London Insight 2019

Preparing for the biggest risks in a brave new world

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Market update: a view from Aon

*Opening 2019's London Insight event at Ironmongers' Hall in the City of London, **Stuart Lawson**, CEO for Aon's Credit Solutions, tells conference delegates that the credit insurance market is responding to economic and political headwinds with new and dynamic solutions.*

"We're seeing an extreme level of uncertainty in trading conditions," said Aon's Stuart Lawson, "which is being driven by a perfect storm of economic headwinds, geopolitical volatility and protectionism." Despite this volatility, he added, we're not yet experiencing a flood gate of claims but there have been some significant failures which will have a material impact on the market – notably Thomas Cook's slide into insolvency earlier this year.

Travel woes

On Thomas Cook, Lawson commented: "It was a failure that was not unexpected given the business's troubles over recent years, but it is likely to result in gross claims of between £750 million and £1 billion, with a significant part of this impacting the reinsurance markets." But what does the failure mean for credit insurance capacity? "It is likely to affect those syndicates who rely heavily on the reinsurance market and currently have significant concentration exposures relative to the size of their overall portfolio. This could result in more stringent underwriting conditions that could impact clients in 2020," warned Lawson.

In addition to Thomas Cook, Lawson told delegates that insurers are also being hit hard by another severity loss relating to a Mozambique contract frustration claim. "One of our key roles is to understand market dynamics and trends so that we can ensure we are best placed to support our clients as they look to increase sales around the world."

Market convergence

Whilst the current market conditions have slowed the pace of change, market convergence continues to evolve. Lawson went on to explain that there has been a convergence between political risk, trade credit and surety, with a number now underwriting across all three key product areas. "It's created a more dynamic market place for clients that has enabled us as brokers and advisors to create more flexible and client specific solutions. For example, when we think about the single risk market, we often refer to its flexibility on wordings and its willingness to participate in multi-insurer placements. When we think of the multi-debtor credit insurers, we recognise their extensive risk analysis capability and high local service levels across the globe, so convergence has, in a number of cases, allowed us to bring the best of both worlds together."

"This observation of this underlying market evolution four years ago was the catalyst for Aon bringing together our trade credit insurance; surety; and structured credit/political risk teams. This has allowed us to extend our advice and solutions to clients beyond receivables to key areas such as, payables/supply chain solution and supporting balance sheet optimisation objectives through collateral replacement products as well as supporting M&A transactions," said Lawson. Product development has been complemented by looking at ways Aon's Credit Solutions can support its clients through technology via its Credit Hub platform. This has been designed to focus on providing clients with insight and benchmarking as well as creating operational efficiencies through its Policy Manager tool.

Developing a strategic roadmap

"Whilst our role is to make sure our clients get the most benefit from their trade credit policy today, it is important that we work with our clients to build a strategic roadmap for three, five and ten years' time. The credit programme should evolve with our clients' business whether through programme evolution, programme enhancement and where justified, structural transformation," concluded Lawson.

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Country and sector risk outlook

*Global trade tensions are fuelling economic uncertainties with business confidence suffering warns **Julien Marcilly**, Chief Economist at insurer Coface.*

Global trade tensions sit at the core of the world's economic uncertainties Coface's Julien Marcilly told London Insight delegates, with businesses as concerned with what is going on elsewhere in the world beyond their own country borders as they are with domestic matters. "Global trade has declined this year for the first time in the last ten years. But the key question is what is next to come in 2020?"

Trump weaponises trade tariffs

At the heart of the tensions, lies the US/China trade war and by mid-December 2019, almost all goods going into the US from China will be subject to their full tariff said Marcilly. "Donald Trump has used his preferred tool of tariffs extensively, but he could do more and has said he wants to impose 45% tariffs on Chinese imports. Alternatively, he could use a different weapon."

Last summer, Trump tweeted a message that US companies should look for alternatives from China, explained Marcilly, implicitly referring to the International Emergency Economic Powers Act of 1977 that makes it possible for him to not only impose tariffs but ban some imports and exports. "I'm not saying he will do that it in 2020, but it is a possibility. One year ago, no one would have expected that he would have done so much on tariffs. Even if he falls behind in the polls with the unemployment rate in the US starting to increase, I don't think it will stop him from deciding on some more painful measures."

If Donald Trump is not re-elected, what then? It could be that the two countries go back to the previous situation and all tariffs go back to normal, said Marcilly, but it's worth remembering that not everything decided by the US government is directly related to the president such as the imposition of sanctions on Chinese companies. These could well remain in place beyond 2020 regardless of who wins the presidency, he added.

Automotive sector hits the skids

Turning to Coface's sector risk assessments for Western Europe, Marcilly noted a key change this year relates to the automotive sector which is rated as high risk for business default for most countries apart from Switzerland, with related supplier risk in areas like metals. "It's really a two speed Europe between on the one side economies that are suffering from domestic political risk like the UK or external political risks like Germany, or on the other side some other economies like France and Spain who are doing comparatively well and where we don't see any sign of a pick-up in business insolvencies because, despite low growth, liquidity is abundant."

In this environment of sluggish export growth and lower growth coming from Germany and the automotive sector, we have to be more cautious with some countries in Eastern Europe such as the Czech Republic, Hungary and Slovakia who are more exposed to Germany and the automotive sector said Marcilly. "The good news is, these economies are much more balanced than they used to be and are much less indebted than they were ten years ago."

Faltering confidence

Looking at US business confidence, Marcilly asked how far a fall in manufacturing confidence will spill over into services. "In the first half of 2019, the US economy remained quite resilient. It's still the same, but we have started to see some spill over with a fall in confidence on the manufacturing side, followed quite quickly by a fall on the services side." However, the two don't always go hand in hand added Marcilly, who pointed out that a fall in manufacturing business confidence in 2015 was not matched by a fall on the services side. "Next year in the US we expect one or two quarters of negative growth and a small increase in business insolvencies, but nothing similar to what happened in 2008/09."

In Asia, Coface carries out an annual corporate payment survey which shows that since 2015, payment delays for businesses in China are increasing. Construction leads the way but automotive and electronics have risen into the top three. "This is partly related to the global trade war with the US and also a new trend in China which reflects the changing behaviour of the consumer given you can't expect growth across all consumer segments as households become well equipped in more areas."

From a political risk perspective, Coface has also developed a political and social fragility index which measures the level of frustration in any given country by looking at factors like income inequality, inflation, pollution and unemployment and whether a population has the tools – such as access to the internet and higher levels of education – that enables frustration to translate into political change.

Some countries of concern and rated high risk are in central Asia, North Africa, as well as the Middle East. "Also, in China as growth slows there could be some consequences in terms of social discontent," warned Marcilly. So far, he added, citizens have accepted low levels of freedom because income growth has continued to rise, but as this slows, will they be prepared to accept this status quo?

Transition risks rise to the surface

There are also plenty of risks related to environmental change for corporates. "We cannot underestimate transition risks related to the environment such as regulatory development, technological change, market and reputation risks which hit the automotive sector hard in Europe and China. With more states implementing strict anti-pollution regulations, the automotive sector in the US is likely to be one of the hardest hit sectors in that country in 2020," said Marcilly.

"The good news is, these economies are much more balanced than they used to be and are much less indebted than they were ten years ago."

Julien Marcilly

Enhanced information analysis

***Andrew Share**, Chief Operating Officer and Commercial Director at Coface, and Aon's Credit Solutions **Aaron Bailey**, Client Director on the quest for high quality information and how it can be used to help achieve a company's strategic goals.*

It is universally understood that high-quality business decisions depend on high-quality information. Whether it concerns mergers and acquisitions, growth strategy or investment opportunity, it is impossible to make the right call without a clear insight into the risks and a plan to mitigate them and maximise the chances of success.

While there is no shortage of data available – at a price – the real challenge lies in accessing a source of comprehensive, current, applicable information that goes beyond a simple snapshot and which is accompanied by expert advice.

Using information dynamically

This was the theme of the London Insight session presented by Coface's Andrew Share alongside Aon's Aaron Bailey. They were able to give their audience a bird's eye view of how Coface uses information dynamically in its business; expertise which Aon has leveraged for a new report which provides clients with an enhanced level of credit and working capital analysis.

Share said: "Coface invest money, time and effort into researching, analysing and monitoring trade risks because we are a trade credit insurer and if we get it wrong, we are likely to pay a claim somewhere. We employ 400 information analysts worldwide, so we can dig deeper into the data and provide a more detailed picture which benefits Coface internally and our clients." He explained how Coface collects information using a wide range of sources, from raw data harvested from credit agencies and international partner databases, to the experience of Coface's own clients in the form of overdue notifications.

Boots on the ground

In addition to these channels, Coface proactively seeks company information such as annual statements and interim results. Analysts don't rely on financial statements: they regularly pick up the phone to companies to get a full picture of what is happening today and the prospects for tomorrow and Coface has the 'boots on the ground' to carry out 50,000 debtor visits every year in order to get a real feel for the business.

Coface's global footprint and enhanced data analysis enable it to provide a detailed assessment of trade risk at a company, sector and country level, taking into account factors like political risk and the business climate. These assessments are constantly monitored and updated as the situation changes.

Supplementing the data

Explaining what this meant for Aon clients, Aaron Bailey said: "The amount of data that Coface captures and their analytics are fantastic so the challenge for us is to supplement this with our own working capital assessment and insurance-backed finance solutions. As well as giving businesses a insight into their risk, we can give them an overview of potential insurance-backed solutions to help improve their working capital position, provide access to finance and ultimately achieve their strategic goals."

Aon clients can use the report service as part of an M&A due diligence process; to obtain an in-depth analysis of their own trade receivables ledger; or evaluate risks in the supply chain said Share. Taking anywhere up to two weeks to compile, the 30-page report and an accompanying dashboard of key metrics is comprehensive in scope. It includes analysis of total debt, counterparty probability of default, estimated liability and the predicted number and value of payment defaults per annum which is needed to comply with the IFRS 9 accounting standard.

Adding value

Aon aims to add value with their own working capital diagnostic which advises the client on ways to improve the short-term liquidity of the business using an insurance or guarantee product. For example, by looking at the replacement of traditional bank issued security such as Letters of Credit with a surety bond facility, issued by an insurer on an unsecured basis, facilitating the release of working capital otherwise tied up supporting bank lines said Bailey, who added: "We believe this is an offer which goes beyond what you typically see from traditional information agencies by combining Coface's global network and insight with Aon to give companies a deeper understanding of their risk at a granular level and at scale."

"We employ 400 information analysts worldwide, so we can dig deeper into the data and provide a more detailed picture which benefits Coface internally and our clients."

Andrew Share

Arbitrage advantage – leveraging insurance capital to maximise deal value

***Piers Johansen** – Managing Director for Aon's M&A and Transaction Solutions – discusses how smart use of insurance solutions can help optimise M&A deals.*

Four or five years ago, M&A insurance (specifically, warranty and indemnity ('W&I') insurance and tax or contingent risk insurance) was a fledgling product. Year-on-year growth since, however, has been "impressive", creating a fast developing and relatively established deal-related solution, said Aon's Piers Johansen. W&I insurance, in particular, has been seen by sophisticated clients as a "pathfinder" for unlocking the tactical and/or commercial value-add that insurance capital can provide, opening the door for similar solutions, including surety and credit insurance, to be applied in a deal context.

A key driver for this development is a recognition among deal principals and their advisers that structuring deal-related insurance can improve the execution process as well as manage transaction risk, observed Johansen: "You're looking to leverage that lower cost of insurance capital versus traditional alternatives such as bank capital or the opportunity cost of your own capital if funds have to be escrowed or otherwise tied up."

Escrow substitute

W&I insurance provides a financial remedy for covered warranties negotiated between buyer and seller in an M&A deal. "A typical sale and purchase agreement contains a set of warranties (contractual promises) relating, among other things, to the business being sold and its operations which, if subsequently found to be untrue, can impact deal value from the buyer's perspective. Understandably, buyers need some degree of financial recourse to manage this risk and, traditionally, would allocate a proportion of the sale proceeds due to the seller to an escrow for a period of time (at least one audit cycle) post-completion, to provide security for this risk. Upon expiry of the escrow period, these sale proceeds would be released to the seller to the extent not already applied to satisfy valid claims by the buyer for breach of those seller warranties," explained Johansen.

Structuring a W&I insurance solution as an alternative form of recourse for the buyer in these circumstances is a creative solution with obvious commercial benefit for the seller (full, unrestricted access to its sale proceeds at completion) and tactical advantage for the buyer (optimising the attractiveness of its proposal to the seller), as well as offering the buyer financial recovery against an independent, professional third party motivated to pay valid claims rather than having to commence legal proceedings against disparate sellers and/or incumbent management involved in the running of the buyer's newly-acquired business. "It's a capital-efficient solution that can create value because the premium charged by the W&I insurer trades more favourably than the opportunity cost the seller would have incurred by having some of its sale proceeds escrowed. Avoiding the escrow, thereby releasing - in full - funds to the seller for deployment in its business or distribution to investors, can improve internal rates of return." This capital arbitrage drives the commercial benefit of structuring M&A insurances in a deal context, Johansen added, which has percolated into other classes as well.

Take the growing use of tax and contingent risk insurance, for instance, continued Johansen. "A key difference compared with W&I insurance, which principally addresses unknown matters – for example, things relating to the state of the business being sold or its operations that the buyer doesn't know about through its due diligence or the seller's disclosure exercise – is that a tax insurance solution can cover identified areas of uncertainty."

One example helps illustrate this distinction: a client was negotiating an M&A transaction where the parties had agreed value for net operating losses ('NOLs') in the target business, subject to a condition precedent in the sale agreement that the relevant tax authority confirm that the target's NOLs would continue to be available to be offset against profits post-completion, i.e. following a post-closing group reorganisation and the change of control. "A tax filing had been made to the relevant tax authority in between signing and completion but no response had been received, with the long-stop date under the deal documentation fast approaching. To keep the deal on track, Aon's tax insurance team structured a 'synthetic' insurance solution that the buyer could call on in the event the tax authority challenged the availability of the net operating losses post-completion, thereby giving sufficient comfort to enable the buyer to waive that condition precedent and for completion of the deal to take place on time," said Johansen.

Adapting surety for M&A

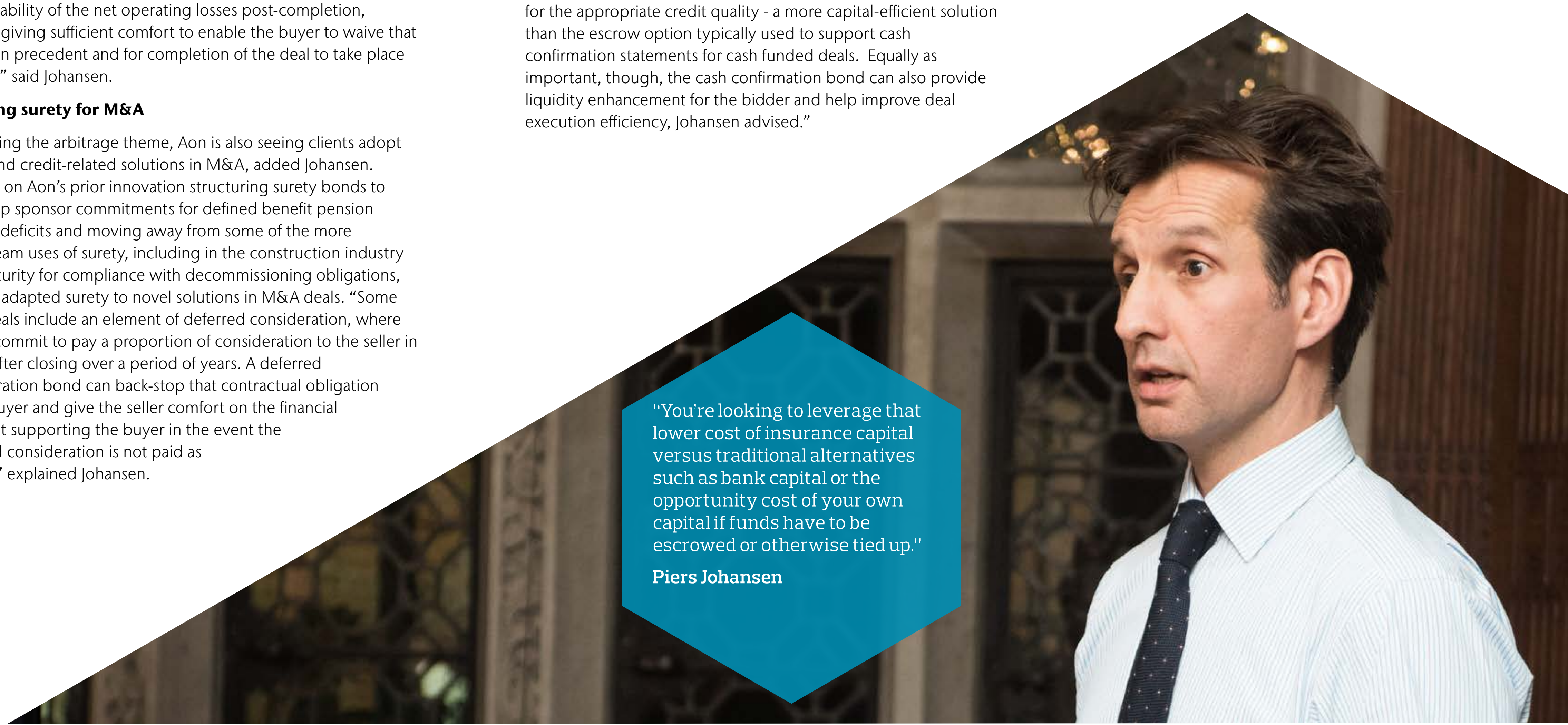
Continuing the arbitrage theme, Aon is also seeing clients adopt surety and credit-related solutions in M&A, added Johansen. Building on Aon's prior innovation structuring surety bonds to back-stop sponsor commitments for defined benefit pension scheme deficits and moving away from some of the more mainstream uses of surety, including in the construction industry or as security for compliance with decommissioning obligations, Aon has adapted surety to novel solutions in M&A deals. "Some M&A deals include an element of deferred consideration, where buyers commit to pay a proportion of consideration to the seller in stages after closing over a period of years. A deferred consideration bond can back-stop that contractual obligation of the buyer and give the seller comfort on the financial covenant supporting the buyer in the event the deferred consideration is not paid as agreed," explained Johansen.

Aon recently structured a deferred consideration bond for about US$700mn to support the obligation of Warburg Pincus, the global private equity firm, to pay post-completion deferred consideration payments on its acquisition of Leumi Card, a credit card business being carved out of Bank Leumi, the Israeli bank. "Our surety team worked with a number of London surety providers to place a significant bond back-stopping the buyer's contractual obligation to pay the deferred consideration, a commercially attractive result from a cost of capital perspective because the highly rated surety paper helped improve Bank Leumi's regulatory capital treatment. The outcome is a good example of how conventional instruments can be applied in a more dynamic context," said Johansen.

Cash confirmation

Slightly more "specialist", added Johansen, is the cash confirmation bond that can be used in the context of a UK cash takeover to support the statement that is required to be provided, usually by the takeover bidder's corporate finance adviser, that the bidder has sufficient cash resources to satisfy its obligation to pay all target company accepting shareholders, in full (the 'cash confirmation'). Analogous to the development of deal-related insurance as mentioned above, a surety instrument can provide - for the appropriate credit quality - a more capital-efficient solution than the escrow option typically used to support cash confirmation statements for cash funded deals. Equally as important, though, the cash confirmation bond can also provide liquidity enhancement for the bidder and help improve deal execution efficiency, Johansen advised."

Aon developed and placed the first cash confirmation bond, a GB£75 million surety instrument back-stopping the obligation of Fiserv, Inc., a US investment grade bidder, to pay the cash proceeds due to accepting shareholders in its takeover of Monitise plc. "The solution gave Fiserv flexibility by allowing it to draw-down funds under its existing revolving credit facility shortly prior to completion, rather than having to do so at the start of the formal takeover process and then escrow that cash for a number of months, pending deal completion. The surety solution also gave comfort to Fiserv's financial adviser, J.P. Morgan, and was a factor which enabled it to give the cash confirmation statement, helping to simplify that part of the deal process," concluded Johansen.



"You're looking to leverage that lower cost of insurance capital versus traditional alternatives such as bank capital or the opportunity cost of your own capital if funds have to be escrowed or otherwise tied up."

Piers Johansen

"While a bank guarantee might impact on the bank credit line, surety is an unsecured facility which can free up working capital."

Barrie Watson

Utilising surety

From performance guarantee bonds to judicial bonds, the use of surety is gathering pace as an alternative to traditional bank guarantees says Aon's Credit Solutions ***Barrie Watson*** *– Head of Structured and Capital Solutions, EMEA.*

For those who see surety bonds as a relatively new-fangled financial instrument, Aon's Barrie Watson had a surprise. "Surety has been around since Mesopotamian times in 2750BC, while in the UK, the first Corporate Surety, The Guarantee Society dates from 1840." Despite its history, Watson added, many are still unsure as to what a surety bond is.

Surety defined

"Surety is a guarantee or promise taken out with the payer to pay you, the first party, a certain amount of money if the payer, the second party, fails to meet their agreed or contractual obligations," said Watson. "This will then be paid by a third party – normally an insurance company – who has agreed to act as surety."

Critically, Watson explained to Insight delegates, surety is a treasury tool delivered by the insurance sector – not the banks – that provides an alternative form of credit line. It can be issued on-demand or on a conditional basis, but it is not an insurance policy in that it does not remove any liability. "If a surety bond is put in place on your behalf by a third party and you default, the insurer will pay out to your counter party but will come back to you to recover the amount. The risk for the insurer is that you will not be around to honour that obligation. A surety bond cannot be issued to a lender to guarantee repayment of a loan."

Performance guarantee

Say you're a pension fund developing a building, you might ask for a performance guarantee from your chosen contractor to guard against defects on construction. "The bank that would have traditionally provided that guarantee on behalf of the contractor, here the bank is replaced by an insurer. If there is a problem in the contract, the bond will pay out to the beneficiary," said Watson.

"Surety pricing is very competitive if not better than the banks," Watson continued, "and while a bank guarantee might impact on the bank credit line, surety is an unsecured facility which can free up working capital. Surety also charges on a pay as you use basis when bank guarantees sometimes incur a non-utilisation fee."

It's important to note however that surety is not like a traditional insurance product in that it doesn't seek to absolve the applicant or contractor from their liability said Watson. "Surety is very different from credit insurance in that most credit insurers will look to underwrite on a 40% loss ratio. Surety insurers underwrite on a 0% loss ratio and are not looking to take any liability. The indemnity structure allows them, when they've paid out to the beneficiary, to go back to the policy holder to settle meaning recovery is pretty good in this market."

How big?

Looking at the size of the market, figures from the Institutional Credit Insurance & Surety Association, reveal that the use of surety is growing with over EU€5 billion of surety premium in 2018 amongst its members, said Watson, while in Europe the wider market is worth over US$2 billion overall, compared to US$6.8 billion in North America. In regions such as North Africa, where the legal frameworks are less well understood, growth is much slower, but Watson emphasised that surety will eventually become globally widespread.

Bond innovation

The market has also grown in terms of the types of bonds offered. "There are now a wide range of surety bonds in use – ranging from performance bonds, to pension bonds and deferred consideration bonds – but essentially the obligation is the same in all these cases: I've got to do something, you want a guarantee that I will do it, but you'd rather have that guarantee from a stronger counterparty than me," explained Watson.

Delivering a number of case studies in the use of surety bonds, Watson described how one power producer was able to free up GB£100 million of working capital from banking lines and trapped cash. Aon identified several areas including letters of credit supporting bilateral trade agreements and performance obligations as well as collateral posted in support of hedging facilities. A GB£100 million surety facility with three carriers was put in place, replacing GB£50 million of letters of credit and GB£50 million of cash collateral.

Freeing up cash

In another example, a judicial bond was issued for a global IT company that had been in litigation with an EU tax authority. The company was fined but was appealing the amount of the fine. "There's no argument that the firm would have to pay the money, but the court says you need to pay something now and the appeal could take years – a particular problem in Latin America. If you go to a bank it will tie up a lot of money whereas the surety market will step in and provide an on-demand guarantee acceptable to the court which instantly frees up the money – in this case EU€30 million of funds," said Watson.

Prevention is better than cure – Health & Wellbeing

*Businesses need to focus more on the five pillars of employee wellbeing advises Aon's **Julie Grinter** – Principal Consultant, Employee Benefits and **Simon Cresswell**, Business Development Consultant.*

An effective staff health and welfare strategy is one which focuses on preventing problems in the first place. And yet, companies typically spend a large proportion of their health and wellbeing budget on treatment and support for staff who become unwell, including private medical insurance and income protection, while proportionally less is spent on preventative measures such as education and health screening.

It is why, Aon's Julie Grinter explained to Insight delegates, it is a good idea for companies to review their employee benefit strategy annually to ensure it still meets the needs and expectations of employees. And she highlighted some of the hot topics that companies now need to take into consideration, including IVF support, mental health, women's health, transgender support and cancer treatment.

Five pillars of wellbeing

Turning to prevention, Grinter advised companies to think in terms of five pillars of wellbeing – emotional, physical, financial, career satisfaction and social interaction - that would support employees to achieve optimal health and performance in their roles.

Conversely, she also outlined the major health risk factors, including smoking, stress, poor diet, lack of sleep and excess alcohol that contributed to 15 of the most common debilitating chronic health conditions – diabetes, heart disease, back pain and depression. She warned that companies would either have to help staff to proactively change their risky behaviour now or be faced with the cost if they became ill further down the line.

"It doesn't have to happen overnight, but we advise companies to start thinking in terms of spending more of their budget on prevention and detection of problems so that the amount spent on treatment and support does eventually start to come down," said Grinter. "Aon can help companies to audit their whole benefit programme in a 'joined-up way' and try and work out how they can both spend money more creatively and get better value out of their existing provision, including employee retention. We can use our range of data analysis tools to measure value across the whole programme, so they can focus on what works best."

Financial pain

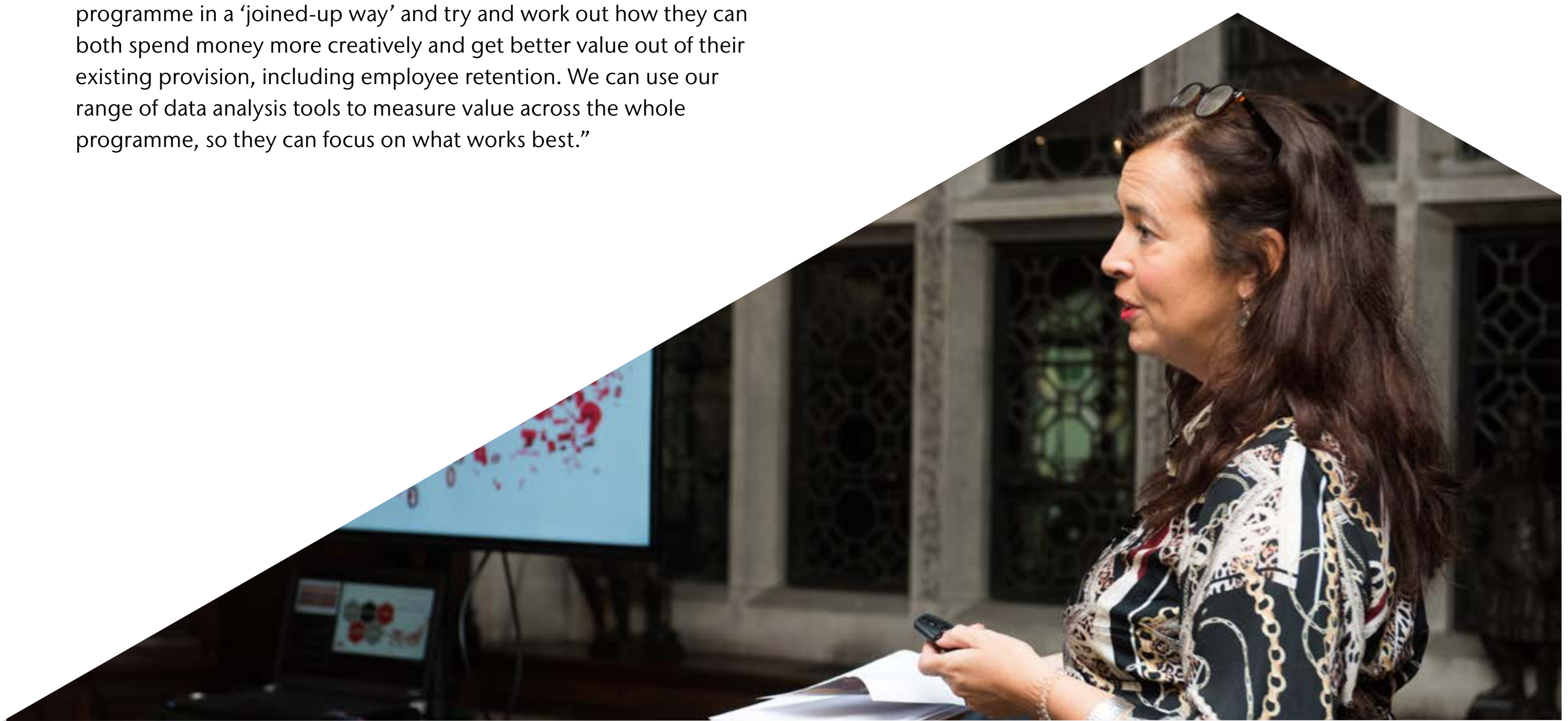
Simon Cresswell explained how Aon's strategic approach could be applied to financial wellbeing, a topical concern with the London Insight event taking place in the run up to Black Friday and Christmas. Cresswell highlighted that money related issues can be a significant cause of stress. However, he also noted a survey* that looked specifically at financial wellbeing in the workplace, which showed 89% of respondent companies were aware that people were having financial difficulties and wanted to do something for them, while 58% of employees said they would value financial wellbeing support from their employer.

"Depending on where we are in our lives, we are likely to experience different financial challenges," said Cresswell. "The challenge for companies is how you create a programme that speaks to all their employees. When we work with clients, we ask how they can develop a holistic approach to financial wellbeing and utilise what they already do. Again, this could range from preventative measures such as financial management advice; initiatives to 'detect and treat' financial problems such as savings initiatives or debt management; and support for those affected by financial stress."

Get your benefits fit for purpose

"By working with Aon to audit all aspects of your employee benefits programme, you can discover whether your existing benefits are fit for purpose and identify potential cost savings that can be invested in a preventative wellbeing strategy," Cresswell concluded.

*Financial Wellbeing in the Workplace: A way Forward, March 2017. Prepared by the Financial Advice Working Group for HM Treasury and the Financial Conduct Authority.



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