BPL Global World Leading CPRI

COVID-19 CRISIS UPDATE

# The long-term impact on the CPRI market and the accompanying threats and opportunities

16 October 2020

## Introduction

So far, our market updates have focused on the relatively short-term effects of the Covid-19 crisis. In the early months of the crisis (March, April and May), there was plenty to report as insurers looked to redefine their attitudes towards various sectors, along with pushing for higher pricing and better terms.

In recent months, insurer appetite within those sectors has not much changed, but the dust has not exactly settled.

The CPRI market is still awaiting the fallout of Covid-19 in terms of the actual financial cost. Indeed, whether we will see a tsunami, flood, wave or ripple of claims is not yet clear, as the "pure Covid-19" claims are only just beginning to crystallise – with most of these early losses emanating from the aviation sector. Until that culminates, the market will be difficult to predict. That said, it does appear to be travelling in certain directions – and with new products being floated, certain opportunities are presenting themselves.

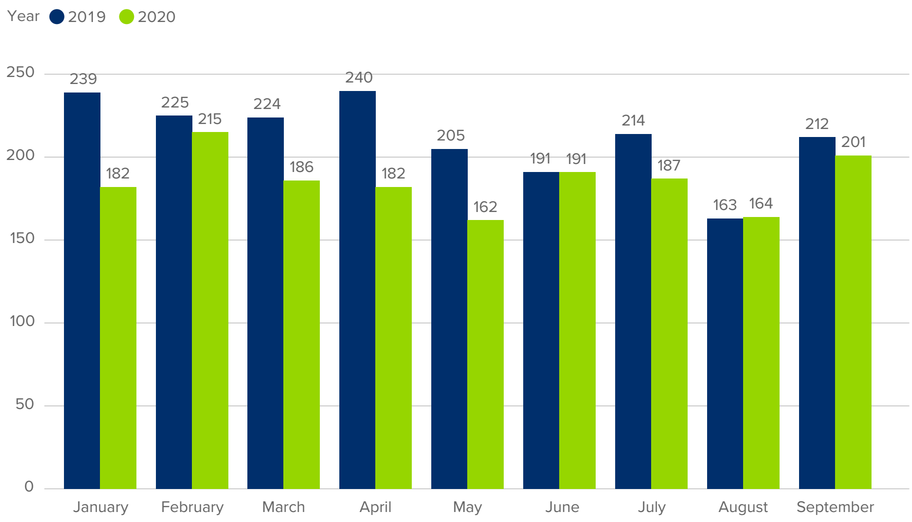
This paper will look at what we think some of the larger opportunities might be, and where long-term trends could take the CPRI market, presenting clients and insurers with more opportunities to partner.

IN THIS UPDATE



## Demand

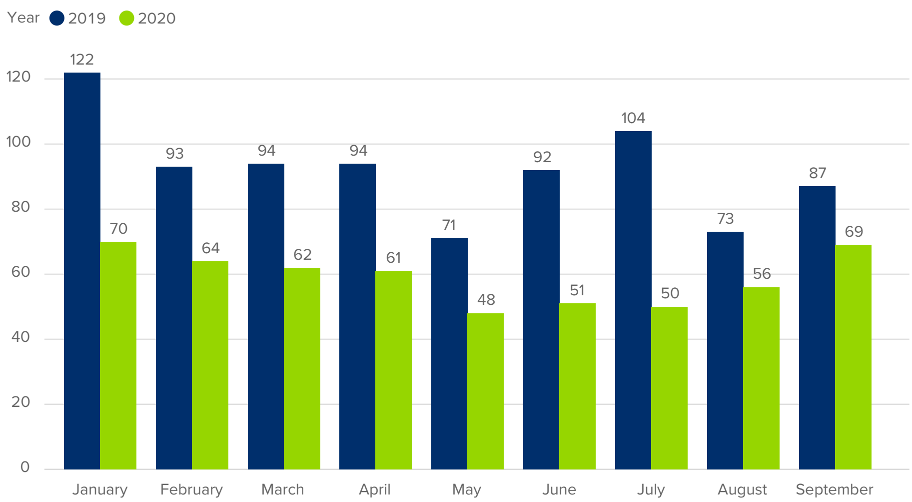
During the first three months following the onset of the pandemic which coincided with negative oil prices, enquiry flow was down by 20% compared to the previous year. The number of monthly enquiries has since rebounded to levels similar to 2019, as seen in the chart below.




**Enquiries in 2019 vs 2020**

The rebound has been driven by banks, which have increased their new enquiry volume by 20% in each of the last three months. We believe this is driven by a tighter secondary loan market, coupled with more conservative credit committees, which are requiring lenders to share more risk.

Enquiries from commodity traders and exporters, on the other hand, have trended downward, possibly as a result of the contraction in global trade as illustrated in the below chart.




**Enquiries in 2019 vs 2020 for Commodity Traders, Exporters and Investors**

## Supply

The insurance cycle has shifted and, in general, the sector has become attractive for capital inflows. As the FT notes, *"in recent months investors have quietly poured billions of dollars into insurance companies, betting the pandemic will ultimately prove the catalyst that ends a period of fallow returns for the industry."*

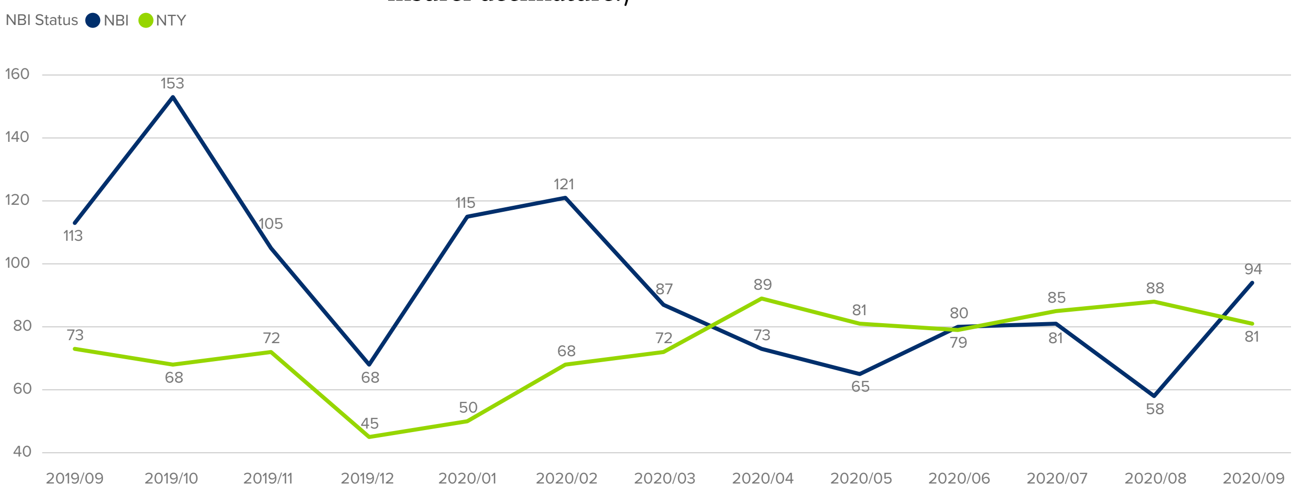
But whether this shift will extend to the CPRI market is doubtful. Though pricing has demonstrably increased, with renewals at around 20% higher, this is a lower rise than many other classes of insurance – and insurers' ability to increase this further is limited by margins in the banking market, which are mostly beyond their control.

Furthermore, the willingness of insurers to place capital in the CPRI market will inevitably be affected by claims performance as a result of the crisis. Early signs may be positive (or less negative than feared), but we have already lost two insurers, being Starstone and AWAC (although we note AWAC will continue to offer the product via a smaller operation in New York), and several insurers have pared back their offering through reducing their appetite to cover risk on private obligors.

These retractions have been offset by the entrance of Convex and HDI Specialty, but we do still expect that the overall number of players will reduce over the next 24 months. This may occur due to insurers pulling out of the class, but it may also result from M&A activity.

This is a double-edged sword for the class. Though it is not always the perfect solution when two active players in the CPRI market combine, it does frequently create strong, well-resourced teams who are then able to analyse more types of credit and take the market into new and profitable areas. Indeed, the depth of each insurer in the CPRI market is just as important as the number of players.

Meanwhile, BPL Global's enquiry data continues to demonstrate that the CPRI market's risk appetite has trended downward. For the 12 months through to February 2020, BPL Global obtained non-binding indications (NBI) on 69% of all enquiries submitted to the market. This figure declined to 50% or less in each month from March onwards. The below chart evidences this trend (Note "NTY" means "No Thank You", the polite response for an insurer declinature.)




**Enquiries by Status over Time – 12 Months**

## Reinsurance programs

A key factor in the ability of the market to maintain a healthy level of supply will be the attitude of the reinsurers to the dynamic described above, especially as most CPRI insurers now enter a crucial period as they negotiate their annual treaty renewals.

For many years, reinsurers have been attracted to the reasonably strong premium growth and profits in the CPRI market. As a result, the number of insurers and aggregate market capacity consistently grew over the last 10 years, while insurers with already-experienced underwriting teams have broadened their product offerings and lengthened their maximum policy periods.

We expect that the anticipated higher volume of CPRI claims, combined with the opportunity for reinsurers to earn higher premium rates in other product lines, will have the following adverse effects on the CPRI market:

- Downward pressure on commissions paid by reinsurers to insurers. These ceding commissions are fees paid to cover administrative, underwriting, and business acquisition expenses. This will put upward pressure on CPRI premium rates and cause some insurers to seek a reduction in distribution costs.
- A flight to quality may take place, causing less experienced primary CPRI insurers to lose some reinsurance support. Some reinsurers may pull out entirely from the CPRI market. This would potentially reduce insurers' maximum line sizes, and therefore also reduce aggregate CPRI capacity.
- Some reinsurers may be less willing to support the underwriting of new or innovative coverages and there may be fewer reinsurers willing to support longer tenor transactions.

## How will insurers fundamentally change their operations?

There has always been a disconnect between how insurers view credit risk on private obligors (referred to as "CR" in the Lloyd's risk codes) and risks on sovereign and sub-sovereign obligors ("CF"). The market gospel is that the CPRI market is much more suited to – and better at – underwriting sovereign, rather than commercial risk, This perception is backed up by Lloyd's statistics, which consistently show better results for insurers under the CF coding, compared to the CR coding, which is frequently not profitable at all.

However, we think the reality is more nuanced and Lloyd's results here are not representative of the CPRI market as a whole. Lloyd's regulations on "Financial Guarantee" and overemphasis on writing "trade-related" business had pushed syndicates into insuring lower-quality obligors, which had resulted in higher levels of claims.

Also, historical expertise skewed underwriting in favour of the more mature market, CF. However, Company markets had employed larger teams devoted to analysing commercial credit, which may have helped them underwrite more successfully.

This has changed in the last decade and the CPRI market including Lloyd's syndicates has been bolstered by a large number of professionals hired from the banking market who have enhanced underwriting culture, as well as the Lloyd's regulations and Reinsurance conditions to enable insurers to select from a wider pool of risk.

However, as with any crisis, results are subject to heightened scrutiny, and areas of lower returns are often earmarked for underwriting refinement and volume contraction. As such, it is "CR", which is bearing the brunt, with insurers looking to take less CR risk in general, with a significant portion looking to limit such exposure to investment-grade obligors only.

There are some more practical effects of this, some of which are listed below:

- **Fraud**: Unsurprisingly, the claims currently in the market that have arisen from – or been exacerbated by – the Covid-19 crisis, include a number of frauds. That isn't a surprise as fraud at the obligor level is one of the major risks that insurers take on when covering non-payment risks, and for obvious reasons, they are likely to be the first "problem cases" when liquidity dries up in the money markets.

  It is also a difficult risk for an insurer to mitigate because insurers are one step removed from the obligor, behind the bank. We do expect insurers to try to protect themselves by supporting only those market-leading lenders that have demonstrated robust client due diligence processes and strong operational standards – as well as potentially asking their bank clients to keep a higher proportion of the transaction retained on their own books.

- **The credit cycle**: If insurers are to take credit risk, then the Covid-19 crisis has reiterated the necessity to be able to write through the cycle and we expect a re-focussing on areas that are seen to be resilient to market crashes, such as Project Finance.

- **Sovereign risk**: A desire to move away from CR – and assuming a continued requirement to maintain top line income – will logically lead to stable competition for CF transactions.

There are issues here. Firstly, the G20 Debt Service Suspension Initiative made this terrain quite difficult for insurers to navigate, while uncertainty remained as to whether countries and individual transactions fell inside or outside the contemplated reschedulings. There are also major bottlenecks with countries that are in high demand, such as Ivory Coast and Angola. These represent major exposures for the market and are also negatively impacted from a credit perspective by Covid-19.

Nevertheless, the perception that there are healthier recovery prospects for sovereigns and that insurers are better placed to underwrite country risk will mean that brokers will continue to have an easier job placing CF risks.

## Where do the other opportunities lie?

There is a fundamental truth in the cliché that great threat brings about great opportunity. This is easy to see in the current Covid-19 crisis where the abruptness of events meant that even well-run companies have encountered unexpected cash-flow problems that have opened the door for funding opportunities, whether it be oil & gas companies, football clubs, cruise operators or airlines.

At the same time, major banking clients of the CPRI market are well capitalised and supported by emergency government regulation and monetary policy, making them well-placed (particularly in comparison to 2008) to benefit from the opportunities, with the insurance industry remaining committed to supporting them.

Below, we attempt to pinpoint some of the types of transactions where we see that dynamic proving profitable for the CPRI market:

### Bank liquidity and margins in emerging markets

As countries recover from the Covid-19 crisis, banks in emerging economies – and especially those with thin domestic financial markets – will most likely face liquidity issues which will limit their ability to fund local exporters and projects. DFIs and multilateral lenders such as the IFC have already stepped up to increase their funding support but there will also be opportunity for the private sector to lend directly to these banks and/or participate in DFI and multilateral facilities.

The CPRI market has historically allocated significant capacity to cover bank-to-bank loans following regional and global crises. We expect the market will be prepared to support this loan class again and be attracted to the relatively wide margins on obligors they know well.

### Funds

The fund finance market remains robust. That said, increasingly conservative lender credit committees are requiring funds to diversify their lending relationships. CPRI insurers have thus developed expertise in several niches:

“Capital Call” Facilities (also known as “Subscription Line” Facilities) provide short-term financing on a revolving basis to funds in order to bridge the period between an investment by the fund and the receipt of capital contributions from investors to finance that investment. Such loans are repaid with the capital contributions as received from the investors. As recent growth in fund sizes has resulted in credit concentration issues on the investors (especially for mega funds), the major lenders have sought to share risk with credit insurers.

Several credit insurers have done the necessary due diligence and concluded that capital call facilities typically represent favourable credit risks due to the strong security and short risk duration. Insurance premium levels are currently acceptable to insurers and lenders alike due to the upward trend on commitment fee pricing and funding rates.

Secondary Fund Loans are also being supported by credit insurers. In this structure, a PE fund which invests in other funds ("PE Secondary Fund" or "Fund of Funds") arranges for a credit facility to be provided to an SPV which is established to hold and/or acquire investments on behalf of the PE Secondary Fund. As security, 100% of the SPV's equity is pledged to lenders, along with the bank accounts receiving both capital contributions from the parent fund and distributions from investments. CPRI insurers view the low loan-to-value ratios on these facilities favourably.

## Project Finance

Government stimulus packages in both developed and emerging countries are expected to result in quality PPP Project Finance opportunities, as many countries seek to accelerate the delivery of their infrastructure programs. There may also be a backlog of projects that were put on hold due to the pandemic, supply chain issues and volatile commodity prices.

In recent years, CPRI insurers have invested the necessary time and resources to understand Project Finance. As such, they recognise that historical project finance default rates are low. Project Finance is also attractive to CPRI providers given the ability to mitigate identifiable risks through structuring. As a result, the market now offers a meaningful amount of capacity and can accommodate the long tenors required for Project Finance lenders.

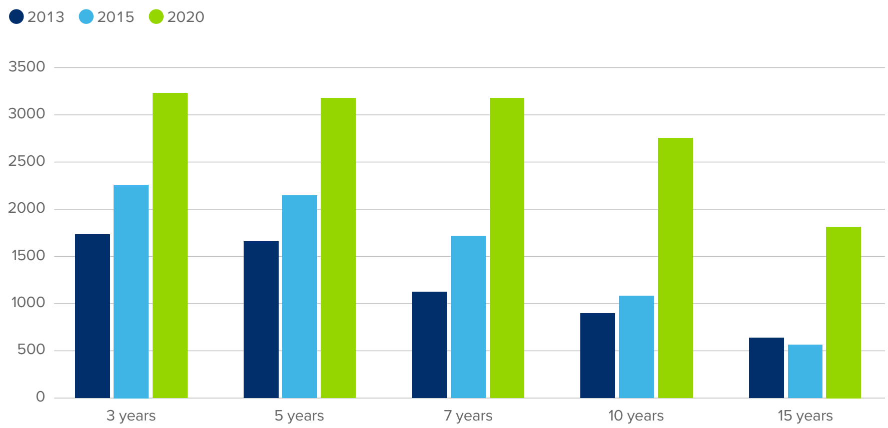
CPRI carriers that have Project Finance expertise have a particularly strong interest in supporting US and Canadian infrastructure projects, in particular, seeing opportunities in LNG facilities, geothermal power and toll roads.

## Sustainable Finance

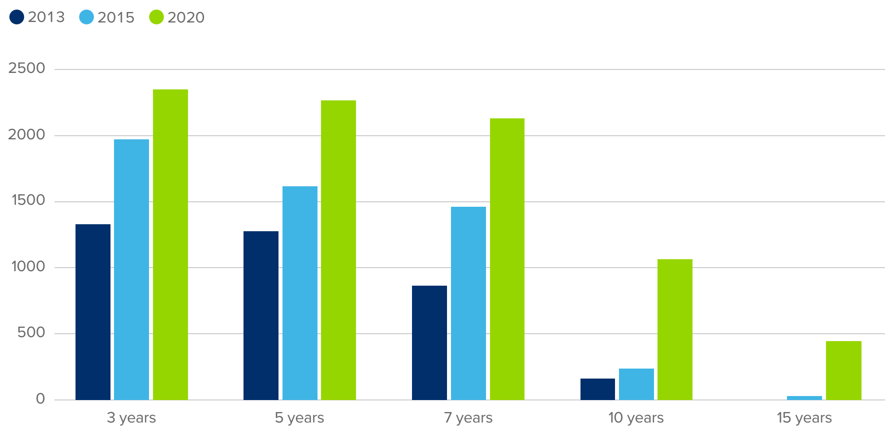
We understand that capacity might be opening up in the CPRI market for Project Finance, specifically targeting the renewables space. This is unsurprising, given the enormous levels of investment needed across the globe for governments to achieve their environmental targets.

But there are a number of other specific reasons as to why the CPRI market is likely to participate in the post-Covid-19 underwriting world and take advantage of opportunities in this space:

- **Default Rates**: As mentioned above, project finance transactions generally have low default rates. Moody's analysis on project finance bank loans for green use-of-proceeds, however, demonstrates an even lower default risk. This makes the area extremely attractive for insurers seeking to improve upon loss ratios that will have been dented by Covid-19 claims.
- **Tenors**: As illustrated in the two charts below (showing the total CPRI market capacity by tenor in 2013, 2015, and 2020, respectively) there has been a major market shift towards extended capabilities, allowing the market to accommodate long-term deals that would have been impossible a decade ago.




**Sov/Sub Sovereign Obligors**




**Private Obligors**

- **Demand from banks**: Many of the large European banks – key clients of the CPRI market – are specifically making a push to support more green projects, in some cases even introducing a Green Weighting Factor to apply to analytical RWA on a transaction. Where these banks go, the insurers follow – and we expect insurers to be able to provide significant support for this drive.

- **Insurers' own Environmental, Social, and Governance (ESG) initiatives**: For several years, insurers have been incorporating ESG ratings into their asset-side investment decisions. Until recently, however, it has been less clear how they factor ESG metrics into their underwriting. We have now seen several insurers such as Zurich and Allianz explicitly describe how they employ ESG considerations into their underwriting process.

  In fact, this year Euler Hermes recently announced that it has augmented its country ratings with a set of indicators related to sustainability. For many CPRI insurers, there is upper management pressure to support quality risks that have a sustainability feature.

- **Diversification**: the CPRI market has been heavily exposed to the Oil & Gas markets via the banks, and also the major traders, which remain key clients of the market. While we don't expect this to change in the near term, support for renewables projects does give insurers some necessary diversification.

## Aviation Finance

Currently, the aviation industry's focus is on liquidity and survival of airlines. In fact, more than 80% of airlines have requested payment deferrals or another form of rent relief – severely impacting leasing companies and aircraft finance lenders. The crisis has proven that few airlines can survive in the absence of government support, now totalling approximately US$150 billion globally and granted in various forms to at least half of the world's largest airlines.

In the near term, airlines will continue to work to build financial war chests by taking on significant debt, while selling assets and deferring expenditures. But airlines continue to face enormous cash burn rates during the current grounding phase, and uncertainty remains about the permanent relaxing of lockdowns, as well as the degree of international coordination that will be implemented for airline traffic. The severe industry downturn, coupled with recent claims activity in the CPRI market, means that only the strongest airlines with explicit government support will qualify for CPRI cover in the near term.

When the world ultimately recovers from the pandemic, the financial impact on airlines will be clearer and the aircraft values will begin to stabilise, most likely at levels which are well below pre-Covid-19 prices.

CPRI underwriters' attraction to aircraft finance has primarily been driven by stable and predictable asset values, so we expect insurance will return when these re-stabilise. At that point, we predict CPRI underwriters will capitalise on the industry expertise they developed over recent years, potentially filling the financing void created by the withdrawal of more conservative bank credit committees and capital market investors.

This should culminate in the CPRI market supporting higher-quality airlines – in contrast to the pre-Covid deal flow which mainly consisted of loans to airlines further down the credit quality curve.

### Derivatives

There is more insurer interest and capability to support repos and hedges (FX, interest rate, commodity price, etc.) than ever before. Some insurers are viewing derivatives as an opportunity to cover good obligors they would not normally see, on structures that offer an improved recovery rate and strong pricing. Though this currently remains a niche area where not all insurers are able to be involved, we expect it to grow in the near future as more insurers enter fuelled by significant demand from obligors that want to manage their financial risk more effectively and those banks which can achieve large RWA savings by insuring a portion of their mark-to-market exposure in the CPRI market.

## Conclusion

The CPRI market has consistently grown despite experiencing serious disruptions approximately every 10 years. We expect the Covid-19 crisis will have a near-term, moderate impact on CPRI capacity, particularly for non-traditional risks and/or longer tenor transactions. Ultimately, however, we expect (re)insurance capital to flow back to CPRI, especially now that the products offered are embedded into the risk mitigation strategies of most major banks, exporters, and investors.

CPRI insurers are typically more willing to “ride out the storm” with existing clients during market disruptions. Therefore, insureds which have established long-term, trusted partnerships with CPRI insurers are more likely to benefit from the current market dynamic, leveraging their positions to quickly mobilise insurance capacity at more competitive premium rates.

While we have identified several trends and potential opportunities in this paper, we expect the CPRI market to continue to evolve, identifying new areas for growth as the global economy recovers.

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