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Docket No. R-1813
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RIN 3064-AF29

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Docket ID OCC-2023-0008
RIN 1557-AE78

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

Ladies and Gentlemen:

The International Underwriting Association (IUA), Lloyd's Market Association (LMA), and the International Credit Insurance and Surety Association (ICISA) appreciate the opportunity to provide comments to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, the Agencies) on the above-referenced Proposal.

We believe the Proposal as set forth in the Federal Register, Vol. 88, No. 179 published 18th September 2023 (the Federal Register text) affords an opportunity for meaningful recognition of credit insurance as an effective and efficient credit risk mitigant for US banks, who have long been disadvantaged vis-à-vis their European, Asian and British counterparts, whose regulators have consistently accepted credit insurance as unfunded credit protection[1].

Credit insurance is an important tool for banks and factoring companies alike. An estimated 80% to 90% of international trade relies on some form of trade credit protection such as credit insurance or alternative products such as letters of credit from banks, and factoring, the selling of account receivables at a discount.[2] Today factoring accounts for 11% of the GDP in the European Union, generating over EUR 2 trillion in volume according to FCI, the global representative body for factoring and financing of receivables. According to the Berne Union, the International Union of Credit and Investment Insurance, their members collectively provide payment risk capital worth USD 2.5 trillion each year, while ICISA estimates that trade credit insurance protected insured shipments valued at c. USD 7 trillion, or over 13% of all global trade

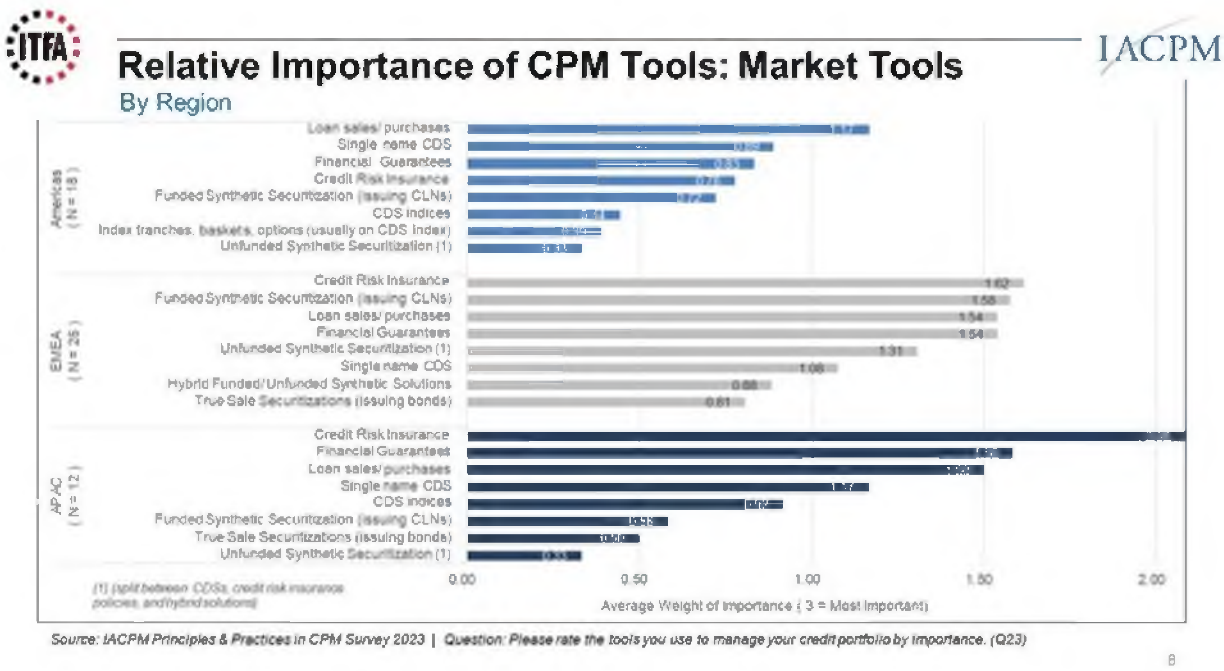
[1] BCBS (FAQ6, QIS3) and the EBA (Single Rulebook 2014_768 and Assessment of the Current CRM Framework (19 March 2018), paragraph 36, page 15); PRA Policy Statement 8/19

[2] Statistical Coverage of Trade Finance – Fintechs and Supply Chain Financing, C. L. van Wersch, IMF working papers, July 2019 and Issues note on macroprudential aspects of trade credit insurance, European Systemic Risk Board, August 2022.

in 2022. A survey of IUA and LMA members of their credit exposures to the UK economy in transactional non-payment insurance (as opposed to insured receivable portfolios) showed that the United States was ranked [as the top/in the top two] country(ies) of exposure. This is reinforced by data from a leading specialist broker[3] that the United States [rose from 20th in their ranking of countries of exposure in 2018 to the country of highest exposure in 2022. This support of lending into the US economy primarily benefits European, Asian and UK lenders rather that US banks.

Credit insurance has evolved to align with the operational requirements of credit risk mitigation (CRM). This allows a credit insurance policy to have the same economic substance as a guarantee under the capital rules 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.

Use of non-payment insurance has grown significantly since the Global Financial Crisis in 2007-2008, where the product proved its worth as a credit risk mitigant by paying out over US$2.5bn in claims. Insurers participating in the credit insurance market are well experienced, well-rated, and well-capitalized, as well as subject to strict regulation of their capital to ensure their capacity to honour policyholder claims. Banks, particularly in the European Union and Asia, have used credit insurance to support their lending where other credit risk mitigants are scarce or unavailable, in long-term partnership with stable, well-capitalised and experienced insurers.



Insurers as Eligible Guarantors

Under the current capital rule, a banking organization is permitted to recognize the credit-risk mitigation benefits of eligible guarantees and eligible credit derivatives by substituting the risk weight applicable to the eligible guarantor or protection provider for the risk weight applicable

[3] Source: BPL Global

to the hedged exposure. The Proposal would require all eligible guarantees to be issued by an eligible guarantor.

An Eligible Guarantor is currently defined as (inter alia): *An entity (other than a special purpose entity): (i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade; (ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and (iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).*

The Basel Committee on Bank Supervision and the European Banking Authority have confirmed that credit insurance can qualify as a guarantee under the current banking regulations (i.e., Basel II and Basel III), for example:

FAQ 6, QIS3 (2006): If a bank is using a credit risk mitigant, like insurance, that effectively functions like a guarantee, is it allowed to treat such risk mitigants as an ordinary guarantee? *"Yes, provided such products meet the operational requirements for guarantees".*

European Banking Authority Assessment of CRM Framework (2018): *"Credit insurance can qualify as a guarantee, but that depends on the circumstances of the individual case and on the intrinsic characteristics of the contract and its economic substance… subject to the fulfilment of all the relevant eligibility requirements set out in the CRR for the usage of guarantees"*

In addition to these responses, the European Banking Authority has also opined specifically on the role of credit insurance in its Opinion on the Treatment of Credit Insurance in the Prudential Framework (March 2020) as has the Prudential Regulatory Authority in its Policy Statement of March 2019 on Credit Risk Mitigation: Eligibility of Guarantees as Unfunded Credit Protection.

Credit insurance is provided worldwide by insurers with specialist experience in this line of business. Insurers involved in this sector are highly capitalised and robustly regulated under equivalent regimes around the world. The majority of capacity in the global credit insurance sector is located in the EU, United Kingdom, United States, Switzerland and other major insurance markets. Market participants operate proprietary models which utilize advanced systems to assess requests for credit limits and draw on large volumes of data from internal databases, as well as accessing information from third parties and public resources.

<u>Insurance as Credit Risk Mitigation (CRM)</u>

Unlike other CRM tools provided within the banking sector, the risk does not remain in the same part of the financial system. An important benefit on a systemic level of using credit insurance in this way is that, in addition to the credit insurers' own expertise in managing credit risk, the insurance sector is separately regulated, risks are mutualised via reinsurance, and the credit risk they bear is uncorrelated to their other risks.

Unlike credit default swaps, non-payment insurance policies are personal contracts that rely on good faith and therefore are unlikely to be used to "manufacture defaults" as has been reported in the Financial Times with respect to the controversial Hovnanian CDS trade[4].

Insurance policies have been drafted to meet the other elements necessary for an eligible guarantee, with the publication in 2022 by the Loan Market Association of a model policy wording for standardized banks demonstrating that a standard approach to insurance as eligible guarantee has developed.

The insurance policies typically provided to banks 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 lender notifying a claim. 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. 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.

<u>Insurance Claims Performance</u>

The insurance claim process is much more in the control of the bank than a CDS settlement:

- CDS settlement only occurs once consensus has been reached (1) that a credit event has been called and has occurred and (2) as to the value of the CDS, determined through an auction process, the framework of which has to be specifically established. Only once the auction has been completed does a settlement obligation exist, at which point payment is made relatively quickly via the clearing houses.
- In addition, a CDS default trigger is potentially different to that of the insurance product in a default process: a restructuring enabled via a consensual route may not result in CDS triggering until the terms of the restructuring have been agreed. This can literally be months or years after a non-payment insurance policy has already triggered and paid.
- Depending on the structure of the company, not all entities would be covered by a CDS; the bank's specific exposure may not be covered ("basis risk")[5].

In contrast, the claims process under an insurance policy operates differently:

- The policy is already tailored to the specific exposure that the bank is running and the bank has a direct relationship with the insurer, allowing communication and certainty during the claims process.
- A claim can be made if the workout has not been agreed by the time the cure/claim settlement period has elapsed (although, as noted above, the preferred course is normally that the policy is restructured to follow the workout for the reasons detailed above).

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[4] "Credit default swaps: fake it until you make it", Financial Times article dated 6th March 2019; "Wall Street cuts a deal to clean up $8.2tn credit defaults swaps trading", Financial Times article dated 6th March 2019; "Reform the Credit Default Swap Market to Rein in Abuses", Financial Times opinion dated 24th February 2019

[5] See for example, Financial Times article dated 25 July 2017: – "Credit default swaps: a $10tn market that leaves few happy

- The claims payment process is generally highly prescribed and includes a detailed timeframe and specifies the steps and information the bank must take or provide to successfully conclude the process.
- The insured's rights under the contractare protected by law and precedent.
- The policy allows for active engagement by the insured bank to ensure its claim is processed in an acceptable manner.

The impeccable track record of claims paid to regulated financial institutions is shown in the below table, compiled from an ongoing industry survey of leading insurance brokers and, since 2021, insurers writing non-broker-intermediated business:

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

Overall, 97.73% of the value of all claims were paid in full, constituting 98.35% of all claims made in total. Of the remaining "compromised" claims where insurers asserted a defense against full claim payment, which would arise when either the applicable loss was arguably not covered by the policy or where the insured failed to honor a condition of the policy, 44% of the amounts claimed were paid. As noted by the Berne Union, this represents a claims/payment ratio of 99.9% where banks comply with insurance policy conditions – a number that is higher than for AAA-rated bonds.[6]

This data from the insurance sector has been corroborated by data from banks in a preliminary report recently issued by Global Credit Data, which confirmed 100% recovery rate on insured loans where the cover was claimed on by the bank.[7]

<u>Request for consideration</u>

Noting that the Proposal requires all 'eligible guarantees' to now be provided by 'eligible guarantors' (with the current exception to this for Advanced Approach banks for single-risk exposures to no longer to apply), we ask that:

1. Be consistent with the Basel Accords by allowing credit exposures to insurance undertakings that are subject to prudential standards and a level of supervision equivalent to those applied to banks to be treated as being equivalent to credit exposures to banks for risk weighting purposes, along with a determination by the regulators that insurance undertakings are subject to such equivalent prudential standards and supervision. Such insurers to include financially strong non-US insurers from jurisdictions with robust regulatory regimes. This could be accomplished, for example, by referencing the National Association of Insurance Commissioners (NAIC) Quarterly Listing of Alien Insurers (the "Quarterly Listing"). Insurers that appear on the Quarterly Listing have been vetted by state insurance regulators and are subject to strict regulation both in their home jurisdiction and under the NAIC requirements. Such a revision would be consistent with the Basel Framework, which was developed in part

6 Berne Union - Berne Union data and research on the Export Credit and Political Risk Insurance Industry
7 Recovery Rates for Loans backed by Insurance Companies, October 2023

by US federal banking agencies as members of the Basel Committee on Banking Supervision; and

2. that the second prong of the definition of "eligible guarantor" be expanded (or clarified) to include issuers whose direct or indirect parent/holding companies have issued, and outstanding unsecured debt securities that are investment grade without credit enhancement.

Question 39: *For what reasons, if any, should the agencies consider applying a lower risk weight than 100 percent to exposures to companies that are not publicly traded but are companies that are 'highly regulated'? What, if any, criteria should the agencies consider to identify companies that are 'highly regulated'? Alternatively, what are the advantages and disadvantages of assigning lower risk weights to highly regulated entities?*

Request for consideration

The IUA, LMA, ICISA recommend that the agencies apply a lower risk weighting for bank exposures to insurance undertakings, given the privileged position of policyholders, where their exposure is as direct beneficiary of an insurance policy.

This should be the case where the exposure is to an insurer that does not issue publicly traded securities but whose parent company does, provided that the insurer benefits from a financial strength rating issued by an acceptable external ratings agency. This should also apply to exposures to Lloyd's syndicates, (which, although not a company, have similar characteristics and protections for policyholders, such as the benefit of the Lloyd's Central Fund). This would reflect regulatory and reserving requirements, prudential regulation and supervision that ensures preferential and effective access to capital for policyholder claims over almost all other creditors.

Preferential Treatment for Insurance Claims

Solvency II provides a general preferential treatment for insurance claims in case of winding-up proceedings of an insurer domiciled in the EU (art. 275, Solvency II). This comfortable position that banks as policyholders have vis-à-vis their position as creditors in respect of protection providers makes Credit Insurance a very advantageous and stable CRM.

According to 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 policyholders and beneficiaries that payments will be made as they fall due."6 This is to ensure the main objective of insurance and reinsurance regulation and supervision which is the adequate protection of policyholders and beneficiaries.

Whilst not directly secured with collateral, claims of banks as policyholders benefit from the preservation 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. These reserves for the benefit of policyholders should be recognised where the bank's exposure to the insurer is that of policyholder.

This is borne out by claims performance data specific to non-payment insurance, as noted above, and is acknowledged by rating agencies, as set forth below:

Improved Recoveries for Policy Holders

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 Ratings[8], the typical order of seniority of creditors at insurance 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

Rating agencies determine an Insurance Financial Strength (IFS) rating, which provides an indication of the insurer's ability to pay its insurance claim 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. As noted in the Fitch Recovery Rating scale replicated below[9], recovery rates for policyholders could be expected to be well above the recovery rate for corporate exposures.

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.

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

Insurers are Stable, Well-Capitalised Counterparties

The capital of US insurers is divided into two broad categories, respectively, minimum capital and surplus capital. Minimum capital must be maintained at all times, typically only in cash or US government bonds.[10] Surplus capital investments are also subject to quantitative and qualitative limitations, including restrictions between admitted investments (which may be counted towards an insurer's total capital) and non-admitted investments (which may not be

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

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

[10] For example, see New York Insurance Law Section 1402; see also 68 N.Y. Jur. 2d Insurance § 188. Other jurisdictions have similar restrictions; we are happy to provide details on equivalently regulated regimes if desired.

counted towards an insurer's total capital).[11] Both minimum capital and surplus capital are then subject to a risk-based capital ("RBC") assessment, which balances, among other things, the value of an insurer's assets, risk-based capital charges on their assets (with higher charges assigned to riskier investments), and policyholder obligations in the event of significant losses.[12] The formula for RBC assessments is devised by the National Association of Insurance Commissioners, a national body led by the respective insurance commissioners that sets out widely adopted model laws and regulations, and is rarely modified on the state level.[13] The results of the RBC assessment are compared to the insurer's total adjusted capital, and insurers which fail to maintain adequate RBC ratios are subject to additional regulatory scrutiny or, if necessary, a takeover of operations by the relevant state regulator.[14]

An insurer's investments are restricted by the distinction between permitted and non-admitted investments. Non-admitted assets are those which cannot contribute to the insurer's overall capital for RBC calculations or other regulatory purposes, as such, insurers typically limit their holdings of such assets. Permitted investments, which are included in calculating an insurer's surplus capital, range from debt securities to equities to holdings in tangible real estate, with safer and better secured investments attracting more favorable RBC treatment. Permitted investments are also subject to qualitative and quantitative limitations to prevent over-concentrations in investment strategies.[15] Insurers are strongly discouraged from participating in derivatives or other exotic investments. To illustrate, in New York, an insurer must file a special plan with its regulator to utilize derivatives, with any such exposure strictly limited to a small portion of the insurer's capital and subject even then to Board of Directors level supervision.[16] Insurers must maintain surplus capital that is significantly higher than their possible exposures to policyholders in order to maintain a high credit rating, which also discourages non-admitted investments.[17]

Every insurer must annually report all its investments to its regulators, including a detailed listing of all assets owned by the insurer.[18] Every three years, insurers must submit to a market conduct examination, which includes an audit of its finances along with an examination of its conduct towards policyholders (ranging from its marketing practices to claims payment rates).[19] Regulators reserve the right to demand a full financial accounting from insurers at any time, and upon any sign of financial distress, regulators may seize operational control of the insurer.[20] This process, known as "rehabilitation," typically involves regulators significantly restricting the insurer from taking on new risks while seeking to reinsure away as many obligations as possible, and reorienting investments in a conservative fashion, with the top priority of regulators being the protection of policyholders.[21]

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

[12] New York Insurance Law Section 1324.

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

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

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

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

[17] For example, see https://ratings.moodys.com/api/rmc-documents/391814.

[18] New York Insurance Law Section 307.

[19] New York Insurance Law Section 309(b).

[20] New York Insurance Law Section 309(a).

[21] New York Insurance Law Article 74.

An insurer may only issue dividends after demonstrating that it has sufficient surplus capital to honour all of its obligations, and even then, the amount of any such dividend is limited.[22] Insurers cannot participate in material affiliated transactions without regulatory approval.[23] The "control" of an insurer, which is presumed for any entity that holds 10% of the voting securities of an insurer, is closely monitored and subject to regulatory restriction.[24] Insurers that are domiciled in the United Kingdom, European Union, or Bermuda are subject to the Solvency II framework[25]. Lloyd's of London insurers are similarly subject to prudential regulation under the Prudential Regulation Authority as well as subject to the unique rules of Lloyd's. Ultimately, all Lloyd's policies are backed by the full strength of the Lloyd's market to ensure that all claims are paid when due.

[22] New York Insurance Law Section 4105.

[23] New York Insurance Law Section 1505.

[24] New York Insurance Law Section 1501.

[25] "The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policy holders and beneficiaries." (paragraph 16 of DIRECTIVE 2009/138/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2009). 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." (ibid, paragraph 62). The priority ranking of policyholders is explicitly protected in the Solvency II Directive (ibid (paragraph 127): "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 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."

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."

Question 41: *What criteria, if any, should the agencies consider to further differentiate corporate exposures according to their risk profiles and what implications would such criteria have for the risk weighting of these exposures and why?*

Request for consideration

The agencies should differentiate bank exposures to insurance corporates where they have a claim as a policyholder, given their lower risk profile and higher recovery rates as detailed below, as well as the significant benefits afforded to banks using credit insurance as unfunded credit protection.

As noted in the above discussion of insurers as Eligible Guarantors, Insurers have low default rates due to regulatory, legal and other prudential requirements that ensure they can meet their obligations to policyholders. This provides institutions using insurance as CRM with well-capitalised, stable counterparties. As insurance underwriters are also able to assess complex transactions and are prepared to provide CRM for institutions' lending in emerging markets, insurance is able to support lending where other CRM tools are not available.

Question 41 could equally be posed with respect to differentiating between credit risk mitigants, as the current capital rule on credit risk mitigants looks not only to the creditworthiness of the guarantor but the features of the underlying contract. In addition to meeting the requirements of an Eligible Guarantee under the current capital rule, credit insurance's distinguishing characteristics make it a superior form of credit risk mitigation.

Credit Insurance as Exposure Management rather than Credit Enhancement Guarantee

It is important to distinguish between credit enhancement guarantees (enhancing the credit of the borrower, issued by parent companies or by the sovereign owners of public-sector borrowers, and bank guarantees, or stand-by letters of credit issued by a borrower's bank) and exposure management guarantees (guarantees managing the lender's exposure including unfunded risk participations, credit insurance and credit derivatives issued by discrete protection providers). i. Credit enhancement guarantees are arranged by the borrower and issued by a guarantor with a close commercial relationship with the borrower and (i) are specifically issued as an inducement to lending; (ii) present a correlated credit risk between a borrower and a guarantor, and (iii) on payment by the guarantor, the borrower's default is cured and its obligation to the lender is discharged.

Exposure management guarantees are arranged and paid for by the lender and (i) are usually issued by a guarantor/insurer who regards the lender as its client, and who has no relationship with the borrower (indeed the guarantee is often silent to them which is invariably the case with credit insurance); (ii) the credit risk of the borrower and guarantor are not correlated; and (iii) on payment by the guarantor, the borrower's default is not cured and its obligations to the lender remain unaltered.

In accordance with the 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.

One of the cornerstone principles for insurers providing non-payment insurance is that the bank retain a meaningful share of the risk that they are covering for the bank: this focus on products that have meaningful risk-sharing features is viewed favourably by rating agencies (e.g., S&P Insurers: Rating Methodology dated 7 May 2013, p. 9).

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.

Insurance Sector

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. This prudential management 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.

A study conducted by KPMG on behalf of the IUA, LMA, ICISA and ITFA, dated 25 February 2020, evidenced the seniority of policyholders in a winding-up of insurance undertakings (as per Article 275 of Solvency II). The study provided empirical evidence of this privileged position of policyholders, tracking since 1990 the size and number of insurance insolvencies in 7 European markets comprising 77% of the EU insurance market (including the UK). The two key findings were that since Solvency I/II was introduced in 2004:

- There has been a marked decrease in both the number and size of insurance undertaking insolvencies; and
- All policyholder claims were paid in full in every case where KPMG were able to obtain details of distributions and the insolvency was complete.

The KPMG study results with regard to the reduction in insolvencies were matched in AM Best's Impairment Report dated November 2023 which updates long-term impairment rates on US-domiciled insurance companies rated by AM Best.[26] The AM Best report also highlighted the stability of ratings: over 87.12% of A-rated companies (the minimum rating of insurers used by banks for credit insurance coverage) were still rated A- a year later.[27] Indeed, the recent upgrade of Lloyd's of London to AA- reflects the robust supervision of the Lloyd's Corporation. [!]

Recent claims data show exemplary performance of credit insurance as CRM: Over US$3.6bn of credit insurance claims were paid by insurers to regulated financial institutions between 2007 and 2020 (inclusive) across 563 claims, with US$2.5 billion paid to support these institutions

[26] AM Best Impairment Report dated November 3, 2023

[27] Ibid

through the global financial crisis. A further US$1.5 bn of claims were paid across the combined 2021 and 2022 years. 100% of the claims made by regulated financial entities over the last five years were paid in full. To put these figures another way, the LGD of the portion of credit-insured loans protected by credit insurance is effectively close to 0%.

Insurance underwriters' risk assessment processes add clear rigour and challenge to a banks' risk assessment. Insurers also run their own pricing and risk selection models as part of underwriting. This allows 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 compensates for capital costs."[28]

Insurers also conduct their own independent review of risks, including all documentation associated with the transaction, using their own information sources as well as the information provided to them by the insured bank. Furthermore, the non-payment product offered normally requires the insured entity to retain a portion of the risk for its own account, ensuring an alignment of risk taking and avoiding the moral hazard of the insured bank managing the transaction without holding any risk itself. The risk retention requirement is a fundament of the underwriting of this product.

Insurance as a highly regulated industry lessens systemic risk

The fact that the bank's exposure to an insurer is not corollated with the bank's exposure to the underlying obligor[29] substantially lowers any systemic risk, as do the unique characteristics of insurers:

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

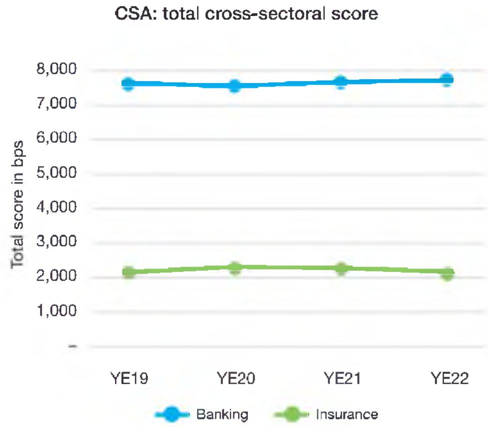
As insurance is an accrual-based credit risk mitigant, that is a direct match to the asset being covered, it assists banks with effective credit risk transfer and reduces balance sheet volatility. This serves to strengthen the banking sector during periods of increased volatility and downturns in the credit cycle through transfer of risk into the insurance and reinsurance communities.

As noted by the PRA in its paper on insurance supervision[30], "Insurers do not, however, present the same risks for financial stability as banks (which are often the counterparties for credit derivatives). For instance, they do not typically undertake maturity transformation and so are less vulnerable to sudden losses of confidence, 'runs', and contagion than banks."

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[31]. 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.

[28] Swiss Re Ltd Economic Research & Consulting: "*Trade Credit Insurance & Surety: taking stock after the financial crisis*" (October 2014)
29 As required by paragraph 123 of Basel III: Finalising post-crisis reforms, December 2017
[30] The Prudential Regulation Authority's approach to insurance supervision October 2018, p.5 (https://www.bankofengland.co.uk/prudential-regulation/supervision)
[31]Swiss Re Sigma research; JLT

The 2023 Global Insurance Market Report by the International Association of Insurance Supervisors, using the cross-sectoral methodology developed by the joint IAIS-BCBS Task Force on Banks and Insurers in 2019, confirmed that the total cross-sectoral scores for banks are still significantly higher than for insurers.[32]



This report also noted key measures by insurance supervisors to manage banking sector interconnectedness, including regular monitoring of exposures and, in some cases, setting investment limits on financial sector or counterparty exposures to ensure diversification. In addition, requirements have been set out for funding and liquidity contingency planning to ensure that liquidity sources remain robust and available even during banking sector downturns, and to ensure greater access to capital markets for insurers to enhance fundraising flexibility.[33]

Role of Reinsurance in Mutualising Risk[34]

Sharing Risk

Reinsurance is "insurance for insurance companies", in other words a "second level of insurance." It was not long before the risk of suffering dangerously high losses as a consequence of payments for major claims prompted a need for "reinsurance" among so-called "primary" insurers. The oldest known reinsurance contracts or "treaties" date back to the fourteenth century. The international reinsurance sector has since developed into a highly specialised financial service. Large individual risks and natural catastrophe risks are spread across the entire globe so as to minimise the potential loss for a single company. Reinsurers, for their part, purchase coverage for assumed major risks (retrocessions).

Economic Role of Reinsurance

Catastrophic events - whether due to natural causes or man-made - are inevitable. The worldwide reinsurance industry improves the resilience of its clients in the face of large losses by compensating those affected in the form of payments financed in advance by the entire community of insureds through their premiums. It facilitates recovery after losses have been incurred and helps to secure the livelihood of individuals and businesses. It also safeguards continued work on large-scale projects and the development of new technologies, thereby making a sustained contribution to economic growth. The industry's vast wealth of experience

[32] GIMAR - International Association of Insurance Supervisors (iaisweb.org)

[33] Ibid

[34] Source: Hannover Re

in risk assessment and risk management similarly assists in identifying new and emerging risks and developing appropriate risk transfer solutions. What is more, reinsurers are prudent investors with a long-term horizon who have a stabilising effect on the capital market.

Risk assessment
Property & casualty reinsurance – the protection of material assets – and life & health reinsurance – the protection of natural persons – are the main areas of business covered by the worldwide reinsurance industry. Material assets, just like people, are exposed to wide-ranging and complex risks. The geographical spread of such risks varies, they can differ in form or structure, and they are shaped by highly diverse natural, social and legal framework conditions. All known factors are included in computational models that calculate probabilities of occurrence for potential loss scenarios on the basis of large volumes of data. Prices for reinsurance protection are determined in this way. The better the models and the data basis, the more precisely the prices can be calculated – which benefits both contracting parties. To this end, the models are subject to continuous review and recalibration.

Highly specialised products and services
In addition to the traditional business of covering risks in property & casualty and life & health reinsurance, support is provided to new insurance companies during the cost-intensive start-up phase. The goal pursued by insurance companies (especially those listed on the stock exchange) of ensuring balance sheet continuity is achieved, in part, by means of reinsurance. A further task of reinsurers is to advise insurers in underwriting, pricing and the development of new insurance products, among other things

Reinsurance specialists
Since treaty terms and conditions are negotiated in each individual case, reinsurers have built up a very high level of expertise in risk-appropriate underwriting. To this end they need experts from highly diverse fields. The reinsurance industry today employs not only insurance specialists, but also mathematicians, meteorologists, medical experts, engineers, computer scientists and other expertise to assist in analysis of the risks taken by reinsurers.

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