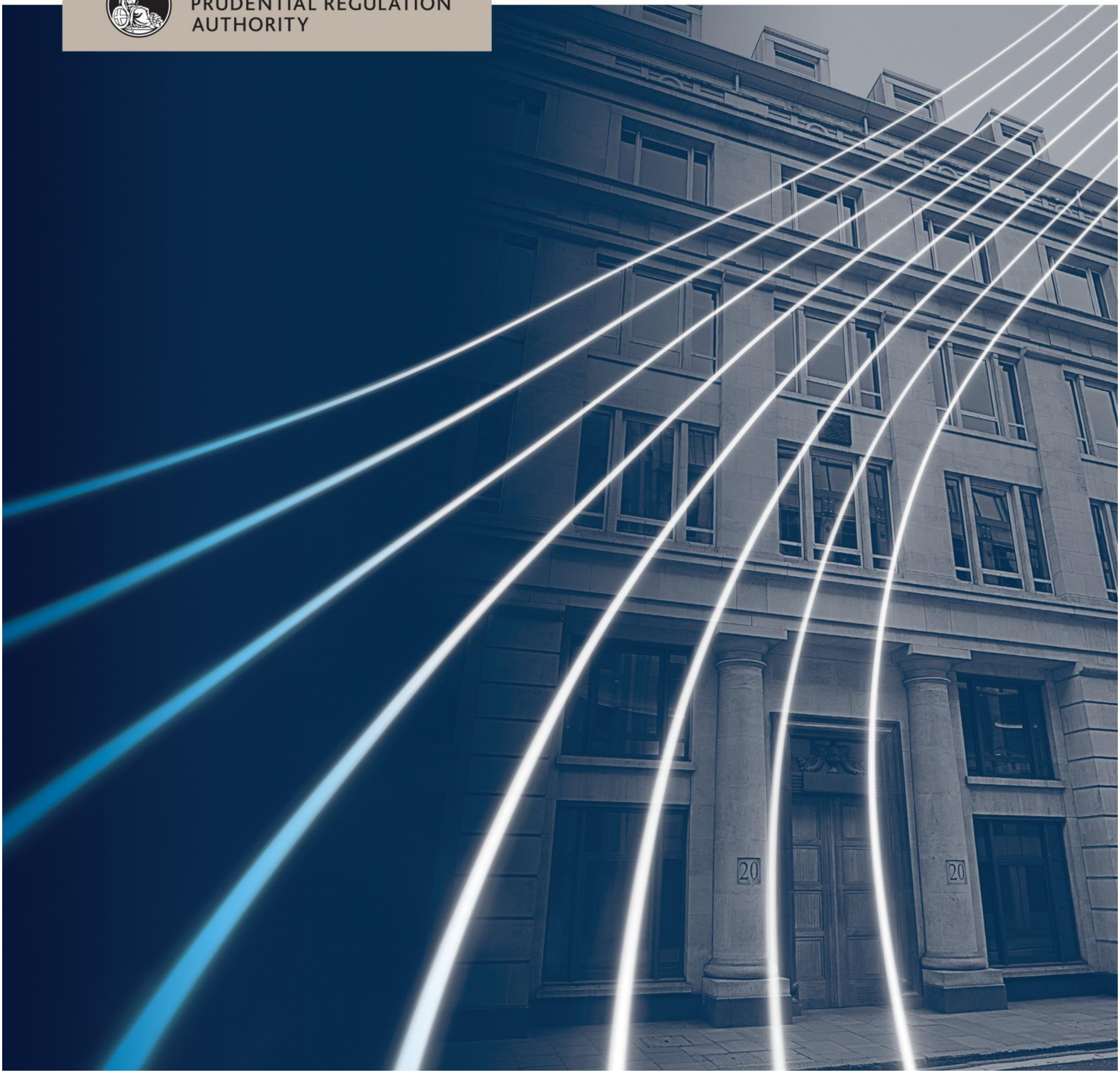
Policy Statement | PS8/19

Credit risk mitigation: Eligibility of guarantees as unfunded credit protection

March 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 6/18 'Credit risk mitigation: Eligibility of guarantees as unfunded credit protection'.[1] It also contains the PRA's final policy in updated:

- Supervisory Statement (SS) 17/13 'Credit risk mitigation' (Appendix 1); and
- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' (Appendix 2).

1.2 This PS is relevant to all firms bound by the Capital Requirements Regulation (575/2013) (CRR).

Background

1.3 In CP6/18 the PRA proposed changes to SS17/13 to clarify expectations regarding the eligibility of guarantees as unfunded credit protection under CRR Part Three, Title II, Chapter 4 (Credit risk mitigation).

1.4 The PRA received 31 responses to the CP. Respondents generally welcomed the PRA's clarification of its expectations regarding the eligibility of guarantees as credit risk mitigation (CRM). However, several respondents raised concerns regarding the impact of the proposals on certain types of guarantees. Several respondents also requested further clarification on certain aspects of the proposals.

Changes to draft policy

1.5 Following consideration of responses, the PRA has made three significant changes to the proposals consulted on in the CP. These changes are as follows:

- the removal of the proposal relating to the meaning of pay out in a timely manner;
- a new expectation around risks arising from eligible guarantee arrangements; and
- a new expectation around recognising any residual risks.

1.6 Further details on these changes, along with a cost benefit analysis, and assessment of impact on mutuals, are set out in Chapter 2.

1.7 The PRA has made other changes to the draft policy which, in the opinion of the PRA, are not significant. This includes minor changes to the proposal on legal effectiveness and enforceability of qualifying guarantees, and to the proposal around qualifying guarantees being clearly defined and incontrovertible. Further details on these changes are set out in Chapter 2. The PRA does not consider the impact is significant, or significantly different, for mutuals. Therefore, the assessment of impact on mutuals and the cost benefit analysis in respect of these changes has not been updated.

Implementation

1.8 The changes to SS17/13 and SS31/15 will be effective six months from the publication of this policy, ie from Friday 13 September 2019.

1 February 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-mitigation-eligibility-of-guarantees.

1.9 The policy set out in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that no additional amendments would need to be made to the changes outlined in this PS in the event that the UK leaves the EU with no implementation period in place on 29 March 2019. Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[2] for further information on the Bank's amendments to rules and standards under the European Union (Withdrawal) Act 2018.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practice, and must publish in such manner as it thinks fit responses to the representations.[3]

2.2 This chapter sets out a more detailed summary of the responses to the proposals in CP6/18, alongside the PRA's feedback.

Pay out in a timely manner

2.3 CRR Article 215(1)(a) requires that the guarantor be obliged, contractually, to pay out 'in a timely manner'. The PRA proposed that 'in a timely manner' meant without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due under the claim in respect of which the protection is provided.

2.4 Several respondents said that the PRA's proposal would prevent many government backed guarantees (including those provided by Export Credit Agencies and Multilateral Development Banks and Development Finance Institutions), and credit insurance (provided by credit insurers), from qualifying as eligible CRM. Respondents noted that these arrangements are commonly used to cover exposures related to trade finance.

2.5 Some respondents noted the difficulty in defining when the clock starts for a pay out period and that the proposal would not allow for a grace period or possible restructuring of the underlying obligation. Some respondents suggested that the contractual pay out period may not have much bearing if there is a dispute between the firm and the protection provider. In these cases, pay out could take much longer. Several respondents noted that the proposal would likely not have an impact on corporate guarantees which typically allow firms to demand immediate pay out.

2.6 After considering the arguments made by respondents, the PRA has decided not to implement the proposal around the meaning of pay out in a timely manner. The PRA acknowledges that there may be difficulties in applying a single measure of timeliness to all the different products which may be used as guarantees. However, the PRA remains concerned that there is a risk that qualifying contracts provide credit protection that is less effective than expected. In particular, the PRA has observed cases where credit insurance that is being recognised as CRM has not paid out for long periods of time, due to a dispute between the firm and the insurer. After considering the impact of the proposal in light of the responses received, the PRA considers that its concerns are better addressed through an approach where firms consider risks arising from eligible guarantee arrangements and any residual risks (see

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2 February 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

3 Sections 2L and 2N of FSMA.

paragraphs 2.17-2.24 of this PS). The PRA considers this to be a proportionate approach that better targets its concerns than the original proposal.

2.7 Notwithstanding the removal of the proposal around the meaning of pay out in a timely manner, the PRA notes that CRR Article 215(1)(a) requires that the firm has the right to pursue, 'in a timely manner', the guarantor for monies due under the claim. CRR Article 213(1)(c)(iii) requires that the 'credit protection contract does not contain any clause, the fulfilment of which is outside the direct control of the lender, that [...] could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due'. As outlined in EBA Q&A 2015_2306, while the expression 'timely manner' allows some flexibility, it would not allow any 'determinable' period, the length of which depends on circumstances on which the firm has no influence.[4]

Legally effective and enforceable

2.8 CRR Articles 194(1), 213(1)(d), and 213(3) require that the guarantee must be legally effective and enforceable in all relevant jurisdictions. The PRA proposed that this would require, at a minimum, the firm to satisfy itself that the guarantee is enforceable under its governing law, and in the jurisdiction where the guarantor is incorporated, but could well include other jurisdictions where enforcement action may be taken. The practical ease of enforcement should also be considered. CRR Article 194(1) requires that the guarantee be supported by an independent, written, and reasoned legal opinion. As part of considering the effectiveness of the guarantee, the PRA proposed that the independent legal opinion consider the eligibility criteria.

2.9 Several respondents said that the proposal that the legal opinion required under CRR Article 194(1) consider the practical ease of enforcement and the eligibility criteria is going over and above the CRR requirements. These respondents said that the practical ease of enforcement and consideration of eligibility criteria are often practical rather than legal questions and therefore could be better assessed by firms rather than as part of the legal opinion. The PRA has considered the responses and acknowledges that a legal opinion is not the only way to demonstrate such compliance, although it is one way of doing so. Consequently, the proposal that the legal opinion also consider the practical ease of enforcement and the eligibility criteria has been removed.

Exclusion clauses

2.10 The PRA proposed that the prohibition on the guarantee containing any clause that could prevent the guarantor from being obliged to pay out in a timely manner under CRR Article 213(1)(c)(iii) should be read with the further condition that the firm must have the right to pursue, in a timely manner, the guarantor for any monies due under the guarantee, and that payment shall not be subject to the firm first having to pursue the defaulting obligor for recovery.

2.11 The PRA also proposed what 'certain types of payment' and 'limited coverage' mean in the context of CRR Article 215(1)(c) – specifically, that 'limited coverage' would refer to a quantifiable portion of the exposure, and that 'certain types of payment' would refer to different sums the obligor may be required to pay to the firm under the contract, such as principal, interest, margin payments, fees and charges. The limited coverage of a guarantee would be reflected in firms' calculation of the value of unfunded credit protection under CRR Articles 233 and 235.

4 See https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_2306.

2.12 Several respondents requested clarification on what exclusion clauses are permitted in the guarantee without infringing the requirement in CRR Article 213. Respondents said that certain standard exclusion clauses (eg nuclear risks, cyber risks, and natural disasters) should not necessarily render a guarantee ineligible for CRM where the excluded risk is independent from the underlying credit risk and the likelihood of it materialising is remote.

2.13 Several respondents requested that the PRA provide clarity on whether the presence of exclusion clauses which are outside the direct control of the firm (such as those which are industry standard in credit insurance) would render the guarantee ineligible for CRM. The PRA expects that such an exclusion clause may well be contrary to Article 213(1)(c), depending on its terms, unless in all the circumstances the clause is immaterial to the guaranteed exposure and the risk of an obligor default under that exposure. The PRA expects that, in many cases, a clause that excluded protection (or entitled the guarantor to do so) in the event that the obligor defaulted due to a cyber event would be contrary to the requirements of Article 213(1)(c). Similarly, the PRA expects that, for many international trade finance exposures, a clause that excludes protection in the event that the obligor defaulted due to a political or civil unrest event would be contrary to the requirements of Article 213(1)(c).

Clearly defined and incontrovertible

2.14 CRR Article 213(1)(b) requires that the extent of the guarantee must be clearly defined and incontrovertible. The PRA proposed that this means that the wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, challenge, or otherwise seek to be released from, or reduce, their liability. When satisfying themselves that a guarantee is 'incontrovertible', firms would consider the terms of the guarantee itself, the remedies available under the law that applies to that guarantee, and whether there are scenarios in which the guarantor could in practice successfully seek to reduce or be released from liability under the guarantee.

2.15 Several respondents commented that it is useful that the PRA has included the word 'practical' since there is always the possibility that a guarantor may dispute its liability even in the face of the clearest possible evidence and this means firms will be able to take a practical and pragmatic approach to this question. One respondent noted that most forms of credit insurance would satisfy the requirement around incontrovertibility, and it may be possible to amend any other contracts so they do satisfy it. Several respondents said there could be scenarios which are within the firm's control (such as not honouring obligations under a credit insurance policy) in which the guarantor 'could in practice successfully seek to reduce or be released from liability under the guarantee' and that this should not disqualify a guarantee since it is within the firm's control that the protection remains effective.

2.16 The PRA remains concerned that there could be a risk that a guarantor 'could in practice successfully seek to reduce or be released from liability under the guarantee'. In particular, the PRA considers that this risk is likely to be greater where guarantees qualifying for credit risk mitigation have broad or vague terms or obligations which the firm must fulfil, such as duties of disclosure commonly found in credit insurance. In light of the responses, rather than addressing this risk via the eligibility criteria around 'clearly defined and incontrovertible', the PRA considers that this risk can better be addressed by the requirement to identify and control risks arising from guarantee arrangements and considering any residual risks (see paragraphs 2.17-2.24 of this PS). SS17/13 has been amended so that firms consider whether the guarantor would, in practice seek to reduce or be released from liability as a residual risk affecting the appropriate substitution rather than through the eligibility criteria around 'clearly defined and incontrovertible'.

Risks arising from eligible guarantee arrangements

2.17 Several respondents said that credit insurance would no longer be eligible for CRM because of the proposal around timeliness. These respondents said that credit insurance that meets the CRM eligibility criteria should be considered an effective form of CRM and that the only times it would not pay out would be where a firm failed to observe policy conditions which were within the its control. Examples of such policy conditions include maintaining an uninsured percentage of the risk, paying premiums on time and disclosing material information to the insurer.

2.18 The PRA has considered the responses and, as outlined in paragraph 2.6, is replacing the proposal around timeliness with a new expectation around risks arising from eligible guarantee arrangements, and a new expectation around residual risks. CRR Article 194(8) requires firms to have adequate risk management processes to control risks arising from credit risk mitigation. CRR Article 213(3) requires that a firm shall fulfil any contractual and statutory requirements in respect of, and take all necessary steps to ensure, the enforceability of its unfunded credit protection. The PRA considers that this requires firms to identify risks arising from guarantees, including the risk of non-fulfilment by the firm of a contractual obligation that could render the credit protection ineffective. Firms are required to have adequate risk management processes in place to control these risks.

2.19 The PRA does not consider that this new expectation around risks arising from eligible guarantee arrangements will impose significant additional costs on firms relative to the proposals in the CP, or that the impact on mutuals will be significant, or significantly different, to the impact on other PRA-authorised firms. The CRR requires firms to have adequate risk management processes to control risks arising from credit risk mitigation. The expectation highlights examples of how guarantee arrangements could become ineffective so that firms can consider them in their existing risk management process, if they are not doing so already.

Residual risks

2.20 The PRA's proposals relate to the eligibility of guarantees as CRM in Pillar 1 of a firm's capital requirements. The CP proposed that guarantees that do not meet the PRA's expectations should not be recognised in Pillar 1 capital. However, that would not preclude the possibility that additional capital under Pillar 2 may be appropriate where a guarantee is eligible under Pillar 1. The use of Pillar 2 to address residual risks is contemplated in Basel II[5]; and Articles 80 and 98(1)(c) of the Capital Requirements Directive (2013/36EU) (CRD) require that the PRA and firms ensure that risks which result from the use of CRM techniques are addressed.

2.21 Several respondents requested clarification on the possibility for additional capital under Pillar 2 for residual risks arising from the recognition of guarantees as CRM. One respondent said that a firm new to the use of credit insurance should consider additional capital under Pillar 2 to address residual risks.

2.22 The PRA has considered whether firms' use of guarantees as a form of CRM has proved to be less effective than expected, resulting in residual risks. This assessment is based on the PRA's observations in supervisory cases, responses to the CP, and the PRA's follow-up discussions on claim pay out rates with some credit insurers and government backed guarantors.

5 Paragraphs 767-769.

2.23 The PRA considers that credit protection could in practice be less effective than would be warranted by a full substitution of the risk weight (under CRR Article 235(1) for exposures under the standardised approach (SA)), or probability of default (PD) (under CRR Article 236(1) for exposures under the foundation internal rating-based approach (FIRB)) of the guarantor. As a result, a new expectation around residual risks has been introduced in paragraphs 2.6A-2.6B of SS31/15 for exposures under SA, and paragraph 7.8 of SS17/13 for exposures under FIRB. In considering whether a full substitution is warranted or not, firms are expected to consider the risk that, although the CRM eligibility criteria are met, the credit protection could in practice become less effective for a reason other than the default of the guarantor. The PRA considers that this risk is likely to be greater where guarantees qualifying for CRM have broad or vague terms or obligations, which the firm must fulfil, such as duties of disclosure commonly found in credit insurance. Based on the PRA's observations to date, most other forms of guarantee would be likely to warrant full substitution, although this would need to be a case-by-case determination by firms based on the terms of the particular contract.

2.24 For firms using the FIRB, CRR Article 236(1) states that for the covered portion of the exposure, the PD for the purposes of CRR Section 4 of Chapter 3 may be the PD of the guarantor, or a PD between that of the borrower and that of the guarantor where a full substitution of the PD is deemed not to be warranted. The new expectation around residual risk would be an input into firms' considerations around PD in Article 236(1), and therefore may lead to additional cost for some firms. For firms using the SA, the new expectation around residual risk would be part of their ICAAP, and therefore would lead to additional cost. The PRA expects the cost would not be material and may also be absorbed by firms' existing processes around determining whether a full substitution of the PD is warranted or not (for firms using FIRB), and existing processes around their ICAAP (for firms using SA). The new expectation aims to ensure that capital requirements better reflect the risk of firms' credit risk exposures: capital reduction arising from the use of guarantees will be based on a corresponding reduction to the underlying risk. The PRA considers that this presents a more targeted, proportionate and risk sensitive approach than the original CP proposal around timeliness. The PRA does not consider that the impact on mutuals will be significantly different to the impact on other PRA-authorised firms.

Requirements for exposures on AIRB approach

2.25 The CRR outlines two approaches for the recognition of guarantees in capital requirements for credit risk, depending on which approach to credit risk is being used. The first is the substitution approach as set out in CRR Part Three, Title II, Chapter 4. It is the only approach available to exposures on SA and FIRB, and was the subject of the proposals in the consultation. The second is an adjustment of PD or loss given default (LGD), which may involve the substitution of the obligor's PD or LGD for the guarantor's PD or LGD, for firms using the advanced internal ratings based approach (AIRB). Requirements for AIRB are set out in CRR Part Three, Title II, Chapter 3 (Internal ratings based approach), and are outside the scope of the CP proposals.

2.26 Some respondents considered that the CP proposals would affect exposures under AIRB due to the interaction between CRR Article 181(1)(f) and the requirements in Chapter 4, Section 3 CRR. However, Article 181(1)(f) only applies to funded credit protection and therefore is not impacted by the proposals in the CP. AIRB firms are reminded of their obligations under CRR Articles 161(3), 183(1), and 183(2) when assessing the effect of guarantees.

Appendices

1	**SS17/13 'Credit risk mitigation', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/credit-risk-mitigation-ss**
2	**SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss**