16 December 2016

Andrea Enria
European Banking Authority
Tower 42 (Level 18)
25 Old Broad Street
London, EC2N 1HQ

Dear Mr Enria,

Unfunded credit protection under the Capital Requirements Regulation: qualifying agreements

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

Regulation (EU) No 575/2013 of June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**CRR**") sets out a credit risk mitigation ("**CRM**") framework whereby the capital adequacy requirement which a credit exposure attracts can be reduced by effective protection in the form of a third party agreement to cover losses. In this regard, the CRR framework recognises "guarantees" and "credit derivatives" as eligible unfunded CRM.

The express recognition of these two financial products (in Articles 203 and 204(1), respectively) raises a question as to whether the form of a financial agreement—or, to put it another way, the legal "characterisation" of the agreement, which may differ as between Member States' legal systems—is a key element in determining whether such agreement will qualify as CRM. If form is determinative, CRM arrangements might be susceptible to certain legal risks; for instance, to the risk that the legal form of the parties' agreement is recharacterised by a court, with the consequence that the agreement itself is reclassified. If form is not determinative, then products not commonly thought of as guarantees or derivatives—such as insurance products—may nevertheless qualify as CRM on the grounds that they provide protection which is, in substance, identical to that afforded by guarantees and/or credit derivatives.

The FMLC takes the view that the correct interpretative approach to the provisions of the CRR on CRM is a substantive or functional one, i.e. that the legal form of the agreement designed to provide protection is not necessarily determinative as to whether it will or will not qualify as CRM.

In this regard and with respect to guarantees, in particular, the European Banking Authority ("**EBA**") would appear to share the Committee's view. In the context of an answer to a question posed in the Single Rulebook Q&A as to whether credit insurance may be recognised as CRM, the EBA explains that

> [in] general, it is not possible to say whether credit insurance can be used as CRM technique; this depends on the circumstances of the individual case. *A credit insurance might qualify as guarantee...*[1]

[1] EBA Single Rulebook Q&A Question ID:201_768 (emphasis added), available at: http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_768

T +44 (0)20 7601 4286
contact@fmlc.org

8 Lothbury
London
EC2R 7HH
www.fmlc.org

A parallel view can be found in the Basel Committee on Banking Supervision's ("**BCBS**") answer. In the context of the answer posed in the Quantitative Impact Study 3 (QIS3) FAQ whether insurance effectively functions as a guarantee, the BCBS explains that:

> Yes, provided that such a product meets the operational requirements for guarantees laid down in paragraph 154 to 165 of the technical guidance...[2]

These views expressed by the EBA and BCBS, respectively, are helpful in that they evidence, in principle, the primacy of legal substance over legal form for the purposes of applying certain provisions of the CRM framework and accordingly, strongly support the FMLC's view that the correct interpretative approach to the provisions of the CRR on CRM is a substantive or functional one. The Committee would be grateful for your confirmation that its view is correct.

The eligibility of insurance as CRM

As regards the circumstances under which credit insurance can be used as a CRM technique, the CRR lays down further specific eligibility requirements in Articles 213, 215 and 216 and it is presumably these that the EBA has in mind when it refers to "the circumstances of the individual case", which will determine whether or not credit insurance will qualify as a guarantee. Article 213(1) (***Requirements common to guarantees and credit derivatives***) of the CRR provides as follows:

> Subject to Article 214(1), credit protection deriving from a guarantee or credit derivative shall qualify as eligible unfunded credit protection where all the following conditions are met:
>
> (a) the credit protection is direct;
>
> (b) the extent of the credit protection is clearly defined and incontrovertible;
>
> (c) the credit protection contract does not contain any clause, the fulfilment of which is outside the direct control of the lender, that:
>
> i) would allow the protection provider to cancel the protection unilaterally;
>
> ii) would increase the effective cost of protection as a result of a deterioration in the credit quality of the protected exposure;
>
> iii) could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original obligor fails to make any payments due, or when the leasing contract has expired for the purposes of recognising guaranteed residual value under Articles 134(7) and 166(4);
>
> iv) could allow the maturity of the credit protection to be reduced by the protection provider;
>
> (d) the credit protection contract is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement.

In many cases, the question whether credit insurance will be eligible as CRM will, in the view of the FMLC, be broadly reducible to the question whether the Non-Payment Insurance Policies ("**NPIPs**") generally available to market participants intending to

---

[2] BCBS QIS3 FAQ: E. Credit Risk Mitigation, question 6, available at: http://www.bis.org/bcbs/qis/qis3qa_e.htm

purchase unfunded credit protection meet the relevant criteria set out in sub-paragraph (c) of Article 213(1) above.[3] In this regard, the FMLC has been given to understand that

- NPIPs tend to permit cancellation by the Insurer only in the event of non-payment of premia and that these are the only circumstances, therefore, in which the Insurer could be said to be entitled to cancel the protection "unilaterally".

- It is now increasingly common for such cancellation rights (i.e. rights triggered by the non-payment of premia) to be exercisable only after the operation of clearly-defined notice and/or cure provisions which are designed to ensure that cancellation rights cannot arise in circumstances beyond the control of the Policyholder.

- NPIPs typically do not provide for an increase in the effective cost of protection before the maturity of the policy as a result of a deterioration of the credit quality of the protected exposure.

- Liability exclusions in NPIPs normally take the form of clauses which restrict the risks which the Insurer is willing to cover. They do not, as a rule, stipulate that payment is dependent on action or inaction by the Policyholder. Therefore, they do not—again as a general rule—prevent timely pay outs.

- NPIPs typically do not allow the maturity of the policy to be unilaterally reduced by the Insurer.

The FMLC would be grateful for an indication that these features, commonly found in NPIPs available in the market today, collectively support a conclusion that a credit insurance policy will be eligible as CRM.[4] The Committee would also be grateful for further guidance as to the meaning of "timely manner" in Article 213(1)(c)(iii) of the CRR and, in particular, for confirmation that this means within a period which is agreed and reasonable in all the circumstances of the credit protection contract, the covered risk and any associated arrangements designed to mitigate credit exposure.

I and Members of the Committee[5] would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins

Joanna Perkins

FMLC Chief Executive[6]

Copied to: Lars Overby, CREMOP Unit, EBA

---

3 Additional requirements for guarantees are set out in Article 215 and additional requirements for credit derivatives are set out in Article 216. An individual NPIP must satisfy the requirements of either Article 215 or Article 216 in addition to those provided for in Article 213.

4 That is, subject to the further question—likely to be heavily fact-dependent—whether the policy satisfies the requirements of Article 215 (*Additional requirements for guarantees*).

5 The Bank of England and the Prudential Regulation Authority are closely concerned with the issues raised in this letter. Accordingly, Sinead Meany took no part in the preparation of this letter.

6 The FMLC is grateful to the members of the Insurance as CRM Working Group, chaired by Dr Robert Purves (3 Verulam Buildings), for their contributions to this letter.