24 May 2019

Consultation response

EBA Consultation on Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGDs

Introduction

This is a submission from the International Trade and Forfaiting Association (ITFA) in response to the EBA's proposed Guidelines (hereafter 'GLs') on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGD. This response focuses on the impact of the GLs on trade and specialised lending in the context of the private credit insurance market. ITFA is in a unique position to comment on the impact of certain aspects of the GLs as its membership is composed of both bank users of and insurance providers of insurance products that will be impacted by the GLs.

This response contains:

- Details about ITFA;
- General comments;
- Responses to the specific questions raised in the GLs, numbered 5, 6, 8, 9 and 11;
- An annex containing the results of the 2019ITFA Credit Risk Insurance survey.

About ITFA

1. ITFA is an association of financial institutions who are engaged in originating trade and distributing trade-related risk across the industry. Founded in 1999, it brings together over 190 banks and financial institutions from all over the world.
2. 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 for risk mitigation becoming a prominent part of both international and local supply chain finance. In this context, ITFA acts as a valuable forum for its members to interact and transact business together in a profitable and safe manner.
3. You can find more information on ITFA and its members here. ITFA is registered in the Transparency Register of the EU under registration number 659141434941-88.

General comments

4. ITFA welcomes the opportunity to comment on the GLs.
5. Over the past 15 years ITFA member banks, in line with the general market trend, have become active users of credit insurance policies to provide unfunded credit protection (UFCP). These

insurance policies are issued by major international insurers with credit ratings of A- or better and operate according to the same principles as guarantees under Basel/CRR, but are not specifically referenced in Basel/CRR, although their effective role is acknowledged by regulators including the EBA[1].

6. ITFA regrets that the unique characteristics of insurance protection are not sufficiently recognised by the current regulatory regimes and that the EBA should consider in its GLs and its pending Call for Advice on finalized Basel III (CfA) how to make appropriate allowance for this form of UFCP which not only plays an important role in the credit risk management of banks but also facilitates and supports the growth of secure international trade.
7. Regarding the proposed guidance for the estimation of the LGD of comparable direct exposure towards the guarantor, **ITFA would like to emphasise the particular case of insurance used as a credit risk mitigation (CRM) tool which in our opinion warrants a lower LGD compared to those prescribed in the F-IRB or indeed observed in direct exposure instances**.
8. In the case of insurance used as a CRM tool, indirect exposure is in fact more beneficial than direct exposure because of key factors which set insurers apart from banks:
   - insurers are not involved in maturity transformation (unlike banks) and thus not exposed to sudden losses of confidence or 'runs';
   - multi-line insurers present extremely low levels of correlation to the bank's credit cycle.

   All of the above are reflected in external credit ratings being invariably better for policyholder obligations (Insurer Strength Rating) than for creditors (Issuer Debt Rating).
9. In respect of further issues that may be better tackled outside the scope of the draft GLs (and within the scope of the CfA), ITFA provides input on the differentiation that should be made between various types of CRM and especially insurance policies used as a CRM tool. Also excluded from the scope of the draft GLs is the interpretation of the word "comparable" in the definition of risk weight floors: if the transaction benefits from another security, would a comparable transaction be then a secured transaction? Similarly, "comparable" is often interpreted as a bank lending to the insurer when in fact the bank is a policyholder. The current framework does not envisage a policyholder position, which is privileged and senior to that of an unsecured creditor which would apply to a bank as lender to an insurer. Our key concern is that the proposed 45% prescribed LGD for insurer exposure under the final Basel III reforms is not reflective of the reality of that specific CRM tool as it will result in the use of much higher risk weights than the actual risk would warrant and potentially a reduction in lending volumes and trade facilitated by this important CRM tool.
10. A 45% LGD for insurance companies would make it uneconomical for banks to seek insurance in respect of risks that are rated A or above. There are two unintended and related consequences that would impact the real economy:

[1] BCBIS, FAQ6, QIS3, October 2002; EBA, Single Rulebook Q&A 2014_768, 2014, http://www.**EBA**.europa.eu/documents/10180/2087449/**EBA**+Report+on+**CRM**+framework.pdf and also Section 4 [Draft Guidelines], page 29, paragraph 15 of the GLs.

Banks will not seek insurance for better rated risks as the cost of buying insurance would render it uneconomic for them to do so. This in itself is likely to reduce the amount of lending support a bank may have available to its customers and therefore ultimate support to the real economy.

On the basis that banks would be seeking insurance for less rated risks (B or lower) this is likely to result in a considerable reduction in the insurance capacity available for credit insurance risks which in itself will impact the real economy. The reason for this is that credit insurers support bank business on the basis that they participate in a bank's diverse portfolio of risks. If this diversity were taken away and insurers are presented only with the lower rated risks, there are consequences for the sustainability of insurance business in this class. It is likely that this would result in a contraction of the insurance capacity available for credit insurance business as some insurers may no longer have an appetite to participate in a class of business that was not diverse and catered only for the lowest rated risks. Without insurance support bank lending will reduce and this in turn will have a knock-on effect to the real economy.

11. In order to mitigate the above-mentioned concerns, **ITFA is making the following policy asks**:
    i. Maintain A-IRB approach for CRM tools, building on useful clarifications from the current consultation for the purposes of the CfA. OR
    ii. Adopt a minimal LGD for credit insurance (close to zero) to reflect banks' position as policyholder as opposed to unsecured creditors.
    iii. In considering i) or ii) above, one can either create a separate category of Unfunded CRM or not. ITFA is agnostic about it as long as some differentiation is made, which helps neutralise the shift to Foundation Approach at 45% LGD for all FIs[2], which we believe was selected to address direct exposures to FIs rather than CRM provided by FIs.
12. ITFA understands it is not in the EBA's remit to implement the above and is conscious that these asks are out of the scope of the consultation on the draft guidelines. Nonetheless, ITFA feels it is important to draw the attention of all regulators to it and is therefore taking steps to increase awareness of each regulator in the run-up to decisions on the Call for Advice. ITFA is convinced that a strong financial system is one that is diverse where different (i.e., de-correlated) sources of capital co-exist to provide optionality and price benefits to clients and increased security for all market participants.
13. ITFA stands ready to work with the EBA, EIOPA and other relevant stakeholders and regulators on this, including on appropriate definitions and guidelines to provide clarity on credit insurance as an independent CRM tool. Further in-depth evidence and argumentation is provided in the following answers and in an ITFA survey (Annex) which provides hard data to support the policy asks.

[2] The shift to Foundation Approach at 45% LGD for FIs was agreed by the BCBS in Basel III: Finalising post-crisis reforms, December 2017.

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?

14. ITFA welcomes clarifications provided by the EBA's proposed GLs concerning the different approaches available to institutions to estimate the effect of UFCP on the RW under the A-IRB approach.
15. However, these different approaches - as their regulations are currently framed - do not take into account the specificities of the various categories of UFCP used by banks, and in particular credit insurance. This raises the question whether and how institutions can use them depending on the category of guarantee used, the nature or status of the protection provider, the nature of the exposure risk mitigated in terms of financing structure, the nature of underlying exposure, etc.
16. ITFA believes that the current mechanics of the proposed approaches fail to properly capture benefits of certain categories of UFCP. In the case of credit insurance, a bank as an insured becomes exposed to the potential default of the insurer only after the prior default of an obligor. This means that, in reality, the probability for an insured bank not to ultimately satisfy its claim corresponds to the multiplication of the obligor's and insurer's probabilities of default. This is especially true when the obligor (or borrower), the bank (or lender) and the protection provider (like a credit insurer) are not correlated, neither in terms of risk nor in terms of industry systemic risks.
17. Furthermore, the proposed rules for taking into account the effect of the existence of multiple CRMs covering the same part of exposure, such as an FCP and a UFCP, raise several concerns. In many asset-backed financing arrangements, the claims of bank on the obligor are secured with collateral, e.g. aircraft in case of aviation financings, resulting in the addition of uncorrelated layers of protection. Therefore, the final LGD should be reduced to take into account effects of addition of several layers of protection, meaning that the probability of each independent layer being affected is remote given the strength of protection. The rules proposed in the GLs do not allow to properly take into account such layered LGD which is the result of the multiplication of credit protections. Considering that, in the above-mentioned case, the default of the obligor, reduction in the value of collateral, and default of the insurer are risks with an extremely low level of correlation, ITFA invites the EBA to further develop the proposed rules, so that they could reflect the existence of multiple layers of protection on the same part of exposure, each of which reduces the risk of a loss. ITFA wishes also to indicate that the rules should reflect the fact that in the case of multiple credit protections in the form of both FCP and UFCP, banks have the option to choose which protection they wish first to activate following an underlying default or to activate them in parallel.
18. ITFA is concerned that reverting to SA/F-IRB would also lead to an increased dependence on rating agencies, which could lead to lack of reliability as proved during the financial crisis.
19. ITFA would like to flag to the EBA that the lack of distinction by the different approaches between the UFCP categories will become more acute once the finalised Basel III standards are implemented at European level, which will introduce new floors for the LGD and will limit the utilisation of A-IRB on certain low default counterparties.

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

20. ITFA acknowledges that the competence of amending the CRR lies with the European Commission and the co-legislators. ITFA would nonetheless like to flag certain areas to the EBA where the current legislative framework leaves room for improvement in respect of the recognition of credit insurance as a credit risk mitigating factor. ITFA therefore sets out below arguments in the interest of consistency between the current regulatory framework and the future framework as addressed in the CfA.

21. Section 4 [Draft Guidelines], page 29, paragraph 15 of the GLs acknowledges that credit insurance may be effectively recognized as a guarantee or as a credit derivative, depending on the way in which it functions. However, existing grey areas may provoke unintended consequences when the product and market have to comply with regulatory requests.

22. Non-payment insurance[3] has characteristics of both current UFCP tools, but also unique benefits. It has a significant role in providing support for businesses of companies belonging to a wide range of industries and markets[4] and contributes to the reduction of systemic risk. One way to maintain the benefits of non-payment insurance for the real economy in the European Union is to recognize credit insurance and its specific characteristics within the legislative or regulatory framework.

23. Those **unique characteristics and benefits** are particularly evident when <u>comparing non-payment insurance to other risk distribution instruments</u>:

    a. It is important to distinguish between <u>credit enhancement guarantees</u> (enhancing the credit of the borrower, issued by parent companies or by the sovereign owners of public-sector borrowers, and bank guarantees, or stand-by letters of credit issued by a borrower's bank) and <u>exposure management guarantees</u> (guarantees managing the lender's exposure including unfunded risk participations, credit insurance and credit derivatives issued by discrete protection providers).

        i. <u>Credit enhancement guarantees are arranged by the borrower and issued by a guarantor with a close commercial relationship with the borrower</u> and (i) are specifically issued as an inducement to lending; (ii) present a correlated credit risk between a borrower and a guarantor, and (iii) on payment by the guarantor, the borrower's default is cured and its obligation to the lender is discharged.

        ii. <u>Exposure management guarantees are arranged and paid for by the lender</u> and (i) are usually issued by a guarantor/insurer who regards the lender as its client, and who has no relationship with the borrower (indeed the guarantee is often silent to them which is invariably the case with credit insurance); (ii) the credit

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[3] Also known as Comprehensive Private Risk Insurance or CPRI, i.e. insurance paying in case of any non-payment default whatever the cause – as opposed to Political Risk Insurance, PRI, which only pays based on a list of defined perils.

[4] Koen van der Veer conducted a research in relation to trade credit and measured a positive multiplier of insurance on the enhancement of exports (The Private Credit Insurance Effect on Trade, DNB Working Paper N°264/October 2010). Results of his research demonstrate that private Credit Insurance had an average multiplier of 2.3, implying that **every euro of insured exports generates 2.3 euro of total exports.** This is a genuine proof of the beneficial effect private Credit Insurance has not only on particular company or bank but on the general economic activity. Even though, no known researches with similar goal, in relation to non-trade transactions covered by private insurers, have been conducted, similar conclusions can be drawn.

risk of the borrower and guarantor are not correlated; and (iii) on payment by the guarantor, the borrower's default is not cured and its obligations to the lender remain unaltered.

b. **Non-payment insurance policies are bespoke contracts** that create and require a trust-based long-term relationship between banks and insurers. In-depth information sharing on transactions, enabling insurers to properly assess credit risk, is an important advantage compared to other risk distribution instruments where providers require much less information. This is a feature which is especially important in markets where transactions are not concluded over public platforms such as a stock exchange. In the context where transaction banking is typically an over-the-counter market, the underwriting activity by credit insurers adds transparency.

c. Credit Insurance as a CRM tool also **contributes to the reduction of systemic risk due to its risk sharing between banking and insurance markets**. In many other cases, CRM tools distribute credit risk within the banking market, increasing possible contagion in case of economic downturn. Credit Insurance splits risk between two industries, which have a low correlation between themselves. Tools to align interest between the bank and insurer, and to reduce possible moral hazard, are embedded in the design of credit insurance. In order for a bank to keep "skin in the game" and to reinforce bank's prudence and vigilance when entering into underlying transactions, usually a minimum of 10-20% of exposure remains uninsured and retained by the bank. The insurance cover is also most of the time undisclosed to the obligor (borrower). Sometimes, the existence of the policy is not disclosed even after the occurrence of default.

d. Whilst CDS may certainly be useful as a CRM tool for very large corporates that issue bonds and therefore boast liquid CDS and/or cleared CDS, one has to recognise that non-payment insurance is **often the only instrument available** for the vast majority of other credits (asset-based financing, structured, trade-related or smaller corporates). Therefore, Credit Insurance may be more important than CDS **when it comes to facilitating lending to SMEs in the real economy or boosting international trade**. This is the case especially in: a) SMEs and large corporates in developed markets or b) SMEs and many large corporates in emerging markets where CDS are rarely available, and for complex and specialized transactions that require bespoke solutions.

e. **Claims performance is of the highest quality**. Non-payment insurance is well tested and proved to be a well-functioning insurance cover corresponding to the expectations of all parties. According to published statistics in the period from 2007 to 2017 capturing data from the single risk insurance market, 436 claims on banks' policies were made for a total amount of USD 2.68 billion. Out of that number 421 claims were paid in full, within the required timeframe and without difficulties, amounting to USD 2.57 billion. Only 15 claims had to undergo a compromise, mostly due to failure by the bank to comply with insurance policy requirements (and yet 44% of the "compromised" amounts claimed were still paid in settlement agreements). A 3% ratio of compromised settlements over a ten-year period demonstrates the robustness of Single Risk Credit Insurance.

f. The **insurance claim process is in the bank's control**

i. The policy as a personal contract is tailored to the specific exposure that the bank is running. A long-term relationship combined with standardized claims procedure clauses allows predictable communication during the whole process.

ii. To claim under a Credit Insurance is considered as a last resort for banks, whose insurance is designed to provide security during the life of the transaction, and only to be activated in cases when the bank considers that there are no other remedies than to claim under the insurance policy. In practice, respecting the created partnership, it is the norm for insurers to be notified when difficulties with obligors arise, even though a claim might not occur, and other solutions could be found during the "cure period". This practice shows the specific nature and advantage of the insurance contract relationship, resulting from the bank's position of being a policyholder and the provider of financing at the same time.

iii. The claims payment process is prescribed quite tightly and includes a detailed timeframe and specifies the steps and information the bank must take or provide to successfully conclude the process. The fulfilment of warranties or conditions precedent must always be directly in the bank's control.

iv. The insured's rights under the contract, including damages for late payment, are protected by the law applicable to the contract. The policy allows for active engagement by the bank to ensure its claim is processed in an acceptable manner.

g. Due to the credit insurance characteristics (personal and highly prescribed contracts), **there is no basis risk** i.e. no discrepancy between the cover and underlying risk. As the conditions are fully in the bank's control which means, apart from an operational failure on the bank's side where the settlement would be compromised, there is no reason why a bank could not expect settlement in full.

h. **Insurer steps into the shoes of the obligor**. It is common practice in credit insurance policies used by ITFA members for insurers as CRM providers to have the right to choose to pay a lump sum or pay out on the original due dates of the underlying transaction. This is in line with Basel II approach (paragraph 190(a)[5] which enables explicitly the guarantor to either make one lump sum payment or assume the future payment obligations of the counterparty covered by the guarantee. We note that this standard has not been incorporated in the EU's single rule book, which could be easily rectified through an amendment to Article 215 of the CRR.

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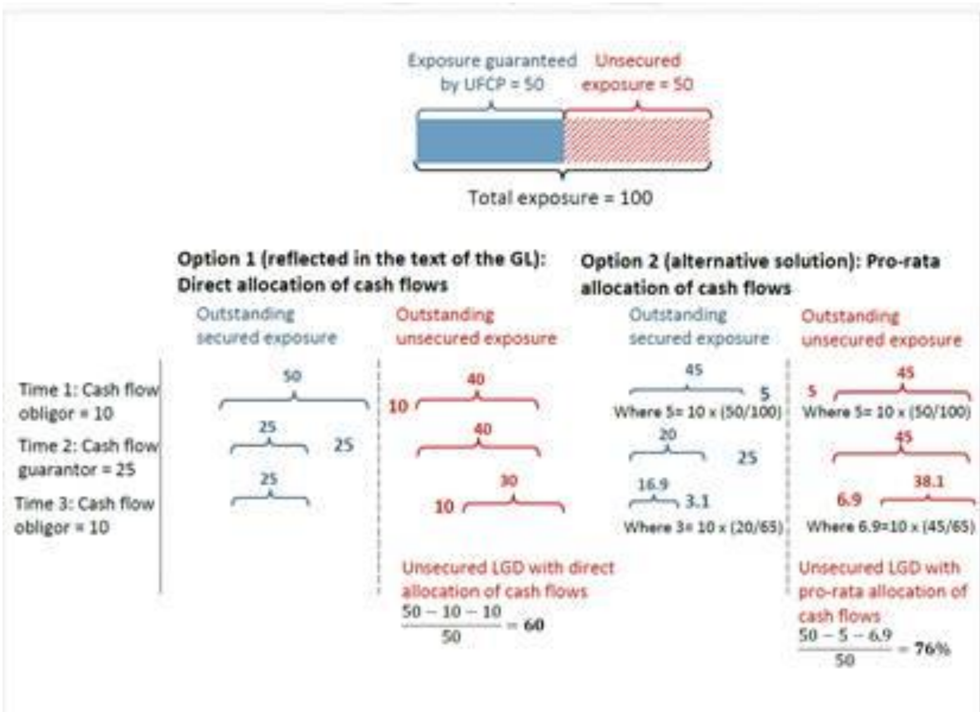
[5] International Convergence of Capital Measurement and Capital Standards, a Revised Framework, additional operational. requirements for guarantees:

190. In addition to the legal certainty requirements in paragraphs 117 and 118 above, in order for a guarantee to be recognised, the following conditions must be satisfied:
(a) On the qualifying default/non-payment of the counterparty, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment.

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?

24. ITFA refers to Figure 1 on page 40 of the GLs (copied below for ease of reference) and the proposal to include Option 1 as the manner in which the guaranteed part of exposure to which the substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures.

Figure 1



25. ITFA appreciates that these options do work in a scenario where the guarantee is a credit enhancement guarantee of the type referred to in paragraph 22.a.i above, such as a guarantee from a parent company in respect of a loan made to its subsidiary.

26. ITFA notes, however, that neither Option 1 nor Option 2 in Figure 1 reflects the accepted credit insurance approach and practice. Credit insurance is provided on an insured percentage indemnity basis i.e. insurers having paid a claim that would have subrogated recovery rights in claiming against the obligor for the amounts not paid. Any recoveries would be shared pro-rata in accordance with the percentage insured. Further, payment by an insurer under an insurance guarantee does not extinguish the obligations of the obligor. Using the Figure 1 example of a loan with a total exposure of 100 of which 50% is guaranteed by UFCP by way of insurance guarantee and 50% is unsecured, the allocation of cash flows would be as follows:

		Outstanding insured secured exposure	Outstanding unsecured exposure
		50 current	50 current
Time 1: Cash flow obligor =10 (allocated pro rata)		45 current	45 current
Default of 50		25 default 20 current	25 default 20 current
Time 2: Cash flow guarantor/insurer =25 (Guarantor/insurer would be paying on 50% basis so this assumes that the obligor has defaulted on a repayment obligation of 50)		0 default 20 current	25 default 20 current
Time 3: Cash flow obligor =10 (50% guarantee prorated; either by (i) Not linked to the defaulted exposure; or (ii) Linked to the defaulted exposure, application of principle of subrogation, recovery is shared pro rata	(i)	0 default 15 current	25 default 15 current
	(ii)	0 default 20 current	20 default 20 current
The LGD on the unsecured exposure will vary from 40% (20/50) to 50% (25/50). It should be noted that the LGD on unsecured insured exposure is 0% because of full recovery from the insurer of all claimed amounts.			

27. The proposal put forward would not change the accepted insurance practice, which by the way also includes strict pro rata sharing of recovery costs.

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

28. ITFA welcomes and appreciates the detail provided by the EBA's proposed GLs, which offer clarity on the CRR rules concerning different approaches, which institutions may use to adjust the risk parameters, notably PD or LGD when estimating the impact of the CRM on the RW.

29. ITFA acknowledges the rules for the modelling approach, as proposed in paragraph 36.a of the GLs, and the flexibility of the design of models to properly adjust the LGD under the modelling approach. However, when credit insurance is used as the CRM instrument, ITFA identifies difficulties for the institutions to comply with paragraph 27.(i)a) page 15 of the Consultation Paper, relating to the back-testing of LGD adjustments. The named paragraph gives clarifications on the application of Article 179(1) (a) of the CRR and provides that the adjustments of LGD estimates should be performed based on the historical experience and empirical evidence and that any theoretical assumptions should be back-tested.

30. The particularity of credit insurance as a CRM instrument is the fact that institutions share risk with stable and sound credit insurers, significantly reducing the possibility of having empirical evidence of default of the protection providers. In the past 20 years, there have been no cases of credit default or bankruptcy of credit insurers. Moreover, in an improbable and hypothetical case of credit default or bankruptcy of credit insurers, institutions using credit insurance would have the preferential treatment of the policyholder, as explained in this document, which further reduces the risk of non-payment by the insurer. The consequence of the efficiency of credit insurance as the CRM instrument is the fact that the LGD should be close to zero, and that institutions can use primarily theoretical models, rather than the data based on the empirical evidence.

31. ITFA invites the EBA to provide more clarification on the following questions:
    a. How can institutions properly make empirical estimates of LGD when cases of default of certain categories of protection providers, in particular credit insurers, have never occurred?
    b. Could institutions use industry data, such as the one provided in paragraph 23 e) of this document, when estimating the LGD of the exposure towards a particular industry, and in particular credit insurers?
    c. Can a more theoretical approach be used indicating that if the unsecured exposed party accounts for an LGD with an element of recovery below 100%, then the senior or secured exposed party should benefit from preferential treatment having an LGD closer or equal to zero?

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

32. ITFA believes the position of banks as insurance contract policyholders should be recognised and that the privileged position that policyholders have in relation to other unsecured lenders should be reflected in a substantially lower LGD. ITFA notes that this issue will be of particular importance for matters related to the CfA and the transposition of the proposed rules for the finalisation of Basel III. Under the proposed new rules, exposures to insurers shall be estimated under the F-IRB approach with an introduced LGD of 45%. In light of everything indicated in this document, such an LGD would not be appropriate to the policyholder exposure to the insurer.

33. We agree that A-IRB banks should have clear policies on the way they allocate various CRM techniques to one exposure and they typically do. The GLs detailed in 37a and 37b are non-contentious. Please note that it is very rare to have multiple unfunded credit protections applying to the same part of the original exposure.

34. It is suggested in paragraph 29a.ii of the draft GLs that when direct exposures to the guarantor are, or would be, treated under the IRB approach, the substitution of both the PD and LGD risk parameters of the underlying exposure with the corresponding PD and LGD of a *comparable direct exposure to the guarantor* is a possible approach. In case of Credit Insurance the exposure of the

bank to the insurer is as a policyholder of an insurance policy, which means the exposure is <u>not comparable</u>.

a. Solvency II provides a general preferential treatment for insurance claims in case of winding-up proceedings of an insurer domiciled in the EU (art. 275, Solvency II). This comfortable position that banks as policyholders have vis-à-vis other claimants in respect of protection providers makes Credit Insurance a very advantageous and stable CRM.

b. According to Solvency II "the Solvency Capital Requirement should reflect a level of eligible own funds that enables insurance and reinsurance undertakings to absorb significant losses and that gives reasonable assurance to policyholders and beneficiaries that payments will be made as they fall due."[6] This is to ensure the main objective of insurance and reinsurance regulation and supervision which is the adequate protection of policyholders and beneficiaries.

c. Whilst not directly secured with collateral, claims of banks as policyholders benefit from the ring-fencing of assets to secure outstanding liabilities to policyholders at the operating company level; bolstered in circumstances where the obligor is in distress by provisioning required by insurance regulators for exposures where the insurer has a potential claim liability. This ring-fencing of assets for the benefit of banks as policyholders should be recognised with lower LGD floors.

35. Additionally, ITFA lays down below further arguments why the future LGD floor of 45% would not be appropriate for the coverage of credit insurance:

a. Since the inception of Basel II, the product has evolved to align with the operational requirements of CRM whilst remaining a policy of indemnity offered (i) under tested insurance law, (ii) by highly regulated insurers with diverse portfolios, strong credit ratings, and based in legal jurisdictions where effective enforcement against the insurer is practicable and (iii) by credit risk experts at these insurance companies providing for a genuine four-eye principle on any covered transaction.

b. As non-payment insurance is not correlated with the insurer's other exposures or liabilities, nor with the bank's exposure to the obligor[7], systemic risk is significantly reduced:

i. As explained above in response to Question 6, the element of risk sharing as a part of the credit insurance design has an important role in systemic risk reduction.

ii. The insurance industry has proved to have large loss absorbing capacity: during the global financial crisis (the period was considered the most difficult test of the non-payment insurance up until now) insurers paid in credit insurance claims

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[6] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 (paragraph 62).

[7] As required by paragraph 123 of Basel III: Finalising post-crisis reforms, December 2017: In order for CRM techniques to provide protection, the credit quality of the counterparty must not have a material positive correlation with the employed CRM technique or with the resulting residual risks (as defined in paragraph 122). For example, securities issued by the counterparty (or by any counterparty-related entity) provide little protection as collateral and are thus ineligible.

about USD 2.5 billion (compared to the amount of approximately USD 100 billion paid in natural catastrophe losses[8]). Private market insurers (with a sole exception) did not have to request state support, did not lose credit ratings, did not reduce their limits and did not stop underwriting the class of business.

The resilience of the insurance market is also reflected in figures from 2017 and 2018: the total economic losses from natural catastrophes and man-made disasters in 2017 were USD 337 billion. Insurance covered USD 144 billion of those losses. Total economic losses from natural catastrophes and man-made disasters in 2018 were USD 165 billion. Insurance covered USD 85 billion of those losses. No recoveries are expected from these losses yet additional capital has already replaced the losses.

iii. Insurers are not involved in maturity transformation (unlike banks) and not exposed to sudden losses of confidence or 'runs'.

iv. Moreover, insurer's exposure to bank lending is insignificant compared to the insurer's overall risk portfolio and is generally favourably treated under Solvency II, given it is uncorrelated to their other exposures.

All of that is reflected by external ratings being invariably better for policyholder obligations (Insurer Strength Rating) than for creditors (Issuer Debt Rating)[9].

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[8] Swiss Re Sigma research; JLT.

[9] The debt ratings of insurance groups are lower than the claims paying rating of an insurer, as reflected in ratings of insurers published by credit rating agencies. Credit rating agencies provide Insurance Financial Strength Ratings which address the insurer's ability to pay punctually senior policyholder obligations and claims, also reflecting the expected financial loss suffered in the event of default. They also assign ratings to specific instruments issued by the insurer or its holding company (Issuer Default Ratings), which are often notched, or rated, below the Financial Strength Ratings. As noted in the Fitch Recovery Rating scale (Fitch Insurer Rating Criteria, 11 January 2019, p.106: https://www.fitchratings.com/site/re/10058790), recovery rates for policyholders could be expected to be well above the recovery rate implied by the 45% LGD floor currently prescribed for financial institutions including insurance companies.

Annex

CREDIT RISK INSURANCE (CRI)

CREDIT RISK INSURANCE (CRI)
SURVEY 2019

Issued: MAY 2019

www.itfa.org
email: info@itfa.org

www.itfa.org
email: info@itfa.org

INTRODUCTION

- This survey was conducted on an anonymous basis by the ITFA Insurance Committee between February and March 2019.
- Some of the most active and significant users of the Credit Insurance Market are included in the survey. These include banks such as BayernLB, BNP Paribas, Commerzbank, DnB, ING Bank, KfW, Natixis, Oddo BHF, Royal Bank of Canada, SMBC, Société Générale, Standard Chartered, UBS and more.
- Results provide a snapshot as at end 2018 of the members' usage of the Credit Risk Insurance market and a split of the total insurance cover provided to the transaction banking sector per sector / rating / obligor size etc.
- Most of the banks that contributed are also members of ITFA, whose membership is made up of 70% of banks.
- Respondents were asked only to consider insurance cover providing capital relief (non-payment credit risk insurance, surety, risk participations by insurance companies), not loss payee positions nor other non-CRR compliant policies. ECA cover is not included in this survey either.
- For the first time, banks have accepted to enter into a comprehensive survey sharing their figures. This was aimed at providing full transparency at a time of consultation and future transposition into law of the reforms of the Basel III rules, which in the past has not captured the specificity of credit insurance. ITFA intends to conduct a similar survey on a regular basis to demonstrate the importance of credit insurance products in particular to European banks.

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EXECUTIVE SUMMARY

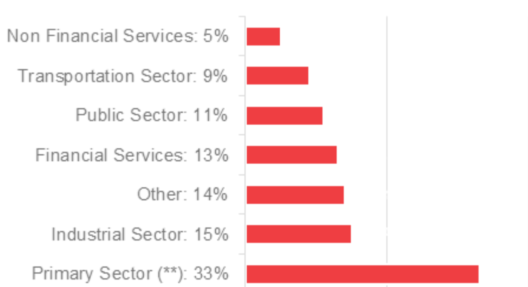
- Over 20 banks responded to the survey. 75% of them are European banks. The sample includes some of largest buyers of credit insurance. ITFA intends to repeat this exercise on a regular basis.
- The quantum of insurance obtained by banks is nearly EUR 90bn and is deemed to have facilitated over EUR 150bn of loans to the real economy. We estimate that the sample, whilst being representative, accounts for only a quarter of the total market for bank-procured credit insurance. Therefore, this topic concerns potentially EUR 600bn of support to the economy.
- Other surveys are being carried out and point to the above figures being on the conservative side.
- European banks are amongst the larger users of the product, mainly for portfolio management purposes but also for capital relief. A lack of recognition of Credit Insurance will impact on the usage of the product, which will in turn hit the economy and trade. Alternatively, it will impact European banks by reducing the capital relief available on the same loan and receivables exposures.
- The survey shows that credit insurance is especially important as a risk mitigation on Non Investment Grade Borrowers/Obligors or specialised finance, which is something Credit Default Swaps cannot fulfil.

QUANTUM OF INSURANCE COVER

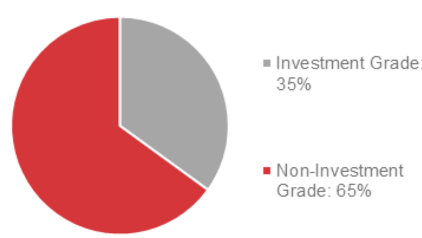
	Amount in EUR bn	# Respondents
Total bank exposure insured as at 31st December 2018	86.8	21
Total bank exposure facilitated*	154.6	17
Total premium paid in 2018	0.46	17

(*) this assumes that the lending would not have taken place to such an extend if insurance cover was not available

Split by Industry Sector



Split by borrower / obligor Rating

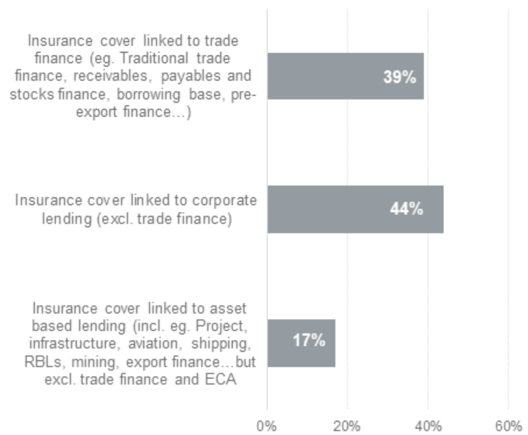


(**) Primary sector = agriculture, mining, natural resources, energy and renewables

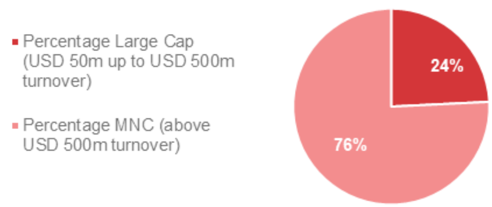
Source: ITFA insurance committee survey Q1,Q2, Q3, Q4 and Q10

MORE DETAILED BREAKDOWNS (1)

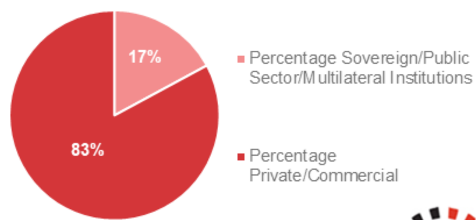
Split by type of exposure



Split by Size of Corporates/Obligors



Split by Type of Borrowers/Obligors



Source: ITFA insurance committee survey Q5, Q6, Q7

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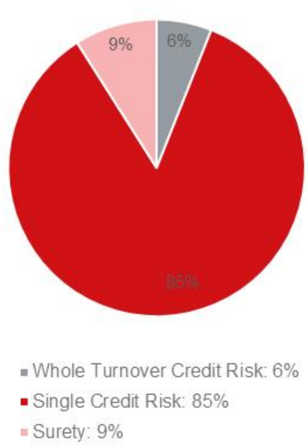
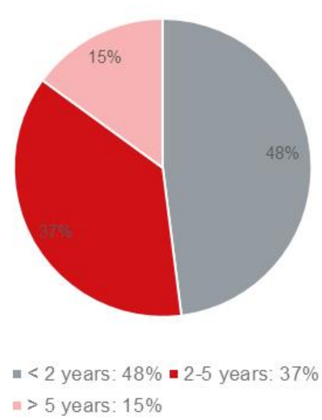
MORE DETAILED BREAKDOWNS (2)

Split by Insurance Product Used



Split by Insurance Policy Period Remaining



Source: ITFA insurance committee survey Q8 and Q9

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SURVEY CONCLUSIONS

- The survey sample indicated up to EUR 0.46n of premium to insurers annually, with 85% related to Single Risk cover. This compares to the worldwide insurance market for Single Risk which is estimated at EUR 2.2Bn insurance premium annually, of which 60% is accounted for by Financial Institutions as Insureds. We therefore conclude that the survey sample accounts for an estimated 28%* of the total market for Credit Insurance for Single Risk, which can be considered as representative.
- The survey shows that EUR 87Bn of Insurance cover supports at least EUR 155Bn of banking facilities provided to the real economy. The Insured Percentage of c. 55% is high enough to suggest that without Credit Insurance, these banks might not have supported to such an extent the corporates benefiting from the underlying banking facilities. As our sample represents an estimated 28% of the Credit Insurance usage, one could see the importance of the topic from the extrapolated figure for 100% of more than EUR 550Bn of support to the real economy.
- ITFA deems the above estimates to be conservative and the total contribution to the real economy might indeed be much larger. Whole turnover credit insurance is for instance a CRR efficient risk cover, which is often taken by subsidiaries of banks or factoring companies which are also subject to CRR. Whole turnover credit insurance has practically not been taken into consideration in this survey.
- European Banks are the most extensive users of Credit Insurance to manage their exposures and resources. A lack of recognition of Credit Insurance will impact on the usage of the product. BCBS released in March 2019 2nd QIS on Q2 2018 data: for Group 1 banks (80 across regions), the impact of Basel 4 will be very significant for European banks (+21% vs American banks +1.5%). It is important to recognize Credit Insurance properly when transposing Basel 4 or reviewing the current Basel 3 framework for A-IRB on CRM, to avoid a double hit on European banks.
- As shown on page 3, Credit Insurance allows risk mitigation on Non Investment Grade borrowers/ Obligors. Credit Insurance therefore provides a complement to other Credit Risk Mitigation tools such as CDS which only provide cover on a limited population of Investment Grade corporates. Moreover, unlike CDS, Credit Insurance provides bespoke solutions to industries or bank financing structures as shown by the survey.

*footnote: (460x0.85) / (2200x0.60)) x 100 = 28%

APPENDIX: SURVEY QUESTIONS

1) What is the total aggregate amount of risk covered / outstanding insured amounts as of end of 2018?
2) What is the total amount of lending / finance / facilities insured to which amount in 1 above is applied?
3) Please indicate the Credit/Risk Rating breakdown of outstanding amount insured:
4) Please indicate the breakdown of outstanding amount by industry sector:
5) Please indicate the breakdown of the outstanding amount by type of exposure:
6) Please indicate the breakdown of outstanding amount by corporate size:
7) Please indicate the breakdown of outstanding insured amount by obligor type:
8) Please indicate the breakdown of outstanding insured amount by insurance product used:
9) Please indicate the breakdown of outstanding amount insured by insurance policy period remaining:
10) What is the total of insurance premium paid in 2018 on instalment of new and prior year's policies?
11) General Comments (if any)

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