



The Basel Committee on Banking Supervision

24<sup>th</sup> June 2016

Dear Sirs,

This is a submission from ITFA, a major international trade finance association, in response to the call for comments to the consultative document “Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches” dated March 2016 (“BCBS 362”).

Insurance operating as guarantees has become an important source of Credit Risk Mitigation (CRM).

The role of insurance has not previously been considered in detail by the Basel Committee and non-payment insurance can be differentiated from other conditional guarantees.

BCBS 362 may reduce the effective use of insurance, and by crimping banks’ ability to mitigate credit risk, constrict the flow of trade finance and other lending into emerging markets.

It is recommended that the Committee examine in detail the role played by insurance as guarantees in CRM and consider the implications of the proposed application of the Standardised approach to insurer counterparty ratings and to conditional guarantees.

The International Trade and Forfaiting Association (formerly the International Forfaiting Association) was founded in 1999. ITFA is a trade association whose members are involved in the financing of international trade.

The membership of 142 companies registered in 35 different countries is composed mainly of banks, but includes other financial institutions, insurers and insurance brokers.

The ITFA acts as a forum for its members located all over the world to interact together, with a mission statement which includes: working to continuously improve governance and best practice; contributing to shaping rules, laws and documentation which affect its members and the industry; facilitating trade.

For further information see <http://itfa.org/about-us/>

### **Credit Risk Insurance (CRI)**

Insurance supports trade finance in two main product areas:

1. Short Term Trade Credit Insurance – which covers both domestic and cross-border receivables, normally up to 2 year credit periods, typically on a portfolio basis.
2. Structured Credit Risk Insurance – which covers a range of more complex credit risks, ranging from short term documentary credits to long-term project finance exposures.

Both are important because they enable banks to obtain Credit Risk Mitigation (CRM) when the insurance is issued in accordance with the principles set out in Basel II (see Appendix 1 for Basel II - CRR references).

For the purposes of this note we will use the generic term **CRI**.



Unfunded credit protection can be provided by insurers as eligible protection providers – see Basel II para 195 and 483. The conditions governing such credit protection are set out in Basel II paras 189ff and 484.

Standardised Banks, as well as FIRB and AIRB banks are able to recognise the effects of CRM.

The most active users of CRI as a risk mitigant are AIRB banks who are also able to benefit from the conditional guarantee recognition set out in Basel II para 484.

There are currently over 50 insurance entities offering CRI in the global insurance markets (London, Paris, Switzerland, New York, Bermuda and Singapore).

They have been providing this coverage for many years and currently are able to offer significant capacity any one transaction, for significant coverage periods.

Key underwriting criteria have been established to ensure that the insurance supports underlying trade transactions and traditional banking activities, including project finance and asset backed transactions

CRI insurers also provide cover to Export Credit Agencies and multilateral financial institutions

These insurance entities are highly regulated, with stable credit strength ratings and offer CRI as part of a diverse, multi-line business.

From the banks' position it is important that the CRI insurers be diversified insurance companies, affiliates or divisions of general insurance groups. Strict controls on insurer counterparty commitments are applied

From the insurers' view it is important that this risk area be uncorrelated with their other exposures such as property and casualty and that the underwriting process be limited to specialist units with aggregate exposures controlled by obligor, country and sector.

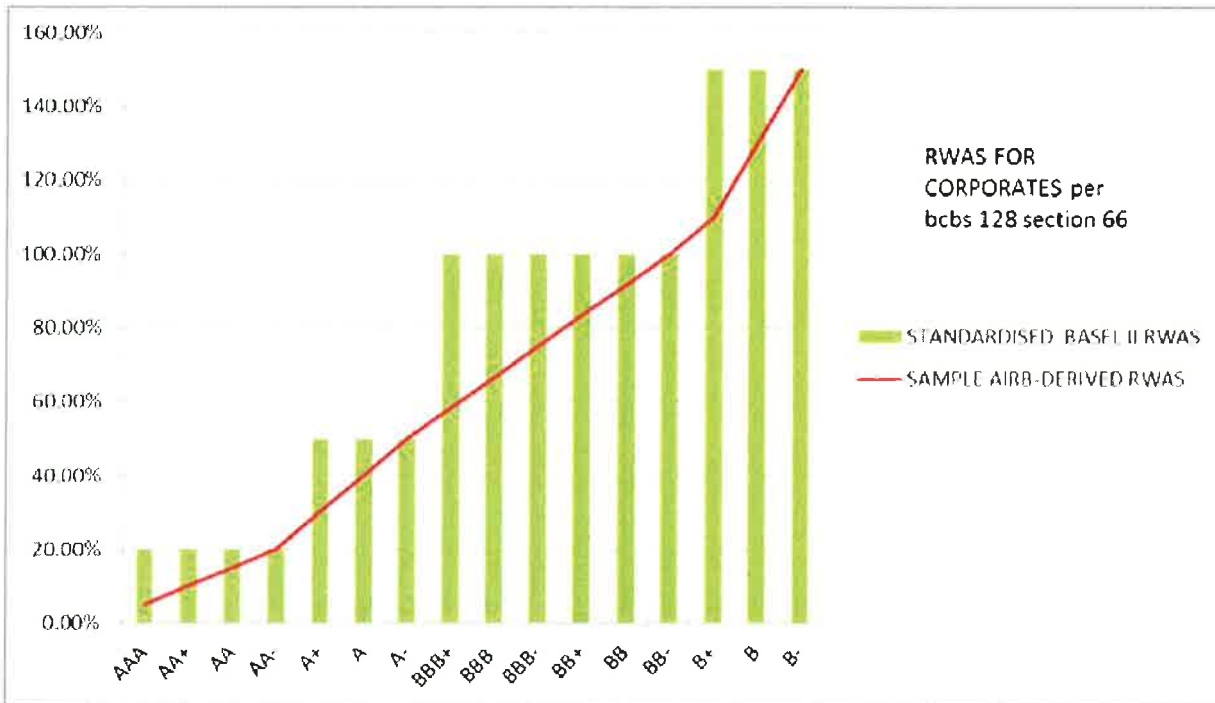
CRI enables banks to continue to support their customers and to finance trade by relieving pressure, sharing risk and maintaining business activity via:

1. Portfolio risk management - mitigate concentration in countries or on obligors/borrowers
2. Individual risk distribution – single credit risk mitigation
3. Capital efficiency - regulatory capital management
4. Market positioning - ability to maintain position or access new clients via a tool used in parallel to, but not a replacement for, traditional distribution methods



ITFA observes that the effect of BCBS 362 is to require banks to set aside more capital, as the chart below suggests, showing a schematic of a theoretical AIRB RWA curve.

It will skew the risk-reward dynamic to favour higher risk borrowers in each of the RWA categories:



The distortion observed in the previous chart will also affect the value/ranking of the CRI protection provided by CRI insurers.

It will not appropriately reflect the greater financial security of the lower-rated insurers in the relevant risk bands.

It may reduce the banks' ability to rely on CRI as effective credit risk mitigation – and thus reduce bank lending and trade finance.

Insurers would potentially lose a good source of uncorrelated risks to assist in balancing their portfolio. To date the counterparty treatment of CRM insurance guarantees has assumed that insurance contract exposure is identical to that of an unsecured loan to the insurer.

However this does not take into account the transactional specifics and the context of insurance:

1. The claim on the insurance guarantee will only occur in the event the insured obligor has defaulted - a double trigger contingency.
2. The claim which an insured party - as a policy holder - has on an insurer is of stronger nature since the insurer has to maintain policyholder/risk reserves – in effect giving a priority over general unsecured creditors



In BCBS 362 Section 4.5 it is proposed that under the AIRB approach, conditional guarantees may be recognised if the bank can demonstrate their effectiveness (paragraph 484 of Basel II). The Committee proposes to amend this text to follow the Standardised and FIRB approach, which prohibits conditional guarantees. However, it will also clarify which types of guarantees are regarded as conditional. Specifically, guarantees that only cover loss remaining after the workout process will be regarded as unconditional, as long as they do not contain any clause outside the direct control of the lending bank that could prevent the protection seller from being obliged to pay. These types of guarantees will therefore remain eligible credit risk mitigants.

The extent of permitted conditional guarantees needs to be clarified. As the text above currently stands, it is unclear whether the AIRB banks' normal CRI policy forms will continue to provide eligible CRM.

**The potential consequences of prohibiting AIRB banks' use of conditional guarantees will be to reduce the amount of CRI market capacity and thus to reduce bank lending and consequently trade finance capacities of banks for their customers.**

Insurance, although a conditional instrument, has responded consistently in paying claims to banks under non-payment policies, justifying banks' treatment of insurance policies as guarantees.

Insurers view their role as back-stopping the risk management efforts of banks through the prompt payment of valid claims upon the default of the underlying obligor.

Significant work has been done by the insurance industry and insurance teams within banks to ensure that banks are aware of and appropriately address operational requirements of policies.

### **ITFA Recommendations**

**ITFA recommends that the Committee note the importance of private credit insurance (as well as public ECA cover), and its trade-enhancing properties and that the Committee give serious consideration to:**

- 1. Eliminating or reducing the distortion which the step- function RWA ratios of the Standardised Approach impose on the treatment of Insurer counterparty ratings.**
- 2. Treating Insurer counterparty exposures arising from CRI policies separately (possibly via a Credit Conversion Factor) to reflect their contingent nature and more privileged quality.**
- 3. Permitting AIRB banks to maintain their tried and tested practice of using conditional guarantees as permissible insurance guarantees**



The ITFA remains at the disposal of the Committee and is ready to provide any further supporting information which may assist the Committee in its deliberations of the ITFA Recommendations.

The ITFA believes that the protection provided by insurance guarantees is fully aligned with the ultimate aim of the regulator: enabling banks to be more resilient while supporting the economy and its growth in a stable environment.

A handwritten signature in black ink, consisting of a stylized, cursive-like script followed by a horizontal line.

The International Trade & Forfaiting Association