectiveness of risk mitigation with deleterious downstream consequences.

2. Issues and recommendations

Though the Associations note the need for careful review of the implications for CRM frameworks, we have several specific concerns related to the Consultation:

a. **"Timely Manner" Definition:** The term payment in a 'Timely Manner'[4] should be better understood and properly adjusted. The consultative document makes clear that the PRA expects a guarantor/insurer to pay out in a 'timely manner', where timely is defined in terms of days and not weeks and months, from the date the obligor fails to make payment due under the claim in respect of which protection or insurance has been provided. This period is too short and too inflexible. The expression "pursue in a timely manner" means the bank should be able to swiftly initiate the enforcement process. In other words, the bank is obliged to carry out all measures necessary to liquidate the security in an appropriate manner and without delay.

   When this is read in conjunction with current business practices for payment of insurance claims as developed to cater for the specific requirements of the above products, we believe that the definition of 'timely manner' is reflective of the business environment in which it is to be applied.

   The current business practice of paying claims is a function of the working capital cycle and the terms of trade of the business. Delays in payment of invoices reflect the realities on-the-ground in terms of the commercial nature of these transactions, which are normally settled mutually between buyers and suppliers, leading to the need for some flexibility in terms of time periods.

   As the insurer normally has no prior knowledge of the default event, it is not possible to make payment immediately or shortly after non-payment by the obligor. Following notification of non-payment by the insured (a long-standing obligation of insurance policies in all fields of business), the insurer must then have sufficient time to

[4] PRA Consultation Paper/ CP6/18. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp618.pdf?la=en&hash=FDC3C115AE5B423A37BAA104C02D476F8EF12057. Pay out in a timely manner Para 2.7

establish the validity of the claim and allow the debtor time to trade and arrange payment. Forcing insurers to settle claims immediately after the date on which the obligor fails to make payment and without following their normal claims assessment process would give no incentive to the insured to recover liabilities from the defaulter prior to the claim settlement. It would not make business sense for an insurer to first have to pay a claim of undetermined status and then, if the claim is found to be subsequently invalid, have to recover that payment from the insured adding an additional credit risk to be considered by the insurer.[5]

Additionally, by focusing on a strict time schedule rather than on the substance of the protection itself, this would de facto exclude all the insurance contracts from eligibility, which is clearly not the aim, of the consultation.

Private and public credit insurance policies typically have waiting periods between 90-180 days. Therefore, the PRA guidance on the concept of timeliness as requiring a payment “without delay” and within “days … not weeks or months” is not in line with market practice nor with the EBA position as expressed in the Single Rulebook Q&A.[6]

In this last reference, the EBA has indicated that the expression “timely manner” allows some flexibility. It would not allow any “determinable” period, whose length depends on circumstances on which the institution has no influence. Therefore, the point in time at which payment under the guarantee can be expected should in a first step be clearly determinable for the institution and the guarantor must not have the ability to postpone the payment in an indeterminable manner.

Additionally, as the PRA indicates that provisional payments from mutual guarantee schemes and public-sector bodies are treated as an exception to the PRA’s timely payment requirement, a number of multilateral development banks and ECAs could be excluded from the definition of mutual guarantee schemes and public-sector bodies and therefore not benefit from this exception.

We note that Article 215 of the Capital Requirements Regulation (“CRR”) only requires that the protected have the “right to pursue” the guarantor in a timely manner and requires the bank only to formulate the credit protection agreement in such a way that it can be realised smoothly and independently of the protection provider. The bank need only ensure that its contractual position is drafted so as not to infringe on the provisions of the CRR. External factors, such as the length of a judicial enforcement process or foreclosure proceedings, do not conflict with the “timely manner” criterion. The bank has no influence over these. The relevant issue is whether or not enforcement proceedings can be initiated immediately in the event

[5] The appendix to this letter sets out as an illustration how an insurance policy covering a Non-Recourse Receivable Finance transaction will work when a claim is made and in the process addresses the issues highlighted herein.

[6] EBA, Single Rulebook Q&A, (reference 2015_2306)

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of default, even if these proceedings may be quite lengthy due to the need for recourse to assistance from the state.

CRR Article 213 also recognises, implicitly, that clauses "within the control" of the protected could lead to a delay in payment; a requirement on the protected to notify the insurer is within its control and is thus, we believe, within the contemplation of the CRR. The period of validation of the claim also allows the protected to discuss and, if appropriate, take remedial action. This is commercially preferred to the insurer forcing the obligor into liquidation or insolvency immediately, which may result in a worse outcome and greater contagion risk for the broader supply chain of the said obligor.

b. **Eligibility Requirements:** Amendment of the eligibility requirements are needed, and in particular what is meant by "Legally effective and enforceable"[7]. The Consultation proposes that the legal opinion itself should cover the practical ease of enforceability across relevant jurisdictions.[8] We are concerned that the proposal could result in a significant financial and administrative burden both for the insureds who rely on the credit protection insurers provide, and for insurers who would need to provide appropriate corporate authorisation documentation for law firms to be able to prepare such legal opinions. The breadth of the proposed scope of legal opinions is also a concern since this covers all eligibility criteria and that several of these appear to go beyond pure legal assessment (*i.e.* capacity and enforceability). Therefore, we believe that the proposed requirement could harm the market and limit the ability of firms to undertake transactions, particularly smaller ones.

At a minimum, we believe the Consultation includes enforceability under the governing law of the CRM instrument, and in the jurisdiction where the insurer is incorporated, but "could well include other jurisdictions where enforcement action may be taken"[9]. This is potentially problematic as opinions to date have been restricted to the CRM instrument and, in some cases, the domicile of the insurer. It is recommended that greater emphasis is given to allowing banks to asses, using a risk-based approach, where and in what circumstances a legal opinion should be obtained. We believe a key consideration is whether a bank as a whole can demonstrate that eligibility requirements have been met.

c. **Alignment of interpretation with the CRR:** The consultative document appears to differ in its emphasis from the recently published European Banking Authority

[7] PRA Consultation Paper/ CP6/18. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp618.pdf?la=en&hash=FDC3C115AE5B423A37BAA104C02D476F8EF12057. Clearly defined and incontrovertible. Para 2.5

[8] Similarly, we understand that the standard exclusion provisions (*inter alia*, natural disasters, epidemics, fire or nuclear explosions) quoted in credit Insurance contracts do not impact the validity of the credit insurance coverage, as in practice, the guarantor does not seek to reduce or be released from its liability (according to the PRA terms of the paragraph 2.5 on page 7).

[9] PRA Consultation Paper/ CP6/18. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp618.pdf?la=en&hash=FDC3C115AE5B423A37BAA104C02D476F8EF12057. Clearly defined and incontrovertible. Para 2.5

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("EBA") paper on Credit Risk Mitigation[10]. As the CRR is a regulation directly binding on European Union ("EU") banks, the Consultation, if implemented in its proposed form, will open up the possibility of varying interpretations across multiple EU jurisdictions. This will go against the stated regulatory objective of achieving consistency and comparability across jurisdictions under the single rulebook. Clarification is therefore needed on how these proposed changes fit with EU rules and regulations. Any front-running of regulatory interpretation should be avoided. It is submitted, however, that it would not be sufficient to simply suspend the Consultation in such a case as the uncertainty created by it, outlined in our submission, would persist. Should this approach be taken it is recommended that further consultation on the issue be considered.

d. **Interaction with other areas of financial services regulation:** The Consultation restricts the scope of CRM to the standardised and Internal Ratings Based-Foundation ("IRB-F") and explicitly excludes IRB-Advanced ("AIRB").[11] From a practical perspective it will not be possible for banks to operate to differing standards of eligibility and it is highly unlikely that regulators will allow banks to do so, particularly when the CRM instrument in question is similar in form and substance. Further, it is highly unlikely that independent legal opinions will be forthcoming for such CRM instruments. In addition, it would be beneficial to provide further guidance as to how the PRA intends to utilise Pillar 2 for guarantees deemed ineligible under Pillar 1 and how, if at all, eligible guarantees under Pillar 1 would need further consideration and inclusion in Pillar 2.

e. **ECA Loans:** Clarification is needed that ECA loans will be exempt from the proposed changes set out in the Consultation. The CRR Article 4-81 defines 'officially supported export credits' as loans or credits to finance the export of goods and services for which an official ECA provides guarantees, insurance or direct financing. These ECAs might be public entities or private entities but always act for the account of their Sovereign.

Under CRR Article 202, credit protection provided by ECAs shall not benefit from any explicit central government counter-guarantee. Since Basel I, credit protections delivered by ECAs have been dealt with as Sovereign commitments. In line with the article 215 of the CRR, they are today dealt with by financial institutions as "Sovereign and other public-sector counter-guarantees". By reference to their long-lasting experience with ECAs, beneficiaries of these protections consider that there is no element to question the timeliness of the commitments of the ECA or the incontrovertibility of their commitments. Conditions to make the cover or a claim void are within the guarantee holder/insured's control and ECAs never create obligations

[10] EBA Report on the Credit Risk Mitigation (CRM) Framework, March 2018: https://www.eba.europa.eu/documents/10180/2087449/EBA+Report+on+CRM+framework.pdf.

[11] The PRA's view is that "limited coverage" refers to a quantifiable portion of the exposure and "certain types of payment" refer to different sums that an obligor may be required to pay such as principal, interest or margin payments. Therefore, where for example a guarantee covers non-payment of principal but excludes interest payments, the expectation is that this limited coverage will be reflected in the calculation of the value of the unfunded credit protection. As such, it does not seem open to an institution to use this as a basis to adjust the value of a guarantee to reflect its assessment of the impact of any documented limitations on coverage in the relevant instrument, such as loss exclusions in an insurance policy.

on the financial situation of the beneficiary of their protection in order to pay or not pay a claim.

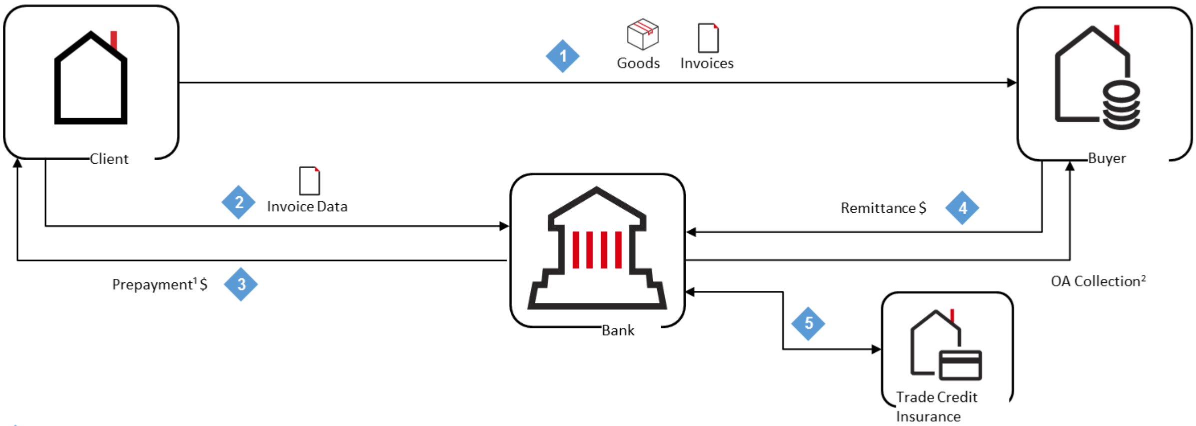
Appendix

Examples of Insurance Policies for Receivable Finance and Trade Loans
Both Trade Credit Insurance (TCI) and Non-Payment Insurance (NPI) policies are similar but not identical in terms of the underlying characteristics of the policy. TCI policies in general are broader in nature as they cover political and commercial risks (which also include non-payment risks) whereas NPI policies only cover non-payment risks. It is also worth highlighting that Banks use TCI and NPI policies not only to manage default risk but to also manage risk appetite, portfolio diversification and risk-return metrics.

Structure of a Receivable Finance Transaction in a Bank: The structure of a typical Recourse and Non-Recourse Receivable Finance (R-RF, NR-RF) transaction is outlined below and is used to explain why and how an insurance policy is used to manage and mitigate credit risk in RF portfolios. Note the use of insurance policies for export-import trade loans and payable financing will work in a similar manner to recourse receivable finance transactions.

RF Transaction Structure without Insurance (for illustrative purposes only)

RF Transaction Structure with insurance



1. Seller delivers goods/services and invoices to buyer(s)
2. Seller provides invoice data to bank
3. Seller draws payment for discounted invoice value from bank
4. At maturity, buyer pays invoice
5. Optionally, bank can provide credit protection (Limited Recourse) to cover the risk of buyer insolvency or non-payment, either taking that risk for itself or supported by trade credit insurance

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Typical Characteristics of a Non-Recourse Receivable Finance (NR-RF) Transaction

- Seller is a client of the Bank financing the NR-RF transaction
- Buyer is **often not** the client of the bank.
- The Buyer is often an export client of the Seller.
- In some instances, the buyer and the seller may have a common bank.
- The primary motivation for the seller to seek financing of these receivables, is to achieve off-balance sheet treatment**.** This means the Financing Institution (FI) is purchasing the receivables and legally becomes the owner of these receivables**.** As such, the FI must get payment on the due date from the Buyer who is often not a client of the financing bank.
- Buying an insurance policy is one of the primary means of managing the buyer payment risk, particularly when these facilities are made available on a non-recourse basis, where the bank has purchased the related receivables.
- Buyer due diligence is done by the bank prior to setting up these financing programmes, and this due diligence covers Know your customer (KYC) and commercial aspects of the transaction.
- Some programmes are structured solely between seller and the bank, with no disclosure being made to the buyer. In such structures, payments reach the bank only via the seller, following remittance of funds by the buyer.
- The Capital Requirements Regulation (CRR) requires banks on the Internal Ratings Based (IRB) approaches to book these exposures on the buyer and as the buyer may not be a client of the bank, assessing credit risk is difficult hence the use of an insurance policy is a useful supplement to managing and mitigating credit risk.
- Banks on the Standardised approach can book the exposure on the seller, as the regulations do not require RF-NR exposures to be booked on the buyer. As the bank has purchased these receivables they have no recourse back to the seller hence the use of an insurance policy to manage and mitigate the credit risk of the buyer defaulting.

Characteristics of a Recourse Receivable Finance Transaction

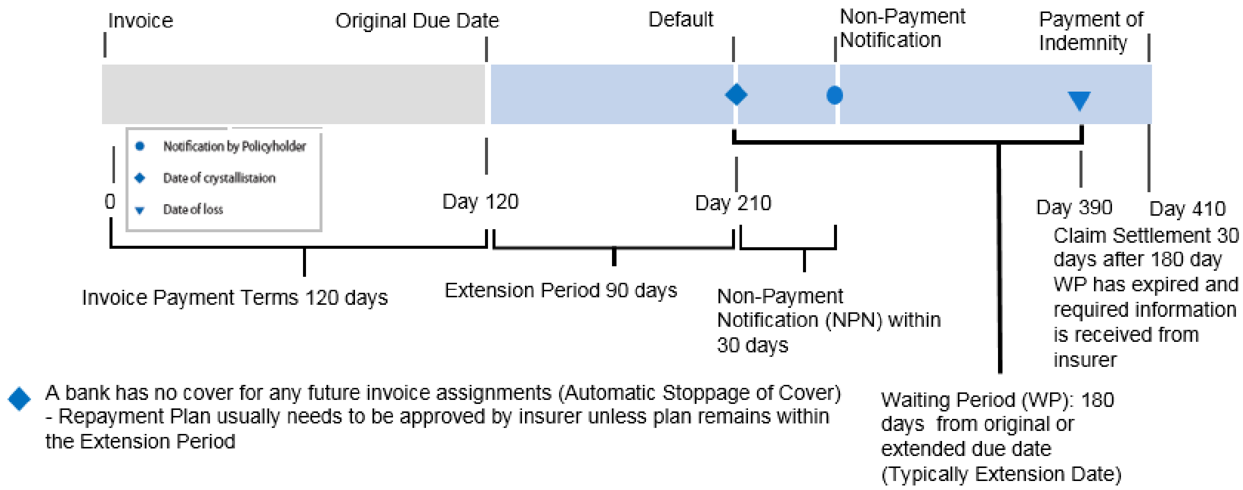
- Unlike NR-RF transactions, recourse transactions are booked exclusively on the Seller who is a client of the bank
- The financing bank is extending a structured working capital loan to the seller with the receivables being the collateral for the loan. The bank does not purchase the receivable.
- On the due date, irrespective of whether the buyer has paid the invoice or not, the bank will look to the seller for repayment of the loan. The seller is ultimately responsible for repayment of the loan.
- An insurance policy may be bought as a means of managing and mitigating credit risk from a risk appetite and concentration risk perspective but not necessarily from a payment risk perspective.
- Additionally, as many of these portfolios will have a mix of Recourse and Non-Recourse transactions, insurance policies are bought to manage portfolio risk/returns.
- Import-Export trade loans and supply chain loans work in a similar but not identical manner as they share many of characteristics of recourse portfolios.

Operational Aspects of Insurance Policies: Some general characteristics of insurance policies and the typical time line for the payment of a policy claim in line with current business practices are outlined below:

- Where insurance policies are compliant with the CRR rules, banks are the direct beneficiaries of the policies and the relationship is between the bank as a lender and the insurer as the credit protection provider. This is in contrast to a financial guarantee where the relationship is essentially between the borrower and the insurer with the borrower arranging the guarantee, as a means of credit enhancement to support the lending relationship.
- Insurance policies may be structured in a highly standardised format to ensure they cover a portfolio of loans and multiple obligors across jurisdictions.
- Irrespective of whether they are bespoke or standardised, insurance policies in general are supported by an independent legal opinion.
- This legal opinion will also cover compliance with the Capital Requirements Regulation (CRR) and the following Articles of the CRR:

Approach	Capital Requirements Regulation (CRR)	Brief Description
Standardised (Std)	Article 122 (1)	External Ratings of insurer.
Standardised	Article 201	List of eligible guarantee/insurance providers
Standardised	Article 213 and 215	Minimum general requirements for insurance/guarantee contracts
Standardised	Article 235	Formula for calculation of risk weighted (RWA) exposures
IRBF/IRBA	Article 201	List of eligible guarantee/insurance providers
IRBF/IRBA	Article 213 and 215	Minimum general requirements for insurance/guarantee contracts
IRBF/IRBA	Article 236	Formula for calculation of risk weighted (RWA) exposures. PD substitution
IRBF/IRBA	Article 183 1 (c)	Minimum requirements for guarantee/insurance contracts which replaces article 213 (1)
Std/IRBF/IRBA	Article 194	Legal certainty and effectiveness

Typical TCI Protracted Default / Political Risk Timeline



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About the International Chamber of Commerce (ICC)

The International Chamber of Commerce (ICC) is the world's largest business organization with a network of over 6.5 million members in more than 130 countries. We work to promote international trade, responsible business conduct and a global approach to regulation through a unique mix of advocacy and standard setting activities—together with market-leading dispute resolution services. Our members include many of the world's largest companies, SMEs, business associations and local chambers of commerce.

About BAFT

BAFT is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. Our members represent the transaction banking segment of financial institutions globally, including the trade finance and cash management business lines which provide financing for the export and import of goods and services. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide.

About IIF

The Institute of International Finance is the global association of the financial industry, with close to 450 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks.

About ITFA

Founded in 1999, and with nearly 200 members all over the world, the ITFA brings together banks and financial institutions who are engaged in originating and distributing trade related risk and finding creative ways to mitigate threats. 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 to become a prominent part of supply chain finance. The ITFA acts as a valuable forum for its members to interact and transact business together profitably and safely.

The aim of the ITFA working with, and for, its members, is to:

- facilitate the expansion of trade and forfaiting in the emerging markets
- continuously improve governance and best practice and shape rules, laws and documentation that affect its members and the industry
- provide unique opportunities for marketing and networking
- disseminate knowledge and education particularly to younger individuals and new entrants to the market
- co-operate with partner associations across the trade finance spectrum to promote the interests of its members and improve relations with regulators and legislators