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FRENCH BANKING FEDERATION RESPONSE TO DRAFT GUIDELINES ON ON CREDIT RISK MITIGATION

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 340 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 340,000 people in France and around the world, and serve 48 million customers.

The FBF welcomes the opportunity to share its comments on the draft guidelines Credit Risk Mitigation for institutions applying the IRB approach with own estimates of LGDs. Please find our main comments below and our detailed feedback within our answers to the EBA's questions.

1. General Comments

The FBF is very supportive of the EBA's IRB repair program. Nevertheless, as already pointed out in previous submissions the timeframe for implementation of the EBA Future of IRB Approach program is not in line with the scope of the challenges connected to the proposed changes, for a number of reasons. It should be noted that:

- 1) The IRB repair will mean that several models will need to be revised whereas the implementation of the final revision of Basel III will revisit the actual scope of portfolios eligible to internal models. Introducing these two reforms at separate times could lead to banks and supervisors having to carry out work for non lasting models. Simultaneous coordination of the revisions, within the same, but less tight, timeframe, would be a more feasible solution, minimising the resources needed for adaptation for both banks and the competent authorities.
- 2) Some supervisors have adopted their own timeframe on reviewing the implementation of EBA guidelines (e.g. the SSM 2-step approach for the new Definition of Default) and consider that the regulatory changes may constitute material changes and therefore require ex-ante supervisory authorization (Delegated Regulation (EU) No 529/2014.TBC reference). The industry supports such constructive approach and calls for further harmonization across the European Union. However,
 - The ECB as a supervisor for significant institutions have enrolled banks in the application of the two-step approach which anticipates the deadlines written in RTS and Guidelines. Also, the ECB carries on their TRIM on-site missions and the banks will have also to deal with the issued

findings. As an example, a post decision letter for a LDP TRIM mission will be sent by end 2019 for the best case and remediation actions will possibly take 2 years. Therefore, remediation will likely last beyond the deadline of the IRB Repair. That will add a complexity in terms of IRB-repair calendar.

- Similarly, the application of the EBA Guidelines on the application of the definition of default by 1st January 2021 is not realistic despite the 2-step approach promoted by the ECB given the timing constraints. Institutions need more lead-time to ensure proper assessment of operational insertion and adequate monitoring of impacts on models, including adjustment of calibration of the regulatory risk parameters and potential model changes.

Hence, the FBF would **strongly recommend that the date of application of the IRB repair measures be postponed to a date which can be discussed between regulators, supervisors and the industry**, the most relevant date being the date of application of the revised Basel III framework, in order to ensure that both banks and supervisors alike have a satisfactory understanding of the implications of the updated regulatory regime as a whole.

In addition, in CRR2, usage of CRM framework for the purpose of the Large Exposure Framework will be further aligned with usage of RWA purposes. Therefore any change to the CRM techniques (especially UFCP eligibility and / or efficiency) will also have to consider any unintended consequences on Large Exposure Framework. Moreover, while supporting the EBA's initiative on credit risk mitigation, we believe that the proposed consultation paper raises some concerns and requires some clarification.

2. [Detailed comments](#)

Question 1: Do you agree with the proposed clarifications on eligibility requirements in accordance with Article 181(1)(f) of the CRR?

On the Public Hearing in relation with this consultation, we understood from the EBA that some paragraphs will be reworded. In particular, the paragraph 19 is misleadingly stating that re-assessing the legal enforceability of a collateral arrangements in a given jurisdiction for each obligor is required. However, our understanding is that substantive variation to the terms of the contract may be better appreciated by exposure class or obligor type.

The Draft guidelines on CRM for institutions applying the A-IRB approach maintain eligibility criteria that some collaterals might not meet. In some cases, those collaterals might however have a material positive impact on the level of realised LGD. Additional clarification is requested on the appropriate approach to properly acknowledge such cash flows while correcting the associated biases in accordance with the article 127 of the Guidelines on PD/LGD estimation to avoid a systematic overestimation of the unsecured LGD.

Question 2: Do you agree with the proposed clarifications on the assessment of legal certainty of movable physical collateral? How do you currently perform the assessment of legal effectiveness and enforceability for movable physical collateral?

As a matter of introduction, it is important to point out that mobility of a financed asset should not be perceived as a negative factor but rather as an opportunity to enforce the mortgage in the most efficient and lender-friendly jurisdiction.

Please also further note that the proposals of the draft guidelines, if implemented, would have serious implications for European banks involved in asset finance in terms of their requirements for legal opinions.

Paragraph 16, for instance, refers to a “reasonable timeframe” for repossession or liquidation of the collateral but this cannot be covered by the standard legal opinions since this assessment is outside the scope of market standard legal opinions currently available by law firms active in this business. Indeed, as a matter of longstanding international market practice, legal opinions would not address or cover factual considerations or elements. It is also worth mentioning that the enforceability in case of insolvency or bankruptcy is not a systematic and general requirement laid down by the CRR (in Chapter 4, Section 3 of Title II in Part Three). It shall not be considered as an eligibility criterion applicable to all CRM techniques or in every case, but shall only apply where expressly required by the CRR ie for certain CRM techniques such as (i) on-balance sheet netting agreements (Article 205 of the CRR) or (ii) master netting agreements for repurchase, securities or commodities lending or borrowing transactions or other capital markets driven transactions as defined in Article 192-3 of the CRR (Article 206 of the CRR).

Paragraph 20 sub clause (a) refers in particular to the jurisdiction of incorporation of the obligor. We assume that the reference in the draft guidelines to the “obligor” should be interpreted as the owner of the asset (namely the collateral), since the owner of the asset would grant the interest under the collateral agreement in favour of the institution (as creditor). While in practice an opinion in the jurisdiction of the obligor would ordinarily be obtained, this would not confirm the legal effectiveness of the collateral unless that jurisdiction were also the jurisdiction of the governing law of the collateral agreement.

Paragraph 20 sub clause (C) – please note that most countries do not have yet a national rail registry. For this reason, we suggest to amend this sub clause as follows: “the jurisdiction where the collateral is registered, if the institution considers appropriate (...)”. In addition, please see the comment in the preceding paragraph on sub clause 20 (a) and the jurisdiction in which the owner of the asset is incorporated; this is in any case a duplication of sub clause 20 (a).

Paragraph 20 sub clause (d) suggests that legal opinions need to be obtained from “the set of jurisdictions where the collateral could move during the lifetime of the loan according to the collateral agreement”.

This position is not market practice to require certain assets (notably ships and aircrafts) to be operated or located within a limited number of jurisdictions. Rather, it is more common to specify in which jurisdictions the asset may not be operated (e.g. prohibited countries by reference to insurance coverage and/or sanctions legislation). We therefore recommend that sub clause 20 (d) be excluded.

Aircraft finance

With respect to aircraft financing, it is important to note that,

- 1) aircraft are highly moveable assets and aircraft financiers have, over the decades, developed a practice of taking appropriate security in the jurisdictions which are most likely to be favourable to a repossession, in the unlikely event that a default would reach the stage of repossession. For example, English law and New York law mortgages and Cape Town Security Agreements are often used in view of the creditor-friendly remedies offered by this security.
- 2) While security is taken over the asset, a majority of cross-border aircraft financing transactions are structured using an SPV established to act (i) as a borrower of the financing, (ii) as owner of the relevant aircraft, (iii) as grantor of the collateral and (iv) as lessor to the airline operator. Please note that the arrangement of certain transactions may require the setting up of various SPVs for the purpose of the leasing of the same asset. By virtue of the security which lenders take over the shares in these SPVs, lenders can potentially become owner of the SPV, or at least direct the actions thereof, and in this respect have an even stronger right to repossess than as a mortgagee.

In light of the foregoing, and the overall robustness of the combined share charge/mortgage/Cape Town Agreement approach (coupled with ancillary documentation such as Cape Town Convention irrevocable de-registration authorisations (IDERAs) allowing for de-registration of the aircraft from the relevant aircraft registry) the market practice is for the legal analysis of external law firms usually to confirm legal validity and enforceability of finance parties' security interests over the asset and SPV shares and related security/de-registration documentation in the jurisdictions which they consider relevant, taking into consideration local applicable law and the Cape Town Convention and Aircraft Protocol on international interests in mobile equipments (16 November 2001), if applicable.

The jurisdiction in which the institution is incorporated does not seem relevant for the purpose of validating FCP for CRM purposes and we propose to delete it (in 20.a)

We understand that contractual arrangements of Specialised Lending, as defined in Article 147.8 b of the CRR, should give the lender a **substantial degree of control over the assets**. In that context, we require additional clarifications concerning types of financing targeted by the legal requirements for movable assets, defined in the explanatory box, as ***“not being under the control of the institution”***.

Ship finance

While the approach in ship financing is similar to that followed in respect of aircraft financing and mentioned above, there are specific issues to emphasize. In the first instance, banks would arrest the ship and attempt to force a negotiated settlement with the borrower. In an arrest (which would precede the enforcement of the ship mortgage in order to sell the ship) the bank will apply to the relevant court of the jurisdiction in which the ship is physically located to prove it has a claim and obtain an order from that court to arrest or immobilize the ship for a certain period. The arrest puts substantial commercial pressure on the SPV since the ship is prevented from trading and thus earning chartering fees. The bank will only seek to arrest the ship if the jurisdiction where the ship is located recognizes the bank's rights as mortgagee to arrest, allows for arrest to occur without the need first to

obtain a judgment under the mortgage or in relation to the default under the loan agreement and does not impose any formalities or other conditions which would make the arrest unduly impractical, difficult or financially onerous for the bank. Criteria for choosing to enforce a mortgage to sell the ship in any given jurisdiction will be similar to those in relation to arresting the ship. Additional considerations will be practical issues, such as the manner of a sale (private or public).

In a default scenario for ship financings, banks would only seek to arrest the ship or enforce ship mortgages in ports of favourable jurisdictions at which the ship may call, and this would be considered carefully according to multiple criteria on a case by case base depending on the ship's location. Ships, as an operational matter, could move in potentially dozens of jurisdictions during the term of the loan (which is often long – sometimes over 10 years). A ship could in any case deviate from its usual anticipated routes/jurisdictions visited. Banks have systems which allow them to track the positioning of the ships they finance, and plan ship arrests, and obtain legal advice accordingly, when a ship is seen approaching a favourable jurisdiction. Accordingly, it would not be relevant or helpful for banks to have legal opinions at inception of a transaction regarding enforceability of a ship mortgage in all the jurisdictions in which the ship could move during the lifetime of the loan – see paragraph 20.d. of the consultation. Nor is it practicable to establish a restrictive list of jurisdictions in which ships may call – this would be unacceptably restrictive for the ship owner, particularly given the long duration of many loans. Current and longstanding market practice would be for banks to obtain a legal opinion regarding the mortgage corresponding to its governing law.

Finally, banks would not be looking to enforce the mortgage in the jurisdiction of incorporation of the owner of the collateral or the jurisdiction where the obligor is incorporated – see paragraph 20.a. and c. of the consultation. Even less relevant would be the bank's own jurisdiction of incorporation – see paragraph 20.a. of the consultation.

Rail finance

The finance parties usually benefit from security interest over the assets (pledge over railway rolling stocks) and security interest over the cash flows generated by the operation of the assets (rentals, termination values, insurance cover). This is traditionally completed by a security over the shares of the SPV (acting as obligor and as grantor of the collateral over the asset).

Unlike in the aviation industry, where the use of manufacturer and engine serial numbers to identify aircraft objects is the norm, railway rolling stock does not currently have the advantage of a globally recognized unique identification system for individual assets.

For costs considerations, it is obviously not possible to request the granting of a security interest over the railway rolling stock under the law applicable in each and every country in which the rolling stock are supposed to circulate. The security interests are then granted in the countries where the relevant assets are expected to be operated on a dominant basis.

In light of the above, we are of the opinion that these proposals if implemented would therefore require banks to obtain legal opinions from an impractically large number of jurisdictions.

The Draft Guidelines acknowledge that “This may be perceived as a too strict approach because [they] implicitly require the collateral arrangement to specify this set of jurisdictions”. They suggest that an alternative would be for the bank to evaluate “the jurisdictions where the collateral is usually located

according to the purpose of its use” but this may be difficult to establish for an aircraft or a ship as it will not usually be located in a single jurisdiction. This requirement to take security in numerous jurisdictions would create huge constraints and costs for both borrowers and lenders upon the inception of transactions and on an ongoing basis for additional protection that we struggle to understand.

We believe that, beyond the pure enforceability of the collateral agreement under the governing law of such agreement, institutions should be given the flexibility to determine whether, based on the facts of the relevant transaction, any further material value could be obtained by obtaining opinions in the jurisdiction of the flag or of the State of Registration and, if relevant and different, the habitual base of the secured asset.

We welcome the clarification (confirming the EBA Q&A) stated in paragraph 19 page 30 on the various types of legal opinions that could be relied on.

Question 3: Do you agree with the proposed clarification regarding the calculation of realised LGD on exposures covered by eligible on-balance sheet netting or master netting agreements?

Some points have been identified that would deserve further clarification.

Indeed, paragraph 27 page 33 of the draft guidelines is not clear enough. In the explanatory box on pages 33 and 34, the EBA’s expectations are a little more specific where the EBA states that *“as the starting point of the economic loss calculation is an exposure value that already considers the netting effects, no such effect should be considered for the purposes of computing the economic loss in the form of recoveries after default.”* Nevertheless, a clear illustrative example would be helpful to better understand the intended application.

Question 4: Do you have specific concerns related to the recognition of collateral in the modelling of LGD? How do you currently recognise collateral in your LGD estimates?

It is worth noting that the effect of collaterals cannot in many situations be insulated from the other recovery flows in case of default of the customer for the following reasons:

- Bargaining power: the pledge on the assets is a security that incentivize the borrower to repay the bank’s debt in priority in case of default or to grant more favourable terms to secured debt in a global restructuring
- Efficiency: banks will prefer to leave the borrower sell the assets (with the bank’s consent and the proceeds being collected by the bank) rather than to repossess the asset and then to sell it.

As a consequence, **if the effect of the collateral improves the recovery rate of the transaction, its effect cannot be solely measured.**

With regards to the Basel framework, the EBA seems to interpret the revised framework as introducing strong limitations in the collateral effects under the advanced approach. Indeed, eligible collaterals are those whose effect on LGD is modelable (those who are not eligible to the advanced approach would

be subject to the stringent foundation requirement)¹ It's very likely that such reading of this requirement will impose the application of the foundation approach to the large majority of secured exposures which was not the intention of the Basel Committee.

Therefore, the revised CRR should **confirm full latitude to institutions to model the effects of collaterals under A-IRB** by removing any limitation to the modelisation of collateral (ie : no requirement to have enough data to model the effect of the collateral on recoveries)".

The guidelines on PD LGD estimation **require to identify properly the cash flows related to the collateral so as to reflect the effect of the collateral on the basis of the institution's own recovery experience and data**. However, they do not prescribe any specific method to model the collateral effect on realized LGD and do not require the effects of a given type of collateral to be assessed separately for each application scope of LGD models/obligor type. There is indeed to our knowledge no strong evidence that the liquidation value of a given collateral or repossession costs are strongly related to the identity of the obligor or even to the obligor type or the exposure class. **We consider that it is of utmost importance to confirm this lack of restriction for modelling the recovery on the collaterals and to clarify that "ability to recognize a funded credit protection in the estimation of the LGD of comparable exposures to the guarantor" does not "require to find an exposure to the guarantor which is collateralized by the same collateral as the original exposure" as indicated in Section 5.1.C of the guidelines**. Such an interpretation would be unduly restrictive in light of the modelling options defined in the guidelines for PD/LGD estimation and empirical evidences related to the recoveries on collateral. More importantly, considering the provisions of article 39 of the present draft guidelines, it would deprive IRB-A Banks from the possibility of recognizing UCP on most specialised lending exposures benefiting also from a FCP, thereby discouraging them to take guarantees or credit insurance, as:

- ✓ Obligors on these scope often are SPV, which unsecured LGD can only be higher than that of guarantors (be them credit insurers or corporate guarantors)
- ✓ Loss experience on exposure to guarantors secured by the very same type of collateral is limited in case of collaterals of a very specific nature meaning of a nature highly related to the core activity of the obligor.
- ✓ The approach defined in article 39 is to be applied for computing the "RW floor" derived from the articles 161 (3) et 164(2) of the CRR

Question 5: What approaches for the recognition of the unfunded credit protection do you currently use? What challenges would there be in applying approaches listed above for the recognition of unfunded credit protection?

WRT transactions secured by both FCP and UFCP, please refer to our comments to questions 4 and 11.

¹ §87 p69

Question 6: Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?

Independently from the issues excluded from the scope of the guidelines the EBA should also consider in this paper the treatment of an exposure treated under the Standardized or IRB Foundation Approaches and covered by a guarantee where the direct credit exposures to the guarantor are treated under the Advanced-IRB approach. In particular, the EBA should confirm that a substitution is applicable but should also clarify that the requirements for the recognition of the credit protection are those applicable under the IRB Advanced approach and not the chapter 4 as far as the guarantor is subject to the IRB-Advanced approach.

In our view, the clarification of the CRM approaches under Basel III regulation these Draft Guidelines are aimed at providing should be considered jointly with the changes related to the finalization of Basel III to avoid excessive model volatility within a very short timeframe . This joint approach is also needed to better assess the final impact of the changes introduced by both the revised Basel III framework and the present draft guidelines. We are especially concerned by the fact that i/ financial institutions including credit insurers will fall under the F-IRB approach under the revised Basel III framework, with a 45 % LGD ii/ the article 39 for the present Draft Guidelines prescribes to apply Part Three, Title II, Chapter IV requirement both to compute the “RW floor” derived from the articles 161 (3) et 164 (2) of the CRR and to apply the substitution approach when insitutions do not use own LGD estimates for the guarantor. In our view, these 2 categories of provisions should be considered jointly as they will discourage the subscription of credit insurance on a wide range of secured IRB-A exposures. We would recommend both to i/ better recognize the specificity of insurance exposures in the LGD values prescribed by the regulation or to maintain the IRB-A approach for exposures to credit insurers ii/confirm that collateral effects can be assessed independently of the identity of the obligor and reflected as such at the comparable exposure level.

Question 7: Do you agree with the proposed clarification regarding the parallel treatment of ineligible UFCP and ineligible FCP? How do you currently monitor the cash flows related to ineligible unfunded credit protection and how do you treat such cash flows with regard to the PD and LGD estimates?

The EBA’s expectations should be further clarified. We do not understand the need and added value of a regular monitoring as proposed by the EBA.

In our view, the cash flows related to an ineligible credit protection have to be taken into account when determining the recovery rate and then the realized LGD. For this purpose, these cash flows should be treated as if they had been received from the borrower.

Question 8: Do you agree with the proposed rules for the application of the substitution approach? Do you see any operational limitations in excluding the guaranteed part of exposure to which substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures?

Paragraph 30 requires that the exposure should remain in the same exposure class of the original exposure. Also, the introductory part of the Guidelines state that : “even if the PD and LGD of the obligor is fully substituted by the PD and LGD of the guarantor, the exposure should remain in the

exposure class of the obligor in order to retain the nature of the original transaction and the related default information.”. Therefore, our understanding is that it will only impact reporting purposes. However, the paragraph 30 seems contradictory with the ITS reporting which requires : “If an exposure is secured by an unfunded credit protection, the secured part is assigned as an outflow e.g. in the exposure class of the obligor and as an inflow in the exposure class of the protection provider. However, the type of the exposure does not change due to the change of the exposure class.” (source : ITS Supervisory reporting, annex of the COREP instructions, 3.1.1. Reporting of CRM techniques with substitution effect, paragraph 44). In this case, clarification is overall welcome, especially on how requirements stemming from Guidelines will overrule ITS requirements.

As mentioned by the EBA in the explanatory box (pages 38 to 40), the 2 different options would produce the same result in almost all the cases. However, we would like to ask the EBA to consider the following comments:

- The first option is less burdensome from an operational perspective and is the simpler of the two options.
- Also, there may be a calculation bias due to the prudential framework. Indeed, the guarantee amount recognized for RWA purpose may differ from the contractual guarantee amount (cf. haircuts to be applied in case of currency mismatch).
- Under the current CRR, the recognition of CRM is an option for institutions.
- However, some banks consider it is useful to distinguish between the guaranteed and unguaranteed part of an exposure. Indeed, some models may have been designed to estimate the LGD for unguaranteed exposures only.

Finally, none of these two options should have to be automatically applied.

Question 9: Do you agree with the proposed rules for the application of the modelling approach?

The paragraph 36(b) seems to restrict the use of the substitution under the A-IRB approach to situations where recovery costs on the UFP are negligible. We think that the requirement should be removed to avoid creating a distortion between F-IRB institutions that are not subject to this additional eligibility condition and A-IRB institution.

Question 10: What challenges would you envisage for back-testing the substitution approach? Do you agree that the back-testing should be performed rather at Expected loss level? Do you have any approach currently in place for the back-testing of substitution approach?

The article 179(1)c of CRR requires that “institutions shall review their estimates when new information comes to light but at least on an annual basis” in quantifying risk parameters. The review tackles the estimates of credit risk parameters. The notion of “back-testing the substitution approach” seems to be a non-identified object in the philosophy of rating systems embedded in CRR. The current approach in place within banks for the backtesting of credit risk parameters (applicable for guarantors and obligors) insures that the estimates stay robust to additional historical data, and therefore is compliant with CRR.

Question 11: Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure towards the guarantor? What concerns would you have about the calculation of the risk weight floor?

Regarding RW floors, the described methodologies seem to be overly complicated to implement for the weak added value that it brings. If institutions correctly implement a RW floor insuring that the RW applicable post substitution is not inferior to the RW of a comparable direct exposure to the guarantor, we suggest that no harmonisation on the way of calculating the floor is introduced. Hopefully, the RW floor will not be triggered in most cases, therefore we want to avoid creating a black box which is burdensome to implement and monitor, in order to not deviate our effort from the initial objective to take into account risk reduction with sound methodologies.

Besides, regarding the proposed treatment for substitution approach in case of both UFCP and FCP, concerns are raised from the current propositions of the paragraph 39 b. Especially, our understanding is that substitution of both PD and LGD is required. In the best case, substituted LGD is the “LGD of a comparable direct exposure to the guarantor including the credit risk mitigation effects of the funded credit protection”. However, we do not understand the conditions introduced in paragraphs 39 b (i) and 39 b (ii), where we need to verify that the unsecured LGD on the guarantor is inferior. This condition will be a strong issue when applying Basel IV as Financial Institutions will receive a 45% LGD which will be in most cases higher than the LGD for unsecured Corporates. Therefore, the condition will never be fulfilled, and banks will not be able to use the LGD estimates of the original exposure to the obligor including the effect of the funded credit protection. Moreover, if the will is to insure that the risk profile of the guarantor is better than the risk profile of the obligor, we deem that the RW floor will be the adequate backstop. Therefore, we urge the EBA to allow for a more accurate treatment which is to use the LGD secured applicable to the obligor taking into account the funded credit protection, without condition.

One concrete example of impacted activities are deals which benefit from credit insurance. By using Credit Insurance, banks are able to reduce their risks and extend more credit to their clients in support of their industrial strategies.

Supposing the borrower is in default:

- Either the insurer would not be in default and would fully indemnify the lenders, implying no loss at all on the insured part of the loan.
- Either the insurer would be in default, and the insurance company could have access to the asset and its proceeds only after having fully indemnified the lenders. Therefore, in case of default of the insurance company, the lenders would keep the full benefit of the security over the asset.

Therefore, the most appropriate RW is calculated using the PD of the insurer (the default considered occurs only in case of default of the insurer; otherwise no loss at all as indicated above) and the lower of either the LGD of the insurance or the LGD of the underlying secured transaction (as lenders keep the full security over the asset in case of default of the insurer).

This reasoning is based on the existence of a security over an asset. It should not be confused with the double default notion (which is the fact that the cases of default of both the borrower and the insurer are fewer than the cases where only one of them is in default), which is not taken into account in the reasoning described above.

WRT the revised Basel framework, Financial Institutions will be treated under IRB-F approach. Therefore, the levels of IRB-F LGDs will desincentivise any use of CRM techniques when unfunded credit protection is provided by Financial Institutions. In this regard, we would welcome further discussion on the introduction of better risk-sensitivity instead of a single value unsecured LGD (45%) which applies to all Financial Institutions. We think it is a better solution to promote a virtuous circle and incentivise banks to insure their deals with credit protection providers.

Regarding insurance companies, we underline that there are two types of exposures:

- an exposure as lender to an insurance company,
- an exposure as beneficiary of an insurance policy provided by the insurer covering a loan

In this second case, the Solvency II framework provides for a preferential treatment of insurance claims in winding-up proceedings with the insurer. The revised Basel III framework does not differentiate between these two cases and we consider that the application of an F-IRB LGD of 45% is greatly overestimating the LGD given the preferential treatment provided by Solvency II.

See our detailed comments and proposals in annex1.

Please also refer to our comments to questions 4 and 6.

Question 12: Do you consider portfolio guarantees as a form of eligible UFCP? Do they include cases where the guarantee contract sets a materiality threshold on portfolio losses below or above which no payment shall be made by the guarantor? Do they include cases where two or more thresholds (caps) either expressed in percentages or in currency units are set to limit the maximum obligation under the guarantee? How do you recognise the portfolio guarantees' credit risk mitigation effects in adjusting risk parameters?

No comments

Appendix 1: FBF comments on the treatment of Credit Insurance under the revised Basel III framework

Credit Insurance is used to underpin lending commitments in Trade Finance, Export Finance, Commodity Finance, Acquisition Finance, Project Finance (including Infrastructure, Renewables), Corporate Loans, Supply Chain Finance and Asset-based Financing (such as Aviation financing). Therefore, by using Credit Insurance, banks are able to mitigate their risks, reduce the capital weighting of their lending activity, and extend more credit to their clients in support of their industrial strategies. This increased credit capacity in turn allows these borrowers to employ staff; manufacture, trade and export their products; and generate tax revenue for their domestic governments.

ECAs are excluded from the scope of this position paper as we understand that no change is expected concerning the ECAs, since they are being treated as Sovereign counterparties.

In the context of strongly increased Risk Weighted Assets (RWA) applied to banks lending to a corporate, due to the restrictions on the use of internal models (inc. the LGD input floors and the output floor), banks will have a highly increased need for Credit Risk Mitigants including insurance in order to manage their RWAs and continue their lending activities.

In the revised Basel III framework, exposures to insurers will be treated under the foundation approach with a 45% LGD. Intention was to set a LGD floor when a bank has exposure to an insurer and not to set an LGD when an insurer takes risk out from a bank. This very penalizing treatment of insurances is inconsistent with the Solvency II framework which aims to minimize the insurers' insolvency risk especially in regard to their policy holders (who rank in priority to any unsecured creditors). Solvency II also shapes Insurers balance sheet with assets whose size, liquidity, and risk profile must be available to pay claims to policy holders.

Due to the significantly increased LGD on insurance (45%), the risk weights on the covered part of loans would in many cases more than double. The high increase in RWA, even after taking into account the mitigation effect of insurance, compared to current RWA treatment, would have a significantly negative effect on the lending capacity of banks or the pricing at which they lend. This will clearly have a knock-on negative impact on the real economy.

We underline that there are two types of exposures with insurance companies:

- direct exposure as lender to an insurance company,
- indirect exposure as beneficiary of an insurance policy provided by the insurer covering a loan

These are not “comparable” exposures as the Solvency II framework provides for a priority claim on insurance companies that banks hold as policy holders in winding-up proceedings with the insurer. Policyholders are in a privileged position compared to unsecured creditors, in the same way that depositors have preference over unsecured creditors in a bank structure. Banks' priority claim as policyholders is most readily compared to banking depositor preference versus unsecured creditors. In addition, Deposit Guarantee Schemes (DGSs) afford depositors further protection under regulatory supervision. Insurance benefits from a similar scheme. The European Insurance regulator, EIOPA, has implemented an Insurance Guarantee Scheme that functions as a similar backstop resource to the policyholder protection regulations.

The revised Basel III framework does not differentiate between direct risk to an insurer as a lender and indirect risk to an insurer as a policy holder. Therefore, we consider that the application of an F-IRB LGD of 45% would greatly overestimate the LGD of an insurance policy. Banks should be allowed to recognise (depending on the jurisdiction and its respective insurance regulations) the improved LGD of its exposure as policyholder.

Finally, in the case of a deal secured by an asset in collateral, the insurer has no access to any recoveries from the asset until such time as it has fully indemnified lenders. Therefore, in the event of a default by the insurer, lenders will retain the full benefit of the asset in security and the LGD related to this asset should be recognised in the RW calculation.

1. Treatment of credit insurances under the Basel III revised framework

It should be noted that a recent survey of the top 9 brokers of non-payment transactional insurance for regulated financial institutions reported that, over the ten-year period 2007-2017, 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. This survey demonstrates the integrity of the product and its reliability as a credit risk mitigant in the event of a default on the underlying loan.

Credit Insurance whether provided by an ECA or a Private Insurer is an important risk distribution tool and as a consequence a significant instrument for regulatory capital reduction. In an intermediated financial system (as opposed to a disintermediated) Credit Insurance is an effective CRM. Furthermore, its function of risk distribution to the highly regulated and stable insurance industry also makes it a reliable CRM. Insurance is a well-capitalised, well-regulated sector capable of managing the credit risk it underwrites without threat to the stability of the financial sector. Credit Insurance is therefore essential to many European banks.

Historically, Credit Insurance has not had a specific treatment under the CRR and is therefore treated as a “guarantee”. This means that regulatory changes related to credit risk calculation when guarantees are concerned have unintended but major consequences on the use of credit insurance as well. Credit Insurance is used by most banks and, in particular, all major European banks, as a distribution tool at the outset of a transaction to boost their lending capacity or during the life of a transaction to manage exposure.

In the following comments do not deal with ECAs as we understand that no change is expected concerning the ECAs, since they are being treated as Sovereign counterparties

The proposed Basel III reforms (a/o dec 2017) shall have a significant impact on the reduction of efficiency of Credit Insurance viz. RWA consumption. Under article 161.3 of CRR, changing the methodology from AIRB to FIRB using preset LGD values to the risk parameters of insurers, irrespective of whether the Bank is policy holder (under a Credit Risk Mitigant or “CRM”) or lender (direct exposure) will punitively affect the RWA benefit in contradiction to the economic effect of credit insurance. The very high F-IRB LGD to be applied to insurance exposures (CRM) is inconsistent with the requisites set under Solvency II on insurers and does not distinguish the unsecured creditor position vs policy holder position. Therefore, the removal of the A-IRB approach for these insured exposures will have little benefit on the reduction of RWA.

When transposing the revised Basel III framework in the European Union, **we recommend upholding the A-IRB approach² for exposures to financial institutions (including insurance companies) in the specific cases where those insured exposures are used to calculate the impact of credit risk mitigation.**

Alternatively, the comprehensive solution could be to provide a specific treatment for the use of Credit Insurance as a credit risk mitigant within future regulation that would appropriately take into account that, as a policyholder, a bank would benefit from a privileged and senior position to that of an unsecured creditor. The 45% LGD level proposed for unsecured creditors should therefore be significantly reduced for policyholders.

² i.e. maintaining the A-IRB approach to the LGD of the guarantor or insurer

We invite European authorities to also uphold the recognition of the effect of credit insurance via the treatment proposed under Article 153(3) (“Double Default”) of CRR (that has been removed from the Basel dec. 2017 accord), which is another sophisticated option to calculate the effect of credit insurance, and which is applicable to exposures both under the F-IRB and A-IRB approaches. A bank as insured becomes exposed to the potential default of the insurer only if obligor previously defaults, meaning that the probability for an insured bank not to ultimately recover any claim corresponds to the multiplication of the obligor’s and insurer’s probability of default, considering the extremely low correlation of default risk between the obligor and the insurer (as opposed to a Corporate Guarantor to a loan to one of its material subsidiaries or affiliates). The probability that both the obligor and insurer default is much lower than the probability of one of them defaulting.

We estimate that the significantly increased RWA on transactions even after taking into account the Credit Insurance as a credit risk mitigation tool would result in diminishing the banking capital available to support the European companies and would encourage shadow banking, much less regulated than the highly regulated Bank and Insurance industries, to provide financing to European companies.

As Credit insurance policies are bilateral and undisclosed, there is limited public data about the overall market. However, current estimates from a recent ITFA survey show that for only the top 21 banks using the product, the total volume of credit insurance outstanding is USD 97 bn, which supported USD 173 bn of financing. With an estimated 70 banks using credit insurance, the total size of the market is expected to be multiples of these figures. This volume of lending could be jeopardised by negatively impacting the capital relief treatment of the product. This lending capacity is fundamental to economic growth and investments in projects that support the job creation and production capacity of the real economy. The negation of the beneficial impact of Credit Insurance as an entire distribution channel would diminish lending capacity for national flagship programmes such as renewable energy, aircraft financing, and exporting (to take just a few examples). Such regulation could spill over into the whole turnover insurance treatment impacting the domestic and/or international trade financings provided to SMEs.

2. Specific case: a loan secured by an asset and benefiting as well from an insurance

The example of a loan secured by an asset and partially covered by an insurance should also be taken into account.

In the event that the borrower is in default:

- If the insurer is not in default it would fully indemnify the lenders, implying no loss at all on the insured part of the loan.
- If the insurer is in default, and does not indemnify the lenders, then it has no rights to the recoveries provided by the underlying asset. In this case, the lenders retain the full benefit of the security over the asset.

In the event that both the borrower and the insurance company default, the loan is still secured by the asset. Therefore, **we suggest that in case of a secured loan covered by insurance, the RW is calculated using the PD of the insurer** (the default considered occurs only in case of default of the insurer; otherwise no loss at all as indicated above) **and the lower of either the LGD of the insurance or the LGD of the underlying secured transaction** (as lenders keep the full security over the asset in case of default of the insurer).

This reasoning is based on the existence of a security over an asset. It should not be confused with the double default notion (which is the fact that the cases of default of both the borrower and the insurer are fewer than the cases where only one of them is in default), which is not taken into account in the reasoning described above. Should we take into account the double default notion a reduced PD should as well be used.

We also note that providing an insurance on an infrastructure project finance for example, is a way for insurers to participate in this asset class, thus enabling insurers to support the financing of the national energy transition programmes (solar plants, offshore and onshore wind farms mainly in Europe) and the realisation of the Juncker plan.

3. Illustrations

We present here a number of examples so as to illustrate the impact of the Basel reform on Credit Risk Insurance (CRI). The calculation file is available upon request.

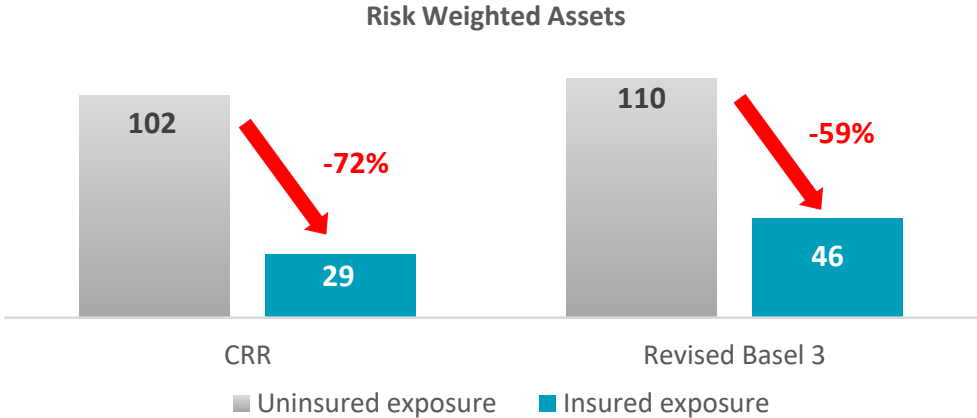
The simulations below show that CRI’s capacity to reduce RWA of the transaction is very significantly diminished under the revised Basel III framework. The increase in RW of the insured exposure is several times higher than the increase in RW of the uninsured exposure. This will inevitably discourage the banks to have recourse to this important risk distribution tool.

The following assumptions are made to estimate RWA:

- We consider that the full exposure (EAD=100) is covered by an eligible credit risk insurance.
- the 1-year PD of the obligor has been set at 1%, representative of a transaction slightly below investment-grade, a good average target to purchase insurance on.
- The 1-year PD of the insurance company has been set at the regulatory floor (0.03% before and 0.05% after the Basel reform): reflecting the rating levels of most insurance companies.
- LGD parameters have been set at average representative levels for the various types of transactions and counterparties, both before and after the impact of the Basel reform
- the insurer is a large financial sector entity. Therefore, the coefficient of correlation set out in the IRB formula is multiplied by 1,25 (under the current CRR and under the revised Basel 3 framework).
- For the sake of simplicity the same effective maturity parameter is used under both the foundation and the advance IRB approaches (5-year in most examples, 1-year for commodities finance). However, it is worth noting that applying a fixed maturity (2,5years) under the foundation approach would highly penalized short term transactions such as commodities financing.
- The impact of the output floor is not measured here

3.1 Unsecured Corporate

Additional hypothesis: it is assumed here that, for the purpose of calculating RWA, the bank replaces the PD/LGD of the obligor with the PD/LGD of the insurer when entering into the credit insurance contract (i.e. *modelling approach, adjust PD and LGD*).

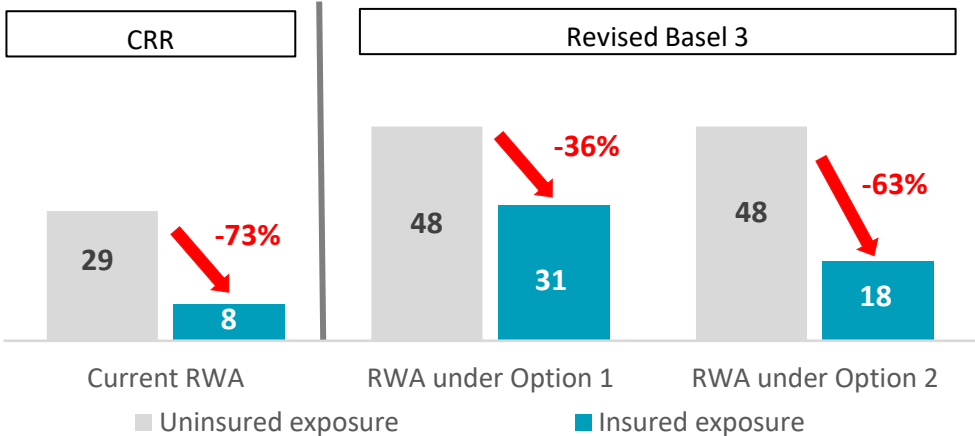


The RWA increases slightly for the unsecured exposure (+8%) but much more significantly for the same exposure when insured. The practical consequence is that the reduction in RWA obtained through credit insurance goes down (59% vs 72% today). This measure is a key consideration for a bank when assessing the effectiveness of insurance: what proportion of the net margin of the exposure can be paid to the insurance company without decreasing the profitability of the transaction? The lower the percentage, the less likely banks and insurance companies are to find transactions that offer sufficiently attractive remuneration to both.

3.2 Specialized Lending – Object Finance

Additional hypothesis:

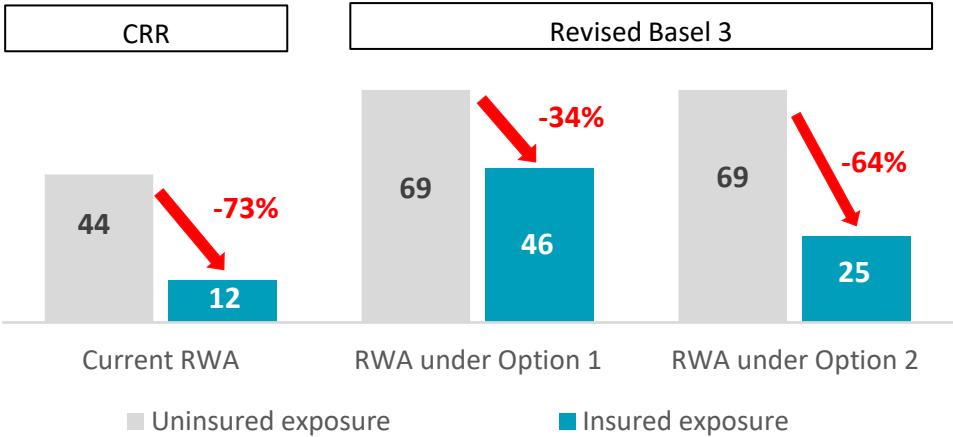
- Under the current CRR approach: it is assumed here that the LGD of the transaction under the A-IRB approach is reduced by the collateral (e.g. aircraft). It is further assumed that, when entering into the insurance contract, the bank replaces the PD of the obligor with the PD of the insurer but keeps the reduced LGD due to the collateral.
- Under the Revised Basel 3 approach, two cases are tested:
 - o Option 1: the LGD of the insured transaction is calculated under F-IRB rules and is therefore much higher
 - o Option 2: the LGD for a comparable direct secured exposure to the insurer is modelled using the A-IRB approach i.e. the object finance transaction's LGD is applied³.



The effect of the Revised Basel 3 framework is much more pronounced for object finance transactions than for Corporate exposures. The RWA of the uninsured exposure rise by 80%. In the meantime, with a reduction in RWA thanks to the insurance of only 36% under option 1, it becomes highly unlikely that banks can offer insurance companies a sufficiently attractive remuneration without jeopardizing their own profitability.

³ See our comments and explanations in section 2.

3.3 Specialized Lending – Project Finance

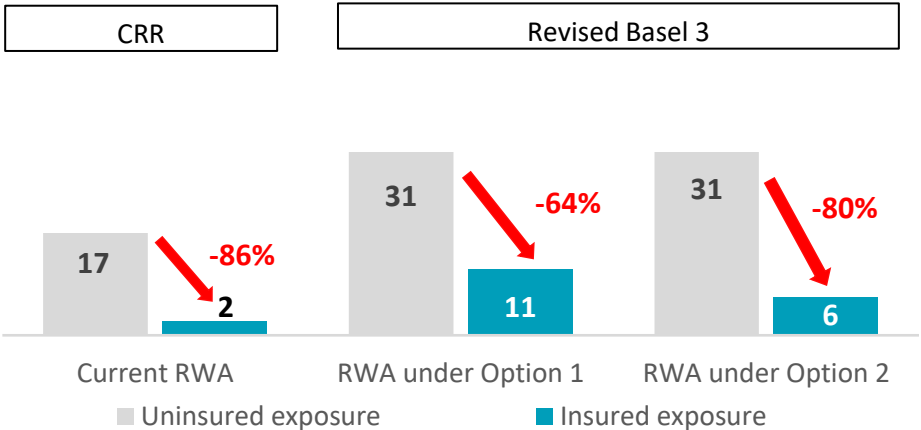


The same options as described in paragraph 3.2 are tested here.

Again, the CRI’s capacity to reduce RWA of the transaction is very significantly diminished under the revised Basel III framework. The RW of the insured exposure under option 1 is even higher than the uninsured RW under the current CRR. Indeed, under the F-IRB approach⁴, a Project Finance transaction should be treated as an unsecured transaction.

In this example, if the RW cannot be calculated using the lower of either the LGD of the insurance or the A-IRB LGD of the underlying secured transaction, the banks will be discouraged to have recourse to CRI as a risk distribution tool thus limiting any bank support.

3.4. Specialized Lending – Commodity Finance



The same options as described in paragraph 3.2 are tested here.

The increase in RW of the insured exposure (x5 under option 1 and x3 under option 2) is several times higher than the increase in RW of the uninsured exposure (x1,8). The prudential efficiency of CRI for these short-term transactions will be questioned by banks.

⁴ Used for the calculation of the LGD input floor

Conclusion:

A bank as insured becomes exposed to the potential default of the insurer only if obligor previously defaults. We suggest upholding the recognition of the effect of credit insurance via the “double default” treatment (as per CRR art 153 §3 of CRR).

The preferential treatment provided by the Solvency II framework for claims under insurance policies (unlike loans exposures to insurers) should be taken into account and we suggest a lower LGD due to the priority senior position of the policy holders.

In the event of a loan secured by an asset and benefiting from insurance cover, lenders keep the full benefit of the asset pledged until such time as the insurer fully indemnifies the banks. For this reason, the RW of the insured part of the loan should be based on the PD of the insurer and the lower of the LGD related to the insurance and of the underlying LGD of the secured transaction, which itself should be kept in A-IRB as the insurance will not affect the recovery provided by the asset.