Credit solutions for a New World 2019

An event summary

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How clients sit at the heart of Aon's 'build and grow' strategy

Opening the Credit Solutions for a New World 2019 conference, held at the Aon Centre in London on 24 April, John Cullen – CEO EMEA for Aon's Commercial Risk Solutions, describes how Aon's strategy brings the best of Aon together for its clients.

Aon's approach to working with clients is all about 'build and grow' said Aon's John Cullen, as he welcomed more than 100 delegates from a wide range of mid-large sized corporates. "It's very simple; how we could help our clients build and grow their business?"

A three dimensional client strategy

At the core, explained Cullen, is the client positioned in the centre of a three dimensional 'xyz strategy'. "The x axis represents our country segments; the y axis is our client solutions – those areas of expertise (such as our Credit Solutions practice) where we believe we can help our clients build and grow their business; while the z axis represents our industry specialisms.

"The xyz axis is all about bringing together all the capabilities of Aon for the good of our clients. And that is what today's conference is all about – bringing together the Credit Solutions team with our financial industry specialism and partners, to help our clients which, in turn, helps their clients."

Financial queries grow

It's a proposition that has changed radically in the last 10-15 years said Cullen: "The credit solutions business was all about insurance and risk transfer but 40-50% of the enquiries we get today are for financial related issues rather than risk transfer. The more challenges, and the more financial enquiries we get, the more we realise how the utilisation of the insurance market and working with insurance partners, provides solutions to help our clients build and grow their business."

Concluding, Cullen told the conference: "We can help you protect your assets, manage your volatility and grow your business. And the more our clients challenge us, the more innovative ideas that come through."

John Cullen
Chief Executive Officer
EMEA Commercial Risk Solutions

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The Speakers

Professor Trevor Williams

Trevor Williams is the former chief economist of Lloyds Bank, a position he held for over 15 years. He has worked as an economist in the city of London for 30 years, including the government economic service. He has managed teams of economists and financial analysts in most of that period. His extensive experience covers financial markets, econometric modelling, banking markets, analysis of the UK and global economy. Topical Issues such as global trade, demographics, productivity, the third industrial revolution, global mega trends and the future of manufacturing are areas he has focussed on.

Trevor also runs his own consultancy – TWC: www.trevorwilliams.biz. He blogs and presents at conferences and other client-focussed events, representing economic views on a range of topics.

He is a visiting Professor at the University of Derby, Chairman of the Institute of Economic Affairs Shadow Monetary Policy Committee (SMPC), author of Trading Economics (Wiley), and writes a regular column in Moneyfacts.

Declan Curry

Expert Journalist

Declan Curry has been a writer and broadcaster for more than twenty-five years. He commentates on the day's business and economic news each morning on LBC Radio. He was the business presenter on BBC One's breakfast TV for almost a decade and presented his own regular programmes on BBC Two and Radio 5 Live.

Declan has brought his experience in the media to the speaking circuit. He facilitates and speaks at conferences, hosts awards ceremonies and acts as an entertaining after-dinner speaker.

He has broadcast in Ireland, the United States and Australia. He has been published in newspapers and magazines in the UK, Europe and the United States. He wrote a regular column for the FT's "Investors' Chronicle" magazine.

He has won several awards for his broadcasting and is an honorary doctor of Middlesex University.

Photographer: Gill Shaw

Hannah Fearn

Managing Associate, Sullivan & Worcester UK LLP

Hannah Fearn is a managing associate in the Trade & Export Finance team in the London office. Hannah's practice area covers trade and export finance. Hannah has advised on a wide range of cross-border trade finance transactions in a variety of jurisdictions, with an emphasis on emerging markets.

She has acted for leading banks in the market and her experience includes advising on syndicated and bilateral secured pre-export commodity financings, commodity repo structures, letter of credit facilities, trade instruments and receivables financings. Hannah has advised clients on related regulatory issues, including sanctions arising out of cross-border finance transactions. She regularly advises on risk sharing techniques, including guarantees, sub-participations, insurance policies and payment instruments such as standbys and demand guarantees, and on the use of such agreements as credit risk mitigation under the EU's Capital Requirements Regulation (implementing Basel III).

Hannah is a contributor to A Guide to Receivables Finance, a special report from TFR published by Ark, and has contributed practice notes on a variety of trade finance topics, including commodity financing and capital adequacy for trade finance, to Lexis PSL. In 2011, Hannah spent six months on secondment to the London-based trade finance legal team of a major US bank.

Jessica Tauare

Partner at PwC

Jessica Taurae is Partner in the Accounting Consulting Services team at PwC in the London office. Jessica has been providing advice and solutions to companies in the UK and around the world for over 20 years. The advice she provides covers all aspects of their accounting for financial instruments under IFRS and UK GAAP. She is PwC's lead in Global IFRS lease accounting working group, helping develop accounting techincak solutions.

Jessica is author to a number of PwC publications on the accounting for financial instruments and new lease accounting under IFRS.

How is IRFS 9 evolving?

Following the implementation of the new IFRS 9 accounting standard in 2018, Jessica Taurae, a Partner at PwC, considers its impact on receivables financing.

Focusing initially on the derecognition of trade receivables, PwC's Taurae told delegates that the new IFRS 9 standard provides two key tests when considering if a receivable is off balance sheet. First is the transfer test – has it been novated, assigned, or does it satisfy the pass-through test? "If you don't have a transfer, you've failed derecognition and it remains on balance sheet, so it's really important that there is a transfer." The second key test is around risk and rewards. "If you retain risk and rewards then from a derecognition perspective, it remains on balance sheet. If you substantially transfer the risk and rewards – around 90% – it goes off balance sheet," said Taurae.

Questions around a bank's SPV

From a bank's perspective, Taurae continued, it will have similar issues as a supplier around transfer, and risk and rewards, but quite often when a bank is looking to remove assets from its balance sheet, it will create a special purpose vehicle (SPV) to ringfence those assets that they are trying to sell. "The question there is whose SPV is it? Who should consolidate the SPV? Is it the bank's, the orphan's, or the insurer's? It's really about control, which is 'power, plus returns, plus ability to affect those returns'. All those things need to be present in terms of trying to think about who consolidates an SPV."

What's the business model?

Once it's decided on which balance sheet the assets are on, said Taurae, then the accounting method needs to be decided. The new standard provides a new way of thinking about how to classify debt instruments – which is what receivables or loans are. Here, the important question, argued Taurae, is what's the business model? "Is it to hold the financial assets to collect the cashflows? If so, then it can be left as amortised cost. If however, the business might think about selling that receivable or holding it, then the business model would lead to the path of fair value. For some of the corporates that have significant factoring programmes, their transition to IFRS 9 has seen many of them move from an amortised cost business model to a fair value business model for those receivables."

Impairment – a forward looking standard

When it comes to impairment, added Taurae, IAS39 was an incurred loss model. "You had to wait until you had objective evidence to impair something. For IFRS 9, you know from day one that you have to reserve for expected credit losses. IFRS 9 is more forward looking and is making businesses think about what could potentially happen in the future."

Looking at the overall framework for impairment in IFRS9, a key feature of the three-stage approach is that newly originated 'good' assets do not automatically have full lifetime expected credit losses (ECLs) but instead have 12-month ECLs, said Taurae. "Only when there is a significant increase in credit risk are lifetime ECLs recognised. For corporates who only have short term trade receivables, they would have to book full lifetime ECLs on those receivables from day one." Taurae added that when the UK banks moved to IFRS 9, they recognised an additional £8 billon in credit reserves as a result of moving to the new standard, whereas for most of the corporate financial statements, "it hasn't had much of an impact."

Impairment – credit guarantees and insurance

Turning to the impact of credit guarantees and insurance on impairment, Taurae emphasised it's important to know when a credit insurance is 'integral' to know how it is going to affect an income instatement and balance sheet. "If a loan is sold with credit enhancements referenced within the loan's contractual provisions, it is very much considered integral. If, at initial recognition the loan is entered into and a third-party credit insurance is taken out, that could also be considered to be integral.

"If, at a later date, the business takes out a third-party credit enhancement, that wouldn't be integral because it wasn't included at the original time the loan was taken out – if that happens, that's just a separate asset that you'd have to recognise on your books." If there are credit enhancements covering a portfolio of loans that were entered into at the initial recognition of loans – even if individually the loans do not refer to the guarantee – that could also considered to be integral added Taurae.

Credit enhancement must meet the definition

Sometimes credit insurance doesn't meet the definition of a financial guarantee concluded Taurae. "It might kick in for example following a credit downgrade, or a restructuring and if that's the case we wouldn't consider it to be a financial guarantee and be able to be offset against impairment losses. Credit enhancement must meet the definition of a financial guarantee, otherwise it's a derivative."

"IRFS 9 is more forward looking and is making businesses think about what could possibly happen in the future."

Jessica Taurae, PwC

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The global financial landscape in 2019 – greater volatility to be the new normal

Nearly three quarters of the world economy is seeing an economic slowdown this year says Trevor Williams, Visiting Professor & Chief Economist at TW Consultancy.

"World economic and policy risks are rising – there's no question, in my view about that. Why and how much they will impact financial markets has got to be the key question," warned Professor Trevor Williams from TW Consultancy, as he introduced a session on the global financial landscape, adding that – despite the appearance of calm – there is a lot going on beneath the surface that could suddenly erupt.

The seeds of the next crisis have been sown

What could some of those things be? "The seeds of the next crisis are always laid in the reaction to the last crisis," said Williams. "And some of the seeds of the next crisis are being laid by some of the things we are currently doing." The 'sovereign doom loop' is one example. "The private sector buys sovereign debt feeling that it's safe but they now have a lot of exposure to sovereign risk, so if one of those sovereigns go under a lot of those holding that debt may go under as well." The biggest risk in Europe, Williams added, is that many banks are overloaded with government debt, some of which may potentially get marked down in a future crisis.

Ten years after the financial crisis, and given record low interest rates, vast amounts of QE, bank bailouts and fiscal stimulus, Williams asked: "When will economic and financial market conditions return to precrisis norms?

Policy uncertainty is high, geopolitical uncertainty is high, yet volatility is below its long run average and asset prices in many instances are at record highs. Moreover, although it has recovered, economic growth has not returned to its precrisis trend and is now slowing. What's the magic trick?" The policy reaction – the perception that central banks will come riding to the rescue – highlights the risk in the structure of the system said Williams. "It's important to understand the link between policy uncertainty and volatility. Volatility is at the sort of levels that we saw in the run up to the last financial crisis and yet policy uncertainty is significantly higher now than it was then. We're clearly exposed to any disruption to either the economic backdrop or the financial backdrop. We should be cautious – and perhaps worried - that financial markets seem so optimistic given the risks we have highlighted."

Money supply indicators

Examining some of the economic risks and financial market vulnerabilities, Williams pointed to money supply growth in the US which indicates a sharper deceleration in economic activity than seen so far. "We may see a sharper slowdown in the US economy than is talked about at the moment, but there is the offset of faster growth in the emerging world – particularly in China and India, which are currently expanding at between 6-7% a year." The monetary statistics, however, show that growth in India is accelerating, said Williams, while growth in China – the world's second largest economy - is slowing.

What is the IMF expecting, asked Williams, when it comes to global growth? "They are predicting a slowdown in the first part of this year and a recovery in the second half of this year and into 2020. Are they right? It is possible that this will happen but 70% of the world economy is seeing a slowdown this year compared with last year. If you look at the probability of a more severe downturn solely based on the experience of significant growth slowdown since 1980 in terms of ten-year cycles, we've got to have one at some point in the next few years. We should be more wary than optimistic."

Inflation is low…

Looking at other indicators, global inflation is low and stable. "There is no inflation problem," said Williams. "One of the reasons for that is the existence of a global market economy which enables us to have the capacity to be able to deal with shocks in one place and offset it in another. It can also have negative consequences in that it transmits economic shocks to, areas, communities and sectors in some countries. If this is not addressed - as it often is not - with an appropriately funded adjustment policy from the government in affected countries you can get economic dislocations that lead to a political backlash. But at least with low inflation, there is nothing to stop policy makers from reacting to signs of economic downturn by using monetary levers, to the extent of course that they have any room to pull those levers given how low rates are. We're starting a period of economic slowdown with record low interest rates, which implies reduced flexibility in the face of a significant shock."

…but debt is high

A problem could be the amount of debt in the system William added. "Global debt is rising – it is higher today than it was during the crisis of 2007-8. In the next crisis we are more vulnerable, less able to respond with fiscal policy and that means the economic risks will be greater. Structural budget deficits persist in many countries, despite years of growth during the economic recovery. If we have a recession, because the starting point is so poor there will be dramatic increases in the debt burden as a share of GDP. Debt servicing will take a larger proportion of current government spending and leave less for other areas of spending, such as on public investment and social care. This leaves us vulnerable if the economic cycle turns out not to be as benign as forecast."

The amount of government debt held by central banks has risen enormously, added Williams, which leaves them exposed to sovereign risk. "But corporate debt is also rising as a share of GDP globally. And it's high at a time that the amount of those bonds, which are going to be maturing at the same time the global economic slowdown may be at its worst, are going to be at record levels. Will there be a problem for financial markets in digesting these maturing bonds at the point at which they need to be refunded?"

There has also been a decline in the quality of the bonds which have been issued, argued Williams. "The share of BBB rated bonds in the total issuance of bonds has quadrupled over the last 5-8 years. Therefore, vulnerability in the system is growing. Leveraged loans may be an issue in the US, and sovereign debt aligned with banking vulnerability in Europe. We have to be very wary that the next financial crisis doesn't come from the banking sector, but comes from somewhere else in the credit universe.

Banks better financed

On the plus side, said Williams, bank balance sheets are healthier than they were in the global financial crisis. "The banks are better capitalised both in terms of total assets, adjusted capital and adjusted capital to assets ratio. They have much higher levels of liquidity, they have more long-term assets, they have reduced their short-term borrowing, and they have increased their deposit ratios. So, banks are much better capitalised and in much better shape to weather a downturn. That's unquestionably good news." For some banks, however, the cost of equity is still below the return on equity, meaning there is still vulnerability to an economic slowdown or a 'risk of' event, especially in Europe.

The way out is through productivity gains

While Williams acknowledged the world economy is slowing, he emphasised that there is still growth and pointed to productivity gains from utilising new technology as a solution to many of the economic challenges for the global economy. "The way out of this is to increase productivity gains – via the spread of best practices, keeping markets open, more global trade deals focussed on opening markets up in the services side of the world economy, hence allowing the digital revolution to take place which will open up all sorts of new avenues for growth." But he cautioned: "If we don't do those things, we're trapped in this slow growth, loose official monetary policy environment that maintains an asset price bubble that at some point must deflate."

"So, banks are much better capitalised and in much better shape to weather a downturn. That's unquestionably good news."

Professor Trevor Williams

The use of insurance for capital relief: the changing regulatory landscape in 2019

Following the publication of the Prudential Regulation Authority's (PRA) Supervisory Statement on credit risk mitigation, Hannah Fearn, Managing Associate, Sullivan & Worcester UK LLP, looks at what it means for banks' use of credit insurance.

Opening a session on the use of insurance for capital relief, Sullivan & Worcester's Hannah Fearn updated delegates on the PRA's recent Supervisory Statement in relation to its interpretation of the Capital Requirements Regulation (CRR) – which impacts how banks use eligible credit risk mitigation (CRM) to reduce the capital they are required to hold for their exposures.

The PRA consults

In February 2018, the PRA published a consultation paper on the use of guarantees as CRM under the CRR. "The purpose was to clarify expectations regarding eligibility of guarantees – including insurance – as unfunded credit protection. Unfortunately, when this paper came out, it was immediately clear that a number of the PRA's proposals were going to be problematic for credit insurers," said Fearn.

In particular, Fearn told delegates, the CRR requirement that the guarantor must be contractually obliged to pay out 'in a timely manner' was, under the PRA's interpretation, proposed to mean 'without delay and within days, but not weeks or months' of the obligor defaulting. "Clearly for a typical credit risk insurance policy, the standard waiting period of 180 days was not going to meet that requirement. If that draft supervisory statement was published as the final position in the form proposed, then a number of well-established credit risk mitigation instruments would have been ineligible for use to achieve capital relief…with a knock-on effect of an inability by banks to finance trade." The other main concern from the PRA's proposals, added Fearn, was the way in which the PRA had interpreted certain provisions of the CRR which meant it had removed any basis to adjust the value of a guarantee to reflect the impact of including certain exclusions.

Robust response

The industry's response to the PRA's consultation was "robust," said Fearn, and ultimately led to the PRA not adopting its proposals on the meaning of 'timeliness'. "It appears that a policy with a market standard waiting period can be seen as timely for the purpose of the CRR requirements, however, the PRA has still raised concerns and says it has observed delays in claims payment that it believes creates residual risks for banks who use credit insurance.

"There is also some clarification regarding the effect of exclusions and a finalised position regarding the PRA's expectations on other relevant CRR criteria, although the PRA has raised some specific concerns regarding the use of credit insurance as CRM." These concerns include a risk that a policy might contain 'broad or vague terms or obligations which the firm must fulfil', said Fearn. "The PRA specifically highlighted the duty of disclosure commonly found in credit insurance."

Nuclear exclusion

When it comes to exclusions, the CRR provides that a policy cannot contain any terms outside the control of the bank that would prevent the policy from responding in case of a default, said Fearn. There were concerns raised in the consultation about the impact of this on certain market standard exclusions, with the application of the nuclear exclusion, for example, being outside the control of the banks. "The PRA has given some guidance and said 'yes', this type of exclusion may be contrary to the eligibility requirements, unless the bank can show that 'in all the circumstances the clause is immaterial to the guaranteed exposure and the risk of an obligor default under that exposure'. There is still a degree of uncertainty but it is very useful to have this clarification from the PRA because it gives us a starting point when looking at the terms of a policy."

Risk management and residual risks

Fearn indicated there were two key new developments in how the PRA is changing its approach to how it will view the use of credit insurance to achieve capital relief, the first being the risk of using insurance as CRM. "The CRR already requires that a bank must be able to demonstrate that it has adequate risk management processes to control risks to which it may be exposed as a result of carrying out CRM practices. The PRA has said that its expectation is that this should include identifying the risk of non-fulfilment of an obligation in a policy which could render it ineffective." Examples of these obligations, added Fearn, include the duty of fair presentation; the requirement to maintain an uninsured percentage of the risk; and, timely premium payment. "It is also important to look at the drafting of policies to minimise the risk of inadvertent breach," said Fearn.

The other development in the PRA's approach, according to Fearn, is the idea of residual risks where, in the PRA's view, the use of insurance has in practice proved to be less effective than expected. This could be due to a dispute resulting in a lengthy delay in claims payment or because a policy contains terms that are 'broad and vague'. "Even if you can show that your guarantee can meet all the CRR requirements for eligibility, in some circumstances the PRA will still expect you to hold some additional capital to reflect these residual risks," Fearn said.

A welcome development

"The PRA's final position is a very positive and welcome development," concluded Fearn, crediting the impact of the coordinated market response. "We are leaps and bounds ahead of where we were last year." She cautioned however that financial institutions should note the PRA's concerns relating to the residual risks of using credit insurance and consider how the PRA will apply the new expectation in practice. She noted again the importance of policy wording: "In order to comply with CRR requirements and the PRA's expectations, policies may need to be adapted."

A panel discussion: evolving financial solutions for clients in different situations

- **Mirka Skrzypczak, Head of Trade Finance and Working Capital Product, NatWest**
- **Jonathan Parfitt, Director Origination Corporate & Institutional Banking, ABN AMRO**
- **Wayne Mills, Managing Director, Trade and Working Capital, Lloyds Banking Group**
- **Natalie Ross, Director, Business Development, Working Capital, American Express**

Opening a panel discussion on financial solutions in the banking sector, NatWest's Mirka Skrzypczak emphasised how quickly customer expectations, particularly amongst millennials, are changing. "Our customers know what they want and the challenge is to keep up with expectations. Customers are not coming to us any more just for a product – whether it's an overdraft, loan, or a credit card – we are now expected to provide a very different experience."

As part of a drive for greater efficiency, corporate customers also want better cross border solutions added ABN AMRO's Jonathan Parfitt. "The customer wants you to follow them to territories where they need to sell their goods. Once upon a time they were prepared to find local solutions, but now they want to deal with one provider, all automated, across multiple territories."

More industry collaboration needed?

The banking sector also needs to take a good look in the mirror said Wayne Mills from Lloyds Banking Group. "What we might define as demanding from a customer perspective, just happens to be something we don't have to offer at the moment," comparing banking to how easy it is to transact with an online retailer like Amazon. "Buyer behaviours from the consumer world are now being mimicked in the corporate world, which drives a need for greater collaboration. The client has more knowledge and power and it's not about them being demanding, it's about us stepping up our game and delivering what they want and we can only do that by working together across banking, insurance and technology partners," added Mills.

Redefining the banking business model

Clients are also becoming much more tech savvy, said American Express's Natalie Ross. "They're talking to us about dynamic discounting, supply chain financing – they know what's out there. We have to keep up." A key element however, argued Mills, as banks respond to the growth of new technology in areas like blockchain and artificial intelligence, is how banks retain trust with their customers. Skrzypczak pointed to trials of new payment and settlement technology by organisations such as the Bank of England and the New York Stock Exchange which showed they are, "pursuing this new technology, trust this technology and want to deploy it."

Despite some on the panel feeling that the industry is too fragmented when it comes to the adoption of new technology, Skrzypczak countered that the existence of initiatives such as the R3 consortium, which comprises of 80 banks globally, means, "we are more advanced than we are giving ourselves credit for." There is though, added Parfitt, a need for greater overall investment by the banks. The threat of the big tech companies to the banking model was also highlighted by the panel. "Google, Amazon, Facebook and Apple (GAFA) are already there in areas like payments," said Skrzypczak. "Technology will allow them to break through into banking and it will be interesting to see what happens in terms of collaboration between financial institutions and GAFA – it's about collaboration not just between ourselves in the banking sector but also collaboration with GAFA."

Where's the money coming from?

In the current environment, with interest rates not likely to go up, the panel were asked how are banks going to make money in the future? Does the industry need a shock to the system that will come from the adoption of new technologies like blockchain? "Some banks will be quicker than others," said Parfitt, "and will see an opportunity, buy the technology or the supplier of the technology and will move the market while others will not move quickly enough and may fall by the wayside."
Ross added: "I don't think it's a desire to not move quickly by any of the institutions, it's because they can't," comparing the nimble nature of a small fintech business that can quickly make decisions and get to contract sign-off. "If we come up with a new project, by the time it gets to the point where we have gone through the regulations and had sign-off, we might have missed the boat. What will speed the process up would be more partnering and joint ventures."

Fragmentation

Returning to the theme of too much fragmentation, Mills argued: "We need a much more radical approach whereby we look at the global picture and we get one global consortium together, balance return on investment considerations against helping the world trade with each other – even using the approach of Tim Berners-Lee in making the world wide web free to all! We have to change our thinking. If we continue with pockets of collaboration, I fear we're not going to solve our clients' needs in a meaningful, scalable way."
Skrzypczak countered that the industry doesn't necessarily need to go that way citing the example of the adoption of Android and iOS smartphone operating systems. "It's the ease of access to those technologies and it's the developer communities that drove that adoption because people who build the applications decide which are the platforms that are easy to play with. I'm not so worried about consortia, it's about the underlying network that's being created. We need the internet effect.

A panel discussion: evolving financial solutions for clients in different situations

Enemies at the gate

Given the growing role of technology, are banks becoming tech companies? "Look at Goldman Sachs. 50% of their employees are engineers," said Skrzypczak. "We have to become more like tech companies. The product manager of the future is no longer the person who simply sets a product strategy, they will have to understand the technologies that impact and drive those products." For American Express's Ross, the concern is the other way. "My fear for financial intuitions is not about whether we're becoming tech companies but whether tech companies are becoming financial institutions. That's a huge risk for all of us." "We are banks and will remain banks – we can't lose sight of the fact that at its heart we are a deposit taking institution, but we have to have technological capability to service our clients at the time and in the way they need us to support them," added Mills.

> "We are banks and will remain banks – we can't lose sight of the fact that at its heart we are a deposit taking institution, but we have to have technological capability to service our clients at the time and in the way they need us to support them"
>
> **Wayne Mills – Lloyds Banking Group**

Evolution of credit insurance

The panel session concluded with an assessment of the role of credit insurance in banking. For American Express, it had allowed the business to scale up its supplier payments area for clients said Ross. While, for ABN AMRO, Parfitt saw credit insurance as not only vital to help the business assume receivables risk on behalf of its clients but also when it comes to helping clients expand. "We are constantly looking to move into new territories and our credit insurer supports us to enter new territories so we can mitigate the risk if we have a recovery situation."

Meet the panel

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