Are you a credit insurer? Or a bank which relies on credit insurance?
Now is the time to respond to the PRA's consultation on unfunded guarantees

It has now been two months since the PRA opened a consultation on the eligibility of unfunded guarantees as a form of credit risk mitigation for banks. The consultation will remain open for responses for two and a half more weeks - until 16 May 2018.

Although the consultation relates to banking regulation, the consultation has caused deep concerns for credit insurers. This is because credit insurers provide a large proportion of the credit risk mitigation protection on which banks rely. If brought into force, some of the proposals made by the PRA in its consultation paper would make many traditional credit insurance products ineligible as a form of credit risk mitigation for banks.

We have been working with some of our clients to consider how the PRA's proposals might affect credit insurers and the products they offer. From our discussions it is clear that there are some points of concern for the industry as a whole – some highlights are below.

How are bank regulatory capital requirements calculated ?

The regulatory capital requirement of a bank depends to a large extent on credit risk. Debts owed to the bank are called "exposures". In calculating the capital requirement, the amount of each exposure is multiplied by an applicable risk-weight, and the results are added together. So if the risk-weight can be reduced, the resulting capital requirement can also be reduced.

The risk-weight depends on the perceived riskiness of the relevant debtor, which is often reflected in the rating of the debtor. For example, the risk-weight is 100% for a corporate borrower which has a BBB rating, but only 50% for a corporate borrower which has an A rating. The associated capital requirement of the bank for the second borrower is therefore half what it is for the first borrower.

The EU Capital Requirements Regulation ("**CRR**"), which is the source of the regulatory capital rules for EU banks, allows a bank to reduce the risk-weight that applies to an exposure in certain circumstances. These circumstances include where the exposure is subject to a guarantee that satisfies certain eligibility criteria. The guarantee is a form of "credit risk mitigation". So long as eligibility criteria are satisfied, the rules allow the bank to apply the risk-weight of the guarantor rather than the risk weight of the original debtor.

So if a bank can rely on a guarantee provided by a A-rated credit insurer, it can halve the capital requirement that would otherwise apply to a loan made to a BBB-rated corporate borrower. Such a guarantee is regularly provided in the form of a credit insurance policy.

For banks with billions of pounds of exposures on their books, credit insurance can result in huge reductions to their capital requirements.

Although we refer in this paper to "banks", what we say is equally applicable to investment firms regulated under CRR.

The question addressed by the consultation:

In its consultation, the PRA has addressed the question: in what circumstances should a guarantee be counted as an eligible form of credit risk mitigation? Its consultation contains proposals which go to the heart of the eligibility criteria.

This question arises because many of the rules themselves, as written in CRR, are not clearly defined and leave considerable room for different interpretations to be applied. This results in uncertainty and different practices developing in different banks.

This is an unsatisfactory situation, and at first sight there is considerable merit in seeking to remove the uncertainty and have a harmonised interpretation of the rules.

However, the PRA's proposals differ markedly from current practice in credit insurance policies which are currently used for credit risk mitigation. They are a much stricter interpretation of the existing requirements than banks, insurers and their advisers have come, over many years of experience, to think is required.

It is worth noting that the PRA has only focused on unfunded credit risk mitigation. Arrangements that rely on funded credit risk mitigation, such as security arrangements, title transfer collateral arrangements and netting arrangements, are not affected. In addition, the PRA made clear that its views do not apply to the interpretation of the Solvency II rules that apply to insurers when they are acting as lenders, even though those rules contain text which is virtually identical to some of the CRR rules addressed in the consultation paper. It is hard to see how the PRA could give a different interpretation to the same words in different EU regulations, so we recommend that insurers who invest in guaranteed loans should pay close attention to the developments resulting from this consultation paper.

The PRA's proposals

- "**Pay out in a timely manner**": the PRA proposes that "*the pay out should be made without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due…*". This statement represents the PRA's interpretation of Article 213 of CRR, which requires that there is no clause "that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due" and Article 215 of CRR, which requires that "on the qualifying default of or non-payment by the counterparty, the lending institution has the right to pursue, in a timely manner, the guarantor for any monies due under the claim". The PRA has indicated some exceptions to this requirement, which are embedded in CRR, such as where the guarantee covers residential mortgage loans.

  However, non-payment insurance policies commonly have payment periods that are much longer than this, such as a requirement for the insurer to pay out within 30, 90 or 180 days of receiving evidence in support of the claim. This proposal could be problematic for the industry. There may be practical difficulties in expediting payments to occur within just a few days of a claim being made. We discuss this issue in the next section of this note.

- "**Legally effective and enforceable**": the PRA proposes requiring a firm to satisfy itself that the guarantee is enforceable under its governing law and in the jurisdiction where the guarantor is incorporated as well as other jurisdictions in which enforcement action may be taken. This is consistent with our existing interpretation of Article 194 of CRR.

  The PRA has indicated that it would expect the independent legal opinion on this to cover all the eligibility criteria – and not just the criteria of enforceability. It would seem that the legal opinion should cover the requirements in CRR Articles 201, 213 and 215. This marks an expansion in the scope of the legal opinion firms require. Read literally, CRR only requires the legal opinion to address effectiveness and enforceability, as provided in Article 194 of CRR. Nevertheless, many banks already ask their legal advisers to address the other eligibility criteria, so this expansion is unlikely to be regarded as particularly problematic.

- "**Clearly defined and incontrovertible**": the PRA proposes to give a definition to the requirement in Article 213 that "the extent of the credit protection is clearly defined and incontrovertible". It explains that this requirement means that "*the wording of the* *guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, and challenge or otherwise seek to be released from, or reduce, their liability*."

Again, this could be considered an expansion in the scope of the CRR requirements, since CRR does not itself define "incontrovertible". However, the PRA's proposed definition is consistent with the approach that we adopt in advising banks on the meaning of incontrovertible, and it is useful that the PRA has included the word "practical" in the passage quoted above – since there is always the possibility that a guarantor may dispute its liability even in the face of the clearest possible evidence. We think most forms of credit insurance policy would satisfy this requirement, and it is reasonable to expect those that do not to be made clearer. However, this is subject to our comment below regarding policy exclusions.

- **Exclusion of certain types of payments**: The PRA proposes to give guidance on the requirement in Article 215 that either (i) the guarantee covers all types of payments the obligor is expected to make in respect of the claim; or (ii) where certain types of payment are excluded from the guarantee, the lending institution has adjusted the value of the guarantee to reflect the limited coverage. The consultation paper says that for this requirement to be satisfied the limited coverage must be "quantifiable", and gives an example of interest payments being excluded, which it says is acceptable.

  The problem that this creates for credit insurance is that typically there will be other exclusions in the policy. A common example is that credit insurance policies written by Lloyd's syndicates are required, under Lloyd's rules, to include an exclusion for losses resulting from nuclear events. Ordinarily, the practice of banks has been to consider that this exclusion can be treated as a type of payment that is not covered, and can therefore be dealt with by an adjustment to the value of the guarantee - which may be an adjustment of zero given the irrelevance of the exclusion to most types of credit insurance policy. However, this would no longer seem possible given the PRA's guidance.

  This is an area where more general guidance from the PRA in relation to exclusions would have been very helpful. In particular, the PRA has not commented generally on what exclusions are permitted in the guarantee without infringing the requirement in Article 213 that there must be no clause "the fulfilment of which is outside the direct control of the lender" which could result in the guarantor not being obliged to pay out. This is a considerable source of uncertainty in analysing these policies. In addition to clauses like the nuclear exclusion, typical exclusions include losses caused by the fraud of the bank and losses caused by the insolvency of the bank. Arguably the bank has control over whether it commits a fraud (although query whether it can realistically control the acts of all of its employees), but it does not have control over whether it becomes insolvent (otherwise no bank would become insolvent).

  The answer often given to these points is that no loss is ever likely to be caused by the bank's own insolvency – losses are the result of the underlying borrower's insolvency not the bank's. But this answer can be disputed (borrowers who are on the brink of insolvency may well choose to repay a solvent bank before they repay an insolvent one, and the resulting delay may mean that they never pay the insolvent bank due to becoming insolvent themselves in the interim period).

  Guidance from the PRA on these issues would be helpful.

The legal foundation of the PRA's interpretations

If the PRA's proposals are implemented they will be added as a new chapter 7 as part of Supervisory Statement 17/13: Credit risk mitigation. This supervisory statement represents guidance of the PRA given in respect of the directly effective rules in CRR. As guidance, the supervisory statement would not in itself be legally binding.

However, it would represent the PRA's interpretation of the CRR rules and, since the PRA is the enforcer of those rules against UK banks, its interpretation of the rules is of great importance. It is the PRA's interpretation which will determine whether regulatory action is taken against a UK bank for an alleged breach of the CRR rules. While a bank could refer an adverse decision to the Tribunal, it would be likely that the Tribunal would also pay considerable regard to the PRA's interpretation in the absence of a clear mistake of law or procedural error.

The European Banking Authority, which has power to issue guidance on provisions of CRR, has not issued any guidance on the meaning of "timely manner". Nor, as far as we are aware, has any other regulator in any EU member state, or any regulator responsible for implementing the Basel requirements on which CRR is based. The PRA therefore appears to have struck out alone in giving this guidance.

Two important points should be noted:

- First, the PRA's consultation is not due to a change in the law itself. The Articles of CRR that it interprets have been directly effective law in the UK since the CRR became effective on 1 January 2014, and before then the PRA's own rules, and before that the FSA's own rules, contained very similar requirements. These rules formed Chapter 5 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). For example, the "timely manner" requirement was in BIPRU 5.7.11. The PRA must be taking to be saying that its interpretation is already the law, and has been the law for many years.

- Second, the CRR rules that the PRA is seeking to interpret do not themselves create any distinction between different types of guarantee. As we will explain in the next section of this note, credit insurance is one form of guarantee, but there are other forms. Since the underlying rules do not distinguish between the different forms of guarantee, it is difficult to see how the PRA's guidance could apply differently. Accordingly, if the PRA's proposals are implemented through the publication of the new guidance, trying to argue for this guidance not to apply to credit insurance will be very difficult.

Were these proposals written with credit insurance in mind?

Interestingly, the PRA's proposals refer throughout to "guarantees". They do not once mention credit insurance as specific type of guarantee. It is conceivable that the impact on credit insurance was not considered by the PRA when it wrote the consultation paper.

Credit insurance is not the only form of guarantee on which banks rely for credit risk mitigation. Another significant type of guarantee is a guarantee given by another bank, for example in the form of a risk participation agreement. Risk participation agreements typically have much shorter time limits for payout, so will not be nearly so affected by the PRA's proposals as credit insurance will be.

The reason for this is that banks are accustomed to investing in a wide range of assets, including very liquid assets to cover amounts that they may have to pay out at short notice – for example, the balances on instant access deposit accounts. For banks who provide guarantees, being subject to a short payout period is not unduly problematic.

On the other hand, insurers generally only have to pay out if and when a claim is received. If a claim is received then there is usually a period of time during which the claim is assessed, and it is useful to have a waiting period to see if the defaulting borrower will make payment, even if the payment is well after the due date. This provides time in which assets can be sold if necessary to generate the cash needed to make payment of the claim.

As a result, insurers have become accustomed to investing in less liquid assets than banks because they know they will have time to liquidate the assets if they do have to pay a claim. These assets generally produce a greater and more stable investment return for the insurer.

For the reasons above, waiting periods on credit insurance policies are generally a minimum of 30 days and more usually 120 days or even 180 days. This provides a very long time for the insurer to liquidate assets if needed, allowing investment in illiquid assets.

There has always been a question of whether a waiting period of 180 days would satisfy the "timely manner" requirement in CRR, and some banks have had concerns that a regulator may consider 180 days to be too long. However, the wide industry practice of including this length of waiting period, and the absence of a publicised objection from any regulator, has allowed many banks to conclude that 180 days is tacitly accepted by the regulator. Against that background, a suggestion that the waiting period must be "days, not weeks or months" comes as a considerable shock.

It is notable that in its cost benefit analysis, the PRA recognises that some banks may "have higher risk weighted assets than they are anticipating, and correspondingly higher capital requirements". However, it goes on to write that it "estimates that the overall impact on capital requirements and lending would be of minimal significance".

Given the extent of reliance by banks on credit insurance, and given that almost every existing credit insurance policy would fail to satisfy the "timely manner" requirement, this estimate is questionable, and it raises the question whether the PRA had credit insurance in mind when it wrote the proposals.

However, for the reason given at the end of the previous section, it will be very difficult for the PRA to propose that its guidance should apply to guarantees given by banks but not guarantees given by credit insurers in the form of credit insurance.

Next steps:

The consultation closes on 16 May 2018. If the PRA's proposals stick, there is likely to be a profound impact on the industry. The requirement that payouts are made within days is a clear example of that. Credit risk insurers, banks and other affected organisation should act now if they wish to influence that outcome. If you want to get in touch to discuss how the proposals might affect you, and to consider responding to the consultation, please contact Steven McEwan, James Richardson or Victor Fornasier.

Links:

PRA consultation paper CP6/18, February 2018



Steven McEwan
Partner
+44 20 7296 2972

Victor Fornasier
Partner
+44 20 7296 5423

James Richardson
Associate
+44 20 7296 5365