Insurance/
Reinsurance

November
2013

EFFECTIVE USE OF INSURANCE POLICIES FOR CAPITAL MITIGATION

For the purpose of Basel II and III (and the First Pillar), banks are required to calculate their minimum capital requirements for credit risk, operational risk and market risk.

In relation to operational risk, this has been addressed both by the insurance market and regulators over a number of years, and capital haircuts (of up to 20%) are available to banks which adopt the Advanced Measurement Approach. Currently, the evidence is that upwards of 12-15% of a bank's regulatory capital is deployed in addressing operational risk.

In addition to operational risk, insurance products have been incorporated in banking institutions' risk matrix (particularly with regard to credit risk) for a considerable number of years, although the appetite and the use of these products to arbitrage capital and insurance premiums has, in our experience, increased significantly.

Use of insurances can greatly increase rates of return on capital as well as replacing elements of regulatory capital. Indications from certain financial institutions are that insurance products can (currently) replace upwards of 25% of their regulatory capital (and perhaps more in certain circumstances).

Credit risk insurance is increasingly being used in more complex transactions (although the credit risk trigger for policy coverage should be defined carefully) e.g. covering credit risks on derivative transactions, including margin shortfalls and "slippage".

Below we discuss two principal forms of cover which the insurance market provides and which can be used (a) to transfer risk and (b) as a capital mitigant.

holman fenwick willan hfw

> Contract frustration insurance provides cover for companies when they suffer losses as a result of the contracts to which they are a party becoming impossible to perform due to a frustrating event.

JOHN BARLOW

Trade credit insurance

An insurance against the possibility of a debtor failing to pay its debts (e.g. accounts receivables). Trade credit insurance may be purchased to secure the credit risk of a single structured transaction or a book of risks. Often an element of political risk cover may be incorporated (see below).

Protection is provided against:

- Non-payment due to commercial risks (frequently the insolvency of the buyer).
- Late payment (or protracted default of trade debts) and/or surety default. The policies will frequently provide for a period in which debts are to be paid once a default has occurred, failing which an indemnity will be paid i.e. a waiting period.

Three features of key importance:

- Pre-qualifying requirements e.g. disclosure obligations, credit limits, retention of title clauses.
- Reporting obligations e.g. a spectrum of notification requirements ranging from awareness of unfavourable information to actual default.
- Obligations to minimise losses – issues may arise as to what constitutes reasonable steps and preservation of subrogation rights.

Contract frustration insurance

Companies that enter into sales and trade contracts outside of their country of domicile will be exposed to cross border perils. Acts of governments such as trade embargoes, import/export licence cancellations, non-transfer of currency, unilateral termination of contracts by governmental entities and non-payment by a government buyer or by a private company (when caused by a political event) can threaten a company's contractual rights and its ability to do business in a particular country.

Contract frustration insurance provides cover for companies when they suffer losses as a result of the contracts to which they are a party becoming impossible to perform due to a frustrating event. There is therefore a contrast with trade credit risk insurance, the trigger for which is crystallisation of a debt. Rather, the focus of contract frustration insurance is a breach of contract, i.e. non-delivery of goods. Nevertheless, it should be noted that the terminology which attaches to these insurance products is often used interchangeably – it is common to find a contract frustration policy insuring trade credit risk.

Contract frustration insurance may indemnify an insured for loss under the following:

- A specified contract or contracts for the sale, purchase, lease or delivery of assets, goods or services.
- An agreement which relates directly to the financing of such specified contracts.
- An agreement concerning financing which is secured against assets, goods or services and/or payment for assets, goods or services due under a specified contract or contracts, or where repayment is to be effected by the sale or receipt of such goods or services.
- Bonds provided within the terms of a specified contract, tender documents or project.

In order to be covered, the loss must arise directly from one or more of the following perils:

- A political force majeure event
- An event resulting directly or indirectly from the actions, inactions and/or default of a government entity, including the inability to make a currency conversion and/or exchange transfer. Such actions may also include default of a government entity which is guaranteeing the performance of

either another government entity or of a commercial organisation.

Political force majeure events include riots, strikes, civil commotions, malicious damage, sabotage, terrorism, war, invasion, acts of foreign enemies, hostile action by national or international armed forces (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power, or other similar events.

Contract frustration policies may protect against non-performance of a trade or sales contract by either party due to political events. The cover may apply to:

- Pre-shipment risks: cover may extend to costs incurred, such as work in progress, raw materials, finished goods or engineering design, up to the point of termination of the contract caused by the triggering event.
- Post-shipment risks: coverage is provided for loss caused by the triggering event.

Issues surrounding the use of insurance

Whilst the demand for these insurance products is relatively sophisticated on the buy side, in our experience, the products which are made available by the market struggle to meet the demands of the buyers for the following reasons:

- Policy wordings are not bespoke and fail to recognise the underlying transaction. Attention must be paid to the underlying transaction e.g. accelerated payments, which can cause significant issues when losses occur.
- Where commodities are concerned, the interests of the bank and the trader which they wish to protect under an insurance programme may differ. Often when a loss occurs, a bank will wish to be paid immediately (rather than on the tranched payment dates) and therefore the policy should contain provisions for the acceleration of amounts due (often this is at the sole discretion of the insurer; these provisions should be removed if possible). Traders will be focused on obtaining the underlying commodity and will therefore wish to renegotiate the deal and consequently there will be waiting periods, upwards of 180/270 days (the "waiting period"). Again, attention should be paid to scenarios where the entire transaction is irrecoverable and therefore accelerated payments should be made.
- Policies are rarely subject to legal due diligence (e.g. warranties and conditions precedent are not picked up or acted upon). Dilution of duties should be negotiated and, where the bank is a co-insured under the policy, non-vitiation and waiver of disclosure clauses (Financier Clauses) should be inserted.
- The nature of the bank's interest in the policy requires careful consideration and legal artifices such as noting of interests and assignment of the policy and policy proceeds should be considered carefully.
- There is often a requirement that the insured transaction/obligations are legally valid and enforceable. The failure to obtain adequate legal opinions (or seek a suitable dilution of this requirement depending on the strength of the local opinion) can result in an absolute defence to the payment of any claim. One method of addressing this issue is to have the opinion addressed to the insured and insurer (and, possibly, the reinsurers).
- The programme may not effect the entire risk transfer (in terms of capacity available e.g. there may be limited capacity in terms of various jurisdictions) and therefore other (non-recourse) facilities may need to be considered.
- The broker's offering should be scrutinised to ensure that they have a security committee which is capable of monitoring the (re) insurers and replacing them, if necessary, for example, if they fall below A – (S&P) (indeed, wording to this effect should be included in the policy (and reinsurance) too).
- Subrogation provisions should be scrutinised carefully – they will often usurp the standard understanding for the application of recoveries i.e. uninsured element, insured element, deductible (if any). Policies will often provide for the allocation of recoveries pro rata between insured and uninsured elements of loss. If the entire exposure is not covered then thought should be given to reverting to the traditional "waterfall" application of recoveries to ensure that the uninsured element is recovered first.
- Policies often fail to reflect the minimum regulatory requirements (e.g. cancellation provisions, payment timing provisions), which can benefit insureds when addressing capital costs.

How HFW can improve your security

Many of the issues which are identified above (and many ancillary issues) have been considered by HFW in policy reviews conducted for bank, trader and commodity clients. Our involvement encompasses reviewing the underlying contract (where we bring to bear our considerable and market leading commodities practice), ensuring the relevant terms and conditions are mapped in to the insurance policy and stress testing local law opinions as to enforceability.

We can advise on structured and captive programmes (the latter are frequently to be found where banks are involved and, therefore, additional issues will need to be considered given the involvement of reinsurers and the degree of control which they may wish to exercise, particularly in connection with the adjustment and payment of the loss).

HFW has advised in connection with the restructuring and rescheduling of transactions as well as ensuring that insurance programmes support the reconstituted transactions.

Our team has considerable experience in recovering indemnities from insurers and reinsurers (notably by way of LCIA arbitrations) as well as securing recoveries in subrogation actions (for example, by way of Bilateral Investment Treaties).

For more information, please contact John Barlow, Partner, on +44 (0)20 7264 8188 or john.barlow@hfw.com, or your usual contact at HFW.

For more information, please also contact:

Paul Wordley
Partner, London
E: paul.wordley@hfw.com
T: +44 (0)20 7264 8438

Olivier Purcell
Partner, Paris
E: olivier.purcell@hfw.com
T: +33 1 4494 4050

Pierre Frühling
Partner, Brussels
E: pierre.fruhling@hfw.com
T: +32 (0) 2643 3406

Dimitri Vassos
Partner, Piraeus
E: dimitri.vassos@hfw.com
T: +30 210 429 3978

Sam Wakerley
Partner, Dubai
E: samuel.wakerley@hfw.com
T: +971 4 423 0530

Paul Aston
Partner, Singapore
E: paul.aston@hfw.com
T: +65 6305 9538

Peter Murphy
Partner, Hong Kong
E: peter.murphy@hfw.com
T: +852 3983 7700

Nick Poynder
Partner, Shanghai
E: nicholas.poynder@hfw.com
T +86 21 5888 7711

Richard Jowett
Partner, Melbourne
E: richard.jowett@hfw.com
T: +61 (0)3 8601 4521

Andrew Dunn
Partner, Sydney
E: andrew.dunn@hfw.com
T: +61 (0)2 9320 4603

Julian Sher
Partner, Perth
E: julian.sher@hfw.com
T: +61 (0)8 9422 4701

Jeremy Shebson
Partner, São Paulo
E: jeremy.shebson@hfw.com
T: +55 (11) 3179 2900 (Sao Paulo)
T: +44 (0)20 7264 8779 (London)

HOLMAN FENWICK WILLAN LLP
Friary Court, 65 Crutched Friars
London EC3N 2AE
United Kingdom
T: +44 (0)20 7264 8000
F: +44 (0)20 7264 8888

Lawyers for international commerce hfw.com

© 2013 Holman Fenwick Willan LLP. All rights reserved

Whilst every care has been taken to ensure the accuracy of this information at the time of publication, the information is intended as guidance only. It should not be considered as legal advice.

Holman Fenwick Willan LLP is the Data Controller for any data that it holds about you. To correct your personal details or change your mailing preferences please contact Craig Martin on +44 (0)20 7264 8109 or email craig.martin@hfw.com