

## INSURANCE & REINSURANCE | JUNE 2024

# CREDIT INSURANCE AS A CREDIT RISK MITIGANT

### The Case for Clarity

By 30 June 2024, the European Banking Authority (EBA), in cooperation with the European Insurance and Occupational Pensions Authority (EIOPA), is to report to the European Commission on the eligibility and use of credit insurance as a credit risk mitigation technique.

This report will look at the appropriateness of credit insurance policies within the existing legal framework, as well an analysis of the "effective and observed riskiness" of using credit insurance as a credit risk mitigant.

Its findings will be considered by the Commission and form the basis of their legislative proposals in relation to amending Regulation 575/2013 on prudential requirements for credit institutions, which are due on 31 December 2024. The Commission had previously proposed legislative amendments in this regard to respond to the recommendations proposed by Basel III.

The publication of this report is a welcome step in this space and will provide additional clarity to banks looking to maximise their credit insurance products for regulatory capital purposes.

### Unfunded Credit Risk Mitigation

Unfunded credit risk mitigation involves the use of off-balance sheet arrangements, such as guarantees and credit derivatives, to reduce the credit risk associated with a particular financing.

In a guarantee, the risk of non-payment is essentially transferred from one party (i.e. the obligor) to another (i.e. the guarantor). The beneficiary is comforted by the involvement of a third-party entity who can step in and ease the pain in the event of default.

For banks however, risk transfer is not the only benefit. In certain circumstances and provided certain criteria are met, banks can also use guarantees and similar arrangements to manage their capital requirements and gain regulatory capital relief. As a result of the guarantor involvement and the sharing of the risk, the bank is not required to maintain as much capital as they would if there was no third-party involvement.

### Credit Insurance

Credit Insurance, by its nature, operates in similar manner to a guarantee i.e. it provides for the transfer of risk of non-payment from one party, the obligor, to another, in this case a regulated insurance company.

However, there are certain features of a credit insurance policy i.e. disclosure obligations, exclusions etc., which differ from a pure guarantee. Also, while the wording in guarantees are typically short, relatively standard and incontrovertible, the wording in credit insurance policies can vary widely and result in grey areas (albeit there has been a move towards standardised wording in recent times).

It is for this reason that credit insurance policies generally have not been accepted as credit risk mitigants. At the same time, provided it is drafted in a certain way and will ensure the payment of claims in a timely manner, there is no reason why credit insurance cannot operate in the same way as a guarantee in protecting bank risk in the event of default.

If a bank is interested in using their credit insurance policies in this way, the first step would be to due diligence the relevant policy and assess whether it meets the necessary criteria. Typically, such due diligence should be carried out by independent legal specialists and will result in the issuance of a legal opinion. The legal opinion can then be used by the bank to discuss with its regulator whether the latter will permit the use of the insurance policy as an unfunded credit risk mitigant.

## General Applicability

Many regulators have acknowledged the use of credit insurance as a credit risk mitigant, provided the policies satisfy the relevant criteria. The impending report from the EBA should provide some insight into how the EU will approach this issue going forward.

While any amendments proposed by the EBA/Commission will only have direct effect within the EU, the implications of their position will likely have an impact well beyond the shores of the EU.

The EU rules themselves are based on the standards proposed in the Basel Framework and it is therefore no surprise that the CRR has been used as a template worldwide, including in the Middle East. As such, any express recognition of the use of credit insurance as a credit risk mitigant and guidance on how such mitigation procedures should be applied, may be adopted in other jurisdictions too.

If you would like to discuss further, please feel free to reach out to John Barlow and/or Shane Gibbons.

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