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ISRAEL'S EXPORT CREDIT INSURANCE MARKET

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Introduction

State intervention in the export credit insurance market is part of the wider issue of state support for exports.

For centuries mercantilist theory on international trade claimed the state must have a positive balance of trade – greater exports than imports – at all costs.[1] A country with a negative trade balance meant diminishing gold reserves which financed armaments, military recruitment, and national defense from external military threats.

Today government encouragement of exports remains a subject of global debate. Supporters of government export subsidies believe real economic growth can only be generated by a dominant export sector. Strong government agencies are the instrument for export support. Yet supporters of free trade note that government subsidies harm international competition and the multilateral trade system which has found expression in the World Trade Organization (WTO). Some economists warn that when a government amasses foreign currency, it can lead to a recession, such as happened in Japan. The ideal situation is balance because too great a deficit can accelerate inflation.[2]

In Israel, export encouragement is one of the declared objectives of the Ministry of Industry and Trade. The ministry has three instruments at its disposal: The Israel Foreign Trade Risks Insurance Corporation (IFTRIC); the Israel Export Institute; and the Marketing Encouragement Fund.[3]

Support of industry through the Law for the Encouragement of Capital Investment is also essentially an export support because one of the criteria for approving grants by the ministry's Investment Promotions Center is that the plant be export oriented.

This *Policy Studies* will focus on the first of the three instruments used by the Israeli government to support exports: state guarantees to cover insurance of foreign trade risk.

In 1999 Israel's export and domestic credit insurance only covered approximately 10 percent of the GDP. In the United Kingdom, by contrast, 18 percent of the GDP was insured commerce.[4] For years, the Israeli market was controlled by IFTRIC. In 1988, as part of the global trend to reduce state involvement in the sector, the government took a decision in principle to privatize the company's short-term insurance. Two private companies were simultaneously set up to operate in the sector: Clal Credit Insurance Co., Ltd., and Assure Ltd. They faced two problems, because the Israeli credit insurance market currently suffers from two key distortions.

The first of these distortions is the highly centralized market structure in which three companies dominate the market. This structure has a harmful effect which will be analyzed in depth later. The second distortion is the supremacy of political considerations in the foreign trade risk insurance sector. This situation has caused anti-economic decisions paid for by both the exporter and the taxpayer.

In this study we will first define the credit insurance sector and its business. Then we will compare the sector in different countries. The third part will chronologically examine developments in Israel's export credit insurance market. In particular, this part will review the State Comptrollers' investigations of IFTRIC. The fourth part will analyze the economic damage caused by the market structure. The final part will offer recommendations for reform.

Definitions and Concepts

"The sale of credit," as Israeli experts Fight and Klausner have said, "is essentially a question of goods held in trust until payment is received. In the Middle Ages high credit was provided without collateral, based on personal acquaintanceship between the buyer and seller. Nowadays, personal trust and friendship are an insufficient basis for making credit decisions, especially when the business is exports."[5]

The assumption behind credit insurance is that each business deal represents a collection of risks that can be predicted. Only one risk is not open to prediction and that is the risk surrounding the buyer. Credit insurance is intended to neutralize this risk. Similar to property insurance that insures a plant against fire, credit insurance insures the debts of buyers on credit. If the buyer on credit does not pay his debt, the creditor (the seller) is compensated by the insurance company, less the premium.

There are two accepted methods to differentiate types of credit insurance. The first is based on the policy's time period, differentiating between short-term of up to one year, and

medium- and long-term of more than one year. Long-term insurance may be investment insurance, or capital-intensive projects for infrastructure.

The second method is to differentiate between insurance covering commercial risks such as bankruptcy on the part of the buyer, and coverage of political risks such as war, nationalization or non-convertibility of currencies.

International Comparisons

Because the credit insurance market in Israel is in its initial growth stage, this section will examine global market trends and some specific markets that may be suitable models for the Israeli market.

As for the global market body, privatization is the trend. Fight and Klausner give special notice to a Dutch company, NCM, and a French insurer called Coface. Both are acquiring other firms as part of this privatization.[6]

The European market expanded greatly in the past decade, constituting 85 percent of the global credit insurance market which currently totals $430 billion in insured transactions with $5 billion in revenue from premiums.[7] The global ratio between premium and total insured amount is therefore approximately 0.012. The ratio between the insured amount and premium at IFTRIC is 0.003.[8] This means that in actuarial terms, IFTRIC is more exposed to a possible confluence of heavy future claims and relatively low premiums; if this happens, IFTRIC will find it difficult to carry on operations as usual.

In contrast to Europe, the United States and Canadian markets have not demonstrated similar growth in the past decade. It is not possible to determine that government intervention in the sector is a main reason for the undeveloped American credit insurance market. Ian Vasquez maintains the Export-Import Bank of the United States insures only two percent of all American exports.[9] According to one current authority, the reasons for this slow growth are not government involvement.[10]

Eighty percent of the Export-Import Bank's customers are small-scale exporters, but only a low percentage of the small exporters in the U.S. use the bank's services.[11] Moreover, in a survey conducted by the National Federation of Independent Business, the problems involved in exporting goods and services ranked last out of 75 potential problems.

Again, Vasquez found only 2 percent of American businesses considered export issues a problem. He quoted the National Federation of Independent Business as follows: "The reason exporting appears at the bottom of the list of small-business priorities seems obvious. Interest in exporting is modest; the American market has not been fully exploited in most instances."[12]

Nonetheless, the U.S. market is dynamic and is now developing quickly. The effects of globalization and e-commerce will be seen in an expansion of credit insurance. For example, the credit insurance premium of the Euler insurance company in the U.S. grew at an annual rate of

10-15 percent, compared to an average annual growth rate of 5 percent for all their other insurance premiums.[13]

Several models can be discerned in the global credit insurance market. While privately owned Dutch NCM was a sector pioneer motivated by pure economic incentives, privatized French Coface still adheres to the business policy of a "private company whose goal is to develop tools to support French exporters."[14] This approach is in turn different from the British, where the private sector is less obligated to the exporters' benefit.[15]

One of the basic issues on the current agenda following privatizations in the European Union, is the conversion of state agencies into "insurers of last resort." The private market took over commercial risk short-term insurance, while medium- and long-term insurance instruments remained the domain of state agencies. The latter claimed they should be allowed to insure short-term transactions as well in order to balance their investment portfolios.

Such a situation necessarily leads to a retreat from the reforms already enacted because the state re-enters short-term activities. This point is especially relevant to Israel, which also plans to privatize only IFTRIC's short-term insurance instruments.

In contrast to the U.S. market, the government of Canada is heavily involved in the credit insurance sector. This arouses antipathy among private Canadian insurers, and for this reason the Canadian model will be dealt with in depth.

Table 1

The State Share of the Credit Insurance Market in Select Countries

Canada	80%
Israel	70%
Germany	40%
Britain	35%
France	30%
Belgium	20%
The Netherlands	15%
United States	2%

Sources: Tom Leonard, "A Level Playing Field: Increasing the Competition and Capacity in Canada's Credit Insurance Industry," *Policy Recommendations of Insurance Bureau of Canada* (Ontario: Insurance Bureau of Canada, 1998), p. 7; Ami Kamir, CEO of Assure (presentation at a credit insurance conference of the Manufacturers Association of Israel, 26 February 2001; IFTRIC, "Financial Reports for 1999" (Kesselman & Kesselman accountants, Tel Aviv, March 2000).

The second model that will be examined is the British. The state quit the sector in the early 1990s, and a private market is developing.

The third model is in use in France and Germany, where there have been no problems since privatization. The state credit insurance companies in these two countries were completely privatized, but they fill a dual role. In addition to their ordinary business activities, they also insure exporters the state seeks to encourage. This insurance is on a commercial basis in the form of contracts between the state and the companies. The problem with this model is that the state is actually a reinsurer for the sums of credit it handles.

Canada

Tom Leonard is an expert on the Canadian credit industry. His finding is that Canada's credit industry insures only about 10 percent of insurable national sales of $300 billion. Exporters can offer less risk credit due to the non-use of credit insurance, which gives Europeans an edge over the Canadians because credit insurance is "more widespread in Europe."[16] The reason for lack of interest in Canada's private sector in credit insurance is the near monopolistic control of the market by the federal agency Export Development Corporation (EDC). Canada is the only country of the Group of 7 that offers domestic credit insurance, which increases the distortion and infuriates private insurance companies operating in Canada.[17]

The EDC operates in principle like a private short-term credit insurance company, but unlike a private company, it does not face cost/benefit pressures. As a government company, the EDC has crucial competitive advantages. These advantages, combined with the unrestrained competition vis-à-vis the private sector, harm the industry.[18] For example, the company is fully reinsured by the federal government at no cost, while private insurance companies pay substantial costs for reinsurance. The government company is also exempt from the three percent premium tax and income taxes.

Despite the unfair competition, four private export credit insurance companies operate in Canada, and 20 insurers are considering entering the sector if the mandate of the government company is reduced.[19]

Another distortion created by the EDC is the preference for high-volume businesses, with the result that small businesses with growth potential are uninsured. A similar charge is leveled against the Export-Import Bank of the United States. "An examination of the EDC's client portfolio for 1996 reveals that approximately 1,800 businesses with an annual turnover of less than $1 million [each] were insured [by the agency]."[20] Even though small businesses comprised the bulk of the company's customers, they amounted to two percent of the transactions it insured if calculated according to the total dollar basis. In the final analysis, the private insurers insured $3 billion worth of exports, while the state-owned EDC insured almost $16 billion.

United Kingdom

Before 1991 the situation in Britain was similar to the current situation in Canada. A single private insurer dominated the domestic credit insurance market, and the state was the owner of the Export Credit Guarantee Department (ECGD). This agency within the Department of Trade and Industry controlled the export credit insurance market. In 1991 the multinational

corporation NCM acquired the short-term insurance instrument with the result that British exporters now enjoy better insurance service.[21] Although the British credit insurance industry is privately owned, the state still offers reinsurance in cases of political risk for the medium and long term.

The number of export credit insurers has quadrupled since the state's partial exit from the sector in 1991.

An additional positive aspect has been the steady reduction in premiums paid by the insured.[22] Using the premium pricing charged by Britain's leading insurer Trade Indemnity as an example of this process, it can be seen that competition has led to manufacturers and exporters paying 38 percent less in premiums in 1996 than they paid in 1990. Despite the decline in premiums, the total premiums collected by insurers have risen with the market competition and the entry of new companies. Total premiums rose 5 percent in 1995-1996 from $500 million to $525 million.[23]

Today the British market insures transactions worth $280 billion, constituting 20 percent of GDP. The British case teaches that the state's leaving the market eliminates the subsidy that harms competition. In such a case, a small number of private companies in the market at the moment of privatization is sufficient to provide competition in the industry.

The Foreign Trade Insurance Industry in Israel

In turning to Israel's foreign trade insurance industry, we will highlight the work of three State Comptrollers and their invaluable critique. These reports from 1968-1999 (from which we quote liberally and paraphrase over the next several pages) are effectively "the literature" on the main government organization IFTRIC, the Israel Foreign Trade Risks Insurance Corporation.

IFTRIC was established by the government in July 1957 based on a recommendation from a committee appointed by the minister of trade and industry the prior year. The aim was to assess the problem of non-payment for exports, and to expand exports based upon credit. A company was formed, namely IFTRIC, and in the same year it was duly registered with the Government Companies Authority. In the following year, 1958, it began operations. It covered exports of consumer goods on short-term credit. Six years later IFTRIC extended its insurance business to contracting and services on credit. It also insured overseas investment.[24]

But IFTRIC's troubles began almost at once. It adopted what the Comptroller reports call one of its basic business principles: *comprehensive credit.*[25] Essentially this was a means to coerce Israeli exporters to insure all their export credit business. Or to put it differently, by putting a blanket rule upon every business to insure all of its exports sold on credit, IFTRIC, the state, affected the way all Israeli exporters were forced to take the export policies of the government into account regarding how much or how little to export on credit, and related business aspects.

Essentially this engendered a contradiction. It worked its way into IFTRIC. Since insurance risks vary across the spectrum of exporters, exporters were forced to take low-risk insurance they didn't want or else IFTRIC would be forced to take only high-risk exporters. Since the purpose of the state company was to encourage exports this discrepancy was bound to force the state into waste either way. The result was a predictable search to expand state authority and opportunities for insurance business — for example, IFTRIC offered insurance guarantees to bankers who financed exporters already insured by IFTRIC. Beyond this, IFTRIC extended guarantees to small exporters whose exports IFTRIC itself did not insure; these exporters were insured against "loans from export funds."[26] The aim of encouraging exports by insuring exporters soon became a program for finding things to insure and for coercing exporters. By 1972 insured exports totaled $150 million; double that figure in 1975.[27]

Israel's otherwise governmentalized, socialist economy, especially so in the case of exports, involved IFTRIC in the economy's problem with depreciated currency by 1981. Thus the Comptroller's Report of 1996 showed that IFTRIC had to be insured by itself, by the state. A program "was set up as an insurance arrangement, with the insurer being IFTRIC, which issued insurance policies to exporters while the Ministry of Finance [the state] acted as the re-insurer."[28]

And then the dike burst. Here follows the Comptroller's Report of 1996 at length.

Anatomy of a Failure: The Plan to Insure an Export Exchange Rate and Defense Exports

"In July 1993, the government halted the exchange rate insurance program effective 31 August 1993. IFTRIC continued to pay exchange rate insurance payments on exports delivered prior to the program's cancellation date, in accordance with the dates of payment….During the [twelve-year] duration of the program, IFTRIC paid a total sum of $4.2 billion in insurance payments according to its own figures."[29] This sum amounts to approximately $350 million annually.

Why did the state pay such high sums to exporters through IFTRIC?

"The payments relied on documentation testifying to the export deal (export registration) and on payments received overseas (a statement from the bank receiving the payment). An audit discovered there had been no proper supervision of the details of the export documentation that were the basis of the payments. Consequently, exporters received payments *they did not earn* [emphasis added]. The survey, which covered only a small proportion of the program's activities, discovered exporters received overpayments totaling hundreds of millions of dollars. In the course of the audit the State Comptroller several times warned the management of IFTRIC that the deficiencies in the program did not appear to be random errors, but a widespread and systematic phenomenon. Given the damage the overpayments to exporters caused the state treasury, IFTRIC should give the matter the attention it deserved….[Yet] the company's board discussed the subject only once…."

"IFTRIC explained to the State Comptroller that though it was aware of the problem of the data's reliability in the documentation, it thought that clause 8 in the reinsurance contract

between IFTRIC and the Ministry of Finance, that it was not required to examine the facts or documentation….Even after accumulated experience in managing the program showed the documentation — the basis for the payments — was flawed, the Ministry of Finance declined to demand that IFTRIC improve its supervisory mechanisms. The fear that the demand would be seen as burdening exporters was not justification for this failure."[30] Journalist Nehemia Strassler of the Hebrew daily *Ha'aretz* referred to the exchange rate insurance as "a gross and corrupting subsidy," which is especially appropriate regarding IFTRIC.[31]

To see what happened next we need to go back to the Comptroller's Report for 1995.

"Since the exchange rate insurance program for exporters began operating in the early 1980s, the Ministry of Finance held the position that these arrangements to pay exchange rate insurance were for exporters in general, and would not apply to certain defense exports. The idea was to prevent a situation in which the government would use the export encouragement budget to pay its own agencies financed by the state budget, or other agencies, for business deals to which the Ministry of Defense was either a party or the initiator….The State Comptroller carried out a random examination of the exchange rate insurance payments for defense exports. The examination revealed extensive payments for transactions that were ineligible for them under the Ministry of Finance directives. The State Comptroller [viewed] the behavior of a state corporation (Israel Aircraft Industries) with particular severity. It operated in defiance of the Ministry of Finance policy which it was aware of, and obtained exchange rate insurance payments by providing incorrect details in its export registration and other documents related to the sales. Even after clear instructions on this matter were given by the Finance Ministry in July 1991 to everyone involved…the Finance Ministry and IFTRIC failed to check whether exporters were following instructions."[32] Only after the entire exchange rate program was ended in 1993 did the subsidizing of defense exports by IFTRIC stop as well. IFTRIC was the company delegated by the state with the responsibility for managing a program involving great sums of money . It failed in its task.

Failure and Reform: Export Guarantees

In the Comptroller's Report of 1999 the history of this government company was reviewed.

"Since 1976, IFTRIC has been operating a program to guarantee export financing, designed to aid exporters who have already exhausted their banking credit collateral and who need additional credit. Under the principles of this program, guarantees are provided based on feasibility studies. They were provided without collateral except for a personal guarantee by the plant owners receiving the credit. The audit revealed there were many deficiencies in the program's operation during the period audited, including the absence of business caution by IFTRIC. According to IFTRIC figures, the company paid claims to the banks totaling $88.2 billion for guarantees it provided or renewed in 1990-1996. The state's participation in covering the claims…totaled approximately $33.2 million.

"…[T]he IFTRIC managing director deviated from his authority and company regulations in some of the guarantees. He did not disclose complete information about the risk involved in the guarantees or the findings and recommendations of reports on the…exporters' economic standing to the Guarantees Committee or the board of directors. Neither the board nor the committee properly supervised IFTRIC's management of the program…nor therefore did they prevent the losses engendered by the guarantees."[33]

Legal Steps

Now let us see how IFTRIC responded to its own mismanagement and possible legal irregularities:

"On 23 October 1994…the [Government Companies] Authority director notified Minister of Finance Avraham Shochat and Minister of Industry and Trade Micha Harish…that IFTRIC's board was going to discuss the results of the audit in light of legal advice it had received, and might decide to deliver the IFTRIC auditor's findings to the police for investigation, and the Authority's representative would support this action if it were proposed. On 18 May 1995, the Control Committee of the IFTRIC board of directors discussed what action the company should take against the managing director….

"The Control Committee decided that although the information presented to it showed evidence of improper management by IFTRIC's managing director, the overall aspects as presented by IFTRIC's legal counsel and the good of the company justified reconsidering legal action against him. The committee chairman noted his reservation to the decision, stating that the economic calculation of loss and time were irrelevant and that the managing director's actions in deviating from the board's instructions demanded the police be notified immediately. [IFTRIC's external legal counsel stated in an opinion of 14 June 1995 that] the company was obliged to deliver all information in its possession to the [responsible] ministers, the Government Companies Authority and the State Comptroller, but was not obliged to notify the police or file suit against the managing director….On 18 July 1995, IFTRIC's chairman of the board notified Harish and Shochat of the board's suspicions against the managing director and its decision on the matter. An examination by the State Comptroller in June 1997 showed that the ministers did not respond to the letter or notify the Attorney General as required by clause 67 of the Government Companies Law of 1975…."

"Following the audit and afterwards, the Ministry of Finance and IFTRIC instigated numerous changes in the handling of the export guarantees program, which shrank from $160 million at the end of 1992 to $31 million in June 1998."[34]

In January 1994 IFTRIC managing director Amior (Ami) Kamir resigned and was replaced by Doron Klausner. Reforms instituted in the company included changing approval procedures for guarantees for exporters. An interministerial committee was set up to convene at IFTRIC's request, while IFTRIC was no longer able to approve long-term guarantees without this committee's permission.[35]

The committee comprises two subcommittees. The smaller committee, headed by Ministry of Finance deputy general accountant Eldad Fresher, approves guarantees of up to $5 million. The larger committee, headed by the Ministry of Finance general accountant, approves guarantees larger than $5 million. Committee members include a representative of the Bank of Israel, the Ministry of Industry and Trade's Foreign Trade Administration director, and the Ministry of Foreign Affairs deputy director general for economics. Because the Ministry of Industry and Trade is in a minority on the committee it is harder for it to win insurance based on its own trade policy considerations; this is especially true since the Ministry of Finance usually fears risking state revenues, even when the Ministry of Industry and Trade claims it is to benefit Israel's strategic relations with other countries.[36]

IFTRIC managing director Klausner brought the company to profitability in 1997 with a profit of $10 million. He supports the state leaving the credit insurance sector, at least for short-term credit.[37] On 10 March 1998, the ministerial committee for privatization decided to privatize the short-term credit insurance market.[38] Immediately following the decision, Dutch and French foreign trade risk insurance companies expressed an interest in acquiring IFTRIC. Interest was also expressed by Assure Ltd., managed by former IFTRIC managing director Ami Kamir.[39]

On 15 February 2001, as the partial privatization neared, the courts approved a cabinet decision to split IFTRIC into two separate companies. The company that would handle short-term credit insurance, designated for privatization, began independent operations on 1 April. The privatization process is scheduled for completion by the end of 2001, after which the state will own only the medium- and long-term credit insurance company.

The Private Market for Export Credit Insurance in Israel

Until the 1990s, IFTRIC had a total monopoly on the export credit insurance market. In 1981, the Israel Credit Insurance Co. Ltd. began operating. It was limited to the domestic market, while the Ministry of Finance's supervisor of capital markets and insurance banned IFTRIC from providing domestic credit insurance. In early 1994 NCM joined the Israel Credit Insurance Co. as a strategic partner.[40] The Dutch company is one of the two largest credit insurance companies in the world. The partnership enabled the Israeli company to offer export credit insurance as well as domestic.[41]

Clal Insurance Co. Ltd. took control of the Israel Credit Insurance Co. Ltd. in 1998, buying 70 percent of the company's shares in May 1998.[42] Clal Insurance completed its takeover in March 1999, buying NCM's 30 percent stake. The name of the company was changed to Clal Credit Insurance Co. Ltd.[43]

In July 1999 one of the world's leading credit insurance companies, Gerling, bought 20 percent of Clal Credit Insurance's shares as a strategic investment.[44]

In 1996 a group of former IFTRIC managers headed by Kamir founded Assure Ltd., a subsidiary of the Israel Land Development Corporation Insurance. The company planned to operate in the domestic and export credit insurance sectors.[45]

These three companies, IFTRIC, Clal Insurance and Assure, dominate the export credit insurance market. Besides being highly concentrated, the market also suffers from limited insurance capacity. Kamir claimed upon founding Assure in 1996 that Israel's export insurance market insures only $5 billion of a potential $17 billion market because of the "lack of suitable insurance services for exporters."[46]

Analysis of Damage by the Export Credit Insurance Monopoly

1. Trade Distortion

The following remarks, made by the CEO of Assure, Ami Kamir, in February 2001 show an important awakening among Israeli businessmen: "Israel's export sector has been severely distorted, if not interfered with, because of state intervention in the credit insurance sector, and because IFTRIC is a monopoly. In the 1960s, Israel attempted to develop strategic relations with newly independent African countries. A resulting policy was the state's exploitation of credit insurance — mostly long-term credit for project execution — to encourage Israeli exports to Africa."[47] The politically motivated focus on the African market proved to be ineffective after most African countries severed diplomatic relations with Israel in the wake of the 1973 Yom Kippur War. Israel found its trade relations elsewhere were lagging, which would not have happened had it concentrated from the outset on exports to developed countries such as the United States.

The harmful pattern of state intervention in trade policy was repeated in the early 1990s. In 1992 Minister of Finance Yitzhak Moda'i was urging the privatization of IFTRIC. A year later, Minister of Industry and Trade Micha Harish delayed the move in order to promote Israeli exports to Eastern Europe, and especially Russia, following the collapse of communism and the region's opening to the West.[48]

In 1993 in a Knesset debate on the activities of the Ministry of Economics and Planning, MK Meir Sheetrit (Likud) put his finger on the problem of government preferences for particular export destinations:

"There are many industrial companies in Israel that could be chief or subcontractors for economic projects in the United States and Europe worth tens of millions of dollars. Their biggest problem is obtaining foreign trade credit insurance. Without insurance, they cannot be chief contractors, with the result that they must cooperate with American companies who become the chief contractors because they have access to foreign trade risk insurance, while the Israeli contractor is doing all the work building the project. The most prominent example is [the Israeli company] Ormat…which built a geothermal plant for Southern California Edison. The only reason Ormat was not the chief contractor was its inability to obtain foreign trade risk insurance. I wish to express my opinion on this anti-economic matter. Successful companies that actually carry out projects worth tens of millions of dollars in exports, are left without remedy."[49]

Supporters of long-term credit insurance, mostly intended for infrastructure projects, have a set slogan for placing emphasis on the developing world, regardless of economic feasibility:

"market failure," i.e., the private market will not provide long-term credit insurance for projects in the high-risk countries of the developing world. Therefore the state must intervene. The government essentially declares that economically feasible projects in developed countries can wait. Long-term insurance in unstable economies is the prevailing fashion.

In 1999 IFTRIC approved medium- and long-term transactions in Brazil, Uzbekistan, Turkey, Romania, Mexico, the Philippines, Croatia, Venezuela, Sri Lanka and Argentina. These countries carried IFTRIC's highest risk rating for medium- and long-term transactions.[50] Nevertheless, the total insured turnover in developing countries was $1.5 billion, 63 percent of the total long-term insured turnover in 1999, which amounted to $2.4 billion.[51]

Is there an actual market failure in Israel in long-term credit insurance?

Clal Credit Insurance, which has been active in the export credit market for only three years, was prepared in September 2000 to insure high-risk countries. The insurance was made possible by credit insurance giant Gerling's 20 percent stake in the company. Clal Credit Insurance expanded its operations in Eastern Europe by signing a strategic agreement with Russia's leading foreign trade risk insurance company. In China, Gerling obtained a government license to promote insurance and expand its activities in the country.[52] Gerling's activities show that the market exists, and is functioning well.

In another instance, a dispute arose between the Ministry of Finance, which did not want to approve insurance guarantees for export transactions with Russia, and the Ministry of Industry and Trade, which strongly supported the move, to the point of offering to finance it out of its own budget. To the latter's disappointment, local manufacturers chose not to take advantage of it.[53]

In January 1998 IFTRIC's managing director announced the company was offering a $20 million insurance package to exporters interested in short-term transactions with Russia. The government approved the package. Minister of Industry and Trade Natan Sharansky said: "The program is designed to accelerate short-term exports to Russia, and to increase them by $50 million a year."[54]

Sharansky emphasized that he considered Eastern Europe in general, and Russia in particular, a key target for expanding Israeli exports. Despite the government's efforts to direct international trade, exports to Russia fell in 1998 from about $256 million to about $185 million – a 30 percent plunge.[55] Russia's severe debt crisis of August 1998 merely served to underscore the problematic nature of the government's export encouragement policies.

The policy of encouraging exports to areas that could be considered economically high-risk applied not just to Eastern Europe and Russia, but also to the Far East. In February 1998 IFTRIC offered a $75 million insurance package to Israeli exporters to South Korea and Thailand. Klausner said: "There is a mixed assessment regarding the economic climate in the region. Today [1998], indicators are much more favorable following the debt settlement between the World Bank and International Monetary Fund (IMF) and South Korea and Thailand."[56]

Ministry of Finance general accountant Shai Talmon, who approved the renewal of the insurance after a meeting with Klausner, did so in the belief the decision was part of a wider program to encourage Israeli exports to Asia.[57] By December 2000, Klausner was much more conservative about the economic situation in South-East Asia. In a published interview, Klausner stated: "The heavy intervention by the IMF encouraged renewed growth in Asia, led by South Korea, followed by Thailand and Malaysia….Many reforms are still needed in some countries. For example, China's government has the challenge of privatizing many heavily indebted and troubled state-owned companies. We are aware of worrisome signs including falling Asian stock exchanges, the crisis of parent companies Daewoo and Hyundai, and the collapse of two of Japan's insurance companies."[58]

It may be that IFTRIC was aware of the medium- and long-term insurance risk of South-East Asian markets in particular and emerging markets in general, but relied on the cross subsidies from the more profitable short-term instruments: Ministry of Industry and Trade attaché of economic affairs to Denmark and the Netherlands, Mordechai Ish-Shalom, commented on the privatization of short-term instruments: "The acquisition of IFTRIC [its short-term insurance instrument] at the right price could give the new owners a handsome return. There are no miracles and wonders in the foreign trade risk sector. Generally, short-term commercial insurance transactions subsidize the higher risks inherent in medium- and long-term political insurance, which remains in the hands of the state."[59]

2. Absence of Credit Insurance as a Lever to Finance Export Transactions

The credit insurance market is expected to supply not just direct credit insurance, with policies being issued to exporters. It has two other vital functions, in terms of financing credit transactions: factoring and letters of credit for the financing bank.[60] In Israel, the stunted development of the private sector's credit insurance has had the side effect of leaving these two financing tools largely undeveloped as well.

Factoring: Factoring offers both the exporter and the factoring company advantages over standard credit insurance. The main advantages for the exporter are:

1. Factoring effectively creates a temporary financial resource. Even if the deal is based on credit, the exporter guarantees immediate payment for himself by effectively selling the debt to the factoring company. The payment is completely risk free, in contrast to coverage by an insurance policy, which requires a claim to be filed in a time-consuming and uncertain process.

2. Public companies can utilize "debt selling" as a method to reduce the account payable item in their financial reports in order to improve their financial balance, especially prior to floatation.

3. Small and medium-size exporters can essentially outsource all or part of the their credit management, thereby saving collection expenses on the debts.

The factoring company also has a major advantage over credit insurance: It handles the exporter's debts directly, unlike credit insurers who must rely on the insured party to handle the debt. A factoring company can identify changes in the debt payment at early stages, allowing for more rapid response than is possible by credit insurers.[61]

In Europe, as a result of the move to the open sale of credit in recent years, there has been a substantial increase in the use of factoring as a financial resource. The global factoring market is estimated to be $600 billion a year, and to be growing steadily by 10 percent annually. The industry has not developed in Israel because IFTRIC does not offer factoring services. Only Clal Credit Insurance has offered quite limited factoring services.

Letters of credit for the financing bank: An exporter with credit insurance is offered the opportunity to transfer his rights to the bank. When an insurance company provides such a letter it means that any payment the insured party is entitled to under his policy is paid to the bank. Alternatively, the bank is made the beneficiary of the policy in the event compensation is paid on the policy. This type of security is extremely important for the banking system because it provides external protection.

In the early 1990s many exporters in Israel tried to obtain bank financing for overseas credit transactions. They did this because IFTRIC was effectively the sole guarantor in the export credit market and its insurance capacity was inadequate to meet the market's demand. Exporters unable to obtain credit insurance were forced to provide the banks with static guarantees. The exporters accepted bank financing for their transactions, but they had to invest in the bank's stock on the bourse.

This closed circle meant that nonpayment of debts by overseas customers led to massive sales of bank shares by exporters needing immediate financial resources. By 1993, a serious crisis overtook the banking sector, mainly due to the absence of credit insurance.[62]

Besides the potential damage to the banking system, it is now obvious that exporters who are unable to provide the banks with insurance policies for the sale of credit will find it quite difficult to obtain financing. For example, IFTRIC and Citibank have an agreement allowing Citibank to finance approved IFTRIC-backed transactions. Citibank Israel CEO Nandan Mar said: "The Citibank branch, and the bank's Structured Trade Finance Group, view IFTRIC's program as a basic product for the bank's domestic activities."[63] He added that in early 2001 Citibank Israel offered $185 million to finance IFTRIC-backed export transactions. This raises the question, what does an exporter do when IFTRIC, for reasons mentioned above such as trade distortions, does not back him?

In the past the exporter had no insurance solution. The situation has improved now with the entry of Clal Credit Insurance and Assure to the market. While private companies may not insure economically risky exporters, there is also a concern that successful exporters might not receive insurance due to the market's low capacity.

1. The Government as Reinsurer: the Foreign Trade Guarantees Law

The legal basis for IFTRIC's activity is the Foreign Trade Guarantees Law (1959). Articles 2 and 3 of the law stipulate:

"The minister of finance is authorized to guarantee in the name of the state of Israel a guarantee given by a person in respect of losses arising from export transactions or to guarantee against such losses directly. A guarantee under this law may be given for export transactions generally or for a particular export transaction or class of export transactions and for losses generally or for a particular class of losses, on such conditions as the minister of finance may think fit….Guarantees under this law may be given if the finance minister thinks it will encourage exports."[64]

The law's language reveals that IFTRIC is used only as an insurance instrument by the government, and that the government effectively authorized itself to be the sector's reinsurer by allocating guarantees for exports whenever the minister of finance saw fit to do so. In fact, the distortion would remain even if IFTRIC's short-term credit insurance were to be privatized. There is nothing to prevent a private company from turning to the government to act as reinsurer instead of or in addition to IFTRIC.[65] It can be said that state reinsurance is a subsidy paid from the state budget, and that insurers are the country's taxpayers.

Unlike in an ordinary business deal, no dividend is paid on success, but only for failure. The case of the long-term credit insurance on a $500 million infrastructure deal with Turkey may turn out to be an example. IFTRIC saw no problem with this insurance and did not even demand a letter of indemnity from the government.[66] IFTRIC has not altered its policy towards Turkey, assuming that Turkey would receive an IMF emergency loan if the political system took strong action on economic reform, and the economic situation would stabilize. Such a policy is acceptable for a company in the private sector, but when the country's citizens are not asked if they wish to invest their taxes in a high-risk market, the policy becomes illegitimate. However, IFTRIC believes increased state intervention in the medium- and long-term insurance market is a positive development.

Along these lines, Klausner claims: "One of the company's major achievements in recent years is its ability to convince the decision-makers, headed by the Ministry of Finance general accountant, to improve the coverage terms for medium- and long-term transactions….The improvements include the extension of the credit term up to 10 years, raising the coverage to 90 percent, agreeing to finance premiums for joint projects, and expanding coverage to investment insurance and commercial risks. The government's willingness to expand its participation in the long-term risk sector can be seen in the significant rise in the number of approvals in recent years…."[67]

The economic significance of the exercise of the state guarantees in the event of a Turkish economic crisis, for example, would not only be the budget expenditure amounting to hundreds of millions of dollars, but the totally *unplanned nature* of the expenditure. Such scenarios have already happened in other countries. A good example is France's Coface prior to its privatization.

In the early 1990s, the company incurred losses on insured loans, and the French government was forced to increase its 1991 expenditures by FF 6 billion to cover them.[68] The significance of the budget breach to the economy should not be minimized. Budget breaches on this scale can adversely affect inflation targets as well as causing unplanned budget diversions from essential allocations.

After reviewing the distortions created by the law, we can now estimate the damage it can cause. According to the letters of guarantee issued by the state of Israel under the Foreign Trade Guarantees Law, the state guarantees IFTRIC losses (and in turn, IFTRIC pays guarantee fees to the state) in the following ways:

a. The state is guarantor for all politically caused losses the company incurs up to $200 million. This sum is also intended to protect IFTRIC's equity in the event it falls below $5 million, or if underwritten economic damages in a year exceed twofold the net premiums earned in that year.[69] As of January 2000, the Ministry of Finance does not reinsure for coverage of short-term political insurance. IFTRIC bought alternative reinsurance for these risks from Israeli and foreign reinsurers.

b. The state as reinsurer provides full coverage for medium- and long-term insurance up to $200 million.[70]

c. The state periodically guarantees specific political risks.

The total potential damage is $400 million.

2. A Low Premium Structure as an Entry Barrier to the Sector

Given the complicated nature of the actuarial calculations necessary for determining foreign trade risk insurance premiums, and the inability to predict economic crises, political changes and other catastrophes affecting debt repayment, premiums are often based on one company copying another's premiums.[71]

Export credit insurance premium rates in Israel are among the lowest in the world. This situation is bad for the credit insurance sector because insurers will tend to take fewer risks due to the low premium flow.[72]

The low level of premiums is a side effect of the longstanding state monopoly. In a 1984 interview IFTRIC managing director Ami Kamir was asked by the insurance magazine *Bitu'ah* why a government credit insurance company was needed, and why private companies did not enter the sector. Kamir responded: "States try to maintain low premium rates due to the tough competition in exports, *which do not offer adequate incentive for the entry of the private sector*" (emphasis added).[73]

Table 2

International Comparisons of GDP/Premium Ratios

Country	GDP/Premium Ratio
Spain	0.059%
France	0.054%
Benelux	0.054%
Germany	0.049%
United Kingdom	0.046%
Italy	0.023%
Israel	**0.018%**
United States	0.004%

Sources: Tony Dowding, *Developments in Credit and Political Risk Insurance* (London: International Credit Insurance Association, 2000), p. 41; Ami Kamir, CEO of Assure (presentation at a credit-insurance conference of the Manufacturers Association of Israel, 26 February 2001); IFTRIC, "Financial Reports for 1999" (Kesselman & Kesselman accountants, Tel Aviv, March 2000).

The low premium structure may deter foreign companies from entering Israel, leaving them satisfied with the acquisition of shares in existing Israeli companies or strategic partnerships with them. As noted earlier, this is how Gerling and NCM entered Israel in the early 1990s. Coface obtained a license to enter the Israeli market in 1999, but preferred to wait to participate in the IFTRIC privatization tender. Financially, it seems unfeasible for a foreign company to establish an independent insurance presence in Israel due to the low expected premium flow.

Doron Klausner claimed in an interview with the author that premiums have fallen from an average (on insured turnover) of 0.007 to an average of 0.003, but thought the reason was competition in the sector.[74]

Eldad Fresher believes "low premiums will not last for long in the insurance market. Companies must buy reinsurance. No reinsurer will participate in an insurance coverage tender if the premiums are unfeasible. The process is global, and exposed to the global market, and it is therefore unreasonable that insurance companies will maintain fire-sale prices over time."[75]

3. Status Quo Versus Innovation

Advocates of state support for exports believe state insurance agencies are able to consider macroeconomic data and make determinations for the benefit of the general population. One of the important variables, according to supporters of state encouragement of exports, is employment. Their assumption is that there is a direct proportional correlation between a country's exports and the level of employment, which in turn generates a general improvement in the standard of living. An Israeli company that manufactures its product in Israel for export, benefits from credit insurance because it promises it safety. Thus, such insurance encourages Israeli exports, which generate employment. However, for whatever reasons, not every company is interested in manufacturing in Israel. One consideration is the lower labor costs in other

countries. A second consideration is a desire to be close to one's markets in order to reduce high transportation costs. A third consideration is the ability to respond quickly in competitive markets, and the final consideration is political. There are cases of an absence of diplomatic relations between Israel and certain countries, with whom nevertheless there are commercial relations. The ability to market Israeli goods through third countries helps overcome political hurdles.

Because IFTRIC was given the political objective of encouraging Israeli exports as a macroeconomic variable, the company never considered a situation in which an Israeli exporter would manufacture overseas, and sell the goods through third countries without moving them through Israel. When Assure entered the market, it offered an innovative service: Insurance for transactions including the purchase of goods in one country, and marketing them in a third country, without the goods having a "Made in Israel" label, or being shipped through Israel. Clal Credit Insurance also offers special export insurance policies for goods manufactured overseas. The competition left IFTRIC with no alternative, and it too began marketing innovative policies that included the insurance components noted above.

The story of one exporter will serve as an example of the importance of credit insurance companies' ability not only to respond to national economic changes, but also to respond to the needs of specific exporters:

"The Palram Industries group of Kibbutz Ramat Yohanan currently has 15 subsidiaries in Israel and overseas, which manage a number of plants for the manufacture of plastic sheeting, warehouses, marketing and representative offices spread worldwide, including Britain, France, the Netherlands, Belgium, Italy, the United States and in the Far East. The group's total sales are $100 million a year….In the early 1990s, Palram realized that its target markets were changing as customers preferred buying smaller quantities than previously, with shorter delivery times. Customers preferred holding smaller inventories and relying on shorter delivery times by their suppliers. Palram decided to respond by building plants under its ownership, with the result that Palram became a company that manufactured over half of its goods overseas. Being a local manufacturer overseas, close to its markets, gave the company a competitive advantage both in Israel and overseas….Palram began obtaining IFTRIC coverage in 1983, even being paid claims submitted over the years. Palram is currently considering expanding its insurance coverage for goods manufactured in its plants in the United Kingdom and United States — making use of the new policies which offer the possibility of insuring goods not made in Israel."[76]

Summary and Recommendations

This study examined Israel's export credit insurance market. It paints a dismal picture of state intervention in the sector. The state had monopoly control for over four decades, that only began to crack in the mid-1990s when private companies began operating and the government decided to consider privatizing part of the sector's operations.

This study has described the distortions and damage caused to Israel's economy from the overcentralized structure of the sector, and the complex state intervention in the management of

the insurance industry, characterized by conflicting objectives, including contradictory national interests and foreign policy goals, and macroeconomic policy goals versus the net economic feasibility objectives of particular exporters. The damage has included adverse affects on the competitiveness of Israeli exporters in international markets, possible harm to taxpayers, inefficient allocation of resources, and the nondevelopment of supplementary financial instruments for Israel's insurance industry.

The reforms recommended below have three aspects: Legislative change; privatization of short-term credit insurance instruments; and outsourcing long-term credit insurance.

Recommended Reforms

1. Abolishing the Foreign Trade Guarantees Law (1959)

This law is a remnant of a time when there was thought to be an urgent need for government encouragement of Israeli exporters, and economic growth was believed to be dependent on exports, therefore deserving the highest national priority. The global credit insurance market was undeveloped everywhere, and only governments were prepared to take the insurance risks. This situation no longer exists. The industry is highly developed, and there is a global trend for the state to get out of the industry and for the private sector, to take over. Privatizing IFTRIC without abolishing the law will not get the government out of the sector, because under the law the minister of finance has the authority to provide letters of indemnity (guarantees) to cover insurance for any exporter. The result could end up being the transfer of the subsidy from IFTRIC to a private company, but the legal status of the state as reinsurer will remain.

2. Completing the Privatization of IFTRIC's Short-Term Credit Insurance

The decision to privatize the short-term credit insurance was taken three years ago. The tender is only now being published, with the aim of completing the process by the end of 2001. Any delay in the privatization will hurt the chances of multinational companies entering the Israeli market, which lends urgency to the process. Exporters will also ultimately pay the price, because of the market's stagnant capacity. Although short-term credit insurance currently relies on private reinsurers, it still enjoys state coverage, such as the protection of IFTRIC's equity.

3. Outsourcing Medium- and Long-Term Credit Insurance

Medium- and long-term credit insurance will not be privatized, because the government sees a "market failure" for this time frame. The problem is that medium- and long-term insurance is riskier, because the longer time frame increases the chance of an event occurring that will require the payment of the policy, especially for long-term political risks. The government, therefore, should spread the risk and not be the sole reinsurer in the sector. The state must turn to the private sector for long-term insurance budgets, in order to handle specific cases of demand for insurance, effectively creating a mechanism of tenders for long-term credit insurance. Private companies will compete to provide insurance, while the state only acts as manager of the tenders.

Though the government claims there is a market failure in the long-term credit insurance sector, the private market has already begun proving itself as a long-term credit insurer (see the section on trade distortion above).

If we take the example of the company Hermes, a private company managing the German federal insurance program on behalf of the German government, one can see that the company has miraculously succeeded in setting precise premiums for risky transactions. The premium for state transactions is classified as the highest risk. For three-year credit periods the premium is calculated at 5.7 percent of the insured export.[77] This is a very high premium indeed for a sector in which the accepted premiums are measured in thousandths of a percent, but if the exporter is willing to pay such a premium to the state, why shouldn't it be paid to private companies? It seems the reason for the government's unwillingness to give up its control in the long-term insurance market is purely political.

Israelis would be better off if the market functioned in Israel, and this is true for the long-term credit insurance market as well. Economically speaking, there is no reason for this not to be done — to say nothing of freedom.

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