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Banking and Financial Institutions

Primer on Non-Payment Insurance

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Non-payment insurance (NPI) policies are contracts issued by insurance companies to institutions seeking a form of credit risk mitigation for their third-party liabilities (such as obligations under a credit facility[1]). These policies constitute unfunded, uncollateralized credit protection that provide full recourse to the insurer for the insured sum.

As compared with letters of credit or parent company guarantees, 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[2].

So-called failure-to-pay insurance has several advantages over Credit Default Swaps (CDS). It can provide capital relief on specific names, but as it is directly insuring a bespoke portfolio of loans, it reduces the risk that the underlying default triggers the hedge. It is also not marked-to-market, so changes in value do not appear on banks' earnings statements. Market capacity for non-trade related credit insurance has increased to over $1.5 billion per risk for tenors of up to seven years, while volumes of $700 million are available for risk tenors of 10 years[3].

DIFFERENCES BETWEEN CREDIT DEFAULT SWAPS AND NON-PAYMENT INSURANCE

NPI policies bear a resemblance to CDS and other similar credit protection instruments (such as financial guarantees), insofar as each product aims to mitigate counterparty credit risk by way of the seller of the product making payments to the purchaser upon the occurrence of certain specified events.

Under a typical CDS, one party (the Protection Buyer) will pay periodic premiums to another party (the Protection Seller) in return either for payments to cover loss in value, or the right to dispose of an asset at its face value, following the occurrence of certain pre-agreed credit related events (Credit Events) in respect of obligations (Obligations) owed or guaranteed by a party (the Reference Entity).

Whilst the purpose of CDS and NPI are similar, they may be distinguished from each other by both their legal characteristics and their commercial structures.

	NPI	CDS
Insurable Interest	Yes	No
Loss Insured	Yes	No
Duty of Fair Presentation	Required	Not applicable
Subordination Rights/Recovery Rights	Yes	None
Exclusions	Yes	Not required
Triggers of Settlement	Loss required	Other causes can be used for claims
Settlement/Amount Payable	Amount related to insured loss	Based on market wide dealer auction
Liquidity	Customized policies	Very liquid

[1]Non-payment insurance: a regulatory capital solution, Butterworths Journal of International Banking and Financial Law, May 2018
[2]Non-payment insurance as Credit Risk Mitigation under Regulation Q, Clifford Chance, May 2017.
[3]Non-payment insurance grows as banks shun stuttering CDS Market, Natasha Rega-Jones, Jan.24, 2019, Risk.net

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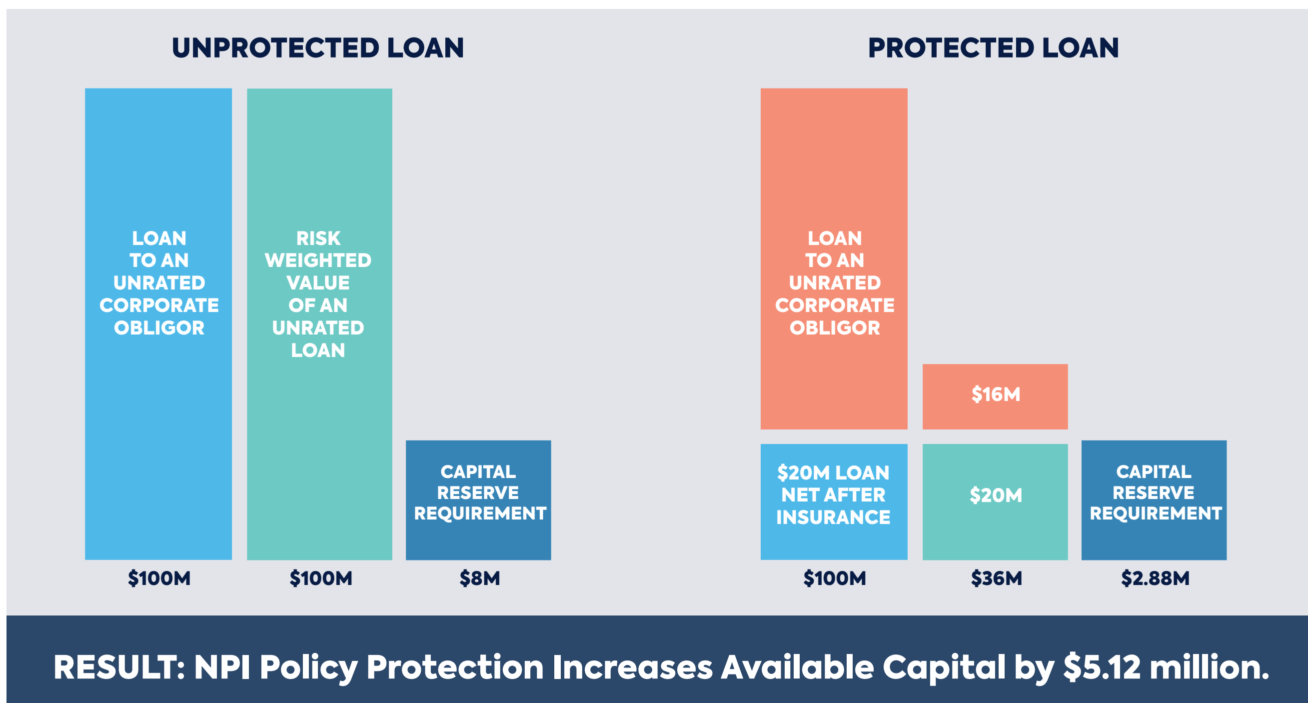
ILLUSTRATION OF CAPITAL RISK WEIGHT REDUCTION[4]

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 an "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.



[4]Illustration adapted from "Non-payment insurance as Credit Risk Mitigation under Regulation Q, Clifford Chance, May 2017"

FOR MORE INFORMATION PLEASE CONTACT:

Cedric Franklin
Vice-President, Client Executive — Surety and Credit Risks Solutions
T. 437-828-1162 **C.** 647-202-8406
cfranklin@bflcanada.ca

THIS DOCUMENT WAS ISSUED BY:

BFL CANADA Risk and Insurance Services Inc.
181 University Avenue, Suite 1700
Toronto, Ontario M5H 3M7

T. 416-599-5530 **F.** 416-599-5458
Toll Free: 1-800-668-5901

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