March 31, 2023

Re: Finalisation of Basel 3 in the UK

Contribution of the IACPM to PRA consultation CP 16/22

The International Association of Credit Portfolio Managers (IACPM) welcomes the PRA consultation on the final implementation of the Basel 3 standards in the UK.

IACPM's specific purpose is to support **credit portfolio management** across the spectrum of financial services. Consistent with this purpose, the IACPM is providing feedback specifically on the impact of the PRA's proposals on the various **tools used by banks for managing the credit risk associated with their lending activities through risk sharing with long-term investors and insurers.**

For information, we attach a note **(Att 1)** providing an **overview on the credit risk mitigation tools** used by banks for credit risk mitigation and optimisation of regulatory capital at the level of individual loans or borrowers, as well as for portfolios of exposures.

Our proposals have been developed taking into consideration the perspectives of banks and investors (including private and credit funds), as well as the increasingly important perspectives of private credit insurers.

You will see that our response to the PRA consultation highlights the below proposals affecting the use of risk mitigation instruments:

- **For instruments used to support lending growth at the loan and borrower level:**

    - For **Private Credit Risk Insurance**, we advocate for a fairer LGD, consistent with the super-senior position of insurance policy claims versus other obligations of insurers under the Solvency2 regime

    - For **Credit Default Swaps and Guarantees (including Credit Risk Insurance)**, we propose that the PRA allows banks to buy protection based on the Exposure At Default of the underlying exposure, without being required to apply a 100% conversion factor under either the IRB or Standardised Approaches

- **For instruments used to mitigate risk and release capital at the portfolio level, and specifically for synthetic on balance-sheet securitisation:**

    - We propose a **transitional arrangement** on the treatment of the **output floor**. Because applying SEC-SA to retained tranches which have been sized under the SEC-IRBA would drastically reduce the efficiency of the securitisation, we recommend the "p" factor is divided by two for the purpose of output floor calculation.

    - We advocate for a **fair treatment of credit insurers in on balance-sheet transactions**, so that the protections provided by the Solvency 2 regime can benefit from a favorable capital treatment. The number of SRT transactions entered into by credit insurers during 2022 has more than doubled as compared with the position pre-Covid. This growth is expected to continue on all asset classes, from residential mortgages to SME's, large corporates, project and asset-based finance.

As always, we are available to share more details on the results of our annual surveys on private credit insurance as well as synthetic on balance-sheet securitisations executed by banks and by credit insurers, and to discuss these proposals with the policy makers.

Yours sincerely,

Som-lok Leung
Executive Director
International Association of Credit Portfolio Managers

Accompanying consultation (CP16/22): https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards

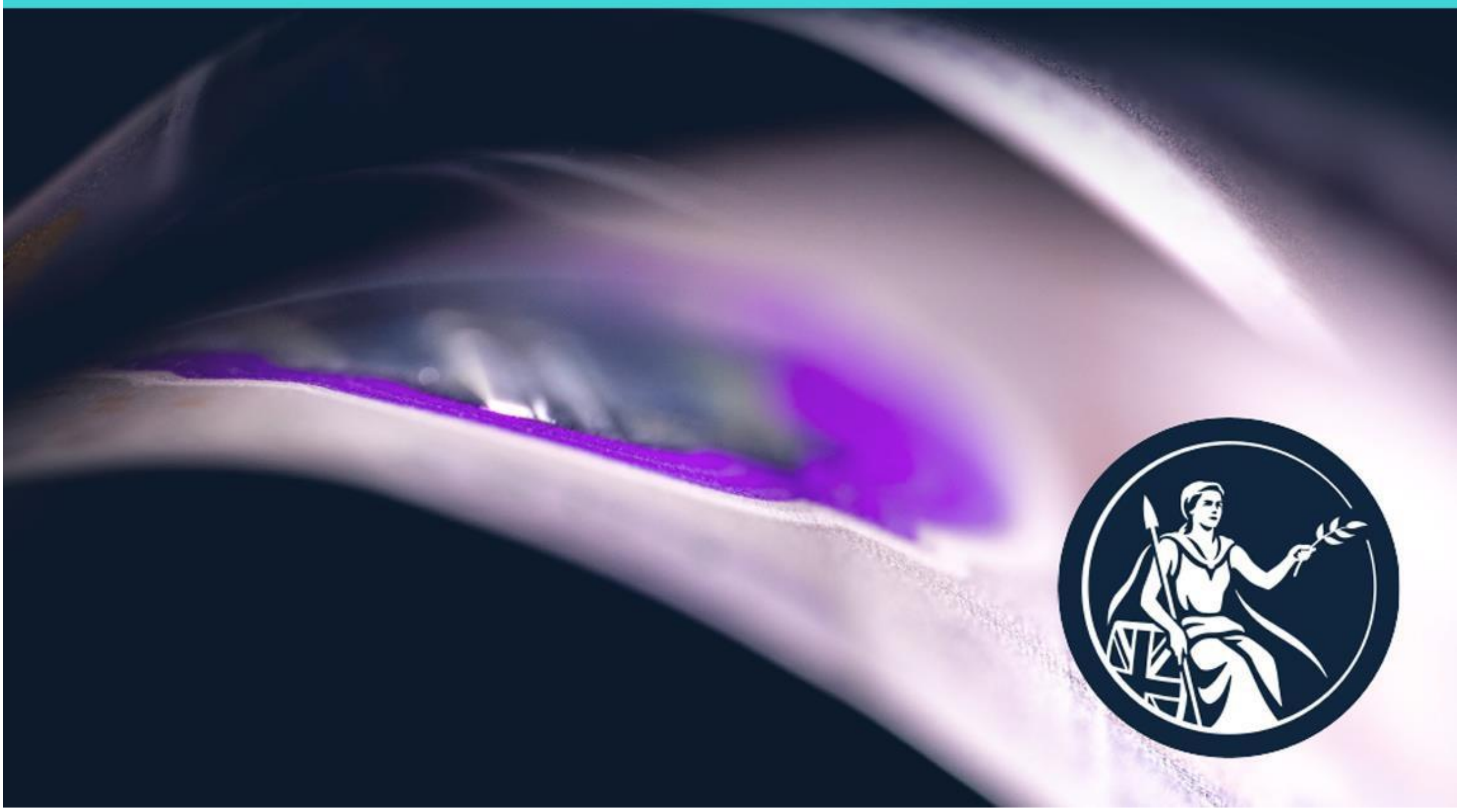
Bank of England

Prudential Regulation Authority

Appendix 2: List of questions

Consultation Paper | CP16/22

November 2022



Appendix 2: List of questions

Consultation Paper | CP16/22

November 2022

[*Separate IACPM Introduction to be inserted.*]

-

The full list of specific questions addressed to stakeholders in Chapters 2 to 9 of the Consultation Paper (CP) to which the Prudential Regulation Authority (PRA) would welcome responses are set out below. The PRA also welcomes responses on all aspects of this CP.

Chapter 2 – Scope and levels of application

Q1: Do you have any comments on the PRA's proposals for the Transitional Capital Regime?

Q2: Do you have any comments on the PRA's proposed Simpler-regime criteria?

Chapter 3 – Credit risk – standardised approach

Q3: Do you have any comments on the PRA's proposed approach to the use of external credit ratings and the proposed due diligence requirements?

Q4: Do you have any comments on the PRA's proposed definition of commitment and proposed conversion factors (CF) for commitments?

Q5: Do you have any comments on the PRA's proposed CFs for issued off-balance items? Do you have any additional data that the PRA could access? In particular, do you have any data relating to the appropriate CF for 'transaction-related contingent items' in downturn conditions?

IACPM members do not have any specific comments on the PRA's proposed conversion factors.

However, we do wish to raise one issue in relation to the use of credit risk mitigation in respect of exposures to which a CF of less than 100% is applied. Under the existing CRR (Articles 223(3), 235(1) and 236(3)), and the Proposed CRR Instrument (Articles 223(4), 235(1) and (1A) and 236(1) and (1A), an institution is required to apply a CF of 100% to calculate the exposure value to be mitigated, notwithstanding that for the purpose of calculating the underlying RWA for that exposure a lower CF may apply. We have a number of concerns with this approach.

First, this requirement is not reflected in the Basel 3.1 Standards (see paragraphs 73, 146–7, 160 and 200 of the Basel 3.1 Standards, which make no reference to applying a 100% CF to calculate the exposure value). While paragraphs CRE 32.31 and 32.66 of the Basel Framework do provide that, where a bank has securitised drawn balances, it must continue to hold capital against the undrawn balances, that is dealing with a different issue, namely that the exposure value for a partially drawn commitment is equal to 100% of the drawn balance *plus* the undrawn commitment multiplied by the applicable CF. In a traditional securitisation of the drawn balance, the portion of the exposure value of the undrawn commitment remains with the bank. However, it does not follow from this that all credit risk mitigation, which can apply equally to the drawn and undrawn exposure, should need be treated in the same way. Rather, it should be permitted to deduct the notional amount of the commitment from the total exposure value (ie, taking into account the CF applicable to the undrawn commitment) at any point in time to determine the residual exposure value which the bank must continue to risk-weight against the underlying obligor at that time. This residual unprotected exposure will then fluctuate over time in the same way as the exposure value of a revolving commitment will fluctuate over time depending on the level of drawings at that time.

Secondly, and more fundamentally, applying a CF of 100% for the purposes of CRM is inconsistent with the purpose of applying conversion factors in the first place, which is to reflect the likelihood of the relevant undrawn exposure being drawn prior to default, and which should be assessed on a portfolio basis rather than on an individual exposure basis. There is no reason why this assessment should change solely as a result of the institution using credit CRM techniques to mitigate the credit risk of individual exposures given that the amount payable by the protection provider will track the amount payable by the underlying obligor.

There is always a cost associated with credit risk mitigation, whether it be funded (by reducing the interest or fees charged by the institution in connection with the exposure) or unfunded (where it takes the form of a fee payable to the protection provider). By applying a 100% CF to all exposures when calculating the effect of credit risk mitigation, the rules make the effective cost of such protection disproportionately higher for an institution than would be the case for the same protection provided in respect of an on-balance sheet item, given that the nominal amount of protection required is the same in each case, notwithstanding that the actual risk for the institution is actually lower. This acts as a disincentive for institutions to utilise CRM for off-balance sheet exposures, despite those exposures being considered lower risk from an RWA perspective in the first place. The most significant impact of this for IACPM members is on revolving credit facilities provided to large corporates. IACPM members therefore request that the PRA aligns with the Basel 3.1 standards and removes the requirement to apply a 100% CF to an exposure for the purposes of calculating the effect of CRM.

Q6: Do you have any comments on the PRA's proposed approach to exposures to central governments and central banks, regional governments and local authorities, public sector entities (PSEs), and multilateral development banks (MDMs)?

Q7: Do you have any comments on the PRA's proposed changes to the external credit rating approach (ECRA), the proposed introduction of the standardised credit risk assessment approach (SCRA), for exposures to unrated institutions, and the proposed treatment of covered bonds?

Q8: Do you have any comments on the PRA's proposed approach for exposures to unrated corporates? Do you have any evidence – quantitative or qualitative – to support your comments, particularly in respect of the proposed 135% risk-weight for non-investment grade exposures?

Q9: Do you have any comments on the PRA's proposed approach for specialised lending exposures, or data that is relevant to this analysis?

Q10: Do you have any comments on the PRA's proposed removal of the infrastructure support factor? Do you have any evidence – quantitative or qualitative – to support your comments?

Q11: Do you have any comments on the PRA's proposed removal of the small and medium-sized enterprise (SME) support factor? Do you have any evidence – quantitative or qualitative – to support your comments?

Q12: Do you have any comments on the PRA's proposals for retail exposures?

Q13: Do you have any comments on the PRA's proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?

Q14: Do you have any comments on the PRA's proposed approach to risk-weighting real estate exposures?

Q15: Do you have any comments on the PRA's proposals on capital instruments, defaulted exposures and high-risk items?

Chapter 4 – Credit risk – internal ratings based approach

Q16: Do you have any comments on the PRA's proposed implementation timelines?

Q17: Do you have any comments on the PRA's proposals for permission to use the internal ratings based (IRB) approach?

Q18: Do you have any comments on the PRA's proposed IRB exposure classes and sub-classes?

IACPM members consider that one of the shortcomings of the Basel 3.1 Standards is that they do not include a separate asset class for insurers/or and reinsurers. Rather, insurers are effectively treated as corporates (see, eg., paragraph SA-38 of the Basel 3.1 Standards). Despite this, there are various places throughout the Basel 3.1 Standards where insurance companies are effectively treated in the same category as banks or other financial institutions rather than corporates (see, eg., paragraphs SA-151(c) and SA-197 of the Basel 3.1 Standards, as well as paragraphs IRB-34, IRB-52 and IRB-70 of the Basel 3.1 Standards). Many of these references are also reflected in the CRR and the Proposed CRR Instrument. In our view, these references reflect the fact that insurance and reinsurance companies are indeed fundamentally different from general corporates, at least where they are subject to prudential regulation such as is the case in the UK and EU.

Although not explicitly referred to in the Consultation Paper or the Proposed CRR Instrument, we assume that it is intended that insurance and reinsurance undertakings will remain "financial sector entities" as is currently the case under the CRR, and thus would be classified as exposures to corporates under the Standardised Approach (Article 112(g) of the Proposed CRR Instrument) and as "large corporates" for the purposes of paragraph 4.55 of the Consultation Paper and Articles 147(2)(c)(ii) and (4E) of the Proposed CRR Instrument under the IRB Approach.

Nevertheless, and given the somewhat confused treatment of exposures to insurance companies in the Basel 3.1 Standards, IACM members submit that the Proposed CRR Instrument should treat exposures to prudentially regulated insurance companies as a separate exposure class of their own. This is already the case to a limited extent (see, eg., Articles 153(1), 161, 325ah and 325ak of the Proposed CRR Instrument).

Please also see our responses to Questions 19, 29 and 35 below for further detail on the reasons why it is appropriate to treat exposures to insurers differently from exposures to general corporates. In particular, and for the reasons discussed in more detail in our responses to Questions 19 and 29 below, for the Standardised Approach, we suggest that the risk-weight for insurers which are subject to prudential regulation should be at least in line with that applied to financial institutions (e.g. 30% for "A" rated) rather than corporates (e.g. 50% for "A" rated).

Q19: Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?

While IACPM members do not necessarily agree with many of the proposed restrictions on the use of the IRB Approach, we acknowledge that these are one of the fundamental changes in the Basel 3.1 Standards, and are expected to be applied in other jurisdictions, including the EU.

However, IACPM members do consider that one problematic implication of these restrictions is the removal of the AIRB Approach for exposures to, *inter alia*, insurance companies and the resultant effect on credit insurance as a form of credit risk mitigation. As further discussed in our responses to Questions 29 and 35, below, the LGD that would need to be applied under the FIRB Approach and the RWs that apply under the SA Approach are not in our view appropriate when it comes to the particularities of credit insurance. IACPM members acknowledge that one key intention of the final Basel recommendations is to reduce variability, and the proposed removal of the AIRB Approach for large corporate exposures is an important facet of this. However, in our view the specific nature of credit insurance was not (or not properly) considered when those recommendations were made. This is likely to be due to the fact that the use of credit insurance for CRM by banks was much less widespread at that time. However, since those recommendations were made, there has been a significant increase in the use of credit insurance. Indeed, according to IACPM surveys conducted in 2021, loan-by-loan private credit risk insurance is now the second most important credit mitigation instrument tool for European respondents (behind portfolio sales), surpassing synthetic securitisations. Moreover, although less common in the UK than in the EU, credit insurers play an increasing role in providing the credit protection for the placed tranches of synthetic securitisations on all asset classes.

Q20: Do you have any comments on the PRA's proposed approach to roll-out, permanent partial use, and reversion?

Q21: Do you have any comments on the PRA's proposals relating to the 1.06 scaling factor and to the 1.25 asset value co-efficient of correlation multiplier?

Q22: Do you have any comments on the PRA's proposal to **remove the SME support factor** under the IRB approach? Do you have evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for SME exposures in the absence of the support factor?

IACPM members disagree with the PRA's proposal to remove the SME support factor which currently applies under Article 501 of the CRR. While acknowledging the PRA's comments in paragraphs 4.135 of the Consultation Paper, we note that the EU is not proposing to make a similar change as part of its implementation of the Basel 3.1 Standards (see EU proposals dated 21 October 2021, which have not been proposed to be changed in the recent EU Parliament deliberations). In our view, a significant departure from the requirements applicable to EU banks will place UK banks at a considerable competitive disadvantage with many of their peers in the EU, both in respect of EU banks providing credit to UK SMEs, and for UK banks providing credit to EU SMEs.

Against this backdrop, we also disagree with the PRA assertions in paragraphs 1.28 of the Consultation Paper. While it is acknowledged that the EU rules (both current and proposed) deviate from the international standards in various respects, we disagree with the suggestion that these deviations are in all cases negative from a policy perspective. On the contrary, some of those changes (most notably the extension of the STS framework to on-balance-sheet synthetic securitisations) have been a very positive development in redressing some of the overly conservative features of the Basel framework which do not reflect the observed reality of the EU or UK experience, but rather were based on the experience of sub-prime mortgage securitisation in the United States.

Further, while the PRA notes that a number of jurisdictions (Canada, Australia, Switzerland, Singapore and Hong Kong) are proposing to adhere largely to the Basel 3.1 Standards, it must be acknowledged that those jurisdictions, while important, together represent a market not significantly larger than the UK, whereas the EU market is more than five times the size of the UK and is much more closely connected with the UK financial sector.

Generally-speaking, IACPM members support adherence to international standards, but in circumstances where the two most significant regulatory communities (the EU and US) do not propose to follow those standards, it does not make sense for the UK to do so where this will place UK financial institutions at a comparative disadvantage compared with their EU, and potentially US, competitors. Given that we do not think the observed experience is that the application of the SME support factor has given rise to institutions being undercapitalised for their exposures to this asset class, we therefore consider that it should be retained.

The impact of this change will be more significant if no changes are made to mitigate the impact of the Output Floor as discussed in our response to Question 49 below. This is because, if the Output Floor is implemented as currently proposed, it will make it more difficult for banks to mitigate the RWA capital requirements in relation to their SME lending business through significant risk transfer synthetic securitisations, which is one of the few effective tools credit risk mitigation tools available for this asset class.

We note that the PRA has requested qualitative and quantitative feedback on whether the IRB approach would appropriately reflect the risk of SME exposures the SME support factor is removed. Our member are intending to provide this feedback as part of their individual responses to the Consultation.

Q23: Do you have any comments on the PRA’s proposal to move the **infrastructure support factor** under the IRB approach? Do you have evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for infrastructure exposures in the absence of the support factor?

As with the SME support factor, IACPM members do not agree with the PRA's proposal to remove the infrastructure support factor, for essentially the same reasons as set out above (see our response to Question 22, above). We note, in this regard, that the proposed EU implementation of the Basel 3.1 Standards retains the infrastructure support factor to corporate exposures IACPM members urge the PRA to adopt the same approach.

We note that the PRA has requested qualitative and quantitative feedback on the impact of the removal of the infrastructure support factor. Our member are intending to provide this feedback as part of their individual responses to the Consultation.

Q24: Do you have any comments on the PRA's proposed approach to calculation of risk-weighted assets and expected loss, not covered by the questions above?

Q25: Do you have any comments on the PRA's proposed general requirements for use of the IRB approach?

Q26: Do you have any comments on the PRA's proposed approach to the definition of default?

Q27: Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?

In relation to the PRA's proposals in relation to conversion factors (paragraphs 4.210 and 4.211 of the Consultation Paper), please see our response to Question 5, above.

Q28: Do you have any comments on the PRA's proposals on PD estimation?

Q29: Do you have any comments on the PRA's proposals to LGD estimation?

The impact of the removal of the AIRB Approach for large corporate exposures on the use of credit insurance as a method of credit risk mitigation will result in banks needing to apply FIRB LGD (being 45% or 40% for unsecured transactions depending on whether insurers are designated as "financial sector entities" or "corporates", as discussed in Question 18) to the insured exposure. This is too high and does not reflect the fact that an exposure to a credit insurer under a policy is not comparable to a debt claim to the same insurer, largely as a result of the requirements under the Solvency II regime. It also does not reflect the reality that credit insurance provides a second layer of recourse in respect of the same underlying exposure, and that that additional recourse is almost always uncorrelated to any other security or guarantees held by the bank for that underlying exposure. Thus, the bank has two parallel, uncorrelated and concurrent routes of recovery in respect of that exposure.

The Solvency II regime in the EU (which remains applicable in the UK) imposes robust reserve and solvency requirements on insurers. In addition, one of the key features of the regime is that claims of insurance *policyholders* take precedence over *all* other claims against insurance companies (with respect to the insurers technical provisions, i.e. reserving/liabilities) and *most* other claims (save for a couple of very specific examples e.g. tax liabilities) with respect to other claims. In our view, this, along with other points more particularly discussed in response to Question 35 below, means that an exposure that is covered by credit insurance provided by a prudentially-regulated insurer should not be treated as comparable to a general, non-insurance exposure to the same insurer, let alone to a general corporate which is not subject to any prudential regulation at all. A study undertaken by KMPG in February 2020, which we understand has been shared with the PRA separately, confirmed that since the introduction of Solvency [I]/[II] (i) there has been a marked decrease in the both the number and size of insurance undertakings which have become insolvent and (ii) all policyholder claims were paid in full in every case where KPMG were able to obtain details of distributions and the insolvency was complete.

This differential treatment of policyholder and non-policyholder claims is also reflected in the fact that the rating agencies have two different rating approaches for insurance groups. The first is a general credit rating which is given typically to a holding company and which would apply to bond issuance at such level. However, importantly for the purpose of this discussion, they also apply a financial strength rating, which is given to the subsidiaries that actually issue the insurance policies and is therefore usually a better rating largely because of the protections afforded to policyholders under the Solvency II regime.

In this regard, we also refer to analysis undertaken by the European Banking Authority in its opinion on the treatment of credit insurance in the prudential framework of 9 March 2020 (EBA/Op/2020/05). The EBA observed in that opinion that further analysis is required to as to how this seniority should be treated for the purposes of determining appropriate regulatory LGDs, and we would like to drawn to the PRA's attention data that has since been collected from the industry since that opinion as issued. Taking all of this into account, in our view the fact remains that it is not appropriate simply to treat exposures to insurance companies in the same way as exposures to other types of large corporates, and this should be reflected in the Proposed CRR Instrument. As discussed in more detail in our response to Question 35 below, we do not consider this to be a divergence from the Basel 3.1 Standards (which do not address the treatment if CRM exposures to insurers specifically), but rather a nuanced clarification that aligns with the nature of credit insurance claims and avoids creating what we consider to be unintended discrepancies between the treatment of the underlying exposure and the effect of the CRM. IACPM and its members would welcome the opportunity to work with the PRA on any further analysis that the PRA may consider necessary in order to determine the appropriate treatment of exposures to insurers for this purpose.

In light of the priority accorded to policyholder claims under Solvency II (see discussion in our response to Question 19 above), IACPM members therefore think that an LGD of [15%– [30%] for unsecured exposures covered by credit insurance would be more appropriate. This is considering that an exposure to a large corporate would be 40% LGD and to an insurer (if deemed a financial institution) would be 45% LGD, resulting in an effective LGD of ~18% LGD (ie., 40% LGD for the corporate multiplied by the implied 55% recovery from the insurance).

With respect secured exposures, whilst IACPM members recognise that the withdrawal of the double-default treatment is one of the key changes in the Basel 3.1 Standards, the fact that a bank would have two different and distinct routes to *recovery* for secured and insured exposure is not reflected in the proposed LGDs. We welcome the proposed Basel recommendations reducing the LGDs for secured exposures, as discussed further in paragraph 5.79 of the Consultation Paper, but note that where such exposure is also covered by credit insurance the same 40/45% LGDs would apply notwithstanding that the ability to enforce the security exists in parallel to the insurance claim, which is clearly an illogical outcome as it would mean the bank would need to hold *more* capital against that secured exposure as a result of purchasing the credit insurance (or disregard the credit insurance for CRM purposes). IACPM members therefore think an LGD for 10-15% for secured exposures which also benefit from credit insurance would be more appropriate.

In this regard, and by way of comparison, IACPM members draw the PRA’s attention to the treatment of exposures backed by pledged life insurance policies, exposures backed by receivables and covered bonds, all of which have their own preferential treatment based on the particularities of those exposures. These are important proxies to bear in mind for the LGD proposals made here. We also refer to the study undertaken by Oliver Wyman, which was provided to the PRA during the PS 8/19 consultation process, which estimates that the LGD should not be higher than 10-30% for credit insurance.

As discussed further in response to Question 35 below, IACPM members want to emphasise that these suggestions on the treatment of credit insured exposures are not a deviation from Basel recommendations, as credit insurance was simply not considered in those recommendations. Indeed, we think that these suggestions actually show alignment with the Basel approach that the LGD (for FIRB) or RW (for SA) when it comes to UFCP should be reflective of a "comparable direct exposure" to the credit protection provider.

Q30: Do you have any comments on the PRA's proposals to EAD estimation?

Q31: Do you have any comments on the PRA's proposals for maturity?

Q32: Do you have any comments on the PRA's proposals for specialised lending?

Chapter 5 – Credit risk mitigation

Q33: Do you have any comments on the PRA's proposals for recognising funded credit protection (FCP) for exposures that give rise to counterparty credit risk?

Q34: Do you have any comments on the PRA's proposals for recognising FCP for exposures that do not give rise to counterparty credit risk?

Q35: Do you have any comments on the PRA's proposals for recognising unfunded credit protection (UFCP)?

Clarification of applicable methods for recognising UFCP

IACPM members support the PRA's explicit recognition that where IRB exposures are subject to UFCP from a protection provider which is subject to the Standardised Approach, UFCP can be recognised through the risk weight substitution method. Similarly, we also support the recognition that where an AIRB exposure is protected by a protection provider which would be subject to the FIRB approach, UFCP can be recognised through the parameter substitution method, and that the risk weight substitution method can be used in certain circumstances for exposures subject to the slotting approach. This will address some gaps in the current rules where a literal reading of Article 236 of the CRR suggests that UFCP provided by a protection provider which the institution treats as subject to Standardised Approach (including many sovereigns or MDBs) could not be recognised for IRB exposures.

Central counterparties

IACPM members have identified an apparent oversight in the Basel framework (and the CRR) in that while qualifying central counterparties are recognised as eligible providers of UFCP (see Article 201(1)(h) of the CRR and Article 201(1)(h) of the Proposed CRR Instrument), Article 107(2) of the CRR (which is carried over in Article 107(2) of the Proposed CRR Instrument) provides that for all purpose other than calculating RWAs for the purposes of Articles 92(3)(a) and (f) of the CRR, exposures to qualifying central counterparties shall be treated as exposures to an institution, while exposures to non-qualifying central counterparties shall be treated as exposures to a corporate. It is not clear whether the reference to calculation of RWAs in Article 107(2) of the CRR is intended to include when calculating the effect of UFCP provided by a central counterparty (eg., in the case of cleared CDS). While we consider that should be the case, we request that the PRA clarify this in the Proposed CRR Instrument.

Credit insurance

As the PRA is aware, credit insurance is an important and increasingly used credit risk mitigation tool used by many institutions, as is illustrated by the IACM survey results referred to in our response to Question 19, above that showed that, among other things, credit insurance was the 2nd most important credit portfolio management tool after secondary sales for the 43 respondent banks. However, despite this, there is no mention of credit insurance in the relevant sections of the CRR (or the Proposed CRR Instrument). It is also not mentioned in the Basel framework, other than a brief response to a FAQ which confirms that insurance can be used for CRM purposes provided it meets the requirements for guarantees (see QIS3 FAQ: E, Question 6). Against that backdrop, it is helpful that the PRA has previously indicated that credit insurance which meets the substantive requirements under the CRR for guarantees may be recognised as UFCP (see, etc., PRA Policy Statement 8/19), and this is reaffirmed in paragraph 5.104 of the Consultation Paper. However, we ask that the PRA codify this in the Proposed CRR Instrument, to provide much-needed clarity for the market. In this context, IACPM members would welcome further dialogue with the PRA on the specificities and importance of the product and how these could be effectively reflected in the regulatory framework. In particular, following from our response to Question 19, above, we would welcome the opportunity to discuss with the PRA how the special features of credit insurance could be reflected in the framework for UFCP.

The observed experience of IACPM members over many years now has been that credit insurance is a very effective CRM tool, with a very high percentage of claims paying out as expected. Further, as noted in our response to Question 19 and 29, above, insurers are also subject to their own stringent regulatory framework which mitigates the risk of claims not being paid.

In light of this, IACPM members consider that it is appropriate to recognise credit insurance as a distinct form of credit risk mitigation, alongside guarantees and credit default swaps, rather than requiring credit insurance to be analysed as if it were a guarantee for that purpose. Indeed this would be consistent with the PRA's stated preference in paragraph 5.95 of the Consultation Paper for the eligibility criteria for UFCP to depend on the CRM method being used. In our opinion, this would enable the PRA to formulate specific rules that are tailored to the nature of credit insurance, and IACPM and its members would be keen to engage with the PRA in a more detailed consultation in this regard. This would include, but not necessarily be limited to: (1) application of an appropriate LGD for IRB banks that reflects the recovery expectations for credit insured exposures (as discussed in response to Questions 19 and 29 above); (2) an appropriate RW the Standardised Approach banks (which, as mentioned in our response to Question 18, above, we think should be at least in line with those applied for financial institutions); and (3) confirmation that the typical features of the product as recognised by the PRA in PS8/19 do not render it as ineligible for credit risk mitigation under the Proposed CRR Instrument.

We acknowledge that there is no specific recognition of credit insurance in the Basel 3.1 Standards, but nor would introducing a framework for recognising credit insurance as UFCP be inconsistent with the Basel framework. Accordingly, we do not view this suggestion as a deviation from those standards. Rather, we see it as supplementing those standards with rules that are appropriately tailored to what has become a common practice across financial markets, in a way which is consistent with the underlying principles of the CRM framework. The absence of rules in the Basel framework is not a justification for failing to formulate suitable rules to ensure the UK market can function effectively and efficiently, and IACPM members suspect the absence was due to the relative size of the credit insurance market at the time of the proposals (the growth of which since the Basel committee could not have been expected to predict).

By way of comparison, we also note that the proposed EU implementation of the Basel 3.1 Standards does include a requirement for the EBA (in conjunction with EIOPA) to consider the eligibility and use of credit insurance as a CRM technique, and on whether the parameters currently set out in the CRR for UCFP are appropriate for that purpose (see proposed Article 506 of the CRR). Depending on the outcome of that review, the European Commission may be empowered to amend the CRR in relation to the treatment of credit insurance. From the perspective of the competitiveness of the UK financial system, it would not be desirable if the ability to use credit insurance was more difficult for UK banks than it is for their EU competitors. Give the size of the UK insurance sector, this is an opportunity for the UK to take the lead in formulating appropriate rules for the use of this important product by banks.

Lloyds syndicates

Finally, we wish to raise one UK-specific matter which we consider should be addressed in the Proposed CRR Instrument. Presently, insurers are only eligible unfunded credit protection providers through Article 201(1)(g) of the CRR, which requires that they be corporate entities with an appropriate external or internal rating. However, one of the most important participants in the UK insurance market is the Lloyds market, made up of syndicates formed for each policy year. A Lloyds syndicate is not a corporate entity (although it will usually, but not always, be made up of corporate entities). They are, however, recognised as "insurance undertakings" for other UK regulatory purposes. Given that the Lloyds market is unique to the UK it is, unsurprisingly, not mentioned in the Basel framework. However, given the way Lloyds syndicates, and the broader Lloyds market, operate and are regulated in the UK, there is no reason to treat a Lloyds syndicate differently from other insurance companies for the purpose of determining their eligibility as providers of UFCP. IACPM members therefore request that the PRA modifies Article 201(1) of the Proposed CRR Instrument to include Lloyds syndicates.

Q36: Do you have any comments on the PRA's proposals for FCP?

Q37: Do you have any comments on the PRA's proposals for UFCP?

Indirect credit protection

One issue which IACPM members feel is not adequately treated in the Basel framework is indirect credit protection. While we acknowledge the PRA's observations in paragraph 5.101 of the Consultation Paper that indirect credit protection arrangements (such as counter guarantees) are generally likely to be effective than direct credit protection arrangements, we think that one important exception to this concern is where UFCP is provided by a special purpose entity (SPE), which then benefits from a counter-guarantee from an entity which is an eligible protection provider, where the terms of the transaction documentation in totality are such that the ultimate beneficiary of the UCFP provided by the SPE can be confident that it will in fact receive the benefit of the UFCP provided by the eligible protection provider through the use of well-established techniques such as the granting of security or the declaration of a trust over the SPE's rights under the external UFCP, coupled with bankruptcy remoteness features to prevent that external UFCP terminating in circumstances where the UFCP provided by the SPV remains in place as well as a mechanism to enable the ultimately beneficiary to ensure that the external UFCP will be triggered in circumstances where it is permitted to make a claim under the UFCP provided by the SPE. IACPM members do not consider that such arrangements are a departure from the principle that credit protection must be direct. Rather, the use of a properly-structured SPE intermediary should simply be considered part of the arrangements by which the UFCP is provided by the eligible protection provider.

Eligibility of non-R CDS

The Basel 3.1 Standards prescribe that a credit default swap used for credit risk mitigation purposes needs to specify failure to pay, bankruptcy and restructuring of the underlying exposure as credit events that entitle the protection buyer to trigger the protection (see paragraph SA-195(a) of the Basel 3.1 Standards). If restructuring is not included, the credit protection is capped at 60% of the nominal amount of the CDS. However, footnote 83 in the Basel 3.1 Standards qualifies this by providing that it is not necessary to include restructuring as a credit event where a 100% vote is needed to amend the maturity, principal, coupon, currency or seniority of the protected exposures and the relevant bankruptcy laws that would be applicable to the underlying obligor has a well-established bankruptcy code that allows for a company to reorganise/restructure and provides for an orderly settlement of creditor claims.

While it is standard for CDS on European corporate and financial entities to include restructuring, that is not the case for CDS on North American corporate and financial entities, reflecting the more common approach that corporate restructurings occur within the framework of the US Chapter 11 bankruptcy proceedings which fall within the scope of the bankruptcy credit event. This is the type of arrangement which was intended to be captured by footnote 83 in the Basel 3.1 Standards. However, for some reason this derogation has not been reflected in the CRR, and nor is it currently included in the Proposed CRR Instrument. Given the clear statement in the Basel 3.1 Standards, IACPM members urge the PRA to implement this derogation as part of the Proposed CRR Instrument.

Funded-Unfunded Credit Protection

In order to qualify as UFCP, the protection provider must be an entity included in the list of eligible protection providers in Article 201 of the CRR. This reflects the fact that, for UFCP, the protection buyer is exposed to the credit risk of the protection provider. However, this requirement fails to take into account the situation where the protection provider itself provides funded credit protection to secure its obligations under the UFCP where that funded credit protection meets the relevant requirements for CRM under the CRR. The PRA has commented on this scenario from time to time in the past, but has not provided a clear statement of its position on how such an arrangement should be treated. Nevertheless, it has become a common market practice for an institution to treat such an arrangement as "funded-unfunded credit protection", whereby, so long as the UFCP complies with all of the requirements for UFCP other than the eligibility of the protection provider *and* the collateral provided by the UFCP protection provider meets all of the requirements for funded credit protection, the institution calculates the effect of the combined UFCP/FCP arrangements as if the underlying exposure was protected by a form of funded credit protection.

IACM members' view is that this is an entirely appropriate approach to take, and reflects the actual legal and economic effects of the combined arrangements in a way which is entirely consistent with the requirements of the Basel 3.1 Standards. We therefore urge the PRA to clarify that Article 201 of the Proposed CRR Instrument does not apply where the protection provider itself provides collateral in favour of the protection buyer which satisfies all of the requirements for funded credit protection under the CRR.

We note that Article 191A(2)(d) of the Proposed CRR Instrument does contemplate that an exposure may benefit from both funded and unfunded credit protection. However, this appears to be referring to situations where the funded credit protection is provided to secure the underlying exposure directly, rather than the situation described above where the funded credit protection is provided to secure the obligations of the unfunded protection provider.

Timely Payment and Two-Stage Payments

One of the requirements of the CRM framework which has achieved the most attention over the years has been the requirement for a protection provider of UFCP to pay out in a "timely manner" (see CRR Articles 213(1)(c)(iii) and 215(1)(a). The PRA has considered this requirement in the past, ultimately deciding not to prescribe a specific time period that constitutes a "timely manner", but rather requiring institutions to consider the risks arising from eligible guarantee arrangements and any residual risks (see paragraph 2.6 of PRA Policy Statement 8/19). While IACPM members agree with this approach, one point that is not clearly addressed is exactly what needs to be paid in a timely manner. Article 213(1)(c)(iii) of the CRR (also retained in the Proposed CRR Instrument) merely requires the protection provider to be required to "pay out" in a timely manner, which presumably refers to it being required to pay whatever is required to be paid under the UFCP contract. There is then an apparent discrepancy between guarantees, where Article 215(1)(a) requires the beneficiary to be able to pursue the guarantor for "any monies due under the claim in respect of which the protection is provided" and CDS, where Article 216(1)(b) of the CRR (also retained in the Proposed CRR Instrument) merely requires a robust valuation process to *estimate* loss reliably, which clearly implies that the payment may be significantly less than the nominal amount of the protected obligation. Given that the PRA has previously also indicated to individual institutions that it expects the CRM effects of guarantees and CDS to be broadly equivalent (even to the point of requiring restructuring to be included as a trigger event in guarantees when used for the purposes of significant risk transfer synthetic securitisations), it has become common for both guarantees and CDS used for CRM purposes to adopt a "two-stage" loss process, whereby an initial estimated loss is paid relatively quickly after the occurrence of the default by the underlying obligor, with one or more subsequent "true-up" payments to be made during or at the end of the work-out process once the final realised loss is known. This is essentially applying the same approach as that set out in Article 215(2) of the CRR in the context of mutual guarantee schemes or guarantees provided or counter-guaranteed by a central government or central bank. This also avoids the need for a guarantor to be subrogated to the beneficiary's claim against the underlying obligor, which is often undesirable for many institutions.

Given that there is no good reason for treating guarantees and CDS differently in this context (indeed the PRA has made just such this point in paragraph 5.120 of the Consultation Paper), and that the two-stage process achieves the purpose of the timely payment requirement by ensuring that the institution is quickly compensated for the loss it expects to incur as a result of the underlying obligor default, IACPM members consider that this two-step process is an appropriate interpretation of the Basel 3.1 requirements, and request that the PRA clarifies that this is the case in the Proposed CRR Instrument.

In this context, we note that the PRA has included a helpful clarification in Article 213(1) of the Proposed CRR Instrument which provides that an alternative to the protection provider paying all outstanding future amounts due by the defaulting obligor at the time of the default, but instead permitting the protection provider to assume those future payment obligations as they fall due is consistent with the timely payment. In our view, the two-stage process described above is essentially just a variation on this approach. In most cases, the initial/estimated loss payment would be significantly greater than the amounts due at the time of the default (it would usually be based on the regulatory LGD or accounting impairment on the entire protected exposure), and the true-up mechanic ensures that the protection provider remains liable to pay the remaining amounts owed should they not be recovered from the underlying obligor.

Chapter 6 – Market risk

Q38: Do you have any comments on the PRA's proposed definition of "gross jump-to-default" in the alternative standardised approach (ASA) default risk charge?

Q39: Do you have any comments on the PRA's proposal for carbon emissions certificates? What additional information could be considered for the calibration of risk weights and correlations, particularly relating to any historical period of stress?

Q40: Do you have any comments on the PRA's proposals to include the external party approach (EPA) for the treatment of collective investment undertakings (CIU) in the new ASA?

Q41: Do you have any comments on the PRA's proposals to recognise non-modellable risk factors (NMRFs) in your model for the purposes of back-testing at the trading desk level? To what extent would you be able to incorporate NMRFs into your model for back-testing?

Q42: Do you have any comments on the PRA's proposal to allow firms a greater degree of modelling flexibility for CIUs in internal model approach (IMA)?

Chapter 7 – Credit valuation adjustment and counterparty credit risk

Q43: Do you consider the proposed credit valuation adjustment (CVA) transitional arrangement appropriate from risk and operational perspectives?

Q44: Do you consider the standardised approach-counterparty credit risk (SA-CCR) transitional arrangement appropriate from risk and operational perspectives?

Q45: To what extent do you consider the targeted recalibration on risk weights for pension funds and the proposed reduction in the SA-CCR alpha factor to be appropriate?

Q46: To what extent do you think the proposed CVA and SA-CCR package appropriately aligns the risks with the capital requirements for derivatives transactions?

Chapter 8 – Operational risk

Q47: Do you have any comments on the PRA's proposed implementation of the standardised approach (SA) in the Basel 3.1 standards for operational risk capital requirements?

Q48: Do you support the PRA's proposal to set the internal loss multiplier (ILM) equal to 1?

Chapter 9 – Output floor

Q49: Do you support the **scope and levels of application** of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?

As we have previously communicated to the PRA, the application of the Output Floor under the Basel 3.1 Standards is particularly problematic in the context of securitisation. This is due to the fact that a securitisation structured under the SEC-IRBA methodology will generally require significantly thinner tranches to be transferred to investors than a securitisation of the same portfolio under the SEC-SA methodology.

IACPM members note that the PRA has indicated in paragraph 2 of Box A under paragraph 9.37 of the Consultation Paper that the output floor would not directly affect the supervisory assessment of commensurate risk transfer under Articles 244 and 245 of the CRR, the calculation of the maximum risk weights and RWAs under Articles 267 and 268 of the CRR, nor the PRA's expectations in relation to the thickness of sold or protected tranches for portfolios of SA exposures. This last comment is somewhat confusing, as by definition the securitisation of portfolios of exposures which are in any case subject to the Standardised Approach would not be affected by the output floor on the basis that they would usually be assessed under the SEC-SA anyway. We therefore assume that the PRA's comments in this paragraph are intended to convey that there is no need to conduct a parallel SRT or CRT assessment applying the SEC-SA approach the securitisation is structured to apply the SEC-IRBA methodology.

While this clarification is helpful, it does not address the fact that the output floor has a disproportionate impact on securitisations compared with its impact on non-securitised exposures. Even if no separate SRT/CRT assessment is required, the effect of applying the SEC-SA methodology to a securitisation which has been tranched based on the SEC-IRBA methodology will usually generate a risk-weight for the senior retained tranche that is significantly in excess of 100%, thus meaning the cap under Article 268 of the CRR would apply anyway, with the result that the securitisation would generate no regulatory capital relief for the purposes of the institution's output floor calculations. In a survey of 14 UK and EU banks recently conducted by the IACPM, 60% of respondents concluded that the majority (if not all) of the regulatory capital benefit generated by their SRT securitisations being eliminated.

IACPM members do not consider that this was really the intention of the output floor, and that its outsized impact on securitisation transactions was not properly considered when the floor was being developed. We also do not agree that the effect of the output floor on securitisation should be disregarded because the floor applies only at the consolidated group level. All institutions expect to be required to calculate the contribution which each portfolio within the bank, whether securitised or not, makes to the consolidated group's Standardised RWEA, and for each business unit to be required to account for those costs.

We note that the PRA has also stated in paragraph 3 of Box A that it proposes to engage with firms originating SRT securitisations during the output floor transition period, to understand the impact of the proposed use of the standardised methodologies for securitisations for the purposes of the output floor. IACPM members are strongly of the view that this engagement should occur *now*, before the Proposed CRR Instrument is finalised, and not wait until the transition period begins.

In this regard, it is important to compare the PRA's proposed approach with that in the two most important regulatory jurisdictions, being the US and the EU. As the PRA has itself noted, the US has not yet published its proposals to implement the Basel 3.1 Standards. We do, however, note that the US has not even implemented the amendments to the securitisation framework that formed part of the original Basel 3 Standards (despite those standards having been primarily calibrated by reference to the experience of US sub-prime mortgage securitisation and not reflective at all of the experience of EU and UK securitisation), and therefore is continuing to operate on the more favourable Basel 2 Standards. Accordingly, the PRA's proposals are not in line with current practice in the US.

The EU's initial proposals for implementing the output floor were very similar to the PRA proposals. However, during the course of the negotiations (which are still ongoing), important amendments have been approved by the EU Parliament, and now also circulated for discussion by the European Commission in a recent "non-paper" dated 16 February 2023. The proposals approved by the EU Parliament provide for the "p-factor" for STS securitisations to be reduced from 0.5 to 0.25, while for non-STS securitisations the p-factor would be reduced from 1 to 0.5. Although these reductions are expressed to be temporary, until the completion of a comprehensive review of the EU securitisation framework as part of the EU Capital Markets Union, as there is no timeframe set for such review, it is expected that these reductions would essentially apply on an open-ended basis until a more effective long-term solution can be found.

The European Commission "non-paper" also proposes that the p-factor for STS securitisations under the SEC-SA should be lowered from 0.5 to 0.25, although it does not propose a reduction in the p-factor for non-STS securitisations. It does, however, propose a number of other amendments that are not specifically related to the output floor, including capping the p-factor under the SEC-IRBA at 0.3 and reducing the risk-weight floors.

Returning to the US, it is currently applying a p-factor of 0.5 under the predecessor to the SEC-SA, the Simplified Supervisory Approach (SSFA).

A reduction in the p-factor under the SEC-SA will not eliminate the adverse impact of the output floor on securitisations. However it will lessen that impact. The p-factor was originally introduced in response to regulatory concerns about agency and model risk associated with the SEC-SA and SEC-IRBA methodologies. These risks are, however, less applicable in the case of originator institutions, as they by definition have access to all of the information necessary to model the risk appropriately. IACPM members would be supportive of any reduction in the p-factor being limited to originator institutions.

One of the PRA's "have regards" considerations in the Consultation Paper is the relative standing of the UK as a place to operate and competitiveness. In is assessment in paragraph 9.40 of the Consultation Paper, the PRA states that it will continue to monitor approaches in other international jurisdictions and take into account competitiveness in finalising the proposals in the Consultation Paper. In this regard, given the very tight integration between the UK and EU markets, a positive legacy of the UK's membership of the EU, it is the EU standards which are most relevant here. The competitiveness of UK banks will be seriously disadvantaged if they are subject to the excessively conservative impact of the output floor for securitisations while their major competitors in the EU enjoy a less conservative requirement. This will also reduce the attractiveness of the UK as a jurisdiction for institutions based in third countries (eg., the US, Canada or Japan) seeking to provide financial services into the broader European markets.

Accordingly, IACPM members urge the PRA to reduce the p-factor under the SEC-SA to from 1 to 0.5. In addition, given the additional importance of this issue for the originator of a significant risk transfer securitisation, and in view of the fact that, unlike in the EU, the STS framework does not apply to on-balance sheet synthetic securitisations in the UK, we urge the PRA to allow a p-factor of 0.25 to be used by the originator of a securitisation for which the PRA has not objected to the recognition of significant risk transfer.

IACPM members will separately provide to the PRA illustrative examples showing the impact which the current proposed implementation of the output floor will have on SRT securitisations, as well how that disproportionate impact can be partially mitigated by a reduction in the p-factor for the SEC-SA formula. members would welcome the opportunity to discuss this further with the PRA.

In addition to a reduction in the p-factor, IACPM members also ask for clarification that institutions are permitted to take unfunded credit protection (eg., protection provided by insurers) into account for the purposes of calculating the RWA of securitisation positions. To date, institutions have understood that, despite it clearly being permitted under Article 249 of the CRR, and a common practice across the EU, the PRA has had reservations about the use of private sector UFCP for the purpose of reaching the threshold for recognising SRT (although banks have certainly been allowed to use UFCP to transfer additional risk over and above that required to achieve SRT). However, with the output floor making it necessary for institutions to transfer risk on thicker tranches in order to reach the risk-weight floor under the SEC-SA, even for a securitisation which is otherwise being assessed under the SEC-IRBA, one possible solution is for the institution to transfer risk on an upper mezzanine tranche to an insurer using UFCP at much lower cost than if that tranche was transferred using funded credit protection. It would be helpful if the PRA was able to confirm that this would be permitted once the output floor is in place.

Q50: Do you have any comments on the PRA's proposal that when the output floor is activated 'floored' RWAs should be used wherever relevant in all elements of the capital stack? Do you have any additional evidence that is relevant to this proposal to inform the PRA's analysis?

Q51: Do you have any comments on the PRA's proposed transitional arrangements including the proposal to not apply the discretionary transitional cap?