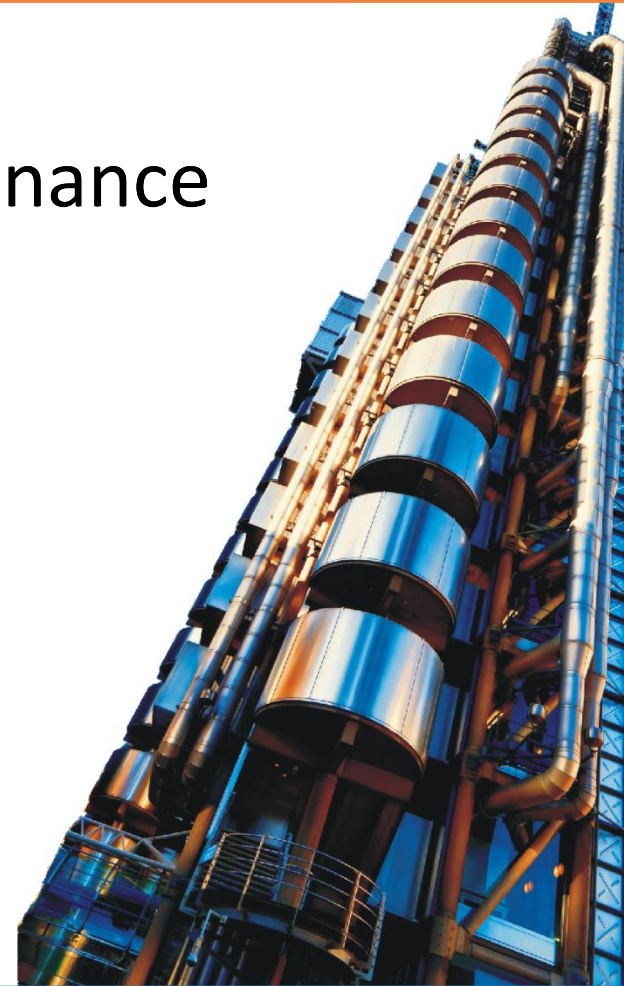
Gallagher London



Commodities Trade & Export Finance under Basel III

Political and Credit Risk Insurance

BASEL III ACCORD – or discord?

London, 30 March 2011

Geneva, 16 March, 2011

About Us

- Founded in 1927, World's 4th largest insurance broker
- Revenues 2010: USD 1.8 billion
- 10,000 + employees worldwide, 600 in London
- Offices also with Political risk and Trade Credit insurance capability in New York, Sydney, Singapore and Sao Paulo
- London represents the centre for credit and political risk insurance worldwide

Overview of Presentation

- Basel II
- Where are we ?
- Basel III
- Solvency II

Basel II – Key Requirements

Product already compliant

- Must have a claim specifically linked to an exposure or pool of exposures
- Must be irrevocable
- Cost of cover cannot be amended

Areas of contention

- Conditionality – Any conditionality must be within the direct control of the bank
- Residual Risks – Are permitted but the bank must be able to demonstrate that such risks have been identified and are controlled

Basel II - Conditionality

What changes had to be made?

- Five Powers
- Currency Fluctuations
- Third Party Insolvency
- Disputes?
- RACE?

Waiting Periods

- 180 days versus 90 days

Basel II – Residual Risks

- Identify individuals within the bank responsible for the operation of the policy
- Conduct a review to ensure that operationally speaking the bank can comply with the terms of the policy. The lawyers may accept the language of the policy but the bank must be able to meet the requirements.
- Ensure that insured transactions are clearly identified to the relevant parties within the bank.
- Seek a policy which sets out a clear timetable for information to be submitted and responded to during the waiting period. Avoid unnecessary delays.

Basel II – Business Impact

What has been the result so far?

- Extended client base (more banks buying the product).
- Broader number of structures being shown to the private market.
- Increased volume of business? (Timing of the Global Financial Crisis, GFC).
- Emerging from the GFC.

Insurance as a Credit Risk Mitigant under Basel II

- Insurance is an acceptable "guarantee", subject to meeting the operational requirements (FAQ, No6, Basel Committee, BIS Website, October 2002)
- Comprehensive "Failure to Pay" insurance can have benefits under all 3 ratings approaches but Political Risk ONLY can only benefit those on Advanced
- ".....it is possible that banks employ robust procedures and processes to control [residual] risks (November 2005 Revised Framework, Para 115 re Overarching issues of CRM)

Insurance Policies and Qualifying as a Credit Risk Mitigant

- Must have legal certainty –Paras 117 and 118 –Not an issue
- Must represent a direct claim and must be explicitly referenced to specific exposures or a pool of exposures (Para 189) –Not an issue
- Para 189 does not require that ALL transaction payments are covered (e.g. penalty interest) and Para 190 explicitly allows for uncovered obligations

Insurance Policies and Qualifying as a Credit Risk Mitigant

- Must be irrevocable – not an issue
- Cost of cover cannot be amended – not an issue
- Must be unconditional – any conditionality must be in the direct control of the bank – 5 Great Powers and RACE
- Material non-disclosure issue which makes a policy also conditional. Who needs to know what and how much control is reasonable?

Insurance Policies and Qualifying as a Credit Risk Mitigant

- Waiting Periods: Para 190 refers to banks being able to pursue guarantors in a timely manner and it specifies the bank must have a right to receive payments without first having to take legal action –neither is an issue.
- N.B. Residual risks are permitted but the Bank must demonstrate it has identified these and can control them

Post-crisis in the private insurance market

- Still recovering from Global Financial Crisis
- Political Risk and Trade Credit insurance products have proven themselves very strongly; reinsurance proved effective and resilient
- Mono-line trade credit insurers paid claims without the need for government intervention
- New entrants – primary insurers and reinsurers (influx of capital)

Post-crisis in the trade credit insurance market

- Trade credit insurance market becoming more diversified
- Single name credit insurance – now 20 - 30 players
- Multi-buyer credit insurance – expanding, was previously limited to three
  - Euler-Hermes
  - Coface
  - Atradius
- Range of credit insurance is broadening – positive influence by newcomers from outside the traditional multi-buyer market
- Survived worst storm since the 1930's – Solvency II will assist stability

Observations of private market insurers

- focus on comprehensive product for Basel III
- demand for trade finance business insuring sovereign obligors, sub-sovereigns & state oil companies
- pricing ratio becoming an issue due to increased cost of funds
- Basel II resulted in a significant increase in demand from banks
- will Basel III lead to a less level playing field?

Regulatory changes

- Lloyd's – new regulation for trade credit insurance: there must be a tie to a specific contract or security against assigned receivables or assets
- Basel II – much of framework WILL remain in place
- Basel III – negative impact on trade finance
- Solvency II – introduction of risk weighted capital for insurers

Basel III – Key Concerns

- No allowance for risk mitigation
- No distinction between asset quality and underlying pledges
- Increased cost of capital will make trade finance unattractive due to lower rates of return
- Trend towards all liquid assets – banks will invest in T-bonds due to better return on equity
- Increased cost of funds for trade finance

Basel III – Key Concerns

- Leverage Ratio: approach is too general, does not recognise low risk assets;
- Trade finance instruments will count for 100% credit conversion factor (was 20%).
- Liquidity ratio: Highly liquid assets are too narrowly defined
- Net Stable Funding ratio: banks will need to hold sufficient liquidity to cover all requirements for 30 days, assuming all lines of credit withdrawn AND depositors withdraw all cash AND no new deposits are made.

Basel III – Key Concerns

- Asset value correlation (AVC) multiplier for large financial institutions such as insurance companies revised to 1.25 (point 2 p.39 A global regulatory framework…)
- Rights under an insurance policy will not qualify as high quality liquid assets (p.5 International framework for liquidity risk measurement…..)
- Insurance represents a risk on another financial institution so does not qualify to provide inflow (p.24 Int'l framework for liquidity risk measurement…..))
- Not taken into account as "stable funding" for NSF as no immediate funding upon default. Apply low RSF factor- discuss with Regulator? (p.25 Int'l framework for liquidity risk measurement…..)

Basel III – Unintended Consequences

- Banks will not lend for long tenors due to costly match funding
- Developing markets will be considered too risky
- SMEs will suffer as banks prefer highly rated corporates
- Banks will switch to high risk business to gain higher returns on scarce capital
- To meet NSF ratio banks will be inclined to hold T-bonds rather than lend
- Application of leverage ratio does NOT recognise value of ECA guarantees

Solvency II

- Rules approved in year 2008 : an EU initiative to be adopted elsewhere
- Implementation due 1/1/2013 for FY 2013
- Will change the capitalisation of a lot of insurance companies in Europe
- Larger companies tend to be quite well capitalised, smaller ones less so
- Regulatory capital surplus is an important buffer
- Details of final regulations yet to be determined
- Difficult to make long term decisions without knowing what the best strategies will turn out to be

Solvency II = an M & A Bonanza?

- Much consolidation of smaller companies, some will fare better than others
- Good news for the rating agencies – at last a risk weighted requirement for the amount of capital required, with increased emphasis on risk and capital management
- Will put more pressure on technical pricing with focus on data quality
- Capitalisation will be impacted as will underwriting strategy

Solvency II - and the good news?

- Will result in exit of some insurers from certain lines of insurance, BUT
- Political Risks and Export Credit Insurance create diversification benefits as they represent non-correlating lines of business

Solvency II – the regulator's answer to Basel III?

- Structured trade credit thrives in the regulatory arbitrage between the banking regulations and insurance regulations
- Solvency II (like Basel III for banks) is addressing the appropriate capital requirements to meet solvency, BUT INSURERS NEED LESS LIQUIDITY BECAUSE
- Insurers have developed sophisticated models to show that they are capital efficient, and in addition
- Insurers benefit from portfolio diversity (avoiding systemic failure) and specific and umbrella reinsurance

And how can insurers stay ahead ?

- being imaginative by offering :
  - more tailored products to appeal to more sophisticated buyer who wants to work with an intelligent informed insurer
  - innovative products – even if just more tailored wordings
  - consider offering funded products ?
- accept 70 - 85% of net margin (not gross)
- widen scope to accept non-trade deals

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…..”not only do emerging markets remain exposed to political risk – but investors now live in a world that is increasingly unpredictable in both an economic and political sense”……..

Financial Times, 28 January, 2011