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INSIGHT CONSENSUS INFLUENCE

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LMA Response to "*CP on Guidelines on Credit Risk Mitigation for institutions applying the IRB approach with own estimates of LGDs*"

About the LMA

The Lloyd's Market Association (LMA) represents the interests of the Lloyd's community, providing professional and technical support to our members. All managing and members' agents at Lloyd's are full members, who together manage a gross premium income of around £31 billion per annum. Through the LMA, their interests are represented wherever decisions need to be made that affect the market. Lloyd's members include European and international insurance groups and Lloyd's is the world's leading global market for specialist insurance.

The purpose of the LMA is to identify and resolve issues which are of particular interest to the Lloyd's market. We work in partnership with the Corporation of Lloyd's and other market-related associations to influence the course of future market initiatives.

Our agenda is driven by and on behalf of our members - many of whose staff freely give up their time to participate on our committees and business panels, as well as other groups who are essential to the strength of the association.

Executive Summary

The Lloyd's Market Association (LMA) welcomes the European Banking Authority's (EBA) Consultation Paper (EBA/CP/2019/01) on Credit Risk Mitigation (CRM) and the Call for Advice on the impact of the final Basel III framework. Following the EBA hearing in Paris (15th April 2019), the LMA is appreciative of the constructive position the EBA has taken regarding credit insurance along with the significant accompanying evidence provided by the banking and insurance industries. The LMA wishes to re-emphasise some of the unique characteristics of credit insurance and as such we provide the additional clarification in this response to the Consultation Paper. The main areas we wish to highlight, with supporting detail in the appendices, are as follows:

- **Enhanced counterparty**: Credit insurance, provided by regulated insurance companies, affords the banking industry an enhanced counterparty risk over and above that of an unsecured creditor. The fact that external credit agencies assign Issuer Default Ratings (IDR) for the benefit of unsecured creditors that are generally lower than the Financial Strength Rating assigned for the benefit of policyholders is evidence of this (see Annex B, 1.18] below). Regulators may best appreciate this in the same class as a depositor guarantee scheme. It therefore is not the same as a direct exposure to the Credit Risk Mitigation (CRM) provider, as with a guarantee from a banking institution. In light of this, we believe the application of Loss Given Default (LGD) floors should take this stronger creditor position into account.

- **Low-correlated Credit Risk Mitigation providers**: The insurance industry is less correlated to the policyholder than other banking and financial institutions. The core business of multiline insurers, including Lloyd's Syndicates, operate in traditional international property and casualty insurance and reinsurance markets, and so are less exposed to financial risks than other CRM providers. This reduces systemic risk and we believe the application of LGD floors should consider this material benefit.

- **"Step into the shoes"**: Alignment with the Basel Committee on Banking Supervision (BCBS) operational requirements to permit *either* one lump sum payment or assume the future payment obligations of the counterparty is a core function of credit insurance. We understand the EBA is amenable to this approach and request that the EBA support a similar approach in future Capital Requirement Regulations.

- NB We understand the Capital Requirements Regulation (CRR) as currently drafted does not contemplate a separate category of CRM for credit insurance. Our request to the EBA therefore is for clarifications in the Guidelines that cater for the unique advantages of credit insurance as CRM.

The LMA would welcome future discussions with the EBA in relation to any of the issues that arise in this Consultation or any aspect of CRM relating to the CRR.

Question 6: Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?

1.1 Although we understand from discussions at the public hearing on 15th April that clarification on this point may be forthcoming through the Quantitative Impact Assessment process, and we will engage with the European Commission (EC) on this point as well, we would respectfully request that the EBA support amending Article 215 of the CRR (additional requirements for guarantees) to reflect the explicit permission granted in Article 190(a) of the Bank Committee on Banking Supervision's International Convergence of Capital Measurement and Capital Standards; a Revised Framework for the guarantor to "step into the shoes" of the underlying obligor:

1.2 Article 190(a) permits the guarantor to either make one lump sum payment or "assume the future payment obligations of the counterparty covered by the guarantee"[1] so a single payment is not required by the BCBS in order for a guarantee to meet operational requirements.

1.3 The "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor"[2] should not be applied for exposures of the bank as policyholder to insurance companies, as it is not equivalent exposure, given the priority claim on insurance companies that banks hold as policyholders. The banks should be allowed to recognise (depending on the

[1] International Convergence of Capital Measurement and Capital Standards; a Revised Framework, clause 190(a) (additional operational requirements for guarantees)

[2] Section 2.4.5 of the Call for Advice

jurisdiction and its respective insurance regulations) the improved LGD of its exposure as policyholder, based on the risk differentiators set forth in this paper.

1.4 Paragraph 29a.ii of the Draft Guidelines in the consultation document (p.35; see also paragraph 33 which references "comparable exposure") states that banks using the substitution approach should substitute both the PD and LGD risk parameters of the underlying exposure with the corresponding PD and LGD of a ***comparable direct exposure*** [emphasis added] to the guarantor. However, this does not correctly reflect the exposure of the bank to the protection provider as a policyholder of an insurance policy. The exposure is not comparable to the bank's exposure as a creditor, as policyholders are in a privileged position compared to unsecured creditors (see Annex B to the LMA response). We also recommend that the EBA reviews the Fitch Report (attached with LMA response).

1.5 As discussed at the public hearing on 15th April, we appreciate that the CRR as currently drafted does not explicitly address credit insurance as CRM and therefore we intend to participate in any public consultation and otherwise will engage with the EU Commission on amendments to the CRR on this point. However, we would ask that the European Banking Authority, in responding to the Call for Advice of May 2018, consider clarifying the recognition of non-payment insurance and its unique characteristics. Paragraph 15 of the Draft Guidelines suggests that "credit insurance [can] effectively [function] like a guarantee *or* like a credit derivative [emphasis added]. It therefore is logical to provide explicit recognition of credit insurance, which has characteristics of both of the current UCP tools, but also unique advantages (see Annex C of the LMA response).

1.6 The insurance industry would be prepared to work with EBA and European Insurance and Occupational Pensions Authority (EIOPA) and other relevant stakeholders and regulators on this, including on appropriate definitions and guidelines to provide clarity on non-payment insurance as an independent CRM tool.

See Annex A for additional supporting points.

Question 8: Do you agree with the proposed rules for the application of the substitution approach? Do you see any operational limitations in excluding the guaranteed part of exposure to which substitution approach is applied from the scope of application of the LGD model for unguaranteed exposures?

2.1 We feel that the GL are unclear on this point and warrant clarification. In addition, it is important to note that neither of the two options presented are consistent with/both the options presented conflict with the normal contractual arrangements with regard to the allocation of cashflows from the obligor between insurers and banks using credit insurance for UCP.

Question 11: Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure to the guarantor? What concerns would you have about the calculation of the risk weight floor?

2.2 Due to strength of insured policyholders' claims compared to unsecured creditors, we advocate that the EBA guidance should explicitly permit banks to recognise their priority claim as policyholder in their LGD calculations.

2.3 Paragraph 29a.ii of the Draft Guidelines (p.35; see also paragraph 33 which references "comparable exposure") states that banks using the substitution approach should substitute both the PD and LGD risk parameters of the underlying exposure with the corresponding PD and LGD of a *comparable direct exposure* [emphasis added] to the guarantor. However, this should not apply where the exposure of the bank to the protection provider is as policyholder of an insurance policy, as the exposure is not comparable, as policyholders are in a privileged position compared to unsecured creditors, in the same way that depositors have preference over unsecured creditors in a bank structure. Therefore, we request that a lower LGD should be considered where the bank's exposure is as a policyholder.

2.4 This is also a concern that should be addressed by the EBA in responding to the Call for Advice of May 2018 (Section 2.4.5), regarding the "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor".

2.5 Paragraph 35c. of the Draft Guidelines states that "the degree to which the guarantor's ability to fulfil the contractual obligation under the unfunded credit protection agreement is correlated with the obligor's ability to repay can only result in a conservative adjustment of the grades, pools or LGD estimates.". In our view this Guideline should be modified to address situations where the credit protection is provided by non-payment insurance, given insurers are regulated entities whose multi-line liabilities are diverse and whose capital is ring-fenced by regulation in order to meet their obligations to policyholders. The likelihood of correlation with the risk of default by obligors covered under non-payment insurance is therefore very low.

Please see additional points in Annex B.

Annex A

Question 6: Additional Supporting Points:

1. Key risk differentiators that should be permitted to be taken into account in modelling the PD and LGD of banks' claims as policyholders

1.1. Since the confirmation by both the BCBS (FAQ6, QIS3) and the EBA (Single Rulebook 2014_768 and Assessment of the Current CRM Framework (19 March 2018), paragraph 36, page 15) that non-payment insurance can function as effective credit risk mitigation, the product has evolved to align with the operational requirements of CRM whilst remaining a policy of indemnity offered (i) under tested insurance law and (ii) by highly regulated insurers with diverse portfolios, strong credit ratings, and based in legal jurisdictions where effective enforcement against the insurer is practicable.

1.2. The fact that the non-payment product is only weakly correlated with insurers' other exposures or liabilities nor with the banks' exposure to the underlying obligor[3] substantially lowers any systemic risk:

1.2.1. Regulatory and reserving requirements ensure liquid, callable capital is available to pay claims to policyholders.

1.2.2. The insurance industry's ability to absorb large losses is well tested: The figure paid by those same insurers during the global financial crisis – the most severe test of the non-payment product to date – was roughly USD 2.5 billion; at the same time the insurance industry handled roughly USD$100 billion in natural catastrophe losses[4]. Capacity for this class of insurance has grown significantly since then, with some insurers still making recoveries 10 years later, reducing the loss to insurers. Evidence of the resilience of the insurance market is also reflected in the figures from 2017 and 2018 in respect of losses paid due to hurricanes and other natural catastrophes; in 2017 insurers paid roughly USD 144 billion and in 2018 they paid USD 85 billion, with no recoveries expected from these losses; yet additional capital has already replaced the losses.

1.3. The banks' claims as policyholders are in a privileged position compared to unsecured creditors' claims in the unlikely event of the bankruptcy of an insurer (see, for example, The Insurers (Reorganisation and Winding Up Regulations) 2004, Part IV, regulations 21-26); regulated insurance companies have minimal, if any, preferential debt. Furthermore, borrowings by insurance groups are done at the holdings level, outside the regulated entity which holds the capital and thus are structurally subordinated: the debt ratings of insurance groups are lower than the claims paying rating of an insurer, as reflected in ratings of insurers published by credit rating agencies.

1.4. Whilst not directly secured with collateral, banks' claims as policyholders benefit from ring-fencing of assets to secure outstanding liabilities to policyholders at the operating company level; bolstered in circumstances where the obligor is in distress by provisioning required by insurance regulators for exposures where the insurer has a potential claim liability. This ring-fencing of assets for the benefit of

3 As required by paragraph 123 of Basel III: Finalising post-crisis reforms, December 2017

4 Swiss Re Sigma research; JLT

banks as policyholders should be recognised, and therefore the 45% LGD under paragraph 70 of the Basel III: Finalising post-crisis reforms (p.66) should be modified to be significantly lower, to acknowledge this benefit to banks as policyholders, rather than unsecured creditors, of an insurance undertaking.

1.5. Using the Fitch methodology as an example, if the insurer operates in a country that implements Group Solvency or Ring-Fencing regime, the Insurance Financial Strength (IFS) rating assumes a recovery prospect of “Good” and will notch the IFS rating down by at least one notch to determine the Issuer Default Rating (IDR). The IFS rating is for obligations to policyholders while IDR is for creditors and Fitch always determine the IFS rating of an insurer first (known as anchor rating) and notch downwards to determine the IDR.

1.6. In accordance with the new IFRS9 accounting standards, a bank is required to calculate forward provisions which must be made to protect its balance sheet from future volatility and exposure to assets. As insurance is an accrual-based CRM tool that is a direct match to the asset being covered, it assists banks with effective credit risk transfer, and reduces balance sheet volatility. This protection serves to strengthen the banking sector during periods of increased volatility and downturns in the credit cycle through transfer of risk into the insurance and reinsurance communities, while insurers/reinsurers’ regulated capital and diverse portfolios of exposures in turn protect them from market volatility or any correlation on the liability side.

1.6.1. Furthermore, use of non-payment insurance by banks is not a wholesale transfer of risk from the banking sector to the insurance sector.

1.6.2. Moreover, insurers’ exposure to bank lending is a very small proportion of their overall risk portfolio and is generally considered to be uncorrelated to their other exposures. For example, the total Gross Written Premium for credit and contract frustration business (all lines, not just banks business) forms only 1.3% of Lloyd’s total Gross Written Premium.

1.7 Solvency II requirements “are calculated to ensure that the insurers could still pay out to policyholders after the occurrence of a 1-in-200 year stress event, where the stress event used in the calculation reflects the risk profile of the particular insurer.”[5]. To ensure that the capital required to be held by insurers is directly relevant to policyholders, the Prudential Regulatory Authority (PRA) in the UK expects “capital to be located in the regulated entities where it is needed… We expect insurers to take responsibility for maintaining at all times an adequate level and quality of capital, taking into account the risks to which they are exposed, and consistent with their safety and soundness and the protection of policyholders [emphasis added].”[6]

1.8 According to the 2017 XLCatlin Global Credit Insurance Monitor[7], credit insurance was seen by the policyholders polled as “the most efficient, transparent and acknowledged way to manage credit risk and to comply with corporate governance requirements”.[8]

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5 The Prudential Regulation Authority’s approach to insurance supervision October 2018, p.19 (https://www.bankofengland.co.uk/prudential-regulation/supervision)

6 The Prudential Regulation Authority’s approach to insurance supervision October 2018, p.21 (https://www.bankofengland.co.uk/prudential-regulation/supervision)

7 Global Credit Insurance Monitor 2017 - XL Catlin

8 Ibid, P.6

1.9 Non-payment insurance provides effective credit risk mitigation able to support bank lending and associated trade and investment in emerging markets where credit derivatives are rarely available and for complex transactions not easily covered by other CRM tools.

Annex B: Supporting Arguments: (Q11)

1.10 Privileged position of policyholders

1.11 The banks' claims as policyholders are in a privileged position compared to unsecured creditors' claims in the unlikely event of the bankruptcy of an insurer (see, for example, The Insurers (Reorganisation and Winding Up Regulations) 2004, Part IV, regulations 21-26); regulated insurance companies have minimal, if any, preferential debt. Furthermore, borrowings by insurance groups are done at the holdings level, outside the regulated entity which holds the capital and thus are structurally subordinated: the debt ratings of insurance groups are lower than the claims paying rating of an insurer, as reflected in ratings of insurers published by credit rating agencies.

1.12 Moody's, Standard & Poors and Fitch rating agencies all provide Insurance Financial Strength Ratings which address the insurer's ability to pay punctually policyholder obligations and claims, also reflecting the expected financial loss suffered in the event of default. They also assign ratings to specific instruments issued by the insurer or its holding company (Issuer Default Ratings), which are often notched, or rated, below the Financial Strength Ratings.[9] For example, Fitch assigns Lloyd's an Insurance Financial Rating of AA-, which is one notch higher than the long-term Issuer Default Rating of A+.

1.13 "The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policy holders and beneficiaries."[10]. Therefore, as stated in Solvency II: "The Solvency Capital Requirement should reflect a level of eligible own funds that enables insurance and reinsurance undertakings to absorb significant losses and that gives reasonable assurance to policy holders and beneficiaries that payments will be made as they fall due." [11]

1.14 Banks' priority claims as policyholders is most readily compared to banking depositor preference versus unsecured creditors. In addition, Deposit Guarantee Schemes (DGSs) afford depositors further protection under regulatory supervision. Insurance policyholders benefit from a similar scheme. The European Insurance regulator, EIOPA, has implemented an Insurance Guarantee Scheme that functions as a similar backstop resource to the policyholder protection regulations.

1.15 The priority ranking of policyholders is explicitly protected in the Solvency II Directive[12]: "It is of utmost importance that insured persons, policyholders, beneficiaries and any injured party having a direct right of action against the insurance undertaking on a claim arising from insurance operations be protected in winding-up proceedings… Member States should be provided with a choice between equivalent methods to ensure special treatment for insurance creditors, none of those

[9] "The relationship between IFSRs and instrument ratings depends on the legal and regulatory framework in a particular jurisdiction and the relative standing of policyholders and instrument holders in the event of insolvency, bankruptcy, reorganisation or liquidation of the entity." (Moody's Rating Methodology: Property and Casualty Insurers published 29 May 2018, p. 30).

[10] (paragraph (16) of DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009)

[11] DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 (paragraph 62)

[12] DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009 (paragraph 127)

methods impeding a Member State from establishing a ranking between different categories of insurance claim. Furthermore, an appropriate balance should be ensured between the protection of insurance creditors and other privileged creditors protected under the legislation of the Member State concerned."

1.16 Article 275 of DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009: "1. Member States shall ensure that insurance claims take precedence over other claims against the insurance undertaking in one or both of the following ways: (a) with regard to assets representing the technical provisions, insurance claims shall take absolute precedence over any other claim on the insurance undertaking; or (b) with regard to the whole of the assets of the insurance undertaking, insurance claims shall take precedence over any other claim on the insurance undertaking with the only possible exception of the following: (i) claims by employees arising from employment contracts and employment relationships; (ii) claims by public bodies on taxes; (iii) claims by social security systems; (iv) claims on assets subject to rights in rem."

1.17 Whilst not directly secured with collateral, claims of banks as policyholders benefit from ring-fencing of assets to secure outstanding liabilities to policyholders at the operating company level; bolstered in circumstances where the obligor is in distress by provisioning required by insurance regulators for exposures where the insurer has a potential claim liability. This ring-fencing of assets for the benefit of banks as policyholders should be recognised, and therefore the 45% LGD under paragraph 70 of the Basel III: Finalising post-crisis reforms (p.66) should be modified to acknowledge this benefit to banks as policyholders, rather than creditors, of an insurance undertaking.

1.18 Fitch Ratings, having established the value available to creditors and the approximate scale of creditors at each level of priority, applies a waterfall to determine estimated recovery ratios, based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. According to Fitch Ratings13, the typical order of seniority of creditors at operating company level is as follows:

1. Policyholder obligations with seniority (for example, life insurance policyholders in certain jurisdictions)
2. Policyholder obligations without seniority
3. Secured debt
4. Unsecured senior debt
5. Subordinated debt
6. Hybrids

1.19 As noted in the Fitch Recovery Rating scale replicated below[14], recovery rates for policyholders could be expected to be well above the recovery rate implied by the 45% LGD floor currently prescribed for financial institutions including insurance companies.

1.20 As you may be aware, rating agencies determine an Insurance Financial Strength (IFS) rating, which provides an indication of an insurer's capacity to pay its insurance claim

[13] Fitch Insurer Rating Criteria, 11 January 2019, p.105: https://www.fitchratings.com/site/re/10058790

[14] Fitch Insurer Rating Criteria, 11 January 2019, p.106: https://www.fitchratings.com/site/re/10058790

and benefit obligations. An Issuer Default Rating (IDR) is also issued, which is a rating assigned to the company itself and it provides an indication of default or failure risk. The IFS serves as the initial "anchor rating" in the notching process. Depending on the regulatory regime, an operating company's IDR is normally notched at least one notch down from its IFS rating, given the average recovery assumption.

Fitch Recovery Rating Scale

The recovery scale is based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. As such, it is an ordinal scale and does not attempt to precisely predict a given level of recovery. While recovery ratings (RRs) are in relative terms, Fitch does employ the following recovery bands in assigning RRs.

Recovery Rating	Definition	Recovery Band (%)
RR1	Outstanding recovery prospects given default	91–100
RR2	Superior recovery prospects given default	71–90
RR3	Good recovery prospects given default	51–70
RR4	Average recovery prospects given default	31–50
RR5	Below-average recovery prospects given default	11–30
RR6	Poor recovery prospects given default	0–10

Note: Issue and obligation ratings will be notched up or down from the Issuer Default Rating (IDR) based on their RR. It is generally assumed that all of the obligations of a given entity share the same default risk, as reflected in the entity's IDR.
Source: Fitch Ratings.

1.21 To the best of the LMA's knowledge, there have been no known defaults on accepted claims to the Lloyd's Central Fund in the 300+ year history of the Lloyd's market.

Annex C

General Supporting Comments

1. **Importance to Trade**

2. "Financial institutions play an important role in facilitating international trade. An estimated 80 to 90 percent of world trade relies on some form of credit, insurance or guarantee, issued by a bank or other financial institution (Auboin 2007)"[15] Thus insurance support of bank lending clearly supports international trade.

3. This is particularly true in non-OECD markets and for complex risks and lesser-known credits where other forms of credit risk mitigation may be less available. A broker of transactional (or "single situation") insurance has confirmed that US$ 2.4 billion in coverage placed for a banking client's trade and export finance lending supported US$ 13.5 billion in contract values.[16]

4. We estimate over US$300bn in current insurance in support of bank lending. The support available for trade and project finance as well as other lending globally is considerable: for example, USD$2-3 billion of non-payment insurance is available for a single transaction, with support available for lending exposures of up to 15 years. Over 50% of this capacity is available from Lloyd's syndicates alone. This results in effective support for EU exporters and EU-based internationally operative companies, which has been a key component of the European economy through premium income and balance of trade effects.

5. We estimate that 50%-70% of the bank exposures covered on an individual basis by the credit insurance market (transactional insurance) is in non-OECD markets: an area of financing that is thinly covered at best by other CRM tools such as credit derivatives (see also paragraph 17 below)[17].

6. A broker of transactional (or "single situation") insurance has confirmed that US$ 2.4 billion in coverage placed for a banking client's trade and export finance lending supported US$ 13.5 billion in contract values.[18]

7. As an example of the reliance of small and medium size business (SME) on bank financing supported by non-payment insurance, a SME plumbers merchant with the UK distributorship for some European products has a cash cycle that requires payment for product a full 2 months before cash is received from buyers. Terms to suppliers are 30 days end of month from despatch on the continent. The product is brought into the UK weekly, and orders are made up for construction industry customers where payment terms are typically 60 days end of month (and there are retentions).

8. The business depends on credit insurance being in place, with sales made up to the level of the credit insurer's limit on each buyer, the bank financing the company's invoices and sharing in credit insurance claims. The company has variously arranged the credit insurance policy itself, attaching the bank as joint policyholder for financed

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Auboin, M. (2007). "*Boosting Trade Finance in Developing Countries: What Link With The WTO?*" Economic Research and Statistics Division Discussion Paper, World Trade Organiza tion. Geneva: WTO .

16 Source: Aon Risk Services; data from 2010-2017

17 LMA estimate based on discussion with Lloyd's underwriters.

18 Source: Aon Risk Services; data from 2010-2017

debts, and has also used the bank's invoice finance facility whereby the bank buys the invoices and is the policyholder. Both solutions provide the valuable protection for the receivables asset against bad debt (non-payment within 6 months of due date) and insolvency, and enable the working capital finance to flow so that the business can thrive.

9. Depending on the outcome of the EBA Consultation, its non-affirmation of the efficacy of non-payment insurance as CRM could shrink the availability of trade, export, structured credit and corporate financing from banks who have incorporated partnership with insurers in their business and risk management models.

Important Support of Bank Lending

10. A short survey done by the International Association of Credit Portfolio Managers (IACPM) in 2019[19] showed that bank respondents use credit insurance to support a wide variety of lending: short-term trade finance, asset-backed lending, and project finance, all of which support investment and trade. Also of note was the use of credit insurance for emerging market lending and for sub-investment grade corporate credits as well as investment grade credits, as other credit risk mitigation is not usually available for these exposures.

11. The majority of IACPM respondents were banks based in EMEA, specifically Europe: removing their ability to benefit from this unique CRM would be disadvantageous.

12. During the global financial crisis (2007-2009), non-payment insurance proved its worth as credible credit risk mitigation by paying out over USD$2.5 billion[20] in claims to banks and commercial entities. Since then banks have increasingly turned to this product to support their lending, particularly as a risk distribution tool that enables banks to increase their lending activity. Certain banks' ability to obtain regulatory capital relief on the non-payment insurance product has also made it a more economically feasible, as well as effective, risk transfer that compares favourably to other CRM tools.

13. Insurance is provided on the basis of a partnership between insurers and banks, with full disclosure by the bank of the risk to be insured, supplemented by insurers' independent underwriting and prudential management, which is in turn reinforced by insurance regulation. Insurers use their own credit risk analysis, pricing models and information sources in addition to relying on the disclosure required by insurance law to ensure that their underwriting is informed and that they are accurately assessing and managing the risk of transactions presented for their acceptance. This external validation may provide additional comfort to regulators for standardised banks using credit insurance.

14. The IACPM survey showed that the majority of respondents using non-payment insurance deployed the substitution approach and therefore benefited from capital relief; whilst this is not the only motivation, the economic effect of using credit insurance has been cited by many bank as enabling them to lend where otherwise either (a) the risk would either be greater than the bank was willing to bear on its own or (b) the economics of the transaction would not be sufficient for the bank to provide the lending.

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[19] Source: Intl Association of Credit Portfolio Management

[20] LMA estimate based on discussions with Lloyd's underwriters

15. Preliminary data from a LMA/IUA sponsored survey of leading insurers and brokers of "transactional" or single-situation non-payment insurance show that every $1 of insurance supported on average $17 in bank facilities financing economic activity, including project finance, corporate lending and trade finance. The survey results were affirmed by preliminary data from the wholeturnover, or portfolio credit insurance market, which showed a similar multiplier effect.

16. The preliminary data also substantiated that non-payment insurance is a valuable tool supporting bank lending in emerging markets and for transactions where CDS and other CRM tools are not available: roughly two-thirds of the non-payment insurance registered on the survey was for exposures in emerging markets, with 26% of support provided in Africa, for example, where banks have little or no recourse to other private sector risk transfer tools.

Background on Non-Payment Insurance

17. The non-payment insurance product has developed, over the last 35+ years, into a sophisticated Credit Risk Mitigation (CRM) tool, forming an important part of risk transfer for banks. The product has evolved to align with the operational requirements of banks and is recognised in other regulatory jurisdictions as an effective CRM. The private transactional insurance market paid to regulated financial entities over US$2.6bn in claims between 2007-2017, with no claims unpaid (other than due to operational errors within the insureds' control). It supports a wide range of lending, with global exposures estimated at over US$300bn, more than 50% of which relate to non-OECD credit exposures – an area poorly served by other forms of CRM.

18. The non-payment insurance product typically provided by Lloyd's underwriters covers the insured lender against non-payment for any reason, usually arising from insolvency or bankruptcy but also due to simple default on a payment when due. Policies are triggered by an insured notifying a claim. The product is a policy of indemnity, providing a specified amount of cover tailored to a specified individual risk (whilst largely uniform in principles and substance) and paying a contractually agreed amount in the event of default.

19. The policies generally include a "waiting period"; this is essentially a "standstill" agreement, mirroring best practice by the banks to first constructively address payment/credit issues with borrowers/obligors. This period enables banks to use the time to enact a cure, remedy minor delays in repayment, resolve currency shortages, etc; allowing for the debt to be rescheduled if feasible. Simultaneously this period enables claims assessment and validation. Waiting periods are of negotiable length, typically 90-180 days.

Risk Transfer to Robust Sector used to Managing Risk:

20. Insurance is a well-capitalised, well-regulated sector capable of managing the credit risk it underwrites without threat to the stability of the financial sector.

21. Underwriters' risk assessment processes add underwriting rigour and challenge to banks' risk assessment.

22. Insurers run their own pricing and risk selection models as part of their underwriting, allowing them to "model a broad range of risks and account for correlations between

them, while incorporating expenses, forward-looking default probabilities, expected loss patterns and also compensate for capital costs."[21]

Insurers conduct their own review of the risk, including all documentation associated with the transaction, using their own information sources as well as the information provided to them by the insured bank.

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21 Swiss Re Ltd Economic Research & Consulting: "Trade Credit Insurance & Surety: taking stock after the financial crisis (October 2014)