EC Consultation on Basel III review – Response due by January 3, 2020

Question n°109 : **"In your view, which other aspects, if any, should be considered in the context of revising the CRM framework under the IRBA?"**

For **Non-Payment Insurance** (NPI) policies eligible as financial guarantees under CRR, the current CRM rules do not recognize the specificities of insurance products while assessing their risk mitigating effect, notably 1) the **absence of mismatch** between the insured loan and the protection product, 2) the **legal seniority** of the insurance policies vs insurers' debt, 3) the **private** nature of NPI policies, and 4) the **low correlation** between the banking and insurance industries. The ***attached*** summary of a survey conducted at the end of 2019 among 46 IACPM and ITFA bank members, with a majority of European AIRB banks, shows that it is important to recognize when transposing finalized Basel III an appropriate treatment for NPI, as:

1. **Banks are increasingly using NPI solutions** across all asset classes: corporate loans, asset-based finance, trade finance, etc. Product attractiveness is growing to mitigate credit risk on corporate loans, where NPI comes as a close second to secondary loan sales, well ahead of CDS or synthetic securitizations.
2. **Banks use NPI solutions as an additional risk distribution channel to increase lending capacity to borrowers specifically to unrated and non-investment grade borrowers** that do not trade in CDS, while avoiding accounting or risk mismatch between loans and protection instruments. As releasing regulatory capital is the 2nd most important objective of participating banks, and 75% of insured loans are non-investment grade, **NPI fulfils a unique function as CRM for banks** to support their lending to mid-corporates, SMEs and specialized finance.
3. **European banks are more advanced in usage of NPIs.** They have used the product as a distribution tool for longer and show greater volume of transactions than American or Asian banks, diversifying thereby their sources of credit protection
4. **Methodologies vary between banks** to calculate the RWA impact of NPI. The top 3 approaches are PD substitution & best LGD of both, followed by PD & LGD substitution and double default. This is aligned with EBA findings in EBA/CP/2019/01. The variety of methods captures the NPI specificities in current CRR while giving a fair treatment to the diversity of insured asset classes. We request to maintain the current flexibility in the revised CRM guidelines.

The takeaways of our survey demonstrate that **clarification is needed from regulators** as to the appropriate capital treatment of NPI as a CRM. This was started through the EBA's consultation paper of Feb 2019 but requires now more engagement as **the CRR review never envisaged NPI as a separate instrument.** Moreover, **the revised framework could even reduce the risk mitigation effect of NPI**, because the risk-weighted exposure to an insured borrower under AIRB could inappropriately be capped by the risk weight of a "comparable direct exposure" to the insurer estimated under FIRB with a 45% input floor, without recognizing the preferential treatment of policyholder claims under EU Insurance Law. The LGD input floor, the inappropriate application of "comparable direct exposure" when the Insurer is CRM provider (vs borrower), the limitation to use the approach applicable to the CRM provider (vs. on merits of the NPI) are as many points hindering unduly the effects of NPI.

Designing an appropriate regulatory solution for NPI as CRM is key:

- for **banks**, as Basel III review will require additional capital for large banks: lending could become more restricted if the regulation negatively affects NPI, as the survey demonstrates its importance to facilitate lending to unrated and non-investment grade borrowers while benefiting from regulatory capital relief.
- for **credit (re)insurers**, willing to partner with banks in private sharing of credit risks to support increased lending across all secured and unsecured asset classes, and to protect banks against tail losses.

- for **European regulators**, as 1) risk transfer to less systemic insurance sector is beneficial to financial stability, 2) European banks and insurers are leading in usage of NPI, and 3) the long-term balance-sheet of insurers can fit better the nature of some types of lending exposures.

We therefore request that, **when transposing guidelines on NPI as a credit risk mitigant,**

1. **the current risk mitigating effect of NPI is not negatively affected**, and
2. **the specificities of NPI are appropriately recognized** while reconfirming current eligibility criteria under AIRB.

Transposition should include or combine the following improvements: (i) defining a specific LGD lower than 10% (or the LGD floor of the NPI provider), (ii) maintaining the AIRB approach for NPI as CRM and/or (iii) recognizing the legal right of NPI to recover from both the borrower and the credit insurer, which is ignored by the substitution approach.

The IACPM is happy to assist European regulators by sharing practices, data and longstanding experience in management of NPI solutions.