Trade Finance banks – time to stand up for your products!

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What is this all about?

On 16 February 2018, the Prudential Regulation Authority ("**PRA**") published a consultation paper containing a draft Supervisory Statement to clarify the PRA's expectations regarding the eligibility of guarantees as unfunded credit protection under the Capital Requirements Regulation (575/2013) ("**CRR**").[1]

The proposals are the first meaningful guidance published by the PRA on its interpretation of the CRR eligibility criteria for guarantees. Unfortunately, they also raise some serious concerns for banks.

Guarantees and beyond

The Supervisory Statement will apply to any instrument purporting to be a "guarantee" for the purposes of achieving unfunded credit protection under the CRR. "Guarantee" is not defined in the CRR, and the PRA appears to confirm that it is not intended to be limited to guarantees in the strict sense as a matter of English law, but includes various different forms of instruments that meet the relevant eligibility criteria. This has since been further confirmed by the European Banking Authority ("**EBA**") in a recent report on the credit risk mitigation framework under the CRR.[2] The EBA states that the term "guarantee" should be interpreted from a substantive or functional viewpoint rather than a legal one.

The umbrella of "guarantees" includes unfunded risk participations, demand guarantees, export credit agency guarantees and credit insurance. In trade finance, banks use a wide range of CRM techniques, and the availability of credit protection might determine whether a bank can finance a client in an emerging market where it might otherwise be prevented by internal limits, or where the capital cost might be too high without being able to substitute the better-rated third party protection provider. Many common CRM tools are threatened by the proposals in the consultation paper.

Who is affected?

The consultation paper is relevant for PRA-regulated banks and other firms that use CRM under the CRR. The guidance applies to institutions applying the substitution approach available to exposures on the Standardised Approach and Foundation IRB Approach under CRR Part Three, Title II, Chapter 4.

The alternative method under the Advanced IRB Approach, set out in CRR Part Three, Title II, Chapter 3, is outside the scope of the guidance. However, it is relevant in respect of any parts of the CRR that cross-refer to the Chapter 4 requirements (including for example the double default rules), meaning that many AIRB banks should also pay close attention to these proposals.

Key issues arising from the proposed guidance

The requirement to obtain Article 194(1) legal opinions

Article 194(1) CRR requires banks to obtain independent, written and reasoned legal opinions confirming that a credit protection arrangement is legally effective and enforceable in "all relevant jurisdictions".

The proposals state that, at a minimum, a bank must satisfy itself that the guarantee is enforceable under its governing law, in the jurisdiction where the guarantor is incorporated, and possibly in other jurisdictions where enforcement action may be taken.

This could mean the PRA requires legal opinions in a number of jurisdictions for each CRM instrument, although from a practical perspective the scope of the third limb – "jurisdictions where enforcement action may be taken" – is not clear. The guidance does not say whether a pragmatic approach, such as relying on the mutual enforcement of judgments and arbitration awards between the relevant jurisdictions, would be acceptable.

The PRA does not address the requirement for opinions to be "independent", the use of generic rather than transaction-specific opinions, or how often opinions should be refreshed. The use of in-house and generic opinions has, however, received some limited endorsement from the EBA.[3]

The guidance states that legal opinions should also address the applicable eligibility criteria for guarantees in the CRR, which may go beyond the scope of the enforceability opinions some banks typically obtain.

In practice, a requirement to obtain additional external legal opinions will be significant financial and administrative burden, and banks may struggle to meet the PRA's expectations.

Guarantees must pay out in a "timely" manner

Article 215(1)(a) CRR requires that the guarantor is obliged to pay out in a "timely" manner following a default. The PRA considers "timely" to mean *"without delay and within days, but not weeks or months"* (subject to some exceptions, such as residential mortgage exposures which benefit from a 24-month maximum payment period). The PRA has considered market practice for guarantees in coming to this view, but it is not clear whether this review included widely

used CRM products with extended payment periods, such as credit insurance.

The PRA's views are likely to be of serious concern for banks, particularly those on Standardised Approach. A number of instruments, such as credit insurance policies, ECA guarantees and some risk participation agreements (including, typically, those provided by multilaterals) have longer waiting periods before the guarantor's payment is due. Public sector bodies, such as ECAs, benefit from an exception to the timeliness requirement in Article 215, where the instrument provides for a timely provisional payment that represents a robust estimate of the amount of the loss. In reality, the exception is unlikely to be as helpful as might have been thought on a cursory reading of the guidance.

Adjusting the value of guarantees to reflect limited coverage

Article 215(1)(c) CRR provides that where certain types of payment are excluded from a guarantee, the lending institution may adjust the value of the guarantee to reflect the limited coverage. In the PRA's view, "certain types of payment" refers to different sums the obligor is required to pay (e.g. principal, interest fees), and "limited coverage" refers to a quantifiable portion of the exposure.

This appears to remove any basis to adjust the value of a guarantee to reflect the bank's assessment of the impact of any documented limitations of coverage in the relevant instrument, such as loss exclusions in an insurance policy.

So what might this mean?

If the Supervisory Statement is not changed before it is finalised, then banks may find the use of some credit risk mitigants for capital relief purposes is no longer available to them, despite the fact that these mitigants have an exemplary track record of paying out when required. This could seriously reduce banks' ability to finance transactions and, importantly for trade finance, reduce the funding of trade and projects in the emerging markets where banks are reliant on the support of ECA guarantees, credit insurance or risk participations from development finance institutions.

The PRA's Supervisory Statement will also apply to existing credit risk mitigation, meaning that banks will need to consider the arrangements they currently have in place and whether capital adjustments are needed.

It is of course open to protection providers to adjust the terms of their instruments to meet to PRA's expectations. For example, insurers may agree to remove problematic exclusions from insurance policies. However, this will likely take some time to achieve, particularly as reinsurance contracts will need to be renegotiated, meaning there will potentially be a period of very limited capacity for banks to be able to place CRR-compliant policies.

In terms of reducing payment periods, it is not clear from the guidance whether protection providers other than public sector bodies would be permitted to use a provisional payment mechanism to meet the timeliness requirement.

Unintended consequences?

It is possible that the PRA's proposed guidance will have unintended consequences. There appears to be little evidence of wide consultation prior to publication of the guidance as to its potential impact, particularly on trade finance. It seems likely that trade finance and finance for the emerging markets will be impacted if the current Supervisory Statement is not amended significantly.

What should banks do now?

The PRA's Supervisory Statement is not yet in final form and there is time before the final version is published for banks and other stakeholders to respond. Banks need to act.

The PRA has invited feedback on the proposals, and in particular on the nature of banks' existing guarantee arrangements for CRM, the impact of the proposals existing CRM practices, and any other issues arising as a result of the proposals. We would suggest that any response should also address the specific terms of established guarantee products and how the drafting of those instruments takes account of legal risks and regulatory requirements. The reasons for having different payment periods should be addressed.

Banks should explain their practices as sophisticated users of a variety of different instruments, including the importance to banks of having access to a range of products and the due diligence involved in entering into different arrangements. It is clear that the PRA's position will impact some institutions more than others, and the PRA needs to be aware of the disparity.

It is possible that a robust response, including both individual responses from banks and the combined efforts of industry bodies, could result in changes or helpful clarifications in the final version of the Supervisory Statement. Several of the industry's associations are expected to take the lead in formulating responses on behalf of their members.

There are a number of possibilities which could be considered. For example, a reinterpretation of key words like "timely" to allow a degree of flexibility depending on the type of guarantee, where the bank can demonstrate that the instrument is sufficient legally and commercially robust. Banks might also attempt to persuade the PRA to accommodate a transition period to allow banks to deal with existing CRM that does not meet the PRA's expectations, and to allow providers of credit protection time to adjust their practices.

However, time is short, with the deadline for feedback being Wednesday 16 May 2018. It is going to be a huge challenge for stakeholders to generate useful and reliable data in the period of time available. It is important that banks act now, before it is too late. ●

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Notes

1 PRA Consultation Paper 6/18. The full text of the consultation paper can be found here: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-mitigation-eligibility-of-guarantees

2 EBA Report On The Credit Risk Mitigation (CRM) Framework 19 March 2018: https://www.eba.europa.eu/-/eba-published-an-assessment-of-the-current-credit-risk-mitigation-framework

3 EBA single rulebook, question ID 2013_23