



Perspectives on Medium and Long Term (MLT) Export Credit Insurance

Choice and the “mixed market”
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“The PRI market is the market for “non-marketable” risk - and it has an increasing appetite for MLT business.”



Medium and long term (MLT) export credit insurance, once considered the preserve of the ECAs, is inexorably changing

Change is coming to the medium and long term (MLT) export credit insurance market. This paper looks at pure cover (which traditionally accounts for about 90% of the Berne Union members' MLT business) rather than lending, and argues that the de facto monopoly of the government export credit agencies (ECAs) is being replaced by a "mixed market" in which both ECAs and private insurers compete. This mixed market will, for the first time, give exporters and banks a choice.

The European Commission (EC) competition authorities divide credit insurance into "marketable" risk and "non-marketable" risk. "Marketable" risk is defined as short term business (up to two years credit) on buyers in the EU and certain other developed countries. Short term risks in the developing world and all MLT risks are defined as "non-marketable". EU ECAs are only permitted to write "non-marketable" risk.

In the private sector, there are essentially two separate credit insurance markets. The first market writes about USD6-7 billion premium per annum of short term multi-buyer business of mainly "marketable" risk; is dominated by the monoline private insurers like Euler-Hermes, Atradius and

Coface; and is well known. The other market, the political risk insurance (PRI) market, writes around USD2 billion of premiums per annum and is less well known, partly because many remain unclear about its activities. Here the EU definitions are useful. Apart from a small amount of investment insurance business, amounting to little more than 10% of its annual premium, the PRI market writes "non-marketable" credit insurance. As such, the PRI market is the market for "non-marketable" risk - and it has an increasing appetite for MLT business.

Our recent capacity survey, monitoring the private PRI insurers' maximum capacity per risk, reveals that:

- a. for government buyers, the market capacity is about USD1.75 billion per risk. Periods vary but nearly half of this capacity comes from insurers which can commit to 10 years on a non-cancellable basis and a quarter of the capacity from those which can commit for 15 years.
- b. for private buyers, the market capacity is about USD1.2 billion per risk. Two thirds of this capacity can be committed for 7 years on a non-cancellable basis and some is available for periods of 10 years.

Increasing overlap where both ECAs and private insurers can compete



There is still a "market gap" for the very long term commitments, but it is getting smaller. Likewise, the area of overlap where both ECAs and private insurers can compete is growing. This area lacks a name, but let's call it the "market window".

A recent example of the "market window" involved a Latin American borrower on whom ECAs are currently writing pure cover. At the same time, BPL Global has recently placed a policy of over USD200 million of MLT cover on the same borrower. The market lapped up this "non-marketable" risk – as shown by our being able to place all the risk at a rate that was significantly lower than the leader's original quote and less than the original price offered by all other participants bar one. What is more, there is equally keen appetite from the market to take more risk on a second policy of similar size on the same borrower. For this and many other MLT risks, there is now often a choice: ECA, private market or a combination of both.

Despite this, we are NOT seeking to restrict ECA activity in any way in the so-called "non-marketable" area and we do not want the EC to redraw the line between "marketable" and "non-marketable" risk. We agree the EC should only deem risk to be "marketable" (and therefore forbidden to EU ECAs) where the private market has enough capacity to write ALL economically

justifiable risks of the type. Clients need ECAs to participate not only in those risks that fall in the diminishing "market gap", but also for those that fall in the "market window" where the private market has appetite, but limits to their capacity, as PRI insurers always write within buyer and country aggregates.

In this respect, the only point we would make is that the EU's terminology is unhelpful. They would promote understanding by referring on the one hand to "fully marketable" risks and on the other to risks which are "not fully marketable" or where the market is "capacity constrained".

Recently available figures from the Berne Union on the 30 year records of premiums, claims and recoveries of their members throw light on the growing appetite of private insurers for MLT business (see Figure 1).

A review of the Berne Union's 30 year loss ratio (the ratio that paid claims net of received recoveries bears to premium income) is also revealing (see Figure 2).



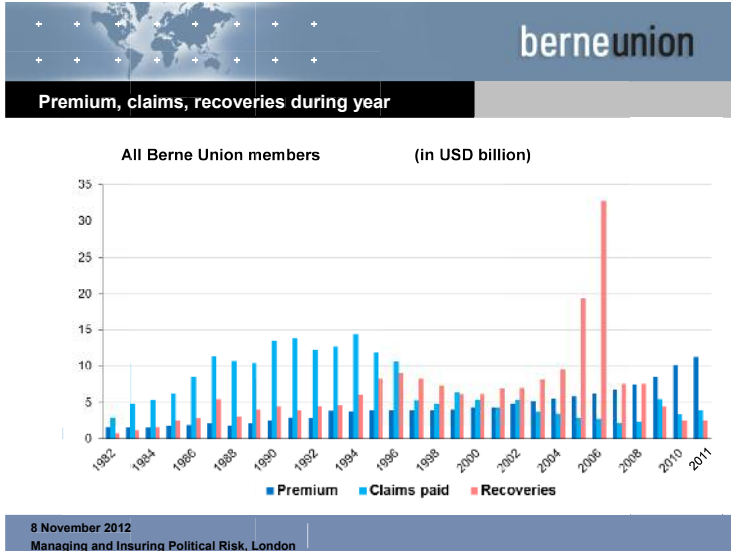
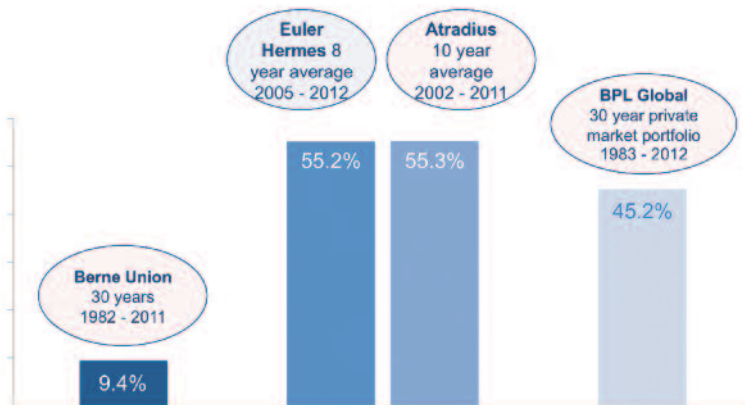


Figure 1: Berne Union members' premium, claims and recoveries by year 1982-2011

Net loss ratios*



* Claims, net of recoveries, as a percentage of premium

Figure 2: Loss ratios of Berne Union, Euler Hermes, Atradius and BPL Global

The Berne Union members' average loss ratio over the 30 year period of about 10% of premium income will probably surprise even those who were aware that the rather dismal performance in the 1980s and early '90s had been turned around over the last 15 years or so.

The comparisons in Figure 2 show first the loss ratios of Euler Hermes and Atradius' private sector business over recent years. These ratios were actually slightly higher than one would expect due to the effects of the financial crisis. We also show BPL Global's equivalent loss ratio on its private market PRI book of business over the last 30 years. For further comparison, in general insurance market classes, loss ratios tend to fluctuate quite widely but may average about 60-70%. For the avoidance of doubt, low loss ratios mean higher profitability. So the Berne Union members have done remarkably well for their predominantly government owners.

However, on reflection, the Berne Union loss ratio is less surprising when you remember that their clients over the period have enjoyed very little choice, especially in the MLT arena: they have been clients of a de facto monopoly.

“For many MLT risks there is now often a choice: ECA, private market or a combination of both.”

Basel regulation: A potential game changer

ECAs are of course not meant to compete with each other and are sensibly constrained from distorting international trade by the OECD Consensus Agreement. But why have the ECAs not been subject to more competition from the private insurers, particularly in recent years?

The answer is Basel regulation. To date, the major ECAs have been handed a key competitive advantage in the form of a zero risk weighting. As a result, Basel regulation has tilted the playing field heavily in favour of the ECAs and made it impossible for the private market to compete for the ECAs key clients – the banks.

However, changing Basel regulations now require banks to allocate capital to officially supported export credit transactions based on the ECAs own country rating. For private PRI insurers rated in the AA to A range, this significantly levels the playing field with AAA Hermes state cover in Germany and AA+ Coface state cover in France, and gives the private insurers a competitive advantage over, for example, BBB+ SACE in Italy and BBB- CESCE in Spain. This is the game changer in the MLT market that will open the door for client choice.

Interestingly though, the new Basel rules have also upset the level playing field previously enjoyed by the developed world's ECAs. This raises policy issues about the existing ECA system, particularly in the context of the EU where all exporters should enjoy a level playing field. As SACE's Raoul Ascari has pointed out, the Basel changes "will create new ground for trade distortions, as countries with better ratings will be able to offer a competitive advantage to their exporters". CESCE's chief operating officer, Beatriz Reguero, has also commented: "the fact that Spanish exporters may not be able to complement their technical offers to their clients with competitive financial packages puts them at a disadvantage in the

face of their counterparts from countries that are better rated".

As they grapple with these policy issues, which need resolving not only in the European context but also in the context of global competition with countries outside the OECD Consensus, officials may well contemplate that the more MLT business is captured by the private sector, the smaller the problem they need to resolve.

Levelling the playing field to achieve fair competition between government ECAs and private insurers

Meanwhile there are policy issues within the mixed market. Firstly, should ECAs withdraw from the overlapping "market window" and only operate in the "market gap"?

We think the answer is a categorical "no". ECAs should not be a market of last resort in the "non-marketable" risk area. We firmly believe in choice for policyholders and this would not be achieved by depriving exporters and banks of the services ECAs provide.

We are aware that complex competition issues arise over the rights of the private insurers to be protected from unfair ECA competition. However, we feel that there has perhaps been too much sensitivity to the rights of the private insurers and not enough to the interests of the clients. We believe that the clients' need for choice will be balanced with the rights of private insurers to be insulated from unfair competition as long as the ECAs abide by the OECD Consensus. ECA competition within the Consensus terms, including the new minimum premium rates, should be seen as fair.

It goes without saying that this fair competition between government ECAs and private insurers

should be conducted on a level playing field. There is a specific issue here that needs resolving, namely that in some countries there is unequal treatment between ECAs and their private insurance competitors when it comes to premium tax. This is a particular problem in Germany – not least as the rate of premium tax is high at 19%. When Hermes provides pure cover for "non-marketable" risk, the premiums are quite rightly exempt from this tax. However, when the private insurers seek to provide the same cover in competition with Hermes they are quite wrongly handicapped by having to add 19% tax to their premiums. Not only is this grossly unfair to the private insurers, but it also reduces the amount of choice for German exporters. This needs resolving either by the German Government following most other EU countries in exempting all export credit insurance from premium tax or, if they do not want to lose the revenue they derive from taxing "marketable" risk, simply clarifying that private insurers writing "non-marketable" risks are exempt.

Risk sharing between the ECAs and the private insurers: Competition or co-operation?

Finally there is the question of "co-operation" between the ECAs and the private insurers. While both public and private members of the Berne Union universally acclaim co-operation a "good thing", to us, sitting on the client's side of the table, the word nevertheless causes some disquiet.

Of course as London Market-based brokers we are in favour of risk sharing. Most, if not all, of our placements in the PRI market are syndicated placements, involving multiple insurers participating on the same risk, and we would be delighted to see more syndications involving both private insurers and ECAs.

Rather, our concern rests with the process through which this risk sharing is achieved: should the

process be one of competition or co-operation?

The PRI market is used to a competitive subscription market process. Best practice ensures that the client, through its broker, controls the syndication; the insurers do not talk to each other about the risk throughout the process; the insurers compete for the leadership of or participation in the placement; choice is preserved. This process produces the best result for the client, and may lead to placements at prices lower than originally quoted, as occurred in the Latin American example mentioned above.

The ECAs' process for syndicating risk is very different. As befits an environment that seeks to limit competition between ECAs, when they syndicate, they co-operate. They DO talk to each other about the risk and the terms they will offer; they reach a consensus and produce a single choice for the client.

If such co-operative practices are brought into the private market arena by ECAs they will reduce or eliminate client choice. This is admittedly a complex area (it recently required a 600-page report following an EC enquiry into the subscription market which lasted many years only to conclude that the subscription market is indeed competitive). But we can assure ECAs that if they want to foster client choice when operating in the market window and the market gap, they need to understand and follow subscription market best practice.

In conclusion, change is never welcome. For ECAs, it is particularly unwelcome given that it comes as a result of regulatory shifts in a different industry (the Basel regulations) and follows a period of marked achievement for them. Furthermore, the MLT business is hardly in crisis. But the coming change presents an opportunity too. It remains highly unusual for any line of insurance business that has been successfully underwritten for a long period of time to offer its clients little or no real choice. We can and should put that right.

"To date, the major ECAs have been handed a key competitive advantage in the form of a zero risk weighting."



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