



REPORT ON CREDIT INSURANCE

MANDATE UNDER ARTICLE 506 OF THE CRR AS
AMENDED BY THE CRR3

EBA/REP/2024/21

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Abbreviations

A-IRB	Advanced Internal Ratings Based Approach
Basel III	Basel III capital framework
CI	Credit Insurance
CRM	Credit Risk Mitigation
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council
CRR3	Regulation (EU) 2024/1623 of the European Parliament and of the Council amending Regulation (EU) No 575/2013
FCP	Funded credit protection
FCCM	Financial Collateral Comprehensive Method
FCSM	Financial Collateral Simplified Method
F-IRB	Foundation Internal Ratings Based Approach
GCD	Global Credit Data Consortium
IRB	Internal Ratings Based Approach
LGD	Loss-Given-Default
PD	Probability of Default
RW	Risk Weight
RWEA	Risk-weighted Exposure Amounts
SA	Standardised Approach
Solvency II	Directive 2009/138/EC of the European Parliament and of the Council
UFCP	Unfunded Credit Protection

Executive Summary

1. The growing role of Credit Insurance (CI) in financial intermediation has brought discussions on its eligibility and use as credit risk mitigation (CRM) technique to the spotlight. As such, concerns have been raised that its use is severely impaired by the modelling restrictions for low-default portfolios brought by the final Basel III framework.
2. Against this background, this report revisits the prudential banking framework on CRM in relation to those changes affecting credit insurance that are brought by the final Basel III framework. Credit insurance, which is recognised as an unfunded credit protection (UFCP) as it shares the same economic nature as guarantees, is still expected to lead to a reduction of own funds requirements, albeit to a lesser degree than under the current framework. The analysis breaks down the impact on credit insurance of the final Basel III framework into three components, bearing in mind the level-playing field considerations compared to other products with similar features, or players subject to the same modelling restrictions as credit insurers.
3. First, the risk weight (RW) floor on the recognition of UFCP does not allow for the recognition of the double default, nor double recourse impact that a lending institution holds towards both the obligor and the credit insurer. This long-standing principle was put in place to ensure the consistency of the CRM framework, remains unchanged under the final Basel III framework and is further reinforced by the removal of the dedicated double default treatment, which no longer allows to recognise that both the underlying exposure and the protection provider must default for a material loss to be incurred by the lending institution. The RW floor does not put credit insurance compared to other forms of UFCP at a disadvantage, as all of them remain on equal footing with respect to the application of the floor and the non-recognition of dual recourse.
4. Second, the new framework no longer allows lending institutions to produce own-LGD estimates for direct exposures towards credit insurers. The absence of observed defaults of credit insurers within the European Union (EU) reinforces the argument underlying the final Basel III framework that credit insurers are low-default portfolios.
5. Third, the calibration of the Loss-Given-Default (LGD) parameter for credit insurers at 45 % under the so-called Foundation IRB approach has raised concerns by the industry of not giving justice to the safeguards in place for insurance companies under the Solvency II Directive. However, the 45% LGD value is equally binding for other financial sector entities for which comparable prudential frameworks apply, notably through Regulation (EU) No 575/2013 (Capital Requirements Regulation or CRR). The credit insurance-specific argument regarding the seniority of insurance policy claims in the EU is not sufficient to ensure a low level of LGD risk, notably considering the concentration towards insurance policy claims in the balance sheet of exposures and the discretion provided under Solvency II on how to implement this.
6. Finally, supervisory and industry data have been analysed to assess the potential conservativeness of the supervisory-prescribed LGD, subject to the caveat that no credit insurer in the EU has so far defaulted, and hence any attempt to “proxy” the LGD should be interpreted with caution. In doing so, different datasets have been assessed that still fall short of providing satisfactory data evidence to anchor any potential re-calibration of the framework.

Introduction

7. Credit insurance (CI) provides credit risk mitigation (CRM) towards lending institutions in event of non-payment from the obligor, with the potential to play a mitigation role in crisis times from a financial stability perspective. While industry surveys point at the growing role of CI in financial intermediation¹, the levels of credit insurance held by institutions in the European Union (EU) represent 0.8% of institutions' total credit risk exposure value.
8. The focus of CI taken out by credit institutions is on corporate loans, including specialised lending as well as trade finance. Corporate loans refer mainly to larger companies, with industry evidence that SME credit insurance has also started to pick up. Specialised lending refers mainly to project and object finance. Trade CI are policies that protect against loss on trade finance transactions. While trade credit finance may play a role in promoting trade finance and ultimately economic growth, a stand-alone analysis on this segment is not performed for the purposes of this report. Export credit guarantees and counter-guarantees provided by central governments are considered outside the scope of the mandate.
9. CI is understood for the purposes of this report as a *contract between an insurer and a bank specifying an insurance coverage of a certain credit exposure of the bank to an obligor*. Such a contract would specify the losses that are covered, e.g. the principal amounts which are not received by the bank when due and which result from a non-payment by the obligor. Following non-payment by the obligor, the insurer will compensate the bank for any losses incurred, as specified under the contract, by non-payment of the obligor after the bank has made a loss claim to the insurer.
10. This report addresses the mandate given to the EBA under Regulation (EU) No 2024/1623 (CRR3) amending Regulation (EU) No 575/2013 (CRR), which requires to report to the Commission on the eligibility and use of CI policy as CRM. An assessment is requested on:
 - The appropriateness of the associated risk parameters referred to in Part Three, Title II, Chapters 3 and 4;
 - An analysis of the effective and observed riskiness of credit exposures where a CI was recognised as a CRM technique;
 - The consistency of own funds requirements laid down in the CRR3 with the outcomes of the analysis under the two previous paragraphs
11. The EBA has previously publicly commented on the topic of CI as a CRM technique, as published in the EBA Opinion of March 2020 ('the EBA Opinion'),² which concluded that, at the time of publication, *'the absence of data was preventing the EBA to make a quantitative assessment of the appropriateness of the framework'*, with hence a conclusion that *'there was no sufficient rationale for allowing a preferential treatment to the claims on credit insurance'*. This report should therefore be read as a follow-up of the said EBA Opinion.

¹ [2023 Global Survey on Credit and Political Risk Insurance - IACPM and ITFA](#)

² [Opinion of the European Banking Authority on the treatment of credit insurance in the prudential framework](#)

12. The first section of this report recalls the relevant features of the regulatory framework in relation to the recognition of unfunded credit protection (UFCP) and the key changes brought by the CRR3 that impact the treatment of credit insurance. The second section discusses the risk weight (RW) floor imposed on the recognition of UFCP, which prevents the RW of a guaranteed exposures to be lower than a comparable direct exposure to the protection provider. The analysis provided in this section is new compared to what was presented in the previously published EBA Opinion and frames the next step of the argumentation by defining the target risk parameters. The third section addresses the quantification of the LGD risk parameter for direct exposures to credit insurance (as required by the RW floor discussed in the previous section). It discusses the appropriateness of the removal of the possibility to model the LGD risk parameters for direct exposure toward the protection provider, i.e. the credit insurer, and of the regulatory calibration of the regulatory LGD risk parameter under the so-called Foundation IRB (F-IRB) approach. In the same way as in the previously published EBA Opinion, this section recalls the possible ‘theoretical arguments’ in favour of a reduction of the LGD risk parameters for CI, by looking at the specific features applicable to credit insurers (e.g. ‘Solvency II’). This section is then complemented by additional empirical evidence collected since the EBA Opinion. Specifically, data has been collected via the Basel III monitoring exercise through additional EU-specific panels,³ the Global Credit Data Consortium (GCD);⁴ and the EBA benchmarking exercise.⁵

³ [Quantitative impact study/Basel III monitoring](#)

⁴ <https://globalcreditdata.org>

⁵ [Supervisory benchmarking exercises | European Banking Authority \(europa.eu\)](#)

Background: recognition of credit insurance as credit risk mitigation

1.1 The new framework reduces the modelling possibilities to recognise the effects of credit insurance

13. The framework to recognise CI as a CRM technique is explained in the EBA Opinion and is recalled in this section, along with the references to the new CRR3 requirements.
14. UFCP has been defined in Article 4(1), point (59) of the CRR as a technique of CRM where the reduction of the credit risk on the exposure of an institution derives from the obligation of a third party to pay an amount in the event of the default of the borrower or the credit facility, or the occurrence of other specified credit events.⁶ While specific requirements for UFCP in the CRR refer to guarantees and credit derivatives, it has previously been clarified that where the economic substance of CI is the same as the guarantee, and hence meets the definition of UFCP, it can be recognised as CRM for the purpose of own funds requirements in accordance with applicable requirements for guarantees.
15. In accordance with the regulatory framework prior to the introduction of the CRR3, under the IRB Approach the effects of the UFCP can be recognised in the calculation of own funds requirements for credit risk in various manners, either through the substitution approach, the modelling approach or the double default treatment.
16. However, the CRR3 introduces restrictions to the methods for recognising the effects of UFCP together with limitations regarding the application of the most advanced approaches regarding portfolios typically characterised by a low number of default observations:
17. The Internal Ratings Based (IRB) Approach with the use of own estimates of LGD and conversion factors (A-IRB Approach) will no longer be available for exposures to financial sector entities⁷ which includes insurance companies.⁸ Therefore, the only approaches allowed to be applied to direct exposures to entities providing CI will be the Standardised Approach (SA) or the so-called Foundation (F-IRB) Approach, where the use of own estimates of LGD and conversion factors is not permitted. This change will affect not only the RW for the direct exposures to such entities, but also to indirect exposures secured by such CI policies.
18. Furthermore, in the case where the exposure benefiting from a CI ('the guaranteed exposure') is risk weighted according to the SA, subject to requirements of Chapter 4 of Title II in Part Three of the CRR, a CI can only be recognised by applying to the secured portion of the exposure the RW of the credit insurer derived under the SA (risk weight substitution), independently of the approach used to treat the direct exposure to the credit insurer.⁹

⁶ The part underlined is an amendment brought by CRR3 which is a technical clarification without bringing substantial changes to the recognition of CI.

⁷ Article 151(8)(b) of the CRR3

⁸ Article 4(1)(27)(d) of the CRR3

⁹ Article 235 of the CRR3

19. In practice, this means that for guaranteed exposures risk weighted according to the supervisory slotting criteria approach (SSCA), the F-IRB approach or the A-IRB Approach, subject to requirements of Chapter 4 of Title II in Part Three of the CRR, a CI can be recognised in one of the following manners:
- When the direct exposures to the credit insurer are treated under the SA, by applying the RW of the credit insurer to the secured portion of the exposure (risk weight substitution);¹⁰
 - When the direct exposures to the credit insurer are treated under the F-IRB Approach, by applying the PD of the credit insurer and the regulatory LGD applicable to the secured portion of the exposure (substitution of risk parameters).¹¹
20. Insurance companies meet the definition of a financial sector entity¹² hence they are assigned a supervisory-prescribed LGD value of 45%, whereas a lower regulatory LGD value of 40% would apply to other corporate exposures. The consequence of insurance companies to the category of ‘financial sector entities’, also affects the asset value correlation coefficients as these entities are, unlike corporate exposures, subject to a scaling factor of 1.25 under the IRB approach.¹³
21. Conversely, the following additional approaches in case direct exposures to the CI were treated under the IRB Approach were possible before the date of application of CRR3, but are no longer available in the new framework:
- **For guaranteed exposures risk weighted according to either the F-IRB or the A-IRB Approach**, a CI could be recognised either by applying the formula specified in Article 153(3) of the CRR (double default treatment) subject to the conditions set out in Article 202 and Article 217 of the CRR, or by applying a PD in between the PD of the obligor and PD of the credit insurer and the regulatory LGD applicable to a direct comparable exposure to the credit insurer to the secured portion of the exposure (PD modelling approach). These two approaches will no longer be available under the CRR3 credit risk framework.
 - **For guaranteed exposures risk weighted according to the A-IRB Approach**, subject to requirements of Chapter 3 of Title II in Part Three of the CRR, a CI could be recognised by adjusting LGD estimates of the obligor to reflect the effect of the CI (modelling approach). This approach will no longer be available under the CRR3 credit risk framework in the case where the protection provider is not treated under the A-IRB approach.¹⁴
22. Where the modelling approach was used, the final RW was floored at the level of the RW of a comparable direct exposure to the protection provider.¹⁵ This RW floor is the one used for the substitution approach, and its increase is therefore a key driver of the impact of CRR3 on the exposures covered by a CI: even if the modelling approach was maintained, the RW floor would imply that the outcome of the modelling approach could not go below the outcome of the substitution approach.

¹⁰ Article 235a of the CRR as amended by the CRR3

¹¹ Articles 236 and 236a of the CRR as amended by the CRR3

¹² Article 4(1), point (26) of the CRR.

¹³ Article 142(1)(4) and Article 153(2) of the CRR as amended by the CRR3

¹⁴ Article 108(3) of the CRR as amended by the CRR3

¹⁵ Article 183(4) of the CRR as amended by the CRR3

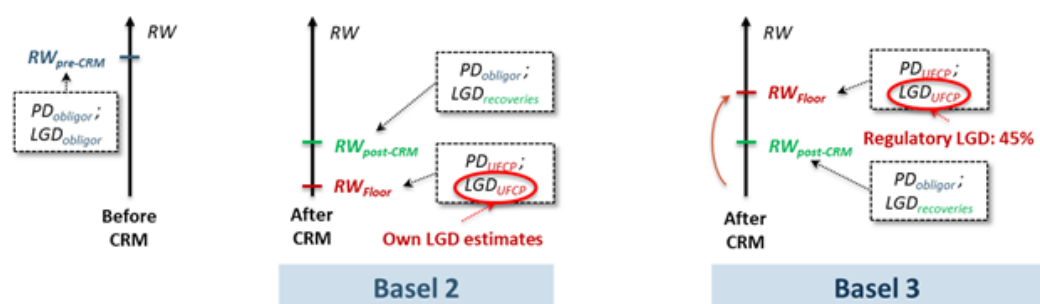
23. As a summary, apart from the eligibility aspects, the impact of the final Basel III framework can be decomposed into three components:

- The **risk weight (RW) floor** imposed on the recognition of UFPC, which prevents the RW of a guaranteed exposures to be lower than a comparable direct exposure to the protection provider.
- The **removal of the possibility to model** the LGD risk parameters for direct exposure toward CI.
- The **calibration of the LGD** risk parameter under the F-IRB approach.

24. However, the combined effect of the substitution of both the PD and the LGD parameters is generally still expected to lead to a reduction of the own funds requirements compared to the situation without a UFPC. Nevertheless, this reduction is lower under the final Basel III framework, due to the increase in the own funds requirements on direct exposures to CI driven by the mandatory use of regulatory LGD parameters, please see Figure 1.

Figure 1: Schematic representation of the recognition of UFPC under Basel 2 and Basel 3

Changes from Basel 3:



Note: Assuming own LGD estimates are used and lower than the supervisory-prescribed LGD of 45%.

25. The RW floor imposes that the RW of the guaranteed exposures cannot be lower than a comparable direct exposure towards the credit insurer. Hence the resulting RW after taking into consideration CRM cannot be lower than the RW resulting from considering the PD and LGD of the credit insurer. Under the Basel II framework the LGD of the insurer could be modelled, while under the final Basel III framework this option is removed and replaced by a supervisory-prescribed LGD value of 45%.

26. Assuming that the own LGD estimate yields a lower LGD than the supervisory-prescribed value of 45%, it follows that the RW floor under the final Basel III framework is higher than under the Basel II framework, hence leading to a more conservative treatment. However, the RW floor is still expected to be lower than the stand-alone RW of corporate. This is because it is reasonable to expect the PD of the corporate to be higher than the PD of the credit insurer, and that this offsets differences between the LGD of the corporate and the supervisory-prescribed value of 45%. Looking into numerical examples, the median PD for insurers from the benchmarking exercise is 0.2%. Also from the benchmarking exercise, median PD and LGD can be gathered for several categories of corporates, and the associated RW calculated from the supervisory

formula set out in Article 153 of the CRR, with $M=2.5$. It is noted that corporates under the final Basel III framework will be attached a supervisory-prescribed LGD value of 40%.

Table 1. Stylised comparison of the impact of the risk weight floor for corporates using credit protection

	PD	LGD	Resulting RW
Corporates, before taking into consideration credit risk mitigation			
Large corporate	0.70%	40%	71.6%
SME corporate	2.06%	27%	69.5%
Other corporate	1.50%	27%	63.4%
RW floor from the insurer providing protection			
Insurer	0.26%	45%	50.5%

27. If the own LGD estimate for the insurer is higher than the supervisory-prescribed value of 45% under the current framework, then the RW floor using own-estimates under the Basel II framework is higher than the RW floor under the final Basel III framework, which uses a supervisory LGD value of 45% for insurers. Hence the final Basel III framework does not lead to a more conservative treatment compared to the current framework. In particular, according to EBA benchmarking data over 30% of the own estimates of LGD are higher than the supervisory-prescribed value of 45%.

1.2 Eligibility of credit insurers

28. The mandate requires the EBA to report to the Commission on the ‘*eligibility and use of credit insurance policy as a credit risk mitigation technique*’. As the economic substance of CI is the same as a guarantee, the recognition of CI as a CRM technique is subject to the eligibility requirements for UFCP as set out in Chapter 4 of Title II in Part Three of the CRR.

29. Although the CRM requirements remain largely unchanged in the CRR3, a clarification relevant for CI has been included in the provision governing the requirements for guarantees under Article 213 of the CRR3. More specifically, the unconditionality criteria has been nuanced to specify that the presence of a clause in the credit protection contract providing that faulty due diligence or fraud by the lending institution cancels or diminishes the extent of the credit protection offered by the guarantor does not preclude CRM eligibility.¹⁶

¹⁶ “A clause in the credit protection contract providing that faulty due diligence or fraud by the lending institution cancels or diminishes the extent of the credit protection offered by the guarantor, shall not disqualify that credit protection from

30. The EBA is of the view that there is no need to adjust or clarify further the eligibility requirements applicable to CI. The industry has not raised any particular concerns on these provisions when consulted during a roundtable conducted in February 2024.
31. This treatment of ineligible CRM will be further clarified in the upcoming EBA guidelines mandated under the CRR3 to clarify the treatment of any type of funded credit protection (FCP) and UFCP for the purposes of the application of LGD parameters¹⁷. To note, this issue has been extensively discussed in the context of the answer to the call for advice on implementation of the final Basel III framework¹⁸.

1.3 Treatment of first loss under credit insurance contracts

32. Most CI contracts include a first loss clause according to which part of the loss is to be borne by the insured CI. The first loss clause can apply at the single loan or portfolio level. The treatment of aggregate first clause at portfolio level has been subject to requests for clarification from stakeholders (e.g. EBA [Q&A 4184](#)), together with concerns raised that the application of Article 234 of the CRR for a first loss clause in single loans may give room to different interpretations.¹⁹
33. These issues, which also affect products other than CI, will be addressed in the upcoming EBA report mandated under Article 506e of the CRR as amended by CRR3 to clarify the treatment of capped or floored UFCP.²⁰

being eligible". By contrast, a clause providing that fraud by the obligor cancels or diminishes the extent of the guarantee offered by the guarantor is making the credit protection ineligible for the recognition of own requirements reduction under chapter 4 of Title II in Part Three of Regulation (EU) 575/2013.

¹⁷ Article 181(4) of the CRR as amended by the CRR3

¹⁸ See Recommendation CR-IR 26 and CR-IR 27 on the [Policy Advice on Basel III reforms - Credit Risk.pdf \(europa.eu\)](#)

¹⁹ For further information, please refer to ESAs [Joint Committee's response](#) to the Commission's Call for Advice on the review of the securitisation prudential framework in 2022, where these issues have been raised, also in a more general context than for CI.

²⁰ Article 506e of the CRR as amended by CRR3.

Risk weight floor for unfunded credit protection

1.4 The Basel long-standing principle of a risk weight floor prevents the recognition of double default and dual recourse

34. The principle of a RW floor was introduced in the Basel II capital framework.²¹ It is noted that this principle is applicable for all forms of UFCP across all exposure classes, and any potential deviation from this principle for specific protection providers would require analysing whether the principle should be adjusted for other protection providers as well, to avoid differences in risk-weighted exposure amounts (RWEA) for exposures with similar levels of credit risk and ensure a level playing field.

1.4.1 The RW-floor is applied irrespective of the approach used to calculate the RW for a direct exposure to a protection provider

35. The EBA published in its reply to the Commission Call for Advice on the implementation of the final Basel III framework an extensive analysis on whether the RW-floor principle should be adjusted in the context of implementing the final Basel III framework²². In particular, the assessment included the pros and cons of retaining these measures and acknowledged that the RW floor limits the risk sensitivity for institutions using the A-IRB approach for indirect exposures where less sophisticated approaches are used for direct exposures to the protection provider.

36. Hence this triggered the question on the suitability to restrict the RW floor only to protection providers where the A-IRB approach is available for direct exposures to the protection provider. However, after due consideration it was concluded that such a restriction would provide an undue incentive to institutions to move the treatment of direct exposures to the protection provider from the A-IRB approach to less sophisticated approaches²³. The Co-legislators indeed implemented the option of a mandatory treatment under the SA and the F-IRB approach for exposures guaranteed by SA and F-IRB protection providers treated under the SA and F-IRB Approach by the institution in line with the Basel capital framework and the EBA reply to the Call for Advice.

²¹ <https://www.bis.org/publ/bcbs128.pdf> , paragraphs 301, 306 and 333

²² [Policy Advice on Basel III reforms - Credit Risk.pdf \(europa.eu\)](#)

²³ Please see paragraphs 407 and 408 of the Policy Advice. The option not to apply the risk-weight floor to SA and F-IRB protection providers would have represented a deviation from the final Basel III framework and was duly analysed and finally rejected, in particular on the ground that *'applying the RW floor only to an A-IRB protection provider under this alternative may provide institutions with the incentive to move the treatment of direct exposures to the protection provider from the A-IRB approach to less sophisticated approaches'*.

1.4.2 Double default and dual recourse are common to all forms of UFCP and not specific to credit insurance.

37. The RW floor prevents institutions from recognising the effects of double default and dual recourse, which could potentially be risk-reducing factors. It is noted that double default and dual recourse are, in theory, features of CI contracts, whereby an institution holding an exposure secured by a CI contract has recourse both to the borrower and to the credit insurer. However, double default/dual recourse are not specific to CI but are generally features of all types of UFCP that are eligible under the CRR3 UFCP treatment (e.g. bank guarantees). Hence, the RW floor does not put CI at disadvantage compared to other forms of UFCP, as they are on equal footing with respect to the application of the floor and the non-recognition of dual recourse. Specific characteristics of CI compared to other forms of UFCP, such as skin-in-the-game as opposed to e.g. bank guarantees typically covering the full exposure amount, do not alter the nature of double default and dual recourse on the protected exposure, but only the share of exposures typically protected.
38. **Double default** is understood to be the risk-reducing effect that results from considering that the default of the obligor and the default of the insurer are events that are not fully correlated with each other. In other words, that the default of an obligor does not necessarily imply the default of the insurer, and vice versa.
39. The final Basel III framework has removed double default as a risk mitigant, considering the risk mitigating effect of the less than perfect correlation between the default of the borrower and the insurer cannot be estimated, hence the conservative approach was chosen”.^{24, 25}
40. In addition, and more specifically with respect to CI, the RW floor and the removal of the double default treatment for exposures secured by UFCP were introduced coinciding with the financial stability view of limiting contagion between bank and insurance sectors, as explained in the EBA Opinion.
41. **Dual recourse** implies that an institution could exercise its recourse rights, recover its exposure outstanding and thus reduce its losses by legally and simultaneously pursuing both the obligor and the protection provider simultaneously for any payments due.
42. As the effect of double recourse as a risk mitigant is acknowledged, one could argue that the existence of UFCP should not impair the institution’s ability to recover payments due from the obligor. Under this reasoning, it may be argued that it is appropriate to assign to the UFCP protected exposure the LGD associated with an unprotected obligor, whenever this LGD is lower than the LGD of a direct exposure to an insurer. However, under the assumption where both the obligor and the protection provider default, there is also the possibility that the default of the protection provider and the inability of the institution to recover anything from the obligor are correlated. This would be reflective of a situation where the default of the

²⁴ Basel framework CRE32.22 and CRE36.102: “rating processes are not permitted to consider possible favourable effects of imperfect expected correlation between default events for the borrower and guarantor for purposes of regulatory minimum capital requirements. As such, the adjusted RW must not reflect the risk mitigation of ‘double default’.”

²⁵ QIS 3 FAQ: E. Credit Risk Mitigation: “the true double default effect is highly dependent upon the correlation between obligor and guarantor at the moment of default of the obligor; estimation of this correlation is beyond the scope of the new capital accord, and consequently any double default effects should be ignored for purposes of calculating capital requirements”.

protection provider is partially triggered by the inability to recover anything from the obligor. The EBA notes that it is currently not feasible to calculate the correlation between recoveries from the obligor on the one hand, and the protection provider on the other, given the lack of any double default event.

43. Regarding the sequencing followed by the lending institutions in pursuing the obligor or the credit protector in case of default, it is recalled that the prudential framework does not allow for guarantors to impose the lending institutions to pursue the obligor first, as per Article 215(1)(a) of the CRR. For the avoidance of doubt, this feature is fully warranted to ensure the CRM of protection and does not imply nor restrict double recourse.

1.4.3 Covered bonds dedicated LGD treatment is underpinned by risk-mitigating features broader than dual recourse

44. The industry has put forward the argument that dual recourse warrants a dedicated treatment for credit insurers, in the same vein of the CRR provisions for covered bonds, where a dedicated preferential LGD treatment is introduced.
45. This argument however only partially holds. While dual recourse is acknowledged as a risk-reducing factor, other specific features of covered bonds substantiate the specific deviation in the framework. This refers namely to the strict eligibility requirements concerning minimum over-collateralisation, high quality collateral, specific rules on the dynamic component of the cover pool to substitute non-performing exposures, and the dedicated liquidity buffer to the cover pool. First, covered bonds eligible for the preferential treatment are required to be protected by a segregated pool of high-quality collateral defined under strict criteria, which is composed mainly of real estate mortgages and public sector debt. Further, the issuer is obliged to replace assets that become non-performing, hence reinforcing the quality of the cover pool on an ongoing basis. Finally, the quality of the pool is enhanced by over-collateralisation requirements, whereby the level of collateral exceeds the required coverage for the bond. Specifically, over-collateralisation is set to a minimum level of 5% under the amendments brought to the CRR by the Covered Bonds Directive,²⁶ with a national discretion to go down up to 2% if certain additional safeguards are in place.
46. On top of the specific requirements ensuring the quality of the cover pool, the prudential framework imposes a specific liquidity buffer to address risks of liquidity shortages and ensuring timely liquidation of the cover pool in the event of default of the issuer. Finally, in addition to this, a favourable treatment is provided for covered bonds regarding liquidity requirements, whereby the Liquidity Coverage Ratio (LCR) Delegated Act allows institutions to hold covered bonds as part of their liquidity requirements to meet stressed net cash outflows over a 30-day window. Specifically, covered bonds are eligible as Level 1 assets ("extremely high-quality liquid assets") or Level 2 assets ("high-quality liquid assets") classification for the purposes of calculating their LCR. This preferential treatment signals the depth of the pool of covered bonds and should ease liquidation.

²⁶ Directive (EU) 2019/2162

1.5 Guarantees versus other claims on credit insurers

47. Another avenue to evaluate the appropriateness of the prudential treatment of CI under the UFCP framework is to make a comparison with the relief that would be obtained if FCP issued by the same insurer would have been used instead, i.e.:

- a CI policy from a credit insurer that is hence treated as UFCP; compared to
- a bond issued by a credit insurer that is pledged as collateral and hence treated as FCP.

48. Under both scenarios, when the original obligor defaults, the institution has an exposure on the protection provider, either in the form of a bond or in the form of a CI policy.

1.5.1 Direct comparison of UFCP and FCP is hindered by the use of methods with different levels of sophistication

49. As a stylised example, a comparison is made between two types of protection provided by an insurer to an exposure towards an obligor that is an unrated corporate, namely 1) a CI policy from a credit insurer and 2) a bond issued by the same credit insurer that is pledged as collateral. For simplicity both the CI policy and the bond issued by the credit insurer are assumed to cover the full exposure amount of the obligor. The credit insurer is assumed to hold a Credit Quality Step (CSQ) 1, which is typically associated with an external rating of AAA/AA.

50. When the obligor is protected by a CI policy, the RWEA of an exposure with an exposure value of 100 would go down to 20, given the substitution approach and 20% RW granted to rated corporates with CQS1. Hence the unrated corporate (RW = 100%) would register a five time decrease of the RWEA thanks to the credit insurance policy.

51. When a bond issued by the insurer is pledged as collateral, under the SA the associated relief can be recognised either through the (i) Financial Collateral Simple Method (FCSM), where the collateralised part of the exposure is assigned the same RW as if the collateral were held directly; or the (ii) Financial Collateral Comprehensive Method (FCCM), where the exposure value is reduced by the collateral after applying relevant haircuts, which are volatility adjustments that depend on the revaluation, liquidation period of the collateral and the associated CQS of the issuer.

(i) Under the FCSM, the FCP treatment of bonds issued by an insurer and pledged as collateral generally leads to the similar own funds requirements as recognising the CI under UFCP provided by the same party, considering it relies on similar RW floor mechanic as for UFCP.²⁷

(ii) Using the FCCM, the FCP of a bond issued by a credit insurer would result in a larger relief than when the CI policy is used under UFCP.

52. The collateral value considered under both the FCCM and FCSM is the market value, which may substantially decrease compared to the notional amount of the bond, potentially requiring the replenishing of collateral. However, the FCSM only requires a revaluation of the financial collateral according to the minimum requirements set out in Article 207(4)(d) of the CRR3,

²⁷ Given the RW floor set out in CRR Article 222(3), second subparagraph.

which is reflected in a more conservative treatment and is therefore more aligned with the CI treatment under UFCP. On the other hand, for FCCM more risk sensitivity is introduced for revaluation of collateral according to Article 224 and Article 226 of the CRR by incorporating a specific liquidation period to liquidate the financial collateral depending on the type of financial collateral. This increased risk sensitivity provides for more capital relief where the institution revalues financial collateral more frequently than at the minimum six months frequency.

53. Finally, additional sensitivity is introduced under the FCCM due to the enhanced granularity of the haircuts, which depend on the residual maturity and CQS of the collateral, reflecting the greater uncertainty on credit risk until repayment of the instrument becomes due. Such level of detail is naturally not available under the less sophisticated FCSM.

1.5.2 There is an economic rationale for distinguishing between unfunded credit protection and funded credit protection

54. A key difference between FCP and UFCP is that the lender has the additional possibility to sell the FCP, stemming directly from the definition of FCP and UFCP provided in Article 4(1)^{28,29}. It is recalled that this is not specific to CI and applies for other protection providers that issue guarantees and that are not credit insurers, for instance a bank issuing a guarantee.
55. A CRM-eligible guarantee under UFCP should pay out in a timely manner, noting this time span is not further specified (except for the case of UFCP covering residential mortgage loans, where a period of 24 months is mentioned).³⁰ In practice, in order to recover losses from the insurer, institutions need to initiate a claim on the insurance policy, which then is to be determined by the insurer (and not disputed), so that the insurer pays out. Furthermore, some UFCP insurance policies pay out only upon the non-payment of the obligor according to the contractually agreed repayment schedule of the obligor, and hence does not pay out the full outstanding amount, implying a prolonged exposure to the guarantor.
56. However, when a bond issued by a credit insurer is provided as FCP, the credit protection depends not on the promise of a third party to pay the institution upon default of the obligor, but on the right to retain or liquidate the collateral to reduce the loss resulting from the default, with the associated risk that the collateral deteriorates in market value, effectively resulting in lower coverage of the protection. This additional right allows in practice for a significant difference in the residual risk following the use of either a FCP or an UFCP.
57. It can therefore be argued that the more favourable treatment of the bond under FCCM explained above is also driven by the different economic nature of FCP versus UFCP and the

²⁸ According to point (58) ‘funded credit protection’ means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the right of that institution, in the event of the default of the counterparty or on the occurrence of other specified credit events relating to the counterparty, to liquidate, or to obtain transfer or appropriation of, or to retain certain assets or amounts, or to reduce the amount of the exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the institution.

²⁹ According to point (59) ‘unfunded credit protection’ means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the obligation of a third party to pay an amount in the event of the default of the borrower or the occurrence of other specified credit events.

³⁰ CRR Article 213(1)(c)(iii) and CRR Article 215(1)(a), second subparagraph.

additional risk sensitivity reflective of the ability to capture market risk under the more sophisticated FCCM approach.

Calibration of the LGD under F-IRB

58. When determining the RW considering the credit protection, institutions need, under the substitution approach, to use the LGD risk parameter of a direct exposure to the credit insurer. To recall, as discussed in the previous section, the substitution approach can be seen as the maximum recognition allowed respecting the principle of the RW floor. In this context, the determination of the LGD risk parameter of a direct exposure to the credit insurer is also necessary, to measure the RW of a comparable direct exposure to the protection provider.
59. For the sake of clarity, it is recalled that in the context of the calculation of the RW floor, the LGD estimate for the CI policy should be treated as a direct exposure on an insurer and thus reflect the losses incurred by the lending institution in the event of default of the insurance company. Therefore, the potential losses must be considered under a scenario of the bankruptcy of the insurance company. In other words, for the purpose of the calculation of the RW floor, the realised LGD observed on the protected exposure when the obligor has defaulted but the CI company is operating normally is not relevant.
60. Therefore, this section focuses on the LGD parameter that reflects the level of losses in the event of default of the insurance company, and not the payments expected to be received while the CI company is operating normally. More specifically, it discusses the last two components of the banking regulation that impact the RW applied to exposures benefitting from CI, namely:
- The **removal of the possibility to model** the LGD risk parameters for direct exposures toward credit insurers, discussed in section 4.1.
 - The **calibration of the LGD** risk parameter under the F-IRB approach.
61. When it comes to the evaluation of the appropriateness of the LGD risk parameter calibration (i.e. the supervisory-prescribed LGD value of 45%), the discussion can be conducted from two angles:
- Via theoretical considerations with an assessment of the effect of Solvency II and some other characteristics specific to credit insurers. These elements are discussed in section 4.2
 - Via an empirical assessment, which in practice takes the form of LGD estimates (from the EBA benchmarking exercise)³¹ and realised LGD on claims guaranteed by CI policies and on direct exposures toward insurer (as collected via industry data collected through the GCD³²). These elements are discussed in section 4.3.

1.6 The lack of default data supports the removal of own estimates of LGDs for direct exposures on credit insurers

62. When it comes to the removal of the possibility to model the LGD risk parameters for direct exposures toward credit insurers, the data provided by the industry confirms the lack of

³¹ <https://www.eba.europa.eu/activities/single-rulebook/regulatory-activities/supervisory-benchmarking-exercises/its-package-benchmarking-exercises>

³² <https://globalcreditdata.org>

empirical evidence that can be used for modelling. It is worth noting that no default on credit insurer has been observed in the EU. Therefore, it is expected that any LGD estimate on these exposures would incorporate a substantial part of judgement, with potentially a high risk of variability in the model outcomes, and hence at odds with the intention of the revisions to the Basel capital framework.

1.7 The theoretical arguments in favour of a reduction of the regulatory LGD value are not sufficient

63. The EBA Opinion concluded, at the time of publication, that ‘the absence of data was preventing the EBA to make a quantitative assessment of the appropriateness of the framework’, with hence a conclusion that ‘there was no sufficient rationale for allowing a preferential treatment to the claims on credit insurance’. Nevertheless, Article 506 of the CRR as amended by CRR3 mandates the EBA to report on the appropriateness of the associated risk parameters pertaining to the use of CI policy as a CRM technique.
64. One argument to deviate from the RW floor relates to the seniority of the claims related to a CI in relation to other ‘regular’ claims (e.g. a bond) for which the regulatory LGD value of 45% can be used. As recalled in the EBA Opinion, *‘The main argument raised is that the seniority of the credit insurance policies is higher than the seniority of other credit exposures to credit insurance companies. Directive 2009/138/EC (Solvency II directive) requires specific protection of policyholders and beneficiaries, among others by introducing an appropriate ranking of claims. Implementation of these requirements should ensure that insurance claims take precedence over other claims against the insurance undertaking in the event of the winding-up proceedings of such undertaking. This difference in seniority could in principle lead to significantly lower levels of losses, from which the policyholders would suffer, as compared to other creditors of the insurance company. While under the current framework the level of protection provided by credit insurance can be recognised through LGD estimation, this will no longer be possible after implementation of the final Basel III capital framework, where much less granular regulatory LGD values will have to be used. The industry is therefore suggesting that these regulatory LGD values be reconsidered and additional granularity be introduced to reflect different risk of credit insurance policies.’*
65. Indeed, the Solvency II directive requires that the claims of the insurance policyholders take precedence over other claims against the insurance companies, in particular over the creditors granting loans to CI companies. However, in assessing how efficient this measure is in protecting the policyholders from potential losses, the following elements should be taken into consideration:
- **Counter-argument 1:** The Solvency II directive offers optionality for Member States in how they implement the requirements on the seniority of the insurance claims. In detail, Member States have discretion on how to ensure that insurance claims take precedence over other claims against the insurance undertaking by choosing one or both of the following ways: (i) with regard to assets representing the technical provisions, insurance claims take absolute precedence over any other claim on the insurance undertaking; or (ii) with regard to the whole of the assets of the insurance undertaking, that they come after

claims by employees arising from employment contracts and employment relationships, claims by public bodies on taxes, claims by social security systems and claims on assets subject to rights in rem. This optionality causes an additional challenge in the calibration of a unique regulatory LGD, as the level of losses for policyholders may depend on the extent of other claims towards the insurance companies. Since the regulatory framework for the insurance companies has been defined in a form of a directive rather than a regulation, the implementation is not fully harmonised and may hence have been transposed very differently across Member States.

- **Counter-argument 2:** The Solvency II directive is relevant for insurance companies established in the EU. However, CI may also be provided by entities from third countries, where different regulation may apply. Therefore, specification of differentiated rules for the treatment of CI would also require implementation of specific solutions for the assessment of equivalence of legal and regulatory frameworks in third countries.
 - **Counter-argument 3:** The typical structure of the balance sheet of the insurance company is dominated by the claims from insurance policies. Therefore, while the policyholder benefits from the seniority of the claim, the same seniority applies to all other policyholders. Given that the majority of the creditors of the insurance companies will be treated with the same seniority in the winding-up proceedings, it is very unlikely that there will be enough assets to cover all claims from insurance policies, even if they are treated with the highest seniority.
 - **Counter-argument 4:** The structure of the balance sheet of the insurance company may change in the situation of insolvency of such company. The LGD should be calibrated considering the structure of claims in the bankruptcy process, these however may be significantly different from the structure of claims in times of normal operation of an insurance company. In particular, the levels of claims of the employees, taxes and social security systems may increase in the times of financial difficulties.
66. On the top of the theoretical framework applicable to CI, the industry claimed that the risk taken by the credit insurers is structurally lower than other in the case of a guarantee provided by a bank. More specifically, the arguments relate in particular to the diversification of the risk of multi-line insurers (in particular, typical life and non-life non-credit products are not impacted by the credit cycle).
67. However, before opening the door for insurers to receive a preferential treatment, the following elements should be taken into consideration:
- **Counter-argument 5:** Other entities, i.e. credit institutions or investment firms, that fall under financial sector entities as per the CRR definition are regulated precisely to mitigate the specific risks related to the credit cycle. Credit institutions and investments firms are furthermore subject to requirements related to liquidity, which should cover their vulnerability vis-à-vis insurers towards liquidity risks (e.g. stemming from their maturity transformation profile).
 - **Counter-argument 6:** In addition, the EBA Opinion recalled that ‘The regulatory LGD should reflect the level of losses appropriate for an economic downturn. While the failure of the

insurance company does not necessarily have to be related to economic conditions, the amounts of claims on credit insurance policies are typically higher during the period of an economic downturn. This effect should be considered in the estimation of LGD and in case one wants to set different levels of regulatory LGD values for credit insurance policies.’

68. Hence, the EBA maintains its 2020 assessment that theoretical considerations alone would not justify a deviation from the internationally agreed prudential standards:

- Counter-argument 1 and Counter-argument 2 could be used to set up conditions for the application of a preferential treatment.
- However, Counter-argument 3 and Counter-argument 4 highlight the winding-up provisions of Solvency II alone are not sufficient to ensure a lower LGD risk parameter.
- Furthermore, Counter-argument 5 and Counter-argument 6 qualify the impact of the structural specificities of insures vis a vis other regulated entities.

1.8 Empirical assessment of the appropriateness of the LGD parameter under F-IRB

1.8.1 Availability and caveats

69. This section presents available LGD data evidence to assist in pinpointing any potential misalignment between the underlying level of risk observed from credit insurers and the regulatory levels of the risk parameters under the CRR3.

70. Given the lack of available data to calculate the LGD of a defaulted insurer, any ‘proxy LGD’, either in the form of realised LGD or LGD estimates, should be interpreted with that caveat in mind. In understanding the limitations around LGD modelling and appropriate data available through supervisory reporting and industry sources, it is recalled that LGD is defined in terms of the level of losses in the event of default of the insurer company. As such, two types of data points are available: (i) observation on realised LGD values; and (ii) own LGD estimates produced by credit institutions. After engagement with the industry and within the supervisory community, the EBA concluded that not a single CI company has defaulted in the EU, which implies that the underlying data required to estimate the LGD parameter is not available³³.

71. From the supervisory perspective, data from the EBA benchmarking exercise have been assessed by leveraging from the level of granularity of the benchmark portfolios, which allow to identify LGD estimates assigned by participating banks to insurance companies. Data collected from the EBA benchmarking exercise are exhaustive in terms of coverage of IRB institutions modelling LGD and capture the LGD that is used for the purposes of calculating RWEA, hence it reflects the adequate metric under the prudential framework. On the other hand, the benchmarking exercise does not capture the estimate for insurance policies but the estimate towards the insurer. Further, the bank estimates refer to insurers and not specifically

³³ It is noted that the realised LGD values provided by the industry are not reflective of a default situation of a CI, but they refer either to data on defaulted insurers other than credit insurers, or to defaulted facilities protected by insurers where the insurer is not defaulted.

towards credit insurers. Finally, the estimates are subject to the general shortcoming of lack of empirical evidence on defaulted credit insurers.

72. From the industry perspective, the EBA has engaged with market participants in an industry roundtable, where specific data from the GCD Consortium on banks that use CI has been provided. Two different sets of tailored data are provided, which reflect defaulted facilities where the realised LGDs are observed for 1) insurers (direct exposures to insurers); and 2) exposures secured by insurers (indirect exposures to insurers). These datasets represent the results of all type of insurers (i.e. covering both credit- and non-credit insurance) from a sample of nine participating banks; hence caution should be applied when interpreting the results. The data related to indirect exposures do not represent a default situation of the insurer, hence are not representative of the metric under focus. Data on direct exposures are representative of default situation of insurers, however these predominantly refer to non-credit insurers. Under both cases the LGD under analysis is the realised LGD, hence not LGD estimates used for risk-weighting purposes, which incorporates additional prudential considerations such as downturn estimates or add-ons for margin of conservatism.
73. Finally, the EBA has performed a Quantitative Impact Assessment (QIS) to quantify the changes for banks in RWEA in the specific context of CI and CRR3 modelling limitations.

1.8.2 EBA Benchmarking exercise

74. The EBA benchmarking exercise³⁴ collects harmonised LGD estimates on insurance companies from EU IRB banks since 2016. In particular, information is available on the exposure-weighted average of the own estimates of LGD values assigned by institutions to larger non-financial corporates for the purposes of calculating RWEA. By crossing that information with the list of insurance and re-insurance undertakings in the EU, the dataset can be exploited to display the distribution of LGD estimates for insurers. More specifically, the data exercise has identified bank estimates for 34 insurance and re-insurance undertakings over the period 2016 to 2022.
75. In terms of data caveats:
- The EBA benchmarking exercise is mandatory for all EU institutions that have been granted approval to model LGD, hence there are no issues on the representativeness of the sample
 - The values reported are estimates produced by the institutions, and not observations based on defaulted credit insurers. Hence, this comparison can only provide an indirect evaluation of the relevance of the 45% regulatory LGD parameter value.
 - A number of LGD values are reported values at 45%, which is exactly the level of the regulatory parameter. While this could be the result of a quantification solely based on the observed loss rate, this may also be reflective of CA requests for institutions to temporarily apply the regulatory LGD on the back of potential deficiencies observed during the validation of internal models.³⁵

³⁴ <https://www.eba.europa.eu/activities/single-rulebook/regulatory-activities/supervisory-benchmarking-exercises/its-package-benchmarking-exercises>

³⁵ A share of 15% of all LGDs reported in the period 2016 to 2019 was set at 45%, while the share is around 5% from 2020.

- The LGD estimates may incorporate credit protection (i.e. FCP or UFCP) received in front of the direct exposures.³⁶ This caveat introduces a downward bias and is likely to explain the low values of the estimates observed for some institutions.
- The LGD estimates are not specifically towards CI, hence do not reflect the seniority of these claims. This caveat introduces an upward bias.

76. In terms of results:

- About a third of the reported LGD estimates under the A-IRB exceed the supervisory prescribed level of 45%. The overall average of individual LGD estimates for insurance and re-insurance undertakings is 42.5%, with an interquartile range of 15% spreading from 35% for the first quartile and 50% for the third quartile. It is noted that excluding from the sample all the LGDs reported by participating banks as 45% yields an average estimate of 40%, although it cannot be disentangled if all those excluded LGD refer to supervisory actions.
- The dispersion of LGD estimates is also analysed by considering a single observation for each combination of an insurance company rated by a given institution, where each observation represents the median of the LGD estimates provided by a given institution to an insurer over time.³⁷ This approach allows not to bias the spread of LGD estimates towards those institutions that rate a given insurer for longer time periods.³⁸ This assessment yields an average LGD of 43.5%.

77. The data provided hence shows that the average LGD estimates is close to the regulatory LGD value of 45%. It is noted that, due to its lower risk sensitivity, the F-IRB Approach can naturally encompass some additional conservatism in some segments. The high volatility of the estimates (across institutions for the same credit insurers) also confirms the modelling difficulties of these exposures.

1.8.3 GCD report

78. The GCD has provided specific data to inform the analysis of credit insurers, by producing information from a sample of participating banks that use CI. This dataset would allow to address the observed riskiness of credit risk exposures with CI, as per point b) of the mandate.

³⁶ This refers to data point 150 of template 101 of the benchmarking exercise. This data point is preferred compared to the 'Hypothetical LGD senior unsecured without negative pledge' (data point 140 of template 101) for data quality reasons.

³⁷ This is based on the observation that the dispersion of LGD estimates assigned by a given institution to a certain insurer is limited over time, as displayed in The data provided hence shows that the average LGD estimates is close to the regulatory LGD value of 45%. It is noted that, due to its lower risk sensitivity, the F-IRB Approach can naturally encompass some additional conservatism in some segments. The high volatility of the estimates (across institutions for the same credit insurers) also confirms the modelling difficulties of these exposures. 5 in Annex 1. The data provided hence shows that the average LGD estimates is close to the regulatory LGD value of 45%. It is noted that, due to its lower risk sensitivity, the F-IRB Approach can naturally encompass some additional conservatism in some segments. The high volatility of the estimates (across institutions for the same credit insurers) also confirms the modelling difficulties of these exposures, with an average interquartile range of 3.1% for those institutions that provide estimates for a given insurer for more than one year.

³⁸ As an illustration, let us take Bank A whose estimates for Insurer X are available over the period 2016 to 2022 at 35% LGD, while Bank B estimates the LGD of the same Insurer X at 25% over the period 2020 to 2022. The volatility of estimates for Insurance X may be better reflected by comparing the median LGD provided by Bank A overtime to the median LGD provided by Bank B over time, rather than considering 35% seven times and 25% three times.

More specifically, GCD provided information from a sample of eight EU banks, for the period spanning from 2009 to 2023. Based on total assets, the sample covers about one third of the EU banking sector.

79. It is to be noted that the LGD data presented on this section are based on observed realised metrics, and hence any estimates or regulatory parameter would need to factor in a downturn component and a margin of conservatism (especially relevant in the context of lack of data and representativeness of the defaulted facilities).

a. Defaulted facilities guaranteed by a credit insurer

80. A total of 133 defaulted facilities were identified guaranteed by a CI, out of which 40% were still unresolved. For all facilities where a claim was made to the insurers,³⁹ there was an observed 100% payment rate, with an average payment time of 81 days after the insurance claim. Hence, the realised nominal LGD is 0%, with an associated 6.1% average discounted LGD. However, it is recalled that the issue at stake must be framed in the context of the default of the insurance company, and not on the payments while the CI company is operating normally. The sample indeed reflects no instances where both the borrower and insurer defaulted. Out of the resolved defaulted facilities, on average CI cover half of the facility.

81. Considering that only resolved facilities are assessed, the number of defaults in recent years will therefore be lower, potentially affecting the representativeness of LGD for most recent years. For the purposes of this report, the LGD on the part of the exposure not covered by CI is not in the focus, as the issue at stake is to understand the LGD when CI is used as CRM, and not the unsecured part of the exposure.

b. Defaulted facilities from direct exposures to insurers

82. Finally, GCD collected further collected information on a separate dataset on defaulted facilities related to banks' direct exposures to insurers. The data refer to exposures to non-credit insurers (in the absence of any default observed on credit insurers), where the insurance activities related to other businesses, such as life insurance. The average observed LGD, limited to the sample of resolved facilities, is 15%. Although the data is representative of different business models, this can inform the strength of the seniority claim, as defaulted insurance companies in businesses other than CI are also covered under Solvency II. However, the sample contains only four EU insurers out of a total of 34 insurance companies, hence the representativeness on the effect of the Solvency II framework may be compromised. When isolating the data for the four EU non-credit insurers participating, the associated LGD is 4%. Although the lower LGD featured by EU institutions compared to non-EU insurers could be related to the Solvency II framework in place in the EU, and its associated seniority ranking of insurance claims, the small sample size weakens the validity of any inference.

³⁹ Claims were made to insurers in 86% of cases.

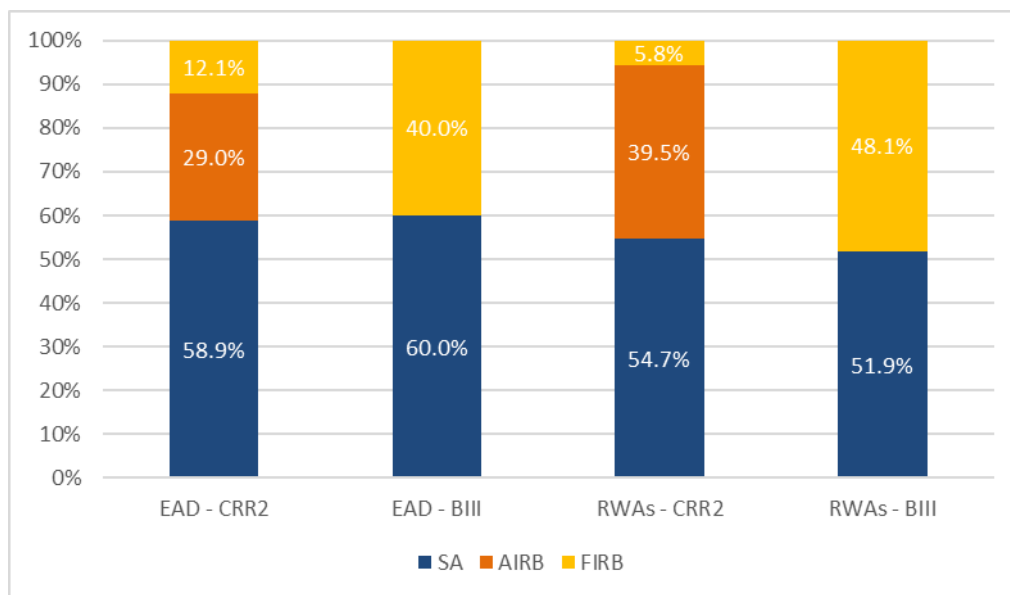
1.8.4 Quantitative Impact Studies

83. This section aims to provide evidence of the materiality of the policy insurance portfolio and the impact in capital requirements of the implementation of the final Basel III framework for indirect exposures to policy insurance. Results are based on data from the QIS as of December 2023 reference date. The QIS data includes results for 156 banks at the highest level of consolidation in the EU.
84. In terms of materiality, only 38 SA banks and 15 IRB banks reported having indirect exposures to policy insurance. For SA banks, this represents on average approximately 1.1% of the total EU SA exposure and 0.7% of the total EU SA RWEA. For IRB banks, the policy insurance portfolio represents on average about 0.5% of the total EU IRB exposure and 0.4% of the total EU IRB RWEA.⁴⁰
85. When focusing only on those banks that reported making use of policy insurance, 2.2% of their total SA exposure and 1.5% of their SA RWEA correspond to indirect exposures to policy insurance. For IRB banks, 1.1% of their total IRB exposure and 0.9% of their IRB RWEA correspond to such type of exposure.⁴¹
86. An analysis of the breakdown of indirect exposures to policy insurance by prudential approach (Figure 2) shows that under the current CRR (CRR2) framework 58.9% of banks' exposures to policy insurance is risk weighted under the SA, 29.0% under the A-IRB and 12.1% under the F-IRB approach. In terms of RWEA, 54.7% correspond to SA RWEA, 39.5% to A-IRB RWEA and 5.8% to F-IRB RWEA. Under the final Basel III framework, the share of exposures that is risk weighted under SA is 60%, while the remaining 40% is under the F-IRB approach following the limitation of using the A-IRB for exposures to financial institutions. In terms of RWEA, 51.9% corresponds to SA RWEA and 48.1% to F-IRB RWEA.

Figure 2: Breakdown of exposures and RWAs by prudential approach under the CRR2 and the final Basel III framework.

⁴⁰ These metrics includes in the denominator the total EU credit risk exposure/RWA as reported by the 156 QIS reporting banks.

⁴¹ These metrics includes in the denominator the total credit risk exposure/RWEA as reported by the banks making use of policy insurance.

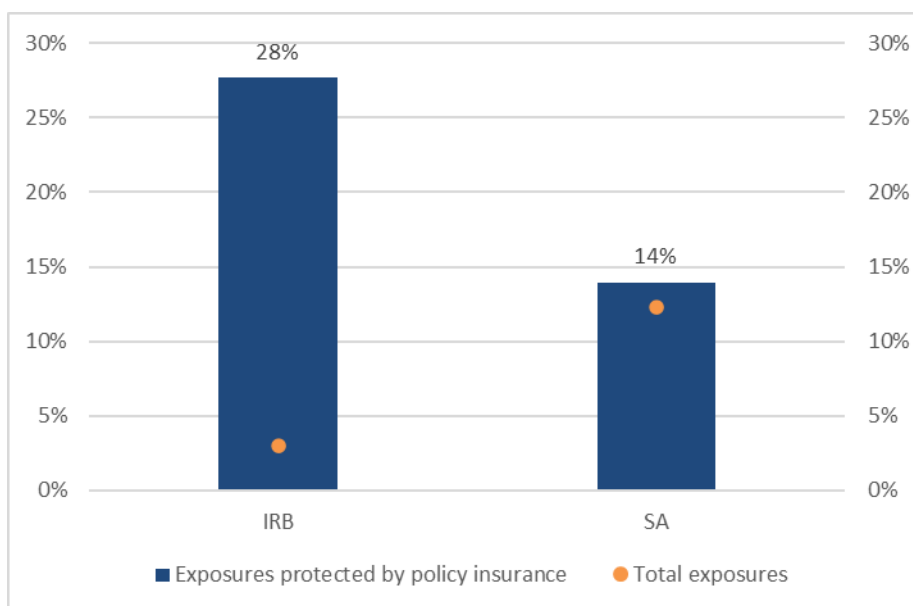


Sample: 38 SA banks – 15 IRB banks, Source: 4Q2023 QIS data

87. Figure 3 shows the expected relative increase in RWEAs following the introduction of final Basel III capital framework for indirect exposures to policy insurance (blue columns) in comparison to the overall relative increase in RWEA (orange dot), by prudential approach to credit risk. The relative increase in RWEAs seems to be more important for indirect exposures to policy insurance under the IRB approach. Indeed, IRB RWEAs to policy insurance would increase by 28% after the introduction of the final Basel capital framework. This number compares to a 14% increase in SA RWEAs, which is due to the to the changes in applicable SA risk-weights following introduction of the final Basel III capital framework⁴². These changes reflect the combined effects in the treatment of the institution's exposures from the final Basel III capital framework.

⁴² Out of the 36 banks reporting having indirect exposures to policy insurance risk weighted under the SA, 16 banks showed an increase in their SA RWEAs.

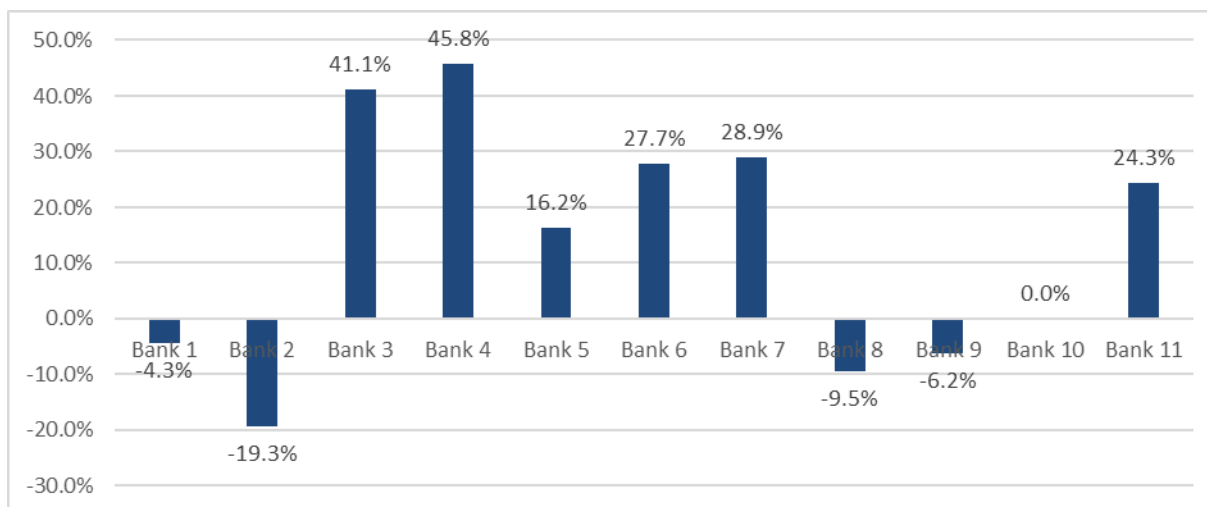
Figure 3: Relative RWAs increase after the implementation of the final Basel III framework for indirect exposures to policy insurance (by prudential approach).



Sample: 156 banks, Source: 4Q2023 QIS data

88. Bank-by-bank results show some heterogeneity as displayed in Figure 4. Six banks in the sample show an increase in policy insurance RWEA under the IRB approach after the implementation of the final Basel III framework, while four banks even show a decrease, and one bank shows no change. In these five cases, the expected increase in RWEAs driven by the limitation to use AIRB models and the associated 45% regulatory LGD for indirect exposures to policy insurance is completely offset by other Basel III provisions with an opposite effect, such as the removal of the 1.06 factor or the different CCFs applicable to off-balance sheet exposures.

Figure 4: Relative RWEA increase after the implementation of the final Basel III framework for exposures to policy insurance.



Source: 4Q2023 QIS data.

1.8.5 EIOPA database on failures and near misses

89. EIOPA collects information on failures and near misses from the insurance and re-insurance undertakings under the supervision of the national competent authorities. The data refers to life and non-life insurance companies. The information on near misses refers to cases where the insurer faced specific financial difficulties (for example, when the solvency capital requirements were breached or likely to be breached) and the supervisor intervened or placed the company under special measures.
90. However, the information collected in the context of the report does not allow for the time being to compute LGD data, as confirmed with EIOPA.

1.9 Other considerations: a recalibration of the F-IRB approach should be justified by strong risk differential and be performed in a holistic manner

91. This section recalls other general considerations raised in the EBA Opinion that remain valid.
92. First, the lower granularity of the F-IRB approach compared to the A-IRB approach is a natural feature of an approach based on standard methodology, whereby the additional complexity brought by any differentiation in the framework should be justified by material differences in risks. As mentioned in the EBA Opinion, *‘The objective of the final Basel III framework was to limit undue variability of own funds requirements by reducing the extent of use of internal models, especially limiting the applicability of models to portfolios characterised by low number of default observations. The less sophisticated approaches lead to the simplification of the framework and greater comparability, although at the expense of lower granularity. Introducing additional categories could therefore lead to increased complexity of the framework.’*
93. In addition, the EBA Opinion recalled that *‘Changes of calibration of selected elements of the framework without considering others may therefore lead to unintended results.’* In other words, re-calibrating regulatory LGD parameters downwards should come with an increase of the regulatory LGD parameters for other exposures. For instance, it could be argued that introducing a downwards LGD re-calibration for CI could be associated with an upwards LGD re-calibration for direct exposures to CI on the back of the lower place in the hierarchy of credits as set out under Solvency II. This is because *‘The calibration of final Basel III framework was considered from an overall perspective, taking into account the expected levels of own funds requirements.’*
94. The introduction of a specific treatment for CI would constitute a deviation from the final Basel III framework, which would add up to other deviations already introduced in relation to insurances. As recalled in the EBA Opinion, *‘the current CRR already includes certain specific provisions regarding equity holdings in insurance companies. Contrary to the final Basel framework, which requires that material equity holdings are deducted from own funds, Articles 49 and 471 of Regulation (EU) 575/2013 allow under certain conditions that equity holdings in insurance companies instead be risk weighted.’*

95. Furthermore, the Basel III framework aimed at limiting contagion arising from firm-level exposures among global financial institutions, including between bank and insurance sectors. Certain elements of the framework were designed specifically for that purpose, such as the inclusion of insurance undertakings in the higher scaling factor of 1.25 for asset value correlation of large financial sector entities. Other elements such as the elimination of double default treatment for exposures secured by UFCP, the ineligibility of conditional guarantees under AIRB and the mandatory use of the SA or F-IRB Approach for financial sector entities also helped indirectly to support that objective. Specification of a preferential treatment for CI could therefore contradict that intention of the final Basel III framework and offset some of such measures to address financial stability and interconnectedness concerns in the framework. Any assessment regarding the treatment of CI should consider the fact that such a product can be offered not only by independent insurance companies, but also by insurance companies being part of a financial conglomerate, where an institution and an insurance company can be part of the same group. Introducing a preferential treatment of insurance claims may have impact on incentives and business models of the institutions vs insurance companies that are part of the same group, and hence these implications should be thoroughly analysed.

Conclusion

96. The levels of CI held by EU banks to hedge credit risk remain modest, representing 0.8% of total credit risk exposure values. While it has already been clarified that CI policies are economically similar to guarantees, and hence are eligible under the banking prudential framework as UFCP if they fulfil the eligibility criteria of Part Three, Title II, Chapter 4 of the CRR, concerns have been raised that their use is severely impaired by the modelling restrictions for low-default portfolios brought by the final Basel III framework. This report has explored the available data evidence to identify any potential mis-calibration, as well as reviewed the arguments brought by the industry based on risk-reducing characteristics of CI.
97. The impact of the final Basel III framework on CI can be decomposed into three components:
- The RW floor imposed on the recognition of UFCP, which prevents the RW of a guaranteed exposures to be lower than a comparable direct exposure
 - The removal of the possibility to model the LGD risk parameters for direct exposure toward credit insurers⁴³.
 - The calibration of the LGD risk parameter under the F-IRB approach.
98. With respect to a possible derogation of the application of the RW floor, the EBA has already published an exhaustive analysis in the context of the Call for Advice for the implementation of the final Basel III framework in the EU. The EBA maintains its stance that deviating from this long-standing principle is not warranted, as it would create an unlevel playing field if lifted partially only for some guarantors or would eliminate a key component of the CRM framework if removed completely, with the associated risks of undercapitalisation and weakening the resilience of the prudential framework.
99. When it comes to the removal of the possibility to model the LGD risk parameters for direct exposures toward credit insurers, the data provided by the industry confirms the lack of empirical evidence that can be used for modelling. It is worth noting that no default on a credit insurer has been observed. Therefore, it is expected that any LGD estimates on these exposures would incorporate a substantial part of judgement, with a high risk of variability in the model outcomes, at odds with a potential revision of the Basel capital framework.
100. The evaluation of the appropriateness of the LGD risk parameter calibration is more complex by nature, considering the lack of data mentioned above. This assessment can be performed in two different ways:
- via theoretical considerations, which refer to, on the one hand, an assessment of the effect of the prudential framework applicable to credit insurers, and, on the other hand, a consistency check within the framework vis-a-vis other CRM techniques with similar features

⁴³ As mentioned in the report, this entails a mandatory '*substitution approach*', which is only a second order effect, as it can be seen as setting the minimum own fund requirements possible respecting the constrain of the RW floor imposed on the recognition of UFCP.

- via an assessment of available data, that in practice takes the form of LGD estimates (from the EBA benchmarking exercise) and realised LGD on claims guaranteed by credit insurers and on direct exposures toward insurers (collected via GCD).
101. Under the theoretical considerations, the dual recourse characteristic of CI, where an institution holding an exposure secured by a CI contract has recourse both to the borrower and to the credit insurer, is not specific to CI but applies in general to CRM-eligible guarantees. Specifically, double recourse can be found as well in covered bonds, where the EU framework introduced a partial Basel-deviation through a dedicated preferential LGD treatment for covered bonds on the back of dual recourse, among other factors. However, while dual recourse is acknowledged as a risk-reducing factor, other features of covered bonds that are not present for CI may also be substantiating the deviation, such as the typically high-quality physical collateral underlying covered bonds.
102. The report has further explored the treatment assigned in the framework to instruments that share certain features with credit insurers, to understand any potential misalignment in the treatment of risks. Specifically, a comparison is made between CI provided by a credit insurer for a specific credit exposure, which is treated under the CRM framework as UFCP, and an exposure that is collateralised by a bond issued by a similar credit insurer and which is treated as FCP. Although it is acknowledged that the exposure which is collateralised by a bond receives a more favourable RWEA treatment (under the FCCM approach) than the exposure protected by a CI policy, it is also recognised that the observed differences are explained by both the additional flexibility inherent in FCP compared to UFCP, and the increased risk sensitivity of the FCCM approach relative to the standardised UFCP approach for CI.
103. It is acknowledged that EU-specific characteristics could support a deviation from the Basel capital framework, in the form of the Solvency II insurance framework, which grants a higher seniority to CI policies. However, the report has discussed related caveats that seem to hinder the reliable determination of the impact of this preferential treatment on LGD and hence raise concerns in supporting a deviation. Other characteristics of Solvency II, like valuation requirements, capital requirements or governance requirements were not analysed because these features are also shared with other regulated entities such as credit institutions that are considered as of low default and hence have also seen their modelling restricted under the final Basel III framework.
104. Regarding the empirical evidence, the EBA carefully reviewed the three data sets available at the time of publication of this report. For the LGD estimates collected via the EBA benchmarking exercise, available data evidence does not warrant concerns that the supervisory-prescribed LGD value of 45% for financial sector entities is not representative of the underlying risk profile of credit insurer. Bank LGD estimates for insurance companies collected through the EBA benchmarking exercise point to average LGDs exceeding 40%,⁴⁴ a result that aligns with the LGD prescribed under the new regulation.

⁴⁴ 42.5% average over the full sample of bank LGD estimates for insurers over time; 43.8% average if a single observation is considered per bank and insurance company considering the low variability observed over time. Please refer to section 4.2 for further reference.

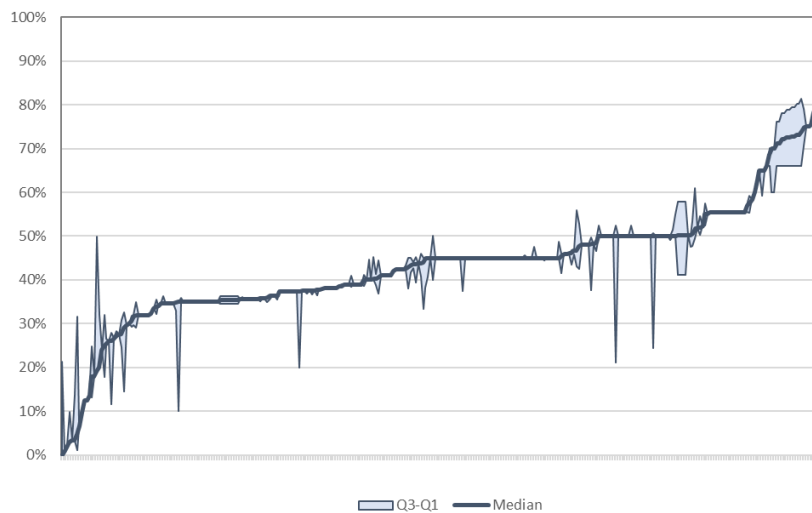
105. For the datasets related to the realised LGD, the EBA has engaged with the industry to collect further data evidence to substantiate any potential mis-calibration. As a result, a tailored data report has been produced and made available by the industry, which has been duly considered. However, the high pay-out ratios displayed from insurers and the associated observed low realised LGDs fail to capture the behaviour of credit insurers under default, as no credit insurer in the EU has defaulted so far, and hence any ‘proxy LGD’ should be interpreted with caution. Data from defaulted insurers in businesses other than CI have been made available, which seem to point at the effectiveness of the Solvency II framework since EU insurers have associated lower LGD values than insurers outside of the EU. However, the limited data sample precludes any inference.
106. The lack of satisfactory data evidence to anchor any potential re-calibration of the framework does not support a deviation from the Basel capital framework in the EU banking package. Further, it has also been clarified in the report that under the new framework CI as CRM technique is still expected to lead to a reduction of own funds requirements, albeit at a lower intensity than currently.
107. The mandate also requires the EBA to assess the eligibility framework applicable to credit insurers. The implementation of final Basel III framework in the EU marginally amends the framework compared to what was previously in place (clarification on the eligibility in relation to fraud exclusion clauses⁴⁵). The EBA did not find any unintended consequences of the new framework, which is aligned with the eligibility requirements applicable to other protection providers. This assessment was not contradicted by the industry in the interactions held with the EBA.
108. Finally, the EBA would like to stress that the underlying calibration of RW is done from an overall perspective, where downward recalibrations of one instrument should in principle be compensated by upward re-calibrations in others, and this may bring unintended consequences on other products that are also newly bound by the 45% prescribed LGD value under the upcoming modelling restrictions for low-default portfolios. This is also compounded by concerns on increasing the complexity of the framework, and efforts to limit the contagion channel between banks and insurers, with potential perverse incentives for conglomerates if a preferential treatment is granted for credit insurers under the banking framework.

⁴⁵ This complements measures already in place in the EU deviating from the Basel capital framework tailored for insurance companies, where equity holdings of insurance companies can be risk weighted under certain conditions instead of deducted from own funds, see Article 49 and Article 471 of the CRR.

Annex 1 – complementary information on the benchmarking exercise

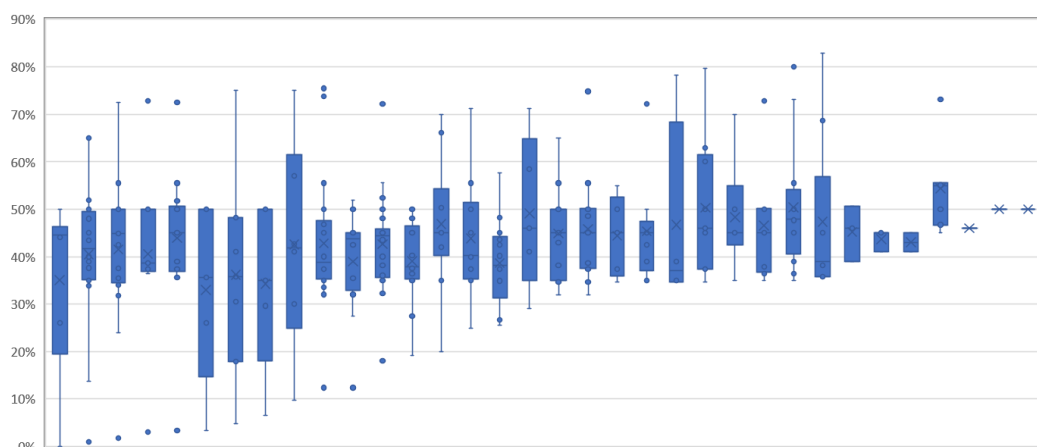
Distributions of LGD estimates

Figure 5: Distribution of LGD estimates assigned by a given institution to an insurer over time



Note: This graph shows the dispersion of LGD estimates for insurance companies across participating banks in the benchmarking exercise by displaying the distribution of the median LGD estimate assigned by each bank to each insurer over the period 2016 to 2022. To supplement this information, the interquartile range of dispersion of the LGD estimates over that period is also displayed through the shaded area. Hence, the x-axis represents each combination of the pairs (single insurer, single bank) available in the dataset. The y-axis denotes the median (line) or interquartile range (shaded area) of the LGD estimate assigned by a given bank to a given insurer over the period 2016 to 2022.

Figure 6: Distribution of LGD estimates by insurer



Note: The x-axis represents the insurance companies for which LGD estimates are provided in the benchmarking exercise. Each boxplot represents the distribution of LGD estimates assigned by banks towards a given insurer. For each bank a single LGD estimate is provided, which has been calculated as the median of the available LGD estimates over the period 2016 to 2022.



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