January 16, 2024

Ann Misback, Secretary
Board of Governors of the Federal Reserve
2001 C St. NW
Washington, D.C. 20551

Docket No. R-1813
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James P. Sheesley, Asst. Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

RIN 3064-AF29

Chief Counsel's Office
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218
Washington, DC 20219

Docket ID OCC-2023-0008
RIN 1557-AE78

Re: Notice of Proposed Rulemaking on the Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity (the "Proposal")

Ladies and Gentlemen:

The International Association of Credit Portfolio Managers ("**IACPM**") appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, the "**Agencies**") on the above-referenced Proposal.

The IACPM is a global industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlap with the membership of several other financial industry associations.

Our perspective is unique, however, in that the IACPM represents the teams within those financial institutions who have responsibility for the prudential management of such institutions' credit portfolios, including actively controlling concentrations, adding diversification, managing

the return of the portfolio's components relative to their risk, and allocating capital to new credit exposures. In addition, our members also include investors, insurers, and reinsurers, which participate in risk sharing transactions as sellers of credit protection.

We have also had the opportunity to review the comment letters by other trade associations, including those filed jointly by the Bank Policy Institute and the American Bankers Association, the International Swaps and Derivatives Association, Inc. and the Securities Industry and Financial Markets Association, as well as the Structured Finance Association, and we echo the concerns they have raised about the impact the Proposal will have on banks' access to capital management and credit risk mitigation tools.

1. Introduction

The IACPM agrees that minimum risk-based capital and leverage requirements are a critical fixture of our banking system, ensuring that losses can be absorbed without posing risks to depositors and taxpayers and reducing the ripple effects of bank failures. Inappropriately calibrated or excessively high capital requirements, however, introduce new safety and soundness risks as they may force banks to exit whole business lines altogether, pushing more credit origination and intermediation activities to the private and non-bank lending system, which to date remains largely unregulated and insufficiently stress-tested. Higher capital requirements will also increase costs to businesses and consumers, reducing economic activity on a macro scale.

The Proposal would significantly increase capital requirements for affected banking organizations in a myriad of ways, including limiting the incentive for banks to use more risk-sensitive internal models to measure and manage credit, operational and other risks, introducing new categories of operational and CVA risk-weighted assets ("**RWAs**") and imposing deductions to regulatory capital that previously only applied to the most complex, inter-connected global systemically important banks, among others. The effect of higher capital requirements is not, as has been suggested by some, a mere matter of "re-direct[ing] a tiny fraction of…profits…to get to the new capital levels."[1] Rather, they risk significantly altering the capacity of banks to lend to corporate and retail borrowers as well as the terms and pricing under which such credit will be extended.[2]

Against this backdrop of ever-increasing capital requirements, banks will have to use a variety of risk sharing tools for prudent risk management and to maintain their lending capacity. Banks need access to an effective source of capital release via risk transfer tools on all types of assets classes and fulfill that objective today by maintaining a professional and transparent network of specialized sellers of credit protection that share risk along the whole credit cycle. Such partners are typically sophisticated investors or insurers that can evaluate single loans (in the case of credit

[1] Sen. Sherrod Brown, *Brown to Financial Regulators: You Are Responsible for Making Sure the Financial System Operates Safely* (Nov. 14, 2023), https://www.brown.senate.gov/newsroom/press/release/sherrod-brown-financial-regulators-responsible-financial-system-operates-safely.

[2] *See, e.g.*, Randal K. Quarles, *Between the Hither and the Farther Shore: Thoughts on Unfinished Business* (Dec. 2, 2021) ("Endlessly increasing capital levels is not costless. In the real world…excessively high capital levels constrain the ability of the banking system to provide credit to the real economy, and we pay the cost in jobs and living standards."), https://www.federalreserve.gov/newsevents/speech/quarles20211202a.htm#:~:text=In%20the%20real%20world%2C%20as,in%20jobs%20and%20living%20standards.

insurance), single borrowers (in the case of credit default swaps) or whole loan portfolios (in the case of Credit Risk Transfer ("**CRT**") securitizations) across sectors, and are increasingly becoming a critical component of a bank's balance sheet optimization and de-risking strategy.

Risk-mitigating capital management trades come in a variety of forms, including insurance products from multi-line insurers, credit derivatives, guarantees, bank-issued credit-linked loans and credit-linked notes and both traditional and synthetic securitizations, including CRT trades. The economic substance of the transactions is substantially the same in all structures: a protection seller sells the bank protection against losses arising from specified events (typically, but not exclusively, credit losses) on a specific loan, a specific borrower, or a portfolio of assets. Those assets are generally held in the bank's banking book and arise from the operation of its banking business.

The Agencies to date have been supportive of a bank leveraging credit risk mitigants as part of a prudent risk management strategy.[3] We note, for example, that the Proposal does not materially alter the types of instruments or conditions under which a bank may claim relief through guarantees and credit derivatives on either a funded or unfunded basis. Bank regulators both in the United States and abroad have long recognized such programs, including securitizations, as an effective risk transfer tool. Importantly, properly structured credit risk mitigants "free up" financial institutions' regulatory capital by reducing the RWAs associated with the underlying credit exposures, enabling them to make more credit available to their customers.

However, certain changes introduced by the Proposal could threaten the viability of certain credit risk mitigation tools. For example, the doubling of the *p*-factor for securitization exposures under the revised Securitization Standardized (SEC-SA) formula from 0.5 to 1.0 will have an extremely adverse impact on the use of traditional and synthetic securitizations by banks to transfer credit risk. Such changes would significantly distort such markets and restrict access to a critical funding pipeline for various bank lending products, which will inevitably lead to higher costs for consumers and businesses alike. Coupled with higher capital requirements, banks may also be disincentivized from originating lower-risk loans and/or incentivized to retain the risk on higher-risk portfolios to ensure an optimal return on capital, introducing new stability risks.

We want to stress that even after executing a risk-mitigating capital management trade in the form of a securitization, the bank is required by regulators and investors to prudently manage the risks of the underlying exposures and is incentivized to do so as any default will have the practical effect of increasing the capital charges associated with any retained exposures. Furthermore, in many cases, the bank will continue to service the underlying loans and have a commercial incentive to maintain relationships with underlying borrowers, including negotiating payment deferrals, restructurings and other loan workouts as needed. Bank examiners will also

[3] *See, e.g.*, Proposal at 64058 ("Prudent use of such [credit risk] mitigants can help a banking organization reduce the credit risk of an exposure and thereby reduce the risk-based capital requirement associated with that exposure"); *see also* OCC Acting Comptroller Michael Hsu, Comments to Senate Banking Committee Hearing (Nov. 14, 2023) ("[Synthetic risk transfer trades] require heightened attention…. However, when done appropriately, in a safe and sound manner, with controls, it can be part of an effective risk management program."); *see also* Federal Reserve Board, *Frequently Asked Questions about Regulation Q* (Sep. 28, 2023), https://www.federalreserve.gov/supervisionreg/legalinterpretations/ reg-q-frequently-asked-questions.htm (the "**Fed CLN FAQs**").

have continued visibility into the bank's credit portfolio and its internal risk management practices, particularly in the case of synthetic securitizations where the loans will remain on-balance sheet. Banks are also more likely to continue providing credit to the broader economy during periods of market stress, as was observed during the height of the COVID-19 pandemic. A system in which banks can both originate credit and have access to credit risk mitigation tools *within* a regulated environment is vastly superior to a system in which credit origination shifts entirely to private and unregulated actors altogether, outside the visibility of bank examiners. For these and other reasons, we urge the Agencies to adopt the changes to the Proposal as outlined further below.

In this letter, we focus in particular on three types of credit risk mitigation tools that would be adversely affected by the Proposal: (i) traditional and synthetic securitizations, which are typically used to hedge risk on whole loan portfolios, (ii) credit insurance products and (iii) credit derivatives.

2. The Revised Securitization Framework Will Hamper the Ability of Banks to Obtain Meaningful Relief Through Traditional and Synthetic Securitizations

Under the existing Simplified Supervisory Formula Approach (SSFA), a banking institution is required to hold more capital against securitization exposures on a transaction-wide basis than it would if the underlying assets had not been securitized, a feature known as "non-neutrality." The SSFA achieves this principally through the supervisory calibration parameter *p* (the "***p* factor**"), which functions as a capital surcharge applicable to any securitization exposures retained or acquired by a bank.[4]

At its baseline, the *p* factor corresponds to a flat percentage increase in the overall capital requirement corresponding to a given portfolio of exposures if held in securitized form. For example, a portfolio of non-defaulted corporate loans under the current Standardized Approach would carry a 100% risk weighting, whereas if the banking institution were to hold the same assets as securitization exposures under the SSFA, they would be subject to a 150% risk weighting. In practice, the aggregate capital surcharge associated with a *p* factor of 0.5 over a portfolio of exposures is significantly higher than 50% due to the SSFA's risk-weight floor of 20%, particularly at the higher levels of seniority within the securitization structure. The impact of defaulted exposures under parameter *W*[5] only amplifies the impact of the surcharge as it slows the rate at which marginal risk weightings decrease as one progresses upwards through each level of seniority within the securitization structure.

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[4] The *p* factor, which was adopted as part of the securitization framework recommended under the Basel II accords, has been justified on grounds that a securitized portfolio exhibits increased risks due to risk models that may deviate from projections, as well as dependencies on agents such as asset servicers and liquidity providers within the securitization structure. *See, e.g.*, Opinion of the European Banking Authority to the European Commission on the Regulatory Treatment of Non-Performing Exposure Securitisations (Oct. 23, 2019) ("…non-neutrality correction factors to capture the agency and model risks prevalent in securitisations. These risks result from the liabilities' tranched structure's making the task of modelling the underlying portfolio's credit risk and the allocation of potential losses to the different tranches more complex and uncertain."), https://www.eba.europa.eu/sites/default/documents/files/document_library/Opinion%20on%20the%20regulatory%20treatment%20of%20NPE%20securitisations.pdf.

[5] Under the SSFA, defaulted exposures factored into parameter *W* are effectively assigned a 625% risk-weighting via parameter K_A.

While it is questionable whether a *p* factor of 0.5 is justified under the current SSFA, we stress that the *p* factor itself is *not* a risk-sensitive input to the securitization framework. Contrary to the versions of the securitization capital framework adopted in other jurisdictions, which largely follow the internationally-agreed Basel III finalization package in 2017, the *p* factor of 0.5 under the SSFA applies uniformly regardless of the underlying characteristics of any one securitization, including its structure, its underlying exposures, maturity, etc.[6] The proposed Securitization Standardized Approach (SEC-SA) would effectively double down on the SSFA's risk insensitivity by increasing the *p* factor for securitizations other than resecuritizations from 0.5 to 1.0.

As compared to the SSFA, a portfolio of securitized non-defaulted corporate exposures under the SEC-SA held by a bank originator would carry a risk weighting of 200% rather than 150%. The impact of the increased *p* factor is especially acute once the securitization is segmented and distributed to private market participants, as any securitization exposures retained by the bank originator would be subject to significantly higher risk-weightings. This will have a particularly adverse impact on synthetic securitizations like CRT trades, including credit-linked notes and portfolio-level credit derivatives, where the bank typically retains a senior tranche of the underlying exposures.

For the reasons discussed below, we urge the Agencies to (i) revert to the original *p* factor of 0.5 for securitizations other than resecuritizations and/or (ii) adopt a framework for "qualifying securitizations" modeled off of the approach for Simple, Transparent and Comparable (STC) securitizations in the Basel III Securitization Framework, which we recommend be eligible for a *p* factor of 0.25.[7]

i. The Doubled *p* Factor Makes the Securitization Framework *Less* Risk Sensitive, Not More

One of the purported aims of the proposed Expanded Risk-Based Approach (ERBA) is to replace the current Standardized Approach, of which the SSFA is a part, with a more "risk-sensitive" and "robust" approach. By doubling the *p* factor, however, the SEC-SA would have precisely the opposite of the intended effect.

The other inputs to $K_{SEC\text{-}SA}$, namely the adjusted weighted average capital requirement of the underlying exposures, K_A, and the seniority level (i.e., tranche) of the securitization exposure (as expressed through attachment point, *A*, and detachment point, *D*) are at least nominally risk sensitive. The SEC-SA, however, replicates the SSFA's approach in so far as it applies a uniform *p* factor to *all* securitizations that are not re-securitizations, without due regard to the underlying features of a securitization such as its size, concentration, term, structure, etc. This carries the implicit assumption that all securitizations (other than re-securitizations) pose the same structural risks and are expected to perform similarly across the credit cycle.

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[6] *See* Basel Committee on Banking Supervision, *Basel III Document: Revisions to the securitisation framework* (Dec. 11, 2014) (rev. July 2016), https://www.bis.org/bcbs/publ/d374.pdf (the "**Basel III Securitization Framework**"). Under the SEC-IRBA, for example, the *p* factor factors in the granularity of the underlying pool the average loss-given default and maturity of the tranche, and is subject to a ceiling of 0.3.

[7] *Id.*

For example, consider two mezzanine tranches with different levels of seniority within a securitization structure, one with attachment (*A*) and detachment (*D*) points of 14% and 17% (Tranche A), and the second with attachment (*A*) and detachment (*D*) points of 17% and 20% (Tranche B). Under the SSFA, if the underlying portfolio consists solely of non-defaulted corporate exposures with an underlying risk weighting of 100% (K_A = 8.0%), Tranche A would carry a risk-weighting of 196% while Tranche B would carry a risk-weighting of 93%, representing a risk-weight decrease of 53% on account of Tranche B's senior position within the securitization's capital structure. Under the SEC-SA, however, Tranche A would carry a risk-weighting of 492% while Tranche B would carry a risk-weighting of 338%, representing a risk-weight decrease of just 31%.

By slowing the rate of decline in risk-weightings as one increases the level of seniority in the securitization structure, the doubled *p* factor would make the SEC-SA *less* risk-sensitive than its predecessor, the SSFA. The disparity is only magnified as one adjusts the weighted average capital requirement of the underlying exposures (K_A) upward, either because the underlying risk weights are higher or because the underlying exposures default. Such a change is not aligned with the overall objectives and spirit of the Proposal.

ii. The Agencies have not Provided an Adequate Justification for Doubling the *p* Factor

In the preamble to the Proposal, the Agencies' stated justifications for doubling the *p* factor are as follows:

> "*The proposed increase to the supervisory parameter p for securitizations that are not resecuritization exposures from 0.5 to 1.0 would help to ensure that the framework produces appropriately conservative risk-based capital requirements when combined with the reduced risk weights applicable to certain underlying assets under the proposal that would be reflected in lower values of* K_G *and the proposed reduction in the risk-weight floor under SEC–SA for securitization exposures that are not resecuritizations exposures*."[8]

The Proposal however provides no empirical data to support why a *p* factor of 1.0 is necessary, nor why a *p* factor of 0.5 under the SSFA is not sufficiently conservative or inappropriately calibrated.

More puzzling is the Proposal's suggestion that a higher *p* factor is necessary to offset the reduced risk weightings applicable to certain exposures under the proposal and an overall reduction in the risk-weight floor from 20% to 15% under the SEC-SA. While some underlying credit exposures under the ERBA such as corporate and consumer exposures may see reduced risk weightings relative to the Standardized Approach, other exposures such as exposures to U.S. banks, certain residential mortgages and subordinated debt would *increase*. If the Agencies have concluded that such revised risk-weights under the ERBA offer a more "robust, risk-sensitive" calibration of the underlying risks, they have failed to explain why having such calibrations flow through to the SEC-SA warrants a more conservative treatment via a higher *p* factor.

[8] Proposal at 64070.

Additionally, a securitization exposure would need to achieve a higher level of seniority within the securitization structure to arrive at the new risk-weight floor of 15%, assuming K_A is kept constant. It is not clear why a decrease to the risk weight floor for securitizations would justify a higher *p* factor. A bank that is hedging the credit risk on a portfolio of loan exposures, for example, would need to purchase a thicker tranche of first-loss protection to realize any incremental benefit from the reduced floor, so the revision to the floor is anything but a "free" benefit.

Most importantly, a doubled *p* factor is grossly disproportionate to any reduction in the risk-weightings of the underlying exposures or the change in the risk-weight floor for securitization exposures from 20% to 15% under the SEC-SA. At nearly every position of seniority within the securitization structure, RWAs would see a significant increase even accounting for any reduced K_G or risk-weight floor.[9] The effect is even more pronounced once defaulted exposures are factored into K_A via parameter *W*.

iii. A Doubled *p* Factor Will Introduce Significant and Undesirable Distortions to the CRT Market

Relative to Europe and elsewhere, the use of funded and unfunded synthetic securitizations by banks in the United States, as compared to other types of credit portfolio management transactions such as whole loan sales and single-name credit derivatives, is small but continues to grow. As evidenced by the IACPM's 2023 Principles and Practices in CPM Survey, differential regulatory treatment for synthetic securitizations in the United States have limited their usage relative to other jurisdictions, but they have nevertheless continued to grow in importance over the past 24 months.[10] To date, the U.S. market for synthetic securitizations has been characterized by high credit-quality assets, low default risk and a healthy return on capital for banks purchasing protection. A doubled *p* factor threatens to alter these dynamics, making risk transfer via synthetic securitizations significantly more expensive and, for some asset classes, uneconomical for larger banks.

Take, for example, a synthetic securitization on a portfolio of non-defaulted corporate exposures, which is currently subject to a 100% risk weight under the Standardized Approach. Under the existing SSFA, the retained senior tranche of a securitization with an attachment point, *A*, of 12.5% and a detachment point, *D*, of 100%, would be risk-weighted at 20%. With a revised *p* factor of 1.0 under the SEC-SA, however, the same tranche would be risk-weighted at 65%. To arrive at the same 20% risk-weight, a bank issuer would need to thicken the protection tranche

[9] *See* Dr. Guowei Zhang and Chris Killian, *How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers* (November 28, 2023), Figure 1 (P-factor, Tranche Risk Weight, and Securitization Capital Non-Neutrality), https://www.sifma.org/resources/news/how-the-basel-iii-endgame-could-impair-securitization-markets-and-harm-us-businesses-and-consumers/.

[10] *See* IACPM, *Principles and Practices in Credit Portfolio Management: Credit Matters: CPM's Critical Role Amid the Rising Credit Risk Environment* (2023), at 4, https://iacpm.org/wp-content/uploads/2023/11/IACPM-Research-Principles-and-Practices-in-CPM-2023-White-Paper.pdf.

(i.e., an increase in the attachment point, *A*, of the retained tranche) from 12.5% to 23%, nearly doubling the size of the credit hedge despite the risk on the underlying exposures being identical.[11]

Below, we provide some figures showing how the SEC-SA raises the minimum attachment points for the senior retained tranche (and thereby increasing the size of the protection tranche) required to obtain the maximum amount of RWA reduction relative to the SSFA, depending on the risk weights of the underlying pool. The increased minimum attachment points are a direct result of the SEC-SA and require tranches of a securitization to be structured even more conservatively to reach previously-achieved levels of capital relief, and are primarily driven by the increased p-factor and secondarily by the reduced floor.

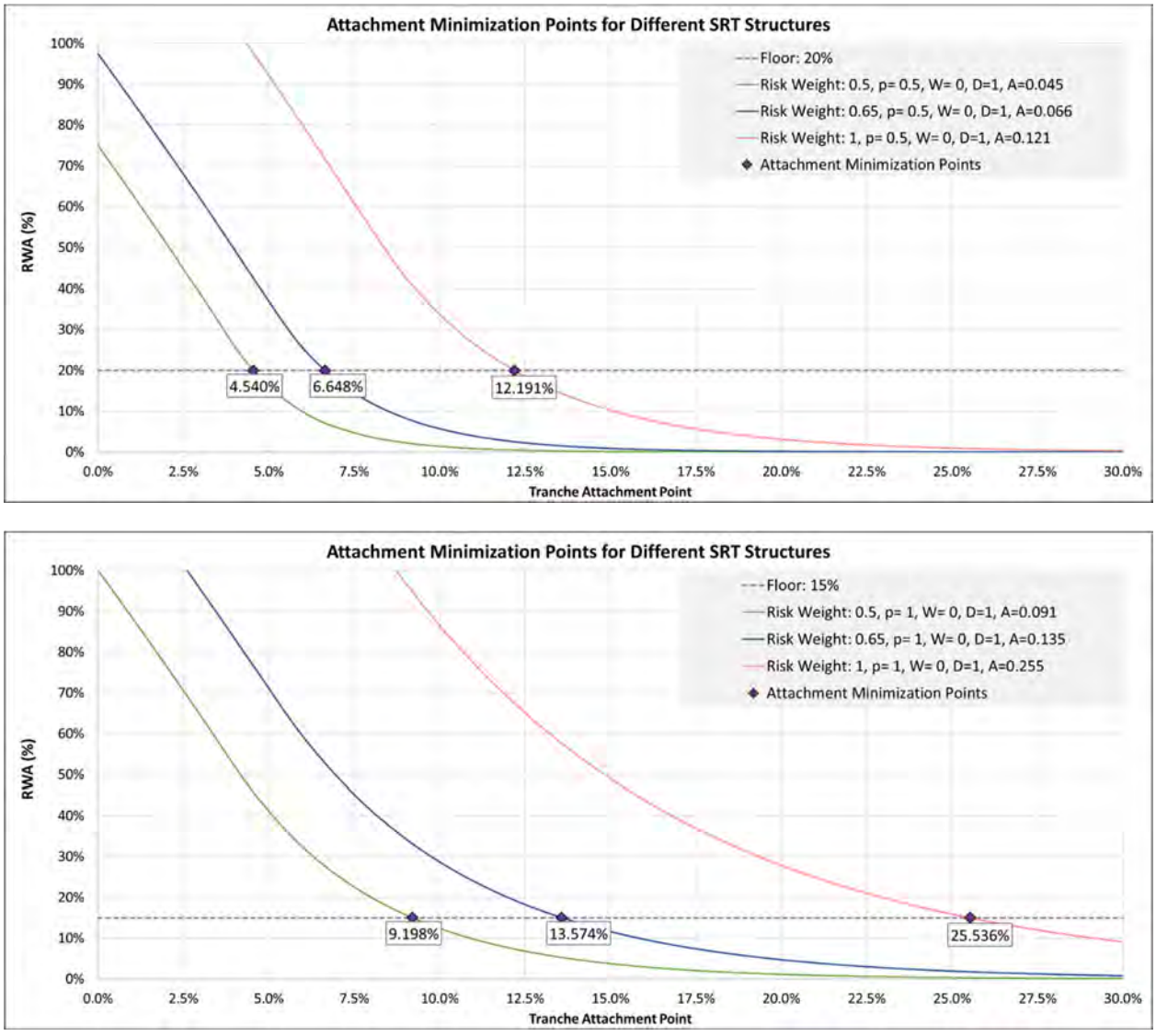
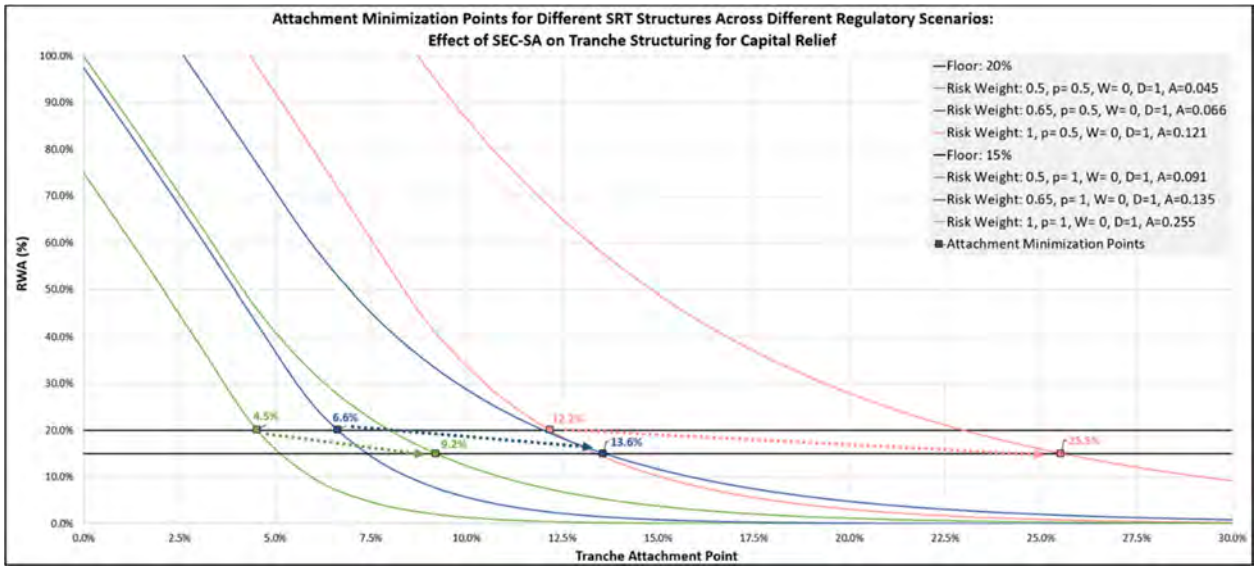


Figure 1. *Minimum Attachment Points Under the SSFA vs. SEC-SA*

[11] We have assumed, for ease of comparison, that the corporate exposures under the ERBA are not exposures to a company that is investment grade with publicly traded securities outstanding and therefore eligible for a general credit risk weighting of 65%. *See* Proposal, §__111(h)(1).

The SEC-SA also decreases the relative effect of an incremental change in tranche thickness on tranche RWA, eroding the relative amount of capital released by increasing the attachment point on the retained tranche.



Asset Type	SSFA	SEC-SA	Δ Attachment Point (%)	Attachment Point Multiple
50% Risk-Weight Assets	4.540%	9.198%	**4.658%**	**2.026x**
65% Risk-Weight Assets	6.648%	13.574%	**6.926%**	**2.042x**
100% Risk-Weight Assets	12.191%	25.536%	**13.345%**	**2.095x**

Figure 2. *Differences in Optimal Attachment Points Across Asset Classes*

The Agencies have not provided an adequate justification as to why such a punitive change is necessary, which would further force market participants to calibrate the size and seniority of the tranches based on regulatory capital needs rather than commercial risk considerations. For CRT trades in particular, under the SSFA, the attachment point for the senior, retained tranche is typically set at the point that achieves the optimum level of capital relief for the bank originator (i.e., a 20% risk weight), which is commonly 12.5% where the underlying exposures are subject to a 100% risk weighting (e.g., corporate exposures, consumer exposures other than first-lien residential mortgages). That attachment point is already multiple orders of magnitude above projected losses on the underlying pools.

To illustrate, the table below reflects the average ratios of Allowance for Credit Losses (ACL) across the loan portfolios of a representative cross-sample of large banking organization that would be subject to the new ERBA, including through the most recent stress period caused by the COVID-19 pandemic.

Average Ratios of ACL for Loans and Leases Across U.S. Banks*		
3Q 2023	*4Q 2022*	*3Q 2020 (COVID-19)*
1.15%	1.08%	1.88%

***** *Based on publicly available company filings*

The difference between the attachment point of the retained tranche for CRT trades on various asset classes and the bank's ACL ratio roughly demonstrates the degree to which banks are already over-hedged relative to the actual economic risk of the underlying pool. Under the SEC-SA, this difference would only widen.

For banks, securitizations under the existing capital framework, including credit-linked notes, have continued to perform and provide for an effective means of risk transfer as underlying exposures default. For investors, synthetic securitizations provide for an attractive risk-adjusted return and exposure to asset classes that, for regulatory and other reasons, may be challenging to access directly. A doubled *p* factor of 1.0 threatens to disrupt this delicate equilibrium and may make it simply uneconomical for most affected banks to leverage securitizations as a tool for effective risk transfer, even as such banks would be subject to the most strident increases in RWAs under the new ERBA. The combination of a standard, less risk-sensitive approach to measuring risk on the underlying assets, as well as a more conservative approach on the capital released by credit risk mitigants, may also incentivize banks to only originate and retain higher-risk portfolios to optimize their return on capital.

Additionally, the Proposal would leave intact the SSFA for smaller banks, which means the availability of securitizations as a tool for risk transfer may shift towards smaller banks. If the Agencies have concluded that the unique risks posed by securitizations warrant a more conservative treatment via a doubled *p* factor, they have failed to explain why that justification should apply exclusively to the largest banks covered by the ERBA. We therefore urge the Agencies to revert back to a *p* factor of 0.5 for all securitizations other than resecuritizations.

iv. The SEC-SA Should Adopt a Lower *p* Factor for Qualifying Securitizations

The Proposal's implementation of a *p* factor of 1.0 for securitizations other than re-securitizations would appear to be aligned with the Basel III Securitization Framework, which similarly provides for a *p* factor of 1.0. However, we stress that the Proposal deviates significantly

from the Basel III Securitization Framework as the Agencies have not adopted the hierarchy of approaches outlined therein and relies on only the most conservative model under the SEC-SA.

Similarly, the Agencies have declined to adopt the Basel III Securitization Framework's criteria for Simple, Transparent and Comparable (STC) securitizations[12] that would be eligible for a reduced *p* factor, which have been implemented as Simple, Transparent and Standardised (STS) securitizations in Europe[13] and are currently awaiting implementation in the United Kingdom.[14] The STC framework is intended to, among other reasons, "help transaction parties…evaluate more thoroughly the risks and returns of a particular securitization" and thereby reduce the structural risks associated with securitizations more generally, warranting a lower capital surcharge.[15]

In addition to adopting our recommendation to preserve the SSFA's *p* factor of 0.5 under the new SEC-SA, we urge the Agencies to adopt a workable version of the STC framework that would be eligible for a *p* factor of 0.25. Such "qualifying securitizations" should eliminate some of the more subjective and operationally complex components of the STS framework currently in place in Europe and provisionally extended to the United Kingdom. We therefore propose the following simplified criteria for "qualifying securitizations", which are modeled off of the original STC criteria, that would be eligible for a reduced *p* factor of 0.5:

- The underlying assets are homogeneous with commonly encountered market interest rates;
- A minimum of five years of historical loss performance data and sources of data;
- At the time of the final cut-off date of the securitized portfolio, no receivables greater than 30 days past due or otherwise qualifying as "defaulted exposures" as defined in the Proposal;
- Securitization should appropriately mitigate interest rate risk and foreign currency risk, and only derivatives used for genuine hedging of such risks should be permitted;
- The priorities of payments should be clearly defined at the time of the securitization, and junior tranches should not have payment preference over senior liabilities that are due, and should incorporate appropriate early amortization events and/or termination of the revolving period for revolving structures;
- The originator and servicer of the receivables should have a minimum of 5 years of experience originating and/or servicing the receivables;

[12] *See* Basel Committee on Banking Supervision, Consultative Document, *Capital treatment for "simple, transparent and comparable" securitisations* (Nov. 2015), https://www.bis.org/bcbs/publ/d343.pdf.
[13] *See* Regulation (EU) 2017/2402.
[14] *See* HM Treasury report on the UK Securitisation Regulation (December 2021) and "The Securitisation Regulations 2023" (December 2022).
[15] *Supra* note 6.

- For traditional securitizations, a true sale and non-consolidation opinion should be obtained or a FDIC safe harbor opinion, as applicable. For synthetic securitizations, an enforceability opinion should be obtained.

We note, in particular, that the European Parliament and European Council have approved a proposal for a transitional relief measure that would lower the *p* factor under the SEC-SA for STS securitizations from 0.5 to 0.25 and the *p* factor for other securitizations from 1.0 to 0.5.[16]

A differentiated *p* factor for "qualifying securitizations" that accounts for their reduced risks would further the Proposal's objectives of improving the overall risk sensitivity and granularity of the capital framework. We also urge the Agencies to afford covered banking organizations the flexibility and discretion to determine which securitizations meet the criteria for "qualifying securitizations", as opposed to the third-party certification and regulatory notification process currently in place for STS securitisations in Europe. The Agencies can just as efficiently leverage the bank supervisory process to ensure banks are implementing the standards for "qualifying securitizations" in a safe and prudent manner.

3. The Proposal Should Provide Clarity for Bank-Issued Credit-Linked Notes

Both in the United States and abroad, pre-funded synthetic securitizations in the form of credit-linked notes ("**CLNs**") come in two varieties: (i) bank-issued CLNs ("**Bank CLNs**"), which are debt instruments issued directly by a bank to investors whose performance are linked to an underlying portfolio of credit exposures, and (ii) special-purpose vehicle credit-linked notes ("**SPV CLNs**"), whereby a bank purchases a fully collateralized credit hedge from an SPV, typically in the form of a guarantee or credit derivative, and the SPV in turn collateralizes its obligations to the bank with proceeds from the issuance of credit-linked notes to investors. From the perspective of the bank as protection buyer and the investor as protection seller, Bank CLNs and SPV CLNs are functionally and economically equivalent. In many cases, Bank CLNs are preferable because they efficiently address regulatory considerations ranging from state insurance requirements, Volcker Rule considerations, CFTC swaps regulations, etc., and are easier to establish from a documentation and structural standpoint.

The Board of Governors of the Federal Reserve (the "**Federal Reserve**") recently released a set of FAQs clarifying that SPV CLNs may meet the definitional and operational requirements for synthetic securitizations under Regulation Q.[17] However, they declined to extend the same treatment to Bank CLNs, which they contend suffer from two technical defects:

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[16] *See* ECON Committee, *Report on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor* (Feb. 9, 2023), at 203/219 ("…[P]arent financial holding companies or parent mixed financial holding companies, stand-alone institutions in the [European] Union shall be permitted, until the completion of the comprehensive review of the [European] Union 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 securitization"),
https://www.europarl.europa.eu/doceo/document/A-9-2023-0030_EN.pdf.

[17] *See* Fed CLN FAQs, *supra* note 3.

> "*First, a synthetic securitization must include a guarantee or credit derivative, and, in the case of a credit derivative, the derivative must be executed under standard industry credit derivative documentation. Directly issued credit-linked notes frequently reference, but are not executed under, standard industry credit derivative documentation. Second, the operational criteria for the simplified supervisory formula approach (SSFA) require use of a recognized credit risk mitigant, such as collateral. The cash purchase consideration for directly issued credit-linked notes is property owned by the note issuer, not property in which the note issuer has a collateral interest*."

We respectfully disagree with the Federal Reserve for a few reasons. Firstly, the Federal Reserve has not provided an adequate rationale for why a credit derivative executed "under standard industry credit derivative documentation" such as an ISDA master agreement is superior to a hypothetical reference credit derivative used in a Bank CLN. The primary objective of the credit derivative in either case, whether as a stand-alone instrument or a hypothetical one, is to size the amount of credit losses that are ultimately transferred to investors. We note also that the CLNs in either structure will reference a credit derivative to which the investor(s) is not a direct counterparty. Requiring an SPV to sit in-between the bank and the investor to satisfy a technical requirement poses unnecessary costs to banks and investors alike. While the FAQs only discuss the treatment of credit derivatives, the same considerations should apply to Bank CLNs that rely on a hypothetical reference guarantee.

Secondly, the Federal Reserve's position that cash transferred to the bank in a Bank CLN does not satisfy the definition of "financial collateral" is, again, overly technical. From the bank's perspective, direct title to cash will be superior in all instances to a security interest in cash collateral as the bank avoids any risk that the SPV may be unable to perform or that its lien will be voided for any reason. Furthermore, cash directly in the bank's possession will be immediately available to cover any losses incurred, whereas cash deposited with third-party custodians would be subject to incremental credit and insolvency stay risk, in addition to increasing interconnectedness among banking institutions.

Thirdly, credit-linked notes are explicitly recognized as cash collateralized credit risk mitigants under the U.K. and European implementations of the Basel III accords, which partly explains their heightened usage in those jurisdictions relative to the United States.[18] Such issuances of credit-linked notes outside of the United States have performed similarly to other securitizations in periods of stress, including through the COVID-19 pandemic. We see no reason why credit-linked notes issued under the U.S. capital framework should be treated any differently and urge the Agencies to align with international standards.

Lastly, banking institutions seeking to claim relief for Bank CLNs are required to submit a request for the Federal Reserve to exercise its "reservation of authority," and such approvals have typically been accompanied by limitations that often restrict further issuances of Bank CLNs.[19] Such a process is unpredictable both in terms of timing and the likelihood that a particular bank

[18] *See* Article 218, Regulation (EU) No 575/2013, Capital Requirements Regulation (CRR) ("…credit linked notes issued by the lending institution may be treated as cash collateral for the purpose of calculating the effect of funded credit protection in accordance with this Sub-section.")

[19] *See, e.g.*, Federal Reserve, Interpretation Addressed to Morgan Stanley (Sep. 29, 2023), https://www.federalreserve.gov/supervisionreg/legalinterpretations/bhc_changeincontrol20230929.pdf.

will obtain the necessary approvals, which acts as a significant deterrent to banks seeking to rely on the structure. Moreover, the FAQs are not rulemakings that carry the force of law and reflect the views of only one of the three Agencies.

In his dissent to the Proposal, FDIC director McKernan asks whether the agencies should "consider changes to clarify the treatment of credit-linked notes under either the standardized approach or the expanded risk-based approach."[20] Credit-linked notes are explicitly recognized in the Basel III framework as cash-collateralized credit risk mitigants, and non-U.S. banks are frequent users of Bank CLNs as a cost-effective means for transferring credit risk. We urge the Agencies to explicitly recognize the treatment of Bank CLNs as part of a final rulemaking.

4. The Simple Approach for Collateralized Transactions Should Recognize Collateral Agreements Subject to a Stay as well as Currency and Maturity Mismatches

The simple approach for recognizing the risk-mitigating benefits of financial collateral under the current Standardized Approach requires that the collateral be subject to a "collateral agreement," which by definition excludes agreements where the bank's rights to the collateral may be stayed or avoided, subject to certain exceptions in the case of special resolution regimes.[21] This definition was first introduced in the context of the Agencies' implementation of the internal models method under the Basel II Accord, and de-recognized financial collateral subject to avoidance or stay risk for purposes of determining the EAD for certain over-the-counter derivative contracts, eligible margin loans and repo-style transactions.[22]

However, as has been noted by other commenters, the Agencies inadvertently expanded this limitation when they moved the definition of "collateral agreement" into Section 2 of the current capital framework as part of the 2013 implementation of the Basel III Accords, thereby applying it to the simple approach for collateralized transactions.[23] As a result, banks are unable to recognize the risk-mitigating benefits of financial collateral securing any credit exposures, even for "cash on deposit" or other collateral against which the bank has a perfected, first-priority security interest, unless certain bankruptcy safe harbors or exclusions apply. Practically speaking, this has the effect of excluding any collateralized lending arrangements that could be stayed under the Bankruptcy Code, placing them on par with unsecured exposures. We do not think this was the Agencies' original intent when they implemented the simple approach back in 2013.

Furthermore, under the Standardized Approach, the types of transactions that benefit from safe harbors under applicable insolvency law (i.e., qualified financial contracts) and therefore meet the definition of a "collateral agreement" are already eligible for an alternative approach: the collateral haircut approach. The Proposal effectively doubles down on this shortcoming by largely incorporating the simple approach in the current Standardized Approach into the ERBA.[24]

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[20] *Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework* (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html.
[21] 12 C.F.R. §3.2, §37(b)(ii); 12 C.F.R. §217.2, §217.237(b)(ii); 12 C.F.R. §324.2, §324.37(b)(ii).
[22] *See* 72 F.R. 69288, 69349 (Dec. 7, 2007).
[23] Note that this definition was not included in the original proposal of the current capital framework back in 2012. *See* 77 F.R. 52888 (Aug. 30, 2012).
[24] *See* Proposal §__.121(b)(1)(ii).

While we acknowledge conceptually that a bank may face incremental risk to the extent its access to or ability to liquidate collateral may be delayed, it would be wrong to conclude that such collateral does not provide *any* meaningful risk mitigation benefits to the bank. We therefore urge the Agencies to revise the "collateral agreement" definition under both the Standardized Approach and proposed ERBA by eliminating the requirement that such contract be free of any stay or avoidance risk.

We also echo suggestions made by other commenters to revise the simple approach to permit the recognition of collateral with maturity or currency mismatches, as is currently the case for eligible guarantees and eligible credit derivatives (subject to applicable haircuts). Financial collateral with a maturity shorter than the residual maturity of the hedged exposure or denominated in a different currency may nevertheless provide valuable risk mitigation benefits to the bank. The haircuts for maturity or currency mismatches currently in place for eligible guarantees and eligible credit derivatives would adequately account for any increased risks, and we urge the Agencies to adopt the same approach for collateralized transactions.

5. The Proposal Should Recognize Prudentially Regulated Insurance Companies as Eligible Guarantors and Reduce the Risk Weightings Applicable to Prudentially Regulated Insurance Companies

The Proposal continues the troublesome trend of excluding insurance companies from partnering with U.S. banks on credit portfolio management transactions as sellers of credit protection, placing U.S. banks at a disadvantage relative to their foreign counterparts. Despite the fact that prudentially regulated, well-capitalized insurance companies generally have a high degree of creditworthiness and already participate as investors in the CRT programs of Fannie Mae and Freddie Mac, the current capital framework continues to prevent banks from recognizing the risk mitigating benefits of transactions with insurers.

The challenges with recognizing credit insurance as a credit risk mitigant are primarily two-fold: 1. insurance companies generally do not qualify as "eligible guarantors" under the current capital framework, and 2. even if they do, they are subject to the same 100% risk weighting as corporate exposures, which significantly hampers any credit risk mitigation benefits to be realized from insurance policies.

The IACPM has jointly prepared a white paper with the International Trade and Forfaiting Association highlighting this issue, a copy of which is attached hereto, and we reiterate the recommendations made in that paper, in particular:

- Expanding the first prong of the definition of "eligible guarantor" to *per se* include insurance companies that are subject to prudential regulation and supervision (including minimum capital and liquidity requirements);

- Clarifying or expanding the second prong of the definition of "eligible guarantor" to include issuers whose direct or indirect parent insurance holding companies have issued

and outstanding unsecured debt securities that are investment grade without credit enhancement. [25]

In response to Question 39 of the Proposal[26], we also urge the Agencies to allow insurance companies subject to prudential supervision to be treated substantially similarly to banks for the purposes of risk weighting such exposures, along with a determination by the regulators that insurance companies are subject to such prudential supervision.

6. The Exception from the 40% Haircut for Credit Derivatives without "Restructuring" as a Credit Event Should be Revised

The Agencies have proposed an exception to the 40 percent haircut that would apply to the notional value of any eligible credit derivative that does not include restructuring of the reference exposures as a credit event. To qualify for the exception, the terms of the reference exposure must not allow the maturity, principal, coupon, currency, or seniority status of the exposure to be amended without unanimous consent, and the bank must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the hedged exposure is subject to the U.S. Bankruptcy Code, the Federal Deposit Insurance Act, or a domestic or foreign insolvency regime that allow for a company to liquidate, reorganize, or restructure and provides for an orderly settlement of creditor claims.[27]

The Agencies have justified the unanimous consent requirement on the grounds that a banking organization has little incentive to consent to a restructuring if it cannot reduce any related losses with an offsetting payment under the eligible credit derivative. While we agree with the Agencies' underlying rationale for limiting the exception, the unanimous requirement is both overly broad relative to the underlying risk and does not reflect current market practice.

If the Agencies' principal concern is that a banking organization may be forced into a restructuring without its consent, such concern could just as easily be addressed with a requirement that the maturity, principal, coupon, currency, or seniority status of the exposure cannot be amended without the consent of all lenders *directly or adversely affected* by such amendment. For example, a bank would face no incremental risk if a borrower were permitted to negotiate with a subset of lenders to defer its repayment obligations to such lenders, so long as its repayment obligations to the bank are otherwise unaffected.

We therefore recommend that the Agencies strike the words "by unanimous consent of all parties" in Section 120(e)(1) and replace with the words "with the consent of all parties directly and adversely affected." Such a revision would be more narrowly tailored to the risk that a banking organization would suffer losses due to a restructuring outside of its control and would also afford the underlying obligor the flexibility to negotiate with only those lenders affected by any proposed amendment of the fundamental rights at issue.

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[25] IACPM and ITFA, *Credit Insurance as a Credit Risk Mitigant to Diversify Risk under the Capital Rules* (June 2023), https://iacpm.org/wp-content/uploads/2023/12/ITFA-IACPM-White-Paper-FINAL-June-2023.pdf.
[26] Proposal at 64054.
[27] *See* Proposal, §__.120(e)(1).

The Proposal also requires that a banking organization have a "well-founded basis" supported by sufficient written documentation that the hedged exposure is subject to the U.S. bankruptcy code, FDIA or an insolvency regime that recognizes liquidations, reorganizations and restructuring. This requirement deviates from the Basel III finalization package, which only requires that the governing law of the underlying exposure is within a jurisdiction that meets the above requirements.[28] We therefore recommend that the Agencies clarify that "written documentation" is not required for each individual underlying exposure for a credit derivative, and that an internal document broadly confirming that exposures with certain characteristics (e.g., governing law, jurisdiction of formation, location of assets) satisfies the above requirements should be sufficient to meet the "well-founded basis" requirement.

7. The Proposal's Requirement for Net Short Risk Positions to be Treated as Market Risk Covered Positions Should be Revised

In Subpart F of the Proposal, the Agencies have introduced a new definition of "net short risk positions," which includes over-hedges of credit exposures that are not treated as market risk covered positions under the current capital framework.[29] While we acknowledge that a banking institution may be exposed to additional losses if it purchases a credit hedge with a notional exposure larger than the underlying risk being hedged, the treatment of net short risks as trading positions is inappropriate and would create significant operational challenges for banks.

As a threshold matter, credit portfolio managers of banking organizations routinely rely on credit derivatives to hedge credit and other risks primarily arising from loans held in the banking book. Any net short risk positions arising from such hedges are therefore tied to the bank's banking book activities, and it would be inappropriate to subject such activities to the risk management and governance criteria (e.g., policies and procedures, control, oversight and review processes) applicable to trading positions under the market risk capital framework more generally. We do not believe it was the intent of the Basel Committee nor the Agencies to bring hedges used in the context of protecting against default risk in the banking book into the bank's regulatory trading book.

Furthermore, the requirement to calculate the net short risk position by "comparing the notional amounts of a [BANKING ORGANIZATION]'s long and short positions in a given exposure" may necessitate that a bank move positions, in full or in part, between its banking book and trading book to properly size such exposures.[30]

We therefore urge the Agencies not to treat net short risk positions as trading positions subject to the market risk capital framework. In the event the Agencies decline to adopt that suggestion, we recommend implementing the following additional clarifications:

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[28] *See* Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (Dec. 2017) at 49, note 83, https://www.bis.org/bcbs/publ/d424.pdf.
[29] Proposal, §__.205(a).
[30] *Id.*

- In certain scenarios, the net short risk position may only be temporary, such as situations where a borrower prepays a loan and the bank does not reduce the hedge in time. Such temporary over-hedges should not be treated as net short risk positions.

- Due to the liquidity of single name credit default swaps, banking organizations may prefer to enter into proxy hedges in the form of single name credit default swaps to hedge portfolio risks. We recommend that the notional amount of such proxy hedges be compared against the notional amount of the related portfolio exposure for purposes of sizing the net short risk position. Additionally, for hedges at the single name level, the banking organization should be permitted to recognize proxy hedges where the reference exposure is to an entity that is an affiliate or parent of the hedged exposure for purposes of sizing the net short risk position.

- With respect to index credit default swaps, a banking organization should be permitted to apply the framework for net short risk positions on a portfolio basis without having to decompose the index credit default swap into individual single names.[31] Relatedly, a position that switches from a net short risk position to a net long position and vice versa should not be subject to the capital re-designation add-on.

8. The Proposal Will Have a Particularly Adverse Impact on Clean Energy Tax Equity Financing Transactions

The federal government subsidizes various activities through the Internal Revenue Code by providing tax credits. Typically, such incentives are provided to the party directly engaged in the activity, but at times the credits must be made transferable to a partner that can make appropriate use of the tax incentive. The most common method for doing so is through a tax equity financing transaction, whereby the party generating the tax credits assigns them to a third party in exchange for an equity investment, thereby "monetizing" the credits. Banks, and large banks in particular, have been active investors in tax equity financing transactions as they typically have large tax obligations against which such credits can be offset. The OCC has explicitly authorized national banks to engage in such transactions on the basis that they are "the functional equivalent of a loan," subject to satisfying certain other requirements.[32] Despite exhibiting features that are more characteristic of a loan, such investments are frequently treated as equity for accounting or tax purposes.

The Inflation Reduction Act (IRA), passed into law in 2022, grants several new tax credits and extends certain other production and investment tax credits to clean energy projects, and updates the Internal Revenue Code to make such tax credits transferable and/or eligible for "direct pay." To date, banking organizations have been frequent investors in such clean energy projects. The most commonly used tax equity financing structure for clean energy projects is the "partnership-flip" transaction, whereby a sponsor of a clean energy project forms a partnership with a tax equity investor. The investor will receive the majority of the tax credits and cash flow

[31] *See* Proposal at 64097 ("For index hedges, the proposal would require a banking organization to evaluate its long and short equity and credit exposures for all positions in the portfolio (aggregating across all relevant individual exposures) to determine if it has a net short risk position for any given portfolio").
[32] *See* 12 CFR §7.1025, OCC Bulletin 7-15 (March 25, 2021).

generated by the project until an agreed-upon target return is reached, at which point the financial benefits of the project are re-allocated to the sponsor.

Under the simple risk weight approach (SRWA) currently in place, banks are permitted to apply a 100% risk-weight to "non-significant" equity investments, which includes the aggregate amount of non-publicly traded equity exposures below 10% of a bank's total capital (the "**Non-Significant Equity Bucket**"). However, the Expanded Simple Risk Weight Approach (ESRWA) under the Proposal would eliminate the Non-Significant Equity Bucket on the basis that doing so will "increase the risk sensitivity of the equity framework by requiring banking organizations to apply a risk weight based on the characteristics of each equity exposure, rather than only for those in excess of 10 percent of the banking organization's total capital."[33] Tax equity financing investments that previously fit into the Non-Significant Equity Bucket are now treated as "non-public equity exposures" subject to a 400% risk weighting, which is quadruple what they would have been under the SRWA. This is because the capital framework treats such investments according to their carrying value as determined in accordance with generally accepted accounting principles, which must be risk-weighted as equity exposures despite behaving more similarly to credit exposures.

The IACPM does not dispute the underlying policy rationale for the removal of Non-Significant Equity Bucket but wishes to highlight that this change will make it virtually uneconomical for affected banking organizations to continue financing clean energy projects via tax equity investment. According to the American Council on Renewable Energy, domestic banks represent over 80-90% of the approximately $20 billion annual market of tax equity financing. Their forced exit from this market is certain to reduce the financing available for clean energy projects more generally, thereby frustrating the policy objectives outlined in the IRA.[34]

The adverse impact for tax equity financing investments is compounded by the fact that the Agencies have retained the 100% risk weighting for community development investments, including low-income housing tax credit investments, and investments in small business investment companies on the basis that such investments "generally receive favourable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general."[35] In maintaining this treatment for such investments, the Agencies also "recogniz[e]… the importance of these investments to promoting important public welfare goals…." Such rationale would appear to apply equally to clean energy and infrastructure tax equity investments.

We therefore urge the Agencies to implement a carve-out for "clean energy tax equity investments" that would be eligible for a 100% risk weighting.

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[33] Proposal at 64076.
[34] American Council on Renewable Energy, *The Impact of Proposed Bank Regulatory Capital Requirements on Tax Equity Investment in Clean Energy* (Aug. 22, 2023), https://acore.org/wp-content/uploads/2023/08/ACORE-Letter-on-the-Impact-of-Proposed-Bank-Regulatory-Capital-Requirements-on-Tax-Equity-Investment-in-Clean-Energy.pdf.
[35] Proposal at 64077.

We appreciate the opportunity to share our comments on the Proposal. If you have any questions or would like additional information, please contact the undersigned.

Yours sincerely,

Som-lok Leung
Executive Director

International Association of Credit Portfolio Managers

White Paper

Collaboration between the International Trade and Forfaiting Association and the International Association of Credit Portfolio Managers

Credit Insurance as a Credit Risk Mitigant to Diversify Risk under the Capital Rules

June 2023

This paper is a collaboration between the International Trade and Forfaiting Association ("**ITFA**") and the International Association of Credit Portfolio Managers ("**IACPM**"). ITFA is a trade association focused on global trade, forfaiting, supply chain, receivables financing, and risk mitigation thereof. Its members include banks, insurers, insurance brokers, lawyers, and others engaged in supporting global trade. The IACPM is an industry association that represents the world's largest banks and teams within those institutions who have responsibility for the prudential management of credit portfolios, including actively controlling concentrations, adding diversification, managing the return of the portfolio relative to the risk, and applying capital to new lending. In addition, its members also include investors, insurers, and reinsurers, which participate in credit risk transfer transactions.[1]

EXECUTIVE SUMMARY

Capital rules encourage banks to balance their portfolios with a healthy distribution of assets across various asset classes and to maintain capital reserves to protect against economic downturns. Similarly, capital risk weight substitution rules encourage banks to seek out strong counterparties for their unfunded risk mitigation strategy. One tool that banks can use to mitigate and diversify their credit risk is credit insurance. Credit insurance is a type of insurance that protects businesses against losses due to the non-payment of trade debts by their customers. By purchasing credit insurance, banks can reduce their risk exposure to non-payment of trade debts.

Under the current US capital rules, credit insurance issued by financially strong insurers is a permitted form of eligible guarantee. However, banks generally cannot obtain meaningful capital risk weight substitution benefits from such policies because insurers are not recognized as lower-risk counterparties compared to any other corporate entities. This gives rise to a concern that US banks lack access to a risk mitigation tool that is expressly contemplated by the US capital rules and utilized by competitor banks subject to other national capital rules, at a time when US banks face increased capital requirements against an economic environment where recession indicators are growing. This paper argues that certain clarifications to the US capital rules would provide US banks with the opportunity to partner with proven, well-rated counterparties in the insurance industry to mitigate their credit risk, reduce their risk-weighted assets, and thereby increase their ability to redeploy capital to support the US economy.

This paper's objectives are (a) to demonstrate that credit insurance can be an effective method for distributing risk among quality protection providers; and (b) to recommend clarification of the relevant capital rules that will better enable US banks to use credit insurance as a credit risk mitigant under the capital rules. The proposed clarification is meant to encourage prudent credit risk diversification within the framework of the strong capital and liquidity requirements applicable to US banks.

This paper consists of three parts. Part 1 discusses credit insurance generally, including an overview of credit insurance policies, policy characteristics, the insurers that underwrite credit insurance, and claim performance of credit insurance policies. Part 2 focuses on the credit insurance market and how credit insurance can be utilized by banks. Part 3 proposes areas of potential clarifications to the capital rules in connection with the finalization of the Basel III rules.

[1] Special thanks to the following for their contributions to this paper: Sanjeev Ganjoo, *Citibank*; Rajat Singhal, *Citibank*; Jennifer Bearden, *IACPM*; Luigi L. De Ghenghi, *Davis Polk*; Andrew Rohrkemper, *Davis Polk*; Benjamin Lee, *Latham & Watkins*; Michael Sullivan, *Sullivan & Worcester*; Scott Ettien, WTW; Scott Pales, *WTW*; Eva Fredriksson, *WTW*; Ben Roberts, *Texel*; Deepti Khaire-Phanse, *Swiss Re*; and Harpreet Mann, *Amynta Trade Credit & Political Risk Solutions*.

PART 1: CREDIT INSURANCE OVERVIEW

Credit Insurance Generally

For purposes of this paper, the term "credit insurance" encompasses both trade credit insurance and non-payment insurance. Trade credit insurance refers to policies that protect against loss on trade finance transactions and may consist of a portfolio of receivables for a short-term tenor between 1 to 3 years. Nonpayment insurance refers to policies that protect against single exposures, such as project finance transactions, with tenors of 1 year to over 5 years.

For the avoidance of doubt, credit insurance does not refer to "wrap" policies offered by mono-line financial guaranty insurers. None of the statistics cited in this paper refer to policies issued by mono-line financial guaranty insurers. Further, credit insurance used in horizontal structures of risk transfer, like unfunded protection on tranches of synthetic securitizations, is not part of the focus of this paper.

Credit insurance has historically been used as a means of encouraging or expanding investment, especially by government export credit agencies. For example, the US Export-Import Bank has long provided support of the export of US made goods through credit insurance. As discussed throughout this white paper, the private credit insurance market has grown significantly over the past 20 years and has the potential to support a significant amount of bank transactions.

There are approximately 60 insurers participating actively in the global credit insurance market today. All of these insurance companies have investment-grade credit ratings (from either Fitch, Moody's, or S&P) ranging from A- to AA. As noted above in the discussion of the capital regulation of insurers, such ratings require, among other things, positive operational performance as well as having significant holdings of surplus capital relative to an insurance company's overall exposures.

Banks, in particular, use credit insurance as a portfolio management tool, and currently over a hundred billion dollars of credit insurance coverage is underwritten globally.[2] Further, studies have shown that credit insurance helps banks unlock additional lending capacity for trade transactions and project finance, especially for fast growing sectors such as renewal energy facilities. For example, a survey of banks conducted by ITFA and IACPM in 2020 found that the $135 billion of credit insurance coverage facilitated $346 billion of loans to the real economy.[3]

Policy Characteristics

The private credit insurance market began to expand for banks starting in the early 2000s in response to Basel II reforms as European banks required policies with clear, simple coverage terms that satisfy the requirements for an unfunded guarantee.

Today, credit insurance policies issued to banks are considered partnerships between insurers and insureds. To satisfy Basel requirements, policies cover nonpayment by the obligor for any reason whatsoever. The policies contain few exclusions or conditions, excepting matters that are clearly within the control of the insured, such as loss caused by a fraudulent act by the insured. Similarly, the policies contain minimal representations, conditions precedents, and warranties regarding essential matters relating to the insured transaction, such as the enforceability (as limited by legal opinions received by the insured) of the underlying obligations.

Insurers balance such policies with several provisions to ensure that the applicable risk is appropriately managed. One requirement generally is the minimum risk retention, which requires that the insureds retain

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[2] The IACPM and ITFA estimate that the private credit insurance market underwrote at least $135 billion in coverage in 2020. http://iacpm.org/wp-content/uploads/2022/03/IACPM-ITFA-Private-Credit-Risk-Insurance-2021-Select-High-Level-Results.pdf.

[3] *Ibid*.

a minimum percentage of the exposure uninsured and unhedged. Insurers also require that insureds consult with them before agreeing to material amendments and waivers that may impact the risk particularly as to payment dates, and following claim payment, insureds are required to cooperate with insurers in pursuing recoveries. Policies covering trade credit receivables may cover up to 90% of any given loss, though any given loss is typically only a small amount of a given trade credit portfolio, and policy aggregate limits are typically equal to half or less of the overall portfolio.

Insurers and insureds in this market take similar approaches to evaluating risks. Both seek to balance their overall exposure to any given insurer or bank, as applicable, as well as aggregate exposures to the applicable sector, country, and obligor, with further internal limits across affiliates and subsidiaries of each such obligor. Both banks and insurers conduct due diligence on the other's business operations. Banks evaluate the credit ratings, financials, and industry knowledge of insurers while insurers review the performance history and credit approval operations of banks.

Capital Regulation of Insurers

Insurers participating in the credit insurance market are well experienced, well-rated, and well-capitalized, as well as subject to strict regulation of their capital to ensure their capacity to honor policyholder claims.

The capital of insurers is divided into two broad categories, respectively, minimum capital and surplus capital. Minimum capital must be maintained at all times, typically only in cash or US government bonds.[4] Surplus capital investments are also subject to quantitative and qualitative limitations, including restrictions between admitted investments (which may be counted towards an insurer's total capital) and non-admitted investments (which may not be counted towards an insurer's total capital).[5] Both minimum capital and surplus capital are then subject to a risk-based capital ("**RBC**") assessment, which balances, among other things, the value of an insurer's assets, risk-based capital charges on their assets (with higher charges assigned to riskier investments), and policyholder obligations in the event of significant losses.[6] The formula for RBC assessments is devised by the National Association of Insurance Commissioners, a national body led by the respective insurance commissioners that sets out widely adopted model laws and regulations, and is rarely modified on the state level.[7] The results of the RBC assessment are compared to the insurer's total adjusted capital, and insurers which fail to maintain adequate RBC ratios are subject to additional regulatory scrutiny or, if necessary, a takeover of operations by the relevant state regulator.[8]

An insurer's investments are restricted by the distinction between permitted and non-admitted investments. Non-admitted assets are those which cannot contribute to the insurer's overall capital for RBC calculations or other regulatory purposes, as such, insurers typically limit their holdings of such assets. Permitted investments, which are included in calculating an insurer's surplus capital, range from debt securities to equities to holdings in tangible real estate, with safer and better secured investments attracting more favorable RBC treatment. Permitted investments are also subject to qualitative and quantitative limitations to prevent over-concentrations in investment strategies.[9] Insurers are strongly discouraged from participating in derivatives or other exotic investments. To illustrate, in New York, an insurer must file a special plan with its regulator to utilize derivatives, with any such exposure strictly limited to a small portion of the insurer's capital and subject even then to Board of Directors level supervision.[10] Insurers must

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[4] For example, see New York Insurance Law Section 1402; see also 68 N.Y. Jur. 2d Insurance § 188. We will refer to New York law for the sake of providing a specific reference point, though we would be happy to provide references to the laws of other states if helpful.

[5] See New York Insurance Law Section 1301 and Section 1302 (distinguishing between admitted and non-admitted assets); New York Insurance Law Sections 1403 – 1407 (imposing restrictions on such investments); 68 N.Y. Jur. 2d Insurance § 189.

[6] New York Insurance Law Section 1324.

[7] For additional background on RBC calculations, see https://content.naic.org/cipr-topics/risk-based-capital.

[8] New York Insurance Law Article 74; see also 68 N.Y. Jur. 2d Insurance § 334.

[9] New York Insurance Law Section 1409; see also 68 N.Y. Jur. 2d Insurance § 192.

[10] New York Insurance Law Section 1410; 68 N.Y. Jur. 2d Insurance § 199.

maintain surplus capital that is significantly higher than their possible exposures to policyholders in order to maintain a high credit rating, which also discourages non-admitted investments.[11]

Every insurer must annually report all its investments to its regulators, including a detailed listing of all assets owned by the insurer.[12] Every three years, insurers must submit to a market conduct examination, which includes an audit of its finances along with an examination of its conduct towards policyholders (ranging from its marketing practices to claims payment rates).[13] Regulators reserve the right to demand a full financial accounting from insurers at any time, and upon any sign of financial distress, regulators may seize operational control of the insurer.[14] This process, known as "rehabilitation," typically involves regulators significantly restricting the insurer from taking on new risks while seeking to reinsure away as many obligations as possible, and reorienting investments in a conservative fashion, with the top priority of regulators being the protection of policyholders.[15]

An insurer may only issue dividends after demonstrating that it has sufficient surplus capital to honor all of its obligations, and even then, the amount of any such dividend is limited.[16] Insurers cannot participate in material affiliated transactions without regulatory approval.[17] The "control" of an insurer, which is presumed for any entity that holds 10% of the voting securities of an insurer, is closely monitored and subject to regulatory restriction.[18]

Insurers that are domiciled in the United Kingdom, European Union, or Bermuda are subject to the Solvency II framework. Lloyd's of London insurers are subject to the unique rules of Lloyd's, though ultimately, all Lloyd's policies are backed by the full strength of the Lloyd's market to ensure that all claims are paid when due.

Claims Payment Data

As noted above, credit insurance is often seen as a partnership between banks and insurers, with a balance of risk between the parties. Insurers expect that banks will retain risk and manage losses accordingly, while banks expect that their claims will be paid when due. The performance of credit insurance can be demonstrated in an ongoing industry study of claim performance based on data provided largely by leading insurance brokers (with some data being provided by insurers joining in 2022), which found the following:[19]

	2007 – 2020	2021	2022
Total claims paid to banks	578	140	190
Total Amount Claimed	$3,753,470,551	$1,010,242,049	$529,534,436
Total Amount Paid	$3,633,104,370	$1,010,242,049	$529,534,436
Compromised Claims	15	0	0

Overall, 97.73% of the value of all claims were paid in full, constituting 98.35% of all claims made in total. Of the remaining "compromised" claims where insurers asserted a defense against full claim payment, which would arise when either the applicable loss was arguably not covered by the policy or where the insured failed to honor a condition of the policy, 44% of the amounts claimed were paid.

Further, 29% of the aggregate amount of claim volume referenced in the above data were made in 2021 and 2022, which is both a reflection of losses arising due to the onset of the Covid-19 pandemic and growth

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11 For example, see https://ratings.moodys.com/api/rmc-documents/391814.
12 New York Insurance Law Section 307.
13 New York Insurance Law Section 309(b).
14 New York Insurance Law Section 309(a).
15 New York Insurance Law Article 74.
16 New York Insurance Law Section 4105.
17 New York Insurance Law Section 1505.
18 New York Insurance Law Section 1501.
19 Based on data supplied by A2Z Risk Services Ltd dated April 2023.

of the market, as more policies have been issued in recent years. Demonstrating the reliability of credit insurance policy wordings and the responsiveness of the insurers participating in this market, 100% of all claims from 2021 and 2022 have been paid in full.

Notably, these claim payment rates span from the 2008 financial crisis and the more recent global economic downturn following the shutdowns due to the outbreak of Covid-19. Claim payment rates increased during these times and insurers had the capacity to honor the claim obligations. This reflects the partnership between insurers and insureds where insureds seek to prudently manage risks and insurers accept the risks understanding the resulting payment obligations. Further, in addition to the capability of insurers to meet their claims liabilities, the claim payment experience demonstrates the responsiveness of credit insurance policies to cover the contemplated risk with conditions being within the control of the insured.

PART 2: USE OF CREDIT INSURANCE FOR CREDIT RISK MITIGATION AND DIVERSIFICATION

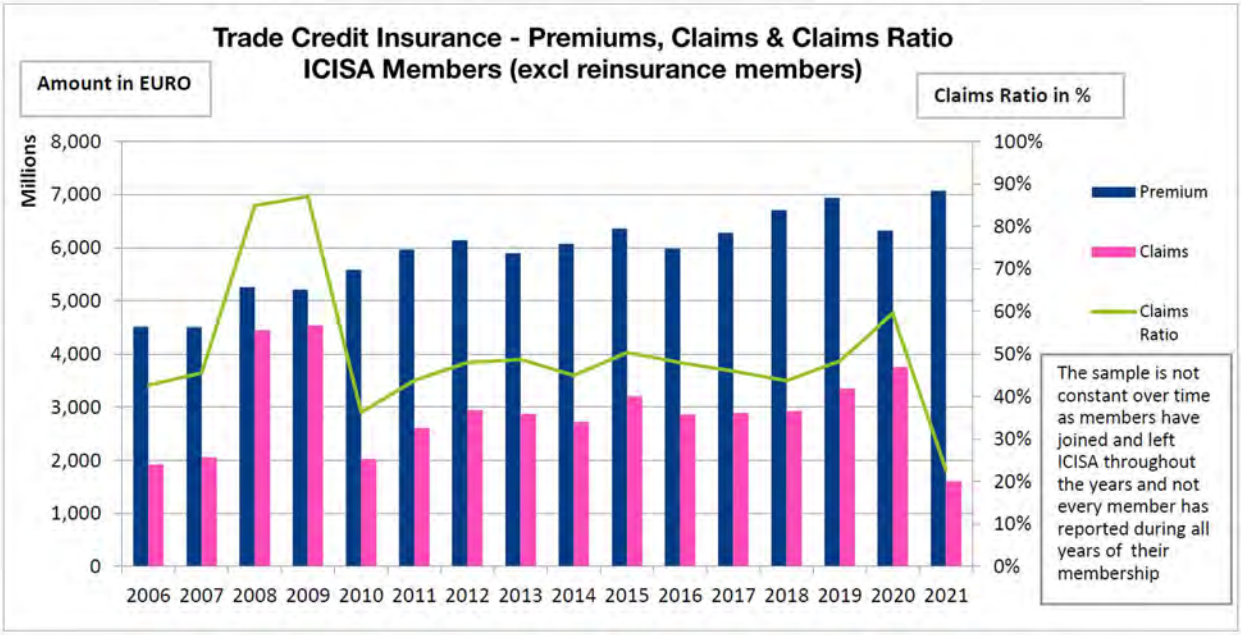
The credit insurance market in the United States has significantly grown over the last 20 years. Part of the overall growth is due to the influx of bank driven programs, e.g., supply chain finance, receivable purchase programs, payable programs, securitizations, and other monetization programs. These programs are designed for banks and differ from "corporate" programs, where the insured is typically a corporate entity seeking to balance the credit risk of transactions with its own customers.

Insurers welcomed the growth and exposure to bank driven credit insurance programs that historically have performed better than corporate credit insurance programs. We briefly outline the nature of these programs in order to demonstrate the opportunity in the credit insurance market, and correspondingly, the opportunity for banks to invest in trade finance to further support the trade markets.

Flight to Quality. Banks and corporate entities have different priorities for their credit insurance programs, which leads to a different selection of risks, and correspondingly different loss ratios and market capacity to match.

Corporate credit insurance programs are focused on mitigating the credit risk of the corporate's customers and fostering best practices in the corporate's credit management practices. Purchasing credit insurance coverage on a portion of its portfolio of customers, or all their corporate customers, adds a key layer of protection that protects cashflow against non-payment of outstanding receivables. Some smaller size corporate insureds use credit insurance to outsource the credit risk function where the insured relies on the insurer for counterparty risk assessment, including the amount the insured will be able to trade with its customer. For some larger corporate insureds, credit insurance is part of a larger risk mitigation strategy such as minimizing concentration risk in a particular number of customers or geography.

Some of a corporate's customers may not be insurable or are only partially insurable. During negotiations with the underwriter, it's common to see a push to have these marginal risks insured under the policy. Insurers can support providing coverage to these "riskier" obligors to a certain extent, balancing premium income against the probability of loss, though as noted above, insurers must also balance their aggregate risk across obligors. The industry has been able to sustain such risks with higher industry loss ratios during the severe economic events due to the Global Financial Crisis ("**GFC**") in 2008-09 and the COVID shutdowns in 2020. The data provided by the International Credit Insurance & Surety Association ("**ICISA**"; please see the table below) reflects the historical premiums and claims data for trade credit insurance.



By contrast, the historical loss ratios for bank business have been under 20%, which has allowed for a good diversification of insurers' business.[20] Banks traditionally purchase credit insurance for credit enhancement on a monetization program as their primary motivation, with the objective of achieving a targeted financing within a current portfolio where the bank has broader relationships with the customer risk being covered, so that the bank can deepen its existing relationships while freeing up capacity for lending to other customers. Risk transfer is a by-product of such an arrangement, consequently minimizing some of the risks of adverse selection.

This approach allows positive selection for the credit insurers versus adverse selection. Rather than stretch to cover weaker obligors, bank programs typically focus on the stronger credits, focusing on program structure, reliability of the policy wording (as banks seek the "Basel" compliant wording described in Part I, whereas corporates can accept a range of exclusions that would not be acceptable to banks), and pricing to finalize the program.

This benefits the overall trade economy in two ways. First, bank-driven insurance programs simply create more capacity for banks to expand their trade finance programs, thereby expanding the amount of funds available from banks for investment and lending into the trade economy. Second, the higher quality credits underlying bank-driven insurance programs help insurers hold better diversified portfolios, which increases capacity for insurers to offer coverage to corporate programs and therefore allowing corporates to better support their customers.

It is important to note that the bulk of the US bank monetization programs that are supported by the US credit insurance market are unable to receive a substantive benefit from capital risk weight substitution due to the limitations discussed below. Therefore, the insurance market for these bank programs, while strong, remains in its infancy. If US banks, on a wholesale basis, were able to use credit insurance as a meaningful risk distribution tool, the number of US bank programs would substantially increase while maintaining the historical risk profile and loss ratios outlined above. Further, such an approach mirrors how non-US banks and credit insurers currently operate outside the United States with respect to the use of credit insurance as a meaningful risk distribution tool that provides capital risk mitigation.

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[20] This 20% figure is an estimate based on the experience of the members of ITFA and IACPM involved in this collaboration. No industry wide study has been conducted. If useful, we would also be happy to conduct a market survey through both organizations to further supplement this data.

Projected Exposure Shift – Credit Risk Transfer ("CRT").

Credit insurance plays a significant role in global trade, with one indicative study by the ICISA estimating that insurers for bank and corporate programs covered €6.35 trillion in shipments in 2020, constituting a total of 14.52% of all global trade.[21] As noted, insurers consider bank-driven programs to have a stronger risk profile than credit insurance provided to corporates, and therefore seek to create additional capacity for such programs. We estimate that if US domiciled banks were eligible to use credit insurance as a capital risk mitigation tool in the future, there would be a growth of $250 billion in notional coverage amounts over a three-year period.

The anticipated credit quality of such exposures is investment grade or near investment grade risk. However, despite the high quality of these risks, which is further supported by insurance, US banks receive zero capital benefit for insurance company exposures versus other corporate exposures. Because the standardized risk weight for exposures to insurance companies under the US capital rules is the same as that for any other corporate exposure, for the same exposure amount the standardized risk weighted assets ("**RWA**") amount is the same for each of these risks, regardless of the ratings provided by the external rating agencies or the internal investment grade risk assessment by the banks.

Due to this fact, the banks cannot access the benefit from credit insurance as a credit risk mitigant and risk diversification tool under the capital rules. Therefore, the bulk of the transfer will be centered on investment grade obligor risks. Even when falling below investment grade, the US banks typically will not venture too far from investment grade ratings for unsecured risk.

RWA Calculations – Current vs. (Potential) Future. The table below illustrates the impact of the proposed treatment under the US capital rules with respect to a $100 million exposure. The proposed interpretation would reduce the capital amount by $6.08 million.

	Current Treatment	Proposed Treatment
Program size	$100,000,000	$100,000,000
Senior tranche	Insurance coverage 95% of receivable nominal value and 5% recourse to the seller	Insurance coverage 95% of receivable nominal value and 5% recourse to the seller
Insured Amount	$95,000,000	$95,000,000
Uninsured Amount	$5,000,000	$5,000,000
Risk Weight	100%	20%[22]
Risk Weighted Assets	$100,000,000	$24,000,000
Reserve Capital	$8,000,000	$1,920,000

Extending the above to a projected $250 billion in assets, three-year, insurance-supported asset group results in more than $15 billion of capital savings to US banks, which could be utilized for further lending and investment to support the trade economy.

Optimize Use of Capital. Under the current environment, US banks over allocate capital for a particular deal thereby increasing RWA, which has a bearing on the overall Capital Adequacy Ratio. If US banks can use credit insurance as a credit risk mitigant under the capital rules, US banks will be able to optimize the use of their capital while continuing to maintain a conservative approach in managing their overall RWAs. Further, the post-pandemic shifting of supply chains has resulted in additional pressure on company cash flow, which in turn has increased the need to monetize bank programs. The ability of US banks to benefit from a better capital treatment will, therefore in turn, directly benefit US companies and their liquidity

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[21] See https://icisa.org/wp-content/uploads/2022/08/ICISA-Estimate-of-TCI-role-in-world-trade-June22.pdf

[22] As discussed in Part 3, the risk weight applicable to an insurer under the Basel Framework could be as low as 20% in the case of a short-term exposure to a prudentially regulated insurer qualifying for a risk weight equivalent to that of a Grade A bank under the Basel Committee's revised Basel Framework.

requirements, especially in the current economic environment where costs of borrowing are substantially higher with the resulting pressure on liquidity.

Risk Distribution Tools. In order to manage risk effectively, credit portfolio managers rely on front-end and back-end tools. The front-end tools consist of managing a portfolio at inception through risk appetite frameworks, concentration issues, and their overall general credit assessment. The back-end tools that banks utilize are credit default swaps ("**CDS**"), loans sales, and synthetic on balance sheet securitization (funded and unfunded). However, these tools are becoming less viable options given the regulatory environment. Therefore, banks welcome the opportunity to utilize other risk distribution tools like credit insurance.

In contrast to other risk distribution tools, credit insurance is especially nimble and reliable. Further, as noted above, the insurance market has significant capacity for bank-driven programs, which when used, will allow banks to accept more credit risk exposure to a particular borrower and directly assist the real economy, including project financing for infrastructure projects and other transactions that support trade.

PART 3: SUGGESTIONS FOR CLARIFICATIONS

Under both the international capital standards of the Basel Committee on Banking Supervision (the "**Basel Framework**") and the capital rules of the US federal banking agencies implementing those standards in the United States (the "**US Basel III Capital Rules**"), banks may recognize certain credit risk mitigants to reduce the capital requirements for certain credit exposures. Eligible guarantees are a form of credit risk mitigation recognized by the Basel Framework and the US Basel III Capital Rules that, if certain requirements are satisfied, permit a bank to shift the risk weight associated with a credit exposure from the original obligor to a guarantor.[23] If the guarantor has a lower risk weight than the original obligor, this risk-shifting treatment reduces the risk weighted asset amount associated with the credit exposure.

A credit insurance policy is economically similar to a guarantee and acts as an economic credit risk mitigant to a banking organization. In order for a credit insurance policy to qualify as an eligible guarantee, however, the policy must satisfy 10 different definitional elements,[24] including that the protection provider be an "eligible guarantor."

This section analyzes the primary obstacles to applying risk-shifting treatment to credit insurance policies under the existing US Basel III Capital Rules and shows how these obstacles could be overcome with modest changes to the US Basel III Capital Rules that are consistent with the Basel Framework.[25] Section 3.A addresses the fact that insurers providing credit insurance policies are generally not eligible guarantors under the US Basel III Capital Rules. Section 3.B analyzes the remaining elements of the definition of an eligible guarantee, and shows that these requirements would generally be met for credit insurance policies, without changes to the existing US Basel III Capital Rules, but shows how, consistent with the Basel Framework, the US Basel III Capital Rules could be interpreted or modified to make certain insurance companies eligible guarantors. Finally, Section 3.C addresses the fact that, even if a credit insurance policy satisfied the definition of an eligible guarantee, the application of the risk-shifting approach would generally not reduce risk weighted assets for such exposures because prudentially regulated insurers are currently treated as corporate exposures under the US Basel III Capital Rules, and how this issue could be revisited as part of implementing the remaining parts of the Basel Framework in the United States as part of the so-called "Basel III Endgame."

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[23] 12 C.F.R. § 217.36(b)(1) (Federal Reserve rule); 12 C.F.R. § 3.36(b)(1) (OCC rule); 12 C.F.R. § 324.36(b)(1) (FDIC rule).

[24] 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining "eligible guarantee").

[25] As of May 2023, the US federal banking agencies are expected to soon propose changes to the US Basel III Capital Rules to implement changes to the Basel Framework finalized in 2017 and known as the "Basel III Endgame." The revisions to the Basel Framework contained in the Basel III Endgame became effective on January 1, 2023.

A. Insurers as Eligible Guarantors

The definition of eligible guarantor has two prongs, under both the US Basel III Capital Rules and the Basel Framework.[26] The first prong encompasses per se eligible guarantors, which under the US Basel III Capital Rules include sovereigns, multilateral development banks, depository institutions, and bank holding companies. While the US Basel III Capital Rules do not include insurance companies among per se eligible guarantors, the Basel Framework defines eligible guarantors to include "other prudentially regulated financial institutions with a lower risk weight than the counterparty" which may include insurance companies.[27] In implementing the Basel III Endgame, we recommend that the US federal banking agencies add insurance companies that are subject to prudential regulation and supervision, including applicable capital and liquidity requirements, to the list of per se eligible guarantors on the basis that they are prudentially regulated financial institutions that, like banking organizations, are engaged in the activity of assuming principal risk, in this case credit risk.

In addition, an insurance company could be considered an eligible guarantor under the second prong of the definition, which is available for operating entities other than the types of entities enumerated in the first prong, provided certain requirements are satisfied. Under the US Basel III Capital Rules, this prong requires among other things that, at the time of entry into the guarantee or thereafter, the protection provider must have issued and outstanding investment grade debt securities.[28] However, it is frequently the case that credit insurance policies are written by an operating subsidiary of the insurance group which does not itself issue debt, which precludes this prong under the current US Basel III Capital Rules.

The analogous provision in the revised Basel Framework requires "corporate entities (***or the entity's parent company***)" to "have securities outstanding on a recognized securities exchange" in order to be considered an eligible guarantor under this prong.[29, 30] The key distinction is that, unlike under the current US Basel III Capital Rules, an insurance company could qualify as an eligible guarantor under the revised Basel Framework if its ***parent company*** has issued and outstanding securities trading on a recognized securities exchange. Alignment of the US Basel III Capital Rules with the revised Basel Framework could be achieved by allowing an insurer to satisfy the US rules' "issued and outstanding investment grade debt securities" requirement through its parent's issuance of debt securities, rather than applying this provision to the insurer itself.

We believe that this could be accomplished either through issuing clarifying guidance or an interpretation under the current US Basel III Rules, on the basis that the "investment grade" creditworthiness of an insurance holding company's debt securities would inevitably reflect in part the creditworthiness of its regulated insurance operating subsidiaries. A debt security issued by a regulated parent insurance holding company of a regulated insurance company subsidiary would thus have a substantially similar effect, in terms of assessing creditworthiness for purposes of being an eligible guarantor, as the issuance of a debt security by the subsidiary itself.

In addition, in implementing the Basel III Endgame, we recommend that the US banking agencies modify the existing debt securities requirement in the US Basel III Capital Rules to explicitly include investment grade debt securities issued by the guarantor's parent company, consistent with the revisions made in the Basel Framework.

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[26] 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining "eligible guarantor").

[27] Basel Framework, CRE 22.76 (Basel Committee on Banking Supervision, 2023) (hereafter, "CRE XX.XX"). Footnote 11 to this provision defines prudentially regulated financial institutions to include "prudentially regulated insurance companies."

[28] *Ibid.*

[29] CRE 22.76(3)(a)(i) (emphasis added).

[30] The Basel Framework would also require guarantors eligible under this prong to be "investment grade," meaning they have adequate capacity to meet their financial commitments (including repayments of principal and interest) in a timely manner, irrespective of the economic cycle and business conditions. CRE 22.76(3)(a). Furthermore, the creditworthiness of such investment grade guarantors must not be positively correlated with the credit risk of the exposures for which they provided guarantees. CRE 22.76(3)(a)(ii). These requirements are already incorporated into the existing US Basel III Capital Rules.

B. Remaining Criteria for Eligible Guarantee

The remaining nine criteria contained in the definition of an eligible guarantee under the US Basel III Capital Rules are typically satisfied by credit insurance policies that cover trade credit exposures, as follows: [31]

- The first criterion requires that the guarantee be written, which is true of all credit insurance policies.

- The second criterion requires that the guarantee be unconditional. The meaning of "unconditional" is not defined in the US Basel III Capital Rules. Practically all guarantees, however, contain some conditions which do not necessarily render the guarantee ineligible, e.g., the requirement that certain specified documents be provided to the guarantor. We believe that the types of provisions contained in a typical credit insurance policy – all of which are in any event within the control of the beneficiary of the guarantee (such as submitting a claim in a particular form) – are consistent with an unconditional guarantee for the purposes of this criterion.

- The third criterion requires that the guarantee cover all or a pro rata portion of all contractual payments of the obligor on the reference exposure. In most cases, a credit insurance policy covers a pro rata portion of accounts receivable, satisfying this criterion. In cases where a credit insurance policy includes a deductible or where the amount of the policy is less than the exposure amount of the exposures it covers, this criterion would not be satisfied, but the policy would likely qualify as a securitization exposure under the US Basel III Capital Rules.[32]

- The fourth criterion requires that the guarantee give the beneficiary a direct claim against the protection provider. Under a typical credit insurance policy, the beneficiary would have a direct claim against the insurer for any losses covered by the policy, thereby satisfying this requirement.

- The fifth criterion requires that the guarantee not be unilaterally cancelable by the protection provider for reasons other than breach of contract by the beneficiary. A typical credit insurance policy does not contain any such cancellation provision.

- The sixth criterion requires that the guarantee be legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced. As a practical matter, a bank would conduct diligence to ensure this requirement is satisfied as part of the credit approval process prior to executing the policy.

- The seventh criterion requires the guarantee to require that the protection provider make payment to the beneficiary upon the occurrence of an obligor default on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment. A credit insurance policy covering short-term transactions typically requires payment within 15 business days after the end of a 90-day waiting period beginning on the notification of a default. Furthermore, while credit insurance policies typically require the insured bank to preserve the value of defaulted credit exposures, they do not require the bank to first take legal action against the obligor prior to making a claim under the policy. While the meaning of "timely manner" depends at least in part on the commercial context and industry custom, we believe that a credit insurance policy with customary terms would satisfy the "timely manner" criterion.

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[31] Each of the following elements is contained in 12 C.F.R. § 217.2 (Federal Reserve rule); 12 C.F.R. § 3.2 (OCC rule); 12 C.F.R. § 324.2 (FDIC rule) (each defining "eligible guarantee").

[32] In such cases, the insurance coverage would be akin to a tranched exposure, having an attachment point equal to the deductible amount and a detachment point equal to the deductible plus the total amount of coverage under the policy. Although such a policy would not be eligible for the risk-shifting approach applicable to eligible guarantees, such policies could potentially benefit from the treatment of securitization exposures under the US Basel III Capital Rules, provided certain definitional and operational requirements were satisfied and provided similar amendments to the definition of "eligible guarantee" and "eligible guarantor" as proposed in this white paper were implemented.

- The eighth criterion requires that the guarantee does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure. The typical credit insurance policy contains no such cost adjustment mechanism.

- The ninth criterion requires that the guarantee is not provided by an affiliate of the protection purchaser. The typical credit insurer is not an affiliate of the bank seeking credit protection.

C. Risk Weight Applicable to Insurers

Under the standardized approach to credit risk in the existing US Basel III Capital Rules, a credit exposure to an insurance company is considered a general corporate exposure and assigned a risk weight of 100%.[33] Under the Basel Framework, however, an exposure to a prudentially regulated insurance company is eligible to receive a lower risk weight (equal to the standardized risk weights for exposures to banks) if the insurance company is "subject to prudential standards and a level of supervision equivalent to those applied to banks."[34, 35] Such a risk weight could be as low as 20% in the case of a short-term exposure to a low risk (i.e., Grade A) obligor.[36] The Basel Framework states that "[n]ational supervisors should determine whether the regulatory and supervisory framework governing securities firms and other financial institutions in their own jurisdictions is equivalent to that which is applied to banks in their own jurisdictions."[37]

We recommend that, in implementing the Basel III Endgame, the US banking agencies modify the existing US Basel III Capital Rules to be consistent with the Basel Framework with respect to the standardized risk weights applicable to credit exposures to insurance companies. This could be accomplished through a provision allowing insurance companies subject to prudential supervision equivalent to banks to be treated as banks for the purposes of risk weighting of credit exposures, along with a determination by the regulators that insurance companies are subject to such prudential supervision. Such a revision would be consistent with the Basel Framework, which was developed in part by US federal banking agencies as members of the Basel Committee on Banking Supervision.[38]

In the case of traditional credit insurance, the original credit exposure is to the customers of a corporate client of the bank. If the insurance policy were recognized as a credit risk mitigant, the bank could obtain capital relief by, e.g., substituting the customers' risk weight (presumably 100%) with that of the insurer (which could be as low as 20% under the approach outlined above if the insurer qualifies for the lowest risk weighting applicable to banks under the Basel Committee's revised Basel Framework).

If the US Basel III Capital Rules are aligned to the revised Basel Framework as described above, banks seeking credit insurance could, consistent with international standards, achieve capital relief by substituting the insurer's risk weight in place of the risk weight assigned to its corporate clients. As explained above, alignment of the US capital rules with the revised Basel Framework furthers the US regulators' policy of maintaining US capital requirements that are consistent with the Basel Framework, and would put US banking organizations on an even playing field. In addition, this convergence would be consistent with broader policy considerations by enabling banks to protect credit exposures using an established credit insurance product, while recognizing the credit risk mitigation benefits of such a hedge in a manner consistent with economically equivalent single name risk mitigation techniques, such as traditional guarantees and credit derivatives.

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[33] 12 C.F.R. § 217.32(f)(1) (Federal Reserve rule); 12 C.F.R. § 3.32(f)(1) (OCC rule); 12 C.F.R. § 324.32(f)(1) (FDIC rule).

[34] CRE 20.40.

[35] Implementing statutes in other jurisdictions, including the Capital Requirements Regulation in Europe, currently allow a similar treatment of exposures to non-bank financial institutions subject to "comparable" prudential requirements. CRR Article 119.

[36] CRE 20.21. For purposes of this white paper, all comparisons to the Basel Framework reflect the Standardized Credit Risk Assessment Approach, applicable in jurisdictions, such as the United States, that do not allow for the use of external credit ratings in determining risk weights.

[37] CRE 20.40.

[38] The Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are all members of the BCBS. https://www.bis.org/bcbs/membership.htm?m=3071.

CONCLUSION

Credit insurance is a proven, reliable product offered by well-capitalized and regulated counterparties that can helps banks responsibly diversify their portfolios. Such diversification, in turn, will encourage more investment, the associated risks of which will shared by banks and insurers to the ultimate benefit of the US trade market. Clarifying the rules as suggested above would allow US banks to compete on a equal basis with their peer banks in other jurisdictions.

The authors appreciate this opportunity to outline this issue and would be happy to discuss any time should you have any questions or concerns.