

## PRA PUBLISHES PS8/19 ON ELIGIBILITY OF GUARANTEES AS UNFUNDED CRM UNDER CRR

The PRA published its Policy Statement ([PS8/19](#)) on "Credit risk mitigation: Eligibility of guarantees as unfunded credit protection" yesterday.

This provides feedback to the PRA's consultation CP6/18 as well as the PRA's final policy, set out in:

- Supervisory Statement [SS7/13](#) 'Credit risk mitigation'
- Supervisory Statement [SS31/15](#) on the ICAAP and SREP

The changes to these Supervisory Statements will be effective from 13 September 2019 (i.e. 6 months after publication of PS8/19).

### KEY ISSUES AND RESPONSES TO CP6/18

The PRA has taken on board a number of issues raised by the industry in response to CP6/18, notably in relation to its interpretation of 'timely manner'. In summary:

#### Timely manner

In CP6/18, the PRA proposed interpreting the requirement to pay out in a timely manner as meaning "*within days, but not weeks*". The industry raised concerns that this would adversely impact existing unfunded credit protection products, including insurance products which typically have longer pay out periods.

In response, the PRA has dropped this proposed interpretation of timely manner.

The PRA does however remind firms of EBA Q&A 2015\_2306, noting that "*while the expression 'timely manner' allows some flexibility, it would not allow any 'determinable' period, the length of which depends on circumstances on which the firm has no influence*".

#### Legal effectiveness and enforceability in all relevant jurisdictions

As set out in CP6/18, the PRA confirms that at a minimum, it would expect firms to satisfy themselves that the guarantee is enforceable under its governing law and in the jurisdiction where the guarantor is incorporated.

#### Key issues

- PRA has dropped proposed interpretation of timely manner.
- PRA has removed its proposal that the legal opinion consider the practical ease of enforcement and the eligibility criteria.
- Exclusion for cyber, and political and civil unrest would be contrary to CRR Article 213(1)(c).
- Nuclear exclusion may be problematic from CRR perspective unless the exclusion is immaterial to the guaranteed exposure and the risk of an obligor default under that exposure.
- PRA expects adequate risk management processes to control risks arising from eligible guarantee arrangements and around residual risks.
- PRA considers residual risks relating to the use of guarantees should be reflected in Pillar 2 requirements.

In CP6/18, the PRA indicated that ease of enforcement should be considered and the PRA would expect an independent legal opinion to consider the eligibility criteria. However, the PRA has taken on board industry responses that these include practical questions which may be better considered outside a legal opinion.

The PRA has therefore removed its proposal that the legal opinion also consider the practical ease of enforcement and the eligibility criteria, offering firms greater flexibility about how they address these issues.

## **Exclusion clauses**

The PRA has made some noteworthy comments in response to requests for clarification about exclusions clauses that would be permitted under Article 213(1)(c) CRR.

In particular the PRA identifies the following types of exclusion clauses as potentially problematic, "*unless in all the circumstances the clause is immaterial to the guaranteed exposure and the risk of an obligor default under that exposure*":

- Cyber events: The PRA states it expects that, in many cases, a cyber event exclusion clause would be contrary to Article 213(1)(c)
- Political and civil unrest: Again, the PRA states it expects that for many international trade finance exposures, exclusion clauses for political or civil unrest would be contrary to Article 213(1)(c)

## **Risks arising from eligible guarantee clauses, residual risks and Pillar 2 requirements**

The PRA has introduced new expectations around:

- identifying risks arising from eligible guarantee arrangements and having adequate risk management processes in place to control these risks and around residual risks; and
- residual risks, where the PRA has indicated that residual risks relating to the use of guarantees should be reflected in Pillar 2 requirements.

This appears to be the way in which the PRA is balancing or justifying the removal of some of the hard eligibility criteria under Pillar 1 discussed above.

In relation to residual risks, the PRA expects firms to consider as part of their ICAAP the risk that, "*although the CRM eligibility criteria are met, the credit protection could in practice become less effective for a reason other than the default of the guarantor*."

The PRA notes it "*considers that this risk is likely to be greater where guarantees qualifying for CRM have broad or vague terms or obligations, which the firm must fulfil, such as duties of disclosure commonly found in credit insurance*".

The PRA also expects firms to consider whether the guarantor would, in practice, seek to reduce or be released from liability as a residual risk under the ICAAP, rather than through the Pillar 1 eligibility criteria around 'clearly defined and incontrovertible (as originally proposed in CP6/18).

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