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CREDIT AND POLITICAL RISK: RELEVANCE AND RIGOR

Dan Osman, Senior Credit and Political Risk Underwriter at Aspen Insurance, discusses the recent focus on credit risk mitigation which has already encouraged a more proactive stance from the Credit and Political Risk Insurance (CPRI) industry. In particular, he believes that greater data provision, as well as collaboration and dialogue, will highlight the relevance and strengths of the CPRI product.

The role of regulation

The Financial Crisis Inquiry Commission concluded that "widespread failures in financial regulation and supervision" proved devastating to the stability of the nation's financial markets.[1] Indeed, much has since been achieved in order to strengthen the global financial regulatory system following the financial crisis of 2007/08. In the UK, the Financial Services Act 2012 enacted a number of important changes, including the creation of a subsidiary of the Bank of England, the Prudential Regulation Authority (PRA), to act as prudential regulator.

Consultation

Bank balance sheets have been significantly strengthened and supervision to ensure their resilience is ongoing. As part of this process, the PRA published a consultation paper in February 2018 (CP6/18) to clarify expectations regarding the eligibility of guarantees as unfunded credit protection. Credit risk associated with an exposure can be reduced through credit risk mitigation, which may also impact the capital requirements calculation. The paper highlighted four key criteria relating to eligibility of the guarantee:

- Legally effective and enforceable;
- Clearly defined and incontrovertible;
- Paid in a timely manner without any clauses outside of the lender's control; and
- Cover all types of payments of the obligor or reflect any more limited coverage in the price.

In essence, the consultation paper sought to underline the difference in risk mitigation from a guarantor and an insurer. While the guarantor offers an unconditional and irrevocable guarantee, the insurer offers a conditional product.

Through the collaborative efforts of insurers and brokers, the insurance industry was able to produce a strong and timely response to the PRA's consultation submission deadline of May 2018. Furthermore, it has created a drive for data collection to gather information on premiums written, types and sizes of exposure, and claims data, which sets the foundation for a

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more robust framework and structure for the credit insurance market. Traditionally, the sector had communicated through the London Market Association and/or the International Underwriting Association and/or the International Credit and Surety Association. It, therefore, acknowledged the need to form its own body to foster greater collaboration and dialogue and this is currently in train. Moreover, insurers have now been welcomed to have a closer dialogue with the banks through the International Association of Credit Portfolio Managers.

A promise to pay

The global financial crisis highlighted the consequences of when a risk mitigation product was not specific to the asset. When the risk mitigation is non-specific, it introduces basis risk – for example, differences in tenors, repayment profiles and security. As a result, the regulators have introduced capital charges and/or reductions in the capital relief that can be applied.

The CPRI product is a tailored risk mitigant that has been shaped to comply with banking regulation and provides cover directly referenced to the asset. A further benefit to banks of the CPRI product is the reduced correlation of insurers (generally diversified property/casualty insurance companies) to the economy and economic cycle. As evidenced in 2007/8, failures among correlated providers of credit protection can have a significant impact on bank balance sheets (e.g. Lehman Brothers).

The very nature of (re)insurance is unfunded since it is a promise to indemnify the insured in the event of a future potential loss. The capital charges applied internally for (re) insurance reflect the unfunded nature of the business and are, therefore, lower than would otherwise be the case. As a consequence, this benefit has been reflected in the competitive pricing of the product. The insurance industry is committed to supporting the banking industry with strong and relevant products but should not lose sight of what the product is – namely, a promise to indemnify.

Fit for purpose

In terms of the four key criteria raised by the PRA consultation paper, much interest has centred on incontrovertibility and timeliness of payment.

Credit insurance policies normally contain nuclear, chemical, biological and radiological (NCBR) exclusions. Such exclusions enable both insurance and reinsurance capacity to be maximised and any removal of such from policies would alter risk aggregations and thus appetite given the geographical concentration of such risk. In essence, it is similar to the force majeure clause used by the loan markets and banks to manage exposure aggregations and significant events.

While the benefits and justification of these exclusions may be apparent, the amount of capacity for policies without these exclusions has increased. This in turn raises questions as to whether this new capacity will be finite or whether further progress can be made. Much depends on the continuing risk appetite of the insurers and their ability to accommodate such business. An alternative solution would be to look at other sources of capital and exploratory discussions with third-party capital providers have taken place. Whatever the outcome, the issue of cost is likely to be a larger element in the equation.

The payment of credit risk mitigation products “in a timely manner” has prompted much discussion. Insurers can work with long payment periods from notification of the loss through verification by a loss adjuster to payment after validation resulting in a period that can be 90 or 180 days. There are various schools of thought concerning formalisation of the period. Some regulators have specified a 90-day waiting period and it has been suggested that a 30-day payment period could also be specified in policies. However, such a prescriptive approach has been questioned on the grounds that “one size does not fit all.” An extended period affords flexibility and facilitates negotiation of a restructuring, which could be more favourable for all parties, rather than providing a level of incentive for a (premature) determination of a loss. The economics of a 30-day trade finance instrument are very different from that of a 15-year term loan and it should be remembered that the insurance product is aimed at indemnification and not acceleration.

The PRA has yet to publish its response following the feedback as part of the consultation paper, but it is hoped that clarification within the market should help both demand and supply and encourage growth in the industry. Indeed, greater certainty and recognition should lead to greater formalisation and standardisation of the product’s construct, as well as clarity over its use as a credit risk mitigant. A commitment to improve data and technology should help create a more efficient and transparent market.

Nevertheless, the market must not lose sight of the fact that credit insurance is an indemnity product. It is a promise to pay the insured for an incurred loss. As such, certain conditions, like the behaviour of the insured and its adherence to fit and proper processes is fundamental to its construct – as is the unfunded nature of the product. To change this underlying principal would alter the dynamics of the CPRI product and, importantly, its cost. This latter point is particularly relevant to the next chapter in the CPRI’s history. If the PRA consultation has centred around eligibility, then “Basel IV” focuses on efficiency. The CPRI industry should continue to champion the benefits of unfunded credit protection ahead of the proposed reforms slated for implementation in January 2022 and beyond.

[1] The Financial Crisis Inquiry Report, Financial Crisis Inquiry Commission, February 2011