The Insurance Insider

(Re)insurers face $2.5bn political risk loss

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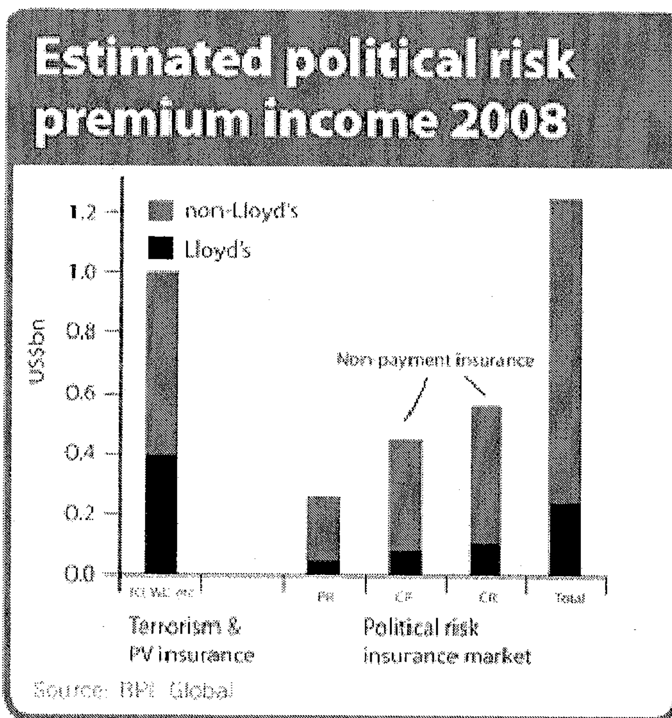
(Re)insurers' rapid expansion into providing structured credit style cover to Western banks and investors is now fuelling the industry's estimated $2.5bn of political risk/trade credit loss exposures emerging from the 2008-09 economic downturn.

Beazley became the latest Lloyd's insurer to unnerve investors on 9 November when it disclosed a £33mn loss on its Political Risk and Contingency book in the first half of the year. The announcement provoked Collins Stewart to immediately downgrade its recommendation on the stock in a note entitled "Political Risk loss hits confidence".

A similar negative reaction was endured by fellow Lloyd's (re)insurer Novae when it admitted to an even more modest trade credit loss of around £8mn during its half-year results in August, again demonstrating investors' sensitivity to the prospect of unpleasant surprises from the class.

But notwithstanding these recent announcements, the writers that are widely thought to dominate this class include Ace, Axis, Catlin and ZFS, and reinsurers such as Munich Re, Swiss Re and Hannover Re. They have all been at the vanguard of a rapid evolution in the structure of the cover, which has seen P&C (re)insurers take on the role of underwriting debt default.

As the chart demonstrates, in recent years the traditional market of political risk has been dwarfed by structured credit/specialty non-payment insurance. Indeed, it is now estimated that around 80 percent of the political risk market is in various forms of debt non-payment and only 20 percent is "pure" political risk cover, in the traditional form of government expropriation.



This expansion proved exceptionally profitable between 2002-07 – years that Axis Capital's CEO John Charman recently said experienced "hardly any loss activity" – but heavy loss

activity is being seen on the more recent years.

While there are different structures, at a fundamental level (re)insurers are providing protection in case of non-payment of debts. For example, the cover has proven increasingly popular with Western banks as an alternative or extension to syndicated debt when they seek to protect their own exposures to emerging markets, not least those arising from loans to industry or financial institutions.

This year, for example, Central and Eastern Europe are proving particularly combustible territories with their combination of newly privatised banks, heavy economic reliance on commodities and political instability.

The recent flurry of bank collapses in Ukraine, for example, is leading to estimates of a $500mn+ loss to (re)insurers just from that country. Ukraine, which is heavily dependent on steel, is expected to see its economy contract by as much as 20 percent by the end of the year. Meanwhile Kazakhstan – whose second largest bank BTA collapsed earlier this year, defaulting on $12bn+ of debt – is predicted to cause similar losses to the (re)insurance industry.

And it is not just the emerging economies of Europe. For example, the collapse of the Bahrain banks TIBC and AWAL this year is also expected to lead to (re)insurance losses, for example, while Axis Capital's credit insurance for $399mn of bonds underpinning the lavish $20bn Blue City hotel and apartments complex in Oman may be exposed after the bonds were downgraded.

As the notifications have stabilised – most came in late last year or in Q1 2009 – greater clarity is being achieved on the industry's overall potential exposures. While a figure of $4bn is often used to capture all the "problem cases" and notifications that have occured, the current consensus among market experts is claims of around $2.5bn - a significant sum for a sector which, if you exclude the separate market for terrorism/political violence, is estimated at around $1.2bn in annual premium income.

There is, however, an important factor that may mitigate this eventual figure. Embedded into the fundamental nature of the policy is the recovery period. It is what Charles Berry, chief executive of sector-leading broker BPL Global, describes as "reported but not incurred" which means that underlying many of these defaulted debts is a security that can be recovered.

Over time, this can be significant. For example, Berry points out that BPL Global's political risk book in 1997 – the year of the Asian financial crises – actually returned to the black because of strong recoveries.

Indeed, speaking at a Lloyd's lecture in early November, Berry said this was a defining time for the sector and that it was responding with "great maturity" to claims and clients' needs.

He told the audience that he expected recoveries of $1-$1.5bn, which would lead to an eventual net loss of $1bn-$1.5bn.

For the industry at large – which has just enjoyed a remarkably benign US catastrophe season – this is wholly manageable. However, it is possible that the loss estimates may continue to travel north, especially if the global economic recovery shudders to a halt next year.

And even if that does not happen, it is highly conceivable that some (re)insurers will take disproportionate losses. Brace yourself for more disclosures as investors scrutinise political risk numbers when the industry reports its full-year results.