

January 15, 2024

**Board of Governors of the Federal Reserve System**

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Washington, DC 20551

**Federal Deposit Insurance Corporation**

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400 7th Street S.W., Suite 3E-218  
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**RE: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity) [RIN 1557-AE78, 3064-AF29,7100-AG64] / Docket No. R-1813 / Docket ID OCC-2023-0008<sup>1</sup>**

Ladies and Gentlemen,

Marsh McLennan is writing to provide our input in relation to certain of the proposed changes to the regulatory capital rule referenced in the NPR issued by the Federal Reserve Board (“FRB”), Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”). This letter and the accompanying paper focus on the regulatory capital requirement shifts under the Expanded Risk-based Approach (“ERA”) and the potential impacts on the market for insurance and reinsurance-based credit risk mitigation (CRM) in the United States. The accompanying paper seeks to provide a holistic view that explains the mechanics of credit risk transfer to insurers and reinsurers as a form of credit risk mitigation, the regulation of relevant insurers and reinsurers that offer these solutions, and the current and potentially expanded use of such insurance policies by US banking organizations and internationally. The NPR’s proposed changes would appear to encourage among banking organizations wider use of credit risk transfer to insurers as a CRM technique under the proposed regulatory capital rules.

**Insurance and Reinsurance-Based CRM**

Insurance and Reinsurance Supported Credit Risk Transfer is a form of a credit-risk mitigation guarantee in which a lender transfers the risk of borrower default or non-payment to an insurer or reinsurer, in exchange for a premium. It appears to us that credit risk transfer could qualify as an eligible guarantee under the proposed regulatory capital rules and therefore would reduce the risk weightings associated with certain corporate exposures, from 100 percent under the current standardized approach to 65 percent under the proposed rules, provided that the insurer or reinsurer, or its controlling parent company, issues investment grade publicly traded securities. This reduced risk weighting could allow banking organizations to distribute credit risk and promote efficient capital management. Thus, we respectfully request the FDIC, OCC and FRB confirm this view in the final rules.

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<sup>1</sup> Notice of proposed rulemaking, 88 Fed. Reg. 64028 (September 18, 2023), available at <https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant>

## Analysis

Under the proposed regulatory capital rules, credit risk transfer would appear to qualify as eligible guarantees (Section 2.2.2 of Paper). In addition, non-monoline insurers or reinsurers would appear to qualify as “eligible guarantors” under 12 CFR 3.2(2) (OCC)<sup>2</sup> based on the following analysis supported further by the Paper:

First, an insurer that is the direct issuer of and counterparty to a credit risk transfer transaction is typically a wholly owned subsidiary under the control of a parent holding company that itself has outstanding and investment grade rated debt. As the aim of the “eligible guarantor” definition appears to ensure that the ultimate credit risk taker is of solid credit and has sufficient access to the capital markets during times of stress, it would be reasonable to conclude such insurer should be deemed to meet the first prong of the definition.

Next, the creditworthiness of diversified insurers and reinsurers do not materially correlate with the credit risk of the exposures insured, satisfying the second prong of the definition. Insurers limit the concentration of correlated assets in accordance with minimum capital requirements and enterprise risk management, both of which are monitored by state regulators. State regulators have regular and detailed reporting standards that allow for the tracking of firm liquidity, solvency, and internal risk management practices. Regulators use risk-based capital (“RBC”) requirements that identify permitted assets and assign risk weightings that correspond to an asset’s inherent risk. RBC calculations enable regulators to limit higher risk asset types, assess ability to pay back obligors, and promote insurer financial stability. The result of RBC-based regulations is that insurers’ investments have been channeled into stable asset classes – around 80 percent of property and casualty insurers’ and reinsurers’ assets are in stocks, bonds, and cash (See Appendix D of Paper). The top 25 P&C Insurers on average hold risk-based capital in excess of 500 percent of the regulatory minimums (Section 3.1 of Paper). Insurers have also maintained a 28.5 percent capital and policyholder surplus as a percent of total assets percent and a current liquidity ratio over 106 percent (Section 3.1 of Paper).

Finally, insurers write relatively few CRM transactions as a proportion of their overall portfolio (See Section 2.2.2 of Paper). Monitoring by state regulators can be expected to limit the extent of growth of credit risk transfer products on insurers’ balance sheets. In addition, state regulators along with the Federal Insurance Office collect data to monitor growth and trends in the market to help prevent systemic risk which could arise from a sharp rise in the level of adoption of credit risk transfer in the market.

## Conclusion

Insurance and reinsurance-based CRM has the potential to be an increasingly useful instrument in the United States financial system, as it can serve to underpin lending confidence within banking organizations, act as an indirect economic driver, and encourage market stability and sustainable growth (See Appendix B.1 of Paper).

We thank you for the opportunity to provide input on the proposed regulatory capital rules in the NPR and would encourage the FRB, FDIC, and OCC to confirm the use of insurance and reinsurance-based CRM and that insurance and reinsurance companies qualify as eligible guarantors.

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<sup>2</sup> 12 CFR 3.2(2) provides that an “[e]ligible guarantor means ... (2) an entity (other than a special purpose entity): (i) [t]hat at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade; (ii) [w]hose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and (iii) [t]hat is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).”

Sincerely,

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# INSURANCE AND REINSURANCE SUPPORTED CREDIT RISK TRANSFER

## MMC RESPONSE TO BASEL III NPR

January 15, 2024

Marsh GuyCarpenter Mercer OliverWyman

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## Executive Summary

The changes to the regulatory capital rules (the Proposal) proposed by the Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) present the opportunity for banks to potentially engage with investors, insurers and reinsurers in insurance-based credit risk mitigation transactions. These transactions would reduce total risk in the banking sector as the insurance companies involved in these transactions are highly regulated and hold diversified portfolios. Transfer of credit risk into the insurance market can promote a more stable and resilient banking system by distributing risk more broadly across the financial system while also increasing lending capacity to the economy.

In the context of the Basel III endgame proposals, credit risk mitigation would appear to be incentivized by a reduction in risk-weights applicable to bank exposures to highly creditworthy insurers and reinsurers under the Expanded Risk-based Approach (ERA). The proposed rules would appear to treat non monoline insurance or reinsurance companies, including their subsidiary entities, as eligible guarantors, subject to certain conditions that such insurers should satisfy. This allows insurance and reinsurance companies to issue eligible guarantees as is required for banks to receive capital relief under the synthetic securitization framework and substitution approach. By utilizing credit risk mitigation techniques, banks may be able to more effectively manage credit risk and increase their lending capacity.

# 1. Changes to prudential banking regulation

The Proposal contains updates to the approaches to Risk Weighted Capital, Capital Requirements, and Capital Buffers, across Category I, II, III, IV and other banking organizations. This paper focuses on the updated Risk Weighted Capital approach, and more specifically the framework for evaluating credit risk.

The Risk Weighted Capital approach includes a new, dual structure for calculating risk weighted assets, combining slight alterations to the current 'Standardized Approach' with a new, 'Expanded risk-based approach' (ERA). Both approaches address calculations of credit risk, operational risk, CVA risk, and market risk, varying in updates depending on the approach. The Standardized Approach maintains its current general credit risk model and implements a new standardized approach for evaluating market risk. The ERA includes expanded risk-based credit risk modeling, standardizing the approach across credit, equity, and securitization mitigation exposures. Further, the ERA has standardized CVA risk models, standardized operational risk models inclusive of internal loss multiplier methodologies, and a revised internal model for market risk. For a given banking organization, the existing model may continue to apply.

Further, the updated framework aligns capital rules for all banks classified as Category I, II, III, and IV banking organizations, which together encompass all organizations with assets totaling greater than \$100B. The framework's impact varies depending on the bank's categorization.

The following section will detail the Proposal's implications on components of credit risk, including changes to corporate exposures (including project finance exposures), real estate exposures, and small or medium-sized entity (SME) requirements, concluding with the expected impact of the proposal's framework, once implemented.

## 1.1. Corporate exposures

The updated guidelines define corporate exposures as all exposures not individually defined within the NPR (for example, real estate, retail, and bank exposures). The Proposal stipulates a risk weighting of 65 percent be assigned to corporate exposures with companies that are investment grade, and that either have a publicly traded security outstanding, or are controlled by a parent company with a publicly traded security outstanding<sup>1</sup>.

- **Investment grade** means that the entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure<sup>2</sup>

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<sup>1</sup> Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 F.R. 64053 (Proposed September 18, 2022) (pts. 3, 6, 32 (OCC); pts. 208, 217, 225, 238, 252 (Federal Reserve); pt 324. (FDIC)

<sup>2</sup> Regulatory Capital Rule, 88 F.R. 64040, Footnote 57 (Proposed September 18, 2023) See 12 CFR 3.2 (OCC); 12 CFR 217.2 (Board); 12 CFR 324.2(FDIC)



- Such an entity or reference entity has **adequate capacity** to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected<sup>3</sup>
- **Publicly traded** implies a listing on any US national securities exchange or non-US securities exchange that provides a liquid, two-way market for the instrument in question<sup>4</sup>
- A company is considered **controlled by a parent** or second company if the second company or parent either owns 25 percent or more of any class of the subsidiary company's voting securities, or if the parent company consolidates the first company for financial support purposes<sup>5</sup>

Thus, given the definitions laid out in the NPR, insurance and reinsurance companies that issue, or whose controlling parent issues, publicly traded securities would be eligible for the 65 percent risk weighting, provided it maintains a sufficient investment grade.

### 1.1.1. Project finance exposures

Corporate exposures also include both project finance and subordinated debt instruments. Under the updated regulations, the former incurs a 130 percent risk weighting if the project finance exposure is not an operational phase exposure, and a 100 percent weighting during the operational phase. A subordinated debt instrument or an exposure to a covered debt instrument would incur a 150 percent weighting.<sup>6</sup>

## 1.2. Other exposures

Outside of corporate exposures, the ERA also alters risk weightings for real estate and retail exposures, discussed in detail in **Appendix B**. Under the NPR, risk weights of real estate exposures hold a direct relationship with loan-to-value (LTV) ratio. The proposal introduces a new definition of retail exposures, distinguishing them from real estate exposures compared to the current regulations. Retail exposure weightings account for whether or not the exposure is regulatory, transactional, or neither. See **Table 1** for a general overview of changes made non-corporate exposures.

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<sup>3</sup> See footnote 2 (88 F.R. 64040, Footnote 57)

<sup>4</sup> Regulatory Capital Rule, 88 F.R. 64054, Footnote 96 (Proposed September 18, 2023)

<sup>5</sup> Regulatory Capital Rule, 88 F.R. 64054, Footnote 94 (Proposed September 18, 2023)

<sup>6</sup> Regulatory Capital Rule, 88 F.R. 64054 (Proposed September 18, 2023)

**Table 1: Overview of changes to risk weightings of real estate and retail exposures**

Exposure type	Risk weightings – standard approach	Risk weightings – ERA approach
Regulatory residential real estate <sup>7</sup>	50%-100%	40%-125%, depending on LTV ratio and cash flow dependency
Regulatory commercial real estate <sup>8</sup>	100%	60-110% <sup>9</sup> , depending on LTV ratio and cash flow dependency
Retail	100%	55%-110%, depending on exposure sizes and whether or not the exposure is to a transactor
Non-regulatory real estate exposures <sup>10</sup>	50%-100%	50%-100% (unchanged from current standard approach)
Other real estate exposures <sup>11</sup>	100%	100%-150%
Defaulted exposures <sup>12</sup>	100%	100%-150%

### 1.3. Projected impacts

See **Table 2** for the proposal’s projected impacts on risk weighted assets. Inclusive of credit, market, operational, and CVA risk, RWA are set to increase by 20 percent leading to an expansion in common equity tier 1 capital requirements by 16 percent in aggregate.<sup>13</sup> However, there are disparate impacts across differing sizes and complexities of the affected banking organizations, driven by varying exposures.

<sup>7</sup> See Appendix B for definition of regulatory residential real estate exposure.

<sup>8</sup> Per the NPR, regulatory commercial real estate exposures are defined as real estate exposures that are not any of those listed in the definition for regulatory residential real estate exposures (see Appendix B). Further the exposure must meet five criteria listed in Appendix B.

<sup>9</sup> Risk weights can fall outside this range depending on the rates applicable to the borrower, see Appendix B for explanation.

<sup>10</sup> Per the NPR, Includes high-volatility commercial real estate, statutory multifamily mortgage, acquisition, development, or construction (ADC), and pre-sold construction exposures.

<sup>11</sup> Includes real estate exposures that are not statutory (pre-sold construction, HVCRE, or statutory multifamily mortgage), ADC, or regulatory commercial or residential real estate exposures.

<sup>12</sup> Applies to all real estate exposures.

<sup>13</sup> Regulatory Capital Rule, 88 F.R. 64169 (Proposed September 18, 2023)

**Table 2: Current and projected RWA by risk category and holding company categorization<sup>14</sup>**

Risk category	Aggregate RWA (\$B), Category I and II holding companies			Aggregate RWA (\$B), Category III and IV holding companies	
	Current standardized	Current advanced	Basel III proposal projection	Current standardized	Basel III proposal project
Credit	6,900	4,300	6,700	4,000	3,800
Market	430	430	760	130	220
Operational	-	1,700	1,400	-	550
CVA	-	240	260	-	28
<b>Total</b>	<b>7,400</b>	<b>6,700</b>	<b>9,200</b>	<b>4,200</b>	<b>4,600</b>

Due to the breadth of regulatory requirements of Category III and Category IV banking organizations, the changes are projected to increase RWA and CET1 regulatory capital by 6 percent across domestic banking organizations. Category I and II organizations incur the proposal's more significant impacts, with these organizations anticipating a 24 percent increase in RWA under the new stringent ERA guidelines.

The Proposal projects an increase in RWA associated with lending, due to the ERA requiring \$380B or 30bps of additional required capital across both credit and operational risk-weighted asset calculations. In addition, the requirement of using input-sensitive risk weighting for certain asset classes such as those described in sections 1.1 – 1.2 tends to incentivize banks to seek capital relief opportunities using a range of different transaction structures which are today utilized by both the Government Sponsored Enterprises, Fannie Mae and Freddie Mac, as well as international banking institutions.

## 2. Credit risk transfer market overview and mechanics

### 2.1. The mechanics of insurance and reinsurance-based credit risk transfer

Credit risk mitigation techniques include several transaction types and structures that allow banks to maintain ownership of the assets and its customers. See **Table 3** for an overview of common credit risk transfer transactions and the sectors that typically use them.

<sup>14</sup> Regulatory Capital Rule, 88 F.R. 64168 (Proposed September 18, 2023)  
Marsh McLennan

**Table 3: Overview of common insurance and reinsurance-based credit risk transfer transactions**

Transaction type	Description	Asset Classes	Risk Retention
Credit risk transfer using Non-payment insurance (NPI)	Refers to policies that protect against single exposures or pools of assets with tenors of less than one year up to 20 years. These transactions are often widely syndicated.	Various (including Trade & Commodity Finance, Corporate Lending, Project Finance, Fund Finance, Leveraged Loans, Derivatives)	On a pro-rata basis, banks typically retain 5-70% of the reference assets
Credit Risk Transfer known as 'CRT Transactions'	Also widely syndicated transactions that protect portfolios of assets typically on a tranching basis with tenors up to 20 years.	Residential and commercial mortgages, portfolios of consumer, corporate & SME loans	On a tranching basis, with banks typically retaining first loss and senior tranches of reference pool exposure

Issuance volumes for single family and multifamily reinsurance CRTs have been exceptionally strong in the US with Fannie Mae and Freddie Mac transferring over \$63.7 Billion of risk on 185 transactions across \$3.5 Trillion of UPB since 2013<sup>15</sup>. However, banks' demand for insurance supported credit risk transfer transactions, including both NPI and CRT, has been more limited in the United States due to the lack of clarity on regulatory capital treatment related to allowing such transactions. (In the US, such transactions tend to provide limited capital relief given 1) the current risk weightings for corporate exposures, a fact that changes under the lower risk-weightings laid out in the NPR and 2) the uncertainty of the applicability of parent company debt in the definition of an eligible guarantor (currently limited to operating company debt which is not a common practice for insurance and reinsurance companies). However, due to the differing regulatory frameworks outside the US, a mature market for NPI and CRT exists in the EU, UK, Canada, and Japan, further elaborated on in Section 2.3.

With a NPI policy, the credit risk owner (the banking organization in the context of the NPR), commonly begins the risk transfer process by originating an exposure with a third party. The banking organization then pays a premium to the primary insurer, assumed to be a diversified investment grade company(ies) (i.e., not a mono-line insurer or mono-line reinsurer). This type of credit risk transfer covers non-payment for any reason outside of the operational control of the credit risk owner.

In almost all scenarios, insurers require credit risk owners to maintain a minimum percentage of the credit exposure uninsured and unhedged, referred to as a minimum risk retention. The insured commitment is a subset of the total exposure and is covered for a percentage of total

<sup>15</sup> Freddie Mac, ACIS Pricing, <https://capitalmarkets.freddie.com/crt/reinsurance/pricing>, (accessed 12/27/2023); Freddie Mac, "Multifamily MCIP Program Overview as of September 30, 2023", Freddie Mac, [https://mf.freddie.com/docs/mcip\\_investor\\_presentation.pdf](https://mf.freddie.com/docs/mcip_investor_presentation.pdf), (accessed 12/27/2023); Freddie Mac, Multifamily Securities Pricing, <https://mf.freddie.com/investors/multifamily-securities-pricing>, (accessed 12/27/2023); Freddie Mac, Clarity, (accessed 12/27/2023); Fannie Mae, CIRT Pricing, <https://capitalmarkets.fanniemae.com/credit-risk-transfer/single-family-credit-risk-transfer/credit-insurance-risk-transfer/cirt-pricing>, (accessed 12/27/2023); Fannie Mae, Multifamily CIRT Transactions, <https://capitalmarkets.fanniemae.com/credit-risk-transfer/multifamily-credit-risk-transfer/multifamily-credit-insurance-risk-transfer/multifamily-cirt-transactions>, (accessed 12/27/2023).

losses, relative to the loan size. In return, the primary insurer generally receives approximately 50 to 70<sup>16</sup> percent of the interest margin (per annum), on the insured portion of the loan (the ‘premium’, mentioned above). See **Figure 1** for an illustrative example of this form of credit risk transfer.

**Figure 1: Illustrative example - Non-Payment Insurance transaction for a loan, including minimum risk retention of the exposure**



NPI policies provide capital relief through the reduction in risk weightings (and thus capital requirements) on the insured portion of the exposure. Consider a hypothetical example in which a banking organization holds a project finance exposure. Highlighted in section 1.2, a project finance exposure in an operational phase incurs a risk weighting of 100 percent. A credit risk transfer policy allows a banking organization to substitute the associated RWA to that of the primary insurer(s) (for the portion of the loan that is insured). If the primary insurer meets the requirements as an eligible guarantor, the insured commitments would be subject to a lower risk weighting of 65 percent, reducing capital requirements. See **Figure 2** for an illustrative example of a credit risk transfer agreements’ impact on capital requirements under the new regulations, using a project financing corporate exposure example.

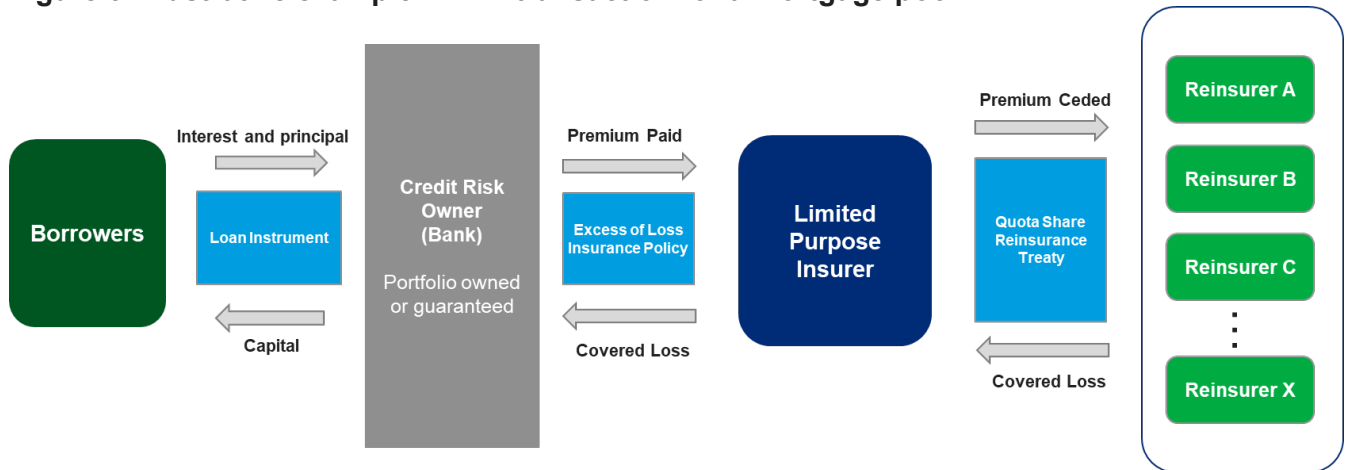
**Figure 2: Illustrative example – Potential capital relief provided by credit risk transfer on a project finance exposure. Assumes capital requirement of 10 percent for illustrative purposes**

	Loan facilities	Risk weighting	Capital requirement	Regulatory capital	
<b>No insurance</b>	\$500 M	* 100%	* 10%	\$50M	
<b>Insurance</b>	Uninsured commitments: \$250 M	* 100%	* 10%	\$25M	Difference (\$8.75M)
	Insured commitments: \$250 M	* 65%	* 10%	\$16.25M	

In the case of a CRT transaction, the banking organization purchases excess of loss / tranching protection on a portfolio of assets covering losses above a threshold of expected losses up to a maximum loss amount before being retained again in the most risk-remote senior tranche. CRT transactions provide capital relief following the capital rule’s synthetic

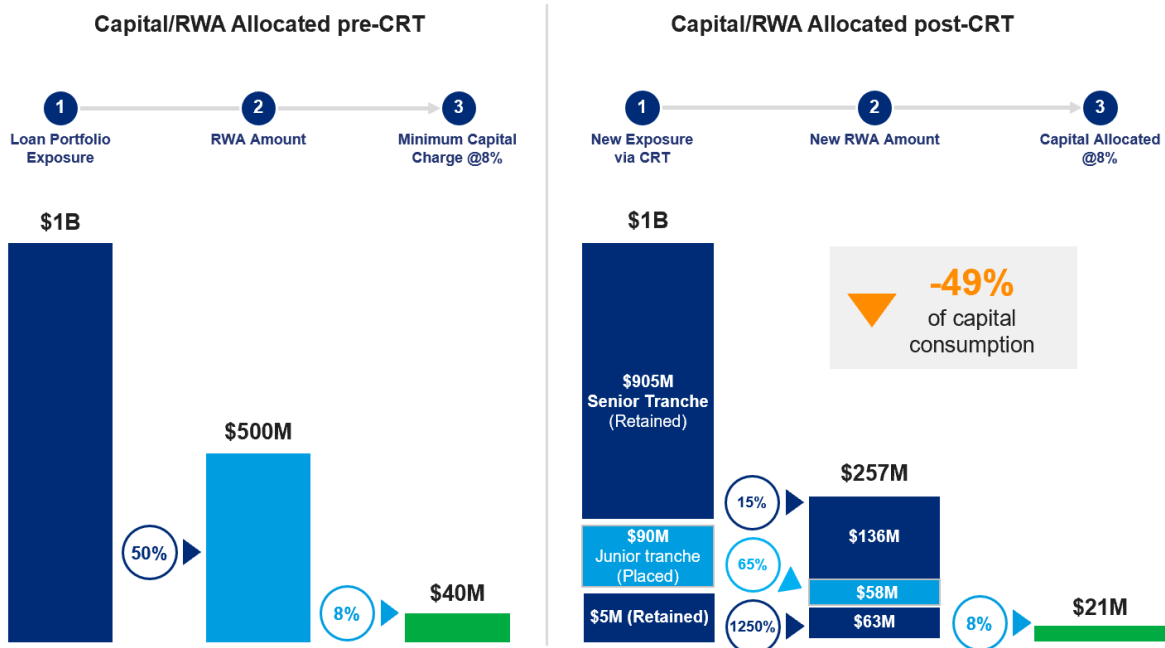
securitization framework. Just as with NPI, CRT transactions are typically insured by highly rated, diversified insurers and reinsurers. See **Figure 3** for an illustrative example of a CRT transaction.

**Figure 3: Illustrative example – CRT transaction for a mortgage pool**



In this example, the credit risk from a \$1.0 Billion pool of mortgages is tranching and transferred to a syndicated panel of reinsurers through a limited purpose insurer in Figure 3. In Figure 4, the example assumes the underlying reference pool incurs a risk weighting of 50 percent which requires \$40 Million of regulatory capital before the use of any credit risk transfer.

**Figure 4: Illustrative example – CRT transaction capital relief**



**Assumptions**  
 50% risk weight for mortgages pre-CRT  
 Capital Requirement pre-CRT = \$1B mortgage loan pool x 50% RW x 8% minimum capital requirement = **\$40M**

CRT attaches at expected loss and detaches at unexpected loss  
 For CRT pool, 1250% risk-weight for retained 1<sup>st</sup> loss, 65% for CRT reinsurance-enhanced tranche and 15% RWA for senior tranche (as proposed in NPR)

Assuming the CRT transaction is tranching and covers losses between 0.50 percent and 9.50 percent of the underlying mortgage reference pool, the required capital net of the CRT program is \$21 Million – a \$19 Million reduction in required capital under the basic principles of the synthetic securitization rules. The retained first loss incurs a 1250% risk weight, the CRT tranche incurs a 65% risk weight (assuming diversified reinsurers are treated as an eligible guarantor) and the retained senior tranche incurs a 15% risk weight. Programs similar to this example for other asset classes have become a core part of the credit risk transfer programs of the GSE's and international banking institutions.

## 2.2. Credit risk mitigation techniques and Basel III endgame proposed rules

### 2.2.1. Credit risk mitigation

Credit risk mitigation (CRM) refers to the methods and techniques employed by financial institutions to reduce the credit risk associated with their exposures. In the context of US capital rules, CRM encompasses a range of practices such as collateralization, netting, guarantees, and credit derivatives. Some of these tools allow banks to secure their lending and other exposures via collateral such as real estate, securities, or other assets, thereby lowering their loss given default. Another approach is to mitigate losses via guarantees from third party investors, insurers and reinsurers, transferring the credit risk from the bank to a separate entity that assumes this risk.

Within the proposed regulatory framework and as discussed in Section 1, appropriate CRM could lead to a reduced risk weight for a particular exposure, which in turn could reduce the amount of regulatory capital a bank is required to hold against that exposure. This would not only safeguard the bank's balance sheet but also align with regulators' objectives to ensure financial stability within the system. The CRM tools should be legally enforceable, and the bank should have procedures in place to manage and monitor the risks associated with them.

### 2.2.2. Insurance and reinsurance-based CRM as a guarantee

For a guarantee to be recognized under the regulatory capital rules for credit risk mitigation, it must meet specific criteria designed to ensure its effectiveness and reliability in mitigating credit risk. In the context of this paper, guarantees discussed hereon include credit risk mitigation transactions such as NPI policies and CRT transactions, **not credit derivatives**. The guarantee must be legally enforceable in all relevant jurisdictions, meaning that in the event of a borrower's default, the bank can legally and promptly enforce the guarantee to recover the insured portion of their loss. Additionally, the guarantee can only be provided by an eligible guarantor, which is defined below. The terms of the guarantee must be explicit and must clearly define the obligations, with any conditions or triggers for the guarantor's payment stated unambiguously. Any potential risks linked to the guarantor or the enforceability of the guarantee itself should also be closely monitored by the bank to assess ongoing effectiveness.<sup>17</sup>

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<sup>17</sup> 12 CFR § 3.36 (2013).  
Marsh McLennan

Viewing credit risk transfers as eligible guarantees when transacted between banking organizations and insurance companies based on the following:

- A. These transactions qualify as an eligible guarantee (please see Appendix C for this criteria) as they meet the common eligibility criteria laid out in both 12 CFR 3.2 “Eligible guarantee” as well as the proposed rule in the NPR, which appends the rule that eligible guarantees be issued by an eligible guarantor.<sup>18</sup>
- B. Diversified insurance and reinsurance companies that are non-monoline insurers or reinsurers, would appear to qualify as eligible guarantors because they meet the following criteria based 12 CFR 3.2 “Eligible guarantor” definition:
  - I. That at the time the guarantee is issued or anytime thereafter, has issued and has outstanding and unsecured, a debt security without credit enhancement that is investment grade;
  - II. Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and
  - III. That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).

The intent of this portion of the rule appears to be to ensure the credit risk taker is highly creditworthy and has sufficient access to the capital markets during times of stress. Insurance and reinsurance companies, are controlled fully by parent companies which have outstanding and investment grade rated debt and are likely to be of sufficient credit quality to meet these requirements.

- C. Exposures to an insurance company would meet the broader definition of corporate exposures provided in the definition of “Corporate exposure” as found in § 324.2 of the proposed rules:

Corporate exposure means an exposure not listed below:

**Non-corporate exposure definition**

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<ul style="list-style-type: none"> <li>• (1) An exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, the European Stability Mechanism, the European Financial Stability Facility, a multi-lateral development bank (MDB), a depository institution, a foreign bank, or a credit union, a public sector entity (PSE)</li> </ul>	<ul style="list-style-type: none"> <li>• (2) An exposure to a government sponsored enterprises (GSE)</li> <li>• (3) For purposes of subpart D of this part, a residential mortgage exposure</li> <li>• (4) A pre-sold construction loan</li> <li>• (5) A statutory multifamily mortgage</li> <li>• (6) A high volatility commercial real estate (HVCRE) exposure</li> <li>• (7) A cleared transaction</li> <li>• (8) A default fund contribution</li> <li>• (9) A securitization exposure</li> <li>• (10) An equity exposure</li> </ul>	<ul style="list-style-type: none"> <li>• (11) An unsettled transaction</li> <li>• (12) A policy loan</li> <li>• (13) A separate account</li> <li>• (14) A Paycheck Protection Program covered loan as defined in section 7(a)(36) or (37) of the Small Business Act (15 U.S.C. 636(a)(36)–(37))</li> <li>• (15) For purposes of subpart E of this part, a real estate exposure, as defined in § 324.101 or</li> <li>• (16) For purposes of subpart E of this part, a retail exposure as defined in § 324.101.</li> </ul>
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<sup>18</sup> Regulatory Capital Rule, 88 F.R. 64059, Footnote 116 (Proposed September 18, 2023)



- D. Finally, insurance or reinsurance company debt qualifies as a corporate exposure based on the proposed definition from the Basel III NPR at the 65 percent risk weight for investment-grade companies with publicly traded securities or those controlled by such a company. Those same characteristics would satisfy the following counterparty criteria:
- I. Good credit quality of the exposure, expecting timely repayments; and
  - II. Enhanced transparency and market discipline for publicly listed companies.

In-scope insurers and reinsurers are non-monoline and have parent companies with investment grade debt that wholly own the subsidiary. These companies, as mandated by their regulators, are obliged to follow prudent enterprise risk management (ERM) standards and are subject to minimum capital requirements that measure inherent asset risk. These practices include managing concentration risk of both assets and liabilities. Thus, the overall creditworthiness of diversified insurers is not correlated with the credit risk of credit risk transfer exposures as they write relatively few of these policies compared to their portfolio size. Even if these insurers were to grow the number of credit risk transfer transactions in their portfolios, the concentration of correlated assets would likely continue to be limited pursuant to standard industry-wide ERM practices.<sup>19</sup> See Section 3 for a discussion of the management of capital and ERM standards as required and monitored by state regulators. Reading the proposed rules in combination, the intent appears to be that an insurance or reinsurance company – provided it is not a mono-line bond insurer or mono-line reinsurer, together with its subsidiary entities, would be treated as an eligible guarantor. See Appendix C for a breakdown of eligible guarantor and eligible guarantee requirements and characteristics of credit risk transfer policies and credit insurers.

## 2.3. Credit insurance and reinsurance markets

In part due to the lack of clarity surrounding the bank regulatory capital treatment of well-diversified insurers and reinsurers as eligible guarantors, the market in the US for insurance and reinsurance-based solutions is limited to the usage of NPI by banks and a small number of CRT transactions related to handful of asset classes. In EU, Japan, Canada and UK however, banking organizations which use either an internal ratings-based approach (IRB) or the standardized approach for evaluating the risk weightings of their exposures commonly employ credit risk transfer transactions for risk management as well as capital relief. Insurance and reinsurance-based credit risk mitigation is designed to be responsive to the needs of banks and flexibly cover a variety of exposure types given the fundamental tenets of risk retention and the retention of assets on balance sheets. These characteristics promote the alignment of interests and partnership approach between banks and the credit insurance and reinsurance market. There are approximately 60 investment grade insurance companies (rated between A- and AA) that provide non-payment insurance to banks globally.<sup>20</sup> Many of the leading credit insurers are Berne Union members who provided

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<sup>19</sup> To test this point, Marsh McLennan surveyed three of the largest US P&C companies active in this space: Chubb, Everest, and Liberty Mutual. In the Insurance industry, Gross Written Premium (GWP) is used as a proxy for exposure of the relevant insurer's capital position. In 2022, total GWP related to non-payment and trade finance risk (Credit risk as used in this paper) represented 0.375%, 0.475%, and 0.26% of total GWP, respectively for these three companies. In 2021, Chubb's GWP for the same risks represented 0.364% of GWP, and for Everest, the number was 0.364%. In 2020, the figure for Chubb was 0.259%, and for Everest, 0.399%

<sup>20</sup> Marsh Credit Specialties Political Risk & Structured Credit (PRSC) Capacity Guide 2023 (US Version).

payment risk protection of approximately USD 2.83 TN in 2022, amounting to 14% of global cross-border trade.<sup>21</sup>

The credit insurance market’s ability to absorb significant losses has not gone untested. The most serious test of the market to date was the global financial crisis during which it is estimated that the figure paid by insurers was in excess of \$2.5B. More recently, per the 2021 ITFA-IACPM Private Credit Insurance Survey, 31 banks reported approximately \$400M claims made on \$116B of total insured exposures.<sup>22,23</sup> A separate, third-party survey of brokers, insurers and a leading bank user of the product reported payment of over 97 percent of claims on NPI policies over the past fifteen years, the remaining 3 percent having been compromised due to the operational failures within the control of the insured bank.<sup>24</sup> The survey’s findings also indicated that 100 percent of claims made over the past five years were paid in full, further supporting the reliability of these policies.

In the United States, a mature reinsurance CRT market for mortgages exists. Fannie Mae and Freddie Mac routinely transfer mortgage credit risk through their CIRT and ACIS programs and receive capital relief under the Enterprise Regulatory Capital Framework, a capital regime now more closely aligned with the principles of Basel III. The market emerged following the financial crisis as a risk sharing mechanism which allows the Enterprises to better fulfill their stated objectives of delivering liquidity, stability, and affordability to the US housing market. In the past ten years, single-family and multi-family mortgage CRT volume transferred to insurers and reinsurers amounted to \$63.7 billion across Fannie and Freddie on unpaid principal balances of \$3.5 trillion<sup>25</sup>. See **Table 4** for a detailed breakdown of CRT volume.

**Table 4: Cumulative single-family and multifamily (re)insurance CRT volume, 2013-2023**<sup>26</sup>

Program		Freddie Mac	Fannie Mae	Total
Single-Family	Number of Credit Risk Transfer Transactions	96	70	166
	(Re)insured Limit Transferred	\$33,982,783,821	\$25,864,143,198	\$59,846,927,019
	Reference Pool Unpaid Principal Balance	\$2,495,341,482,208	\$870,212,814,862	\$3,365,554,297,070
Multifamily	Number of Credit Risk Transfer Transactions	7	12	19
	(Re)insured Limit Transferred	\$1,047,417,000	\$2,773,260,000	\$3,820,677,000
	Reference Pool Unpaid Principal Balance	\$32,800,000,000	\$120,170,000,000	\$152,970,000,000
Total	Number of Credit Risk Transfer Transactions	103	82	185
	(Re)insured Limit Transferred	\$35,030,200,821	\$28,637,403,198	\$63,667,604,019
	Reference Pool Unpaid Principal Balance	\$2,528,141,482,208	\$990,382,814,862	\$3,518,524,297,070

<sup>21</sup> Berne Union (2023). *Annual report of the export credit and investment business of Berne Union Members*, 30

<sup>22</sup> See footnote 15 (IACPM/ITFA Survey)

<sup>23</sup> Lloyd’s Market Association (2018). *LMA Response to Consultation Paper CP6/18*, 3

<sup>24</sup> A2Z Risk Services Ltd. (2023)

<sup>25</sup> Freddie Mac, ACIS Pricing, <https://capitalmarkets.freddie.com/crt/reinsurance/pricing>, (accessed 12/27/2023); Freddie Mac, “Multifamily MCIP Program Overview as of September 30, 2023”, Freddie Mac, [https://mf.freddie.com/docs/mcip\\_investor\\_presentation.pdf](https://mf.freddie.com/docs/mcip_investor_presentation.pdf), (accessed 12/27/2023); Freddie Mac, Multifamily Securities Pricing, <https://mf.freddie.com/investors/multifamily-securities-pricing>, (accessed 12/27/2023); Freddie Mac, Clarity, (accessed 12/27/2023); Fannie Mae, CIRT Pricing, <https://capitalmarkets.fanniemae.com/credit-risk-transfer/single-family-credit-risk-transfer/credit-insurance-risk-transfer/cirt-pricing>, (accessed 12/27/2023); Fannie Mae, Multifamily CIRT Transactions, <https://capitalmarkets.fanniemae.com/credit-risk-transfer/multifamily-credit-risk-transfer/multifamily-credit-insurance-risk-transfer/multifamily-cirt-transactions>, (accessed 12/27/2023).

<sup>26</sup> See footnote 26. (*Credit Risk Transfer Progress Report*)

Referenced in **Table 4**, both diversified insurers and reinsurers comprise the CRT market for the GSEs, with approximately 50 firms participating".<sup>27</sup>

## 3. Insurance and reinsurance company risk management and solvency

Insurance and reinsurance companies follow regulatory guidelines relating to risk management practices. State regulators, with the aid of centralized bodies such as NAIC and government bodies like the Federal Insurance Office (FIO), monitor capital and liquidity levels to assess solvency as well as individual insurers' enterprise risk management practices. The following section discusses capital requirements, financial stability measures, and risk management practices of property and casualty (P&C) insurers and reinsurers in the United States. P&C insurers are the primary providers of credit risk transfer in international markets and reinsurers are the primary providers of portfolio credit risk transfer transactions. Insurers and reinsurers focus on assessing the risks associated with property damage, liability, and other non-life risks by analyzing historical data, statistical models, and other factors to estimate the likelihood and severity of potential losses which aligns closely to the analysis conducted for credit exposures.

### 3.1. Measures of P&C insurers' financial stability

As the Basel III regulations impose regulatory capital regulations, so too do insurance regulators through the enforcement of risk-based capital (RBC) requirements, which measure insurers' assets accounting for the inherent riskiness of held assets as well as intra-asset risk correlations. RBC requirements seek to guard against introduction of outsized risk on credit exposures. For a detailed breakdown on RBC requirements and the risks they are designed to mitigate, see Appendix D. P&C insurers comply with regulatory capital minimums. The top 25 ranked insurers (with ranking based on gross written premiums, with the total GWP written by the group representing approximately 65 percent of FY2022 US gross written premiums) held an average of 509 percent of the applicable minimum capital requirement, with none having less than 309 percent of the minimum<sup>28</sup>. Each of the top 25 rated insurers had an S&P investment grade rating with an average and a median rating of "A". These ratings take into account the financial strength, operating performance, business profile, risk management practices, regulatory environment, as well as the reinsurance programs of insurers to assess their ability to meet their obligations to both policyholders and others.

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<sup>27</sup> Fannie Mae (2023), *CIRT Transactions and Servicing Reports*. <https://capitalmarkets.fanniemae.com/credit-risk-transfer/single-family-credit-risk-transfer/credit-insurance-risk-transfer/cirt-transactions-and-servicing-reports>

<sup>28</sup> MMC Analysis, S&P Capital IQ FY2022

High levels of RBC translate into significant excess capital, which can be measured as the ratio of capital and policyholder surplus to total assets. Considering the same group of insurers as mentioned above, in 2022 they held an average of 28.5 percent capital and policyholder surplus as a percent of total assets, with 75 percent of the group holding in excess of 22 percent, and no insurer holding less than 14.8 percent. This suggests significant financial cushion relative to liabilities and the ability to absorb large losses.

An insurer's liquidity ratio, cash and equivalents, common stock and carrying value of bonds with a NAIC 1 or 2 rating as a percent of statutory liabilities<sup>29</sup> help to assess the insurer's ability to cover their obligations. For the top 25 P&C insurers ranked by GWP, they maintain significant liquidity. The average liquid investment as a percentage of liabilities<sup>30</sup> was over 98 percent. 75 percent of these insurers held a liquidity ratio of above 106 percent, with no insurer having a ratio of less than 68 percent. As discussed in the following section, for insurers, liabilities include reserves for potential obligations to policy holders. Thus, the aforementioned ratios suggest an ability to provide credit protection while maintaining a significant buffer to pay losses and meet liquidity needs.<sup>31</sup>

## 3.2. Insurance and reinsurance enterprise risk management and regulation

### 3.2.1. General regulation practices

Insurers and reinsurers domiciled in the United States are subject to regulation by state regulatory bodies. Regulators focus on both the solvency of insurers and reinsurers as well as market regulation, with the goals of ensuring that all valid claims are paid and that the market provides fair pricing to clients. Ultimately, state legislators maintain responsibility for signing insurance regulations into law, but centralized bodies such as NAIC often inform regulations by laying out guidelines that states usually adopt with few alterations.<sup>32</sup>

Financially, regulators conduct annual exams or audits of insurers' financial statements to examine their financial stability and solvency. Accounting standards differ for insurers, as they report to regulators using Statutory Accounting Principles (SAP), rather than the standard GAAP. Under SAP, reserves for obligations to policy holders are reported as liabilities, giving regulators a complete view of financial standing.<sup>33</sup> Assets and liabilities as reported under SAP inform the liquidity and capital metrics discussed in Sections 3.1.

Furthermore, state regulators along with the Federal Insurance Office (FIO) collect data to monitor growth and trends in the market to help prevent systemic risk.<sup>34</sup> These bodies'

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<sup>29</sup> Cash and equivalents, common stock and carrying value of bonds with a NAIC 1 or 2 rating as a percent of liabilities (NAIC 1: Equivalent to AAA or Aaa rating by Moody's and Standard & Poor's, indicating the highest credit quality and lowest risk of default. NAIC 2: Equivalent to AA or Aa rating by Moody's and Standard & Poor's, indicating a very high credit quality and low risk of default.)

<sup>30</sup> Liabilities include all statutory P&C liabilities in NAIC filings S&P Capital IQ FY2022

<sup>31</sup> MMC Analysis, S&P Capital IQ FY2022

<sup>32</sup> NAIC & CIPR (2011). *State Insurance Regulation*, 2-5

<sup>33</sup> Insurance Information Institute. (2020, October 20). *Background on: Insurance accounting*. <https://www.iii.org/publications/insurance-handbook/regulatory-and-financial-environment/background-on-insurance-accounting>

<sup>34</sup> US Department of Treasury. *About FIO*

monitoring of industry-wide risk would also help to identify concentration risk that might arise from increased adoption of credit risk transfer.

### 3.2.2. Enterprise risk management

Emerging from the global financial crisis, regulators and insurers alike took a renewed approach to enterprise risk management (ERM). ERM defines a holistic approach to risk management, focusing not only on quantitative measures of risk including scenario analysis and stress testing, but also an enterprise-wide orientation toward accountability, governance, and a defined risk appetite.

Insurers' and reinsurers' ERM look at risk at a portfolio and company-wide level, which is designed to account for the interdependencies of risks across different policy types and to identify clusters of risks across the portfolio, so that concentration risk can be mitigated. Stress tests are often based on historical events and act as a measure by which regulators assess solvency. Studies across the industry agree that there exists a correlation between an insurer's ERM sophistication and their firm performance.<sup>35</sup>

In 2015, NAIC's 'Risk Management and Own Risk and Solvency (ORSA) Assessment Model Act' was enacted. The act provides insurers that write greater than \$500 million in direct or assumed premiums or insurance groups that write more than \$1 billion must produce an annual ORSA summary report, assessing the adequacy of their risk management capabilities. Insurers' reports must account for 'all reasonably foreseeable and relevant material risks', including liquidity risks, underwriting, credit, and more. While the ORSA report is produced internally, the insurer must provide the summary report to the lead regulator of the insurer or insurance group. Adoption of the ORSA model has been widespread, with the NAIC reporting in 2019 that all states excepting certain territories had adopted the ORSA model in a 'substantially similar manner'.<sup>36</sup>

With respect to credit risk, insurers manage balance sheet risk by diversifying both their assets and liabilities across products, sectors, and tenors while also using hedging techniques to reduce market and credit risk positions and reinsurance to reduce portfolio or concentrations of specific obligors. On the liability side, insurers and reinsurers account for inherent risk in their policies through the diversification of their portfolio of exposures. Credit risk transfer policies tend to account for a small proportion of gross written premium, with surveys of multinational insurance companies reporting credit risk transfers as less than 2 percent of gross written premiums.<sup>37</sup> Credit risk is seen largely as diversifying and not correlated to traditional property and casualty risk. It therefore seems unlikely that greater adoption in the US would grow significantly on the balance sheets of insurers or would become a primary liability for P&C insurers. For assets, RBC calculations account for inter-

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<https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/federal-insurance-office/about-fio>

<sup>35</sup> Anton, S. & Nucu, A. (2020), Enterprise Risk Management: A Literature Review and Agenda for Future Research, *Journal of Risk and Financial Management*

<sup>36</sup> NAIC Model Laws, Regulations, Guidelines and Other Resources (2021). *Risk Management and Own Risk and Solvency Assessment Model Act*, ST-505-2 – ST-505-5. <https://content.naic.org/sites/default/files/model-law-state-page-505.pdf>

<sup>37</sup> A2Z Risk Services Ltd. (2020)

risk correlations between various asset classes.<sup>38</sup> Correlation risk spurred by credit risk on the liability side of the balance sheet and bond holdings on the asset side is adequately addressed via ERM by way of stress testing and cluster risk identification.

## 4. Potential benefits of increased insurance supported credit risk transfer utilization

Insurance and reinsurance-based credit risk mitigation tools have the potential to be incredibly useful instruments for distributing credit risk globally and maintain a healthy and robust financial system. The increased use of credit risk transfer mechanisms in the US market under the new ERA may promote three primary benefits and also may create spillover effects for the broader financial system.

**Increase lending opportunities:** By freeing up additional capital, insurance, and reinsurance-based credit risk mitigation can increase the market capacity of banking organizations to extend loans. Increased capital and lending may allow banking organizations to further express goals of promoting financial inclusivity by allowing them to extend credit to a broader range of borrowers, some of whom might have been traditionally marginalized due to their perceived risk profiles<sup>39</sup>. Access to credit also could serve as a catalyst for various economic activities potentially spurring additional consumption, investment, and employment opportunities.

**Risk diversification:** Credit risk transfer tools afford banks an effective mechanism to prudently manage and diversify risks. At its core, credit risk transfers cover a lender against the risk of default by a borrower for any reason outside of the operational control of the lender. If a borrower defaults, the credit risk transfer policy compensates the bank, for the defaulted amount insured. This immediately reduces the potential loss that a bank might face. Credit risk transfers also allow banks to distribute their exposures across a spectrum of assets, ensuring that a downturn in any one sector or region does not lead to a significant proportion of defaults adversely impacting financial health, as the risk is spread out.

**Efficient capital allocation:** By protecting a portion of their loan portfolios, banks can maintain lower capital reserves for potential bad loans, facilitating a more judicious use of capital<sup>40</sup>

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<sup>38</sup> Herzog, T. (2011). NAIC & The Center for Insurance Policy and Research: CIPR Newsletter, *The Simple Algebra of the Square Root Formula Behind RBC and Solvency II*, 6-8.  
<https://naic.soutrnglobal.net/Portal/Public/en-GB/DownloadImageFile.ashx?objectId=7688&ownerType=0&ownerId=24281> (Note: Per NAIC (June 2023), the formula for RBC last revised in 2011, see the following: <https://content.naic.org/cipr-topics/risk-based-capital> )

<sup>39</sup> Calem, P.S., & LaCour-Little, M. (2004). Risk-based capital requirements for mortgage loans. *Journal of Banking & Finance*.

<sup>40</sup> Santos, J.A.C. (2001). Bank capital regulation in contemporary banking theory. *Financial Markets, Institutions & Instruments*.

## Appendix A. Responses to NPR questions

*Question 39: For what reasons, if any, should the agencies consider applying a lower risk weight than 100 percent to exposures to companies that are not publicly traded but are companies that are “highly regulated?” What, if any, criteria should the agencies consider to identify companies that are “highly regulated?” Alternatively, what are the advantages and disadvantages of assigning lower risk weights to highly regulated entities (such as open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies)?*

Highly regulated entities, such as banks and insurers, are subject to various requirements aimed at ensuring financial stability and risk management. Regulation of insurers includes the following components:

1. Capital requirements: Insurers are required to maintain capital levels at least equal to regulatory minimums.
2. Liquidity requirements: Insurers must maintain liquidity levels at least equal to regulatory minimums.
3. Reporting and review: Insurers are required to submit regular reports to regulatory authorities, providing detailed information about their financial condition, risk exposures, and compliance with regulatory standards – These reports undergo review and analysis, and the key ones are available to the public and markets as well, promoting transparency and accountability,
4. Risk management requirements: Insurers are required to follow risk management frameworks and practices – They must identify, assess, and mitigate various risks, including credit risk, operational risk, and market risk. These risk management requirements include effective controls to manage risk exposures.

By assigning lower risk weights to highly regulated entities, regulatory authorities acknowledge the stability, reliability, and resultant lower risk profile associated with these entities. This differentiation allows for a more accurate assessment of risk and promotes a more efficient allocation of capital, with capital requirements that are proportionate to the risk exposure.

Insurers providing credit risk transfers are generally subsidiaries of holding companies with public debt. These subsidiaries are directly controlled by their parent companies, which are typically well-capitalized and have publicly held debt with investment-grade ratings. This control structure provides additional financial support and stability to the subsidiary entities.

## Appendix B. Non-corporate exposures

### B.1. Real estate exposures

Real estate exposures vary within the ERA depending on the exposures LTV, the type of mortgage, and its dependency on cash flows. The calculation of the LTV ratio is standardized within the NPR as the extension of credit divided by property value where ‘extension of credit’ refers to the total outstanding among of the loan, including any undrawn committed

amount.<sup>41</sup> Aside from capital risk management, the Agencies maintain a stated goal of promoting moderate- to low-income buyers and ‘historically underserved markets.’<sup>42</sup> The regulations attempt to avoid any unintended impact on the ability of credit-worthy borrowers to take out a loan as they increase risk weightings (and thus regulatory capital requirements) across real estate exposures. Notably, credit risk transfer policies as discussed herein, could reduce overall capital charges for credit risk, indirectly spurring capital to flow back into the market to serve low and middle income borrowers.

### B.1.1. Regulatory residential real estate exposures

Regulatory residential exposures are defined as first-lien residential mortgage exposures that are not defaulted, and are not high volatility commercial real estate, pre-sold construction loan, statutory multifamily mortgage, or acquisition, development, or construction exposures.<sup>43</sup> Further, the exposure must:

- I. Be secured by a property that is either owner occupied or rented;
- II. Have been made in accordance with prudent underwriting standards;
- III. Involve application of underwriting polices that took into account borrower’s ability to repay the loan in a timely manner at the time of underwriting; and
- IV. Have been valued in accordance with loan-to-value ratio calculation principles, laid out within the NPR.<sup>44</sup>

Risk weightings are conditional on whether the mortgage is dependent on the cash flows of the real estate or not, with cash flow dependent exposures incurring higher risk weights, holding LTV ratio constant.<sup>45</sup> See **Table 5** for a detailed breakdown of residential real estate risk weights, by LTV ratio.

**Table 5: NPR standard and ERA proposed risk weights for residential real estate exposures<sup>46</sup>**

Dependent of cash flow?	Standardized risk weighting	LTV ratio					LTV ratio > 100%
		≤ 50%	50% < LTV ratio ≤ 60%	60% < LTV ratio ≤ 80%	80% < LTV ratio ≤ 90%	90% < LTV ratio ≤ 100%	
No	50% or 100% <sup>47</sup>	40%	45%	50%	60%	70%	90%
Yes	50% or 100%	50%	55%	65%	80%	95%	125%

<sup>41</sup> Regulatory Capital Rule, 88 F.R. 64047 (Proposed September 18, 2023)

<sup>42</sup> Regulatory Capital Rule, 88 F.R. 64048 (Proposed September 18, 2023)

<sup>43</sup> Regulatory Capital Rule, 88 F.R. 64186 (Proposed September 18, 2023)

<sup>44</sup> See footnote 39 (88 FR 64186)

<sup>45</sup> An exposure is considered dependent on cash flows if the underwriting process considers cash flows such as leases or rental payments at the loan’s origination.

<sup>46</sup> See footnote 38 (88 F.R. 64048)

<sup>47</sup> Under the standardized approach, the exposure is assigned a 50 percent risk weighting if the exposure is a first-lien residential mortgage that is secured by a property that is owner occupied or recently, made in accordance with underwriting standards, not 90 days or more past due or in non-accrual status, and not restructured or modified. Otherwise, the risk weighting is 100 percent.



### B.1.2. Regulatory commercial real estate exposures

Regulatory commercial real estate exposures are defined as exposures that are not defaulted, regulatory residential, HVCRE, statutory multifamily, pre-sold construction, or ADC. Additionally, the exposure must:

- I. Be primarily secured by fully completed real estate;
- II. Have the banking organization which holds the exposure hold a first priority security interest in the property that is legally enforceable in all relevant jurisdictions;
- III. Be made in accordance with prudent underwriting standards;
- IV. Apply underwriting policies that took into account borrower’s ability to repay the loan in a timely manner at the time of underwriting; and
- V. Be valued in accordance with loan-to-value ratio calculation principles, laid out within the NPR.<sup>48</sup>

Like with residential exposures, regulator CRE exposures calculate risk weighting based on LTV ratio and cash flows under the updated guidelines. See **Table 6** for a detailed breakdown of commercial real estate risk weights, by LTV ratio.

**Table 6: NPR standard and ERA proposed risk weights for commercial real estate exposures<sup>49</sup>**

Standardized approach	LTV ratio ≤ 60%	LTV ratio > 60%	Standardized approach	60% < LTV ratio ≤ 80%	LTV ratio > 80%	Standardized approach	
				LTV ratio ≤ 60%	90%		110%
100%	Lesser of 60% risk weight or the risk weight applicable to the borrower	Risk weight applicable to borrower	100%	70%	90%	110%	100%

### B.1.3. Other and non-regulatory real estate exposures

Real estate exposures are not limited to residential and commercial. Other exposures highlighted in the NPR include defaulted real estate exposures, ‘other’ regulatory exposures, ADC exposures and statutory exposures.

Statutory exposures include high volatility commercial real estate exposures (HVCRE), pre-sold construction loan exposures, and statutory multifamily mortgage exposures. ADC exposures are defined as a loan secured by real estate for the purpose of acquiring,

<sup>48</sup> See footnote 39 (88 FR 64186)

<sup>49</sup> See footnote 38 (88 F.R. 64048)

developing, or constructing residential or commercial real estate properties, along with land development and other land loans.<sup>50</sup>

Under the ERA, for both defaulted real estate exposures and other regulatory exposures, exposures receive a weighting of 100 percent if exposures do not depend on cash flows, or 150 percent if they are cash-flow dependent.<sup>51</sup> ADC exposures receive a risk weighting of 100 percent, so long as the exposure is not classified as high volatility commercial real estate (HVCRE).<sup>52</sup> HVCRE exposures receive 150 percent risk weightings, statutory multifamily receives 50 percent, and pre-sold construction loans receive 100 percent if the purchase contract is cancelled and 50 percent if not cancelled.<sup>53</sup>

## B.2. Retail exposures

The proposal introduces a new definition of retail exposures, defining them as exposures to 'a natural person or persons or an exposure to a small or medium-sized entities (SME)' and those where the exposure is a revolving credit or line of credit or a term loan or lease.<sup>54,55</sup> As stated previously, retail exposure weightings account for whether or not the exposure is regulatory, transactional, or neither.

See **Figure 7** for a breakdown of risk weightings for regulatory retail exposures.

Per the figure, three conditions determine the final risk weighting for a retail exposure: the 'aggregate limit,' the 'granular limit,' and whether or not the exposure is to a transactor.<sup>56</sup> The aggregate limit means that a bank can only classify accounts for an SME that amount to less than \$1M as regulatory retail exposures. The granular limit states that a regulatory retail exposure must be less than 20 basis points of all non-defaulted regulatory retail exposures.<sup>57</sup>

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<sup>50</sup> Regulatory Capital Rule, 88 F.R. 64186 (Proposed September 18, 2023)

<sup>51</sup> Regulatory Capital Rule, 88 F.R. 64045 (Proposed September 18, 2023)

<sup>52</sup> See footnote 47 (88 FR 64045)

<sup>53</sup> See footnote 47 (88 FR 64045)

<sup>54</sup> Regulatory Capital Rule, 88 F.R. 64051 (Proposed September 18, 2023)

<sup>55</sup> SMEs are defined as enterprises generating annual revenues of less than \$50M. Source: Regulatory Capital Rule, 88 F.R. 64051, Footnote 92 (Proposed September 18, 2023)

<sup>56</sup> A transactor exposure is defined as a regulator retail exposure that is a credit facility where the balance has been repaid in full at each scheduled prepayment date for the previous twelve months or an overdraft facility where there has been no drawdown over the previous twelve months (Regulatory Capital Rule, 88 F.R. 64052 (Proposed September 18, 2023)

<sup>57</sup> See footnote 50 (88 F.R. 64051)

**Figure 7: Proposed risk weightings for retail exposures<sup>58</sup>**

For a given SME...	"Aggregate limit"	"Granularity limit"		Weight
Exposure is a revolving line of credit or term loan or lease	Exposures <\$1M	Exposures < 20 bps of aggregate regulatory retail exposures (all SMEs)	Exposure to transactor	
Yes	Yes	Yes	Yes	55%
Yes	Yes	Yes	No	85%
Yes	No	No	N/A	110%
No	N/A	N/A	N/A	Corporate exposure

Retail exposures that fail to meet the aggregate or granularity limits received a weighting of 110 percent. If the exposure for an SME does not fall under the conditions for a retail exposure, it's risk weighting follows the guidelines for corporate exposures discussed in Section 1.1.

## Appendix C. Eligible guarantee and eligible guarantor requirements

**Table 7: Requirements for an eligible guarantee and credit risk transfer characteristics (as defined in 12 CFR 3.2)**

No.	Eligible guarantee means a guarantee from an eligible guarantor that:	Credit risk transfer characteristics
1	Is written;	Yes.
2	Is either: <ul style="list-style-type: none"> <li>i. Unconditional, or</li> <li>ii. A contingent obligation of the US government or its agencies, the enforceability of which is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party;</li> </ul>	Yes, the insurance contract is unconditional to the extent the contract performance and compliance is entirely within the control of the insured.  N/A
3	Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;	Yes, policies cover interest and principal if required.

<sup>58</sup> Regulatory Capital Rule, 88 F.R. 64052 (Proposed September 18, 2023)  
Marsh McLennan

4	Gives the beneficiary a direct claim against the protection provider;	Yes, the policyholder has a direct contractual claim against insurers.
5	Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;	Yes, the insurance contract is generally non-cancelable by insurers except for non-payment of premium, which would be a breach by the insured.
6	Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgement may be enforced;	Yes, insurers are regulated by state regulators and are required to hold minimum levels of assets in excess of liabilities to cover claims.
7	Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;	Yes, the beneficiary of the insurance contract is entitled to receive funds directly from the protection provider.  The insurance contract stipulates a timeframe for payment to the beneficiary. There is no requirement in the contract for the beneficiary to first take legal action to pursue the obligor for payment, this is typically stated within the contract.
8	Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure;	Yes, pricing is fixed in contracts without additional cost triggers on the deterioration of the cover credit.
9	Is not provided by an affiliate of the bank, unless the affiliated is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that: <ul style="list-style-type: none"> <li>i. Does not control the bank and</li> <li>ii. Is subject to consolidated supervision and regulation comparable to that imposed on depository institutions, US securities broker-dealers, or US insurance companies.</li> </ul>	Yes, insurers are not bank affiliates.

**Table 8: Requirements for an eligible guarantor and credit insurer characteristics (as defined in 12 CFR 3.2)**

No.	Requirements to be an eligible guarantor	Credit insurer characteristics
1	At the time the guarantee is issued or anytime thereafter, the insurer has issued and outstanding an unsecured debt security without credit enhancement that is investment grade.	Yes. Insurance company subsidiaries, which are most often the counterparties in credit risk transactions, are fully controlled by parent companies. These parent companies, which are non-monoline insurers or reinsurers, may have outstanding and investment grade debt.

2	The guarantor's credit worthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees.	Yes. Diversified insurance companies follow prudent enterprise risk management (ERM) standards that are monitored by state regulators which include the management of concentration and correlation risk of assets and liabilities.
		Insurers account for liability risk through the diversification of their portfolio of exposures. Credit risk transfer policies today account for a small proportion of gross written premium and thus have little impact on the credit worthiness of the multinational insurance companies that provide the policies.
		Insurers account for intra-risk asset risk through their adherence to risk-based capital minimums. Inter-asset risk is addressed via enterprise risk management through focus on stress testing and cluster and concentration risk identification.
3	The guarantor is not engaged predominately in the business of providing credit protection (such as a mono-line bond insurer or mono-line bond reinsurer).	Yes. Diversified insurance companies, by definition, engage in a variety of businesses and hold a diversified portfolio of exposures outside of credit risk transfer.

## Appendix D. Risk-based capital detailed overview

Risk-based capital (RBC) requirements measure an insurers' assets accounting for the inherent riskiness of held assets as well as intra-asset risk correlations. As in the banking industry, insurers are subject to RBC minimums with regulations based on the insurance company's size and the riskiness of their exposures. Life, health, and property and casualty (P&C) insurance companies are subject to varying RBC requirements, commensurate with the risk profile of the policies. This overview focuses on RBC requirements for P&C insurers due to their applicability to credit risk transfer. Five main risk types drive regulatory minimums for P&C insurers including claim reserve, inadequate pricing, fluctuating asset values, catastrophe, and rapid growth.<sup>59</sup> The formula for RBC, defined by the National Association of Insurance Commissioners (NAIC), calculates RBC using six risks: affiliated investment risk, fixed income risk, common stock risk, and credit risk (together comprising 'asset risks') as well as reserving risk and net written premium risk (together comprising underwriting risk).<sup>60</sup>

RBC regulations also stipulate permitted assets, which contribute to capital minimums, and non-admitted assets, which do not. Examples of permitted assets include debt securities, equities, and some real estate holdings. Non-admitted might include certain derivatives, tax deferments or non-tangible assets.<sup>61</sup> While not explicitly prohibited under the regulations, regulators tend to discourage investment into derivatives, with states such as New York requiring an additional filing with the regulators if a company chooses to invest in derivatives.<sup>62</sup> See *Table 9* for a breakdown of investments within the P&C sector in the United States over the past five years. Bonds and common stock comprised approximately 80 percent of total investments in 2022 (where investments made up over 80 percent of the sector's total assets in 2022), a trend that holds over the five year lookback period.<sup>63</sup> RBC calculations also account for concentrations of permitted assets in order to limit concentration risk. Regulators require a yearly report of investments, including a list of all assets.

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<sup>59</sup> American Academy of Actuaries (2015). *Regulatory Capital Requirements for US Insurers* (Presentation to the Financial Stability Oversight Council). [https://www.actuary.org/sites/default/files/files/Regulatory\\_Capital\\_Requirements\\_for\\_Insurers\\_FSOC\\_Bennett\\_MacGinnitie\\_12082015\\_0.pdf](https://www.actuary.org/sites/default/files/files/Regulatory_Capital_Requirements_for_Insurers_FSOC_Bennett_MacGinnitie_12082015_0.pdf)

<sup>60</sup> Herzog, T. (2011). NAIC & The Center for Insurance Policy and Research: CIPR Newsletter, *The Simple Algebra of the Square Root Formula Behind RBC and Solvency II*, 6-8. <https://naic.soutrnglobal.net/Portal/Public/en-GB/DownloadImageFile.ashx?objectId=7688&ownerType=0&ownerId=24281> (Note: Per NAIC (June 2023), the formula for RBC last revised in 2011, see the following: <https://content.naic.org/cjpr-topics/risk-based-capital>)

<sup>61</sup> NAIC (1998), Original SSAP and Current Authoritative Guidance: SSAP No.4; NAIC (1998), SSAP No. 20

<sup>62</sup> New York Insurance Law Section 1410; 68 N.Y. Jur. 2d Insurance § 199.

<sup>63</sup> Federal Insurance Office, US Department of the Treasury (2023). *Annual Report on the Insurance Industry*, 53. <https://home.treasury.gov/system/files/311/FIO%20Annual%20Report%202023%209292023.pdf>

**Table 9: Breakdown of P&C sector investments by asset types (expressed as % of total investments)<sup>64</sup>**

<b>Asset Type</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>
Bonds (long-term)	60.3%	57.0%	55.4%	53.1%	55.4%
Preferred and common stock	23.2%	26.7%	26.6%	29.4%	27.1%
Cash & Short-term investments	6.0%	6.2%	7.0%	7.1%	7.1%
Other <sup>65</sup>	10.5%	10.1%	11.0%	10.4%	10.4%

While insurance companies in the US are regulated on the state level, one body, NAIC, provides the formula for the calculation of RBC. State regulators can adjust this formula, but updates are not common so that capital restrictions remain largely consistent.

<sup>64</sup> See footnote 59 (Department of the Treasury, *Annual Report on the Insurance Industry*)

<sup>65</sup> Other includes mortgage loans, real estate, contract loans, derivatives, and other investments.

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