Enabling growth.
Securing capital.
Recovering from crisis.

POST-EVENT REPORT

ENABLING GROWTH. SECURING CAPITAL. RECOVERING FROM CRISIS.

On 10 February 2021, Marsh JLT Specialty and TXF welcomed nearly 700 guests for an exclusive client webinar to help guide insurance users 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 JLT 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 JLT 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 at 7.3% (in March of 2021). However, their latest forecast predicts a positive recovery with

[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.

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) have 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$30.5B (according to Marsh data as of Jan 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 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 observed rate increases in Credit Specialties throughout 2020, varying by product line and risk, driven by increased uncertainty during the crisis. Credit Specialties 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, Michael Kornblau, Managing Director & US Trade Credit Leader, Credit Specialties at Marsh JLT Specialty was joined by Larry Sesmer, Head of Trade

Finance – Americas at insurance underwriter AIG and Florence Shoshany, Head of Distribution and Credit Solutions – Americas at Deutsche Bank.

Before the session began, an audience poll was taken to determine the extent of the popularity of AR and SCF products amongst viewers. With more that 50% of viewers stating they are already users of such products, it's clear to see just how valuable short term insurance backed finance is to corporates.

When describing a typical company who can benefit from such types of financing, it can broadly be stated as any entity which is seeking to extract liquidity from their supply chain in a working capital efficient fashion. It's important to differentiate between the two vantage points from which these programs arise, whether they be buyer led or seller led. Seller led programs, often referred to as accounts receivable finance or factoring, are tailored to entities with short term accounts receivables due from single credit-worthy buyers or a portfolio of buyers. Those entities are seeking to optimise working capital through the sale of those receivables at a discount to a purchaser. Where the buyer's credit rating is higher than the seller, it could lead to a lower cost of funding, which is further supported by capital efficiency achieved through a trade finance insurance policy.

Conversely, buyer led programs are often referred to as supply chain finance or reverse-factoring. These programs are often established by well rated buyers seeking to support their suppliers' liquidity through an integrated early payment mechanism, through which these approved invoices can be discounted to the supplier. Supporting supplier liquidity can limit supply chain disruptions, particularly during times of economic uncertainty. The buyer can also benefit from suppliers choosing to extend payment terms. While companies can choose to fund such programs themselves, typically they will reach out to a bank for assistance. The benefits to banks of such programs are that they can provide an additional level of support to their customers and it provides a fantastic way of mitigating risk through benefitting from the commercial relationship between the obligors and the counterparties.

Supply chain finance programs can often be huge and in the event of a bank reaching their own internal credit limits, they will call on the insurance market to provide capacity and share some of the risk. Again, there can be credit risk mitigation with capital efficiency for banks by partnering with insurers. This will allow the bank to provide even more support to the customer than would be possible were insurance not in place. Leveraging the strong bank and insurer underwriting and monitoring processes can also help by offering early warning signs of potential payment problems.

Throughout 2020, the product was in high demand. Many trade finance providers saw their clients approach them to support their trading partners by extending payment terms and adding new suppliers and obligors.

Climate and transition risk. Supporting clients on the transition journey.

Climate has become one of the top board level issues since the G20 established the task force on climate related financial disclosures in 2015. To discuss how the insurance market can help support clients on their transition journey, Ed Nicholson, Political Risk and Structured Credit practice leader for continental Europe at Marsh JLT Specialty was joined by Simon Cooper, partner at Oliver Wyman.

A mixture of heightened media attention, improved quantification of climate risk, major recent weather events and pressure from institutional investors has caused a large shift in intensity when it comes to companies tackling the issue of climate change.

Focusing on the transition risk from a banking perspective, there are two key factors to consider. The first is the risk of climate change to the organization. This risk typically has two main drivers: physical risk and transition risk. Physical risk is the impact of a changing climate on businesses and therefore on lending portfolios. Acute physical risk is the impact of severe climate events such as storms, floods and fires. This can impact real estate and supply chains. Chronic physical risk can occur, for example, in the form of rising average temperatures and the effect on crop yields. Transition risk, on the other hand, is the need for consumers and organizations to change their behaviors and adapt to a low carbon future. If we are to meet the Paris agreement and reach net zero by the mid-century, there is a need to change the way businesses operate, which will challenge existing business models.

The second factor of transition risk from a banking perspective is reputational risk. An example would be bank loans to projects which support fossil fuels and thereby incurring reputational damage. Banks need to balance their commitment to achieving net zero while also considering their lending portfolio to make sure they align.

Rather than ending lending to the real economy, regulators want banks to take climate risk seriously by identifying the key risks and taking the necessary actions to tackle them. This will then become a lever to influence corporates and help drive the low carbon transition.

One of the keys to a successful transition may be found in the continuing use of risk distribution. This is an area that the insurance market has played a crucial role for banks, whether on the credit side or in respect to their management of risk weighted assets. Higher levels of ESG compliance will lead to higher insurance capacity, therefore it is important that companies engage with insurance providers and bring them in regarding their transition plans.

The role of Export Credit Agencies (ECAs) going forward during the crisis

The mission statement for all ECAs is to support the export and internationalization of domestic goods and companies through insurance coverage and financial guarantees. To discuss how the COVID crisis has caused ECAs to evolve and adapt their mandate, Fabrizio Mazza, Managing Director & Global Public Agency Leader at Marsh JLT Specialty sat down with Dan Riordan, President, Political Risk, Credit and Bond at AXA XL and Alessandra Sbardella, Head of Reinsurance at SACE.

Over the last 12 months, governments have introduced several initiatives to support their economies and contain the impact of the shock caused by the COVID crisis. One of the key initiatives has been to expand the role of the ECA to focus on the domestic market. This has been often in the form of providing a direct state backed guarantee to domestic companies to ensure the availability of bank financing during the crisis, including a focus on supporting the purchase of medical supplies to fight the effects of COVID-19 but also – very importantly – in the form of the short term trade credit reinsurance scheme. This scheme provides a governmental backstop to private trade credit insurers, so that the availability of essential trade credit protection for corporates was only partially affected by the reduction in the risk appetite of the private carriers, during the crisis.

This focus on the domestic economy however was not at the expense of the more traditional export credit business. In this space, ECAs continue to rely heavily on the support of the private insurance market, particularly through the reinsurance of large transactions. This helps ECAs to manage concentration levels, optimize capital and mitigate risks. The trends which emerged in 2020 are expected to continue with significant capacity challenges, along with a cyclical price hardening of the private insurance market, which could create a misalignment between private insurers' and ECA's interests, stymieing collaboration. Both guests agreed that to avoid that, communication will be key: the deeper the understanding of the value that public agencies bring to the private market, the more likely the market will react positively and continue to support even where conditions are less commercially viable. Private insurers will likely look to work with a limited number of key customers, focusing on preserving and prioritizing these relationships to maximize value, in order to ensure a continued positive engagement with ECAs, multilateral development banks and DFIs. Clever solutions will need to be found to optimize the returns for private insurers in more challenging market conditions, such as structuring portfolio of projects, as opposed to single transactions.

Importantly, there are also new areas of collaboration where we see growth: one of the key new areas in which the public and private insurance markets will look to cooperate is that of the energy transition, with a focus on decarbonization. With the US re-entering the Paris Accord and Europe focused on the ambitious European Green Deal, we anticipate lots of new exciting opportunities to work together, particularly as ECAs now look to dedicate a significant amount of their resources to foster domestic energy transition and infrastructure.

Collateral replacement solutions to enhance liquidity

It's 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, Vincent Moy, International Surety Leader at Marsh JLT Specialty sat down with Carrick Bligh, US Bank & Commercial Surety at Marsh JLT Specialty and Robert Ling, UK Surety Leader at Marsh JLT Specialty.

Surety is the insurance sector equivalent of a bank guarantee. Surety is not insurance and is in fact a contract of guarantee. A surety provider has recourse rights to the principal so the risk to the insurance provider is the insolvency or the inability to get reimbursement from the principal in the event of a claim. Surety can help generate additional liquidity for banks and corporates and the market overall. It plays an important role with capital relief and preserving valuable liquidity resources. Surety bonds account for approximately US$14 billion in premiums each year.

There has recently been an uptick in the energy transition space and this is an area where the surety product is now being used more intensely. Surety bonds can also play an important role in filling the deficit in corporate pension funds.

The advantages to a corporate treasurer who may be considering using surety is the ability to tap into the enormous credit capacity in the surety market and diversify credit providers as a whole. Surety bonds also sit off-balance sheet and do not count as debt.

While surety providers are direct competitors to banks, they also work in partnership with banks by helping them shift bank guarantee exposure into the surety market. Banks can achieve regulatory capital and limit relief, and by distributing risk to highly rated surety providers they can do more business with their customers.

Scalable distribution using portfolio structures

Unfunded risk transfer on single name exposures to private market insurers is a well-established distribution strategy for financial institutions and increasingly we see a marked trend towards the transfer of portfolio structures that bring scalable value. To further explore this dynamic, Sébastien Heurteux, Deputy Head of Portfolio Management Solutions at BNP Paribas, joined Marcus Miller, Managing Director & Global Lenders Solutions Group Leader and Oscar Holloway, Senior Vice President, Portfolio Solutions from Marsh JLT Specialty.

Ever evolving regulation continues to put pressure on financial institutions' balance sheets and drives the agenda around capital and credit risk management, asset distribution and wider portfolio management strategies. A key difference in portfolio risk transfer to both funded and unfunded investors is the risk assessment. This measure is not applied to a single obligor's balance sheet but against the characteristics of a combined credit pool – key reference points include expected loss, actual loss and commensurate risk weightings.

These transactions are regulatory driven and follow strict modelling, structuring and risk transfer requirements collectively known as Significant Risk Transfer (SRT) where the ultimate determination of SRT satisfaction for each transaction sits with the appropriate regulatory authority. Consequently, the assessment of portfolio risk and SRT requirements introduces a specialist skill set across brokers, financial institutions and specialist insurance companies.

All stakeholders welcome this new diversity of investor base through competitive unfunded insurance and reinsurance capacity, which complements existing funding partners and importantly has application across a financial institution's wider portfolio of assets classes (such as consumer finance). Portfolio risk transfer enhances distribution costs, operational efficiencies, provides exponential and scalable RWA value versus single names, and positively aligns to effective capital management and distribution strategies for financial institutions.

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

When polling the audience on their comfort level investing in infrastructure projects in emerging markets, just 20% of respondents stated they had a high level of comfort. Additionally, when asked if they are currently using political risk insurance to protect their infrastructure investments in emerging markets, just 18% of the audience stated they were using it for all of their investments. To weigh up the significance of these results, Julie Martin, US Political Risk & Structured Credit Practice at Marsh JLT Specialty spoke with Neil Duchesne, Global Non-Bank Financial Institutions Leader at Marsh JLT Specialty and Justin DeAngelis, Partner at Denham Capital.

One source estimates 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. While there has been an increasing level of comfort with investing in emerging markets over the last few years, there is likely to be a growing push for sustainable projects in developed markets which will compete for this capital with emerging markets.

Key criteria for making a positive investment decision include being a low cost provider of power or other service, respect for the rule of law and contract integrity in the host country, and a partnership with and mobilization of public agencies as lenders or providers of political risk insurance as a risk mitigant. Currency is also a key factor and if the underlying contract cannot be denominated in

USD, the local currency payments should be indexed to dollars or other reference currency. To reduce risk, a project's goal should be to provide a good resource to the host country and not be linked to one government party or another as well as be a good corporate citizen with respect to the environment, social aspects of the project and governance. These elements associated with strong infrastructure projects can help create country stability and assist in moving the country forward.

Political Risk Insurance has been used by both small start-up investment funds as well as the large sophisticated funds to mitigate the risk of investing in emerging markets such as expropriation, contract frustration or inability to remit investment returns.

Some non-bank financial institutions use the availability of Political Risk Insurance as a threshold question to determine whether to consider an opportunity, and others use coverage placement as a positive factor in achieving potential hurdle rates.

About Marsh JLT 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 JLT 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.