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Finance for Europe

AFME response to PRA consultation on credit risk mitigation: Eligibility of guarantees as unfunded credit protection (CP 06/18)

16 May 2018

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: www.afme.eu.

Response

On behalf of the Association for Financial Markets in Europe ("**AFME**") and its members, we welcome the opportunity to respond to Consultation Paper CP6/18 (the "**CP**") entitled "Credit risk mitigation: Eligibility of guarantees as unfunded credit protection" published by the Prudential Regulation Authority (the "**PRA**") on 16 February 2018.

Our response raises some general comments prompted by our review of the CP. Our main concern relates to the PRA's proposed interpretation of the phrase "*in a timely manner*" at Articles 213(1)(c)(iii) and 215(1)(a) CRR[1] to mean that the guarantor should be obliged to pay out "*within days, but not weeks or months*" of the obligor's failure to make payment when due (with some limited exceptions).

As discussed further below, we consider this proposed definition is too prescriptive and does not allow firms sufficient flexibility to take into account certain features of particular credit risk mitigation ("**CRM**") products and associated market practice, or of underlying exposures, which may mean that longer pay-out periods are appropriate without negating the effectiveness of the risk mitigation. For example, it is not practical to require a guarantee to pay out "within days" for assets with grace periods that may be longer than this – and in practice, the non-payment is often resolved within the relevant grace period, without requiring the guarantee to be called. In addition, AFME members have not in fact observed these standard delay periods resulting in the firm not receiving payment in due course.

Because the PRA's proposed definition of timeliness is inconsistent with long-standing market practice in some areas, including for CRM provided by multilateral development banks ("**MDBs**"), export credit agency ("**ECA**") guarantees and credit risk insurance and similar products[2], where longer pay-out periods are common, it is also likely to have a significant impact on firms' capital and lending. If UK banks were unable to recognise some or all of these existing products as CRM under CRR, this has the potential to drive UK firms away from such CRM products, with a corresponding reduction in liquidity and increased pricing for such products. This would restrict banks' lending capacity, which would in turn negatively

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

[2] The European Banking Authority ("**EBA**") has confirmed in its March 2018 Report on credit risk mitigation and in Q&A 2014_768 that credit insurance may qualify as a guarantee for CRM purposes, as long as it fulfils the relevant eligibility criteria. We understand this is consistent with the acknowledgement in the draft supervisory statement ("**SS**") that the term "guarantee" is not defined in CRR and guarantees can take many forms.

impact the wider economy. In particular, it would have direct negative implications in infrastructure lending, as well as for businesses engaged in import and export activities.

Therefore, AFME asks the PRA to amend its proposed guidance in the CP to allow firms to take into account relevant features of the relevant CRM product and underlying exposure, as well as associated market practice, when determining what a "timely manner" should mean in a particular context.

AFME would also welcome clarification that the PRA does not intend to impose requirements that go beyond Article 194(1) CRR, by requiring an independent legal opinion to address all eligibility criteria, including factual matters that legal counsel is not in a position to assess. Instead, business, risk or finance experts within the relevant firm may be best placed to assess whether certain eligibility criteria are satisfied and firms should be able to rely on the analysis provided by those experts, with the requirement for legal opinions to be limited to the legal effectiveness of the CRM arrangements.

Finally, we make some comments and requests for clarification about the scope of limited coverage adjustments, when Pillar 2 adjustments may be appropriate and the potential wider impact of the proposed guidance set out in the CP, including for institutions using the advanced internal ratings based ("**AIRB**") approach and for other types of CRM.

Should the PRA wish to discuss any aspect of our response in further detail, we would be pleased to arrange this.

1. Requirement to pay out "in a timely manner"

AFME is concerned that the PRA's proposed interpretation of the requirements under Articles 213(1)(c)(iii) and 215(1)(a) CRR for the guarantor to pay out "*in a timely manner*" is too prescriptive and goes beyond the wording of CRR itself. Instead, for the reasons set out below, firms should be able to consider the relevant fact pattern as a whole, in order to assess what a timely pay-out period would be in the circumstances.

(a) Right to pursue the guarantor distinct from timing of pay-out

Article 215(1)(a) requires that the lender must have "*the right to pursue, in a timely manner, the guarantor…*" We consider that the "right to pursue" the guarantor is not equivalent to a requirement to receive a pay-out from the guarantor.

This is an important distinction, as institutions would typically have the right to pursue the guarantor (i.e. call the guarantee or initiate a claim process under an insurance product) without delay, even though there may be a longer waiting period before the payment is made – although as discussed further below, institutions may sometimes choose not to exercise this right immediately, for example if they decide to grant a grace period.

However, the CP does not seem to recognise this distinction, stating that "*CRR Article 215(1)(a) requires that the guarantor be obliged, contractually, to pay out in a timely manner*". Therefore, AFME requests that the PRA reflects this distinction in any final guidance, that Article 215(1)(a) refers to a right of the lender to pursue the guarantor in a timely manner, rather than a requirement for the pay-out to actually occur within a given time frame.

(b) Article 213(1)(c)(iii) CRR and consistency with EBA guidance

Article 213(1)(c)(iii) CRR does refer to the timeliness of the pay-out itself (rather than the right to pursue of the guarantor). However, the substance of this requirement is that "*the credit protection contract does not contain any clause, the fulfilment of which is outside the direct control of the lender, that… could prevent 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*...".

As set out in paragraph 7.5 of the draft SS, AFME understands that Article 213(1)(c)(iii) is a requirement to ensure that the guarantee does not contain any contractual impediment or provision outside the lender's control that would prevent it from obtaining payment from the guarantor in a timely manner, rather than imposing a positive obligation on the lender to seek payment as quickly as possible in all circumstances.

EBA Q&A (2015_2306) also provides further guidance on this requirement, explaining that "*the expression "timely manner" allows some flexibility*" although "*the guarantor must not have the ability to postpone the payment in an indeterminable manner*". AFME considers that it would be consistent with this existing EBA guidance to take a more contextual interpretation of "timely manner", allowing for relevant features of a particular fact pattern to be taken into consideration as discussed further below. Given that CRR imposes EU-wide requirements, it is important that the PRA's interpretation of "timely manner" remains consistent with this EBA guidance, in order to maintain a level playing field across the EU.

(c) **Practical considerations and market practice**

As noted in the draft SS17/13, guarantees used as CRM can take many forms and they may be applied in respect of a wide range of underlying exposures. Given the multitude of different fact patterns to which the "timely manner" requirement may apply, it does not seem possible to provide a single, "one size fits all" interpretation that would be appropriate in all cases.

Whilst in some situations it may be appropriate to require a guarantee used as CRM to pay out in a matter of a few days, this will not always be the case. For example, it is not practical to require a guarantee to pay out "*within days*" for assets with grace periods that may be longer than this – and where in practice, the non-payment is often resolved within the relevant grace period, without requiring the guarantee to be called. Grace periods also tend to vary depending on the type of exposure in question. Whilst loan agreements would typically allow for grace periods of a few days, trade receivables due 30 days after invoice date may be 90 days past due before they are treated as defaulted under a receivables purchase agreement.

In some cases, it may take longer than a few days to establish relevant facts to determine whether an event has occurred entitling the lender to claim under the guarantee. Similarly, for certain types of underlying exposures, particularly those for which it is common for firms to use credit insurance as a form of CRM, it may take longer than a few days to ascertain the extent of the loss caused by the obligor's default (which may in some cases require a certificate from an independent accountant or loss auditor) and serve relevant notices, making it inefficient for all parties to require an immediate payout before the amount being claimed has been determined.

Turning to consider features of different types of CRM products, while it is not uncommon for such arrangements to provide for an initial payment followed by a true-up mechanism, this is not the case across the board. For example, for credit insurance and other similar risk transfer products used as unfunded CRM, longer pay-out periods are common (e.g. 90, 120 or 180 days). However, this longer pay-out period should not adversely affect the effectiveness of the CRM, for example if the relevant insurer has a good credit rating (and so is "good for the money"). On the contrary, the risk that the guarantor does not pay out is already addressed through the counterparty credit risk weighting applied to the guarantor, so there should be no additional reason why the guarantor needs to pay immediately from a credit risk perspective.

We also note that the eligibility of some UK government guarantee schemes (that are not securitisations for the purposes of CRR) may be adversely impacted by the PRA's proposed interpretation of "timely manner" under the CP, as the pay-out periods under these schemes are typically longer than "*days, but not weeks or months*" following an obligor's failure to pay. If banks were unable to recognise these guarantee schemes as CRM, it would restrict their capacity to lend and undermine the purpose of these schemes to support SME financing.

In some cases, firms may actually prefer to have a longer pay-out period for practical and operational reasons. For example, firms may want flexibility to grant a grace period and/or to complete a workout and determine the final amount of any claim before receiving the pay-out, rather than incur the operational burden of receiving a large upfront payment, much of which may subsequently need to be returned. Protection sellers are also likely to charge higher protection fees in the latter scenario, because of the consequential credit risk they would be taking on the firm. Such an increase in pricing may have an adverse economic impact by reducing the availability of lending to businesses.

Taking the example of export credit guarantees or credit insurance, pay-out periods of up to around 180 days are common in the market. Nevertheless, members consider that this market works well at the moment, the payment period does not cause concern for firms and pay-outs do occur under these products in practice. In members' experience, the timing of claims and payments also varies in practice depending on the reason for the underlying non-payment or default. For example, in the case of an underlying trade finance obligor's insolvency, a claim would usually be submitted and the resulting pay-out made quickly. On the other hand, in the context of corporate finance transactions, lenders would typically seek to explore restructuring and other options before deciding to call a guarantee or similar CRM product. Therefore, any eventual claim and resulting pay-out may occur much longer after the initial non-payment in practice, even if the lender had a legal right to make a claim at an earlier stage.

Members therefore consider that the proposed requirement to pay out within "*days, but not weeks or months*" is unnecessary and does not provide the flexibility needed to take actions such as granting a grace period, if appropriate, or determining the amount of any loss resulting from the non-payment.

For these reasons, members consider that any interpretation of "timely manner" should be principles-based, allowing firms to assess what would be timely in a given situation, rather than prescribing a particular time period that would apply in all cases. When making this assessment, firms should be able to take into account relevant features and practicalities of different underlying exposures, CRM products and associated market practice. These factors for firms to take into account would include the creditworthiness of the protection seller (including whether this is correlated with the creditworthiness of the underlying obligor), the tenor of the original exposure and the likely loss that would be suffered following a default by the underlying obligor.

(d) **Comparison with CDS pay-out periods**

Although members understand that the CP does not directly impact CDS (as it relates to eligibility criteria for guarantees only), the CP indicates that the PRA's reasoning for specifying a maximum pay-out period of "*days, but not weeks or months*" was based in part on "*the timeliness of settlement of credit derivative contracts once an event of default has* *been declared*".[3] However, analysis carried out by AFME members indicates that there is significant variability in the time take to settle credit derivatives, from 8 to 139 days in the sample reviewed, with an average payout period of 39 days. See the Annex for a summary of this data.

Therefore, AFME does not consider that a comparison with CDS settlement periods should lead to the conclusion that the maximum pay-out period under a guarantee used as CRM should be "*days, but not weeks or months*".

(e) **Exceptions to the "timeliness" requirement**

AFME notes that the exceptions to the PRA's proposed interpretation of timeliness in the CP reflect specific provisions in CRR and welcomes the PRA's recognition that different pay-out periods are appropriate in these circumstances. However, if these exceptions are understood as the ***only*** circumstances in which a pay-out period longer than a few days may be appropriate, this would generate odd results, as very different maximum pay-out periods would apply for similar CRM products covering similar underlying exposures. Conversely, we consider that a principles-based interpretation of "timely manner" as described above would lead to more consistent overall conclusions about timeliness.

AMFE understands that there are policy reasons why these particular exemptions for residential mortgage loans and public sector guarantees are specified in CRR. For example, exposures to public bodies are generally given zero credit risk weightings, while residential mortgages generally are considered comparatively low risk. However, there is a spectrum of credit risk profiles across different types of exposures and, in general, we consider that timeliness should be interpreted in a similar manner for exposures with similar substantive features. For example, CRR allows a 24 month pay-out period for residential mortgage loans, whereas under the PRA's proposed definition of "timely manner", the maximum pay-out period for commercial real estate would be "within days". It does not seem consistent to impose such very different maximum pay-out periods for underlying exposures with relatively similar credit risk profiles.

Similarly, guarantees provided by some but not all ECAs may fall within the exception for provisional payments made under guarantees provided by mutual guarantee schemes or by public sector bodies (as some but not all ECAs would be "public bodies"). Therefore, we would ask the PRA to clarify that it does not intend to preclude other protection providers from making timely initial payments with subsequent adjustments. This is a common market practice, which reflects the practical reality that there may be a lengthy process to complete a workout and determine the actual amount that should be paid out under a guarantee. This approach is also in line with guarantor subrogation rights as a matter of English law.

AFME welcomes the carve out for securitisations, and notes that this is in line the EBA's recent Discussion Paper on Significant Risk Transfer in Securitisation, which indicates that an interim credit protection payment within a year following reporting of a credit event "*is a desirable feature from the perspective of the originator's capital position*". As a point of clarification, we should be grateful if the PRA would confirm our understanding that this exception is intended to cover CRM obtained on existing securitisation positions as well as guarantees used as the means of transferring credit risk in synthetic securitisations.

In addition, we consider that it would be appropriate to take a similar approach to interpreting timeliness for other similar types of transactions that are not technically

3 Paragraph 2.7 of the CP.

securitisations, such as untranched portfolio protection arrangements. Whilst this could be done by expressly extending the exemption, a more flexible, principles-based interpretation of "timely manner" as discussed above ought to achieve the same outcome.

(f) **Wider implications for other CRM types**

Although the CP states that it relates only to guarantees, the interpretation of "timely manner" in this context would have wider implications for other types of CRM. For example, the reference to "timely manner" in Article 213(1)(c)(iii) CRR is also relevant for unfunded credit protection provided in the form of credit derivatives, there are other references to "timely manner" in the CRM rules (such as in relation to funded credit protection under Article 194(4) CRR) and firms generally seek to interpret common terms and requirements consistently across different forms of credit protection (including both funded and unfunded CRM) where possible.

However, as the CP only appears to address the requirement for "timely" payment in the context of the eligibility of guarantees used as unfunded CRM, it is therefore unclear what impact this is to have on other references to "timely manner" in the rules. In this respect, members are of the view that such timeliness requirements should also be interpreted taking into account relevant factors such as the nature of any security arrangements, types of collateral and the nature of the protected exposure.

(g) **Comparison with other language versions of CRR**

CRR is an EU legislative instrument and as such, the versions of CRR in all official EU languages are equally authoritative across the EU. Accordingly, in seeking to interpret these rules, it is important to ensure that the meaning given to a particular expression in one language is not inconsistent with the interpretation of the same provision in other official language versions of the rules. The wording used in some of these other versions of CRR is more consistent with the more flexible approach proposed by AFME members in this response than its narrower interpretation proposed by the PRA in the CP.

In the English language version of CRR, the same wording of "timely manner" or "timely" is used is at Articles 194(4), 206(b), 212(2)(h), 213(1)(c)(iii) and Article 215(1)(a) CRR. Although we understand that the CP is intended to be limited to the interpretation of "timely" in the context of unfunded CRM, as discussed at section (f) above, this may nevertheless have implications for other CRM types.

For example, the Dutch translation uses different words in several of these Articles:

- "*bijtijds*" in Article 194(4) which probably translates "as quickly as the situation requires":

- "*zo spoedig mogelijk*" in Articles 206(b) and 213(1)(c)(iii), which means "as quickly as possible". This leaves open the question what "possible" means in this context. Presumably it would at least allow for the validity of the claim to be checked;

- "*zo spoedig mogelijk… indien daarom wordt verzocht*" in Article 212(2)(h) which means "as quickly as possible if and when requested"; and

- "*het recht zo spoedig mogelijk een vordering in te stellen*" in Article 215(1)(a), which means "the right to file a claim as quickly as possible". Again, this supports the point made at section (a) above that Article 215(1)(a) relates to the right to pursue the guarantor in a timely manner, rather than the timing of payment itself.

Similarly, looking at other language version of CRR:

- The French version uses "*dans les délais opportuns*" (which could be translated as "in a timely manner" or possibly "in an appropriate timeframe") at Article 194(4) "*rapidement*" ("quickly") at Articles 206(b) and 213(1)(c)(iii) and "*sans délais*" ("without delay") at Article 215(1)(a) CRR;

- The German version only uses the word "*zeitnah*" ("in a timely manner"); and

- The Italian version uses "*a tempo debito*" (which could be translated as "in a timely manner" or possibly "at the appropriate time") at Article 194(4)) and "*tempestivamente*" ("promptly" or "without delay") elsewhere.

(h) **Grandfathering and clarification of "days, but not weeks or months"**

For the reasons set out above, AFME is asking the PRA to amend its proposed guidance on the meaning of "in a timely manner" to allow firms to take into account relevant features of the relevant CRM product and underlying exposure, as well as associated market practice.

However, if the PRA does retain its proposed definition of "in a timely manner", AFME requests that the PRA provides the market with a reasonable period to adjust to these new expectations, including grandfathering of existing CRM entered into in good faith, in order to mitigate the potentially significant impact this change would have on firms' capital and lending. In this case, AFME also requests the PRA to clarify what it means by "*days, but not weeks or months*" as this phrase is ambiguous. For example, does the PRA intend there to be a hard cut-off at 13 days (i.e. less than 2 full weeks) or might longer pay-out periods still be acceptable and, if so, in what circumstances?

In the context of capital requirements, it is common for the market to have about a year (or longer) to prepare for changes to existing requirements. Therefore, AFME would also ask the PRA to allow firms a transitional period of a year from publication of any final guidance on the interpretation of "timely manner" before the new interpretation would start to apply, in respect of new CRM.

2. **Legal opinion**

AFME would welcome clarification that the PRA does not intend to introduce new requirements on firms in relation to legal opinions that would go beyond the requirements of CRR and which may impose an additional burden on firms in terms of due diligence and associated costs, without providing any corresponding benefit.

Article 194(1) CRR requires firms to obtain an "*independent, written and reasoned*" legal opinion confirming that the relevant credit protection is "*legally effective and enforceable in all relevant jurisdictions*". As noted in EBA Q&A 2013_23, this opinion could be provided by external or internal legal counsel, provided that it is an independent, written and reasoned opinion. AFME considers that it is important from the perspective of maintaining a level playing field across the EU that the PRA's expectations for legal opinions remain consistent with this EBA guidance and do not effectively gold plate CRR requirements. Therefore, the PRA is asked to clarify that firms may continue to rely on this EBA Q&A.

The same EBA Q&A also indicates that it should not always be necessary for firms to seek an individual legal opinion for each specific contract that a firm seeks to use as CRM, but that firms may rely on a single opinion to support multiple transactions where the same template documentation is used. For example, certain firms take out credit insurance based on a template credit insurance policy which has been confirmed to be compliant by external counsel and seek advice from external counsel for any substantive variations to the policy wording. Members submit that this is an appropriate and proportionate approach to take in the circumstances, as obtaining a legal opinion on a policy-by-policy basis would result in the incurring of unnecessary costs.

As set out in Article 194(1) CRR, the key question that the legal opinion is intended to address is the legal effectiveness and enforceability of the credit protection. Institutions may also take legal advice in relation to satisfaction of certain of the other CRR requirements, which may or may not take the form of a legal opinion. However, some of these requirements are factual matters, where independent legal counsel is not necessarily in a position to assess whether these are satisfied. Instead, it is more appropriate for business, risk or finance experts within the firm to examine whether these requirements are met. Therefore, the independent legal opinion should not need to address all eligibility criteria. Instead, the key consideration is whether an institution as a whole can demonstrate that eligibility requirements have been met. AFME considers that firms should be able to continue to rely on their internal analysis in order to determine whether these non-legal criteria are met.

The PRA is further asked to clarify that it does not require firms to obtain legal opinions on the capacity and authority of insurers issuing credit insurance policies. It is market practice not to get formal legal opinions from external counsel where counterparties are sophisticated and well known financial institutions, and this approach is consistent with the market position taken for other risk mitigation products, e.g. LMA sub-participations.

Similarly, we would be grateful for clarification of the PRA's expectation set out in the CP that "*[t]he practical ease of enforcement should also be considered*". This is a practical question rather than a purely legal question. Therefore, whilst firms may seek legal advice on this question, independent counsel are not necessarily in a position to provide a formal legal opinion addressing the practical ease of enforcement. The legal opinion addresses the legal enforceability of the guarantee in court, not the operational enforceability of the guarantee. We do not think the PRA intends to impose a new requirement to this effect but would be grateful for confirmation that this is the case.

Finally, when identifying the jurisdictions in respect of which legal opinions should be sought, the CP sets out the PRA's expectation that this "*could well include other jurisdictions where enforcement action may be taken*", in addition to the jurisdiction where the guarantor is incorporated and the guarantee's governing law. We understand the PRA has in mind situations where a guarantor acts through a branch and/or it has material assets a different jurisdiction, that that there is no expectation for firms to seek additional opinions covering jurisdictions associated with the underlying exposure(s) or protection purchaser (assuming the protection purchaser could take action against the guarantor in another jurisdiction covered by an opinion). However, we should be grateful if the PRA would confirm that this understanding is correct.

We should also be grateful for confirmation that this should not prevent firms from undertaking preliminary analysis for potentially relevant jurisdictions but ultimately concluding that a formal legal opinion may not be required for all those jurisdictions (i.e. if a firm concludes that a formal legal opinion is not required for a particular jurisdiction, it should not require a legal opinion to evidence this conclusion).

3. **Exclusions**

AFME would be grateful for confirmation that certain types of standard exclusion clauses (e.g. nuclear risks, cyber risks, natural disasters and other force majeure events) should not necessarily render a guarantee ineligible for CRM. We consider that this is a practical and sensible outcome, particularly where the excluded risk is independent from the underlying credit risk and the likelihood of it materialising is remote.

We note that risks such as nuclear and cyber risks are not usually taken into account when determining the credit risk of the original obligor. For example, firms would not consider the likelihood of a nuclear or cyber event when determining the risk weight to apply to an obligor under the standardised approach ("**SA**").

In general, these sorts of risks are also independent from the underlying credit risk, meaning that they are not relevant for determining the credit risk of the underlying obligor but are separate risks that exist either way. Where the likelihood of such risks materialising and causing a loss is remote, we consider that there is no practical impact on the effectiveness of the guarantee in mitigating the underlying credit risk. Therefore, we consider that these sorts of exclusions should not generally fall within Articles 213(1)(b) or 213(1)(c)(iii) CRR.

Members propose that firms should be able to take into account the relevant factual scenario in order to determine to whether or not a particular exclusion is relevant to the assessment of credit risk (and therefore whether it may impact the effectiveness of the guarantee as CRM). Members consider this type of substantive analysis would lead to practical and pragmatic outcomes for firms, and would reflect the reality of the risks to which they are exposed. AFME would suggest that any perceived residual risks arising from these sorts of exclusions could be addressed by making an appropriate adjustment of the value of the credit protection, possibly by taking a broader interpretation of Article 215(1)(c).

4. Incontrovertibility

In the CP, the PRA states that it interprets "incontrovertible" to mean that the wording of the guarantee is clear and unambiguous and that is leaves "*no practical scope for the guarantor to dispute, contest, challenge or otherwise seek to be released from, or reduce their liability*".

Members are concerned that this could be interpreted as meaning that inclusion of dispute resolution language in a contract could cast doubt on the incontrovertibility of the guarantee, and therefore on its eligibility as CRM under Article 213(1)(b) CRR. This could be problematic, as it is very common for the parties to agree a contractual mechanism for resolving disputes, for example if a factual dispute arises as to whether or not the lender is entitled to claim under the guarantee. Indeed, these sorts of dispute resolution mechanisms often allow the parties to establish the facts of a potential claim and resolve any dispute in an efficient and effective manner.

We do not think that it is the PRA's intention to suggest that there should be no scope for disputes whatsoever under a guarantee that is eligible for recognition as CRM. In particular, we take comfort from the statement that the PRA expects firms to consider "*whether there are scenarios in which the guarantor could in practice successfully seek to reduce or be released from liability under the guarantee*", when assessing "incontrovertibility" under Article 213(1)(b) CRR. Here, we understand the words "in practice" to indicate that firms should be able to take a practical and pragmatic approach to this question.

We also note that in the context of credit insurance, policies issued to UK banks will typically be subject to the provisions of English law, including the Insurance Act 2015. Policies generally include pre-contractual and ongoing obligations on the bank, which form a critical component of the insurer's appetite to provide protection and reflect the allocations of risk and responsibility under the policy. The Insurance Act 2015 also provides a clear framework (subject to contractual modification) for the remedy of any breaches. Again, we understand that the mere existence of remedies for breach of contract should not render a credit insurance contract ineligible for recognition as CRM under CRR.

Nevertheless, we should be grateful for clarification that the PRA does not intend to suggest that the inclusion of dispute resolution language in a guarantee or language relating to a framework for remedies for breach of contract could affect the "incontrovertibility" of a guarantee under Article 213(1)(b) CRR.

5. **Pillar 2**

The CP indicates that the PRA's proposed expectations relating to the eligibility of guarantees to be recognised as CRM under Pillar 1 does not preclude the possibility that the PRA may require firms to hold additional capital under Pillar 2 to address any residual risks associated with use of CRM. However, the CP does not provide any further guidance about the circumstances in which the PRA may consider Pillar 2 adjustments to be appropriate.

We understand that this statement in the CP is merely intended to direct firms to other existing requirements relating to Pillar 2, such as the requirements for firms to address and control potential concentration risk arising from CRM and the risk that CRM techniques may prove less effective than expected (including through written policies and procedures), and that this statement is not intended to impose any new requirements or supervisory expectations on firms.

Nevertheless, we would be grateful for clarification as to whether the PRA has any additional expectations for firms' use of guarantees as CRM that are not set out in the CP, or if there are other risks that the PRA is concerned may not be fully addressed by the requirements of Articles 213 and 215 CRR, which may lead to the PRA concluding that additional capital under Pillar 2 might be appropriate. If so, we request that the PRA provides further guidance about these additional risks and supervisory expectations, to provide firms with clarity on this point and allow application of capital requirements in a transparent and consistent manner across all CRR firms.

6. **Potential impact for AIRB institutions**

Whilst the CP specifically states that the AIRB approach for the recognition of guarantees under Part Three, Title II, Chapter 3 CRR is out of scope, AFME notes that the CP may nevertheless have wider implications for institutions using the AIRB approach.

For example, whilst institutions may use the AIRB approach for some portfolios, they may not have approved models for particular obligors or guarantors and so would need to satisfy the Chapter 4 requirements for these exposures. As noted below, some of the AIRB rules also expressly cross-refer back to Chapter 4 rules. Even where this is not the case, banks often have a single policy for CRM and so may seek to apply consistent criteria across all portfolios (whether or not AIRB) to the extent possible. In particular, AFME would be grateful for clarification as to whether the PRA intends to apply similar requirements on a bilateral basis through model approvals.

In addition, we note that the draft amendments to SS17/13 state that they are relevant to other parts of CRR that cross-refer to Part Three, Title II, Chapter 4, such as large exposures requirements (where Chapter 4 eligibility criteria must be fulfilled in order for any institution to recognise unfunded CRM for large exposures purposes), double default rules and underlying exposures that are securitisation positions, even where those underlying exposures are otherwise subject to the AIRB approach, and so they do have wider implications. This impact on institutions applying the AIRB approach is likely to be further magnified under the finalised Basel III standards published in December 2017, as fewer exposure classes will be eligible for the AIRB approach and institutions would also need to calculate credit risk under the SA for the purposes of calculating the output floor. The requirements for legal opinions under Article 194(1) CRR also expressly applies to other types of CRM. Again, AFME requests that the PRA takes these wider impacts into consideration when formulating its final guidance.

In closing, we wish to emphasise that the engagement of the PRA with market participants is greatly appreciated. We hope this response is helpful. We are grateful for the opportunity to comment on the CP and we would be happy to answer any further questions that you may have or develop further issues of interest to you.

Kind Regards,

Constance Usherwood

Director, Prudential Regulation

Annex – CDS Payout Days Data

CDS Payouts Days

CDS Payout Days	Event Date to Auction Date	Auction Date to Settlement Date	Event Date to Settlement Date
Max Days	132	11	139
Min Days	1	3	8
Avg Days	**32**	**6**	**39**

Large Obligation – Default CDS Payout Days – ISDA & Markit

Firm	Fannie Mae	Lehman	WAMU	Tribune	GMC	TXU
Filed Bankruptcy	9/7/2008	9/15/2008	9/26/2008	12/8/2008	6/1/2009	4/29/2014
Auction Date	10/6/2008	10/10/2008	10/23/2008	1/6/2009	6/12/2009	5/21/2014
Settle Date	10/15/2008	10/21/2008	11/7/2008	1/16/2009	6/18/2009	5/29/2014
Days to Auction	29	25	27	29	11	22
Days to Settlement	9	11	15	10	6	8
Days to Payout	38	36	42	39	17	30
					Avg Days	34
					Max Days	42
					Min Days	17