DFI and ECA Guarantees and CRR

Presentation by:

Daniela Barrdear
Counsel
Sullivan & Worcester UK LLP
dbarrdear@sullivanlaw.com

Mark Norris
Partner
Sullivan & Worcester UK LLP
mnorris@sullivanlaw.com

Sullivan
SULLIVAN & WORCESTER

Introductions

Mark Norris

Partner, Trade & Export Finance

Daniela Barrdear

Counsel, Trade & Export Finance

Agenda

- Guarantees offered by multilaterals, DFIs and ECAs in context of CRR
- Benefits of obtaining these guarantees as credit risk mitigation
- Consideration of eligibility requirements specific to these types of guarantees
  - Enforceability against DFI/multilateral or sovereign
  - Immunity
  - Timely payments
  - Incontrovertibility
- In the horizon – CRD 6

Why banks looking to DFIs and ECAs

- Banks looking to reduce the amount of regulatory capital the bank is required to hold in respect of an underlying portfolio

- The protection acquired needs to be structured to be eligible as funded or unfunded credit protection under the Capital Requirements Regulation (CRR)

- Guarantees are one of the instruments used to transfer credit risk as they provide unfunded credit protection

Regulatory Capital Requirements

- Under the CRR, banks must calculate a **total risk exposure amount**, which is the sum of their credit risk, their operational risk, their market risk and the risk of a credit valuation adjustment
- The total risk exposure amount includes the risk-weighted exposure amount

Risk – weighted exposure amounts

- Risk-weighted exposure amount for a loan = exposure value x risk weight
  - Exposure value is the amount the bank would lose in the event of a total default on the loan (=balance sheet value)
  - Risk-weights are derived from CRR tables (standardised approach) or from bank's own assessment (internal ratings based (IRB) approach)

Credit Quality Step	Fitch's assessments	Moody's assessments	S&Passessments	Corporate	Institution (includes banks)			Sovereign
					Sovereign method	Credit Assessment method		
						Maturity > 3 months	Maturity 3 months or less	
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%	20%	20%	20%	0%
2	A+ to A-	A1 to A3	A+ to A-	50%	50%	50%	20%	20%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%	100%	50%	20%	50%
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	100%	100%	100%	50%	100%
5	B+ to B-	B1 to B3	B+ to B-	150%	100%	100%	50%	100%
6	CCC+ and below	Caa1 and below	CCC+ and below	150%	150%	150%	150%	150%

How does credit risk mitigation work ?

- Two forms:
  - Funded (assets made available as collateral)
  - Unfunded (guarantee or similar protection)
- Types of unfunded credit risk mitigation
  - Guarantee
  - Credit insurance
  - Credit derivative
  - Unfunded risk participation
- Unfunded credit risk mitigation allows the bank to substitute the risk-weight of the guarantor in place of the risk-weight of the borrower - subject to meeting the eligibility requirements set out in the regulation

Entities have a 0% risk weight

Article 117: Multilateral development banks

(a) the International Bank for Reconstruction and Development;

(b) the International Finance Corporation;

(c) the Inter-American Development Bank;

(d) the Asian Development Bank;

(e) the African Development Bank;

(f) the Council of Europe Development Bank;

(g) the Nordic Investment Bank;

(h) the Caribbean Development Bank;

(i) the European Bank for Reconstruction and Development;

(j) the European Investment Bank;

(k) the European Investment Fund;

(l) the Multilateral Investment Guarantee Agency;

(m) the International Finance Facility for Immunisation;

(n) the Islamic Development Bank;

(o) the International Development Association;

(p) the Asian Infrastructure Investment Bank.

Article 118: Multilateral development banks

(a) the European Union and the European Atomic Energy Community;
(b) the International Monetary Fund;
(c) the Bank for International Settlements;
(d) the European Financial Stability Facility;
(e) the European Stability Mechanism;
(f) an international financial institution established by two or more Member States, which has the purpose to mobilise funding and provide financial assistance to the benefit of its members that are experiencing or threatened by severe financing problems

Example – A rated guarantor

- €10m loan to a BBB rated corporate borrower
  - BBB rated corporate borrower has a risk weight of 100%
  - Risk-weighted exposure amount = €10m x 100% = €10m
  - Own funds requirement = €10m x (10.5% to 21.5%) =€1.05 to €2.15m

- A rated corporate guarantor provides a guarantee that satisfies the CRR eligibility requirements
  - We substitute the risk-weight of the guarantor, which is 50%
  - Risk-weighted exposure amount = €10m x 50% = €5m
  - Own funds requirement = €5m x (10.5% to 21.5%) =€0.525 to €1.075m
- Own funds requirement has been halved

Example, now DFI Guarantee

- Consider a €10m loan to a BBB rated corporate borrower
  - BBB rated corporate borrower has a risk weight of 100%
  - Risk-weighted exposure amount = €10m x 100% = €10m
  - Own funds requirement = €10m x (10.5% to 21.5%) =€1.05 to €2.15m
- Now the EIB provides a guarantee that satisfies the eligibility requirements
  - We substitute the risk-weight of the guarantor, which is 0%
  - Risk-weighted exposure amount = €10m x 0% = €0
  - Own funds requirement = €0 x (10.5% to 21.5%) =€0
  - Own funds requirement has been reduced to zero (in relation to credit risk)
- The same treatment would result from a guarantee from a multilateral development bank which has a 0% risk-weight

Benefits of credit risk mitigation for banks

- Reduces capital requirements
- Enables the bank to offer reduced pricing to the borrower
- Creates additional lending capacity for the bank
- Simplifies credit approval
- Faster recovery on default of the borrower
- Enables the bank to avoid/reduce large exposures

Eligibility requirements for credit risk mitigation products

- Enforceability (CRR Article 194)
- Eligibility of the counterparty (CRR Article 201)
- Substantive terms (CRR Article 183 (IRB approach), Articles 213 and 215 (standardised approach)

Eligibility requirements - Enforceability

- CRR, Article 194(1)

- The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by the lending institution shall be such as to result in credit protection arrangements which **are legally effective and enforceable in all relevant jurisdictions**.

- The lending institution shall provide, upon request of the competent authority, **the most recent version of the independent, written and reasoned legal opinion or opinions** that it used to establish whether its credit protection arrangement or arrangements meet the condition laid down in the first subparagraph.

Considerations with Enforceability

- Opinion: "obligations expressed to be assumed by *Guarantor* under the Guarantee Agreement would constitute legally effective and enforceable obligations of the *Guarantor*"
- Governing rules
- Immunity
- Disputes /proceedings against multilaterals?

Entity governing rules

- Analysis of charter/ treaty/ articles of agreement/statute required
- Waiver of Immunity

  "Nothing in this Agreement shall operate as or be construed to constitute a waiver, renunciation or any other modification of any privilege or immunity of the Guarantor under ….Guarantor's Statute or under any applicable law….. "

- Articles
  - *Guarantor's property and assets, wherever located shall be immune from search, requisition, confiscation, expropriation or any other form of seizure by executive or legislative action.*

Dispute and Proceedings

- Can proceedings be brought against guarantor?
  - *Guarantor possesses full juridical personality including the capacity to contract and institute legal proceedings*

- Enforceability process
  - *Arbitration in accordance with the ICC Rules*
  - *Actions may be brought against the Guarantor only in a court of competent jurisdiction and that the Guarantor's assets shall not be liable to attachment or seizure by way of execution within the European Union except by a decision of the Court of Justice of the European Union*
  - *Proceedings may be brought in a court of competent jurisdiction in the territories of a member in which the Guarantor has an office*

Eligibility requirements - Counterparty

CRR Article 201

- (a) central governments and central banks;
- (b) regional governments or local authorities;
- (c) multilateral development banks;
- (d) international organisations exposures to which a 0 % risk weight under Article 117 is assigned;
- (e) public sector entities, claims on which are treated in accordance with Article 116;
- (f) institutions, and financial institutions for which exposures to the financial institution are treated as exposures to institutions in accordance with Article 119(5);
- (g) other corporate entities, including parent undertakings, subsidiaries and affiliated corporate entities of the institution, where either of the following conditions is met:
  - (i) those other corporate entities have a credit assessment by an ECAI;
  - (ii) in the case of institutions calculating risk-weighted exposure amounts and expected loss amounts under the IRB Approach, those other corporate entities do not have a credit assessment by a recognised ECAI and are internally rated by the institution;
- (h) central counterparties.

Export Credit Agency (ECA)

- Has the financial and legislative backing of its home state
- Obligations considered direct (or indirect, depending on the legal status of the ECA) sovereign obligations
- Not multilateral agencies (which are supported by multiple states) nor development finance institutions (which are focused on development rather than exports)

Type of ECAs?

- Part of government
  - UK Export Finance (UKEF), formerly the Export Credits Guarantee Department (ECG)
  - Export-Import Bank of the United States (USEXIM)
- State-owned corporations
  - China Export & Credit Insurance Corporation (Sinosure)
  - Danmarks Eksportkredit (EKF) in Denmark
- Privately-owned organisations (with full faith and credit of the sovereign)
  - Euler Hermes Aktiengesellschaft in Germany
  - Atradius in the Netherlands

Eligibility – Other qualitative requirements

- Credit protection is direct
- Extent is clearly defined and incontrovertible
- No clause outside the direct control of the lender that:
  - would allow the provider to cancel the protection unilaterally
  - would increase the effective cost of protection as a result of deterioration in the credit quality of the protected exposure
  - could prevent the protection provider from being obliged to pay out in a timely manner
  - could allow the maturity of the credit protection to be reduced by the protection provider
- On the default or non-payment of the counterparty, the bank has the right to pursue, in a timely manner the guarantor for payment

Outside of the direct control

- Eligibility Criteria
  - Within the control of the bank
  - Clear and unambiguous terms
  - Processes for monitoring
- Side Agreements with obligor may be necessary

Timely payment

- Limited guidance on the meaning of “timely”, form EBA and PRA
- Flexibility is recognised – EBA would not allow any "determinable" period, whose length depends on circumstances on which the institution has no influence.
- The PRA has acknowledged that there may be difficulties in applying a single measure of timeliness to all the different products which may be used as guarantees.
  - “Guarantor must pay the Confirming Bank on the fifteenth day after receipt of a Notice of Unpaid Claim”;
  - Ninety (90) day time period in guarantees given by an export credit agency are consistent with current market practice

Clearly defined and Incontrovertible

- PRA interprets "incontrovertible" - wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, challenge or otherwise seek to be released from, or reduce, its liability *(paragraph 7.4 of the updated SS 17/13).*
- Consider representations and covenants to be made by Bank under the guarantee:
  - Misrepresentation will enable Guarantor to rescind the Guarantee
  - Bank must carefully limit scope of representations – wide scope is harder to monitor and ensure compliance – limit to knowledge of Bank
  - Failure to comply with broadly worded undertakings is greater

Clearly defined and Incontrovertible

- PRA: *an institution should consider the terms of the guarantee itself and the remedies available under the law that applies to that guarantee (paragraph 7.4 of the updated SS 17/13).*
- Would PRA expect an institution to consider, for example, the likelihood of scenarios such as a change in sanctions laws or occurrence of a fraud preventing payment by Guarantor?
  - Although acceptable from a CRR perspective for a guarantee to state that the guarantor shall not be required to make payment in breach of applicable binding sanctions - as it would be contrary to public policy to compel a party to act in breach of laws.
  - Guarantee language may go further and enable guarantor to refuse to make payment on the basis that it has elected (in its discretion) to comply with laws that it is not legally required to comply.

Horizon Scanning – CRD 6

- EU legislators expected to adopt amendments to the EU Capital Requirements Directive (CRD 6) Q2 2024
- Will restrict on the ability of non-EU banks to provide “core banking services”
- To provide “core banking services” non-EU banks will need to establish an authorised EU branch or fall within an exemption
- EU branches of non-EU entities conducting banking business will be subject to:
  - new capital and liquidity requirements
  - enhanced governance and risk controls
  - detailed reporting requirements

CRD 6 – Harmonization of treatment

- The driver for the new regime is harmonization of treatment
- Current regime leaves treatment of TCBs largely to national law with the requirement that they be treated no more favourably than EU-bank branches
- In order to provide "core banking services"
  - deposit-taking
  - lending
  - guarantees and commitments

  in a Member State third-country institutions will need:
  - a branch
  - apply for authorisation

CRD 6 – ECA finance - Europe

- Unprecedented ECA activity in 2023
- Europe represented 40% of the global ECA market in 2023
- 270 transactions (ahead of Asia Pacific (71) Africa (80) North America (46))
- Transport 81 transactions; manufacturing and equipment 65 transactions; renewables 43 transactions

CRD 6 - timetable

- Final timetable will depend on when the final text is published in the Official Journal (expected Q2 2024)
- After publication there will be an 18-month transposition period for Member States to implement CRD 6
- Followed by a 12-month period of transitional relief for licensing applications before restrictions on cross-border services apply
- Assuming the legislation is published in the Official Journal Q2 2024 - new licensing requirements will go live Q3 2026

Daniela Barrdear

Counsel, Trade & Export Finance

Daniela advises on trade and commodity finance structures, acting for banks and non-bank financial institutions, development finance institutions and multilateral organizations as well as borrowers. She has significant knowledge of supply chain finance techniques, blended finance and export financing across the globe with a focus on emerging markets.

Education

- BPP Law School (GDL and LPC)
  - Graduate Diploma in Law
  - Legal Practice Course
- University of Manchester (M.Sc)
  - Trade Policy and Development (M.Sc)
- Emory University
  - Political Science (B.A.)

Mark Norris

Partner, Trade & Export Finance

Mark's practice covers project and export credit finance, asset finance, structured trade and commodity finance, debt restructurings, acquisition finance and corporate advisory work. He represents financial institutions, export credit agencies, corporates, boards, and national and supranational sovereign organizations in relation to finance transactions throughout Western, Central and Eastern Europe, Africa and the Middle East

Education

- College of Law
  - Law Society Finals
  - Common Professional Examination
- London School of Economics and Political Science
  - Banking Law and Financial Regulation (LL.M.)
  - Econ-Social Policy (BSc)

Awards & Recognition

Global Trade Review (GTR) "Best Export Finance Law Firm", 2023
GTR named Sullivan "Best Export Finance Law Firm" at the GTR Leaders in Trade Awards, 2023

Trade Finance Global "Legal Innovation in Trade" 2023
Sullivan recognised for "Legal Innovation in Trade" 2023 by *Trade Finance Global* (in connection with BAFT) at its Trade, Treasury and Payment Awards 2023

The Legal 500 UK, 2024
Sullivan ranked in Tier 1 for Trade Finance by *The Legal 500 UK, 2024* for the tenth year running
Partner Geoffrey Wynne is included as a Leading Individual for Trade Finance in the "Hall of Fame"
Partners Simon Cook, Mark Norris and Sam Fowler-Holmes are recognised as Leading Individuals

Chambers UK, 2024
Chambers UK, 2024 ranked Sullivan for Commodities: Trade Finance (UK-wide)
Geoffrey Wynne and Simon Cook are both ranked in Tier 1
Mark Norris and Sam Fowler-Holmes are both ranked in Tier 3

IFLR1000, 2024
Sullivan recognised for Banking Lending - Lender Side in the United Kingdom by the *IFLR1000, 2024*
Partner Geoffrey Wynne is recognised as a Leading Lawyer – Highly Regarded in the United Kingdom

The Best Lawyers in the United Kingdom®, 2024
Best Lawyers included five London partners — Marian Boyle, Simon Cook, Sam Fowler-Holmes, Mark Norris and Geoffrey Wynne — in the 2024 edition of *The Best Lawyers in the United Kingdom®*

Receivables Finance International (RFIx) Annual Awards, 2023
Geoffrey Wynne named "Industry Ambassador of the Year" 2023 at the Receivables Finance International (RFIx) Annual Awards

Trade Finance Global "Best Trade Finance Law Firm" 2022
Sullivan named "Best Trade Finance Law Firm" 2022 by *Trade Finance Global* (in connection with BAFT) at its International Trade Awards, 2022

In 2022, 2021, 2020 and 2019, GTR recognised Sullivan
The firm was named "Best Trade or Supply Chain Finance Law Firm" at the 2022 *GTR* Leaders in Trade Awards, "Law Firm of the Year" in the category "Leaders in Trade for Innovation" at the 2021 *GTR* Leaders in Trade Awards and "Best Trade Finance Law Firm" at the GTR Leaders in Trade Awards in 2020 and 2019

2021 Lexology "Client Choice" award for Banking, United Kingdom
Geoffrey Wynne named a recipient of the *Lexology* "Client Choice" Award 2021 for Banking, United Kingdom

Trade Finance Global "Best Trade Finance Law Firm" 2019
Sullivan named "Best Trade Finance Law Firm" 2019 by *Trade Finance Global* at its International Trade Finance Awards, 2019

Boston
One Post Office Square
Boston, MA 02109
+1 (617) 338-2800

Washington, DC
1666 K Street, NW
Washington, DC 20006
+1 (202) 775-1200

London
Tower 42
25 Old Broad Street
London EC2N 1HQ
+44 (0)20 7448 1000

Tel Aviv
28 HaArba'a Street, HaArba'a Towers
North Tower, 35th Floor
Tel Aviv 6473925
+972 74 7580480

New York
1633 Broadway
New York, NY 10019
+1 (212) 660-3000

sullivanlaw.com

@sullivanlaw

What's Your Next?

Move forward with Sullivan

Sullivan
SULLIVAN & WORCESTER