

## **Banking Package 2021 – Finalisation of Basel 3**

### **Contribution of the IACPM to the “Have Your Say” procedure of the European Commission**

The International Association of Credit Portfolio Managers (IACPM) welcomes the EC proposals for Basel 3 finalisation as per the 2021 Banking Package, and want to provide feedback on the impact of the proposals on the various instruments used by banks for risk transfer to the long-term investors that support their lending growth.

For information, we attach a note (**Att 1**) providing an **overview on the credit risk mitigation tools** used by banks' credit portfolio managers at loan, borrower and portfolio levels for risk mitigation and capital release.

Our proposals below have been developed considering both banks and investors perspectives, as well as the increasingly important role not only of private credit and pension funds, but also of private credit insurers, in support of banks to *financing the real economy*. The attached documents provide additional insights and data to support our recommendations.

You will find in attachment the proposals for the risk mitigation instruments used by credit portfolio managers to manage risk:

- **For instruments used to support lending growth at the loan and borrower level :**
  - For **Private Credit Risk Insurance**, we support the ITFA proposal for a fairer LGD, consistent with the super-senior position of insurance policies versus other credit obligations in case of a Solvency2 (or equivalent) insurer would default
  - For **Credit Default Swaps**, we propose in **Att. 2** that EU regulators allow banks to apply CDS as unfunded credit protection to Exposure At Default when an (undrawn) off-balance sheet exposure is hedged, both in the IRB-Foundation and Standardised approach
  - For **Sovereign Guarantees**, we request that the exemption to the application of the PD, LGD and CCF input floors is also applicable to guarantees from EU sovereigns and central banks. This proposal, outlined in **Att 3**, is aligned with Basel 3 text.
- **For instruments used to mitigate risk and release capital at the portfolio level, and specifically for synthetic on balance-sheet securitisations :**
  - We propose in **Att. 4** a **transitional arrangement** on the treatment of the **output floor**, without prejudice to the final decision of the EU co-legislators on the potential recalibration of securitisation capital requirement formulas after the EC Call for Advice which runs up to September 2022. Because applying SEC-SA to retained tranches would annihilate the efficiency of the risk transfer securitisation transactions, we recommend the « p » factor is divided by two for the purpose of output floor calculation, as a transitory measure, to avoid undue cliff-effects in the calculation of the output floor

contribution of securitisation positions.

- We advocate in **Att. 5** for **eligibility of credit insurers in STS on balance-sheet transactions**, so that the growing volume of protections purchased from Solvency 2 (or equivalent) credit insurers can benefit from a favorable capital treatment. As you will see from the sample survey summarized in the attachment, the number of SRT transactions credit insurers entered into during 2021 has more than doubled vs pre-Covid. A similar growth is expected in 2022 on all asset classes, from residential mortgages to SME's, large corporates, project and asset-based finance.
- We want also to confirm that, despite the fact that, for synthetic securitisations which are not be eligible to EU Green Bonds Standards (EUGBS), regulators will apply a « look through » approach to the tranches retained by banks, investors and insurers, so that they can incorporate in their **Green Assets Ratio** calculation a weighted share of the taxonomy-aligned assets which are securitised.

We are appreciative that the above proposals are considered during the legislative process, and IACPM is available to discuss these proposals with the policy makers.

Sincerely,



Som-lok Leung

Executive Director

IACPM

### Attachments

1. **IACPM overview of risk mitigation techniques** used in credit portfolio management (this document is included at the end of the paper)
2. **Credit default swaps** – Exposure At Default (Art. 235, 236)
3. **Sovereign guarantees** – Extension to all sovereigns (Art 159.a)
4. **Synthetic securitization** – Transitional arrangement (Art 465)
5. **Synthetic securitization** – Eligibility of unfunded protections from credit insurers

## Attachment 2

### **Credit derivatives swaps (CDS) - Hedging at Exposure At Default (Art. 235, 236)**

Amongst Credit Risk Mitigation (CRM) techniques used by credit portfolio managers, unfunded credit protections, and more specifically Credit Default Swaps (CDS), have been a widely used tool ever since its creation in the early 1990s. Thanks to its decades-long history of proven efficacy in transferring/hedging credit risk, credit default swaps (CDS) are particularly useful for banks when it comes to managing sector/country/single-name concentration risks.

From a regulatory standpoint, the Basel Committee had soon recognized CDS as an eligible credit protection, in the early days of the Basel Accord (Basel I). This recognition was then carried to subsequent Basel Accord (Basel II, Basel III), with the product showing its consistent efficacy in protecting banks' balance sheet through different economic cycles. Transposed into EU legislation, this in turn has allowed banks to free up capital when needed, thus helping them to better finance the real economy.

With Basel Committee's finalisation of the Basel III framework in Dec 2017, IACPM and institutional member firms strongly recommend that by strengthening supervised banks' resilience, the new rules continue to assist banks in financing the real economy. Especially as far as CDS are concerned, it is important to avoid unintended consequences of regulatory provisions, to preserve and even improve their regulatory treatment.

The purpose of this letter is to provide suggestions on treatment of CDS as a tool for credit protection, which could increase European banks' ability to support real economy finance particularly following Covid-19, and to provide much-needed capital for an efficient transition to green growth.

#### **1 Current Regulatory Treatment**

- Thanks to the highly standardized product and efficient indemnity process, tested and proven over decades, successive Basel Accords and corresponding EU legislation have always recognized CDS as an eligible credit protection (cf. Article 204 of current CRR).
- As a quick reminder, Credit Default Swap (CDS) is a protection under the derivative format that offers a **standardized way** to transfer credit risk to a third party:
  - This contract provides protection against the credit risk on a particular company (known as the reference entity) for a given debt seniority, amount & maturity.
  - It allows the buyer of CDS protection against the occurrence of a number of Credit Events, which include at minimum: Bankruptcy, Failure to Pay and Restructuring (Restructuring being required only in certain cases as specified in the Basel Committee's finalisation of the Basel III framework).
  - On the occurrence of a credit event, the CDS is triggered and the protection buyer can choose between cash settlement or physical settlement. When the defaulted asset on the Reference Entity is delivered to the protection seller, the protection buyer receives in return 100% of the protected notional amount.
  - According to current ISDA rules, there are no restrictions on defaulted & deliverable assets, as long as they fall under the Borrowed Money category, i.e. any obligation from the company to repay borrowed money at some point in the future. This typically

means bonds, term loans and **drawn portion of revolving credit facilities, which means protection buyers are protected on the first EUR drawn, up to the CDS notional. In other words, CDS protect buyers against the contract notional, regardless of the drawing rate.** This is a contractual feature, irrespective of the CDS regulatory treatment.

- To reflect the particular feature highlighted above, the current Basel framework, transposed through CRR – CRR2, allows<sup>1</sup> banks, **under the Advanced-IRB approach, to apply the unfunded credit protection on the Exposure At Default** (*i.e. after application of the Credit Conversion Factor – CCF*) when an off-balance sheet exposure is hedged. Indeed, in Advanced-IRB approach, conversion factors used by institutions are their estimate of the drawing rate at the time of default, calibrated in a prudent manner and validated by the competent supervisory authority.
- This recognition is critical for European banks competitiveness as the hedged amount is fairly calibrated, aligned with their internal assessment of the Exposure At Risk, allowing to actively manage their credit portfolio and increase their lending capacity to companies requiring liquidity to fund their post-Covid 19 and green transition.

## 2 Impact of the Basel 3 finalisation

- With Basel Committee’s finalisation of the Basel III framework, to be implemented from Jan 2025, most of the corporate exposures which can be hedged by CDS will fall under the IRB-Foundation approach for the purpose of RWA calculation. Simultaneously, the Standardised Approach will also apply, for the purpose of the Output Floor calculation.
- The new Basel framework does not specifically mention the ability to apply unfunded credit protection on the Exposure At Default (40% of notional) to release capital on the total underlying credit facility. Without this amendment, **banking institutions would have to buy protection on the exposure notional, i.e., the total credit facility and not the EAD, to have the same RWA relief.**
- Furthermore, banks will end up having more protection than the amount at risk at the time of default. **To avoid excess hedges, regulators should therefore maintain the ability to release capital on the full credit facility when protection is purchased on the EAD amount.**

## 3 Proposed amendment

- **We therefore strongly recommend that when transposing the finalised Basel 3 framework into EU legislation, EU regulators allow banks to apply Credit Default Swap as unfunded credit protection, to Exposure At Default when an off-balance sheet exposure is hedged, both in the IRB-Foundation and Standardised approach**
- We consider this as one of the important measures for banks to provide much-needed capital to support real economy finance particularly following Covid-19, and to accompany the transition to green growth.
- For this purpose, please find in highlight below our proposal for wording in the related CRR articles (Sub-Section 2 Unfunded Credit Protection / Articles 235, 235a, 236 and 236a).

<sup>1</sup> Ability confirmed by EBA through its periodic Q&A: [https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015\\_2063](https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_2063)

## ANNEX I

### ***Proposed wording for Article 235, 235a, 236 and 236a of Sub-Section 2 Unfunded credit protection***

#### ***Article 235***

##### ***Calculating risk-weighted exposure amounts under the substitution approach when the guaranteed exposure is under the Standardised Approach***

1. For the purposes of Article 113(3), institutions shall calculate the risk weighted exposure amounts for exposures with unfunded credit protection to which those institutions apply the Standardised Approach, irrespective of the treatment of comparable direct exposure to the protection provider, in accordance with the following formula:

$$\max\{0, E - G_A\} \times r + G_A \times g$$

where:

*E = the exposure value in accordance with Article 111. For that purpose, institutions shall calculate the exposure value of an off-balance sheet item listed in Annex I by using percentages indicated in Article 111(1) if the unfunded credit protection protects against credit loss on each outstanding defaulted exposure up to the protection amount regardless of the exposure utilization rate, or by using a percentage of 100% otherwise.*

*G<sub>A</sub> = the amount of credit risk protection as calculated under Article 233(3) (G\*) further adjusted for any maturity mismatch as laid down in Section 5;*

*r = the risk weight of exposures to the obligor as specified under Chapter 2;*

*g = the risk weight of exposures to the protection provider as specified under Chapter 2.*

2. [...] to 3. [...]

#### ***Article 235a***

##### ***Calculating risk-weighted exposure and expected loss amounts under the substitution approach when the guaranteed exposure is treated under the IRB Approach and comparable direct exposures to the protection provider are treated under the Standardised Approach***

1. For exposures with unfunded credit protection to which an institution applies the IRB Approach referred to in Chapter 3 and where comparable direct exposures to the protection provider are treated under the Standardised Approach, institutions shall calculate the risk-weighted exposure amounts in accordance with the following formula:

$$\max\{0, E - G_A\} \times r + G_A \times g$$

where:

*E = the exposure value determined in accordance with Chapter 3, Section 5. For that purpose, institutions shall calculate the exposure value for off-balance sheet items other than derivatives treated under the IRB Approach by using the SA-CCFs or IRB-CCFs provided for in article 166, paragraphs 8, 8a and 8b if the unfunded credit protection protects against credit loss on each outstanding defaulted*

exposure up to the protection amount regardless of the exposure utilization rate, or by using CCFs of 100% otherwise.

$G_A$  = the amount of credit risk protection as calculated under Article 233(3) ( $G^*$ ) further adjusted for any maturity mismatch as laid down in Section 5;

$r$  = the risk weight of exposures to the obligor as specified under Chapter 2;

$g$  = the risk weight of exposures to the protection provider as specified under Chapter 2.

2. [...] to 3. [...]

#### **Article 236**

**Calculating risk-weighted exposure amounts and expected loss amounts under the substitution approach when the guaranteed exposure is treated under the IRB Approach and a comparable direct exposure to the protection provider is treated under the IRB Approach**

1. [...] to 2. [...]

3. For the purposes of this Article,  $G_A$  is the value of  $G^*$  as calculated under Article 233(3) further adjusted for any maturity mismatch as laid down in Section 5.  $E$  is the exposure value determined in accordance with Section 5 of Chapter 3. For this purpose, institutions shall calculate the exposure value of the items listed in Articles 166(8) to (9) by using a conversion factor indicated in those paragraphs if the unfunded credit protection protects against credit loss on each outstanding defaulted exposure up to the protection amount regardless of the exposure utilization rate, or 100% of its value otherwise.

#### **Article 236a**

**Calculating risk-weighted exposure amounts and expected loss amounts under the substitution approach when the guaranteed exposure is treated under the IRB Approach using own estimates of loss given default (LGD) and a comparable direct exposure to the protection provider is treated under the IRB Approach**

1. [...] to 5. [...]

6. For the purposes of this Article,  $G_A$  is the value of  $G^*$  as calculated under Article 233(3) further adjusted for any maturity mismatch as laid down in Section 5.  $E$  is the exposure value determined in accordance with Section 5 of Chapter 3. For this purpose, institutions shall calculate the exposure value of the items listed in Articles 166(8) to (9) by using a conversion factor indicated in those paragraphs if the unfunded credit protection protects against credit loss on each outstanding defaulted exposure up to the protection amount regardless of the exposure utilization rate, or 100% of its value otherwise.

## **Attachment 3**

### **Eligible sovereign guarantees - Extension to all sovereigns (Art 159a)**

#### **CRR 2 – New Article 159a – Non application of PD and LGD input floors**

Proposed amendment:

*« For the purposes of Chapter 3, and in particular with regard to Articles 160(1), 161(4), 164(4) and 166(8c), where an exposure is covered by an eligible guarantee provided by a central government or central bank or by the ECB, the PD, LGD and CCF input floors shall **not** apply to the part of the exposure covered by that guarantee. (...)»*

#### **Rationale for proposed amendment**

According to the new article 159a, input floors would not be applicable to exposures guaranteed by sovereign (EU) member states, while require to apply to apply them to guarantees issued by non-member sovereigns (for example: US guarantees, Japanese, Korean,...).

This new Article is not very clear as to its application: e.g., an approach envisaged in IRBA is the substitution of risk parameters, where there is no reason to apply a floor.

It is also a significant deviation from the Basle text and even from the intentions displayed by the commission:

- BCBS quote "*§66 In the case of an exposure that is guaranteed by a sovereign, the floors that apply to the risk components do not apply to that part of the exposure covered by the sovereign guarantee (ie any part of the exposure that is not covered by the guarantee is subject to the relevant floors).*"
- EU detailed explanations quote "*A new Article 159a is added to specify in line with the Basel III standards that the new input floors (described under the previous section) applicable to institutions' own PD, LGD and CCF estimates are not applicable to sovereign exposures.*"

We therefore request that this article is modified as proposed.

## **Attachment 4**

### **Synthetic securitisation - Transitional arrangement (Art.465)**

Coordination between the call for advice to ESA's Joint Co and Basel III finalisation

IACPM members recognize the stated objectives of the Basel III finalisation Output Floor which aims at reducing unwarranted variability and increasing comparability of bank capital ratios.

IACPM members also support the BCBS goal of introducing more risk-sensitivity in the standardized approaches, in order to ensure that standardized approaches are valid benchmarks for the internal models.

However, in the case of securitization, the SEC-SA lacks risk-sensitivity, resulting in a massive gap between the SEC-IRBA and SEC-SA. This issue has not been surfaced in any previous monitoring reports, as securitization tranches represent, in the current subdued securitization market in Europe, a very small proportion of EU banks' balance sheets. However, it is crucial to address it, given the stated goal of reviving the securitization market.

Indeed, the application of the current SEC-SA in the context of the output floor would make any transactions, structured in order to transfer risk to investors, unviable.

The unconditional application to all asset classes causes significant problems, particularly for securitisation:

- Uniquely from other asset classes under the credit risk framework, securitisation transactions would fundamentally be structured differently at closing if using the IRB (SEC-IRBA) or standardised (SEC-SA) approach – this is not the case for other asset classes, such as bonds, loans or insurance/CDS
- The SEC-SA and the Standardised Approach (SA) under the credit risk framework are not directly comparable and do not serve the same purpose – the SA has been around since 2004, whilst SEC-SA was only introduced in 2019 due to a specific need to i) make securitisation more accessible for smaller EU banks and ii) reduce reliance on external ratings
- The SEC-SA contains a double conservatism, requiring the use of both i) a conservatively-designed, regulatory-defined formula and ii) regulatory-stipulated SA inputs to such formula - this is in contrast to application of the SA to IRB portfolios under the output floor, where only a single layer of conservatism is applied

Due to the above, the impact of the output floor on securitisation is highly punitive and significantly in excess of the impact to all other asset classes under the credit risk framework, which presumably is not the intended outcome and is contrary to the stated objectives.

We welcome the Call for Advice issued by the European Commission as a follow-up to the recent targeted consultation on the EU securitisation framework and in preparation of the "comprehensive review" of the securitisation framework that is part of objective 1, action 6 of the CMU Action plan.

The EC is seeking advice, among others items, on the non-neutrality factors and notably

- the "p" factor embedded in the formulae of the SEC-IRBA (Article 259(1) of the CRR) and
- the SEC-SA (Art. 261(1) of the CRR) as a capital surcharge on the securitisation tranches' capital requirements.



This Call for Advice, however, runs until September 2022, which entails a worrying drift in the implementation of the CMU Action Plan, keeping in mind that until recently, the stated objective of the EC was to publish the comprehensive review by Q4 2021. We fully understand how busy you are now with the many ongoing regulatory reviews and initiatives, but would like to propose a contingency plan if the securitisation comprehensive review (and capital treatment) would not be completed before the provisions related to the output floor enter into force.

As discussed with your teams, explained in our note dated Sept 15 and in our response to the targeted consultation, combining inappropriate non-neutrality factors with the output floor approach would severely reduce the efficiency of securitisation structures covering IRB portfolios, or even make them worsen the effects of the output floor.

The consequences of the output floor on securitisation are particularly worrying with regards to synthetic securitisations of corporate portfolios where, by definition, large senior tranches are generally retained by originating banks. In our note of Sept 15, simulations on several corporate portfolios (STS, non-STS, with different maturities and risk parameters) did evidence that halving the p factor for SEC-SA to 0.5 for non-STS and to 0.25 for STS would at least partially offset this very negative impact.

Without prejudice to the final decision of the EU co-legislators on the potential recalibration of securitisation capital requirement formulas, it seems both efficient and reasonable to add a **transitional arrangement** to avoid undue cliff-effects in the calculation of the output floor contribution of securitisation positions.

We therefore propose the following amendments to the proposed Article 465:

- **Current EC proposal:**

*(196) Article 465 is replaced by the following:*

**‘Article 465**

***Transitional arrangements for the output floor***

1. *By way of derogation from Article 92, paragraphs 3 and 6, .... [..]*
2. *By way of derogation from Article 92(3), point (a), .... [..]*
3. *By way of derogation from Article 92(5)(a), point (i), .... [..]*
4. *By way of derogation from Article 92(5)(a), point (iv), .... [..]*
5. *By way of derogation from Article 92(5)(a), point (i), .... [..] ‘*

- **IACPM proposal:** Add an additional temporary derogation 6 to the 5 derogations here above, until the completion of the comprehensive review of the securitisation framework as part of the CMU Action Plan, as outlined below

*(196) Article 465 is replaced by the following:*

**‘Article 465**

***Transitional arrangements for the output floor***

1. *By way of derogation from Article 92, paragraphs 3 and 6, .... [..]*
2. *By way of derogation from Article 92(3), point (a), .... [..]*
3. *By way of derogation from Article 92(5)(a), point (i), .... [..]*
4. *By way of derogation from Article 92(5)(a), point (iv), .... [..]*
5. *By way of derogation from Article 92(5)(a), point (i), .... [..]*
6. *By way of derogation from Article 92, paragraph 5, when the standardized risk-weighted exposure amounts for credit risk and dilution risk referred to in paragraph 4, point (a), and for counterparty risk arising from the trading book business as referred to in point (f) of that paragraph shall be calculated using the SEC-SA following Article 261 or Article 262 of Regulation (EU) n°575/2013, parent institutions, parent financial holding companies or parent mixed financial holding companies, stand-alone institutions in the EU or stand-alone subsidiary institutions in Member States shall be permitted, until the completion of the comprehensive review of the EU securitisation framework as part of the Capital Markets Union Action Plan, to apply the following modifications:*
  - (a)  $p = 0,25$  for a position in an STS securitisation*
  - (b)  $p = 0,5$  for a position in a non-STS securitisation'*

We look forward to discussing with you this proposed amendment.

## Attachment 5

### **Synthetic securitisation - Recognition of private credit insurers in the STS framework for synthetic on balance-sheet securitisations (Art 506)**

We are referring to the clauses below of the 2021 Banking Package:

**Page 22:** *“Enabling clauses for [leasing exposure and] credit insurance”*

*(...) Furthermore, a new Article 495d is inserted mandating EBA to report to the Commission on the eligibility and the use of credit insurance as a credit risk mitigation technique and on the appropriate risk parameters they should be associated with under the SA-CR and foundation IRB approach. Based on that report, the Commission is required to submit, if appropriate, a legislative proposal on the use of credit insurance as a credit risk mitigation technique. »*

**Page 209 :** *“Article 506 is replaced by the following :*

#### **Article 506: Credit risk – Credit insurance**

*By 31 December 2026, EBA shall report to the Commission on the eligibility and use of policy insurance as credit risk mitigation techniques and on the appropriateness of the associated risk parameters referred to in Part Three, Title II, Chapter 3 and 4.*

*Based on the report of the EBA, the Commission shall be empowered to amend this Regulation by adopting a delegated act, where appropriate, in accordance with Article 462, to amend the treatment applicable to credit insurance referred to in Part Three, Title II.”*

and advocate for their application to any type of private credit risk insurance transaction, whatever the underlying asset protected, i.e., loan-by-loan credit insurance, but also protection of tranches of synthetic on balance-sheet securitisations.

We have noted the final decision on the STS framework for synthetic on-balance sheet securitisations. The IACPM and its members are concerned that **this framework will not facilitate private credit insurers’ ability to continue to offer credit protection to banks so that these are in turn able to increase their lending capacity to the real economy.**

Prudentially regulated **private credit insurers** provide credit protection in respect of bank loans by underwriting credit insurance:

- Some private credit insurers provide **trade credit insurance** and play a critical role in supporting the real economy, including through the Covid-19 crisis, facilitating access to short term liquidity and longer-term growth capital.
- Credit insurance is also a well-established and relied upon tool for banks wishing to distribute the credit risk associated with banks’ lending businesses outside of trade credit. Through the use of credit insurance in these diverse areas, which include corporate lending, SME lending, asset backed lending, mortgage lending and project and infrastructure financing, banks are able to undertake further lending while prudently managing their exposures, risk limits and regulatory capital. On this topic, we refer you to the work done by the International Trade and Forfeiting Association (ITFA).
- Credit insurance has also developed as an increasingly important tool for many banks wishing to distribute the junior or mezzanine risk associated with **pools of lending exposures in on**

**balance-sheet synthetic securitizations.** The ability of well capitalized, highly rated and prudentially regulated private credit insurers to provide unfunded risk transfer in respect of synthetic on balance-sheet securitizations has significantly broadened the distribution options available to banks for these transactions, offering counterparty diversification and providing greater opportunities for banks to manage credit risk, counterparty limits and capital, and ultimately undertake further lending.

On the last point here above, private credit insurers are active partners to banks in risk transfer across a range of asset classes, including corporate and SME lending, trade finance, project and infrastructure financing, asset backed finance and mortgage lending. They have worked closely with banks in supporting them throughout economic cycles for more than two decades and have responded to their client banks' needs as new lending sectors have developed and existing lending markets have grown.

Private credit insurers have been therefore also very supportive of the HLF's CMU recommendations for growth in **on balance-sheet synthetic securitisations**. They are already long-term risk sharing partners with the banking sector and are active in on balance-sheet synthetic securitisations. Credit risk protection is provided by private credit insurers in the form of a financial guarantee or an insurance policy, mostly on the mezzanine and senior mezzanine tranches. **It is important, therefore, that the regulation does not prevent private credit insurers from playing their role and, on the contrary, help them to further support the real economy.**

However, the STS framework for on balance-sheet synthetic securitisations requires either funded credit protection (by way of cash collateral or 0% risk-weighted debt securities) or unfunded credit protection provided by a limited number of potential counterparties (e.g. 0% risk-weighted multilateral development banks). To appeal to the widest range of appropriate investors, notably private credit insurers and re-insurers, the STS Requirements should be amended so as not to limit the availability of a key distribution channel currently available to banks in respect of balance-sheet securitisations.

To support this:

- The unfunded credit protection providers referred to for these purposes and who have been active in providing unfunded credit protection are multi-line (re)insurers with diversified business and limited correlation to the credit risk they assume via their credit insurance business. These multi-line (re)insurers are well-established and experienced in assuming and underwriting credit risk of the type originated by banks. **They are not and should not be confused or equated with monoline credit insurance companies** which are subject to different regulatory requirements, only underwrite financial risk and have very different asset, liability and risk profiles to the multi-line (re)insurers who have been active in synthetic securitisations and credit insurance to date.
- The credit risk assumed as part of synthetic risk transfer transactions forms a small part of multi-line (re)insurers' overall underwriting books.
- The Credit Risk framework requires banks to hold capital against the (re)insurer counterparty risk and indeed, pursuant to Article 249 of Regulation 2017/2401, private credit insurers are already subject to minimum rating requirements over and above the requirements that apply to credit risk mitigation used in respect of non-securitisation exposures when providing credit risk mitigation in respect of securitisation positions.

- The STS Requirements also do not take into account that private credit insurers regulated under the Solvency II (or equivalent) framework will be subject to its robust capital requirements. This differentiates credit insurance policies and financial guarantees underwritten by (re)insurance undertakings from other unfunded credit protection provided by counterparties who are not Solvency II (or equivalent) regulated entities.

The IACPM conducted a short volume survey in December 2021 aiming at providing insight on private credit insurers' capacity to support real economy finance by selling unfunded protection on tranches of synthetic on balance-sheet securitisations. This short survey covered the SRT transactions closed by a sample of 9 credit insurers in the years 2019 to 2021, and highlighted that:

- Between January 2019 and end 2021,
  - The asset classes protected by credit insurers have diversified: on average over the three years, close to 40% (vs 77% in 2019) of the number of new transactions and of the notional amount of underlying pools referred to loans granted to companies (SMEs and large Corporates), the second largest asset class being residential mortgages (27%) and the remaining transactions protecting commercial mortgages (18%) and project or asset-based finance loans.
  - 65% of these transactions were structured and syndicated between several private credit insurers (as opposed to just one insurer). The average share decreased in the syndication (30% in 2021, vs 66% in 2019), thereby spreading the counterparty risk.
  - The number of unfunded synthetic risk transfer transactions entered into by the sample of nine private credit insurers increased considerably in 2021, with 25 new transactions (vs 11 in 2019) protecting tranches on € 58bn of underlying loans (vs € 22bn in 2019).
  - Similar to the trends in synthetic securitisations, the market was dominated by European transactions in 2019, but is now expanding to North America and Asia.
  - On average over the three years, half of the transactions (vs 27% in 2019) are protecting tranches at mezzanine to senior mezzanine level, with an average tranche thickness of 6%, and attachment - detachment points at 1.6% - 7.7%. Protected tranches are generally more junior in mortgages deals than in other asset classes.
- On average, the sample of credit insurers are expecting to - at least - double the number of transactions they are protecting, mainly on pools of loans to SMEs, large corporate and project finance during 2022.

For all the reasons explained above, we strongly recommend that **the treatment of credit insurers as sellers of unfunded credit protection in synthetic on balance-sheet securitisations is legislated for in CRR, so that the STS Requirements are amended in the STS framework with respect to credit protection provided by a Solvency II or equivalently regulated credit (re)insurer.** Private credit insurers meeting the requirements of current Article 249 of the CRR (as amended by Regulation 2017/2401) will then be able to continue protecting the credit risk of banks pursuant to on balance-sheet securitisations so that these can further increase their lending capacity into the wider economy in the same manner as they currently do.

International Association of Credit Portfolio Managers

IACPM overview of

# Risk mitigation techniques in credit portfolio management

**Risk sharing with credit investors is an integral part of portfolios' sustainable growth strategies**

*January 2022*

The logo for the International Association of Credit Portfolio Managers (IACPM). It features the acronym "IACPM" in a blue, serif font. A thin, dark blue curved line arches over the letters, starting from the left and ending on the right, passing above the 'A' and 'C'.

## Introduction

Today credit market conditions, as well as prudential and sustainability regulations, are reshaping the financial services industry. In all industry sectors, the discipline of **credit portfolio management** is expanding coverage across all asset classes, and evolving to assist:

- The “**front-end**” function of credit origination into the portfolio, in policies related to risk appetite and concentration limits framework, in risk and risk/return assessment and pricing, in loan documentation, and in promotion of sustainable finance,
- The “**back-end**” function of loan portfolio management, aiming at facilitating lending growth by creating more lending capacity, mitigating concentrations and reducing capital requirements, using risk transfer solutions like loan sales, private credit insurance, credit default swaps, funded and unfunded securitisations.

The IACPM recognizes the unique and evolving role of credit portfolio managers in today's financial environment and in the transition towards a more sustainable and resilient economy. With its members active in banking, investment and insurance, the Association seeks to foster sound practices in the active management of credit exposures originated by banks and is recognized as a trusted advisor by global regulators.

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*The purpose of this paper is to provide an overview of the various risk mitigation and risk sharing techniques used in the “back-end” function of loan portfolio management through the whole credit cycle, describe their purpose and impact, as well as inform about IACPM initiatives to support and advance the effective and prudent usage of these tools by loan portfolio managers.*

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## Overview of the risk mitigation techniques

### Rationale

When executing risk mitigating transactions, credit portfolio managers aim to:

- **Mitigate portfolio risk**, by reducing exposure to large jump-to-defaults events or to systemic concentrations per asset class, per sector or per geography, and/or
- **Support lending growth**, by releasing capital to increase capital velocity, or reducing exposure to release limits at individual customer level.

To effect these goals, portfolio managers engage in a number of considerations related to 'front-end' risk mitigation (ie, compliance with risk appetite and concentration limits, assessment of risk adjusted return, etc) and can also consider the use of risk mitigation tools ('back-end').

Key risk mitigation tools include:

- **Loan sales**
- **Financial guarantees** and **loan-by-loan private credit risk insurance (PCRI)**, to release limits and capital on mostly illiquid borrowers
- **Single name credit derivatives (CDS)** to release limits and capital on liquid borrowers
- **Synthetic securitisations with first and/or mezzanine risk mitigation (SRT)**, to release capital on portfolios of loans

Risk mitigation tools are essential to prudent risk management and to increase lending capacity. Along the whole credit cycle, Credit Portfolio Managers will select the appropriate solution depending on their objective of risk mitigation, but also on financial, accounting, regulatory and market considerations (\*).

IACPM, and its membership, have a crucial role in assuring that these tools are effective in risk mitigation so that capital flows appropriately between the full range of participants in credit markets, as these tools support real economy lending.

(\* See IACPM Principles and Practices at: <http://iacpm.org/research/principles-and-practices-in-cpm/>

## Overview of risk mitigation techniques

### Level of risk transfer

To achieve these goals, risk can be transferred at different levels:

- At **single position** level, i.e. per loan, or per legal borrower
  - By reducing exposure at borrower level, a firm releases credit limits and the capital absorbed by the transferred exposure.
- At **portfolio level**, the portfolio being sliced either vertically or horizontally (via securitisations)
  - Vertical slicing releases genuine credit default risk at position level, similar to single loan or single name credit protection,
  - Horizontal slicing ("securitisation") releases the portfolio risk and the capital attached to tranches of the distribution of losses.



### Instruments used for risk transfer

Whatever the level of risk transfer as described above, the instruments used for risk transfer are:

- either **funded** (“true sale”), via loan sales or syndication, or loan sales to a true sale/cash securitisation vehicle,
- or **unfunded**, via financial guarantees, credit derivatives or private credit risk insurance (PCRI), transferring risk to sellers of credit protection. Such a risk transfer can be structured with prior horizontal slicing by synthetic securitisation, and this synthetic securitisation can be funded by credit linked notes, using eventually a separate securitisation vehicle.

The combination of level of risk transfers and instruments used is summarized in the table below.

Instruments	Level of risk transfer				
	Single loan	Single Borrower	Portfolio of loans, sliced		
			Vertically	Horizontally (“securitisations”)	
True sale	Loan sales, syndication		Loan sales	Loan sales	Cash securitisation
Unfunded credit protection	Private credit risk insurance	Credit derivative	Private credit risk insurance	Private credit risk insurance	Synthetic securitisation (funded or not)
	Financial guarantee		Financial guarantee	Financial guarantee	
			Credit derivative	Credit derivative	

### Impact of the risk transfer: risk mitigation and risk transformation

Depending on transaction structure, risk mitigation can reduce

- either exposure at single name level, or
- cumulative expected losses (“first loss”), which are increasing with the intensity of default and severity risks in the underlying loans (PD, LGD), or
- uncertainty of losses, i.e. capital absorbed (“mezzanine”), which is increasing with
  - the exposure to jump-to-default events, in non-granular assets pools, and/or
  - the stress correlation between the loans of the pool, which can be inflated when correlation exist also between the credit standing of the borrowers and the value of collateral assets (e.g., residential and commercial mortgages).

Below is a summary of the credit risk mitigation objectives that can be achieved or cannot be achieved by transferring different levels of risk:

Releasing lending capacity by reducing....			Exposure to a borrower	Provisions for loan losses	Stressed losses/capital
Single loan level					
Single borrower level					
Portfolio level	Vertical slicing				
	Horizontal slicing	First loss			
		Mezzanine			
		Senior			

■ Can be achieved    ■ Cannot be achieved

However, depending on the instrument used for credit risk mitigation, the risk transformation introduces new financial and non-financial risks, which can be complex to estimate and mitigate, like

- counterparty risk for unfunded risk protection
- flow-back risk in the retained senior tranche, generally called model risk
- mismatches in default and recovery in credit derivatives that do not reference the exact same borrower and loan
- mismatches in accounting between the underlying assets and the risk mitigating instruments

New risks			True sale	PCRI	Financial guarantee	Credit derivative
Single loan level				Counterparty (CP) risk		Counterparty risk; Mismatches or basis risk (PD, LGD, accounting)
Single borrower level						
Portfolio level	Vertical slicing					
	Horizontal slicing	First loss	Model risk	Model risk Counterparty risk		
		Mezzanine				
		Senior				

This transformation of risk must be understood and managed by credit portfolio managers, and is one of the main shared concerns not only of financial institutions but also of regulators, who are adding layers of conservatism by buffers in capital, transparency requirements, processes of significant risk transfer assessment, etc.

## IACPM initiatives to support and advance effective usage of risk mitigation techniques

For the most widely used and for emerging techniques of risk mitigation, the IACPM is providing support to its members in the form of ongoing and ad-hoc working groups, data collection / targeted research and advocacy vis-à-vis the main regulatory bodies across the world.

In particular, in this specific domain of Credit Portfolio Management, the Association prioritizes its research and advocacy efforts on the documentation, risk assessment, regulatory treatment and transparency of critical tools which are the foundations of the above transformation in banks' credit portfolio management, i.e,

- Private credit risk insurance (PCRI),
- Credit default swaps (CDS),
- Synthetic securitisations with first and/or mezzanine risk mitigation (SRT).

### Data collection / Research

#### **Annual Synthetic Securitisation Volume & Performance survey (banks only)**

Collecting transaction-level data on volumes, structuring features, pricing, investor profiles and underlying portfolio performance on public and private synthetic securitisations executed by member firms

#### **Biennial IACPM/ITFA survey on Private Credit Insurance (banks only)**

Collecting data on volumes, protected assets, pricing and claims on non-payment insurance transactions executed by banks and eligible as financial guarantees

#### **Annual SRT survey (credit insurers only)**

Collecting data on volumes, underlying assets and protected tranches of synthetic securitisations executed by credit insurers

#### **Biennial Principles and Practices survey (all members)**

Updating on developments in the credit portfolio management function, including usage of risk mitigation tools

#### **Ad-hoc surveys**

Performed to better understand practices in specific domains (e.g. Reporting and transparency practices)

## Working groups

### Monthly Regulatory Update Call

Covers global regulatory developments

### Securitisation Working Group

Focuses on synthetic on balance-sheet securitizations, including significant risk transfer assessment, frameworks for Simple, Transparent and Standard and for green/sustainable securitizations, treatment in the various prudential capital regulations, disclosure requirements, etc

### Credit Insurance Working Group

Engages with regulators for a fair treatment of non-payment insurance as credit risk mitigant

### Accounting and Market Working Groups

Meet as needed on issues related to IFRS 9/ CECL (accounting) and market developments such as NoR CDS (Market) and machine learning for loan sale documentation

### Climate Risk Focus Group

Meets quarterly to discuss evolving risk assessments, metrics and portfolio approaches

## Effectiveness of regulatory capital release – IACPM advocacy priorities

The current credit and market environment continues to evolve rapidly amid the stresses of the credit crisis and the requirements to support growth while balancing risk and return. Credit portfolio managers are being called upon to assess and mitigate the new risks emerging from the pandemic, as well as contribute to design the transition path of their credit portfolio to deliver the sustainability objectives of their firms.

Accordingly, there are a number of transformative considerations for the financial industry looking forward that will require public – private partnership to assess and mitigate risks and establish or adjust the appropriate risk management and regulatory frameworks. Among these challenges, which have an effect on capital allocation priorities, are:

- Improvement of profitability, requiring allocation of capital not only to balance-sheet growth, but also to digital investments
- Increase of market-based funding of the economy, notably by long-term institutional investors like pension funds
- Growing role of insurers in supporting economic growth, both on the assets (investments) side and the liability (credit insurance) side of their balance-sheet
- Transition to sustainable finance, and growing investors demand for investments that promote climate transition

Therefore, the IACPM wants to promote the best practices that assure the effective and prudent use of risk transfer techniques in lending books, and their alignment with the related treatment in prudential regulations.

## Appendix

For 2022, IACPM advocacy priorities can be summarized as follows for each of the instruments:

	Research	Advocacy
PCRI	<ul style="list-style-type: none"> <li>• Biennial PCRI Survey with ITFA</li> </ul>	<ul style="list-style-type: none"> <li>• Recognition of the super senior level of insurance protections</li> <li>• Standardisation of PCRI insurance policies</li> <li>• Impact of Basel III finalisation</li> </ul>
CDS		<ul style="list-style-type: none"> <li>• IFRS accounting of CDS hedges (completed)</li> <li>• Eligibility of CDS without restructuring clause</li> <li>• Impact of Basel III finalisation</li> </ul>
SRT	<ul style="list-style-type: none"> <li>• Yearly survey with banks on synthetic securitisation</li> <li>• Yearly survey with credit insurers on SRT transactions</li> <li>• Ad-hoc survey on ESMA reporting adequacy</li> </ul>	<ul style="list-style-type: none"> <li>• Participating to or incentivising for comprehensive review of securitisation regulations</li> <li>• Simplification of the significant risk assessment process</li> <li>• Reduction of the non-neutrality effect for on synthetic B/S transactions</li> <li>• Impact of Basel III finalisation</li> <li>• Simplification of the disclosure templates for private securitisations</li> <li>• (EU) Eligibility of credit insurers as providers of credit protection in STS transactions</li> <li>• Framework for sustainable securitisation supporting the ESG transition</li> </ul>

## Further Information

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## About the IACPM

The Association represents its members before regulators around the world, holds bi-annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk.

There are more than 125 financial institutions worldwide that are members of the IACPM. These institutions are based in 26 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

Today credit market conditions, and new regulations, are shaping the financial services industry. The discipline of credit portfolio management is evolving within firms to include the measurement and management of credit risk at the enterprise level, in addition to execution of risk mitigation strategies in credit markets.

CPM has increasing linkages with: front-end credit originators; the setting of risk appetite and limit structures; funding and liquidity for the firm; and management of counterparty risk. CPM is also expanding coverage of credit assets beyond investment grade and leveraged to include middle market and retail, as well as in some cases bonds and other credit-sensitive instruments.

The IACPM recognizes the unique and evolving role of credit portfolio managers in today's financial environment, and offers an excellent forum through which these issues can be identified, understood and addressed.

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