

Berne Union Feedback to PRA Consultation Paper | CP6/18

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1. The Berne Union and its members' support for trade

The Berne Union, founded in 1934, is the international association of export credit and investment insurers. The 85 members include government-backed export credit agencies (ECAs), private credit and political risk insurers and multilateral agencies from 73 countries – representing all aspects of the industry worldwide.

In 2017 Berne Union members collectively provided payment risk protection of approximately USD 2.2 trillion, equivalent to around 14% of annual world cross-border trade, compensating banks and exporters for losses suffered due to defaults by buyers, borrowers or other obligors abroad, and providing flexible risk capacity to support international trade transactions. Private insurers provided about 57 % and public insurers (ECAs and multilateral agencies) provided about 43 % of the cover.

Their exposure for this type of business at the end of 2017 amounted to USD 2.4 trillion. Since the start of the global financial crisis in 2008, Berne Union members collectively paid more than USD 45 billion in claims due to non-payment by obligors, thus enabling global trade also in financially challenging times. UK banks hereby frequently use both UK and other European and non-European public and private insurers to mitigate their credit risks when financing trade related transactions.

2. Why credit insurance is important to trade and economic growth

The origin of credit insurance dates back to immediately after the First World War. Many countries in Europe were devastated or impoverished by the war. Governments wanted to stimulate their economies by protecting exporters, and banks financing exports, against non-payment risk. Without this protection, companies would often not enter into supply contracts with foreign buyers, thus hindering economic recovery.

The world's first export credit insurer was the UK's Export Credits Guarantee Department (now operating as UK Export Finance (UKEF)), established in 1919 and one of the first Berne Union members. This lead was soon followed by other countries. In addition, private (commercial) credit insurance companies were set up as well. Nowadays almost all mature economies, many emerging market economies and some developing countries have an ECA. In addition, there are currently some 70 private providers of export credit insurance worldwide, many of them with an establishment in the UK.

There is ample evidence about the positive impact of export credit insurance on job creation, especially in manufacturing, and economic growth. In this regard, UKEF's mission is to ensure that no viable UK export fails for lack of finance or insurance, while operating at no net cost to the taxpayer. Research done in industrialised countries such as Germany, Austria, Denmark, the Netherlands and Finland shows a considerable impact on job creation. Over the last few years the annual contribution by ECAs to domestic job creation is estimated to be on average

between 8,600 (Finland) to 86,000 (Germany)¹. In addition, it is safe to assume that further jobs are created in supply chains from third countries, as also mentioned in the report from Germany. These data do not include job creation through export credit with private market cover.

3. How credit insurance works

Credit insurance includes a range of products to exporters and banks to protect them against non-payment by obligors. In the context of this paper, we will focus on protection of banks against non-payment of cross-border loans financing borrowers for their purchase of goods or services. This type of financing is commonly called export finance, as the exporter is paid from the loan. Banks use credit insurance both for credit risk mitigation and for risk weighted asset purposes. This insurance, thereby, not only supports their export finance activities, but also a wider spectrum of structured and corporate lending.

Insurance is provided on the basis of a partnership between insurers and banks, with full disclosure by the bank of the risk to be insured, supplemented by the insurer's independent underwriting process. In addition to the disclosure required by their insurance conditions and/or insurance law, insurers use their own credit risk analysis, pricing models and information sources, to ensure that their underwriting is informed and that the risks of the transactions are acceptable. This process is further reinforced by insurance regulation.

When referring to export credit insurance, this also includes export credit guarantees. There is no strict dividing line between insurance and guarantees to banks, as often export credit guarantees – like insurance - contain some degree of conditionality. In practice, however, these conditions for both insurance and guarantees are under the control of the insured banks themselves and not related to the payment risk. One such condition is e.g., that the bank must monitor the risk and remind the borrower of his obligation to pay. In the decades' long history of cover provided to banks, we are not aware of a rejection of a claim due to a breach of a condition over which the insured had control, except for very exceptional circumstances such as fraudulent action on part of the bank. This record of near full indemnification is evidenced by the data from the Trade Register of the International Chamber of Commerce (ICC, see below).

4. Transparency of the product

Credit insurance policies are bespoke in the description of the transaction(s) covered, reflecting the need to ensure that the cover accurately mirrors the underlying risk.

In addition to the description of the underlying transaction, credit insurance policies – as, of course, any insurance policy – include terms and conditions. In the case of private insurers, the terms and conditions are often negotiated, so that the rights and obligations of both the

¹ For Germany: <https://www.cesifo-group.de/DocDL/Executive%20Summary%20Hermes%20en.pdf>
For Denmark: <http://www.ekf.dk/en/about-ekf/EKF-in-figures/Documents/Annual-Report-2015-UK-Final.pdf>
For Finland: <http://annualreport2015.finnvera.fi/en/finnvera/role-and-impact-of-operations.html>
For Austria: https://www.bmf.gv.at/wirtschaftspolitik/aussenwirtschaft-export/WIFO_Update_2015-2016_Exportgarantien.pdf?67ry4u
For the Netherlands: <https://www.cbs.nl/en-gb/background/2017/38/public-export-credit-insurance-in-the-netherlands>

insurer and the insured are well understood and the wording meets the individual bank's specific internal requirements. This allows the bank to receive a consistent product, and to be aware of, and manage, the operational risk. While terms and conditions, therefore, to some extent, may differ from bank to bank, and from insurer to insurer (the latter also due to the applicable (national) law of the insurer), they do reflect market-wide principles that embody insurance law and the operational requirements of credit risk transfer. In the private insurance market, English law policies are governed by long-standing insurance principles embodied in court precedent and insurance law (Marine Insurance Act 1906 and Insurance Act 2015).

ECA terms and conditions are typically not negotiable, but may differ from ECA to ECA. Also here, however, these terms and conditions reflect the above principles. For ECAs, in addition, these principles are laid down in the EU Council Directive 98/29/EC² and in the inter-governmental Arrangement on Officially Supported Export Credits of the OECD to which the EU is a signatory³.

In short, both for public and private credit insurance, in case of non-payment by an obligor, the product provides cover (loss indemnification) – within a fixed time period – of the specified payment obligations, as long as the bank fulfils its operational requirements.

5. Probability of default, loss given default and expected loss under loans supported by export credit insurance

The ICC has collected a vast amount of data about Probability of Default (PD), Loss Given Defaults (LGDs) and Expected Loss (EL) under export finance loans covered by ECAs⁴. The register contains a data set of over USD 670 billion of exposures in export finance, across 40,000 transactions. The EL of covered export finance loans in the period 2007-2016 (i.e. including the global financial crisis) has been 0.019% (for completed cases) and 0.026% (including partially completed cases, i.e. recent losses where recovery has yet to be made). These figures are extremely low compared to any asset class by any standard. As the ICC Trade Register Report 2017 clarifies: 'This low risk is largely a function of the ECA coverage.' Losses are limited unless the ECA defaults, which is unlikely since most ECAs are supported by investment-grade-rated OECD governments. The same holds true for private market insurers, which in some cases have a higher credit rating than some of the ECAs included in the ICC Trade Register. Particularly in times of crisis of the interbank market, e.g. in 2008/2009, ECAs have significantly stabilised not only trade and industry (particularly SMEs who typically rely even more on bank financing than larger corporates), but also the banking market in having been a major reliable means for banks to obtain (long-term) refinancing and providing parties with certainty that funding is available.

6. Timeliness and incontrovertibility

Both timeliness and incontrovertibility are important requirements for CRM instruments in the PRA proposal. These requirements may need some clarification when applied to credit insurance. Below we provide comments from the credit insurance perspective.

² <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31998L0029>

³ [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=tad/pg\(2018\)1](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=tad/pg(2018)1)

⁴ ICC Trade Register Report 2017, p 47 and further, <https://iccwbo.org/publication/icc-trade-register-report-2017/>

6.1 Timeliness of payment

An important feature of credit insurance is the timeliness of indemnification to the insured. The timeframe for indemnification under credit insurance consists of three periods:

1. A loss prevention period. For EU ECAs this is typically 3 months, as laid down in the Annex to the aforementioned EU Council Directive. Non-EU ECAs and private insurers may apply different periods, but normally not much dissimilar. This period is designed for the borrower and lender(s) to work out any issues that may prevent payments by the borrower and find a solution to allow the transaction to continue.
2. Following this, a claims settlement period, typically 1 month, during which period the insured provides the proof of loss and consult further with the insurer as to any loss mitigation that may assist in resolving the default. Some insurers combine the loss prevention period with the claims settlement period.
3. And subsequently a payment period of typically between a few days and two weeks.

Although these periods may differ from insurer to insurer and may also vary between the specific risk (country) covered, they are clearly defined in the specific insurance policy or guarantee.

The PRA consultation document includes a proposal for timeliness:

PRA Proposal: The PRA considers that ‘the requirement for the guarantor to be obliged, contractually, to pay out in a timely manner’ means that the pay-out should be made without delay and within days, but not weeks or months, of the date on which the obligor fails to make payment due under the claim in respect of which the protection is provided (clause 2.7 of the PRA paper).

From the credit insurance perspective, there are a number of concerns and issues:

- Perhaps the most fundamental observation with regard to payment of a claim is that banks do not expect insurance to act as primary source of repayment. Instead, banks are prepared to work out the problem, knowing that the policy will indemnify a valid claim if required. The banks would prefer to sort out the problem and continue the loan. Moreover, the problem is often resolved within the cure period of the borrower default, through (late) payment or restructuring.
- Unlike the case of a parent company guarantees, the insurer may not even be aware of the underlying default until notified by the insured bank; the period following submission of the claim is time to ensure that the legal, compliance and treasury functions are able to give their considered approval for the transfer of monies to the beneficiary of the guarantee; this process is also to satisfy reinsurers that the claim payment is not gratuitous.
- Should immediate indemnification be required, the insurance would be more akin to a liquidity product, where the claim payment provides funds to bridge rescheduled/recovered payment obligations. This would increase capital charges for insurers and reinsurers, making it a more expensive CRM as well as changing the nature of the business model (currently underwritten in the expectation of loss management and as a backstop for lenders rather than an immediate source of cash). This change would also reduce insurers and reinsurers’ appetite to support lending activity, and disrupt trade finance, where short delays are normal and even, in emerging markets, expected.

- A shorter cure/claim assessment period might be possible for bankruptcy situations – and is then sometimes applied *ex gratia* by the insurer to avoid having to indemnify delay interest over the full loss prevention/claims settlement period; however, imposing a shorter period will cut the pool of available insurance support for bank transactions, as the product may no longer be considered insurance (but quasi-banking).
- Policies under English law that do not pay valid claims in accordance with policy terms must pay for any consequential damages to the insured resulting from the late payment of the claim (Insurance Act 2015. In addition, Section 13 of the Insurance Act 2015 Act provides that a reasonable time includes time to investigate and assess the claim.
- Insurers are subrogated to the bank’s rights against the obligor in the event of paid claims. Such rights are not a solvency asset for insurers, meaning that their ability to accrue them into their balance sheet at full value is problematic. Should the insurers be required to take on these assets, then they will be incentivised to begin the recovery process, whether through insolvency proceedings, sale of the asset to a (vulture) fund, or by other means. This has the potential to create stress on obligors that would not be required if the banks were permitted to use non-payment insurance as a fall-back indemnity rather than a liquidity product.
- There are distinctly defined periods for other forms of credit protection from insurance (e.g., securitisation, mortgages) that are not subject to “within days” settlement periods, reflecting the nature of insurance and credit risk mitigation.
- The private insurance market is a supporter of ECAs through reinsurance. Allowing access to a deeper capital pool enables ECAs to be more supportive to banks. Private insurance in turn increases the ability of ECAs to support lenders in developing and frontier economies, as well as supporting UK-based internationally active companies. With shorter periods for loss prevention/claims settlement and, as a consequence, ECAs insurance being considered more of a (quasi-)bank products, the *reinsurance* pool for ECAs may be cut as well. Of new export finance business written by ECAs in 2016, approximately USD 32 billion was reinsured in the private market.

Some further legal considerations on timeliness

- Although the PRA states in clause 2.7 that it has considered other uses of the phrase ‘in a timely manner’ in CRR Part Three, Title II, Chapter 4, it is worth noting that ‘in a timely manner’ is used in the CRR (Part Three, Title II, Chapter 4, Article 215.1(a)) with respect to the ‘right to *pursue* the guarantor for monies due’ (as noted in clause 2.6 of the PRA paper), rather than payment by the guarantor; certainly upon the default of the borrower whose credit risk is covered by an insurance policy, the insured bank has the right to submit its claim for indemnification under the insurance policy without delay.
 - It may be worth noting that, although not explicitly mentioned in the CRR’s Article 215 (additional requirements for guarantees), the Basel Committee on Banking Supervision permits the guarantor to *either* make one lump sum payment *or* “assume the future payment obligations of the counterparty

covered by the guarantee”⁵ so a cash payment is not necessarily required by the BCBS in order for a guarantee to meet operational requirements.

- The PRA paper states in clause 2.7 that the PRA have considered ‘the timeliness of settlement of credit derivative contracts once an event of default has been declared’. English law (the Insurance Act 2015) enforces timely settlement of a claim once the claim has been validated: this is consistent with the credit derivatives process (without the perceived failings of the CDS process, as highlighted in the *Financial Times* article dated 25 July 2017 – “Credit default swaps: a \$10tn market that leaves few happy”). As said insurers typically pay validated claims between a few days and two weeks.
- EU Council Directive 98/29/EC defines loss from credit risk materialising when the policyholder has been unable to obtain payment of any amount due to it under the relevant commercial contract or loan agreement during a period of *three months* [emphasis added] after the due date; the current proposal is not consistent with this. Not only is this problematic for EU-based export credit agencies, but the EU directive is more aligned with the business model, used by both public and private sector insurers, of underwriting bank transactions on the basis of a cure period during which the insured seeks to avert a default. Insureds choose this approach because they do not wish either to assign the debt and exit the obligor relationship at the first instance of trouble or have the insurer subrogated to their position at this early stage; this structure also allows insurers to provide coverage on a more cost-effective basis.

Recommendation:

Under credit insurance banks know exactly when they are entitled to indemnification and when this indemnification is paid. The current system has been functioning well for all involved. Shortening the loss prevention or claims settlement period risks changing the product to (quasi-)banking, thus cutting the *insurance* pool. This is an undesirable effect for exporters, buyers, banks and insurers, and should, therefore, be avoided.

6.2 Incontrovertibility

As mentioned under 3, above, credit insurance cover includes conditionality. The PRA consultation document contains proposals for removing conditionality.

PRA Proposal: The PRA interprets ‘incontrovertible’ in CRR Part Three, Title II, Chapter 4 to mean that ‘the wording of the guarantee should be clear and unambiguous, and leave no practical scope for the guarantor to dispute, contest, and challenge or otherwise seek to be released from, or reduce, their liability.’ (clause 2.5)

If, in this context, liability means the obligation of the insurer to pay *after the validation of the claim* (i.e. after it is established that the insurance conditions have been met), then the PRA proposal would indeed make much sense. However, it is not clear from the text whether the requirement refers to situations *before* or *after* validation. If the proposal also refers to situations before validation, then this would raise a number of concerns and issues:

- The PRA ‘expects firms to consider the terms of the guarantee’

⁵ International Convergence of Capital Measurement and Capital Standards; a Revised Framework, clause 190(a) (additional operational requirements for guarantees)

- Policy wordings are drafted to cover payment default of the underlying obligor for any reason: this cover is clear and unambiguous.
- Insurance policy terms have been drafted to ensure that, provided the insured bank meets its clearly stated obligations under the policy, the insurer has no *practical* [emphasis added] scope to contest a claim; for example, where claims have been contested, these have been due to operational failures by the insured bank resulting in breach by the bank of its contractual obligations.
- The PRA expects firms to consider ‘the remedies available under the law that applies to that guarantee’
 - English insurance law, particularly since the Insurance Act 2015, give policyholders protections against late payment of claims in the form of consequential damages, in addition to the reputational and other considerations that drive prompt settlement of claims (see also next point).
- The PRA expects firms to consider ‘whether there are scenarios in which the guarantor could *in practice* [emphasis added] successfully seek to reduce or be released from liability under the guarantee’
 - Insurers do not dispute claims that are valid, as evidenced by claims data from the ICC.
 - It is not in insurers’ interest to dispute claims, due to reputational issues as well as the potential negative impact on the “willingness to pay” analysis contained in ECAI financial strength ratings on which insureds rely.
 - As banks do not have many options for effective credit risk mitigation for export finance, given the limitations of the CDS market for this type of risk, in particular for emerging market risks, they will seek ways to continue to use the non-payment product.
 - Finally, it can be argued that, should the risk mitigation product be totally unconditional and policies would pay out regardless of the behaviour of the insured, there is a risk of both “moral hazards” and of banks’ internal credit procedures would becoming less stringent and less careful.

Recommendation:

Clarification that the liability of the insurer refers to the situation *after* validation of the claim (as there is no liability of the insurer *before* validation of the claim).

7. Conclusion

Credit insurance as provided by the members of the Berne Union is an important tool of risk mitigation to exporters and banks, enabling global trade even in challenging times. Parties to credit insurance are well familiar with the functioning of the product.

A stricter interpretation of the CRR operational requirements for guarantees such as that contemplated by the PRA could either restrict banks’ ability to use the non-payment product, thereby potentially stimulating them to carry more risk on their own balance sheet, or could move insurers towards offering a product that functions more like a liquidity product and less

like an indemnity product. This would increase financial systemic risk and reduce the support available from the insurance sector. This would not only have a direct impact on the banking activities themselves but would also:

- Negatively affect manufacturing and trade (particularly in the case of SMEs who heavily rely on bank financing), as bank financing to these sectors would decrease
- Increase the cost of the risk mitigation instrument, which would have consequences both for funding, particularly in case of stressed banking markets as was the case in 2008/2009, and for the banks' profitability
- Reduce a crucial stabilising force not related to bank systemic risk.