INSIGHTS | MARCH 2020

COVID-19: Credit Risk Insurance Implications

Overview

As the number of cases outside China rises, it appears that many of the world's largest economies will be affected, posing downside risks to global trade and business operations.

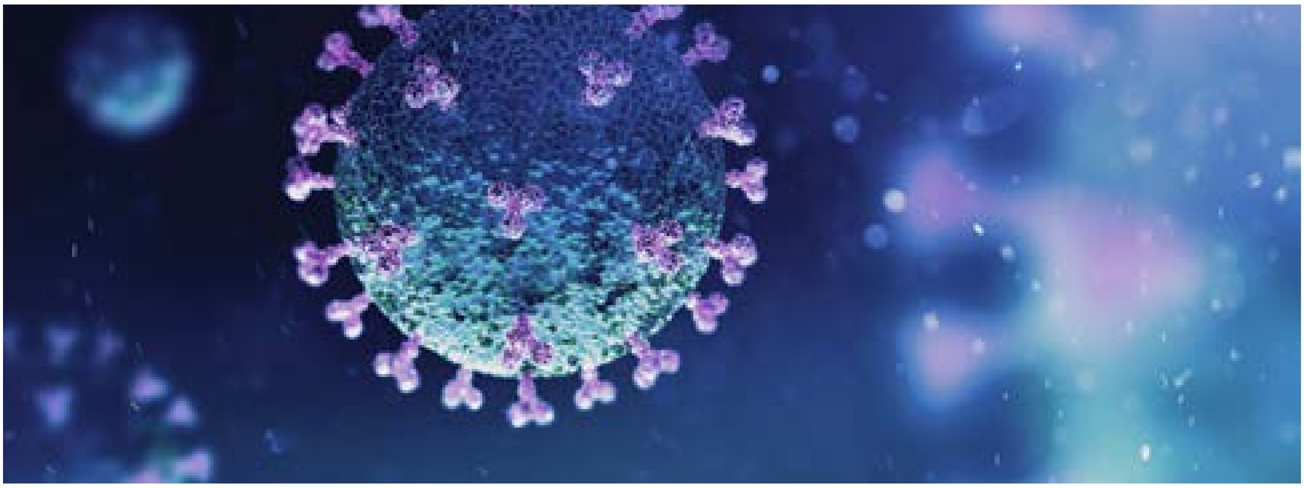
Disrupted production will drive lower revenues, corresponding to lower margins and profit levels, with the automotive, textile, and chemicals sectors hardest hit initially. Airlines and transport and travel operators are also experiencing demand-side challenges, as global and domestic travel slows.

If global commerce faces extensive and protracted disruptions, companies across various sectors are likely to experience financial strains and heightening credit risks.

Provided there are no gross violations of stipulated clauses, insureds should be able to make a valid claim for losses related to COVID-19 under a trade credit policy, as the proximate cause of the loss is default or non-payment and the coverage does not consider the underlying cause of the loss, if it is not excluded.

Businesses with interests in severely affected locations should:

- Adopt a careful approach to exporting into the location, reviewing any contracts in place.
- Be prepared for requests from insurers for specific information on any funds outstanding on goods or services sold to risks based in that location, along with instructions to refrain from shipping, if ports reach capacity.
- Make a determination, before a potentially insurable shipment is made, as to whether conditions on the ground would be so impactful that they are shipping into a foreseeable loss, and if they are exercising due care and diligence.



The COVID-19 pandemic and efforts to contain its spread are disrupting economic activity, with implications for the trade credit, political risk, and surety insurance markets. As the number of cases outside of China rises, it appears that many of the world's largest economies will be affected, posing downside risks to global trade and business operations.

The global economy faces heightened risks as the number of new cases reported outside of China exceeds those within the country. Following outbreaks in South Korea, Italy, Iran, and Japan, the World Health Organization (WHO) upgraded the status of the COVID-19 outbreak from epidemic to pandemic, and new epidemics are likely to emerge. The likely disruption to commerce caused by containment measures across multiple locations, prompted market losses in late February. Global equities lost a tenth of their value in the week beginning February 24, 2020, with US$5 trillion wiped from the value of global stocks.

While analysts initially expected economic effects to be confined to Q1 2020, COVID-19 appears set to have a longer impact. In early March, the Organisation for Economic Co-operation and Development (OECD) warned that a long-lasting and intensive outbreak across Asia-Pacific, Europe, and North America could reduce global growth to 1.5% in 2020, from its pre-outbreak forecast of 2.9%. Even without such an outbreak, the OECD revised down global growth forecasts to 2.4% for 2020.

The combination of slowing Chinese growth, tightening global financial conditions, disrupted supply chains, and localized outbreaks elevates demand- and supply-side risks. In China, over 80 cities, accounting for 48.6% of Chinese GDP in 2018, were placed under full or partial lockdown. Chinese growth estimates for 2020 have been revised down. Even if the disruptions could be confined to Q1 2020, the outbreak could reduce the GDP growth rate by 0.6%.

A deceleration in China would weaken global demand for commodities and tourism, generating knock-on economic effects. Asian economies will be particularly exposed, given deep trade and investment links to China. Commodity exporters in Africa and Latin America also face risks.

Containment measures initially used in China are being replicated elsewhere, with implications for businesses across many sectors. Work stoppages and restricted travel will hamper manufacturing and trade in a growing number of markets. Data released in early March 2020 pointed to sharp contractions in Japanese and South Korean factory activity, while Italy is also likely to experience an economic contraction. As further outbreaks emerge, similar economic impact is likely elsewhere in the world.

Developed economies experiencing low growth and limited space for fiscal and monetary stimulus are most exposed to COVID-19-related shocks, alongside emerging markets reliant on commodities with twin deficits. Developed markets at particular risk include Italy, South Korea, Spain, and Japan, while Chile, South Africa, and Malaysia would be exposed to a Chinese deceleration.

The central banks of the world's largest economies have pledged monetary support. The US Federal Reserve, European Central Bank, Bank of Japan, and the Bank of England have underscored their willingness to intervene to support market and financial stability, implementing stimulus measures, liquidity operations, asset purchases, and interest rate cuts. The Federal Reserve made an emergency rate cut on March 3, lowering its benchmark rate by 50bps.

Although such statements can support market gains, monetary policy is unlikely to offset the full impact of a protracted global outbreak, particularly in the case of widespread business shutdowns and interrupted cash flows. After more than a decade of accommodative monetary policy, many developed markets lack the space to address risks in this way.

Trade and Supply Chain Disruption

China's extensive integration into global supply chains, married with the international spread of COVID-19, will affect global operations. Even as factories in China begin to reopen, staff shortages and component shortages are likely to see firms continuing to operate below capacity. As outbreaks occur in other key manufacturing hubs, such as northern Italy and South Korea, supply chain disruption is likely to occur over an extended period.

In February, the UK recorded the largest monthly fall in suppliers' delivery times in three decades. In addition, Hyundai halted car production outside of China as a result of a parts shortage from China, while also recording a 13% year over year fall in sales in February. Similarly, Jaguar Land Rover reported supply issues, while Apple and many other retailers and manufacturers indicate they may fail to meet quarterly revenue targets, following store closures in China, temporary halts in production, and delays in shipments. In March, Volkswagen also suspended European production activity for at least two weeks, following the spread of COVID-19 to Europe and disruption to supply chains.

Most industries are likely to be negatively impacted by COVID-19, with the effects intensified as the pandemic's severity and length grows. Disrupted production will drive lower revenues, corresponding to lower margins and profit levels across the automotive, textile, and chemicals sectors. At the same time, airlines and transport and travel are experiencing significant demand-side challenges, as global and domestic travel slows. Below we outline the potential impact on key sectors:

- **Consumer Electronics:** China-centric supply chains, as well as significant exposure to Chinese consumer markets, leave electronics and tech firms particularly exposed to COVID-19-related disruption. Hardware companies face notable risks, given a reliance on complex Asian supply chains. Estimates suggest that 64 million fewer smartphone devices will be shipped in H1 2020, even as factories begin to reopen. The effect to balance sheets could be confined to the first half of the year if China can normalize manufacturing activity, although dampened consumer activity caused by localized outbreaks could affect demand. Foxconn Technology Group, the principal assembler of Apple's iPhone, indicated that normal production would resume in mainland China by the end of March 2020.

- **Chemicals:** Weaker consumption in China and markets experiencing local outbreaks are likely to reduce demand for petrochemicals. Falling output in the automotive sector, a key source of demand for chemical products, will also affect chemical producers. German firm BASF, which is reliant on the automotive industry for one-fifth of its business, highlighted that the outbreak was likely to weigh on earnings in 2020. Firms with above-average exposures to Chinese demand for petrochemicals are likely to experience increased pressure on balance sheets, potentially contributing to insolvencies among lower-rated entities with more limited financial resilience. Some US chemical producers have revised down earnings outlooks for Q1 2020, but full-year forecasts largely remain unchanged, with companies anticipating impact to be confined to H1. Demand for polypropylene demand has risen, as surgical face mask production is expected to increase in 2020. However, this increased demand is unlikely to offset weaknesses elsewhere in the sector. Production levels are likely to remain below capacity in China, as factories continue to experience worker shortages and disrupted supply chains. The impact will be exacerbated as containment measures are implemented in additional markets, such as South Korea and Japan.

- **Automotives:** Given extensive measures to tackle the spread of COVID-19, China's automotive industry has been particularly hard-hit. In January, light-vehicle sales contracted by 20.4% year over year, and only 19% of dealers returned to normal operations by February 10. With some manufacturers not expected to resume work until March, production volume losses in China are estimated at 900,000 in Q1 2020. A 4.3% fall in light-vehicle production is expected in China in 2020. As a critical part of the global automotive supply chain, disrupted activity in China is expected to result in a 1.9% fall in global vehicle output in 2020. With Asia responsible for 50% of global vehicle measures, a more widespread outbreak in the region would further affect the outlook. Containment measures in China have already affected the supply of automotive components outside of Hubei and mainland China, forcing production stoppages elsewhere. Hyundai Motor and Kia Motors stopped production at plants in South Korea due to component shortages (a localized outbreak of COVID-19 is likely to generate additional disruption). The COVID-19 outbreak will put pressure on many automakers' balance sheets; those with significant reliance on Chinese-produced components and Chinese sales are most exposed. Japanese firms such as Toyota, Honda, and Nissan are likely to have sufficient liquidity to weather disruption, although sales are expected to be weaker.

- **Textiles:** The closure of textile factories in China disrupted clothing supply chains, affecting the delivery of apparel to Western retailers. Many clothing manufacturers utilize components such as textiles, zippers, and buttons from around China, and containment measures have caused production bottlenecks. China manufactures approximately one-third of clothing and textiles produced globally, and some retailers have reported that summer collections will be delivered late as a result of production stoppages in the country. Brands have reported delivery delays of between 25 to 45 days. However, some countries' textile-to-garment industries have taken advantage of delayed shipments from China, with Indonesia's domestic and export orders rising by 10% so far this year. COVID-19 may also result in shifting supply chains with fashion firms sourcing more textiles from manufacturers closer to home. However, this is only likely to be a temporary fix if an intensive global outbreak of COVID-19 occurs. Reduced demand in China for luxury fashion goods is also likely to affect European retailers, generating additional credit risks in 2020.

Impact on Surety Markets

Companies have, in recent years, turned to the surety markets for issuance of performance security as viable substitutes for various forms of collateral, including bank guarantees and letters of credit. Surety underwriters have been willing to issue surety bonds for conventional bid and performance guarantees, and bonds to guarantee payments in connection with trade, environmental protection, decommissioning liability, insurance deductible, workers compensation, or social and welfare benefits. Surety markets have expanded in product offerings and gained wider acceptance across many international markets.

Similar to the bank industry, the surety underwriter's credit documentation and indemnity agreements often require companies to maintain minimum financial ratios; in a distressed financial environment, many companies may be at risk of breaching financial covenants and forced to meet collateral calls. In the surety market, underwriters are likely to reduce their support for companies that are unable to sustain themselves through this period of business interruption, particularly if the return to normal economic activity is delayed. Businesses with exposure to Chinese supply chains can also expect extra scrutiny by surety markets.

In construction, contractors and their sureties may seek protection under force majeure provisions, and be granted an adjustment in contract time and compensation. Stress to cash flow and balance sheets will come from slow down and postponement of new projects and the funding of works. In addition to the construction industry, surety underwriters may curtail risk appetite for travel, hospitality, retail, and energy.

Impact on Structured Credit Market

There has been less immediate impact on the structured credit (SC) market, although some disruption has occurred, particularly in Asia. Reports suggest that deals between banks and potential borrowers are being postponed. As a result, there likely will be a delay in banks disbursing funds in Q1-2 2020, but an uptick in activity Q3-4 2020, as pent up deals enter the PRSC market.

Structured credit insurance or non-payment insurance, as with trade credit insurance, does not look at the underlying cause of the nonpayment or default on a scheduled payment (it would be highly unusual for a structured credit insurance policy to contain an exclusion relating to a pandemic). If COVID-19-related measures cause a borrower to be unable to make scheduled payments when they are due, the coverage would respond so long as none of the exclusions apply. Some underwriters are more cautious in indicating risks and support of loans to certain industry sectors, such as airlines, which could be adversely affected.

Recent financial market volatility and oil price falls are likely to exacerbate this trend. One underwriter reports that their appetite for airline, cruise, shipping, and oil and gas sector credit risks will reduce significantly. Given that structured credit insurance is based on the borrower's credit risk, some underwriters are asking potential insureds to address the likely effect of COVID-19 on the business of their borrowers before an indication of cover will be provided.

Impact on Political Risk Market

Political risk protects insureds against adverse actions by the host government, with the exception of actions taken in the public interest to protect health, environment, safety, or the economy. In addition, the adverse actions need to cause a catastrophic loss rather than just reduced revenue. Considering the nature of these two requirements and alongside government action to date, it is unlikely that political risk policies will have triggered so far. However, the chances of direct, discriminatory action by governments cannot be ruled out, changing this dynamic. Much will depend on how government and public response plays out in this unprecedented situation.

If, for example, the government targets a particular business or sector with confiscatory measures, then a policy can respond. Conversely, if a government's action is deemed insufficient or inappropriate by its citizens — leading to civil strife or political violence that damages an insured facility — coverage would apply. Finally, if the impact on the overall economy leads to hard currency shortages, resulting in an inability to convert local currency or transfer hard currency, political risk insurance can provide a mechanism for conversion and transfer of insured remittances.

Impact on Trade Credit Insurance

In the event of extensive and protracted disruptions to global commerce, companies across many sectors are likely to experience financial strains, heightening credit risks. If the global spread of COVID-19 accelerates, the impact on earnings and balance sheets is likely to intensify in coming quarters.

The global impact of the COVID-19 pandemic has immediately affected the trade credit insurance market. In particular, the combination of business interruption resulting in decreasing revenues and cash flows on the covered counterparties, and the issuance of force majeure contracts, is leading insurers to reduce limits.

A minority of insurers have taken dramatic action, with at least one cancelling limits for buyers in Hubei province with little notice. However, most insurers are taking a pragmatic approach and monitoring the situation, although it is anticipated that as the impact of COVID-19 spreads across the globe, the impact on the trade credit markets may be far-reaching and significant. Insurers will continue to monitor this fluid situation.

Most coverage under a trade credit policy is "comprehensive credit coverage," meaning that insureds are covered for the nonpayment of eligible accounts receivables that are not expressly excluded. In simple terms, policies do not name perils covered, but rather list exclusions that negate cover. Policies typically require the insured to exercise due care and diligence throughout the policy period, and stipulate that they cannot continue to make insured shipments that may result in a known foreseeable loss.

Provided there are no gross violations of such clauses, insureds should be able to make a valid claim for losses related to COVID-19, as the proximate cause of the loss is default or nonpayment and the coverage does not consider the underlying cause of the loss, if it is not excluded.

BUSINESSES WITH INTERESTS IN AFFECTED LOCATIONS SHOULD:

Actively monitor the situation.

Adopt a careful approach to exporting into the locations, reviewing any contracts in place.

Be prepared for requests from insurers for specific information on any funds outstanding on goods or services sold to risks based in that location, along with instructions to refrain from shipping, if ports begin to reach capacity.

Make a determination, prior to a potentially insurable shipment being made, as to whether conditions on the ground would be so impactful that they are shipping into a foreseeable loss, and if they are exercising due care and diligence.

Taking these steps and business continuity risk mitigation actions will help your organization be more resilient to COVID-19's economic effects, especially if it continues to spread to other countries.

Although potentially covered by a trade credit policy, communicable diseases such as COVID-19 can be difficult to model or predict. However, for any company that sells on open account and/or has assets overseas, such coverage forms part of a broader, proactive risk management strategy.

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