BPL Global World Leading CPRI

Update to Covid-19 Crisis – Response of the CPRI Market

15 May 2020

General update

Now that another month has passed since Covid-19 was recognized as a pandemic by the World Health Organization (on 11th March 2020) this paper should provide a further update on the Credit and Political Risks (CPRI) Market and how the crisis is continuing to affect our ability to place new policies for our clients, as well as the prospects for the rest of 2020 and beyond by way of market entrants and casualties, premium volumes, enquiries and claims.

Our last update illustrated the foolishness of trying to make bold predictions by containing the sentence: "The CPRI market's fortunes are very closely connected to the oil price and the speculation and ultimate conclusion of the Opec+ deal on Easter Sunday, were extremely positive developments for CPRI insurers." Within a week of that memo being sent to clients, the price of US oil futures turned negative for the first time in history.

Mindful of that experience, it should suffice to say that as of today the price of Brent Crude has just risen past USD 30, but this remains an extremely turbulent market, and a significant portion of the risk underwritten by the CPRI market, being correlated to the oil price, has been adversely affected by the price environment. This applies to E&P companies, refineries, service companies as well as the sovereigns of oil producing nations and the state-owned oil companies. This has not yet crystallised in a large wave of claims in the market, and in general the files that are keeping claims underwriters and brokers busy relate to issues that arose pre-crisis, but there are some signs of inevitable payment delays. The G20 initiative around debt moratorium in emerging markets has also been headline news in the CPRI market as insurers try to assess to what extent it affects the Tied Commercial Loans and other financings they support or are looking to support in future. It seems clear that suspension of debt service is limited to existing loans already in the Paris Club and other restructurings but it has nevertheless

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resulted in some reticence to insure new deals, presumably entirely contrary to intention.

Market participants

Encouragingly, we have not had any instances of an insurer declaring their CPRI business closed. There are a couple of insurers who have hit the “pause” button on any new business that they did not quote before the crisis. Given that most of the pre-Covid transactions are now finalised, it renders these insurers effectively on a watching brief. There have been restrictions imposed on some insurers by senior management (usually credit appetite being pared back in favour of sovereign or investment-grade risk) but this is also rare. This remains a healthy market where some insurers are more bullish than others, and there is different appetite for different sectors, insureds, countries, structures and tenors. It also remains a market where there are likely to be new entrants to partly compensate any future casualties; Convex, Ryan and IICH are all likely to start underwriting CPRI in 2020 with Navaid Farooq having now started at Convex and announcing recruitment of Murray Ross from Chubb and Katie Sparkes to join his team.

Prices

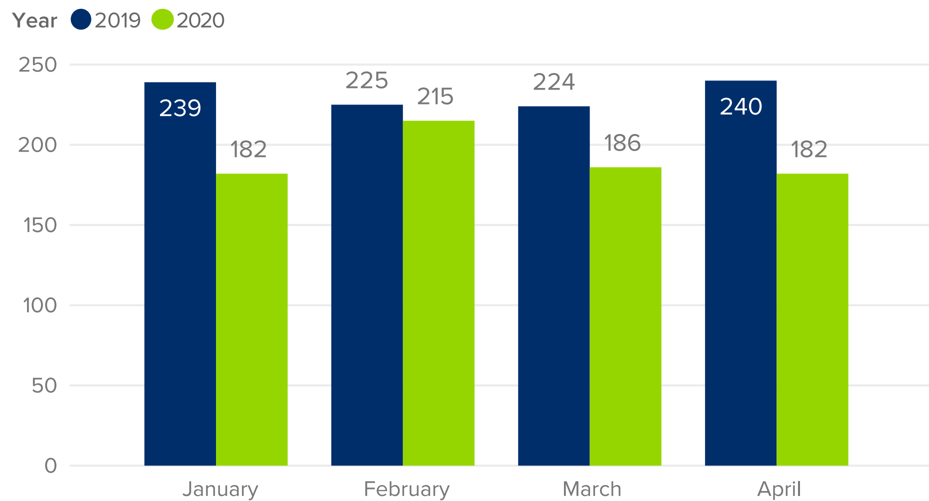
We have seen prices increase. Whilst the market resilience shown by most insurers has been impressive, there is noticeable pressure to increase rates and this has seemingly advanced at a quicker pace than the banking market. For example, we have seen a syndicated loan to a steel producer priced at 190bps pre-crisis being revised to 245bps; an insurer has repriced the premium from 70% of margin to 85%. Coupled with a rising liquidity cost, this clearly puts pressure on banks’ ability to afford the premium.

There is a further drive from insurers to “lock-in” higher pricing and avoid being tied to lower pre-Covid rates. This manifests itself in requests for higher Minimum and Deposit Premiums where there is a perceived risk of refinancing.

Demand

BPL continues to see notably fewer enquiries in 2020 than 2019, with April’s figures (as expected) showing the sharpest drop. Banks are struggling to originate transactions for obvious reasons and we expect this trend to continue while travel bans are in place.

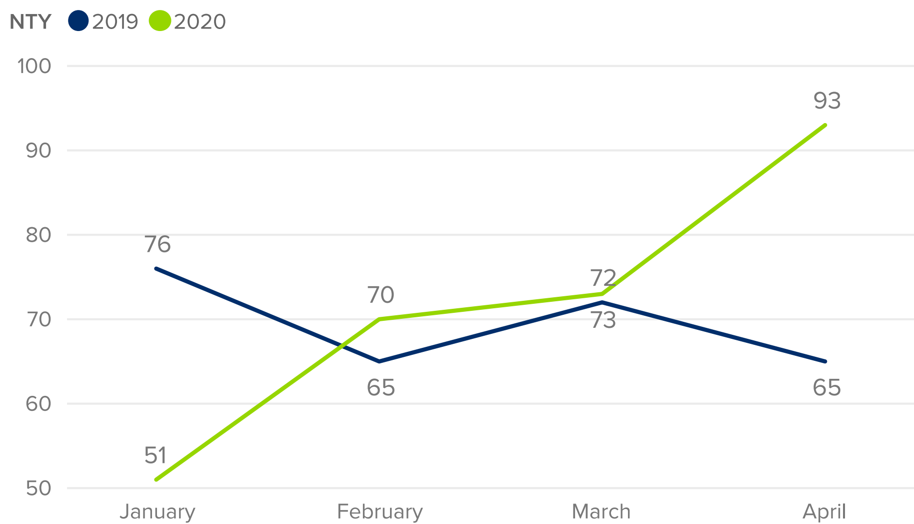
Nevertheless 182 enquiries represent plenty of work and more resilient demand than expected.



Enquiries in 2019 vs. 2020

Supply

On the Insurer front BPL is seeing a marked increase in negative responses which reflects Insurers' reduced risk appetite.



Enquiries with NTY Only – 2019 vs. 2020

Wordings & Regulatory News

The LMA produced LMA5393 "Communicable Diseases Endorsement" and we have seen an amended LMA5391 coronavirus Exclusion. Obviously, we don't expect to see this used in Comprehensive non-payment policies and we have only been asked to on one occasion which was subsequently retracted. We have seen pressure from insurers to include in Equity and Lenders PRI Policies, however, it has been unnecessary given the standard BPL exclusion covering "non-discriminatory" government measures has sufficed.

Claims / Notifications Activity

The CPRI market is still paying claims well and on time, but given standard waiting periods, these all relate to pre-Covid defaults.

In terms of more current problems for insurers, there are several issues on traders in the APAC region (more in the section devoted to Trader RCFs) and in light of the G20 initiative, there are certainly some African sovereigns looking to term out due dates but it is a bit too early to assess how that will affect the CPRI markets (i.e. will these be claims or largely short extensions of Policy Periods / waivers).

Airlines are still largely a watching brief but Norwegian Airlines may be the first to crystallise into a claim. We believe this is on the AFIC program.

Please see sectoral analysis for further details.

How Big is the Insurance Loss from Covid-19?

Estimating the total loss to the Insurance market or more specifically the CPRI market / trade credit market is a bit like pinning a tail to the donkey with vast differences in estimates, and complicated by the fact one may never know if a loss was a true “Covid-claim” or a pre-existing fraud or commercial issue.

There is consensus that despite the very large news, this is not an event that threatens the solvency of the major insurers, but clearly it will have a major impact on profitability.

A brief roundup of expert predictions:

London market (all classes)

PwC say £5.3 billion, with £3.4 billion net of reinsurance.

Initial estimates from the ABI (Association of British Insurers) indicate that its members expect to pay out over £1.2 billion in claims to support businesses and individuals affected by Covid-19.

Global Insurance market

Our competitors Willis have given three scenarios:

- Optimistic: Market losses of $11bn
- Moderate: Market losses of $32bn
- Worst Case: Market losses of $140bn

UBS estimates that BI will represent around $7 to $22 billion losses related to Covid-19. The next biggest loss-affected line is estimated to be trade credit

insurance, with $8 to $16 billion, followed by event cancellation with losses of around $5 to $7 billion. UBS upped their estimates for Covid-19 insured losses to between $30 and $60 billion, from a previous estimate of $20 to $40 billion.

Doom-mongers Morgan Stanley say “up to $46bn [for trade credit insurance alone], with reinsurers perhaps taking as much as 30% of the hit”.

Lloyd’s of London boss John Neal thinks payouts would be higher than the $50bn figure for Hurricane Katrina.

Charles Berry: ***The Big Picture***
Click to read article

Please see our Chairman’s article *The Big Picture* for how we think these numbers fit into the insurance market’s ability to pay its claims.

Reinsurance

In the absence of any obvious Covid-related loss activity affecting the market at present, reinsurers are in a strange hiatus state of having to price and underwrite mid-year renewals without knowing the extent of Covid-related losses that may be hitting their books later in the year.

In this ‘suspended’ state, Reinsurers are definitely talking of a ‘hard’ market developing, especially since 1st April renewals, which went by largely unaffected by Covid loss considerations. Over the coming year, higher reinsurance costs are inevitable, with many reinsurers anticipating quota share commission reductions by 10 percentage points or more, with some programs already experiencing 5 – 8% reductions. With that in mind, the mid-year AIG renewal will very much be seen as a market bellwether in relation to quota share commission levels.

Excess of Loss treaties will also be under strain bearing in mind the surge in the cost of capital for reinsurers, affecting the pricing adequacy of capacity, and not to mention the difficulty reinsurers will have in pricing risk attaching layers for the post-lockdown world. As a result, some cedants with pure Excess of Loss treaties are already experiencing reductions in capacity.

The impact of Covid is also expected to be much more severe on whole-turnover trade credit insurers rather than on structured credit and surety not only as a consequence of the reduced turnover expected during and post-lockdown, as may be obvious, but also due to the uncertain impact of the various state guarantee schemes in Europe and beyond. Reinsurers are concerned to what extent premium and exposure will be diverted to those schemes, affecting the minimum and deposit premiums expected for Excess of Loss and Stop Loss treaties. With reduced exposures, the capital relief generated by those treaties may be also be re-examined by cedants.

Even though the prevailing uncertainty and increased cost of capital is already leading to a hard market, if the second and third quarter loss ratio

figures are worse than expected by reinsurers, we can expect a much harder market at the year-end reinsurance renewal season when the vast majority of the London based CPRI market have their renewals. Interesting times ahead…

Appetite: Key Sectoral Analysis

SPOTLIGHT ON TRADER RCFS

Introduction

Insurers are paring back on Trader RCFs, particularly for Traders who are exposed to the oil price. This trend pre-dates the Covid-19 crisis, and although generally insurers are not concerned about deterioration in creditworthiness, capacity is given on these deals as a favour by insurers in order to get a higher chunk of business on the rest of the Insured's book, so the Covid-19 crisis is being used by some insurers to extricate themselves where they feel this strategy has not worked, or where they no longer feel they need to offer favours due to a change in market condition. There is also less appetite in this area (despite reports that traders have in some places profited out of the crisis).

Insurers are actively trying to reduce lines on non-secured business even for the biggest traders and they want to use their limited capacity for secured transactions and even then for the top tier traders only.

Insurers are actively pursuing a tactic of demanding to be given exposure on a Borrowing Base, if they are to give any unsecured capacity as well. Often this has been part of a promise to management by an insurer (e.g. Aegis) who is under pressure to achieve better rates /terms at renewals in light of a hardening market.

Capacity names

Trafigura is also a major capacity issue in the market. Although most insurers are positive on the credit (market rumours are that Trafigura had their best ever quarter due to hedging / market contango), finding spare capacity is virtually impossible.

There is therefore a Catch-22 scenario whereby there is no appetite on Traders, except for the top names, which are a problem due to capacity…

Negative experience on names

Sometimes there is contagion between insurers negative experience of a trader as a client and their willingness to grant cover on them as an Obligor.

We are aware of a couple of examples, where a commodity trader may have a negative reputation as a client (perception that they were swift to

claim instead of working on restructuring) and this affects our ability to get capacity on them for banks.

Risk analysis

Hin Leong (details below) has reinforced concerns that if banks are struggling to assess the leverage of commodity traders, then insurance companies, who are a further step removed, will struggle even more and therefore should not take unsecured risk. With the most sophisticated trade finance banks getting blindsided, the further involvement of private equity and insurance may be helping to produce a bubble that further complicates risk analysis.

Claims rumours

There is a major issue in Singapore in the form of Hin Leong Trading. Hin Leong Trading has been in a financial crisis in recent weeks and has $3.8 billion of secured debt with various big users of the market. We are aware of 9 insurers with exposure.

Singapore trader Agritrade is also accused of a massive fraud and we expect a sizable claim for insurers. Phoenix Commodities, a Dubai based rice trader now in the news for massive currency hedge losses will most probably lead to additional claims in the CPRI market.

COMMODITY FINANCE

Reserve Based Finance

This is a busy time in the world of Reserve Based Financings with bankers and insurers busy with redeterminations and gearing amendment waivers, but there is new business being done as various Obligors seek liquidity by triggering Accordions (a large transaction covering assets in Norway and the North Sea has been strongly supported by insurers).

There are also some signs that insurers are seeing transactions for major oil producers that previously would not have come into the market and at attractive (or at least acceptable) pricing.

PXF/Prepayments

Insurers' bread and butter business of prepayments and term loans to state-owned oil and gas companies such as Sonangol, Sonabhy, Kazmunaygas etc is still alive and well, with pricing ticking up.

Claims rumours

There are also a number of issues in this area, with the very well-publicised SHT restructuring in Chad being watched nervously, with the SNPC restructuring in Congo deteriorating and a fresh claim being submitted by a bank that had previously held off.

Project Finance

Clearly it is a bit easier in these circumstances to consider projects that generate cash flow over a long term horizon and although they have been subject to heightened scrutiny in the underwriting process as a result of the Covid-19 crisis, insurers are continuing with the long-term LNG deals in Nigeria and Mozambique.

As a general point, the market for long term Project Finance is slightly limited as not all insurers have the long tenor capabilities and/or big teams required to underwrite the deals.

Pipeline projects could work but need extremely strong take-or-pay transport agreements.

Metals & Mining

Insurers are experiencing issues with China metals that came to light pre-crisis (copper and aluminium), so insuring new exposure on similar privately-owned enterprises in the country will be difficult.

In terms of the PXF business, there is still support for a new Indian steel transaction, albeit at reduced pre-crisis levels (and at higher pricing) and the better Russian metals producers are still acceptable to some insurers, but finding a pricing match is increasingly difficult.

We have certainly seen an increase in interest for covering the political risks on mines in emerging markets, particularly gold mines. These remain generally insurable for even relatively unstable jurisdictions (e.g. Ecuador, Mali, Senegal and Burkina Faso are all insurable).

Other

We have seen interesting new Covid-specific enquiries, regarding the purchase of PPE by the NHS in the UK, as well as several credit-worthy US hospitals. There are also ancillary political risks regarding export embargo etc from the country of origin.

ASSET FINANCE

Aircraft

Those involved on the AFIC and Balthasar programs are busy handling their existing transactions, and as previously mentioned we believe AFIC has its first claim in the shape of Norwegian Airlines. We do understand that a couple of new transactions have proceeded on Balthasar, presumably where there is explicit government support.

It is becoming a bit clearer where governments are prepared to support airlines, and this may re-open some insurance capacity for certain Obligors such as Lufthansa or Air France, but clearly the appetite for new aircraft transactions will remain suppressed for some time given internal pressures within insurers.

We were expecting a new player into the market, as Mark Esdaile (ex Sompo) was due to start underwriting at BGC Partners' insurance MGA specialising in Aircraft Finance in May. It may be some time before they can start underwriting due to lack of available capacity.

Shipping

We have seen insurers get comfortable with certain shipping deals - risks on the largest container carriers and well-structured FPSO Financings, but in general this remains an area where appetite is extremely limited (a statement which could have been made pre-crisis).

Real Estate

Generally Real Estate Finance is on hold for the CPRI teams that were open pre-crisis, but insurers have reported finalising some transactions with Real Estate Investment Funds (although some insurers have also suggested that they don't find this business attractive).

Some transactions are still proceeding for locations that are not so severely affected by the crisis (e.g. Japan) but for the business that represented the bulk of pre-crisis business (e.g. Manhattan/London/Frankfurt office space), insurers don't feel able to proceed until they see the likely effect of any tenants delaying rental payments or a clearer picture of when office space will fully re-open. Hotels clearly remain challenging.

Export Finance & Sovereign Lending

The G20 communique remains the headline news. It has complicated new deals because although the general understanding is that the intention of the directive is to encourage favourable lending by extending payment terms, it does create some level of uncertainty as to how debt to named

countries may be treated in future. We understand that it has resulted in countries such as Gabon and Cameroon actively seeking a terming out on existing transactions.

Having said that, there are new deals being finalised with the support of the CPRI market with large budgetary financings in European countries in conjunction with private banks and international development institutions.

There are also Export Finance transaction proceeding in countries such as Ivory Coast and Senegal.

The CPRI market has many large exposures on emerging market sovereigns, particularly African oil-producers and yet there is plenty of appetite to support projects with nations that are not seen so often in the market (and hence have no capacity issues). Botswana, Chile, Colombia, Croatia, Georgia, Hungary, India, Indonesia, Kazakhstan, Mauritius, Morocco, Panama, Paraguay, Peru, Philippines, Romania, Uruguay, are all example of countries seldom seen and where insurers are actively seeking exposure.

Corporate Lending

We have seen a number of enquiries for the power sector, and banking sector. We expect the broad appetite shift from the Covid-19 crisis to remain true: defensive industries will attract appetite, but insurers will generally need convincing. RCFs are clearly more difficult than term loans due to the perception that they will be drawn in the event of a likely default.

Technology, Media & Telecoms

A big growth area for insurers, with increasing interest from insurers to compensate for loss in premium income elsewhere by looking at defensive moves in Fibre Optic and Telecoms space. Some insurers, like Euler Hermes and Aspen, have existing internal expertise but others are looking for guidance from trusted banks who are active in the area.

Transactions have been finalised in Spain, Germany and France with more likely to follow.

Infrastructure Projects

When asked what deals insurers are still looking at and binding, a consistent response has been infrastructure projects.

This makes sense give the following:

- Long-term nature of the financings. Given the construction phases required under most projects, cash is likely to be generated in market conditions in 2024 rather than 2020, which are easier to predict! (or at least structures designed to withstand uncertain environments).

- Expected stimulus from governments in the form of large infrastructure expansion projects.

Insurers are likely to be very cautious when it comes to the jurisdiction of the projects, given the likely divergence in focus between different Emerging Market governments (e.g. India and China are likely to fund large expansion projects, but many African countries are likely to need to focus on short term funding pressures and may even divert funds away from Projects).

Clearly given Covid-19 pressures, there will be additional scrutiny on the EPC contractor and the ability to do the job within the likely regulatory requirements of each country. The strong chance of delays will require addition stress testing.

Derivatives

We have seen a number of new enquiries for repos and currency swaps. These are insurable in our market and may even be more attractive for some insurers who see the benefit in the additional structural safety nets that some of these transactions bring.

However, it is an area where many insurers are closed due to restrictions from management, reinsurers or their own appetite, and it is certainly an area where they are more prepared to go for existing, trusted clients, rather than new entrants.

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