supporting trade and investment since 1934

European Banking Authority

22 May 2019

Dear Sir/Madam,

Consultation Paper | Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGD

The Berne Union (International Union of Credit and Investment Insurers) is the global association of the export credit and investment insurance industry. Our Members include official export credit agencies (ECAs), multilaterals, and private companies that provide (inter alia) credit risk mitigation products, which enable banks to manage the obligor and country risks inherent to cross-border trade transactions. As such the members of the Berne Union have an interest in bank regulation for these CRM instruments. In this capacity, we would like to provide feedback to the proposals in the Consultation Paper.

Enclosed is a note which:

1. Describes the size and significance of credit insurance
2. Describes the relationship between export credit insurance and job creation
3. Describes how credit insurance to banks works
4. Provides evidence about the extremely low Expected Loss for bank loans supported by credit insurance
5. Addresses your questions 6 and 11 (pages 6 – 11)

Also enclosed are our 2018 statistics of members' business, published in our 2019 Spring Periodical. This is available online as well via https://www.berneunion.org/Newsletter

If you require further clarification on the note or our statistics, or would like to discuss, then we would be happy to visit you.

Yours faithfully,

Vinco David
Secretary General

Berne Union
International Union of Credit & Investment Insurers
1st Floor, Thanet House, 231 – 232 Strand
London, WC2R 1DA, United Kingdom

t: +44 (0)20 7841 1110
f: +44 (0)20 7430 0375
w: www.berneunion.org
e: bu-sec@berneunion.org

Berne Union Feedback to EBA Consultation Paper | Draft Guidelines on Credit Risk Mitigation for institutions applying the IRB Approach with own estimates of LGD

May 2019

Background information on the function of export credit insurance

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 2018 Berne Union members collectively provided payment risk protection of approximately USD 2.5 trillion, equivalent to around 13% 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. Of this amount of USD 2.5 trillion reported to the Berne Union, private insurers provided about 49% and public insurers (ECAs and multilateral agencies) provided about 51% of the cover.

Their exposure for this type of business at the end of 2018 amounted to USD 2.6 trillion. Since the start of the global financial crisis in 2008, Berne Union members collectively paid more than USD 50 billion in claims due to non-payment by obligors, thus enabling global trade also in financially challenging times. European banks hereby frequently use both European and non-European public and private insurers to mitigate their credit risks when financing trade 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.

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. Furthermore, there are currently some 70 private providers of export credit insurance worldwide, many of them with an establishment in the European Union.

There is ample evidence about the positive impact of export credit insurance on job creation, especially in manufacturing, and economic growth. Research done in industrialised countries such as Germany, Austria, Denmark, the Netherlands, Finland and Italy 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 or multilateral 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. "Financial institutions play an important role in facilitating international trade. An estimated 80 to 90 percent of world trade relies on some form of credit, insurance or guarantee, issued by a bank or other financial institution (Auboin 2007)"[2] Thus insurance support of bank lending clearly supports international trade.

In the context of this note, 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 trade and 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. 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).

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

[2] "The Private Credit Insurance Effect on Trade", Koen J.M. van der Veer, De Nederlandsche Bank (DNB), Economics and Research Division, October 2010, page 1.

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 this respect, credit insurance is different from CDSs, in which the defined covered cause of loss may to some extent be different from the actual loss suffered by the bank.

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 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.

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/EC[3] and in the inter-governmental Arrangement on Officially Supported Export Credits of the OECD to which the EU is a signatory[4].

The policies generally include a waiting period. This is essentially a standstill agreement, mirroring best practice by the banks to first constructively address payment/credit issues with borrowers/obligors. This period enables banks to use the time to enact a cure, remedy minor delays in repayment, resolve currency shortages etc, allowing for the debt to be rescheduled if feasible. Simultaneously this period enables claims assessment and validation. Waiting periods are typically 90-180 days.

Note: Section 13A of the UK Insurance Act 2015 imposes a statutory requirement to pay claims "within a reasonable time". The law permits insurers a reasonable period to investigate and assess claims, taking into account the size and complexity involved. Where the insurer breaches this duty, the claimant is entitled to extensive remedy, including damages in addition to any sums due and related interest

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 ECAs[5]. 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

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31998L0029
[4] http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=tad/pg(2018)1
[5] ICC Trade Register Report 2017, p 47 and further, https://iccwbo.org/publication/icc-trade-register-report-2017/

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.

Response to the EBA questions

(Also copied – without the references below – in the digital consultation form)

Question 6: Do you have any specific concerns related to the issues excluded from the scope of the Guidelines?

Berne Union response:

A. We understand from discussions at the public hearing on 15 April 2019 that clarification on issues outside the scope may be forthcoming through the Quantitative Impact Assessment process. We would, however, request that the European Banking Authority support the amendment of Article 215 of the Capital Requirements Regulation (CRR) (additional requirements for guarantees), in order to reflect the explicit permission granted in Article 190(a) of the BCBS's International Convergence of Capital Measurement and Capital Standards; a Revised Framework for the guarantor to "step into the shoes" of the underlying obligor:

- Article 190(a) permits the guarantor to *either* make one lump sum payment *or* "assume the future payment obligations of the counterparty covered by the guarantee"[6] so a cash payment is not necessarily required by the BCBS in order for a guarantee to meet operational requirements.

B. Specifically for private sector insurers: The "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor" discussed in Section 2.4.5 of the Call for Advice should not be applied for exposures of the bank as policyholder to insurance companies, as it is not "comparable" exposure, given the priority claim on insurance companies that banks hold as policyholders in the same way that depositors have preference over unsecured creditors in a bank structure. Policyholders are in a privileged position compared to unsecured creditors. The banks should be allowed to recognise (depending on the jurisdiction and its respective insurance regulations) the improved LGD of its exposure as policyholder, based on the risk differentiators set forth in this note.

- Paragraph 29a.ii of the Draft Guidelines (p.35; see also paragraph 33 which references "comparable exposure") requires that the PD and LGD of a "comparable direct exposure to the guarantor" be applied. As said, this should not apply where the exposure of the bank to the protection provider is as holder of an insurance policy.

C. Specifically for public sector insurers (ECAs): As per Article 4 (81) in conjunction with Article 201 of the CRR, officially supported export credits are provided either directly or indirectly by the respective government to the export financing bank. The loan is, therefore, secured by either (i) a direct claim against the state (Ministry of Finance or a special government body), or (ii) a 'public sector entity' (in terms of Article 8 (4) CRR), which in turn avails of a binding undertaking or guarantee by its respective government to ensure compliance with any claim payment obligations. Hence, the treatment of the risk under these officially supported export credits is somewhat different from insurance provided by the private sector, as central governments receive preferential treatment under CRR. A claim under an officially supported export credit therefore benefits from the same credit treatment as exposure to the central government in

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

cases of (i) or (ii) above (provided that the public sector entity is meeting the requirements of Article 116 (4) CRR).

D. As discussed at the public hearing on 15 April 2019, we appreciate that the CRR as currently drafted does not explicitly address credit insurance as Credit Risk Mitigation. In this context, we would ask EBA, in responding to the Call for Advice of May 2018, for clarification to existing requirements that acknowledge credit insurance characteristics under the category of Unfunded Credit Protection based on the following:

- Non-payment insurance provides effective credit risk mitigation able to support bank lending and associated trade and investment in emerging markets where credit derivatives are rarely available and for complex transactions not easily covered by other CRM tools.

- Paragraph 15 of the Draft Guidelines suggests that "credit insurance [can] effectively [function] like a guarantee *or* like a credit derivative [emphasis added]. It would be useful to clarify the acknowledgment of credit insurance as a CRM tool, which has characteristics of both of the current UCP tools, but also unique advantages.

- It is important to distinguish between guarantees issued for the purposes of enhancing the credit of the borrower (those issued by parent companies or by the sovereign owners of public-sector borrowers, and bank guarantees or stand-by letters of credit issued by a borrower's bank) and guarantees managing the lender's exposure (these include unfunded risk participations, credit insurance and credit derivatives). Credit enhancement guarantees are arranged by the borrower and issued by a guarantor with a close commercial relationship with the borrower and (i) are specifically issued as an inducement to lending; (ii) present a correlated credit risk between borrower and guarantor, and (iii) on payment by the guarantor, the borrower's default is cured and its obligation to the lender is discharged. The exposure management guarantees, at the other hand, are arranged and paid for by the lender and (i) are usually issued by a guarantor/insurer who regards the lender as its client, and who has no relationship with the borrower (indeed the guarantee is often silent to them); (ii) the credit risk of the borrower and guarantor are not correlated; and (iii) on payment by the guarantor, the borrower's default is not cured and its obligations to the lender (or its assignee, i.e. the insurer) remain unaltered.

- We would be prepared to work with EBA and other relevant stakeholders and regulators on this, including on appropriate definitions and guidelines to provide clarity on credit insurance as a CRM tool.

In addition to the above, we would like to provide the following supporting arguments:

1. Key risk differentiators that should be permitted to be taken into account in modelling the PD and LGD of banks' claims as policyholders
   1.1. Since the confirmation by both the BCBS (FAQ6, QIS3) and the EBA (Single Rulebook 2014_768 and Assessment of the Current CRM Framework (19 March 2018), paragraph 36, page 15) that non-payment insurance can function as an effective credit risk mitigant, the product has evolved to align with the operational requirements of CRM whilst remaining a policy of

indemnity offered (i) under tested insurance law and (ii) by highly regulated private, public or multilateral insurers with diverse portfolios, strong credit ratings, and based in legal jurisdictions where effective enforcement against the insurer is practicable.

1.2. The fact that the non-payment product is not correlated with either insurers' other exposures or liabilities (if any) nor with the insured banks' exposure to the underlying obligor[7] substantially lowers systemic risk:

1.2.1. In the case of private insurers, regulatory and reserving requirements ensure liquid, callable capital is available to pay claims to policyholders. In the case of public and multilateral insurers, government regulations, government ownership and/or being part of the government allows for sufficient capital to pay claims to policyholders, and typically a claim on the government itself.

1.2.2. The ability of Berne Union private, public and multilateral members to absorb large losses is well tested: The figure paid by our members since the global financial crisis in 2008 and subsequent years – the most severe test of the non-payment product to date – was over USD 50 billion.

1.3. Insurers do not present the same risks for financial stability as banks (which are often the counterparties for credit derivatives). For instance, they do not typically undertake maturity transformation and so are less vulnerable to sudden losses of confidence, 'runs', and contagion than banks.

1.3.1. One of the cornerstone principles for providers of non-payment insurance is that the bank retain a meaningful share of the risk covered: this focus on products that have meaningful risk-sharing features is viewed favourably by rating agencies (e.g., S&P Insurers: Rating Methodology dated 7 May 2013, p. 9).

1.4. Under the Solvency II Directive[8], regulated insurers must have a high quality of capital. To ensure that the capital required to be held by insurers is directly relevant to policyholders, insurers' capital is located where it is needed.

1.5. According to the 2017 XLCatlin Global Credit Insurance Monitor[9], credit insurance was seen by the policyholders polled as "the most efficient, transparent and acknowledged way to manage credit risk and to comply with corporate governance requirements".[10]

2. <u>Non-payment insurance would benefit from an acknowledgement or a clarification to existing requirements given its characteristics, particularly when compared to credit derivatives</u>

2.1. Unlike credit default swaps, non-payment insurance policies are personal contracts with a direct relationship between the covered loss and the actual risk.

2.2. Claims performance within the control of the bank: A recent survey of the top 9 brokers of non-payment transactional insurance for regulated financial institutions over the period 2007-2017 reported that 97% of claims made were paid on time/in full; the remainder were

7 As required by paragraph 123 of Basel III: Finalising post-crisis reforms, December 2017
8 DIRECTIVE 2009/138/EC of the EUROPEAN PARLIAMENT and of the COUNCIL of 25 November 2009
9 Global Credit Insurance Monitor 2017 - XL Catlin
10 Ibid, P.6

"compromised" due to operational failures on the part of the insured financial institution – and yet 44% of the "compromised" amounts claimed were still paid in settlement agreements.

2.3. The insurance claim process is much more in the control of the bank than a CDS settlement:

2.3.1. CDS settlement only occurs once consensus has been reached (1) that a credit event has been called and has occurred and (2) as to the value of the CDS, determined through an auction process, the framework of which has to be specifically established. Only once the auction has been completed does a settlement obligation exist, at which point payment is made relatively quickly via the clearing houses.

2.3.2. In addition, a CDS default trigger is potentially different to that of the insurance product in a default process: a restructuring enabled via a consensual route may not result in CDS triggering until the terms of the restructuring have been agreed. This can literally be months or years after a non-payment insurance policy has already triggered and paid.

2.3.3. Depending on the structure of the company, not all entities would be covered by a CDS; the bank's specific exposure may not be covered ("basis risk")[11].

2.3.4. In contrast, the claims process under an insurance policy operates differently:

2.3.4.1. The policy is already tailored to the specific exposure the bank is running and the bank has a direct relationship with the insurer, allowing communication and certainty during the claims process.

2.3.4.2. A claim can be made if the work-out has not been agreed by the time the cure/claim settlement period has elapsed (although, as noted above, the preferred course is normally that the policy is restructured to follow the work-out for the reasons detailed above).

2.3.4.3. The claims payment process is highly prescribed and includes a detailed timeframe and specifies the steps and information the bank must take or provide to successfully conclude the process.

2.3.4.4. The insured's rights under the contract, including damages for late payment, are protected by law and precedent.

2.3.4.5. The policy allows for active engagement by the insured bank to ensure its claim is processed in an acceptable manner.

2.4. Both export credit insurance and export credit guarantees are conditional. In practice, however, these conditions are under the control of the covered 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 bank had control, except for very exceptional circumstances such as fraudulent action on part of the bank.

[11] See for example, Financial Times article dated 25 July 2017: – "Credit default swaps: a $10tn market that leaves few happy

Question 11: Do you agree with the proposed guidance for the estimation of the LGD of comparable direct exposure to the guarantor? What concerns would you have about the calculation of the risk weight floor?

Berne Union response:

A. Due to strength of policyholder compared to unsecured creditors, we recommend to explicitly clarify favourable treatment for exposures to insurance companies where the bank is policyholder of a non-payment insurance policy.

B. And/or allow banks some discretion on LGD for exposure to insurance companies

- The argumentation is provided in our response to Question 6 under B and C.
- This is also a concern that should in our view be addressed by the EBA in responding to the Call for Advice of May 2018 (Section 2.4.5), regarding the "new requirement to treat guaranteed exposures under the same approach that the institution applies for direct exposures to the guarantor".

In addition to the above, we would like to provide the following supporting arguments:

3. <u>Privileged position of policyholders</u>

3.1. There is further evidence of the banks' privileged position as a policyholder compared to unsecured creditors' claims in the unlikely event of the bankruptcy of, in particular, a private insurer. Regulated insurance companies have minimal, if any, preferential debt. In addition, borrowings by insurance groups are done at the holdings level, outside the regulated entity which holds the capital and thus are structurally subordinated: the debt ratings of insurance groups are lower than the claims paying rating of an insurer, as reflected in ratings of insurers published by credit rating agencies.

3.2. In the case of officially supported export credits, government regulations, government ownership and/or being part of the central government allows for sufficient capital to pay claims to policyholders, and typically a claim on the central government itself.

3.3. As a policyholder of a multilateral insurer, the banks' position is even more privileged, given the extremely unlikely scenario of the multilateral's insolvency, as the shareholders are multiple sovereign states.

3.4. Article 275 of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009:

"1. Member States shall ensure that insurance claims take precedence over other claims against the insurance undertaking in one or both of the following ways: (a) with regard to assets representing the technical provisions, insurance claims shall take absolute precedence over any other claim on the insurance undertaking; or (b) with regard to the whole of the assets of the insurance undertaking, insurance claims shall take precedence over any other claim on the insurance undertaking with the only possible exception of the following: (i) claims by employees arising from employment contracts and employment relationships; (ii) claims by public bodies on taxes; (iii) claims by social security systems; (iv) claims on assets subject to rights in rem."

3.5. While not directly secured with collateral, claims of banks as policyholders benefit from ringfencing of assets to secure outstanding liabilities to policyholders at the operating company level in circumstances where the obligor is in distress by provisioning required by insurance regulators for exposures where the insurer has a potential claim liability. This ringfencing of assets for the benefit of banks as policyholders should be recognised, and therefore the 45% LGD under paragraph 70 of the Basel III: Finalising post-crisis reforms (p.66) should be modified to acknowledge this benefit to banks as policyholders, rather than creditors, of an insurance undertaking.

3.6. Fitch Ratings, having established the value available to creditors and the approximate scale of creditors at each level of priority, applies a waterfall to determine estimated recovery ratios, based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. According to Fitch Ratings[12], the typical order of seniority of creditors at operating company level is as follows:

1. Policyholder obligations with seniority (for example, life insurance policyholders in certain jurisdictions)
2. Policyholder obligations without seniority
3. Secured debt
4. Unsecured senior debt
5. Subordinated debt
6. Hybrids

[12] Fitch Insurer Rating Criteria, 11 January 2019, p.105: https://www.fitchratings.com/site/re/10058790