When the going got tough

Late last year, a group of brokers and insurers met in London to discuss the impact of the economic downturn on claims in the private trade credit and political risk market – and how their industry dealt with the perfect storm.

Participants

Chairman: Peter Flint, head of international arbitration, Barlow Lyde & Gilbert
Kit Brownlees, managing director, political, project and credit risks, AJ Gallagher
Charles Berry, chairman, BPL Global
Olivier David, head of special products, Atradius
Mark Cooper, managing director, TFC Brokerage
Claire Simpson, political risk underwriter, Hiscox
David Neckar, product development director, political and credit risks, Willis
Peter Sprent, deputy head, political risk and credit, Ace Global Markets
Paul Sanders, AVP, Zurich EMS in London
Nick Robson, head of credit and political risk, JLT Solutions
Neil Ross, senior vice-president trade credit, AIG (Chartis)
Andy Lennard, director and founder, Texel Finance
Bernard de Haldevang, head of financial and political risks, Aspen Insurance UK

Flint: This has been a torrid period for insurers and those they insure alike. Are there going to be casualties?

Robson: I think it is highly unlikely at the moment that any of our insurers will collapse into insolvency as a consequence of their credit and political risk losses. That they may exit our marketplace, or reduce what they do, is quite possible. You need to look at what we've experienced so far in the context of the insurance market at large.

Depending on whose estimate you listen to, and in which week you talk to them, and whether it's the two or four or five-billion dollar number for structured credit and political risk losses, that – to our insurance market – still represents a modest-sized natural catastrophe of the nature that they tend to deal with in most years. I don't think we are or should be expecting to see a series of insurers heading into insolvency, but possibly reducing participation, being forced to reduce because reinsurance is being reduced, or choosing to exit.

Berry: Whatever the claims number is, it's a big number for the [political risk insurance] market, but it's not a big number for the insurance industry.

Brownlees: Most insurers are multi-line insurers anyway, and cover themselves with a portfolio of different business classes.

Ross: I think that for the reinsurers, the test of their appetite for this class of business will come when their treaties come up for renewal. You may well see some casualties there.

Berry: But withdrawing or reducing capacity is a completely different issue to an insurer folding.

Sanders: I think we can be pretty satisfied at how the trade and investment insurance community has come through this period. Crucially, this market has stayed open. While lots of other markets have closed altogether, we have continued to service our clients and our products have been seen to respond.

Robson: Staying open when the syndications part of the market has disappeared and when the enormous liquidity of the CDS market in recent years has just evaporated was a hugely valuable thing to do.

Just yesterday I was talking to a client who intends, as a direct consequence of the good performance of the insurance market, to step up their use of insurance, and will buy considerably more going forward where they can.

Lennard: I think it has been a milestone year for the market. The day of reckoning came [in 2009], and the insurance market

has responded precisely as we had hoped. I do feel though that there are one or two stories out there, whether it be bad broker placement or insureds not behaving properly and understanding what they actually signed up to.
You are going to get that in any market, and, obviously, time will tell how many insureds do finally get their claims paid and what impact that has on various brokers' E&O [errors and omissions] insurance. But by and large, it has proved to be the landmark year that those of us who have been around for a few years have probably waited for.
Robson: That points back to the product. Everyone here would probably agree that this is a product that did not need to revalidate itself.
There have been landmark years before, and claims paid, but what was critical [now] was that over the last five years banks had become the majority buyers of the product, which had developed and became clearer for the purposes of Basel II, and this was the first test of the product in the Basel II context. The revalidation of the product in the current context has been particularly valuable.
Neckar: These are still early days. You're right – it is great that we got through what we have. But what we shouldn't be doing is congratulating ourselves that this product is performing. You say to a bank that it is great news that claims have been paid. Well, that's what is supposed to happen, isn't it?
I think the issue that's coming up, taking on the Basel II point, is timeliness. What we've noticed as the year has gone by, from our perspective and what we're tracking, is the time from settlement date to payment date. We now have a table, tracked for quantum against time, which we are intending to share with clients and underwriters. As we go through the year, we can see that some insurers have been performing promptly, and others have been performing less promptly.

Flint: How do you define 'promptly'?
Neckar: It is very straightforward. There's a claims settlement due date in the policy. We are tracking it from that date, whether it be from the waiting period or the agreement of the proof of loss. We can say that from the date at which payment is due, under the policy, we now have a clear table of performance.
David: Are you comparing the settlement against the time that the insured actually paid the premium?
Neckar: We will be comparing premium payments against claims payments as well. We are also making sure it's clear that it is the due date adjusted for the cash transfer process, but we don't want to get into that kind of detail. The fact is, we are tracking it, and we will be sharing that data with underwriters and with clients, as it is very instructive.
Sanders: I think that's quite a harsh approach to take, because, first and foremost, there were doubts among financial institutions over whether this product would perform well under stress testing, as it has been. From what we are hearing, it has on most occasions. There has been a large volume of claims in the market. I think it tends to happen once in every 10 years, and I think that the back-office procedures and loss-adjusting side of things were not initially geared up. So it has taken some time, and I would expect to see improvements.

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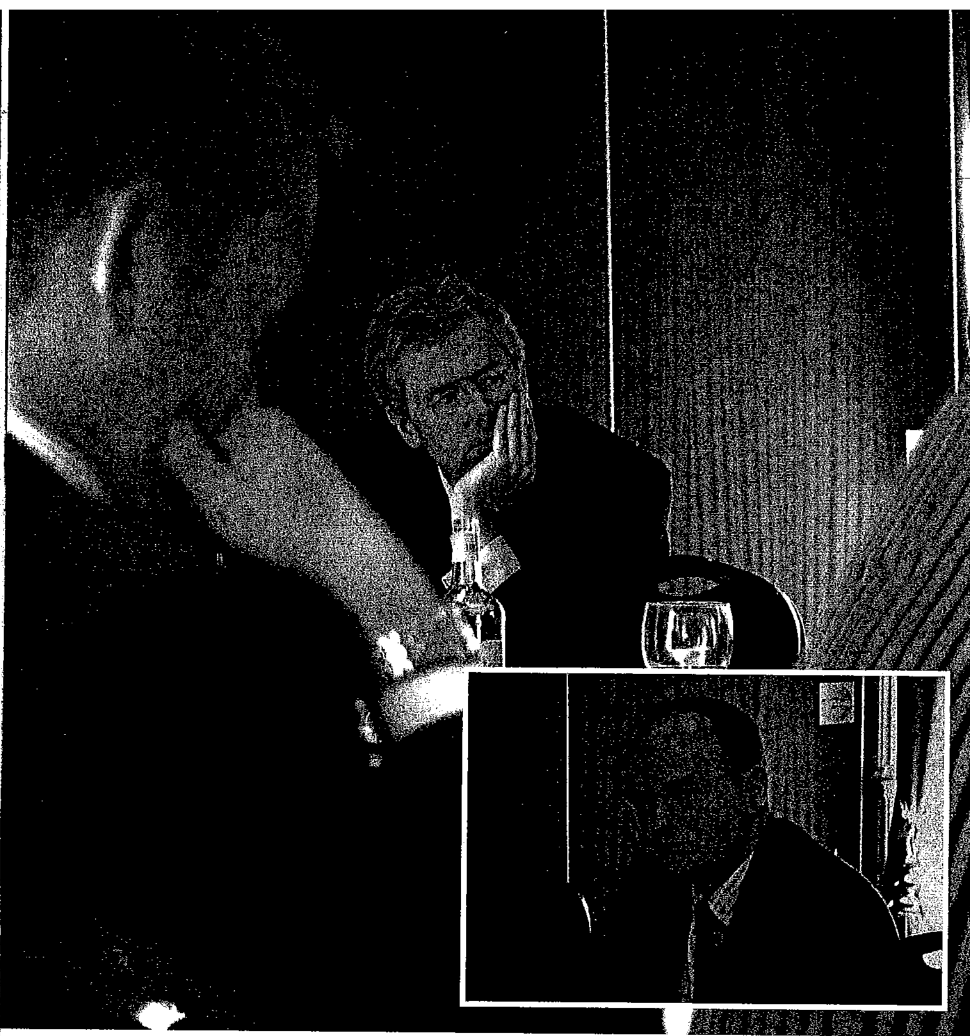
>
> **Andy Lennard, Texel Finance**

Neckar: I don't think that we, as a community, have totally cottoned onto the fact that our banking clients regard time as money. And there is no excuse. Imagine that you have concluded a forward exchange contract, and you expect delivery of dollars at a certain date, and then your bank says 'unfortunately, I'm terribly sorry, but Mavis is ill this week, and we haven't got the backlog sorted out'. Well that message really doesn't work.
Brownlees: That's a valid point. Some insurers – but not all – just don't have the back offices to cope with claims in a timely manner, and that's been amply proved in the last year or so. Is there enough general infrastructure, not just amongst the brokers and the insurers, but among the lawyers and loss adjusters?
David: You cannot have the structure to deal with a perfect storm on a regular basis. We have never seen that many claims for such an amount. We could not, as underwriters, have had enough back-up people or loss adjusters ready to do that. For the past 10 years, they would have been paid for doing nothing.
Neckar: I don't necessarily agree with that. We've had at least a year since Lehman Brothers went down. If you are under-resourced, there are other options.
Berry: The message should still be that we have come quite a long way, if the debate about claims is whether you're getting it on the due date or 60 days later. Among many people who are not close to the market, the assumption is still that you have to litigate, but that's just a myth. It didn't need revalidating to people who have looked at the claims performance in the past. But, as you say, we have a new audience, and on the whole, with the few exceptional cases that we all have, the product is working, albeit not always quite as cleanly as we would like.
Neckar: Basel II says it must be a timely payment of claims. And the difficulty is that if there are any delays – and we are all part of the chain, brokers as well as underwriters – the damage done from one poor performance has a disproportionate effect throughout the entire community, and that's just something we have to recognise.
Sprent: Our market has been very open to addressing issues such as late payment interest, claims payment timetables and so on. It's not in insurers' interests to be paying losses late unless they believe that there is a genuine reason not to pay a claim in the first place.
David: From your experience, when are the claims being paid?
Neckar: We have a wide range of people who pay within four days, and within 70 days, on our initial calculation.

Flint: What are the effects of these losses on the reinsurance market?
Robson: Returning to the reinsurance ramifications, we recently surveyed quite a few insurers and a number of reinsurers to put some kind of sense on the impact of losses. In aggregate, there would be a reduction in what we'd call structured credit and political risk insurance capacity of 20% in 2010.
This said, I think an aggregate 20% reduction is something we can probably cope with due to what's happened in terms of reduction in world trade, commodity prices and so on. The other side of it, which I'm slightly more concerned about, is the possible negative influence of reinsurers on the actual terms and conditions of the product, without necessarily understanding the nuance and detail associated with some of the advances we have made in the clarity and value of our products.
We have experienced some negotiations in recent weeks where insurers have advised that some aspects of wordings that have been in place for the past few years need to be revisited due to, among other issues, reinsurer concerns. My concern is that we may put at risk the very high current level of goodwill among bank clients, having had such a successful year with the product, by going backwards on the positive advances in conditionality



"What we shouldn't be doing is congratulating ourselves that this product is performing. You say to a bank that it is great news that claims have been paid. That's what is supposed to happen, isn't it?"

David Neckar, Willis

that did not and would not have changed the claims situation. I don't think it's a huge problem but I do see some issues emerging, linked to Basel II.

Flint: There are many young bankers who haven't experienced a full-scale crisis before. Do you think it might have been difficult for them to persuade themselves and their customers to incur the cost of insuring these transactions?

Lennard: I think one has to make a distinction between bankers that have funded trade and bankers that have used trade as an instrument for investment. Within that distinction, there are banks that have funded trade for hundreds of years and those that go in and out. The latter, to my mind, have no place in the arena that we all work in. Those that are consistent and have been in there in the years that we have all been exposed to, are the ones that constantly buy the product, or are learning that they have to buy the product, because it is the only stable, consistent, syndicating party. You can't sell risk to 40 banks anymore on a trade transaction. So those bankers know they have to reply on the other syndicating channels, which now consist of a handful of hedge funds and a multitude of insurers, but that's it.

Sprent: I think that distinction between trade and non-trade, or synthetic trade, is going to be a key. But I don't recognise those comments made in terms of the responses or discussion that we are having with reinsurers.

Where underwriters have to hold up their hands on lessons learned is that we didn't stick to what we knew and have always been good at, which is proper trade and not getting involved in loans to banks that are made to look like trade. Or letters of credit, in respect of financing goods that aren't going to end up in the country where the emerging market bank is anyway.

The definition of the trade debt used in Kazakhstan for the Alliance Bank restructuring holds lessons for all of us. From our perspective, going forward, the difference will be that we will be focusing on the old-fashioned definition of trade.

De Haldevang: I agree with you that just because a transaction has 'trade' in front of it, that doesn't mean it is necessarily good, or that because it doesn't, it's necessarily bad. But that's another issue. I wouldn't necessarily subscribe to sticking to pure trade. I think it's more a question of knowing what you are getting into, and working out what's going to happen to it when it goes wrong. Kazakhstan is an interesting one, but it's unclear how it's going to be treated, and how that's going to affect the market. But I also don't recognise the comment about the reinsurers. We have been having a debate with our reinsurers on this very issue of whether or not having trade in front of it makes it bad. And they are accepting that as a concept. But we are in a situation where we are putting that to the test as a market, to see how it works out.

Sanders: I think Zurich is relatively relaxed about the reinsurance schemes as well. We expect to be offering the same capabilities next year with or without reinsurance.

Simpson: There are a number of players who don't buy any reinsurance. We are going to be maintaining the same country and credit lines going forward, so I think there is a positive story to tell about the people whose management is still supportive of this class of business and wants to see it grow off the back of the problems that we have seen over the past year.

Flint: Let's expand on this issue of capacity levels.

Berry: There is some uncertainty about what the capacity of the market is going to be next year. Our feeling is that the pure, traditional political risk lines are going to lose a little capacity, but not anything of significance. The structured credit area is going to be hit in terms of capacity, which is going to produce a pretty hard market for that product and will mean that it is extremely profitable. What is different today is that although this is not the first time that the PRI market has had a large wave of claims coming through, there is a new maturity in the market generally. This time around the PRI market is being viewed as just another established class of business. We are not having any of the 'this is a class of business that we should never have been doing in the first place' reactions.

It is more a case of 'this is a class of business that we support, it's had a bad time; what are the opportunities going forward and what should we do in the changing environment?'. That is a very healthy sign.

Berry: It comes back to the point that everything we do, and want to continue doing, does not fit neatly into this 'trade' box. Fundamentally, though, our class of business supports what people are now calling the utility side of the banking industry, and basically doesn't go anywhere near the 'casino' side of the banking industry. That distinction is now well-understood – we're firmly in the business of supporting lending from banks to real businesses.

Lennard: It is not just the banks, but the providers of capital. These are the traders and to a lesser extent the banks. I think that one can be quite brutal, as an insurer and as a broker, to ask which side of the fence they sit on. Are you a lender, are you a facilitator, are you a taker of risk? Because the market will only support a defined role, which has to be produced upfront in order to get the capacity necessary and achieve the end result. I think the blurring of various roles has caused damage.

Robson: During our survey of a number of insurers, one of the consistent themes was the absolute focus on who you are insuring. For some years we have increasingly focused on what risk has been insured but at the expense at times of who has been insured, which is particularly important for an indemnity product. Now there is a refocus on your client and how they operate and perform. A widespread comment was that we are absolutely there for the key clients, who we believe are there with the same products, support and procedures. And that's a positive message, but it does mean that there is perhaps a more peripheral group of clients or irregular users or entities that have had strained dialogue with underwriters through claims processes that will find it more challenging to buy protection next year.

Flint: In terms of insurers' country ceilings, where is capacity currently lacking?

Brownlees: On country ceilings, from our point of view as brokers, we just find insurers being very selective, which is not a bad thing.

Sprent: It's a matter of appetite, and the experience that the underwriter is having in certain countries. We are learning new things about the way that countries deal with crises and banking problems. So I think it's more a case of underwriters being very selective and looking at who they are insuring.

De Haldevang: I think the other factor on the country scene is that ceilings can be affected by erosions through claims payments and they can be affected by events in those countries. However I don't think that for the right deal, in this market, there is any problem in any particular country.

Ross: We would certainly grade countries, and our appetite and capacity is very much dictated by that. As we have seen, many countries have been downgraded over the last 12 months, and that has certainly affected our appetite.

De Haldevang: And you'd expect that on the trade credit side. On the medium-term secured side, that's less of an issue. It's the transaction itself and the security behind the transaction that gives us our internal view of how that risk should be rated.

David: I agree with that. We have some countries where we see business going to develop and for which appetite is there, like China and other Asian countries, for example. But eventually, the portfolio might become unbalanced and we might then see certain issues there.

Flint: In which regions are you seeing interesting developments or potential problems?

Lennard: The role of China over the next few years is intriguing. I would say they are certainly having a much harder time in Africa than they first envisaged. And what will the Russians do this winter in the Ukraine? There is no question in my mind that the Chinese, and to a much lesser extent the Russians, are playing some games that will become quite apparent in the next 12 to 18 months, particularly if you expect China to continue growing at 7% or 8%. Is that resource nationalism, or just the re-alignment of global forces? Certainly Chavez and his friends in Beijing

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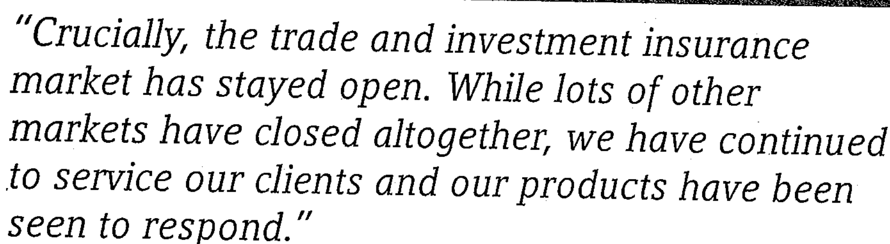
Kit Brownlees, AJ Gallagher



"Crucially, the trade and investment insurance market has stayed open. While lots of other markets have closed altogether, we have continued to service our clients and our products have been seen to respond."

Paul Sanders, Zurich EMS

are going to get closer. And then you have the Cuba issue – at some point in time, the Cubans are going to have to turn around and talk to the US as the Castro family ages.

Berry: What you might call the western crisis – because this has been a crisis that originated in the West and has had its biggest impact there – has certainly produced a fundamental shift in geopolitics. But back to this question of whether there has been an effect upon the perception of clients about these risks – I actually think there has. Starting last September, people finally seem to have woken up to the fact that pure political risk – I'm talking about the 20% of our market that deals with confiscation and political violence and so on – has moved up the agenda in companies. We see opportunities in that area that were visible 18 months ago.

Sprent: At the start of [2009], we built into our plans that there would be a heightened perception of risk, and that we would begin to make more use of our pure political risk capacity. Perhaps because of the huge pressure on corporate budgets, which is pushing people to keep their expenses down, it still seems to be viewed – except for a few extreme circumstances – as a discretionary spend within an overall insurance budget. It's not like employers liability insurance that you have to buy. It's a 'nice to have'. Also, clients' expectations of pricing and what underwriters are prepared to give are miles apart.

Brownlees: Yes, I think our corporate clients are increasingly concerned about credit and counterparty risk, which is good, but they are not rushing to take out confiscation-type risks.

De Haldevang: The market has seen a fall in income and a rise in claims on the default side, and some parts of the market are wanting to refocus on what they see as the traditional political risk markets area of CF [contract frustration] and CEN [confiscation, expropriation and nationalisation], and so there is an element of unrealistic competition in the pricing, even though the CEN market is probably less lively in terms of claims than it has been in the past few years. There is a strange pattern going on there, which is not tenable.

Sprent: Also, the losses in the market have seen a refocusing among insurers on their return on capital, and thus on pricing. Even though the claims in the past have been low, there has been more activity recently. The pricing has been so low, and I think there will be minimum pricing thresholds, which insurers will be looking for. At the moment, there is this gap in expectations on both sides.

Flint: There may be a distinction between political risk insuring trade and selling political risk insurance for big projects, in terms of the size of the claims which might be generated. Is that a factor, from a pure political risk perspective?

Berry: What I think we are seeing is more people being much more aware of country risk and political risk, as well as credit risk.

Neckar: It's inescapable, these things have cycles. Now that the benign cycle has finished, companies are looking much more closely at their budgets, and it's not as easy to access the insurance budget to buy political risk cover. One of the reasons for the growth of the credit side of the political risk market is that the insurance can make the transaction happen, so it's a cost which is paid for in the transaction.

By contrast, the payment for protection of an asset against expropriation is a drag on the business' operating costs. And I think the issues that we will have to deal with increasingly will be business interruption and products like trade disruption. People are going to be less worried about their assets than the impact on their earnings and their stock price. The question to come back to, perhaps, is whether it is possible to claim for P&L-type business interruption losses under a bilateral investment treaty (BIT).

Sprent: A recent survey indicated that the expectation of major western multinationals for 2010-12 was that they

are not looking to expand greatly in terms of foreign direct investment. Where the FDI is coming from is places like Brazil and China, and companies in those markets have a very different attitude to risk and return, especially the Chinese. We are not yet able to fully penetrate those markets in terms of servicing them and convincing those companies that they need our products.

De Haldevang: I think there is a general, fairly stable trend though in those emerging markets, which quite like FDI but don't want to lose control of their assets, and so will often maintain a controlling host stake. This still allows new investments to come in.

Berry: To bring us back to the insurance market, it's true that the perception of risk is fundamentally different to what it was. I do agree that it's pretty difficult to translate that increased perception among our traditional client base into insurance dollars in the bank. I continue to think that a significant part of the reason for that is because the traditional products that we offer them aren't quite right in this area.

Simpson: That's exactly the point. Contract frustration and credit are very saleable products. If you don't get paid, or goods and equipment are not delivered, you are going to get your claim paid. Whereas investment insurance, for me, can be a much more complicated area. Unless it's a straight smash-and-grab, working out whether there has been an expropriatory act can be problematic. So if you are a client, that's a luxury item.

Flint: Quite an important point arises out of that. Expropriation of substantial investments isn't subjective, because there is a huge body of jurisprudence as to what constitutes expropriation, and what doesn't.

Examples range from a government setting a discriminatory tax, to an ICSID arbitration in which I was involved a few years ago where it was alleged that the court system in India, being an organ of government, had abused their position towards investors in a power project, to the extent that they had lost all of their rights of recourse.

Neckar: Those circumstances were there before the risk was written. Staying on this theme, we were talking recently to an export credit agency [ECA], which said they were dealing with a client that wanted to make a resource investment in similar circumstances, and they wanted to cover the actions of the local courts because they saw them as an extension of the country's government and not an independent judiciary as we have in more developed countries.

One point here is how the perception of risk is leading people to look at different coverages, which are not necessarily available, and we know that the whole purpose of this market is to be flexible. Stepping on from that, why is it that the ECAs sometimes get treated differently to the private market, in that the buying of political risk from ECAs is often a much simpler proposition?

Flint: Regionally speaking, which markets are proving interesting to you?

Lennard: Brazil probably interests all of us, as it now has the Olympics, the World Cup coming up and huge quantities of oil have also been discovered. Out of all the South American countries, they seem to have weathered the storm extremely well. But given the fact that there have been some defaults in certain sectors, what is the underwriters' view on medium-term risk in Brazil, and their appetite to underwrite the risk there?

De Haldevang: It's a sector-related problem. People were underwriting short-term commodities on a long-term basis, and things went wrong. I think Brazil has fantastic opportunities, particularly the resource sector.

Lennard: There is certainly a move to expand the licensing to allow more foreign insurance companies in there. And there is a desire by the Brazilian government to expand the use of insurance away from federal insurance companies. Is that something that the insurance market here wishes to embrace?

David: If Brazil allowed licences to western insurers to write credit and political risk business for their exports, or credit for their domestic business, it would certainly make a huge difference for our business and would strongly support their local industry, creating a win-win situation. We feel the same about China or India.

Neckar: The problem with Brazil, if you go back, is that the IRB [Brazil's federally controlled reinsurer] occupied a dominant role that was both statutory and also had an underlying frictional cost. That market has to clean its act up, so that there is a clear ability to issue paper that a corporate will find acceptable. It will take a while.

De Haldevang: This is where Lloyd's has a huge advantage, as it already has a foot in there. It is quite attractive from that perspective.

Sprent: I think the potential in Brazil is huge. We have seen a significant improvement there as a place to do business over the past two to three years. I think it is still very much a question of picking the right partners, as there is still an inherent risk in doing business there.

Also, there is so much liquidity in the local market already, as shown by Santander's recent IPO. They are throwing money at every sector, cutting down the need for cross-border lending into Brazil. So there isn't much demand for our products, and when there is, pricing is very low.

Flint: Can we finish with a discussion of pricing issues?

Lennard: I know that brokers have certainly benefited from the rise in premia, but how do insurers see it over the next year. Do you see rates staying at these levels for the structured trade product?

Sprent: Talking generally, a key focus has to be the results for certain sectors of our business like structured trade credit, and sectors within that area, such as letters of credit, which have generated huge flows of business into our market.

But if you talk to certain underwriters, their loss ratios are several hundred percent for letters of credit. If we are going to continue to get support from our capital providers and reinsurers in that line of business, then we will have to show better returns, meaning that we have to have higher pricing than before going into this crisis.

With regard to the contraction of capacity that we are going to see going forward in the structured trade credit market, prices will continue to rise. My fear is that people withdrawing from the structured trade product will look at their political risk and commodity finance results, and think 'that's the area we need to be in, given that reinsurance support is generally available'. That would then push prices down again in that area.

Sanders: We also need to be realistic and acknowledge the fact, that, to a degree, banks are a major part of our business. And to a degree we are somewhat capped in terms of what we can charge by what they can charge

Lennard: For the borrower this is still, on a net present value basis, the cheapest time to borrow. I think that there will only be a certain few names that can go to their local bond market.

The rest are going to have to use the structured product, and whether it is two years with six months grace, or three years with one year's grace, we are going to see names that you have been underwriting for the past five to seven years coming in and borrowing as much as they can. There are likely to be capacity issues, and I think the pricing will stay up. ●

This roundtable event was organised by emeafinance's sister publication, Global Trade Review.