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Implementation of Basel 3.1: Unintended consequences for credit insurance?

The Basel regulations have been continuously refined and updated to address new risks and challenges in the global banking sector, with the overall aim of promoting financial stability and preventing future crises.

Basel. A historically significant city, sitting at the confluence of the Rhine and Birs rivers, a dynamic and ever-evolving destination, serving as the meeting point of three countries—Switzerland, France, and Germany.

In 1974, following the collapse of the German Bankhaus Herstatt, a committee, known as the Basel Committee on Banking Supervision (BCBS) was founded.

Headquartered at the Bank for International Settlements (BIS), in Basel, BCBS created a set of regulations, aiming to enhance the stability and risk management practices of banks worldwide.

On Friday 29th, March 2023, I crossed one of the four remaining river ferries, Vogel Gryff, across the Rhine. Unbeknownst to me, my vacation coincided with the date for feedback on the Prudential Regulation Authorities' (PRAs) latest iteration of the Basel rules (aka Basel 3.1).

With that in mind, I had the chance to catch up with the International Trade & Forfaiting Association's Silja Calac, insurance committee board member, discussing what Basel 3.1 means for trade credit insurance.

TFG also reviewed ITFA's response to the PRA Consultation Paper 16/22 on the implementation of Basel 3.1 standards in the UK; a concerted market response from major associations in the credit insurance and bank market.

Over the years... a brief history of Basel I – Basel III

The Basel regulations have evolved through three major accords:

- Basel I: Introduced in 1988, the first accord focused on credit risk by setting minimum capital requirements for banks. It established the concept of risk-weighted assets, which required banks to maintain a certain level of capital based on the risk profile of their assets. The Basel I minimum capital requirement for banks was 8% of risk-weighted assets. This means that banks were required to hold capital equivalent to at least 8% of their risk-weighted assets (RWA) to cover potential losses.
- Basel II: Published in 2004 and implemented between 2005 and 2008, this accord expanded the scope of risk management by incorporating operational risk and refining the treatment of credit risk. It introduced a three-pillar structure, which we won't cover in detail in this article. Basel II introduced a more risk-sensitive approach to capital requirements for banks. The minimum capital requirement under Basel II consisted of two components: a minimum capital requirement (8% of RWA) and a capital conservation buffer (2.5% of RWA), bringing the total minimum requirement to 10.5%.
- Basel III: Developed in response to the 2007-2009 global financial crisis, Basel III was introduced to address the shortcomings of the previous accords. It introduced new capital and liquidity standards, such as the Common Equity Tier 1 (CET1) capital ratio, the Capital Conservation Buffer, and the Liquidity Coverage Ratio (LCR). Basel III was agreed upon in 2010-2011, with phased implementation set between 2013 and 2019, and some parts further extended until 2022-2023.

The Basel regulations have been continuously refined and updated to address new risks and challenges in the global banking sector, with the overall aim of promoting financial stability and preventing future crises.

Basel 3.1 (UK perspective)

CP16/22 was a consultation paper published by the Prudential Regulation Authority (PRA) of the Bank of England in November 2022. The paper set out the PRA's proposed approach to implementing the Basel 3.1 standards in the UK.

The PRA's proposed approach to implementing the Basel 3.1 standards in the UK includes adopting the new standards in full, with some modifications to reflect the specificities of the UK banking system. The PRA also proposes to introduce new reporting requirements for banks to ensure that the implementation of the new standards is monitored effectively.

It's worth noting that the PRA is part of the Bank of England, responsible for the prudential regulation and supervision of UK banks, insurers and investment firms. London retains its status as one of the world's leading financial centres, and its insurance market, particularly the Lloyd's of London marketplace, is a key component of the industry.

Since the UK's departure from the EU, the PRA has been working to adapt and refine the UK's regulatory framework for the insurance sector. It is responsible for ensuring that regulations remain effective and relevant while also allowing London's insurance market to remain competitive on the global stage.

The consultation period for CP16/22 ran until 31 March 2023.

The Basel 3.1 standards include several key changes to the Basel III regulatory framework. Some of the key changes are:

1. **Output floor:** The introduction of an output floor that limits the extent to which banks can use internal models to calculate their risk-weighted assets. The output floor is set at 72.5% of the standardised approach, which means that banks must use the standardised approach to calculate at least 72.5% of their risk-weighted assets.
2. **Credit risk:** Changes to the credit risk framework, including the introduction of a new methodology for calculating risk-weighted assets for certain asset classes such as trade finance and asset finance.
3. **Operational risk:** Changes to the operational risk framework, including the introduction of a new standardised approach for calculating operational risk capital.
4. **Leverage ratio:** Changes to the leverage ratio framework, including the introduction of a new buffer for global systemically important banks (G-SIBs) and the removal of some exemptions.
5. **Market risk:** Changes to the market risk framework, including the introduction of a new standardised approach for calculating market risk capital for banks that do not have an internal models approach.

Overall, the Basel 3.1 standards aim to enhance the resilience of the banking system and reduce the risk of financial crises by introducing more robust and consistent capital and risk management standards.

Basel, solvency II and trade credit insurance – managing systemic risk

Basel has an overriding goal of promoting economic stability and ensuring effective management of systemic risk amongst banks. Banks should have sound capital bases and regulators, such as the PRA, are encouraged to take actions to prevent a mass withdrawal of assets which characterises "runs" on banks.

Over the past decade, banks have become active users of credit insurance in order to provide unfunded credit protection (UFCP). Credit risk insurance is not a major component of the overall activity of multi-line insurers, it represents just 2% of overall gross written premium. This sector is regulated by another set of regulatory frameworks, the EU's Solvency II regime.

Basel and Solvency II are two separate regulatory frameworks that apply to different sectors of the financial industry.

Basel regulations apply to the banking sector, while Solvency II regulations apply to the insurance sector.

Under Solvency II, insurance companies are required to hold sufficient capital to cover the risks they take on. The amount of capital that an insurance company must hold is calculated based on a risk-sensitive approach similar to that used under Basel II for banks. Therefore, Solvency II has some similarities to Basel II in terms of its approach to capital requirements.

Though credit insurance has been utilised by banks for many years, there has been a significant increase in the utilisation of credit insurance by banks. Credit insurance has been recognised as the second most important Credit Risk Mitigation (CRM), according to IACPM/ITFA's 2020 survey.

That same study also evidenced that on average each $1 of credit insurance policy limit facilitated $2.55 of lending providing valuable flows of funds to the real economy.

ITFA's response to the PRA's implementation of the Basel 3.1 standards

ITFA welcomed the PRA's recognition of credit insurance as unfunded credit protection and how aspects of its specific characteristics should be interpreted within the eligibility requirements for guarantees. One article of the draft CRR presently being negotiated will allow Europe to explicitly recognise credit insurance within the regulation and consider the appropriate treatment thereof.

1. The importance of trade credit insurance to the UK and to global trade

The ITFA submission said: "ITFA would not wish for the UK to lose the competitive advantage that it had established, particularly in respect of a product in which the UK is so dominant and which brings benefits to the UK economy."

"Though it was impossible to predict the expanded role that credit insurance would be playing in risk mitigation for banks by the time state regulators have to transpose Basel 3.1 into local regulation, ITFA believe this lack of foresight should not inadvertently penalise this critical risk mitigation tool at a time when reducing systemic risk and economic volatility is more important than ever."

2. Internal Ratings-Based approach for calculating capital requirements

In Basel 3.1, the PRA is proposing to restrict the use of the Internal Ratings-Based (IRB) approach for calculating banks' capital requirements. This proposal may have an impact on banks' use of credit insurance.

ITFA supports the use of a specific IRB approach for credit insurance providers. However, the proposed restrictions may prevent credit insurance policyholders from reflecting the true risk of non-payment in their capital requirements. This could lead to increased costs for banks and reduce their use of credit insurance, which could result in higher risk and financial instability.

Calac said: "Banks would then abstain from seeking insurance cover for 'better risks' – this would not only lead to a reduction of credit capacity available for higher rated corporates, but it would also mean that insurers would only be offered the lower end of creditworthiness (BBB- rating). However, this is contrary to the requirement of portfolio diversification, which is important for an insurer when looking at a risk class. This could result in several insurers withdrawing from the credit insurance market."

3. Loss-given default estimations

The PRA is proposing changes to how banks estimate the loss-given default (LGD) of credit insurance policies.

ITFA suggests that the LGD for insurers who provide credit insurance should be lower than that for unsecured creditors.

The ITFA submission said: "We strongly believe that this should warrant a lower LGD for Solvency II or equivalent insurers when used as a credit risk mitigant since banks' exposure, in this case, is as policyholders and not unsecured creditors."

This is because insurance policyholders have precedence over other claims in the event of an insurance company's default. This priority is recognized by Solvency II, a regulatory framework that applies to insurance companies.

ITFA proposes that the super-seniority of credit insurance claims to insurance undertakings should be reflected in the FIRB approach and Standardised Approach by introducing respective LGDs and SA-CR risk weights. For SA-CR, the existing treatment of pledged life insurance policies is the recommended starting point for calibration, providing risk weights from 20% depending on the credit quality of the insurance undertaking.

As for FIRB, ITFA recommends proxying the LGD by comparing it to an exposure fully secured by receivables with a blended LGD of 20-30%. ITFA also suggests that banks should consider both the direct recourse and the recourse from the credit insurance policy when calculating LGDs for covered loans. This approach is more risk-sensitive and consistent with guidelines from the Basel Committee on Banking Supervision.

Overall, ITFA betlieves that the proposed changes to LGD estimation for credit insurance policies could lead to increased costs for banks and reduce their use of credit insurance, which could result in higher risk and financial instability.

4. Recognising unfunded credit protection

ITFA welcomes the PRA's proposal to affirm credit insurance as credit mitigation, provided it meets the Capital Requirements Regulation (CRR) definition to be classified as unfunded credit protection.

However, ITFA believes that insurance companies should have their own recognition as an explicit class of eligible protection providers, and credit insurance

should have its own eligibility requirements and treatment as an identified class of unfunded guarantee.

This would avoid the complexities associated with incorporating it within existing but inadequate definitions and allow for the corresponding appropriate treatments.

The ITFA submission said: "ITFA believes introducing specific recognition and treatment of credit insurance and credit insurers in the PRA's adoption of Basel 3.1 would not be inconsistent with the framework, nor a deviation from the standards as it would reflect a more risk-sensitive approach. This would be entirely consistent with the PRA's primary goal of reducing systemic risk by avoiding unmerited and, we believe, unintended penalizing of credit insurance."

Calac said: "The BCBS did not consider credit insurance when forming the 3.1 recommendations, given the undisclosed private nature of credit insurance. The role of insurance cover in the bank market may well be a small omission; however, this will have unintended consequences and wider implications on the real economy."

ITFA suggests that the LGD for unsecured underlying exposures should be 20% and 10-15% for secured and insured exposures. Calac said: "The European regulator has already acknowledged the necessity to act on this omission by including the possibility for the EBA to act on this topic through the enabling clause of Article 506 of the CRR draft."

ITFA requests that the PRA provide a period during which banks could phase in the implementation of any changes to the treatment of credit insurance to ensure a smooth transition rather than any sudden change in treatment that could add volatility to what has been a stabilising risk mitigation tool.

Calac said: "ITFA appeals to its members and other players in the market to take this seriously, and in its own talks to regulators, to mention the importance of credit insurance to the real economy, and the unintended consequences of blanket wide policy on trade."

The full ITFA submission to the PRA Consultation Paper 16/22 on the implementation of Basel 3.1 standards in the UK can be found here.


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