

EBA/Op/2020/05

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Opinion of the European Banking Authority on the treatment of credit insurance in the prudential framework

Introduction and legal basis

With the December 2017 agreement, the Basel Committee on Banking Supervision (BCBS) finalised the so-called Basel III framework¹, providing a comprehensive set of prudential standards to be applied from 2022, apart from selected elements such as output floor to be phased-in over a period of five years.

In May 2018, the European Commission issued a Call for Advice on the implementation of the final Basel III framework (CfA) requesting the European Banking Authority (EBA) to (i) advise² the Commission on the implementation of the Basel III reforms in the EU; (ii) assess the impact of the overall package of the reforms and its various components; as well as (iii) report on any other issues or inconsistencies identified in both the current EU regulations and in the revised Basel III standards.

In accordance with the request, the EBA has provided a comprehensive advice in August 2019 including the analysis of impact of the final Basel III framework and its main components as well as an extensive policy advice on the implementation of the final Basel III framework in the EU.³

At the same time, the EBA is finalising its work on a comprehensive repair of the Internal Ratings-Based (IRB) Approach, based on the so-called 'IRB roadmap'.⁴ As part of this program the EBA is finalising the *Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGD (GL on CRM)*.⁵ In the feedback to the public consultations on the said draft

¹ <https://www.bis.org/bcbs/publ/d424.pdf>

² <https://eba.europa.eu/documents/10180/2207145/Call+for+advice+to+the+EBA+for+the+purposes+of+revising+the+own+fund+requirements+for+credit%2C%20operational+market+%26+credit+valuation+adjustment+risk+040518.pdf/fa15db69-5527-4fbc-a0e7-0d8ed46547fb>

³ <https://eba.europa.eu/eba-advises-the-european-commission-on-the-implementation-of-the-final-basel-iii-framework>

⁴ <https://eba.europa.eu/eba-sets-out-roadmap-for-the-implementation-of-the-regulatory-review-of-internal-models>

⁵ <https://eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-credit-risk-mitigation-for-institutions-applying-the-irb-approach-with-own-estimates-of-lgds>

Guidelines, the EBA received numerous requests to consider the treatment of credit insurance in the prudential framework for the purpose of recognition of credit risk mitigation (CRM) techniques. However, most of the issues raised in the received feedback were clearly beyond the scope of the Guidelines in consultation, as they touch upon the reforms proposed in the final Basel III framework. As the issue of the treatment of credit insurance under the revised framework was not explicitly addressed in the report provided to the Commission in the response to the CfA, this additional input is provided here in the form of this opinion. Therefore, this opinion intends to complement the previously provided policy advice with additional considerations related to the treatment of credit insurance as a CRM technique for the purpose of the calculation of own funds requirements. In this regard, this opinion refers exclusively to the specificities of credit insurance and should not be understood as addressing the overall aspects of the treatment of guarantees.

The EBA competence to deliver an opinion is based on Article 16a and Article 8(1)(a) of Regulation (EU) No 1093/2010⁶, as contributing to the establishment of high-quality common regulatory and supervisory standards and practices is one of the EBA's tasks.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors⁷, the Board of Supervisors has adopted this opinion, which is addressed to the Commission.

Background

Unfunded credit protection (UFCP) has been defined in point (59) of Article 4(1) of Regulation (EU) 575/2013 as *a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the obligation of a third party to pay an amount in the event of the default of the borrower or the occurrence of other specified credit events*. While specific requirements for UFCP in Regulation (EU) 575/2013 refer to guarantees and credit derivatives, it has previously been clarified that where the economic substance of credit insurance is the same as the guarantee, and hence meets the definition of UFCP, it can be recognised as CRM for the purpose of own funds requirements in accordance with applicable requirements for guarantees.

In accordance with the current regulatory framework for the IRB Approach the effects of the UFCP can be recognised in the calculation of own funds requirements for credit risk in various manners, either through the substitution, the modelling or the double default approach.

Restrictions to methods for recognising the effects of UFCP will come together with limitations regarding the application of the most advanced approaches with regard to portfolios typically characterised by a low number of default observations. In particular, the IRB Approach with the use of own estimates of LGD and conversion factors (A-IRB Approach) will no longer be available for exposures to institutions, large corporates with annual sales exceeding EUR 500 million and for financial institutions treated as corporates. The final Basel III framework and the CRR classify

⁶ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

⁷ Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/01 Rev4).

exposures to insurance companies as exposures to corporates. Moreover, insurance companies are included in the definition of financial sector entities. It is hence likely that in general the only approaches allowed to be applied to direct exposures to entities providing credit insurance will be the Standardised Approach (SA) or the Foundation IRB (F-IRB) Approach where the use of own estimates of LGD and conversion factors will no longer be allowed. This change will affect not only the risk weight for the direct exposures to such entities, but also to exposures secured by credit insurance.

The following list includes a brief overview of the EBA's view⁸ on the functioning of the current CRR in terms of methods for the recognition of the effects of UFCP, with an indication where the rules are changing under the final Basel III framework:

- **For exposures under the SA**, subject to requirements of Chapter 4 of Title II in Part Three of Regulation (EU) 575/2013, UFCP can be recognised by applying to the secured portion of the exposure a risk weight of the protection provider derived under the SA (risk weight substitution), independently from the approach used to treat the direct exposure to the protection provider.
- **For exposures under the F-IRB Approach**, subject to requirements of Chapter 4 of Title II in Part Three of Regulation (EU) 575/2013, UFCP can be recognised in one of the following manners:

In case direct exposures to the protection provider are treated under the IRB Approach:

- by applying the PD of the protection provider and the regulatory LGD applicable in accordance with Article 236(1) of Regulation (EU) 575/2013 to the secured portion of the exposure (substitution of risk parameters);
- by applying a PD in between the PD of the obligor and the PD of the protection provider and the regulatory LGD applicable in accordance with Article 236(1) of Regulation (EU) 575/2013 to the secured portion of the exposure (PD modelling approach);
- by applying the formula specified in Article 153(3) of Regulation (EU) 575/2013 (double default treatment) subject to the conditions set out in Article 202 and 217 of Regulation (EU) 575/2013 – this approach will no longer be available under the final Basel III framework.

In case direct exposures to the protection provider are treated under the SA:

- by applying the risk weight of the protection provider to the secured portion of the exposure (risk weight substitution).

⁸ For more details please refer to the EBA Report on the Credit Risk Mitigation (CRM) framework and the Guidelines on Credit Risk Mitigation (CRM) for institutions applying the IRB Approach with own estimates of LGD.

- **For exposures under the A-IRB Approach**, subject to requirements of Chapter 3 of Title II in Part Three of Regulation (EU) 575/2013, UFCP can be recognised in one of the following manners:

In case direct exposures to the protection provider are treated under the A-IRB Approach:

- by applying the PD of the protection provider and the LGD applicable to a direct comparable exposure to the protection provider to the secured portion of the exposure (substitution of risk parameters);
- by adjusting LGD estimates⁹ of the obligor to reflect the effect of the UFCP (modelling approach);
- by applying the formula specified in Article 153(3) of Regulation (EU) 575/2013 (double default treatment) – this approach will no longer be available under the final Basel III framework.

In case direct exposures to the protection provider are treated under the F-IRB Approach:

- by applying the PD of the protection provider and the regulatory LGD applicable to a direct comparable exposure to the protection provider to the secured portion of the exposure (substitution of risk parameters);
- by applying a PD in between the PD of the obligor and PD of the protection provider and the regulatory LGD applicable to a direct comparable exposure to the protection provider to the secured portion of the exposure (PD modelling approach);
- by adjusting LGD estimates of the obligor to reflect the effect of the UFCP (modelling approach) – this approach will no longer be available under the final Basel III framework;
- by applying the formula specified in Article 153(3) of Regulation (EU) 575/2013 (double default treatment) subject to the conditions set out in Article 202 and 217 of Regulation (EU) 575/2013 – this approach will no longer be available under the final Basel III framework.

In case direct exposures to the protection provider are treated under the SA:

- by applying the risk weight of the protection provider to the secured portion of the exposure (risk weight substitution);
- by adjusting LGD estimates of the obligor to reflect the effect of the UFCP (modelling approach) – this approach will no longer be available under the final Basel III framework.

⁹ Although where the sole adjustment of the LGD does not allow to fully reflect the UFCP, a simultaneous adjustment of the PD can be justified.

Where the modelling approach is used, the final risk weight is floored at the level of the risk weight of a comparable direct exposure to the protection provider.

The EBA has already provided the Commission with extensive advice on various elements of the final Basel III framework for credit risk in the report published in August 2019.¹⁰ In this report, section 4.2.9. (i) deals with the treatment of A-IRB exposures secured by SA or F-IRB protection providers and the application of the risk weight floor. This section, and the advice included in it, is particularly relevant also for the treatment of credit insurance, as after implementation of the final Basel III framework it is expected that insurance companies will be treated under the SA or the F-IRB Approach.

This opinion includes only specific considerations related to the treatment of credit insurance, which have not yet been included in the previously provided policy advice on the final Basel III framework.

Concerns and considerations

The discussion about the treatment of credit insurance has been initiated in the context of the reforms of the final Basel III framework for exposures under the IRB Approach. The concerns of credit institutions and credit insurance companies relate mostly to higher LGD floors introduced for exposures under the A-IRB Approach, and to the obligation to use either the SA risk weights or the regulatory LGD specified under the F-IRB Approach not only for direct exposures to credit insurance companies, but also to exposures secured by credit insurance. It is argued that the introduction of the proposed higher LGD is likely to reduce the effectiveness of insurance policies for capital management purposes and to limit lending and trade finance. However, the considerations regarding the relative riskiness of exposures secured by credit insurance are more general and apply to exposures under all approaches.

The main argument raised is that the seniority of the credit insurance policies is higher than the seniority of other credit exposures to credit insurance companies. Directive 2009/138/EC (Solvency II directive) requires specific protection of policyholders and beneficiaries, among others by introducing an appropriate ranking of claims. Implementation of these requirements should ensure that insurance claims take precedence over other claims against the insurance undertaking in the event of the winding-up proceedings of such undertaking. This difference in seniority could in principle lead to significantly lower levels of losses, from which the policyholders would suffer, as compared to other creditors of the insurance company.

While under the current framework the level of protection provided by credit insurance can be recognised through LGD estimation, this will no longer be possible after implementation of the final Basel III framework, where much less granular regulatory LGD values will have to be used. The industry is therefore suggesting that these regulatory LGD values should be reconsidered and that additional granularity could be introduced to reflect different risk of credit insurance policies.

¹⁰ <https://eba.europa.eu/documents/10180/2886865/Policy+Advice+on+Basel+III+reforms+-+Credit+Risk.pdf>

Calibration of LGD

When considering the arguments and received proposals there are several elements that have to be taken into account, which have direct influence on appropriate calibration of regulatory LGDs:

1. Seniority of the claims

First, it has to be noted that the LGD estimate for the beneficiaries of the credit insurance policy should reflect the level of losses in the event of default of the insurance company and not the payments expected to be received while the credit insurance company is operating normally. Therefore, the potential losses must be considered in the context of the bankruptcy of the insurance company, taking into account the seniority of the claim in the winding-up proceedings.

Indeed, the Solvency II directive requires that the claims of the insurance policyholders take precedence over other claims against the insurance companies, in particular over the creditors granting loans to credit insurance companies. However, in assessing how efficient this measure is in protecting the policyholders from potential losses, the following elements should be taken into consideration:

- The Solvency II directive offers **optionality for Members States** in how they implement the requirements on the seniority of the insurance claims. In detail, Member States can decide how to ensure that insurance claims take precedence over other claims against the insurance undertaking by choosing one or both of the following ways: (i) *with regard to assets representing the technical provisions, insurance claims take absolute precedence over any other claim on the insurance undertaking*; or (ii) *with regard to the whole of the assets of the insurance undertaking, that they come after claims by employees arising from employment contracts and employment relationships, claims by public bodies on taxes, claims by social security systems and claims on assets subject to rights in rem*. This optionality causes an additional challenge in the calibration of a unique regulatory LGD, as the level of losses for policyholders may depend on the extent of other claims towards the insurance companies. Since the regulatory framework for the insurance companies has been defined in a form of a directive rather than a regulation, the implementation may be different in different Member States.
- The Solvency II directive is relevant for insurance companies established in the EU. However, **credit insurance may also be provided by entities from third countries**, where different regulation may apply. Therefore, specification of differentiated rules for the treatment of credit insurance would also require implementation of specific solutions for the assessment of equivalence of legal and regulatory frameworks in third countries.
- The typical **structure of the balance sheet of the insurance company** is dominated by the claims from insurance policies. Therefore, while the policyholder benefits from the seniority of the claim, the same seniority applies to all other policyholders. Given that the majority of the counterparties of the insurance companies will be treated with the same seniority in the winding-up proceedings, it is very likely that there will not be enough assets

to cover all claims from insurance policies, even if they are treated with the highest seniority.

- The **structure of the balance sheet of the insurance company may change** in the situation of insolvency of such company. The LGD should be calibrated taking into account the structure of claims in the bankruptcy process, these however may be significantly different from the structure of claims in times of normal operation of an insurance company. In particular, the levels of claims of the employees, taxes and security systems may increase in the times of financial difficulties.

2. Economic downturn

The regulatory LGD should reflect the level of losses appropriate for economic downturn. While the failure of the insurance company does not necessarily have to be related to economic conditions, the amounts of claims on credit insurance policies are typically higher during the period of economic downturn. This effect should be taken into account in the estimation of LGD and in case one wants to set different levels of regulatory LGD values for credit insurance policies.

3. Availability of data

While EBA has been presented data illustrating high percentages of payouts from the credit insurance policies¹¹, this data is based on the normal functioning of the insurance companies. However, no data is currently available to the EBA on the levels of payouts to policyholders in the event of default of an insurance company. In particular, there is currently no empirical evidence supporting the claim that in the event of default of an insurance company the losses of the credit insurance policyholders would be significantly lower than 45%, as currently specified in the framework of regulatory LGDs. It is a usual practice and a requirement in the estimation of risk parameters that in the case of lack of sufficient data the estimates should be more cautious, allowing larger margin of conservatism.

Other considerations

It has to be noted that specifying a preferential treatment for the claims on credit insurance policies would not be compliant with the final Basel III framework. The BCBS decided not to provide differentiation between the claims related to insurance policies and other types of claims. The calibration of final Basel III framework was considered from an overall perspective, taking into account the expected levels of own funds requirements. Changes of calibration of selected elements of the framework without considering the others may therefore lead to unintended results.

¹¹ For instance according to ICISA: “Claims performance is within the control of the bank: a recent survey of the top 9 insurance brokers of (single situation) credit insurance for regulated banks over the period 2007 to 2017 reported that 97% of claims made were paid on time/in full; the remainder were “compromised” due to operational failures on the part of the insured financial institution – and yet 44% of the “compromised” amounts claimed were still paid in settlement agreements. There was never a non-payment of a claim due to an insurer’s default.”

The objective of the final Basel III framework was to limit undue variability of own funds requirements by reducing the extent of use of internal models, especially limiting the applicability of models to portfolios characterised by low number of default observations. The less sophisticated approaches lead to the simplification of the framework and greater comparability, although at the expense of lower granularity. Introducing additional categories could therefore lead to increased complexity of the framework. In this case, it would be important that the requirements and the scope of applicability are sufficiently clear to ensure consistent application and avoid unwarranted variability of own funds requirements.

Furthermore, the Basel III framework aimed at limiting contagion between bank and insurance sectors. Certain elements of the framework were designed specifically for that purpose, such as elimination of double default treatment for exposures secured by UFCP, mandatory use of the SA or F-IRB Approach for financial institutions or inclusion of insurance undertakings in the scaling factor for asset value correlation. Specification of a preferential treatment for credit insurance could therefore contradict that intention of the Basel III framework and offset some of the measures included in this framework.

While these are not necessarily decisive arguments for the appropriate implementation of the Basel III framework in the EU it has to be kept in mind that the current CRR already includes certain specific provisions with regard to equity holdings in insurance companies. Contrary to the final Basel framework, which requires that material equity holdings are deducted from own funds, Articles 49 and 471 of Regulation (EU) 575/2013 allow under certain conditions that equity holdings in insurance companies instead be risk weighted.

The EBA would like to stress that any decisions regarding calibration of the framework should be supported by empirical evidence on potential levels of losses. In the case of the treatment of credit insurance policies, such evidence would have to include a sufficient number of observations of the levels of losses realised in the event of default of insurance companies, and in the situation of an economic downturn. In the absence of necessary data, the EBA is not able to present an opinion with regard to the appropriate calibration (upwards or downwards) of parameters in the regulatory framework. Similarly, the EBA has not been able to assess, in the absence of empirical data, arguments by some commentators indicating that the Basel III revisions are likely to reduce the effectiveness of insurance policies for capital management purposes.

Any assessment with regard to the treatment of credit insurance should take into account the fact that such product can be offered not only by independent insurance companies, but also by insurance companies being part of a financial conglomerate, where an institution and an insurance company can be part of the same group. Introducing a preferential treatment of insurance claims may have impact on incentives and business models of the institutions vs insurance companies that are part of the same group, and hence these implications should be thoroughly analysed.

Therefore, a specific preferential treatment would require a clear definition of credit insurance to set out the scope of application, and clear eligibility criteria. This scope of application should duly

take into account the credit insurance providers both from the Member States and from the third countries, as well as detailed provisions to account for various potential group structures.

Finally, the consideration of any of the potential solutions should take into account the overall consistency of the framework and potential interactions, including in particular the effects of the output floor.

Proposals

As presented in the considerations above, the EBA is of the view that the issue of credit insurance is much more complex than a mere recognition of the impact of a potential priority of claims. At the same time, the absence of data does not enable the EBA to make a quantitative assessment of the appropriateness of the framework. While we acknowledge concerns raised by the industry with regard to incentives to use credit insurance as a tool to mitigate risk, the EBA considers that there currently is no sufficient rationale for allowing a preferential treatment to the claims on credit insurance.

In the light of the above, the EBA is of the view that alignment with the internationally agreed standards should be the guiding principle in the implementation of the Basel III framework in the EU. It has to be stressed that the Basel framework was calibrated at the overall level and adding an additional category of regulatory LGD values may require recalibration of the existing LGDs.

Considering all the above, the EBA is of the opinion that the final Basel III framework should be implemented as agreed, including the calibration of the regulatory values of LGD used under the F-IRB Approach, subject to considerations presented in section 4.2.9. of the EBA's policy advice on the final Basel III framework for credit risk.

From a risk perspective it is also important to ensure that the sum of the own funds requirements the insurance company has to hold for insuring an exposure and the own funds requirements the institution has to hold for the insured exposure, is at least equal to the amount of own funds that the institution would have to hold for the same exposure without insurance. Otherwise, credit insurance could be used to arbitrage capital requirements across sectors, which could lead to a structural undercapitalisation of the European financial sector.

This opinion will be published on the EBA's website.

Done at Paris, DD Month YYYY

[signed]

[José Manuel Campa]

Chairperson
For the Board of Supervisors

