CLIFFORD
CHANCE

Client briefing May 2017

Non-Payment Insurance as Credit Risk Mitigation Under Regulation Q

How Basel III Compliant Insurance Policies Can Reduce Bank and Bank Holding Company Capital Requirements

Following the 2008 financial crisis, bank regulators around the world enacted wide-ranging reforms to reduce the risk of future crises. These reforms were predominantly drawn from a comprehensive set of post-crisis reform measures developed by the Basel Committee ("**Basel III**") and have been implemented in substantially similar fashion by the European Union ("**EU**"), Japan and the United States ("**US**").

Most notably, the Basel III reforms have resulted in steep increases in bank and bank holding company capital requirements. The reforms have effectively increased the cost of extending credit, as financial institutions must now hold additional capital against each counterparty credit exposure. Many financial institutions have begun to explore solutions that meet regulatory capital requirements while maximizing opportunities to offer credit products to customers and counterparties. This client briefing outlines how US financial institutions can utilize non-payment insurance policies as one such solution.

Regulation Q, Risk Weighting and Risk Weight Substitution

The Basel III Accords require financial institutions to assign a "risk weight" to each balance sheet asset or credit exposure. The risk-weighted amount of such asset or exposure is the basis for determining the corresponding capital requirement. The US implementation of Basel III is set forth in the Federal Reserve Board's Regulation Q, which specifies the standardized and advanced approaches to risk weighting.

For example, under the standardized approach, typical corporate loans are risk weighted at 100%; thus, the risk-weighted amount of a $100 million corporate credit exposure would also be $100 million. Assuming an 8% tier 1 capital requirement, the financial institution must hold $8 million in tier 1 capital against such an exposure. Riskier exposures, such as certain high-volatility commercial real estate exposures ("HVCREs"), might be risk weighted at 150%; thus, the risk-weighted amount of a $100 million HVCRE exposure would be $150 million and require $12 million in tier 1 capital to be set aside. Conversely, safer exposures, such as certain sovereign exposures, might be risk weighted at 20%, in which case the risk-weighted amount of a $100 million sovereign exposure would be $20 million and only require $1.6 million in tier 1 capital.

Under Regulation Q, as well as under the EU and Japanese rules implementing Basel III, a financial institution may use a guarantee to substitute, for the risk weight assigned to the counterparty in respect of a given exposure, the risk weight assigned to the guarantor, provided that the terms of the guarantee meet certain standards. In simple terms, the risk weight substitution

process swaps the higher risk-weighted underlying exposure for the lower risk-weighted guarantee, thereby reducing the applicable capital requirement. For an illustration of the capital risk weight substitution process, please see Appendix 1, below.

A bank (or bank holding company) must conduct a two-part analysis in order to take advantage of credit risk mitigation and risk weight substitution under Regulation Q. First, the terms of the guarantee must be analyzed to determine whether the bank could call upon the guarantee without the guarantor having grounds to refuse payment. Typically, letters of credit and parent company guarantees meet such standards. Second, the creditworthiness of the guarantor is evaluated (under the bank's internal ratings-based model or other advanced approaches) to determine the value of the substitution. Whereas a traditional loan exposure might have a 100% risk weight, a well-rated institution might be assigned the equivalent of a 20% risk weight.

As compared with letters of credit or parent company guarantees, non-payment insurance ("**NPI**") policies are ideal vehicles for credit risk mitigation. NPI policies, which were popularized following the 2001 Argentinean debt default, are specifically designed to provide protection for any non-payment event whatsoever. Whereas parent company guarantees are often issued by entities without formal credit ratings themselves, NPI policies are generally issued by highly rated, established insurers. Further, NPI policies are generally much less expensive than a letter of credit.

Financial institutions in the EU have already developed a significant market for Basel III compliant NPI policies that may be utilized for credit risk mitigation. Based on implementation guidance released in 2002, many insurers offer NPI policies expressly designed to conform to local application of Basel III. As insurers have developed increasing sophistication with this product, NPI policies have a proven record of payment and reliability. Both Marsh & McLennan and Willis Towers Watson estimate that insurers have written billions of dollars in NPI coverage in recent years, with the latter estimating that insurers wrote over $25 billion in NPI coverage in 2014 alone.

By contrast, that same estimate pegged the US market at less than $2 billion in coverage, which is largely attributable to the late implementation of Basel III in the US. As a result, the US market is simply unfamiliar with the product.

US Banks and Bank Holding Companies Can Use NPI Policies for Credit Risk Mitigation Purposes

Regulation Q explicitly permits US banks and bank holding companies to utilize insurance policies for credit risk mitigation purposes. Specifically, a US financial institution may recognize an "eligible guarantee" as a risk weight substitute for a given exposure.[1] In turn, a "guarantee" includes "a financial guarantee, letter of credit, **insurance**, or other similar financial instrument" (emphasis added).[2] The challenge lies in determining whether a given insurance policy can meet the ten-part "eligible guarantee" test set out in Regulation Q.

The process of making such a determination is not well understood in the US. Again, this stems from the relatively recent adoption of Regulation Q. The difficulty is compounded by the fact that the "eligible guarantee" test is meant to apply to three types of instruments – guarantees, letters of credit and insurance – which have fundamental structural differences that makes a uniform "apples to apples" comparison extremely difficult. Notwithstanding the strides made in the EU market to craft straightforward NPI policies that meet official EU standards, interpreting whether a policy qualifies under the US "eligible guarantee" test can be a trap for the unwary.[3]

---

1 12 C.F.R. Part 217.36

2 12 C.F.R. Part 217.2, Notably, the CRR does not contain a parallel clause; the well-developed NPI industry in the EU is based on technical guidance, rather than explicit authorization.

3 We note that, further compounding confusion on this matter, the CRR standard is a seven-part test with significant stylistic and substantive differences from the Regulation Q standard.

For example, an "eligible guarantee" must "require the protection provider to make payment … in a timely manner." [4] Regulation Q provides no additional guidance on the meaning of "a timely manner." Experienced practitioners evaluating similar clauses in the EU have maintained that market-standard waiting periods (*e.g.*, 180 days for project finance coverage) would be acceptable, while clauses that restrict payment until the occurrence of an event with an indeterminate date would not be acceptable. By way of example, many trade credit insurance policies commonly exclude payment until the resolution of litigation between a seller and a purchaser. Because litigation is often protracted, this type of exclusion is impermissible. Applying often opaque rules to complex insurance policies, while accounting for differences in market practice, requires considerable experience and close analysis of a given policy.

Conclusion

NPI policies are an ideal tool for financial institutions to meet Basel III capital requirements through credit risk mitigation and the process of risk weight substitution. This technique has already been proven in the EU, where financial institutions have taken out billions of dollars in coverage. Further, whereas European financial institutions have relied on inferred guidance, American financial institutions are expressly permitted by Regulation Q to utilize insurance policies for capital risk weight substitution. Clifford Chance has taken a leading position in advising financial institutions in the US on the use of NPI policies immediately to mitigate capital requirements.

Authors

Nicholas Williams
Partner
T: + 1 212 878 8010
E: nick.williams
@cliffordchance.com

Jeff Berman
Partner
T: + 1 212 878 3460
E: jeffrey.berman
@cliffordchance.com

Benjamin Lee
Associate
T: +1 212 878 8510
E: benjamin.lee
@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

Clifford Chance US LLP

www.cliffordchance.com

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Linda Widyati & Partners in association with Clifford Chance.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

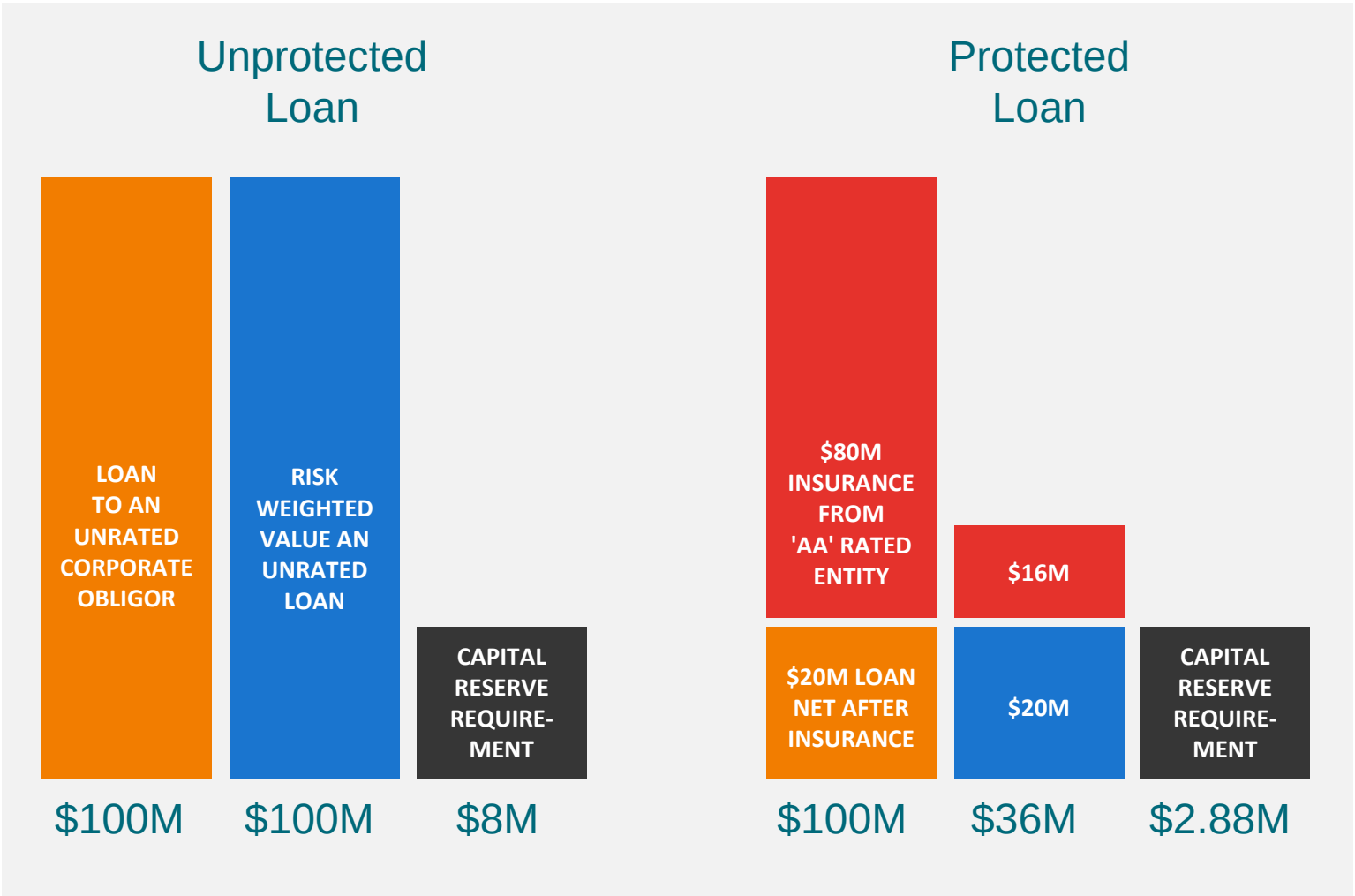
[4] 12 C.F.R. Part 217.2, Part 7.

Appendix 1

Capital Risk Weight Reduction – A Primer

In this simplified example, we examine a typical $100 million loan made to an unrated corporate entity. Assuming a 100% capital risk weight and an 8% tier 1 capital reserve requirement, the risk weight of the exposure would be $100 million, and the financial institution would therefore have to hold $8 million in tier 1 capital reserves.

Next, we examine the same $100 million loan made to an unrated corporate entity protected by a Regulation Q compliant NPI policy issued by a “AA” rated insurer covering 80% of the loan exposure. Assuming that an “AA” exposure qualifies for a 20% capital risk weight, the risk weight of the exposure would be $36 million ($16 million in capital risk weight for the protected portion of the exposure and $20 million for the unprotected portion of the exposure). In turn, the capital reserve requirement would accordingly fall to $2.88 million (8% of $36 million) for such a protected exposure, thereby freeing $5.12 million in tier 1 capital for additional investment.



Result: NPI Policy Protection Increases Available Capital by $5.12 million