# CREDIT INSURANCE

# INTRODUCTION, OVERVIEW AND APPLICATION TO STRUCTURED FINANCE

# Session Aims

- Introduce and give a general overview of the credit insurance market
- Dispel common misconceptions around credit insurance
- Increase awareness of insurance as a tool for originators and risk takers

# What is Credit Insurance

An **indemnity** provided by an insurance company to an insured to pay **loss** in respect of a financial obligation **in which the insured has an interest** on the occurrence of a specified event – usually any failure to pay principal or interest

# Basic Anatomy of an Insurance Policy

1) **Parties and definitions:** defines key terms such as loss to be covered
2) **Insuring clause:** key operative provision indemnifying insured
3) **Limit of liability:** states maximum limit of liability
4) **Insured percentage:** specifies percentage of loss covered in relation to the insured exposure
5) **Representations and warranties:** given by insured about risk covered
6) **Claims provision:** describes how loss can be claimed under the policy and procedures to be followed by insured in the event of a claim
7) **Claims payment provision:** describes to whom and how and when loss is paid
8) **Exclusions and limitations:** set out items excluded from cover – may be more less restricted depending on context
9) **Boilerplate:** governing law, subrogation rights, waivers by the insurer etc.

# Credit Insurance Market

**Size of market:** in excess of **USD 2.7 trillion**[1] of financial risks estimated to be currently insured (c.f. $9.4 trillion[2] of CDS contracts outstanding)

**Capacity:**

- For a given **trade-related** financial risk, potential pool of $3 billion[3] of cover
- For a given **non-trade related** financial risk, potential pool of $1.5 billion[3] of cover available

**Buyers of Credit Insurance:**

- Investment and commercial banks
- Development banks
- Asset managers (including private equity and hedge funds)
- Interdealer brokers and financial intermediaries
- Commodity producers and traders

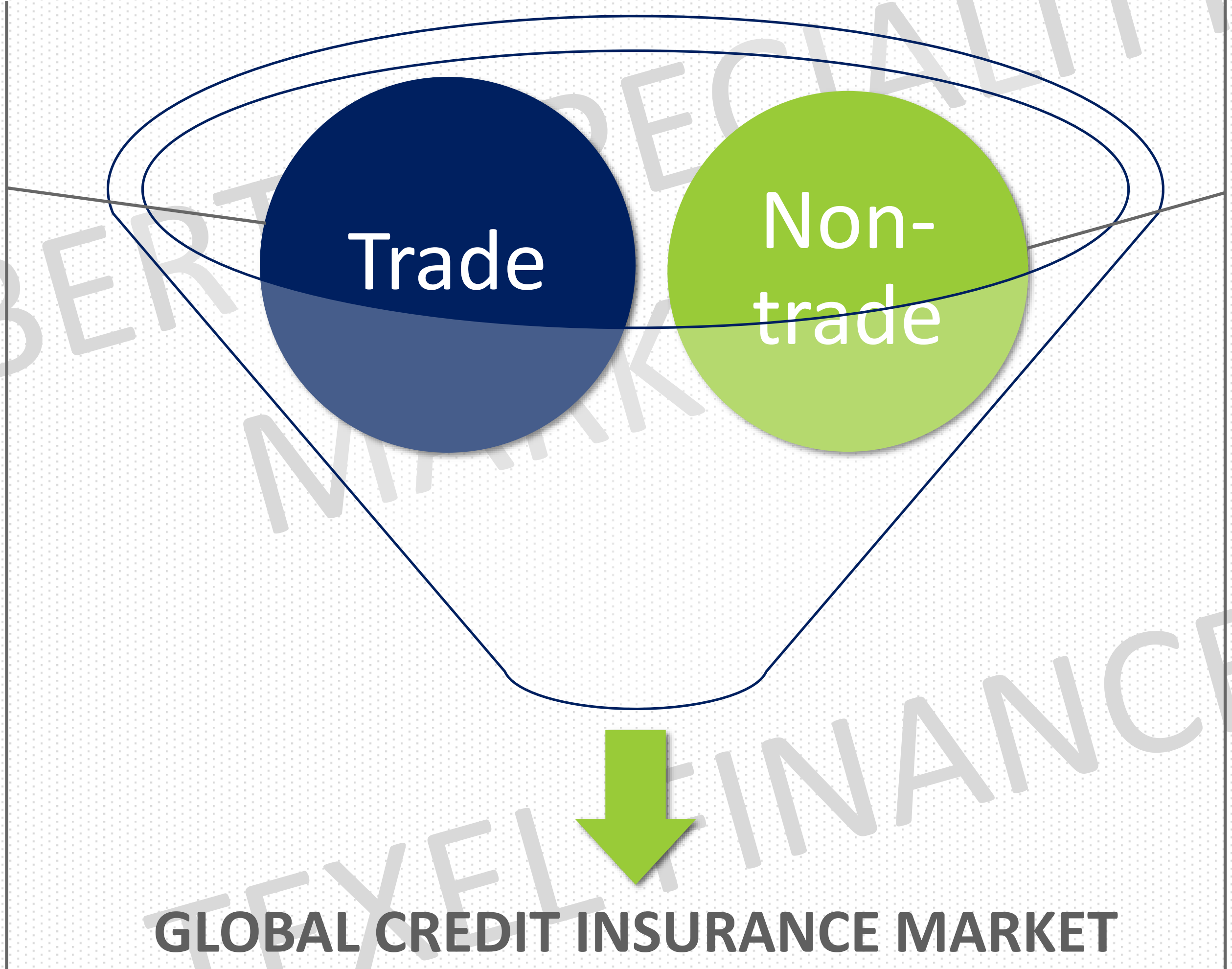
Affect pricing, terms and structure of cover

**Reasons for buying:**

- regulatory capital efficiencies (CRR/RWA, Solvency II, NAIC)
- syndication of risk and/or funding
- exposure limit management
- cost of funding balance sheet support

# Risks Covered

- Pre-export finance
- Whole turnover credit
- Prepayment financing
- Receivables financing
- Revolving credit facilities
- Structured commodity finance
- Letters of credit
- Silent Payment Guarantees
- Borrowing base lending
- Weather derivatives
- Reserve based lending




- General corporate lending
- Specialist lending:
  - Real estate
  - SME
  - Project Financing
  - Infrastructure
- Interest, currency and commodity swaps
- Securities financing
- Bond programs
- Securitisations and repacks
- Synthetic risk transfer
- Non-core assets
- Residual value and lease financing
- Margin lending
- CLOs
- Private equity leverage

# History and Origins of the Credit Insurance Market

1500s England: risk participation arrangements between private individuals and merchant shipowners

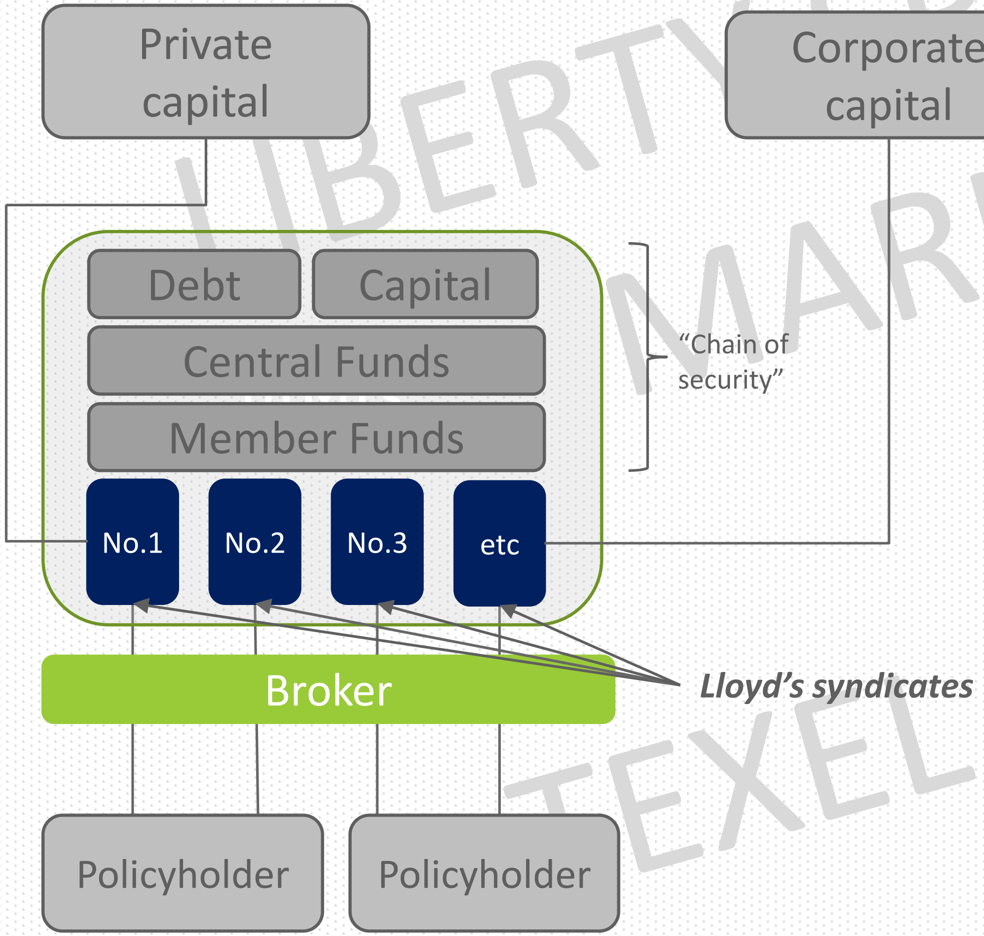
1600s: Lloyds of London ("Lloyds")

Companies Act 1862: Insurance Companies ("Company Market")

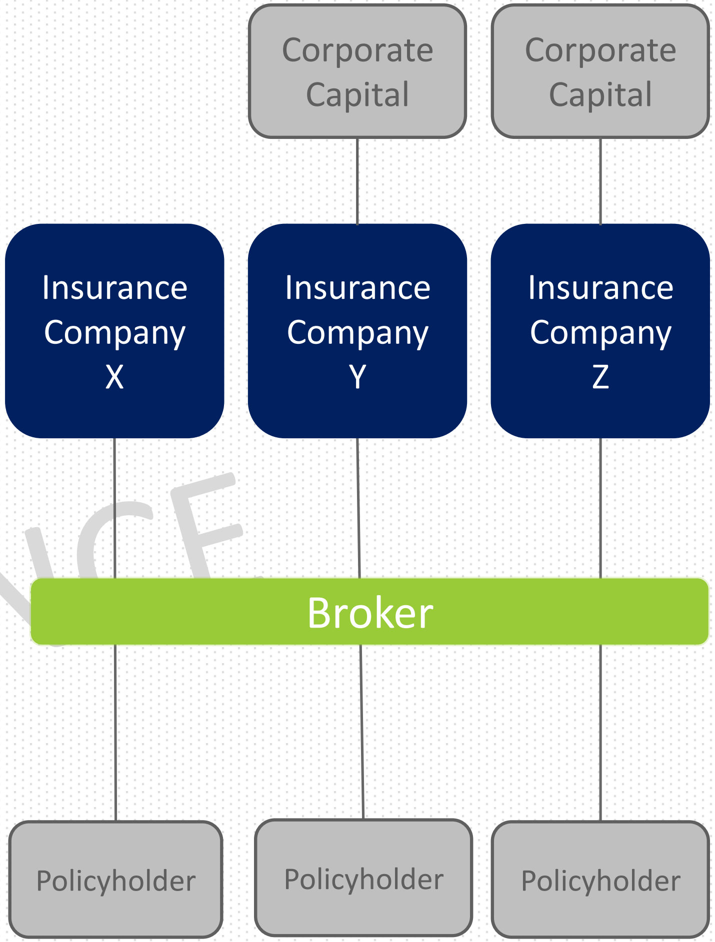
Shipping and cargo insurance → Export credit insurance → Trade finance insurance → General Credit Insurance

# Lloyds Market and Company Market

## Lloyds Market




## Company Market



# Structure of Insurance Market: Lloyds and Company

## Lloyd's Market

- 95 Syndicates
- Rated A+
- Territories:
  - Licensed in over 70 countries
- Capacity: Insurers lines range from $20m to over $100m
- Substantially reformed in 1990s following asbestosis claims
- Subject to law and Lloyd's bye-laws:
  - Trade finance focused
  - FG restrictions on syndicates
    - Generally captures speculative financial risk
    - Limited to 2% of premium income
- Chain of security
- High volume business
- Wide risk syndication

## Company Market

- In excess of 35 major carriers worldwide
- Rated AA+ to A-
- Territories:
  - Typically smaller footprint than Lloyds
  - Sufficient for key client base
- Capacity: Insurers lines range from $20m to >$200m
- Subject to law, licensing requirements and individual company controls
- Flexibility, customisable solutions

# Misconceptions About Credit Insurance

1. Insurers don’t pay claims

2. An insurance policy is not as effective as a “guarantee”

3. The insurance market is inflexible

# Misconception 1:

***Insurers don't pay claims***

# Misconceptions About Credit Insurance



**Insurers don't pay claims**

- Survey recently conducted jointly by the Lloyd's Market Association and the International Underwriting Association found the following for the period from 2007 to 2017 [4]:

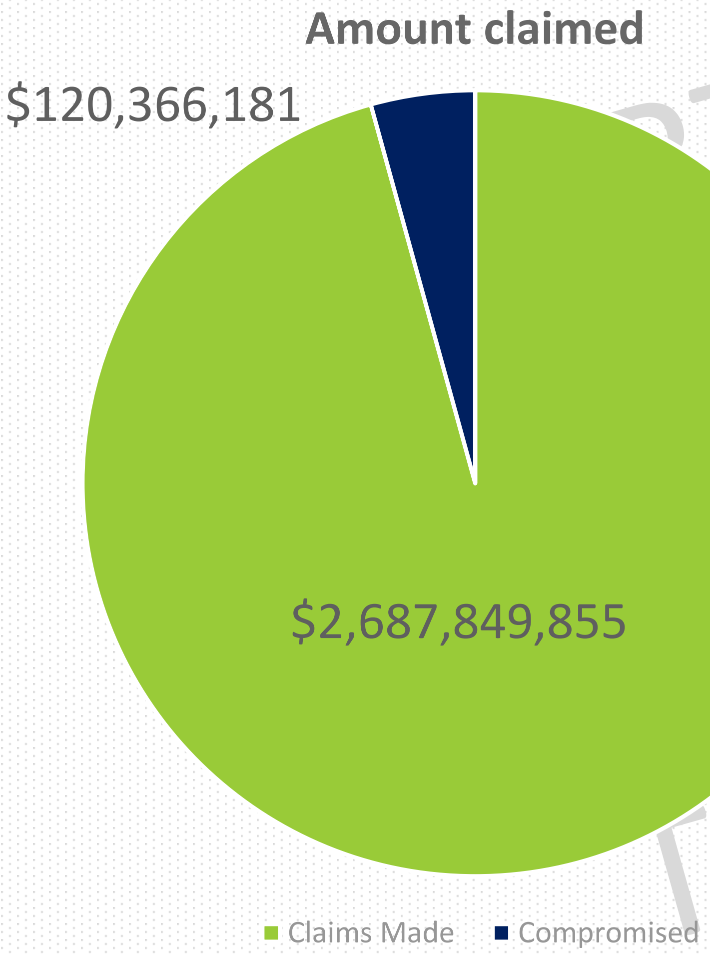
| | |
|---|---|
| **Total Amount Claimed:** | **USD 2,687,849,855** |
| Total Amount Paid: | USD 2,567,483,674 |
| Total Claims: | 436 |
| Compromised Claims: | 15 |

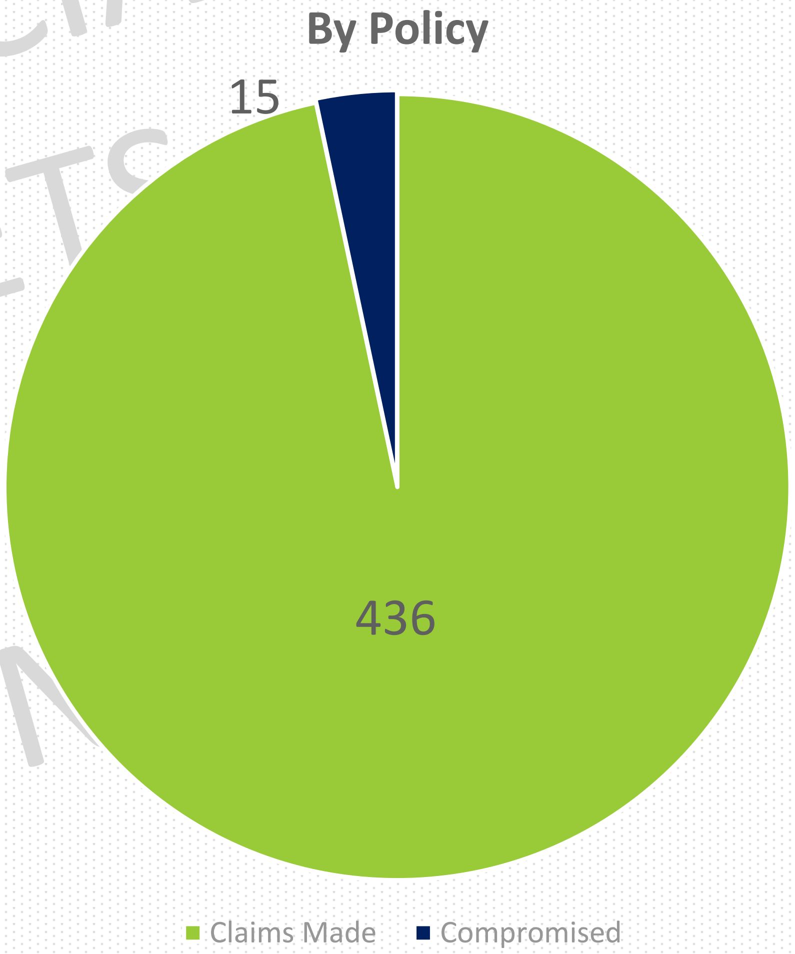
- The reason for every compromised claim not being paid in full was the non-fulfilment by the insured entity of an obligation or term under the policy within the control of the Insured

- Of the 15 compromised claims, 44% of the amount claimed was still paid to the insured

# Misconceptions About Credit Insurance

**Insurers don't pay claims**



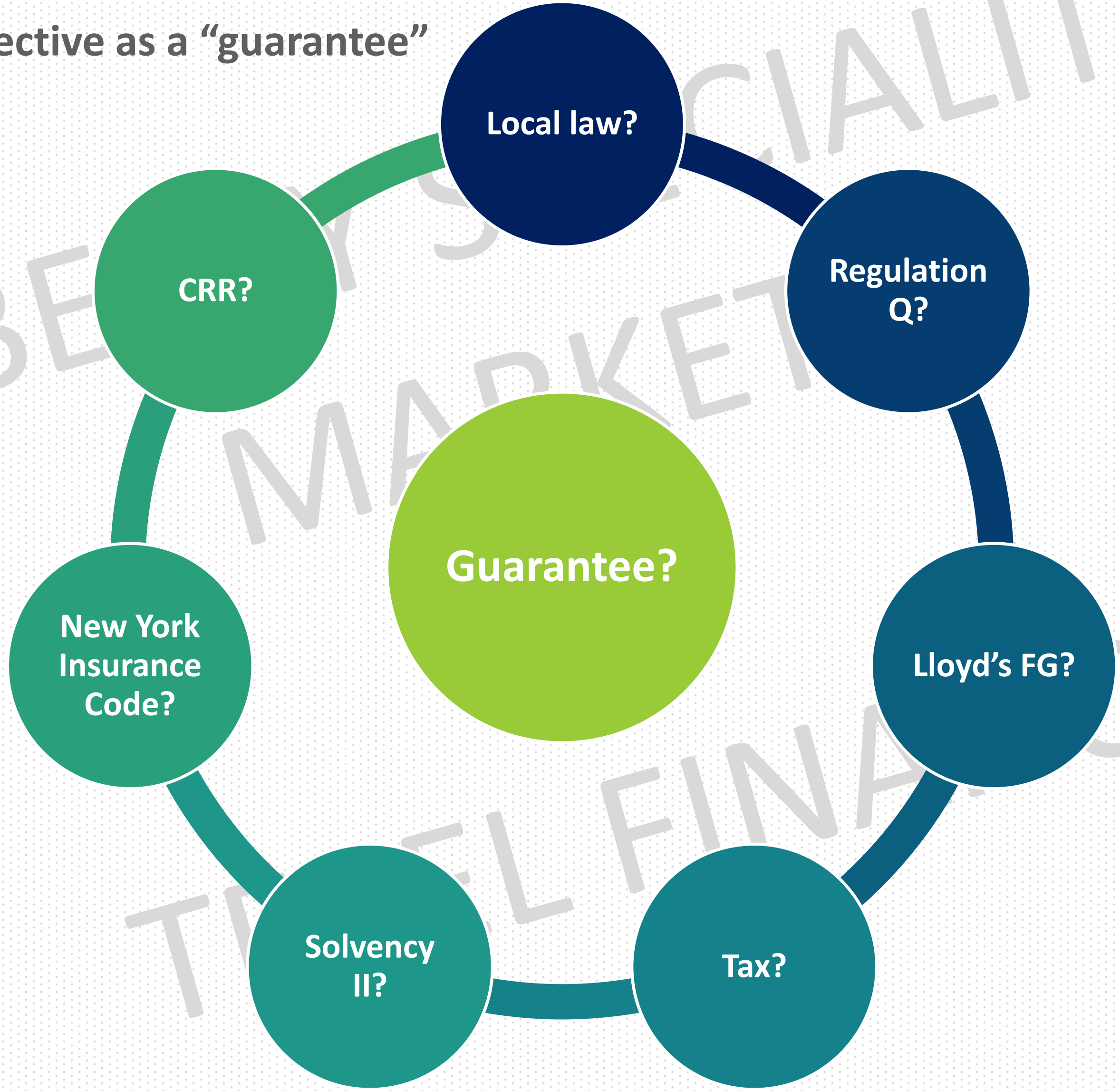



# Misconception 2:

***An insurance policy is not as effective as a "guarantee"***

# Misconceptions About Credit Insurance

**Insurance policy is not as effective as a "guarantee"**



# Misconceptions About Credit Insurance

**Insurance policy is not as effective as a “guarantee”**

- EBA Q&A 2014 768: EBA acknowledged credit insurance can qualify as a guarantee
- EBA Report on CRM Framework 19 March 2018: *“on the question of whether or not credit insurance can be used as a guarantee, where it effectively functions in an equivalent manner, the answer mainly revolves around the economic substance of the financial agreement…<u>the term ‘guarantee’ in the context of CRM under the CRR should be interpreted from a substantive or functional viewpoint rather than a legal one</u>…”*
- Primary distinction between insurance and guarantee for most practical purposes is need for “insurable interest”

# Misconceptions About Credit Insurance

Capital Requirements Regulation compliance

| Credit Risk Mitigation under CRR | Credit Insurance |
|---|---|
| • Provision by eligible protection provider? | ✓ |
| • Guarantee for purposes of CRR? | ✓ |

| Guarantee under CRR | Credit Insurance |
|---|---|
| • Direct? | ✓ |
| • Clearly defined and incontrovertible? | ✓ |
| • No clause outside the control of the insured which could result in: | |
| (i) unilateral cancellation | ✓ |
| (ii) Increased premiums | ✓ |
| (iii) prevent timely payment | ✓ |
| (iv) reduce tenor of protection | ✓ |
| • Legally effective and enforceable in all jurisdictions | ✓ |
| • Primary recourse to protection provider | ✓ |
| • Explicitly documented | ✓ |

# Misconception 3:

***The insurance market is inflexible***

# Misconceptions About Credit Insurance

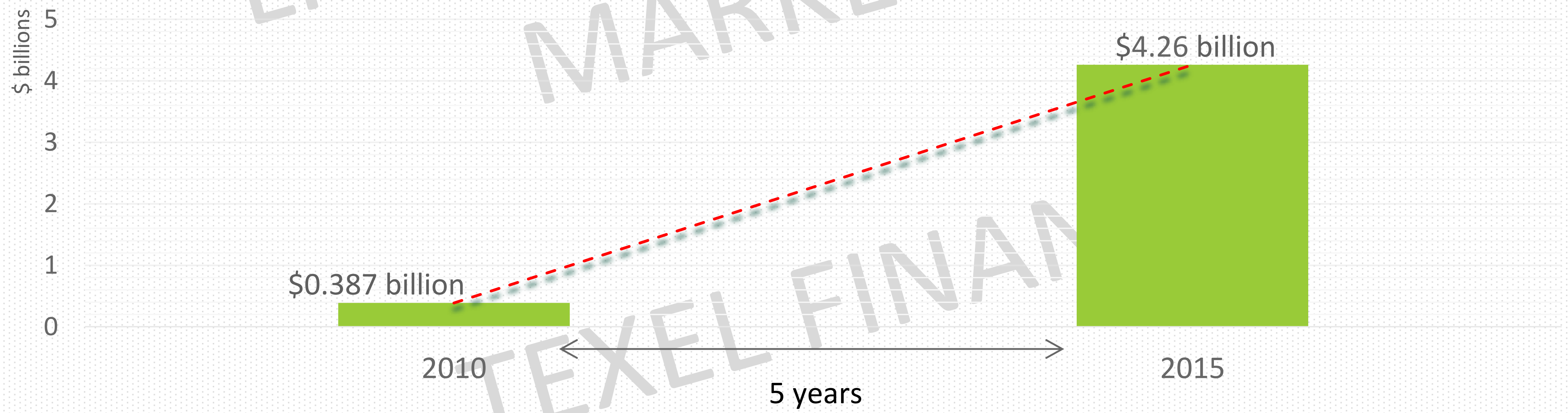
**The insurance market is inflexible**

***Freddie Mac Agency Credit Insurance Structure: limits placed*** [5]

# Misconceptions About Credit Insurance

**The insurance market is inflexible**

*Transactional Risk Insurance in North America: limits placed* [6]



# How to Buy Insurance

**Risks typically placed via a broker:**

- “Smell test” can advise on structure and compatibility with insurance market
- Draft and negotiate documents
- Build programmes of cover:
  - target markets
  - competitive/pricing tension
  - diversification
  - increased limits
- Project and execution risk management

**Direct approach possible:** depending on territory and market

# The Insurance Process

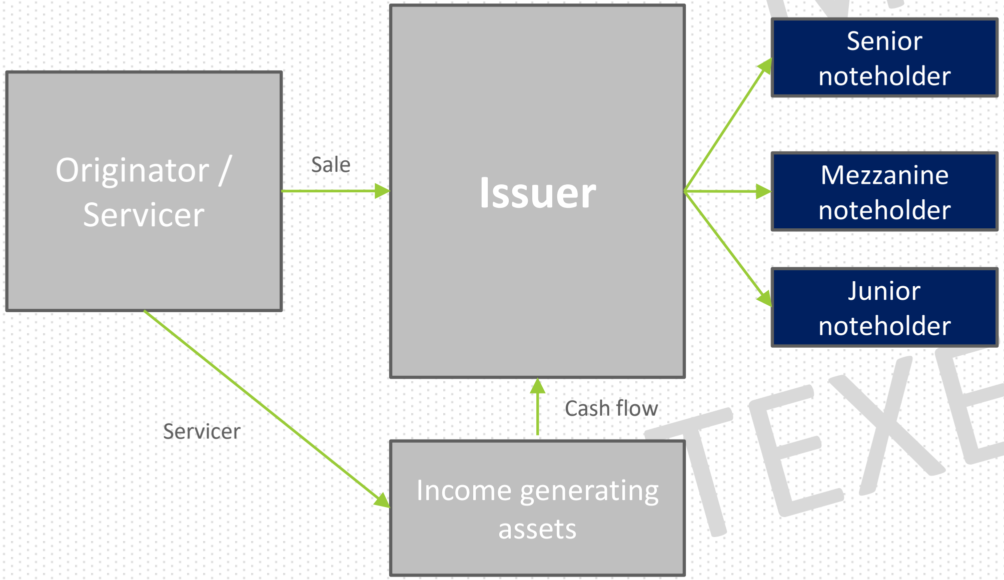
| | Bespoke Transactions | General Credit Insurance |
| --- | --- | --- |
| 1 Initial Enquiry | Come from either a broker or directly through relationship with bank. An enquiry will include overview of the portfolio and risk (i.e. asset class, jurisdiction, WAPD, WALGD). | Receive only from a broker. Information includes insured, obligor, jurisdiction, tenor, limit, bank margin. |
| 2 Preliminary Review | Short review of information provided to determine appetite - this will be determined by asset class, jurisdiction, nature of the bank etc. If there is appetite, a data tape will be requested and high level questions will be sent to the bank. | Insurer responds with initial feedback on pricing, line size and appetite within 48-72 hours. |
| 3 Credit Analysis | Detailed analysis of the sample portfolio will be undertaken, including actuarial support who will model different loss scenarios and support from specialist credit support function. | Insurer checks through financials and credit memos of the obligor to create a proxy internal credit rating. |
| 4 NBI | Having undertaken modelling, pricing and limit indication will be provided, often in the form of a ‘non-binding indication’ (NBI) (which also sets out other key commercial terms and sensitivities/assumptions to the indication). | Provide a formal NBI to the broker, normally subject to a few carve outs (i.e. further DD of structure/obligor). |
| 5 Detailed Underwriting | More detailed due diligence will be undertaken of the portfolio and the bank’s processes and procedures (e.g. origination, credit, stewardship, restructuring), culminating in a one or two day due diligence day at the bank in question. | More detailed diligence of the risk that would be followed by a call with the bank to ask any questions following the DD. |
| 6 Policy Wording | Negotiation of policy wording, the starting point for which will often be provided by the bank’s lawyers. | Insurers have agreed wordings already in place with their insureds so little to no wording negotiations take place. |
| 7 Inception | Policy wording is signed by insurer and insured.<br>Post-inception insurers will take a hands off approach. Only information on the portfolio (i.e. investor reports) and premiums will be provided to the insurer, typically quarterly. | Policy wording is signed by all insurers either by hand or through PPL (an electronic placing platform). |

# Securitisations

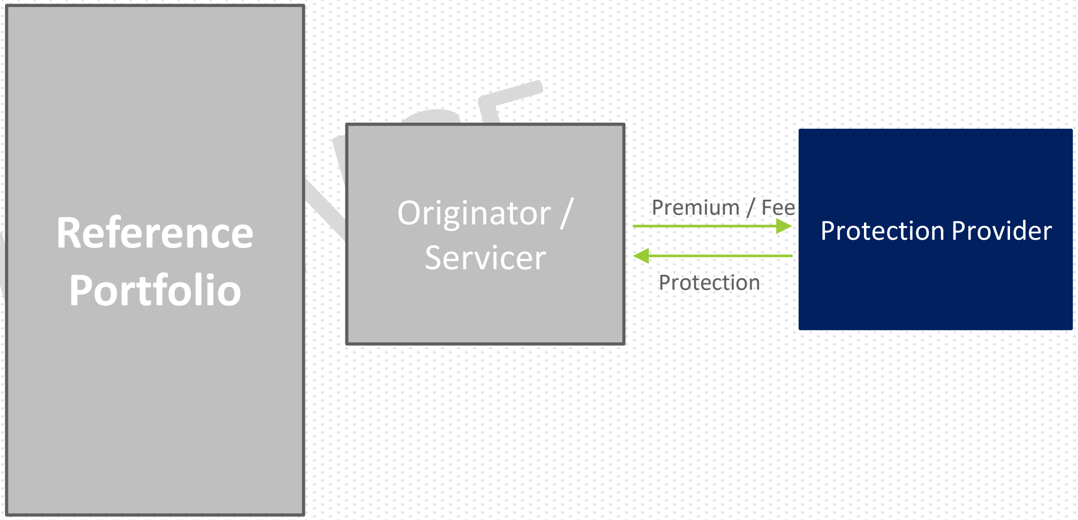
- **Securitisation** is a tool whereby an originating institution (for example a bank) packages up a portfolio of income generating assets (e.g. mortgages, trade finance receivables, vehicle leases) and (either it or a separate SPV) issues securities (typically notes), usually in different rated tranches, to third party investors, whose return on the securities is paid for from the cash flows generated by the assets

- Securitisation can either be done in a **traditional format** (where there is a 'true sale' of the assets to a bankruptcy remote SPV) or **synthetic format** (where the assets remain on the balance sheet of the originator) – former used more for funding and latter more for capital relief

**Traditional:**

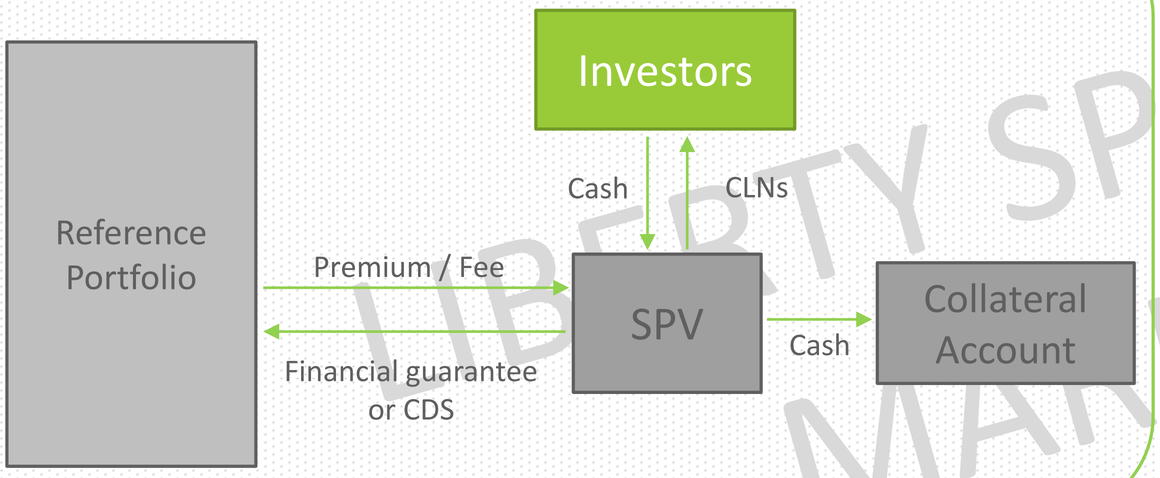



**Synthetic:**



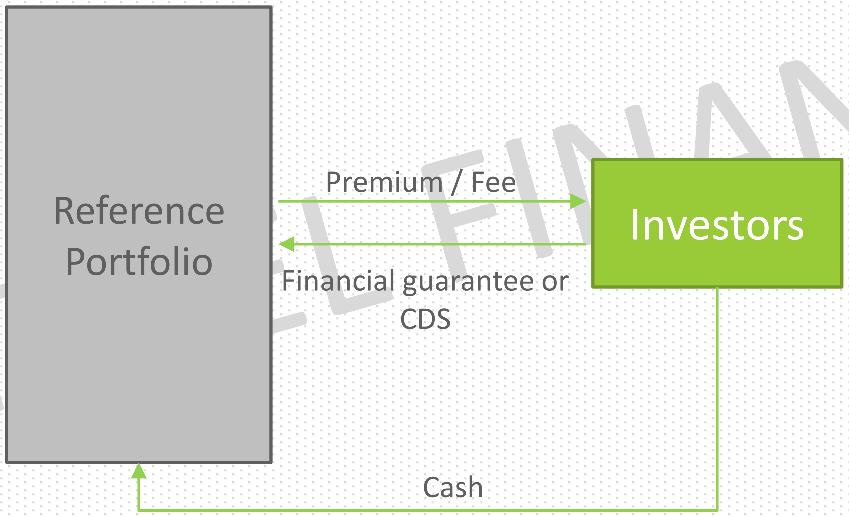
# Cash Funded Structures

## With SPV and Collateral Account:

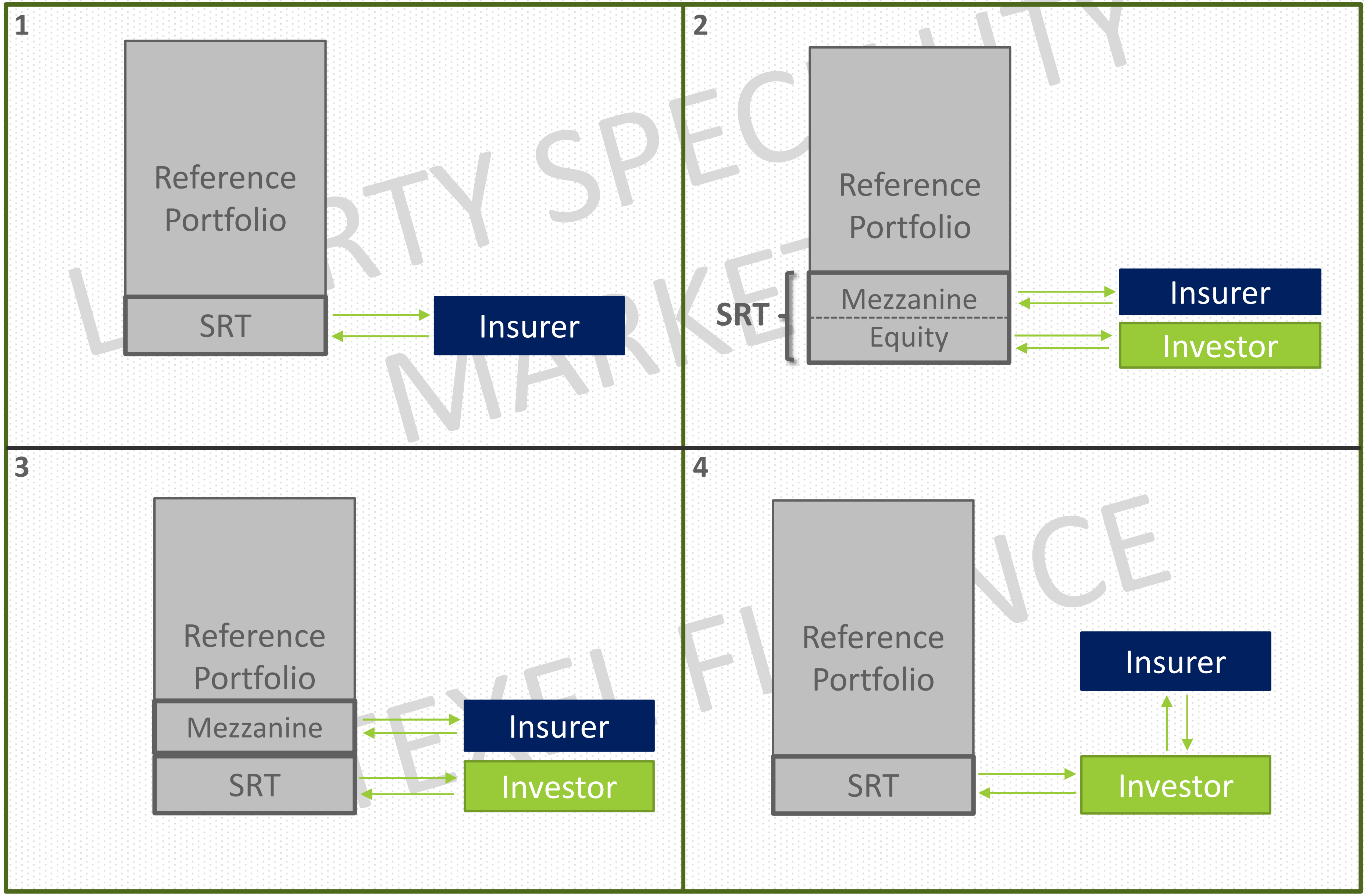



## Without SPV:


## Without Collateral Account:

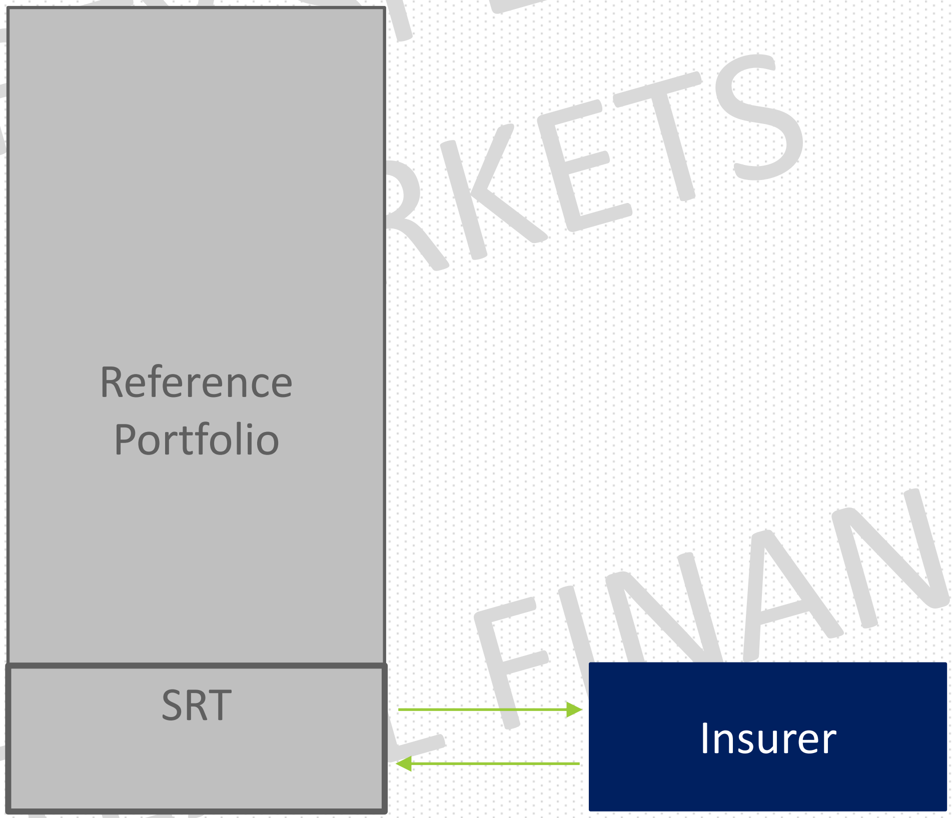


# Solutions Using Insurance



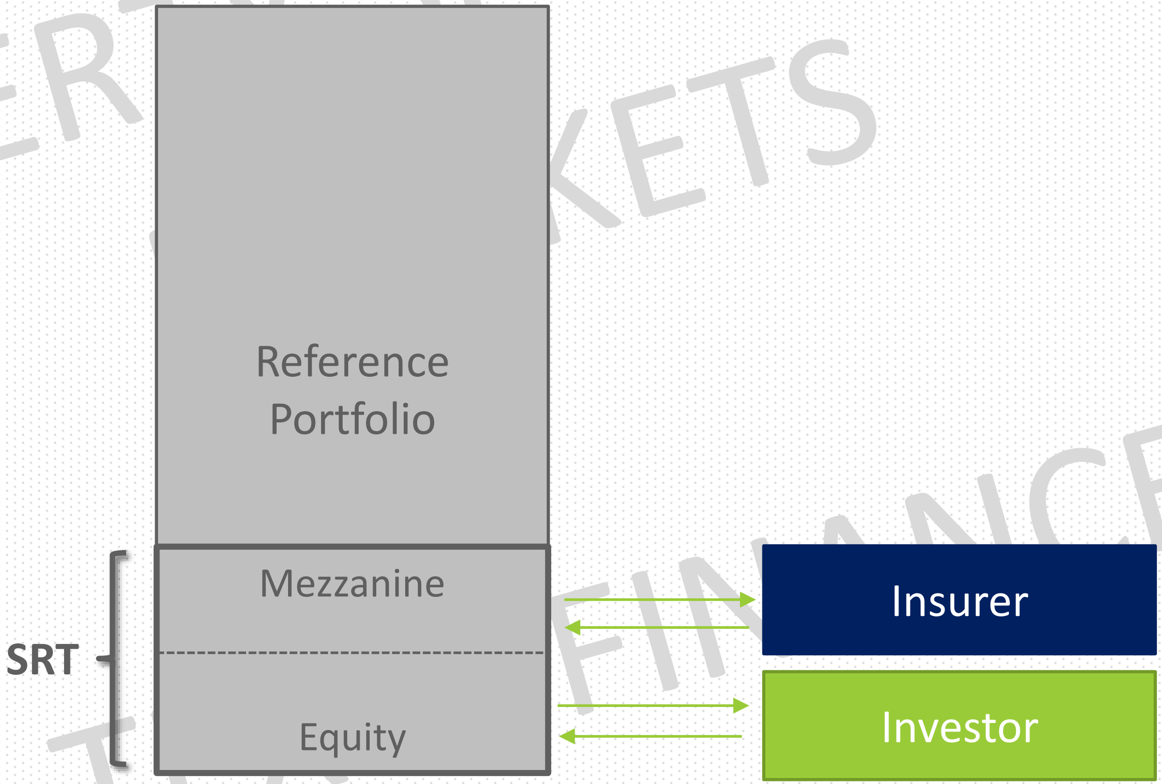
# Solutions Using Insurance

## 1. Using an Insurer Instead of a Funded Investor



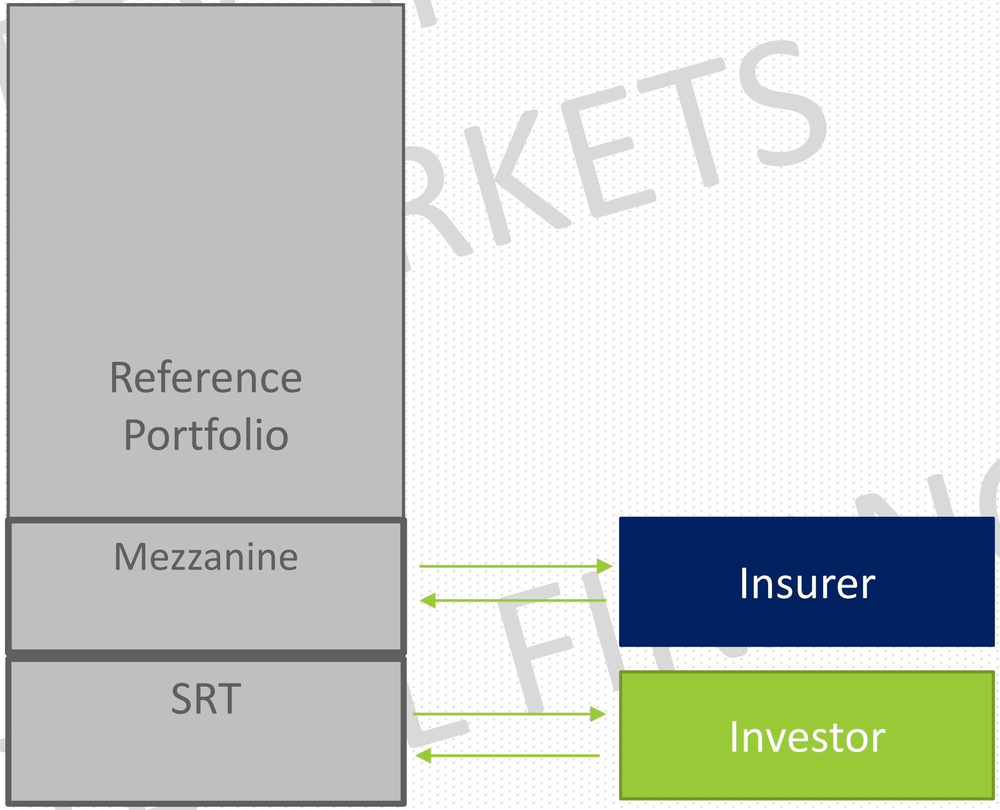
# Solutions Using Insurance

## 2. A Hybrid Option with an Insurer and Investor Working Together



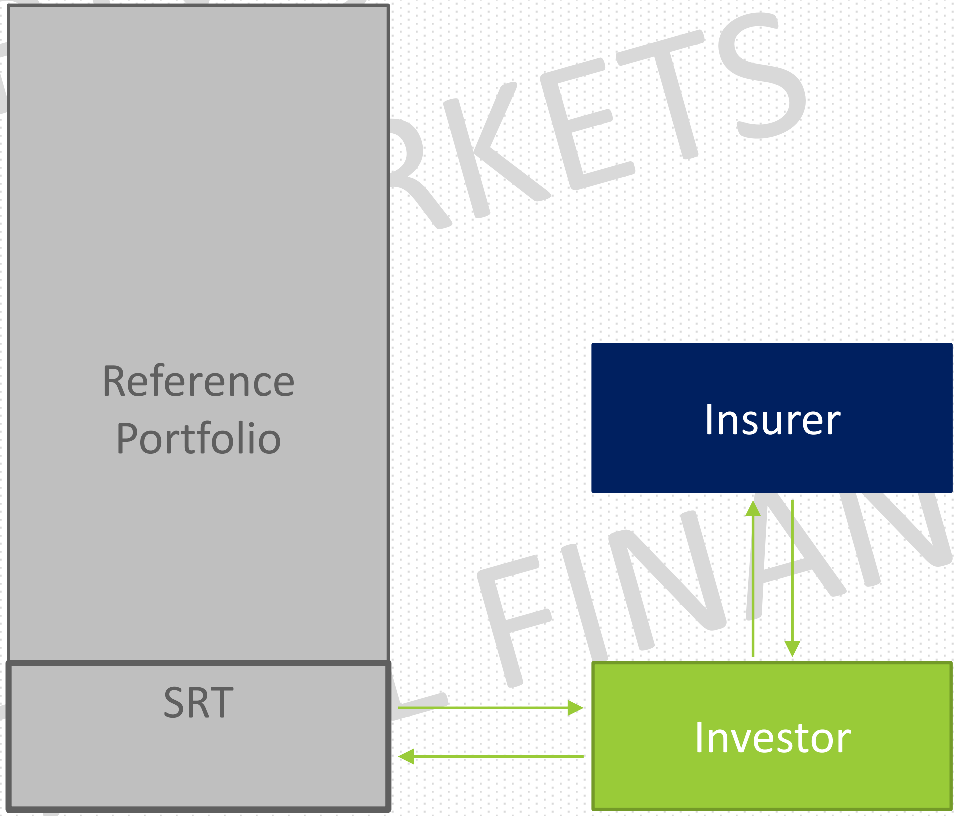
# Solutions Using Insurance

**3. A Hybrid Option with the Insurer and Investor Working Independently**



# Solutions Using Insurance

**4. Using Insurance as a way of Supporting the Investor**



# Key Considerations for Using Credit Insurance

- **Blind pools**
  - Depends on insurer and portfolio / granularity
  - Parallels to reinsurance
- **Loss notification and verification**
  - Verification agent vs. loss adjuster
  - Initial loss payment and final loss payment
- **Timely payment**
  - Insurers able to line-up funds quickly
  - Ground-up v mezzanine protection
  - cf. ‘waiting periods’ for wider credit insurance market
- **Insurance premium tax**
  - Jurisdiction dependent
  - Pricing can be competitive
- **‘Not insurance’ language**
  - Note: ‘insurable interest’ does not necessarily mean lender of record

# Key Considerations for Using Credit Insurance - *continued*

- **Indemnity**
  - Primary obligation – guarantee provisions not needed?
  - No waiver of counterclaim

- **Pricing**
  - Cost of capital benefit for bank weighed up against insurer's required ELR
  - Other factors – asset class, jurisdiction, structure, novelty
  - Comps: CLO tranches and single-loan insurance market?

- **Disclosure**
  - Exclusion of duty of fair presentation (Insurance Act 2015)
  - New securitisation regulation

- **Downgrade risk**
  - Credit counterparty risk on insurer
  - Self-replacement or collateral posting requirement

- **Legal requirements**
  - Documentation
  - No SPV

# Requirements Under A244(5) / A245 (5) CRR

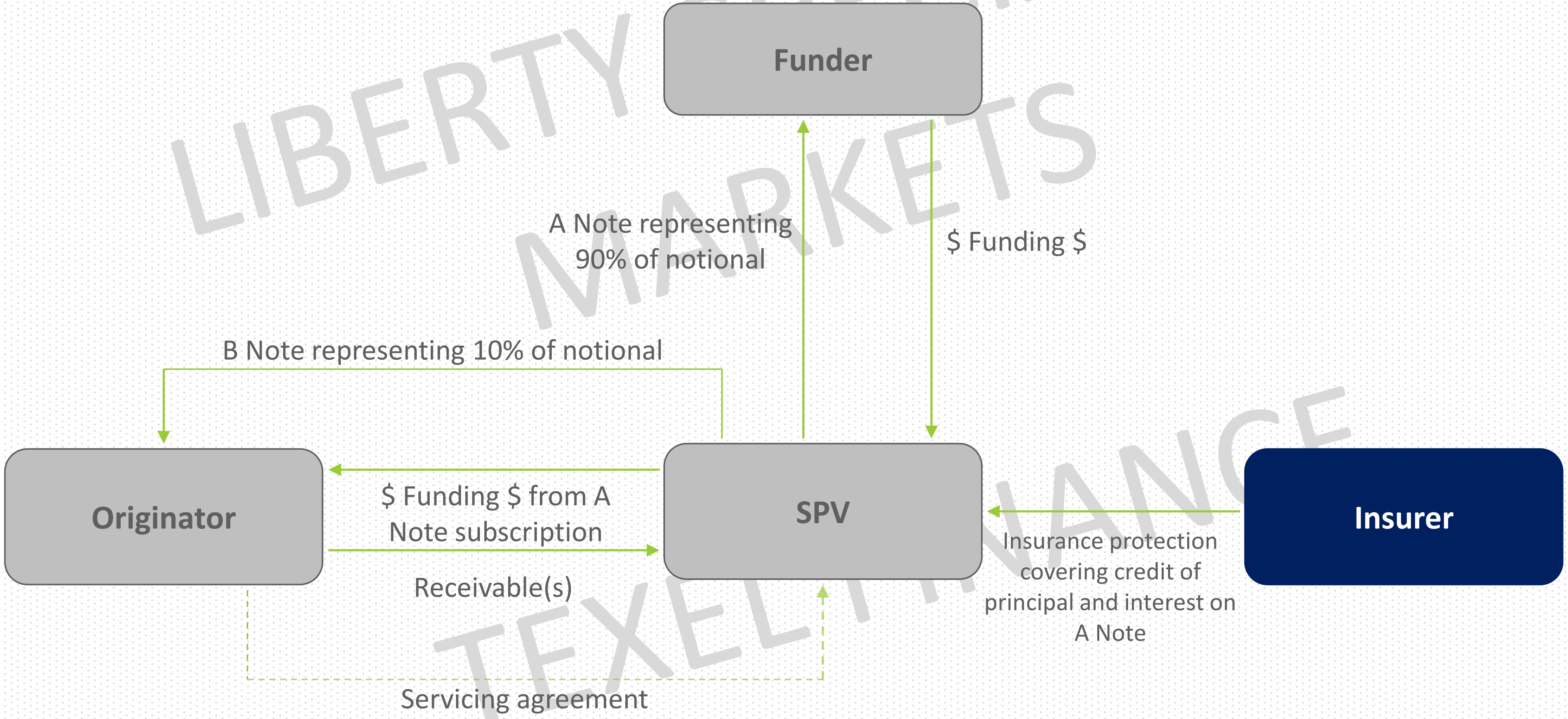
| CRR Requirement – A244(5) | Amended CRR – A245(4) | Credit Insurance |
|---|---|---|
| Securitisation documentation reflects economic substance of the transaction | Same | ✓ |
| Credit protection complies with A247(2) | Credit protection complies with A249 | ✓ |
| Instrument does not contain terms that (i) impose significant materiality thresholds below which credit protection is not triggered, (ii) allow early termination due to deterioration in credit quality, (iii) require positions to be improved (other than early amortisation), and (iv) increase cost of protection when deterioration in credit quality | Same | ✓ |
| Opinion from qualified legal counsel confirming enforceability of credit protection in all relevant jurisdictions | The credit protection is enforceable in all relevant jurisdictions | ✓ |
| Purchase/repurchase by originator outside contractual obligations must be at arm's length | Purchase/repurchase by originator outside contractual obligations are executed in accordance with prevailing market conditions and parties act in own interest free and independent parties (arm's length) | ✓ |
| Where there is a clean-up call, it can only be exercisable at discretion of originator, exercised when 10% or less of the original value and not structured to avoid allocating losses | Same | ✓ |
| | Originator institution has received an opinion from qualified legal counsel confirming that the securitisation complies with requirement above that credit protection is enforceable in all relevant jurisdictions | ✓ |

# Advantages of Using Insurance

- Pricing
- Accounting treatment: accrual or derivative accounting
- Terms can mirror CDS/guarantee
- Significant pool of mezzanine risk takers
- Simplicity of structure
- Advantages for both originators and risk takers
- Huge potential overall capacity

# Other Uses of Insurance in Structured Finance

## Asset repack structure:



# Conclusion

- The credit insurance market is well developed and sophisticated, with a very high rate of claims paid and an ability to be flexible in creating new solutions for financial sector

- Insurance policies have long been used as eligible unfunded CRM under CRR on a single loan basis, therefore reducing RWA for banks

- Since the implementation of Basel III and growth of balance sheet synthetic securitisations, most transactions have been done on an funded basis

- However, insurers who have strong balance sheets and credit underwriting expertise increasingly focussing on portfolio structures like synthetic securitisations – new unfunded protection solutions that are not ghosts of the past where monolines insured super senior tranches for arbitrage transactions

- Looking forward, the regulatory background ripe is ripe to allow new investors to come to the market, particularly those (like insurers) who have appetite for mezzanine tranches

# Sources and References


1. International Credit Insurance & Surety Association: 8 July 2015 press release *"A Guide to Trade Credit Insurance"*

2. BIS Quarterly Review, June 2018

3. BPL Global: *"Market Insight 2018, Credit and Political Risk Insurance"*

4. 2018 survey carried out by Lloyds Market Association and International Underwriting Association in relation to data provided by Aon, AJ Gallagher, BPL Global, JLT, Marsh, Texel and Willis.

5. Freddie Mac: *"Agency Credit Insurance Structure (ACIS) Transactions – Pricing Terms"* and *"Introduction to Freddie Mac and the ACIS Program 2017"*

6. Marsh: "*Transactional Risk Insurance: using transactional risk solutions to close the deal"*