

WELL COVERED?

With the reinsurance renewal season just round the corner, *Trade & Forfeiting Review* talks to five of the top names in trade credit insurance to gauge their opinions.



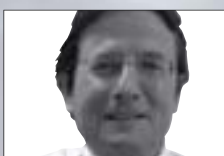
THE PANEL



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Q1. HOW GREAT IS THE RISK THAT THE BIG REINSURERS WILL REDUCE THEIR CAPACITY FOR TAKING ON TRADE-RELATED RISKS WHEN RENEWAL SEASON COMES ROUND IN THE NEW YEAR?

Adrian Lewers, Beazley:

Our view on trade-related business as it relates to banks is that we think there will be a significant reduction in capacity. We consider that the complex combination of systemic risk, adverse selection and inadequate pricing over the cycle mean that this kind of business will not be insurable going forward.

The systemic weakness in the global banking system is new. While insurers will continue to accept risk on the asset side, they will not be willing to insure banks' trading activities where the bank-to-bank contract is separate from the underlying transaction. Where there is no recourse to the underlying trade, and a concern that trade-related finance is actually working capital by another name, insurers have limited recovery options.

Adverse selection complicates the picture further. Generally, banks prefer to syndicate risk with other banks, with risk participation partners (such as other financial institutions or insurers) or, in the last resort, the insurance market. The risks that are brought to the insurance market often represent a relatively narrow portfolio that others, for whatever reason, have already rejected. Experience over the cycle has shown that pricing is unlikely to be adequate to reward risk-taking of this kind.

For these reasons, we believe that trade-related finance no longer passes muster; capacity will be severely limited going forward; and banks will need to find an alternate market in which to lay off risk. By contrast, trade finance – for example, letters of credit, supporting defined trades – does not present the same risk and, as such, will find appropriate coverage.

Reinsurers are also concerned about commodity transactions generally and soft commodities, in particular, with regard to price risk.

Kit Brownlees, Gallagher London:

While some of the big reinsurers, such as Swiss Re, have already announced capacity reductions and, in some cases, of quite significant amounts, there have been newcomers to the class, such as Ariel Re and AXIS and other long-term reinsurers, such as Hannover Re that have confirmed their commitment to it.

On the 'single situation' side, renewals will depend on the direct insurers underwriting results and we could see some withdrawals or reduced capacities. Overall, there will be a reduction in credit capacity available in 2010, but it will not be the Armageddon that some were forecasting a few months ago.

Moreover, many multinationals are looking at alternative excess-of-loss credit structures, sometimes with the use of captives, and this will provide additional capacity. Therefore, unless world trade booms in 2010, there should just be sufficient trade credit available to cover most requirements. Indeed, it is interesting to note that Atradius recently announced that it has increased its credit insurance capacity for 13,000 UK businesses with the print and paper industry expected to benefit.

Anthony Palmer, BPL Global:

We expect to see a small reduction in capacity for contract-frustration risks (CF). For example, for public sector obligors, and a bigger reduction for credit risks (CR), for private sector obligors. We also anticipate that tenors for CR will be shortened, with some insurers who can currently go out to five years cutting back to three years.

Mark Cooper, TFC Brokerage:

There is no doubt that reinsurance for the whole-turnover trade-credit insurance market will be reduced. Whether adequate replacement capacity can be negotiated remains to be seen, but it is likely that insurers will be paying a higher price with more caveats.

The specialist structured-trade markets are less affected as their results have been better, but capacity will remain tight, especially in certain markets: FSU, Pakistan, Sri Lanka and so on. TFC Brokerage has seen a greater push by financial institutions to utilise insurance cover and other risk mitigants to support the transactions they wish to undertake. However, a concern is the removal of capacity from the trade finance market by the withdrawal of certain players and potential limitations on new business.

Dan Riordan, Zurich:

Given that the trade credit industry is emerging from the worst global economic crisis in about 100 years, we would expect to see some reinsurers reduce their capacity. However, as conditions are improving, we may also see some reinsurers increase their capacity, new entrants emerge or carriers increase their net capacities.

The favourable conditions result from the fact that most losses have been identified and recoveries are underway. Also, rates are stronger than they have been for some time. I think overall, we will see some reduction in appetite from reinsurers, with some of them limiting their capacity to a smaller number of carriers to better control aggregations. Demand from banks and exporters will increase for the limited cover available, as global trade rebounds during the recovery. This could drive rates higher in 2010.

Q2. HOW HAVE INSURERS AND THE COVER THEY ARE PREPARED TO OFFER BEEN AFFECTED BY THE SHARP DECLINE IN TRADE OVER THE PAST YEAR?

Adrian Lewers, Beazley:

The credit environment and loss experience have affected insurers' appetite for a range of transactions and counter-parties. While there is no significant reduction in the coverage insurers are able to offer, it will only be offered in circumstances where insurers are able to properly assess the risks and to companies with a demonstrably good track record in their sector and with the insurance market.

Kit Brownlees, Gallagher London:

The insurers who have been most affected by the sharp decline in trade in the past year have been those who had a significant part of their portfolio produced by the banks. Bank trade and export finance was severely reduced from the third quarter of 2008 onwards as liquidity dried up. Those insurers who had a wider portfolio of business covering a mixed group of exporters, contractors and traders in addition to banks, have been less affected.

Obviously, those insurers that have experienced significantly reduced premium income at the same time as rising claims have been suffering. On a more positive note, bank lending activity has picked up quite quickly in the last quarter of 2009.

Anthony Palmer, BPL Global:

Insurers have become much more selective over the past year, especially for CR business, but this has been caused more by the deteriorating creditworthiness of obligors than by the decline in trade. The one area that has been affected by a slow down in demand is the reduction in bank syndication business.

Mark Cooper, TFC Brokerage:

Naturally, the balance sheets of traders and manufacturers have been affected by the decline in both tonnage and prices in the past 15 months. It is frustrating that insurers sometimes do not realise that this translates into financial results.

We should also highlight the positives. The insurance industry has proven its worth in the current crisis. Economies, especially in certain locations, remain dire and much support will be needed for recovery. A tentative figure of \$4bn has been mooted as the level of current claims in the trade finance and structured trade market. This is a huge sum by any calculation, but despite that, the market remains strong, open for business and claims are being paid. Insurers are actively assisting in restructurings and recoveries and that has to be a benefit for trade worldwide.

Dan Riordan, Zurich:

Most insurers are writing less business following the worst decline in global trade in recent memory. Financings in support of trade and investment declined measurably, but the demand for cover on the remaining transactions has been robust. The transactions and related covers has been more traditional, with less exotic structures taking a back seat. This will continue in 2010.

Q3. WHAT KIND OF CHALLENGES HAVE EMERGED AS INSURERS' COUNTRY CAPACITIES FILL UP?

Adrian Lewers, Beazley:

In general, capacity is freeing up rather than filling up as insurers write less business and exposures start to run off.

However, in some countries, such as Ukraine, Russia and Venezuela, there is no doubt that capacity has been reduced. Appetite for risk in developed nations could also best be described as mixed, given the rising incidence of insolvencies as economies start to emerge from recession. Insurers are likely to be wary of offering cover on companies unless they have a demonstrable cashflow and liquidity, market position, a track record and manageable debt levels.

Kit Brownlees, Gallagher London:

In the present market it is not so much a country-capacity issue as a selection one. Because of the downturn in world trade there are very few capacity countries. The issue is more that insurers are very reluctant to write business in a country where they are experiencing significant claims activity, such as Kazakhstan and Ukraine, for example. Also, sectional claims activity plays a factor.

Anthony Palmer, BPL Global:

The reduced risk appetite of banks has had a double effect on the insurance market: first, traders and exporters have seen a reduction in supply from the banks, which has increased demand for alternative insurance products; and, second, the banks that have remained active have become bigger buyers of insurance. These two factors have put pressure on most insurers' country limits, notably Russia, China and Turkey. Inevitably this has pushed up pricing, in the same way that bank margins have increased.

Mark Cooper, TFC Brokerage:

Utilising specialist arrangements, maximising the relationships between frequent reliable users of insurance and underwriters – the usual problems we often face in structuring transactions for clients!

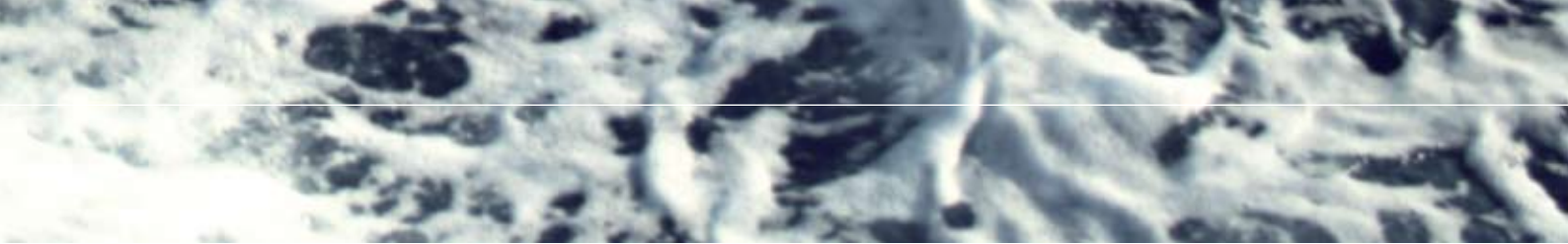
Dan Riordan, Zurich:

Insurer country-capacity constraints have subsided somewhat during the past year, but are still a problem in a few high demand countries, such as Russia, Turkey, Brazil and China. Should the market contract in 2010, country capacity issues will most likely become a significant problem again, leading to rationing of cover to customers.

Q4. WHAT EVIDENCE HAVE YOU SEEN OF RISING RESOURCE NATIONALISM, OR INDEED, FINANCIAL NATIONALISM?

Adrian Lewers, Beazley:

Resource nationalism has tended to rise along with the gradual climb in commodity prices. Although the recent reduction in prices temporarily halted that trend, it is still a feature of the business environment in places like Venezuela, Russia, Bolivia, China and certain parts of Africa. As a general trend, we believe emerging markets are becoming more confident about flexing their



political muscles when they see third-party investors exploiting natural resources.

'Financial nationalism' too seems to be on the rise, particularly in countries where the financial system is under stress and administrators are taking unorthodox views on debt restructuring. Also, where the western economic model may be seen to be flawed, it is possible that governments may start to adopt measures that damage the status quo.

We note that trade disputes are also on the increase, with an increase in the imposition of tariffs at some ports as governments seek to protect domestic markets.

Kit Brownlees, Gallagher London:

Fortunately, the example set by Venezuela, Bolivia and Ecuador has not been universally popular. In a time of severe foreign direct investment constraint would-be copy-cats have not thought it sensible to go down this road. There have, of course, been issues – especially in some of the former CIS countries – as economic conditions deteriorated, but not so much as to create a major problem.

Anthony Palmer, BPL Global:

Resource nationalism tends to be a feature of high commodity prices, which is why there has been less evidence of it since the commodity price bubble burst 18 months ago. Having said that, resource nationalism is still prevalent in countries like Venezuela, Bolivia and Ecuador.

Mark Cooper, TFC Brokerage:

This has been limited in Asia, but there is undoubtedly a greater concern as to the potential defaults of sovereign entities. Managing supply chain security, involving raw materials to the major manufacturing countries, especially as this usually involves emerging markets, is key. Corporates and countries are realising that economic clout is limited where unstable regimes are involved.

Dan Riordan, Zurich:

Resource nationalism is alive and well, particularly related to natural resource projects in mining, oil and gas. There are many examples throughout the emerging markets, especially in Latin America, Africa and the CIS countries.

Q5. HOW HAVE INSURERS' PERCEPTIONS OF THE RISKS OF WAR AND TERROR CHANGED AS A RESULT OF THE FINANCIAL CRISIS AND THE DOWNTURN IN TRADE?

Kit Brownlees, Gallagher London:

Unlike the credit insurance market, the terrorism/war market has very large capacities available with a great deal of competition to write the class. While there have been some specific areas of difficulty, such as hotels (because of Mumbai and Jakarta) and piracy (Somalia), not to mention Pakistan and Iraq, coverage has generally been plentiful.

Anthony Palmer, BPL Global:

A tough economic climate increases the risk of political violence. However, war and terrorism are not the only forms of political violence and civil unrest is more closely correlated to economic

conditions. Insurers' perceptions of the risks of war and terror are influenced more by geo-political factors than by economic factors. Nevertheless, the link between economic hardship, political extremism and political risk is a historical fact.

Mark Cooper, TFC Brokerage:

Quite rightly, credit and risk are at the forefront of buyers' minds. We have a client who wished to ensure that war risk was specifically included in its trading risks with exchanges. Damage does not have to occur to cause a loss and credit committees are willing to shave spreads for the comfort of specific cover.

Dan Riordan, Zurich:

Economic crisis can have profound implications for stability in an emerging market country. Increased political violence, in the forms of civil unrest, rioting, revolution, war and terrorism can result. Fortunately, some countries have weathered the storm very well and have avoided violence, but others have been hit by collapse of commodity prices and a severe banking crisis, which has led to economic volatility and some political violence.

Q6. HAVE YOU SEEN ANY RESURGENCE IN INTEREST IN PROJECT FINANCE – OR DOES THIS REMAIN MORIBUND?

Adrian Lewers, Beazley:

The only interest we have seen has been for projects in the power sector, especially in Asia. In our experience banks are currently proving unwilling to lend on complex projects over long timeframes.

Kit Brownlees, Gallagher London:

To quote Baroness Vadera, there have been some "green shoots" appearing in the project finance area, particularly in the power, and oil and gas sectors. Power, however, is a difficult class for insurers because of the claims they experienced in this sector a few years ago – Indonesia, Pakistan and India spring to mind. Thus, it is very difficult to get their attention, particularly if licence cancellation/PPA cover is required. Oil and gas projects (including pipelines) are more favourably looked upon, although in certain countries, such as Russia, there is a critical examination of both national and local issues.

Mark Cooper, TFC Brokerage:

There have been some interesting projects, many connected with supply-chain security, with extractive and greenfield projects high on the agenda, as well as infrastructure projects in Indo-China, Indonesia and the Philippines, the latter certainly as a result of the 2010 elections scheduled. Conversely, the ongoing uncertainties in Thailand have restricted much investment there.

Dan Riordan, Zurich:

Well secured and heavily structured trade financings are more common than project financings at this time. As the recovery continues, we will see project financings and securitisations return, but it is still a bit early given the severity of the financial crisis and its impact on the banks. □