Enabling growth. Securing capital. Recovering from crisis.

POST-EVENT REPORT

ENABLING GROWTH. SECURING CAPITAL. RECOVERING FROM CRISIS.

On 10 March 2021, Marsh Specialty and TXF welcomed nearly 400 guests for an exclusive client webinar to help guide insurance users in Asia, Pacific, Middle East and Africa on their post COVID-19 recovery journey. Looking back at the webinar, here are some of the key discussion points.

Credit risk review

Setting the scene was Nick Robson, Managing Director & Global Head of Credit Specialties, Marsh Specialty, along with David Edwards, Co-Head of the UK Credit, Bond and Political Risk team at Guy Carpenter. Nick and David provided attendees with a comprehensive review of the macro and credit risk environment.

As we emerge from the COVID-19 crisis, there have been higher rates of negative change in country economic risk, as measured by Marsh Specialty's proprietary World Risk Review ("WRR") rating tool[1], especially in emerging economy medium term sovereign and commercial credit risk. These changes have highlighted the growing disparity between emerging nations and industrialized economies, as industrialized economies were in a stronger position to provide and sustain relief measures throughout the crisis. S&P Sovereign Credit rating data also displayed a higher percent of sovereign credit downgrades in economically weaker regions throughout 2020. Forward looking, S&P predicts high sovereign credit downgrades in Sub-Saharan Africa, Latin America, and Eastern Europe.

The Moody's Global Speculative-Grade Default Rate highlighted the impact of the COVID crisis in view of historical crises (e.g. late-90s, dot-com bubble, and the global financial crisis). According to Moody's, the long-term global speculative-grade default rate averaged 4.2% over the last 40 years. By contrast, the COVID lockdown crisis default rate is expected to peak

[1]The WWR provides a monitored view on how the risk environment by country changes over time. WWR provides risk ratings across nine insurable perils for 197 countries. WRR's Country Economic Risk index indicates where a country is in the economic cycle and is a more nuanced way of assessing risk than simply looking at sovereign credit risk. According to WRR, if a country's economic risk score increases, the economy is slowing, stopping, or going into a recession; conversely, if the risk score decreases, the economy is in a stage of growth or expansion.

at 7.3% (in March of 2021). However, their latest forecast predicts a positive recovery with default rates returning to a “normal” level of 4.7% by the end of 2021. This signals resilience and confidence as countries and corporations look to the future.

According to further data from Moody’s, there is a notable difference between the US speculative-grade corporate default rate and that of Europe and the rest of the world. As of December 2020, 64% of global corporate defaults (by count) were attributed to US corporates, compared to just 18% for Europe. This variation is driven by the US adhering to typical market economics (such as less state support) and therefore the US economy is expected to emerge from the crisis with less drag. However, well-intended government relief measures in Europe may stifle growth and extend the recovery time in this region, as the number of “zombie” companies existing before the crisis (estimated at over 10,000) has multiplied.

According to Moody’s, the COVID crisis has negatively impacted almost every industry sector in terms of default rate, with the hospitality sector suffering the largest deterioration in risk, followed by the automotive industry.

The impact of COVID crisis on the insurance industry has varied, with loss reserves standing at less than US$1 billion across traditional credit specialties lines, and total insurance industry reserves standing at approximately US$30.5 billion (according to Marsh data as of January 2021). Based on current loss and risk data, credit specialties market losses over a two-year period may range between US$10 billion and US$20 billion. This would represent an annualized loss ratio of 18-37% over the two year period and would be considered a modest loss ratio for a catastrophic experience. If government relief programs come to a halt in the first half of 2021, trade credit insurance claims are expected to increase in the second of half 2021. In contrast, at this time Marsh Specialty does not expect a significant uptick in surety and political risk claims, as the market has remained resilient and is performing exceptionally well in most regions. Marsh Specialty observed rate increases in credit specialties throughout 2020, varying by product line and risk, driven by increased uncertainty during the crisis. Credit specialty insurers also reduced capacity and line sizes, especially in the trade credit market, with trade credit insurers reducing aggregate limits underwritten by 10%. By comparison, this is less than the -20% observed during the global financial crisis and insurers are cautiously re-opening. Moving forward, the credit specialties market may remain “harder” with respect to available capacity, pricing, terms and conditions but should remain resilient, driven by increased competition as insurers seize opportunities to write “more attractive” risks.

On balance, it was a year in which the expectation of risk increasing was very high while the actual increase in risk was relatively modest. Furthermore, many industry stakeholders expected the losses to challenge the market, whereas the actual loss experience was low. Looking forward, the focus for all is on growth and the credit specialties market is ready and equipped to directly support global recovery efforts.

Improving liquidity through short term insurance backed finance

Liquidity and working capital is the life-blood and primary form of defense for corporates looking to negate the impacts of a challenging 2020 economic climate. As we emerge from the crisis and companies begin to look towards expanding sales, access to liquidity will be crucial. To discuss the topic of how insurance backed accounts receivable (AR) and supply chain finance (SCF) products can help suppliers address these liquidity needs, Serene Soo, Regional Director, Political Risk & Structured

Credit, Asia at Marsh Specialty was joined by Julien Van Swieten, Head of Trade Finance – Asia at insurance underwriter AIG and Ladislas Gallant, Head of Asset Based Finance, Asia at Rabobank.

The panellists began the discussion by profiling a typical user of AR and SCF products. Clients using such products are often small, medium, and large corporates from across a variety of sectors. They use the products primarily as a working capital instrument to manage their balance sheets, while smaller companies will typically use it as a liquidity instrument and will therefore rely heavily on the use of credit insurance. Conversely, larger corporates and multinational corporations ~~will~~ rely on the products for risk management and balance sheet management. The products are very versatile and would be applicable to any corporates with a working capital position.

The main benefits which these products offer to corporates are improvements to their cash conversion cycle and working capital metrics, such as earlier payment receivables and extended payment terms. We also see positive impacts on the cost of financing for sellers who can leverage the strong credit profile of their largest buyers and gain access to cheaper liquidity than otherwise would be possible. The final benefit is the positive impact on the buyer-seller relationship through mitigating the risks of supply chain disruption, something that has proven invaluable in 2020.

From the bank side, the main benefit of such products is to strengthen their relationship with the client. By financing a client's working capital needs, they are able to get a deeper understanding of the client's operations and structure than would typically be possible with other financing structures such as a classic revolving credit facility for general corporate use. It's a valuable product for banks to get to know their clients and better assess the risk profile of the client and their supply chain.

2020 was a year which put these products to the test, with complex pressures on the cash conversion cycle for many corporates. This triggered a peak in demand for new programs and extension to existing programs. Insurers reacted quickly to the situation by developing new and innovative product lines for their customers. As a result, the performance of AR and SCF products in 2020 were as good as or better than ever before. This demonstrates that these working capital structures are agile and flexible to the client's needs, and enables banks and insurers to build long-term partnerships with clients.

Looking forward, banks and insurers are committed to the product and we can expect an optimistic future with growth in 2021. This will be driven in large part by the trade finance gap which sees small and medium sized corporates lacking the short term working capital which they need. Additionally we can expect to see technology play a key role in the driving improvements in transparency and efficiency.

Collateral replacement solutions to enhance liquidity

It is critical for companies across many industry sectors to implement strategies for liquidity management. To explain how surety bonds can be used as an alternative form of collateral to create and enhance liquidity, Eric Wojcik, Head of Surety & Lenders Solutions Group, Pacific at Marsh Specialty sat down with Meta Hudson, Head of Credit Specialties, Pacific at Marsh Specialty and Jonathan Griffiths, Head of Surety, Australia at Berkshire Hathaway Specialty Insurance. Over the last few years Meta and Jonathan have been instrumental in developing world leading insurance solutions in the Australian and Asia-Pacific surety markets. They began the session by providing an overview of what surety is.

Surety is a three party arrangement between the surety, the customer and the beneficiary whereby the surety guarantees some form of contractual obligation of the customer in favor of the beneficiary. This could apply to a number of different structures and a common example is in construction where the surety would guarantee the completion of a building on time and to specification on behalf of the contractor, in favor of the project owner. If the contractor doesn't complete the job due to insolvency, for example, the surety would pay out. As opposed to an insurance policy, which has certain conditions to be met before payment is made, a surety bond is a contract of guarantee. This works much the same way as a bank guarantee or a letter of credit, and the process which insurers use to assess the suitability of an applicant is similar to how a bank would use to assess the credit strength of a client. In the underwriting process, surety providers will look at three main areas; character, capital and capacity. Character represents the history, experience and capabilities of the individuals running a company. Capital reflects the financial strength of the customer determined through a due diligence process. Finally, capacity is the track record of a provider for carrying out similar projects in the past. Outside of the standard performance guarantee of a construction contractor, some examples of bond types which sureties can provide are lease bonds and equity contribution bonds.

The past year has shown the importance of having different options when it comes to liquidity sources. Surety can provide a big advantage for corporate treasurers looking to create additional sources of liquidity and avoid having their banks lines tied-up in the form of guarantees.

While sureties technically compete with bank guarantees, there is scope and potential benefits for a collaborative partnership between banks and surety providers. Banks are able to move risk exposures from their balance sheets across to the surety market. This achieves the dual benefit of providing a risk transfer for the bank and freeing up extra capacity and liquidity to be provided to the client.

Marsh Specialty works with banking and corporate clients to bring in the right surety to match their needs and become a partner going forwards. Certain sureties will specialize in specific sectors and brokers can help guide clients to provide the right surety match for them.

Key principles of portfolio structures

Unfunded risk transfer on single name exposures to private market insurers is a well-established distribution strategy for financial institutions. We increasingly see a marked trend towards the transfer of portfolio structures that bring scalable value. To further explore this dynamic, Ashish Makhija, Director, Global Credit Insurance Group at Standard Chartered Bank, joined Marcus Miller, Managing Director & Global Lenders Solutions Group Leader and Oscar Holloway, Senior Vice President, Portfolio Solutions from Marsh Specialty.

The evolving regulations since the 2008 financial crisis have significantly changed the banking business model and approach to risk. The transition to Basel IV and the subsequent implications on the cost of capital will likely accelerate the need for banks to find ways to transfer risk off their balance sheet to pension funds, hedge funds, and insurance companies.

The traditional method of transferring risk to the insurance market has always been on a single name underwrite basis, underwriting the underlying structure and balance sheet from a credit risk perspective. Portfolio distribution, however, looks at commonality of risk across a pool of exposures. The risk is assessed on expected loss, actual loss, and the risk weighting, applied against the combined credit pool. Portfolio distribution ultimately provides banks with a more scalable and operationally efficient method of managing exposures and recycling capital to help support originate-to-distribute models.

While insurers were once a minority participant on large scale risk transfer deals, the pricing efficiency and extensive market knowledge offered by insurers now provide banks with a genuine alternative to the funded investor market. Banks now have the resources available to them to diversify their investor base and be more creative through the blending of funded and unfunded capacity.

Each bank will have a unique set of requirements for structuring their portfolios and this is often dictated by their local regulatory environment. Whether it be portfolios based on multiple tranching, master programs or securitization and collateralized loan obligations (CLO), in each case insurers can provide benefits distinct from funded distribution options.

Marsh Specialty, alongside its sister organisations Guy Carpenter and Oliver Wyman, brings a global footprint as well as extensive experience and expertise in both portfolio and single name transaction solutions. By working alongside banks to fully understand their specific needs, Marsh Specialty is able to provide banks with portfolio distribution options that offer a highly efficient alternative form of risk transfer to funded distribution options, as well as traditional single name underwriting.

The role of private capital in plugging the funding gaps for project finance

Sources estimate there will be a US$15 trillion gap in funding for global infrastructure projects up to 2040. According to the World Bank, only 0.7% of the total global investment in developing countries comes from pension funds, mutual funds and institutional investors. A staggeringly low number which indicates the institutional capital potential for plugging the US$520 billion annual financing gap. In our final session of the webinar, Toya de Souza Gomes, Senior Vice President & Global Project Finance Leader at Marsh Specialty was joined by Alex Broggi, Senior Portfolio Manager, Infrastructure Debt Investments at HSBC and Luca Tonello from SMBC Bank to discuss the topic of how private capital can be used to plug the project finance funding gap.

The discussion began with the question of whether the private capital market has the desire to plug the funding gap in relation to infrastructure in emerging markets. Institutional lenders have been active in the infrastructure market for a number of years and it remained important for their asset liability management. Roughly one third of private capital investment has been in emerging markets and the main use case for this is diversification of exposure. While emerging markets present slightly higher risk factors, the increased yield potential provides many opportunities for private investors.

Private capital infrastructure investment into Asia is primarily dominated by the banks and attempts to attract more institutional capital have not proved fruitful so far. When it comes to the question on appetite, the stability of regulations is often lacking in emerging markets and this is always of significant importance to any investor. As such, even if there is appetite for high yield investment opportunities, there is still a need to see stability before entering into a project.

When assessing whether investors and commercial lenders are ultimately competing or complementing each other, one important element to consider is the size of the funding. In Asia specifically, most of the funding will come from commercial banks as institutional investors are limited in the size of their capital. As such, it is unlikely that there will be a situation where institutional investors will be able to replace bank financing any time soon. Generally, there is less competition in the early stages of a project as many investors are still hesitant to take on these risks in emerging markets. When it comes to refinancing, however, there is often a complimentary approach.

When evaluating the key characteristics of an investment decision in developing countries, banks will first assess the macro needs of the country. Fundamentally, the project would need to have a commercial, social or sustainable value to the country to ensure the long term demand for the project remains intact. The next important factor which banks consider is the presence of a sponsor to help provide a level of protection against the risk involved with investing in emerging markets. The final consideration is the sector which they would be investing in. Certain sectors carry more inherent risks, which banks have to be considerate of.

The final topic of discussion for the panel was that of the growing importance of the ESG movement. Public agencies have been putting a strong emphasis on ESG factors for many years and this is slowly starting to become an important factor in the private sector as well. Some banks have taken a more gradual approach to phasing out investment in non-sustainable projects and while regulatory pressures and investor focus towards more sustainable practices in the financial community are increasing, there is a need for more formal metrics and frameworks to be developed to further encourage ESG investment.

About Marsh Specialty

Expertize in payment, performance, country risk, and insurance — delivered by a diverse and creative global team.

We leverage insurance risk capital to optimize and secure our clients' results in a world of continuous change.

We enable growth and enhance returns by facilitating sales, strengthening collateral, securing finance, and releasing capital.

800+

Global credit specialists located in 57 countries.

Marsh Specialty is a leading global specialist in structuring and placing credit insurance solutions, with deep understanding of corporate finance and related banking regulations.

We engage with regulators, rating agencies, and auditors to progress the efficacy and understanding of this form of risk transfer. We are one of the most active brokers in this specialty, advising on over 2,500 of these transactions every year (representing US$100 billion+ of notional credit risk placed into the insurance market).

This transactional insight and market relevance drives our ability to deliver innovative and efficient solutions for our clients, complemented by proprietary digital tools and a dependable operational platform.

Marsh's transactional expertise is strengthened by the broad capabilities of Marsh & McLennan (MMC). These include the strategic perspectives of Oliver Wyman, the analytics and reinsurance market insights of Guy Carpenter, and the people risk and investment expertise of Mercer. MMC's collective capabilities inform Marsh's advice and risk solutions, and are also available to directly support our clients where relevant.