CREDIT RISK REDUCTION REGULATIONS – WHY THE FINANCIAL SERVICES INDUSTRY NEEDS TO PAY ATTENTION

INDUSTRY VIEW

When the Bank of England's Prudential Regulation Authority (PRA), whose job it is to supervise and regulate financial services firms, announces a new consultation paper, it doesn't usually make headline news. But in the case of the 'Credit Risk Mitigation' paper, which was introduced in February 2018, interested parties might find it challenging to see any ripples on the pond at all.

More clarity needed

So, it is all the more important to give proper consideration to the impact that this consultation paper might have. To give it its full title, the Credit Risk Mitigation: Eligibility of guarantees as unfunded credit protection paper sets out the PRA's proposed changes to existing regulation. It wants to clarify expectations regarding the eligibility of guarantees as unfunded credit protection. The proposals extend to any contract or other documented obligation that purports to be a guarantee for the purpose of achieving unfunded credit protection under Capital Requirements Regulation(CRR) Part Three, Title II, Chapter 4. 1.3, and is relevant to all firms bound by the CRR.

Credit insurers, surety and finance companies will all be expected to respond, but the lack of media attention, and, frankly, the lack of open discussion in the industry in general, belies the importance of the consultation.

To put this into context, credit risk mitigation (CRM) is a widely used technique to reduce the credit risk associated with an exposure. Firms may, for sound risk management reasons, wish to use CRM techniques to mitigate credit risk irrespective of any particular capital treatment. The CRR allows organisations to recognise some forms of CRM in the calculation of their capital requirements.

CRM can be funded or unfunded. One of the ways unfunded credit protection can be achieved is through a guarantee. This is reached through the obligation of a third party to pay out in the event of non-payment or default of a credit obligor. In order to be eligible as a guarantee for CRM under the CRR, strict eligibility criteria must be met. The PRA has identified that some firms are unclear about what contracts or other documented obligations are eligible to be treated as guarantees for CRM under the CRR.

The consultation paper has come about because the PRA considers that additional clarity is needed to ensure that capital relief from guarantees is obtained only where the risk has been effectively transferred to the guarantor

This is all very well, but the reality is that the system as it stands currently is working. This makes the consultation paper not only a surprise, but according to many of our colleagues in the industry, possibly surplus to requirements.

Banks, insurance companies and the like have checks and balances that provide evidence that guarantees are in place. Some of our own customers use our RMC Finance for just this purpose, and to easily link banks with credit insurers which assures them that they are fully compliant with the terms of the policy.

There are many aspects to the consultation paper that are puzzling. The most obvious is that the insurance industry has evolved to allow claims to be paid in a reasonable time, which could be weeks, sometimes months, but rarely within a few days. The concern is that any changes, and these are outlined in the consultation paper, would drastically shorten this timespan, and the expectation is that insurers might ask for an enhancement in the claim waiting/processing period as a compromise.

> *To be eligible as a guarantee for CRM under CRR, strict eligibility must be met.*

Any change could have an impact on capacity and would certainly require insurers to move funds or change their cashflow arrangements to ensure rapid availability for claims. This will then have a knock-on effect on costs and premiums.

Why has the consultation paper been published by the PRA now? As far as we understand it, this consultation is only being targeted at the UK, but with Brexit looming, the UK financial services market is doing everything it can to ensure it can continue to compete as a financial hub. The implementation of more rigid regulation, and certainly more rigid than in the EU, or the US, where deregulation is expanding, is likely to affect domestic and export trade for the UK. There is a concern that capital relief will become harder and more challenging to obtain from guarantees.

Asking around, it is clear that the consultation paper is not a subject of wide discussion. However, amongst those that are aware of it, and its implications, the hope seems to be that it will not make capital relief from guarantees within the UK more challenging than any other developed market.

Of course, regardless of how difficult it is to get guarantees and regardless of any changes that do come about, dedicated trade credit insurance software solutions can play a part in helping to bridge the systems from banks and receivable finance companies with credit insurers and guarantees. They can help to ensure that conditions meet compliance, and that, in the event of a claim, the evidence required to support that claim is available to ensure prompt payment.

Organisations have until the 16th May to respond to the consultation paper. At the moment, the over-riding theme amongst peers in the industry seems to be 'if it ain't broke, don't fix it'. Granted, we may not see legislation being brought into force in the end, but even by going through this period of consultation, the industry should recognise that it can't be complacent about the legacy systems and manual processes on which it still relies too heavily. If the argument that digitisation delivers competitive advantage isn't compelling enough, then perhaps the inevitable reach of regulation should be?

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Established in 2000 and headquartered in Paris, France, Tinubu is an independent software provider and employs 170 people, located in Paris, London, New York, Orlando, Singapore, and Montreal. Its clients represent 30 of the top 60 Credit & Surety underwriters worldwide.

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