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Sent via email:
CP6_18@bankofengland.co.uk

Dear Sirs

Consultation Paper CP6/18 - Credit risk mitigation: Eligibility of guarantees as unfunded credit protection (the "Consultation")

We write to you further to publication of the Consultation in February 2018 and your request for feedback in respect of the proposals contained therein (the "**Proposals**").

The use of credit risk mitigation ("**CRM**") as a technique to reduce credit risk in respect of underlying exposures is of fundamental importance to those institutions that are bound by the Capital Requirements Regulation ("**CRR Firms**"). It is on behalf of these firms, being members of the Loan Market Association[1] ("**LMA**"), as well as other affected parties, that we submit this response.

Summary

Whilst we strongly support the underlying objectives of the Consultation and very much welcome the desire of the PRA to provide additional guidance for market participants on the subject of CRM, there are certain aspects of the existing narrative that we believe require greater clarification/amendment. We consider this to be necessary in order to ensure that the use of CRM continues to operate effectively and in the spirit envisaged by both Part Three, Title II, Chapter 4 of the CRR (the "**Chapter 4 Requirements**") and the guidance published to date by the European Banking Authority ("**EBA**").

Above all, we are concerned that, if these matters are not dealt with, the use of certain widely used, financially robust and well tested CRM techniques will be adversely impacted, causing unnecessary disruption to a well-functioning and stable market: something that we believe the

[1] The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 660 across over 60 nationalities and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.

PRA cannot have intended, particularly given the current commitment of the UK government to break down barriers to trade and investment, boost liquidity, and bolster economic growth.

Furthermore, given the absence of grandfathering provisions or transitional arrangements in the Proposals, we also see a potential risk to stability (at least on a short-term basis) within the financial system. This risk is more likely in view of the very wide usage of these products across the market, and the reliance of firms on them for the purposes of complying with the CRR.

Far reaching impact of the Proposals on market participants

Whilst the Proposals are expressed to be limited to the substitution approach (i.e. they will affect those CRR Firms which use either the Standardised Approach or the Foundation Internal Ratings Based Approach), it should be noted that those which use the Advanced Internal Ratings Based Approach ("**AIRB Approach**") are also likely to be impacted. This is on the basis that such institutions often look to satisfy the Chapter 4 Requirements for a variety of different reasons.[2] Consequently, any guidance published as a result of the Consultation will be of relevance to any CRR Firm regulated by the PRA that uses unfunded CRM. Furthermore, the Proposals will also be of interest to the much broader spectrum of credit protection providers which offer products which may be used for these purposes, as well as non-PRA regulated CRR Firms and other EU supervisory authorities who may later seek to adopt the PRA's approach. We therefore urge the PRA to carefully consider the wider implications of its Proposals and the number of parties who might be affected by them, in advance of publication.

Response

We would like to highlight the following key points arising out of the Consultation:

1. **Guidance needs to be applicable to, and appropriate for, all relevant credit protection products for the purposes of CRM**

As an overarching observation, we believe it is extremely important that the Proposals are drafted broadly enough to ensure that those products presently used as guarantees for the purposes of the Chapter 4 Requirements are not adversely impacted. This is particularly important to preserve much needed diversification of CRM techniques, and to ensure that reliance is not placed exclusively on a small range of eligible products. Restricting product eligibility could also bring about a reduction in supply, reduced competition between providers and increased pricing. In turn this could generate a fall in lending capacity by UK regulated institutions, reduced or more expensive access to funding and potential negative implications for economic growth.

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[2] Examples of the relevance of the Chapter 4 Requirements for CRR Firms which follow the AIRB Approach are very usefully provided as part of the response given by AFME, to which we would ask the PRA to refer for further information.

Certain products, such as credit risk insurance, risk participation agreements[3] and guarantee/guarantee-like products provided by, for example, multilateral development banks and export credit agencies (together "**Credit Risk Protection Products**") are already treated as being eligible for CRM and we believe that this treatment should continue. As the PRA will be aware, the EBA recently published a report in relation to the use of the CRM framework (the "**EBA Report**")[4], which expressly acknowledged that credit risk insurance "can qualify as a guarantee, but that this depends on the circumstances of the individual case and on the intrinsic characteristics of the contract and its economic substance." A similar view has been expressed by the Basel Committee on Banking Supervision.[5] Whilst we do not necessarily think express recognition of different Credit Risk Protection Products is required as part of the Proposals (since doing so may inadvertently restrict the use of products not expressly referenced in the guidance but which perform the same purpose), we do believe that the drafting should be considered with all relevant products in mind. We are aware of numerous responses to this Consultation (including those submitted by AFME, BAFT, UK Finance and the ICC Banking Commission) which outline the importance and relevance of these products to the CRM regime, as well as their individual characteristics, and urge the PRA to review these as part of the consultation process, with a view to amending the Proposals as appropriate. We would also ask the PRA to observe the statement made in the EBA Report which emphasises that "the term 'guarantee' in the context of CRM under the CRR should be interpreted from a substantive or functional viewpoint rather than a legal one." This indicates that recognition should be given to the function and purpose of the protection, rather than its precise legal form.

In addition, we believe it should be recognised that many of the tools currently employed for CRM which do not take the precise legal form of a guarantee instrument, may arguably be better suited in terms of their reliability for CRM purposes than those products which fall more decisively within the Proposals. By way of example, one might consider and compare the use of pure corporate guarantees[6] vs. other Credit Risk Protection Products.

For example:

a) The requirement for pay out in a timely manner

The PRA proposes to clarify that the requirement of a firm to have the right to pursue "in a timely manner, the guarantor for any monies due under the guarantee" equates to a contractual requirement to reimburse a guarantor "without delay and within days". For a corporate

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3 A risk participation agreement is a contractual arrangement whereby the provider of the risk participation acquires an indirect economic interest in a particular credit claim from the purchaser of the risk participation and assumes the risk of the claim. It therefore functions in a similar manner to that of an insurance contract or guarantee. In exchange for a series of payments payable by the purchaser to the provider, the provider agrees to make a payment to the purchaser if the underlying debtor does not make a payment due in respect of the claim.

4 EBA Report on Credit Risk Mitigation Framework, dated 19 March 2018, available via https://www.eba.europa.eu/documents/10180/2087449/EBA+Report+on+CRM+framework.pdf

5 https://www.bis.org/bcbs/qis/qis3qa_e.htm

6 By "corporate guarantee", we are referring to a guarantee provided by a corporate entity ("**Corporate Guarantor**"), often affiliated to the underlying debtor, under which the Corporate Guarantor will guarantee to the lender punctual performance of the debtor's obligations. Corporate guarantees are a very common feature of loan financings.

guarantee, this is unlikely to be problematic. This is because many such guarantees (including those provided under LMA facility agreements) typically allow the beneficiary to demand immediate payment by the guarantor if there is a failure to pay in respect of the underlying claim. Indeed, it is often in the firm's best interest to ensure that corporate guarantees are enforced expeditiously upon the occurrence of non-payment of the primary obligation, since many guarantors are linked either legally or economically to the underlying debtor or obligor group which has failed to pay.

However, this may be clearly contrasted to Credit Risk Protection Products. Under these types of "guarantee", the period of time between non-payment of the underlying obligation and an associated claim occurring in respect of the appropriate product is not a relevant factor when considering the likelihood of recovery, since the provider of the protection represents an entirely separate risk from the risk on the debtor itself. Instead, recovery rates are determined by the financial robustness of the relevant counterparty/guarantor. As a result, CRR Firms using these types of product may not seek to make a claim for reimbursement straight away, despite the occurrence of an event of default (indeed, this may not be considered advantageous if the CRR Firm intends to undertake some kind of debt restructuring, which would result in the default being remedied[7]), nor may final pay-out occur until the event in question has been adequately assessed/certified by the provider (incidentally, this is no different in practice to pay-out claims in respect of a CDS).[8] Therefore, although the period of time between the initial claim and the final pay-out may be far longer than is the case under a corporate guarantee, this will have no impact on recovery under the Credit Risk Protection Product itself. It should also be borne in mind that, since corporate guarantors are usually affiliated to the underlying debtor in some way (and, as a result, deterioration in the debtor's financial situation could also trigger a deterioration in the guarantor) recovery rates under third party unaffiliated Credit Risk Protection Products are likely to be higher than under corporate guarantees, particularly given the nature of many of the providers.

Consequently, we believe that this illustrates a need to adopt a much more flexible approach in the guidance as to the meaning of the words "in a timely manner". We would also draw the PRA's attention to the following additional points in support of this view:

(i) Credit Risk Protection Products do not contradict the wording of the CRR itself

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7 Indeed, as a result of the nature of the relationship between the insured and the debtor, particularly in loan financings, it is common for there to be a period of time following a default, during which the insured and the debtor will attempt to remedy the default via some kind of workout procedure or restructuring (the period of time very much dependent on the nature and situation of the debtor, the sector it operates in and its geographical location). As a result of this, and the fact that the time period between default and claim has no correlation to the insured's likelihood of recovery, market practice for certain Credit Risk Protection Products anticipates there being a remedy period of some kind before any "loss" under a policy is deemed to arise. This is reflected, for example, in the EU Council Directive on export credit insurance (98/29/EC) (one of the aims of which is to establish common principles for insurance coverage, premiums, country cover policies and notification procedures), which defines "Loss" from credit risk as arising "when the policyholder has been unable to obtain payment of any amount due to it under the relevant commercial contract or loan agreement during a period of three months after the due date".

8 Further detail on the settlement times of CDS transactions is set out more fully in the response to the Consultation given by AFME, to which we ask the PRA to refer for further information.

None of the features of Credit Risk Protection Products would seem to invalidate them when analysing the precise wording of the CRR. For example: 1) nothing prevents "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"; [9] and 2) we do not consider that a "**right to pursue**" a guarantor is equivalent to a contractual right to receive a payment. We would stress that these are important factors to bear in mind when considering the eligibility of Credit Risk Protection Products and we would ask that the PRA evaluates these distinctions when producing the final guidance.

(ii) Other language versions of the CRR are supportive of greater flexibility

We think it is important to note that the direct translation into English of the "timely manner" wording in other official language versions of the CRR is even more suggestive of a need for a flexible approach. Further detail of this is very usefully provided as part of the response given by AFME, to which we would ask the PRA to refer for further information.

(iii) The use of a time limit would have been included in the original CRR if considered necessary

If the EU Commission had considered a specified time limit appropriate, it could have incorporated one expressly into the underlying legislation (a time limit being much easier to enforce and monitor). The fact that this was not done is suggestive that the Commission intended that there be some flexibility in application of the wording.

(iv) The list of exceptions set out in Paragraph 2.7 indicates that pay-outs should be tailored to the product, where appropriate

We note that the list of exceptions set out in Paragraph 2.7 of the Consultation would indicate that different pay-out periods are acceptable in certain situations (for example, guarantees covering residential mortgage loans) (the "**Exceptions**"). Whilst we welcome explicit recognition of these guarantees by the PRA, we note that when a comparison is made between the length of time permitted in respect of the Exceptions and all other types of guarantee, it would seem to create an inappropriate imbalance, particularly when analysed in terms of the underlying guarantee risk profile. In particular, certain guarantees might not qualify as Exceptions, yet amount to the same thing in terms of substance - ECA guarantees being a notable example (since not all ECAs are public bodies). Consequently, since ECA guarantees typically have long payment periods, a situation could arise where the payment period is acceptable from the point of view of an ECA qualifying as an "Exception", but not for an ECA that fails to meet the criteria.

b) The exclusion of certain types of payments and limited coverage

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[9] This approach is also reflective of EBA guidance contained in its single rulebook Q&A which states that timeliness indicates "some flexibility": see http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_2306

Under the CRR, institutions may exclude "certain types of payment" from the ambit of a guarantee, and adjust the value to reflect that "limited coverage". The PRA, however, proposes that, in the context of Article 215(1)(C) of the CRR, "limited coverage" refers to a quantifiable portion of the exposure and that "certain types of payment" refer to "different sums the obligor may be required to pay to the firm under the contract, such as principal, interest, margin payments, fees and charges". Again, for a corporate guarantee, this is unlikely to be an issue, since such instruments are generally used in a monetary sense i.e. any carve outs are made by direct reference to value, rather than something upon which a value might be placed. However, from the perspective of certain Credit Risk Protection Products, the language used in the CRR has occasionally been used to allow the use of certain mandatory exclusions in insurance contracts (e.g. nuclear carve-outs), which are a key feature of the insurance and reinsurance market. This is on the basis that, since the relevant exclusion can be modelled/quantified by the CRR Firm, it is not incompatible with the overarching guarantee analysis of the CRR. This view is reinforced by the EBA Report, which indicates the need for a flexible approach in respect of insurance terms. Although this relates to the terms of insurance obtained to protect against damage to physical collateral used as funded CRM, it would seem inconsistent if the same analysis could not be applied to insurance policies containing the same exclusions, but entered into in the context of unfunded CRM.

2. Greater clarification required regarding use of provisional payments

When looking at the Exceptions set out in Paragraph 2.7, it could be interpreted that provisional payments must be linked expressly to situations when they are made by "mutual guarantee schemes or by public sector bodies". We would ask that the PRA also clarifies that this does not prevent other eligible guarantee providers from making initial payments in respect of a claim, and subsequently adjusting the payment if required. This is a common feature of market practice which is reflective of the fact that final determination of amounts payable does not always occur until a later point in time.

3. Greater clarification required regarding incontrovertibility

In paragraphs 2.5 and 7.4 of the Consultation, the PRA suggests that firms should consider "whether there are scenarios in which the guarantor could in practice successfully seek to reduce or be released from liability under the guarantee". To the extent that the PRA is asking CRR Firms to consider the requirement of incontrovertibility as a factual as well as a legal requirement, we believe that this risks causing unnecessary ambiguity. It is therefore submitted that the CRR requirement is essentially a legal one, i.e. the relevant guarantee is legally enforceable, does not include any inappropriate exclusions, and is drafted correctly, from a legal perspective, to achieve this.

4. Legal opinions

Under paragraph 2.4 of the Consultation, the PRA proposes that any legal opinion required under Article 194(1) of the CRR should "consider the eligibility criteria" "as part of considering its effectiveness". We are concerned that this statement creates ambiguity, since it could be interpreted in various ways. For example, it could be taken to relate expressly to the

eligibility criteria in paragraph 2.4 of the Consultation (i.e. the legal opinion should cover matters such as the ease of enforcement in all relevant jurisdictions). Alternatively, it could also be taken to mean that the legal opinion should cover all aspects of the eligibility criteria, whether legal or otherwise. We believe that it would be helpful if the PRA could clarify that this statement relates to the eligibility criteria in paragraph 2.4, in line with current market practice. We would also suggest that the last example cited would not be appropriate. This is because of the additional considerations which would need to be taken into account in respect of such a requirement (many of which are matters of fact rather than law, to which a legal opinion would seem manifestly unsuited and which would be more appropriately assessed by a relevant internal expert within the CRR Firm itself).

5. Need for grandfathering provisions or transitional arrangements

In the event that the PRA decides to proceed with its suggested clarifications and publishes guidance in a form that mirrors the Proposals, we would request that market practitioners are given a reasonable period of adjustment, and that this equates to both a transitional period from the date of publication of any final guidance (such period being of the same duration as that given in respect of an amendment to the CRR itself), and grandfathering of any historical CRM contracts entered into by CRR Firms. This is for the reasons set out in paragraph 5 of our letter below.

6. Consequence of non-recognition of Credit Risk Protection Products currently used for CRM

In the event that the Proposals are published in their current form, we believe that there is a real risk of disruption to a market which has, to date, functioned very well, by using products which are reliable and robust. This is particularly likely due to the lack of grandfathering provisions contained in the guidance, meaning that a potentially very large number of contracts used for CRM purposes will become "CRR non-compliant". The repercussions of this could be enormous from a financial stability perspective, particularly given that any reassessment of the suitability of existing contracts could necessitate the injection of additional capital for certain CRR Firms. We therefore ask that the PRA urgently revisits the Proposals to ensure that the market continues to function in the manner in which it has operated so successfully to date.

We would be happy to discuss any aspect of this response with you in more detail and to meet with you as required. If we can be of any further assistance, please do not hesitate to contact my colleague Amelia Slocombe via email at amelia.slocombe@lma.eu.com or by telephone on 020 7006 4114.

Yours faithfully

Clare Dawson
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