Feature

KEY POINTS

- The application of non-payment insurance (NPI) has been extended to provide cover on complex, specialist structured financial risks.
- NPI may qualify as a form of credit risk mitigation (a financial guarantee) under the Capital Requirements Regulation provided that the relevant conditions thereunder are satisfied.
- Whilst NPI policies may not be as readily available as Credit Default Swaps (CDS), they may provide equally tailored coverage and coverage in circumstances where there is no readily available liquid CDS market.

Authors Ingrid York, Richard Blackburn and Luke O'Leary

Non-payment insurance: a regulatory capital solution

Non-payment insurance (NPI) policies are contracts issued by insurance companies to institutions seeking a form of credit risk mitigation for their third-party liabilities (such as obligations under a credit facility). These policies constitute unfunded, uncollateralised credit protection that provide full recourse to the insurer for the insured sum.

In this article, we discuss in particular:

- how NPI may qualify as a form of financial guarantee under the Capital Requirements Regulation 575/2013 (CRR); and
- how NPI compares to other forms of unfunded credit protection such as credit default swaps (CDS).

THE REGULATORY BACKGROUND

Following the recent global financial crisis, during which many financial institutions were found to be holding insufficient capital against their liabilities, regulators and lawmakers across the world sought an appropriate solution to avoid the reoccurrence of what was perceived to be a taxpayer bail-out of various entities. The introduction of the Basel III regulatory framework due to come fully into effect by January 2019 (as implemented in the European Union by way of the amended CRR and the CRD IV Directive 2013/36/EU and known collectively with the CRR as "CRD IV"), and the proposed amendments under Basel IV, have been well-documented and sought to address the problems which this crisis raised.

Regulations have had some of the desired impact of curbing large risk-taking trades (such as re-securitisations which now face substantial risk weights) by financial institutions; one of the consequences however, has been to significantly raise risk weights for certain types of assets (depending on a number of factors, including the type of risk weight model which the relevant institution chooses to use). Risk weights have increased for lower risk investments (such as highly rated government bonds and corporate loans) and institutions will need to hold more capital against investments ranging from simple loans to corporates to more complex capital market instruments, such as securitisations, as explained below.

NPI: A SOLUTION?

NPI is a term covering a range of insurance policies sold by regulated insurance companies which protects against the default of an obligor in respect of an obligation or portfolio of obligations. Depending upon the nature of the insurance and the scope of defaults covered, it can either provide insurance for loss suffered on a single obligation or, similar to synthetic securitisations, tranched protection on a portfolio of obligations.

NPI had been used for credit risk mitigation on project finance transactions for some time, however, its use was first developed in the context of trade finance where it was used to support international trade by offering protection against default on trade receivables and political risk insurance. While there continues to be a large and thriving market in trade credit insurance, the suite of products falling under the NPI umbrella has grown considerably with more specialist and industry specific forms of cover becoming available. In more recent years, we understand the application of NPI has been extended to provide cover (and capital relief) on more complex, specialist structured financial risks such as non-core legacy exposures still held by banks, eg unrated liquidity facilities and swaps provided to pre-crisis securitisations.

The ratings of such exposures under Basel III are usually driven by the rating of the most senior tranche of notes outstanding and, because the Class A and B notes in a legacy deal are, in many cases, redeemed in full, the outstanding class of notes is one of the lower rated tranches. Consequently, liquidity facilities, for example, are treated as below investment-grade and are given a corresponding capital charge (for example, Class C notes in a three-year securitisation carry a 1250% risk weight). Whilst NPI policies written in relation to these risks were single exposure policies, we understand that the market has now expanded and such policies are now written effectively to act as tranche protection on portfolios of investments.

REGULATORY AND UNDERWRITING ISSUES WITH NPI

One of the biggest challenges facing market participants in relation to NPI products for capital relief has been writing a policy which qualifies as insurance but is also still compliant with the unfunded credit protection requirements as set out in Arts 194, 201-202, 213, 215 and 247, as applicable, of the CRR, in order that it be recognised as a valid credit risk mitigant thereunder so as to reduce capital requirements on risk-weighted assets.

The requirements

Under the CRR requirements, in order to qualify as eligible credit protection deriving from a guarantee or credit derivative, the product must comply with the following:

- the credit protection must be direct;
- the extent of the credit protection must be clearly defined and incontrovertible;
- the credit protection contract must not contain any clause whose fulfilment is outside the direct control of the insured, that:
  - would allow the protection provider to cancel the contract unilaterally;
  - would increase the cost of protection if the credit quality of the protected exposure deteriorated;
  - could prevent the protection provider from being obliged to pay out in a timely manner on a payment default of the original obligor;
  - could allow the maturity of the credit protection to be reduced by the protection provider; and
- the credit protection contract must be legally effective and enforceable in all jurisdictions which are relevant to the credit agreement.

(Art 213(1), CRR)

The Financial Markets Law Committee (FMLC) wrote to the European Banking Authority (EBA) on 16 December 2016[1] noting that the EBA had previously indicated in the Single Rulebook Q&A that credit insurance might constitute a financial guarantee for the purposes of the CRR[2] and requesting clarification from the EBA on whether NPI policies would satisfy the above requirements, having regard in particular to typical features of NPI policies which it noted as follows:

- "[NPIs] 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 (ie 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.
- [NPIs] 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 [NPIs] 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.
- [NPIs] typically do not allow the maturity of the policy to be unilaterally reduced by the Insurer."

Whilst the EBA has not published a specific response to the FMLC's letter, a recent consultation paper by the Prudential Regulation Authority (PRA) (Consultation Paper CP6/18, Credit risk mitigation: Eligibility of guarantees as unfunded credit protection, February 2018 (the Consultation Paper)) aims to provide some guidance on the criteria that a guarantee must meet in order to be eligible for credit risk mitigation under the CRR.

In respect of the requirement that the guarantee must be legally effective and enforceable in all relevant jurisdictions, the Consultation Paper states that this will "require the firm to satisfy itself that the guarantee is enforceable under its governing law, and in the jurisdiction where the guarantor is incorporated, but could well include other jurisdictions where enforcement action may be taken".[3] In practice this comfort will be provided by a legal opinion from relevant counsel, which considers enforceability for eligible unfunded credit protection.

The Consultation Paper also discusses that to be "incontrovertible" means that "the wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, and challenge or otherwise seek to be released from, or reduce, their liability".[4]

Whilst the Consultation Paper clearly does not represent binding law, it does provide some insight into how the PRA views certain of the CRR requirements. The consultation will conclude on 16 May 2018.

It should also be noted that in addition to the above requirements, where protection is sold on a tranched basis, the insured or Protection Buyer would need to comply with the provisions of the CRR (under Arts 242 to 270) relating to securitisation. These provisions provide that the originator of a securitisation may reduce its risk-weighted exposure provided that a significant transfer of risk (SRT) of the securitised exposures to third parties is achieved. These provisions may be subject to change following the conclusion of the European Banking Authority's consultation on SRT which is ongoing.[5]

Eligible protection provider

The provider of the product must also be an eligible protection provider under the Chapter 4 requirements of the CRR (Art 247(2)), summarised below. The requirements differ depending on whether the protection being provided is funded or unfunded.

In the case of unfunded credit protection, such as NPI, a protection provider shall only be eligible where it is included in the lists in Arts 201 and 202 of the CRR, as applicable. These include central governments and central banks, regional governments and local authorities, certain international organisations, central counterparties and investment firms (Art 201).

Also, included in the list are institutions, insurance and reinsurance undertakings and export credit agencies, provided that the relevant entity meets certain conditions, summarised as follows:

- it has sufficient expertise in providing unfunded credit protection;

- it is regulated in a manner equivalent to the rules laid down in the CRR or had the appropriate credit assessment at the time the credit protection was provided;
- it had, at the time the credit protection was provided, or for any period of time thereafter, an internal rating with a probability of default equivalent to or lower than the appropriate threshold; and
- it has an internal rating with a probability of default equivalent to or lower than the appropriate threshold. (Art 202, CRR)

A guarantee under the CRR

In turn, a guarantee under the CRR, which is permitted as a form of unfunded credit protection (Art 203), can only qualify as eligible unfunded credit protection where, in addition to all conditions in Art 213 being met, the conditions of Art 215(1) are also met:

- on the qualifying default of or non-payment by the counterparty, the lending institution has the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided and the payment by the guarantor shall not be subject to the lending institution first having to pursue the obligor;
- the guarantee is an explicitly documented obligation assumed by the guarantor; and
- either of the following conditions is met:
  - the guarantee covers all types of payments the obligor is expected to make in respect of the claim; or
  - where certain types of payment are excluded, the insured has adjusted the value of the guarantee to reflect the limited coverage.

The payment of claims needs to be made in a timely manner. We note that the FMLC's letter requested confirmation from the EBA that the phrase "timely manner" 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" however there has been no direct response to this point. Guidance issued by the EBA in the Single Rulebook Q&A prior to the FMLC's letter indicates that:

> "… the point in time at which payment under the guarantee can be expected should in a first step be clearly determinable for the institution and the guarantor must not have the ability to postpone the payment in an indeterminable manner."[6]

Whilst NPI policies would not typically contain provisions allowing the insurer to postpone claims in an indeterminable manner, pay-out under an NPI policy would generally be within a pre-defined 30-60 day waiting period from the date of loss, although it may be longer. The Consultation Paper casts some doubt on whether 30-60 days would qualify as a "timely" payment:

> "The PRA considers that the requirement for the guarantor to be obliged, contractually, to pay out 'in a timely manner' means that the pay-out should be made without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due under the claim in respect of which the protection is provided."[7]

We would hope that an outcome of the consultation period will provide clarity over whether the PRA's point refers to the date on which the right to claim payment is *exercisable* or the date on which the payment under the insurance policy is *actually made*. Given the drafting of the requirement in Art 215(1) (which refers to the lender having a "right to *pursue* in a timely manner"), it seems likely that the PRA's intention is that the right to claim payment is *exercisable* within days. We will await the outcome of this PRA consultation with interest.

CDS v NPI: DIFFERENCES BETWEEN THE PRODUCTS

NPI policies bear a resemblance to CDS and other similar credit protection instruments (such as financial guarantees), insofar as each product aims to mitigate counterparty credit risk by way of the seller of the product making payments to the purchaser upon the occurrence of certain specified events.

Under a typical CDS, one party (the Protection Buyer) will pay periodic premiums to another party (the Protection Seller) in return either for payments to cover loss in value, or the right to dispose of an asset at its face value, following the occurrence of certain pre-agreed credit-related events (Credit Events) in respect of obligations (Obligations) owed or guaranteed by a party (the Reference Entity).

Whilst the purpose of CDS and NPI are similar, they may be distinguished from each other by both their legal characteristics and their commercial structures.

Legal differences

The view set out in a legal opinion provided to the International Swaps and Derivatives Association, Inc. by Robin Potts QC,[8] is that a CDS does not constitute a contract of insurance. An understanding of the characteristics of insurance is important in order to determine when it is appropriate to use NPI and when to use CDS.

Insurable interest

In order to constitute a contract of insurance, the insured must have an "insurable interest" in the asset to which the protection relates. Typically, this will mean that the insured owns the relevant asset. There is no such requirement in relation to CDS and as such a Protection Buyer would not need to own the relevant bonds or loans in respect of which it is seeking protection. This allows CDS to be used speculatively as well as for hedging purposes, whereas NPI could only be used to hedge an existing risk to which the insured is exposed.

It should be noted that even where the Protection Buyer does own an obligation of the Reference Entity, as would be the case where the protection is purchased for the purpose of obtaining regulatory capital relief, a CDS would still not constitute a contract of insurance since there is no requirement under a CDS that the Protection Buyer own any obligation of the Reference Entity.

Loss incurred

Since a contract of insurance requires that the insured has an insurable interest, the insured will always need to demonstrate some loss on the relevant insured asset as part of its claim. An NPI policy will therefore typically require the insured to submit proof of such loss to the insurer. The insurer may also require the insured to submit to the examination of its employees and documents, in order to verify that loss.

A CDS contract is not structured to fall within rules applicable to insurance and so does not impose any requirement that a Protection Buyer demonstrate loss. In practice, a Protection Buyer may often hold the relevant obligation on its books, however, in the absence of a binding requirement to do so and a binding obligation on the Protection Seller to pay regardless of whether the Protection Buyer has actually suffered a loss, a CDS will not constitute a contract of insurance. Note however, that whilst there would be no requirement to submit any proof of loss or agree to any examination under a CDS, there is typically a requirement to provide evidence for the occurrence of the relevant Credit Event based on publicly available information.

Requirements in respect of an NPI policy as to loss therefore differ from CDS, however, typical requirements under a synthetic securitisation are more in line with those of an NPI policy. Since the portfolio of credit exposures may not be fully disclosed to a Protection Seller, it will typically require that the Protection Buyer deliver a document certified as true by senior management stating that a default has occurred and the amount of that default and thereafter a report provided to it by a verification agent, usually the Protection Buyer's auditor, attesting to their independent verification of such details.

Duty of fair presentation

Under the Insurance Act 2015,[9] the insured has a pre-contractual duty to disclose facts, in a reasonably clear and accessible way, that are material to the insurer's perception of the risk of providing such a policy. In NPI policies, the scope of this duty may be restricted by way of clarifying that disclosure by the insured under the policy is limited to information within the possession of a particular transaction desk (after making reasonable enquiries).

Whilst parties to a CDS will typically make certain representations and covenants relating to the contract or the related obligations, no duty of fair presentation will apply to that contract.

No "cut-through" in CDS

Insurance contracts will sometimes provide direct rights to the insured to recover reinsurance payments due to the insurer from a reinsurer, upon the occurrence of certain events, being typically a failure to pay or the bankruptcy of the insurer. Subrogation rights for the insurer also usually exist.

Whilst a Protection Seller may also hedge its risk by way of entering into offsetting derivatives contracts, the Protection Buyer would not have recourse to the proceeds of those contracts upon the default of the Protection Seller and the close-out of the CDS. Likewise there are no subrogation rights.

Exclusions

Note that an NPI policy will typically contain certain "exclusions", that is circumstances in which the insurer will not pay out for a loss notwithstanding that such loss has occurred. In particular, an NPI policy may contain an exclusion where, at the time of entering into the policy, the insured has knowledge of circumstances that could reasonably be expected to give rise to a loss. Where treatment as a guarantee for the purposes of the CRR is a driver for the NPI cover, such exclusions are usually drafted with the provisions of the CRR in mind.

Whilst exclusions are not a feature of CDS, Protection Buyers must ensure compliance with applicable insider dealing laws set out under the Market Abuse Regulation, other equivalent legislation in other jurisdictions and other regulatory standards of behaviour (eg Financial Conduct Authority Principle for Business 5 that firms must observe proper standards of market conduct,[10] which would require, *inter alia*, adherence to the rules of any market on which CDS are trading).

Commercial differences

In addition to the legal differences, there are certain commercial differences between NPI and CDS.

Triggers for settlement

As discussed above, under an NPI policy, the insurer will cover an amount owed to the insured which becomes overdue and unpaid. Triggers for settlement under an NPI policy may not be limited to a failure to pay, however, the insured must nevertheless suffer a loss (although the final quantum of the loss need not be known for some payment to be made).

In contrast, under a CDS both the amount covered and time at which the Protection Buyer can claim may be different. Since a payment under a CDS does not relate to loss incurred, there are triggers for settlement other than where the insured realises a loss. For example, a Protection Buyer may trigger a CDS upon the bankruptcy of the Reference Entity or upon the restructuring of an obligation of the Reference Entity, which may not coincide with a loss as a result of a failure to pay.

Settlement and amounts payable

Under an NPI policy, the amount paid by the insurer will relate directly to the insured's loss and may cover all or a portion of such loss. As such, a claim under an NPI policy may relate simply to a missed scheduled payment of interest and/or principal in respect of that obligation.

However, settlement of a CDS will typically be by way of a market-wide dealer auction in respect of deliverable obligations of the relevant Reference Entity. A Protection Buyer may receive a cash payment in an amount of the difference between par and the final price established in the auction or alternatively may be able to deliver an eligible obligation of the Reference Entity into the auction in return for settlement at par.

Where bespoke credit protection instruments are used in the context of regulatory capital transactions, a Protection

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Ingrid York is a partner in the Capital Markets group and head of the Structured Finance Practice of White & Case in London. Email: iyork@whitecase.com

Richard Blackburn and Luke O'Leary are associates in the Capital Markets group of White & Case in London. Email: rblackburn@whitecase.com and luke.o'leary@whitecase.com

Buyer will receive a cash payment in an amount of the difference between the par value of an obligation and the aggregate of all amounts recovered by the Protection Buyer from the relevant Reference Entity in respect of that obligation during a workout period or based on an estimated loss calculation. The value recovered from the Reference Entity will typically be verified by a third party auditor as mentioned above.

Liquidity

There is a large and active market in CDS and various platforms exist to enable its trading and clearing. As such CDS protection is available quickly and in significant volumes on many liquid credit exposures around the world. In contrast, NPI policies are tailored to the individual circumstances of the insured and therefore tend to be negotiated bilaterally (although where CDS or similar bespoke credit protection instruments are used in a synthetic securitisation, such contracts would also need to be negotiated bilaterally at some length). As such, whilst NPI policies may not be as readily available as CDS, they may provide equally tailored coverage and coverage in circumstances where there is no readily available liquid CDS market.

CONCLUSION

The introduction of the capital requirements and risk weights under Basel III may result in significant changes to capital charges from which financial institutions will seek relief. In addition to conventional credit protection products, financial institutions may also consider using NPI. NPI, despite being an insurance product, may qualify as a form of credit risk mitigation under the CRR provided that the relevant conditions thereunder are satisfied. ■

1 Source: http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_the_european_banking_authority_on_unfunded_credit_protection_under_the_capital_requirements_regulation.pdf

2 Source: http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_768

3 Source: Prudential Regulation Authority, Consultation Paper CP6/18, *Credit risk mitigation: Eligibility of guarantees as unfunded credit protection*, February 2018, para 2.4

4 Source: Prudential Regulation Authority, Consultation Paper CP6/18, *Credit risk mitigation: Eligibility of guarantees as unfunded credit protection*, February 2018, para 2.5

5 Source: https://www.eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/discussion-paper-on-the-significant-risk-transfer-in-securitisation

6 Source: http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_2306

7 Source: Prudential Regulation Authority, Consultation Paper CP6/18, *Credit risk mitigation: Eligibility of guarantees as unfunded credit protection*, February 2018, para 2.7.

8 Provided on 19 May 1997.

9 Source: http://www.legislation.gov.uk/ukpga/2015/4/contents/enacted

10 Source: https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html

Further Reading:

- Insurers as refinancing source for credit institutions following the Capital Requirements Regulation (CRR) (2014) 4 JIBFL 266.
- The difference between the impact of Basel III and CRD IV on a lender's funding costs (2014) 10 JIBFL 672.
- LexisPSL: Banking & Finance: Use of insurance in trade and commodity finance transactions.