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SECTOR IN-DEPTH
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Insurance – Europe

Credit insurers remain disciplined and financially strong as claims will rise

Trade credit insurers, which protect sellers of goods or services from nonpayment by buyers, face challenges ahead amid a global economic slowdown which will translate into a higher number of insolvencies and therefore higher claims. Nonetheless, we expect the industry to maintain relatively good underwriting discipline in 2024. The sector also still holds strong financial buffers.

Claims will increase, revenue growth will slow Corporate defaults continued to increase in early 2024. Although we expect the default rate to decline slightly this year, it will do so only gradually, remaining close to the long term average for a prolonged period. This will push up credit insurance claims and the sector's loss ratios. At the same time, a slowing economy and reduced trade volumes are eroding insurers' revenues after two years of strong growth, which will weigh on their expense ratios.

Credit insurers maintain good pricing and underwriting discipline. Contrary to previous cycles, credit insurance prices have only fallen moderately in the last two years, despite a low level of claims. The average credit quality of credit insurance exposures, although gradually deteriorating, also remains high by historical standards. The sector's strong underwriting discipline makes it less vulnerable to shocks and was a key driver of our upgrades of the largest industry players in 2023.

Financial buffers are strong. Insurers have taken advantage of moderate claims volumes in recent years to increase the buffers in their reserves. These buffers could now be used to offset a potential increase in claims. Some of these buffers will not survive the switch to the new IFRS 17 accounting regime, but the industry's capitalization is also strong. Finally, credit insurers renewed their reinsurance protection for 2024 at similar conditions to last year, further supporting the industry's capacity to withstand higher claims.

Industry faces geopolitical, cyber and social event risks. An escalation of geopolitical tensions leading to a material macroeconomic shock and a surge in corporate defaults would have a significantly negative impact on credit insurers, although it is not part of our base case scenario. The industry is also exposed to cyber risk because of the frequent digital exchange of financial information between credit insurers and their clients. Finally, governments have previously tried to protect the corporate sector in times of crisis by restricting credit insurers' ability to reduce their exposures. This would have materially negative credit implications for the sector, although the probability of a recurrence is currently low.

Claims will increase, revenues will slow down

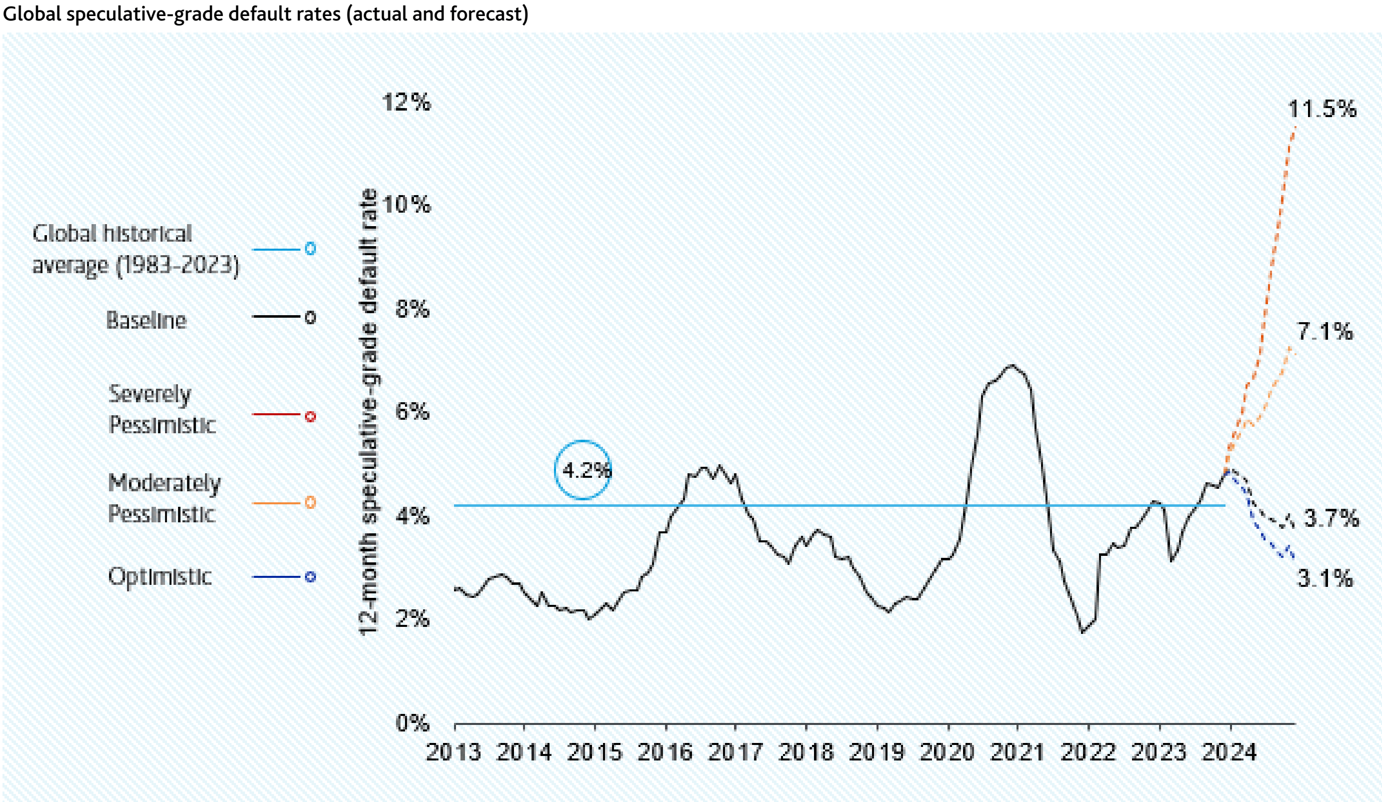
We expect the weak global macroeconomic environment to result in profitability pressures for the credit insurance industry, arising from a deterioration in both the loss ratio (claims divided by premiums) and the expense ratio (expenses divided by premiums).

The global speculative-grade corporate default rate increased to 5% for the trailing 12 months ending in January and February 2024, having already risen to 4.8% at year-end 2023 and 4.3% at year-end 2022. The current 5% level is the highest since the second quarter of 2021.

The increase in defaults suggests that credit insurance claims will rise in 2024, even if the two are not perfectly correlated. This is also consistent with credit insurers' own expectations[1].

In the 2008-09 global financial crisis and the 2020 pandemic, the global speculative grade default rate spiked higher but then fell back again rapidly. While we expect it to decline gradually in 2024, it will remain near its historical average under our baseline scenario. The decline will be particularly slow in Europe, which accounts for a high share of credit insurers' revenue. This mostly reflects the current macroeconomic backdrop of moderating global growth and gradual interest rate normalization.

Exhibit 1
The global default rate will ease in 2024 but will remain near its long-term average
Global speculative-grade default rates (actual and forecast)

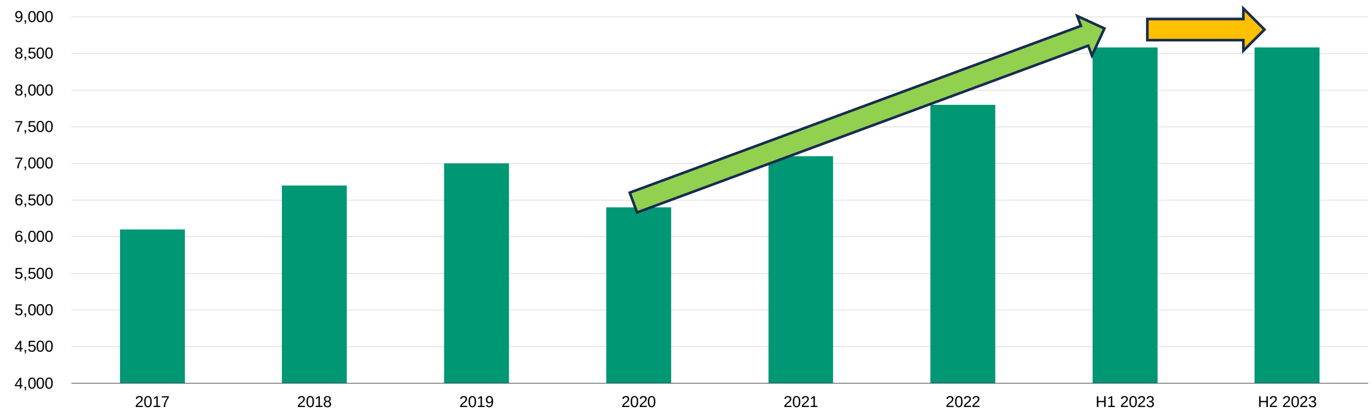


Source: Moody's Ratings

Cost growth may exceed revenue growth

After a long period of strong annual premium growth (around 10% per annum between 2020 and the first half of 2023), the dynamics of the credit insurance market changed significantly in the second half of 2023 (Exhibit 2). The largest players reported on aggregate a modest growth in premiums, and several reported a decline. The change reflects a slowdown in the global economy and consequently lower trade volumes, and to a lesser extent weaker pricing.

Exhibit 2
Premium growth started to slow in H2 2023
Credit insurance industry premiums (€ billion)



2023 figures are annualised and are Moody's estimates based on disclosures from the largest players
Sources: ICISA and Moody's Ratings

As the economy continues to slow in 2024, we expect premiums to grow more modestly or even decline if credit insurers become more prudent. This will put pressure on credit insurers' expense ratios. Some insurers' costs are variable and will automatically adjust with premiums (e.g., commissions paid to distributors), but fixed costs will continue to increase broadly in line with inflation.

Credit insurers maintain good pricing and underwriting discipline

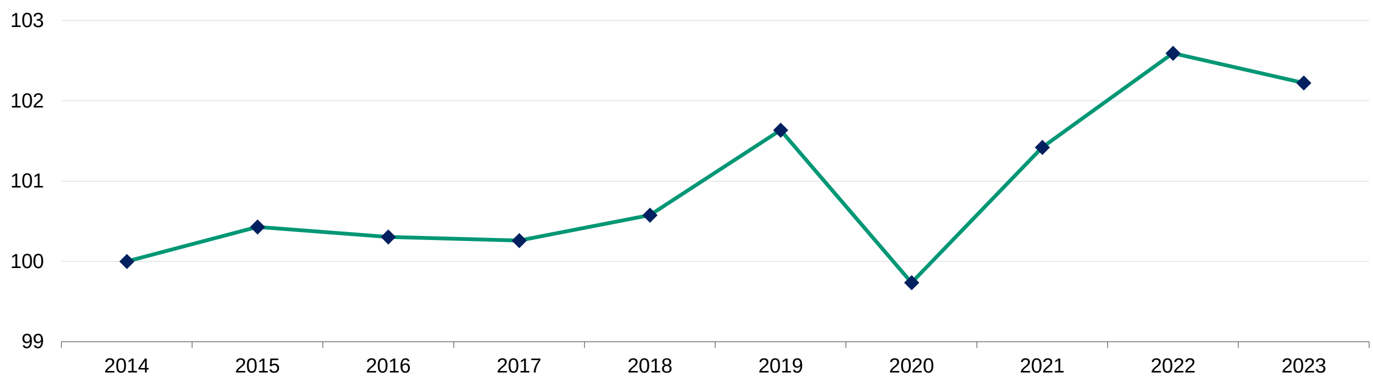
Credit insurers have maintained strong underwriting discipline despite a very low level of claims since 2021, contrary to the pattern in previous cycles.

The sector reported price decreases of just 2% or less in 2023, with signs of stabilization at the end of the year, while combined ratios (costs and claims as a percentage of premiums, a key measure of underwriting profitability) remain historically good. At the same time, retention rates remain very high for most players, suggesting that competitive pressure is mild.

We believe this benign picture reflects credit insurers' accommodation of a rapid increase in demand for coverage from their existing clients as trade volumes recovered after the pandemic. This led to an increase in the sector's covered exposure.

However, we do not believe trade credit insurers have taken on significantly more portfolio risk, despite the increase in their exposure and the deterioration in their pricing. As shown in Exhibit 3, our Credit Insurance Exposure Quality Index[2], which measures the quality of the industry's exposure, has increased sharply since 2020, which means that exposure quality has improved significantly. Although the index has started to deteriorate, partly reflecting a more difficult macroeconomic environment, it remains high by historical standards.

Exhibit 3
The average quality of credit insurers' risk exposure remains very good
Moody's Credit Insurance Exposure Quality Index (100 = 2014 level)



Moodys' Credit Insurance Exposure Quality Index is a proprietary measure of credit insurers' risk in their buyers' portfolio. The higher the index, the lower the risk for credit insurers. The index is built by aggregating selected credit insurers' data related to the breakdown of their exposure by internal score. The index is mostly based on the weight of weakest exposures, acknowledging that internal scoring systems are not comparable among industry players. This index is an industry measure and while largest players tend to take similar actions, the timing of these actions can differ. As such the index does not reflect any individual insurer's quality of exposure.
Source: Moody's Ratings

Credit insurers remain very active in managing their exposures and in implementing targeted action plans to lower or cancel exposures to troubled sectors or countries. The models insurers use to assess the credit quality of the companies they cover will likely reveal some deterioration when those companies publish their 2023 results. However, we expect the insurers to take steps to mitigate the adverse impact on the quality of their exposures.

The three leading European credit insurers have a strong incentive to maintain high quality exposures, as any deterioration has a direct negative impact on their regulatory solvency ratios. This is because these companies calculate their capital requirements using bespoke internal models which give a high weighting to exposure quality. In contrast, under the Solvency II standard formula - a default method for calculating capital requirements in the absence of an internal model - capital requirements are a function of insured volumes (premiums, reserves and exposures).

The trade credit insurance sector's strong underwriting discipline also makes it less vulnerable to shocks. We estimate that credit insurers' premiums relative to the risks they take on are higher than before the pandemic. This was a key driver of our upgrades of the largest industry players in 2023.

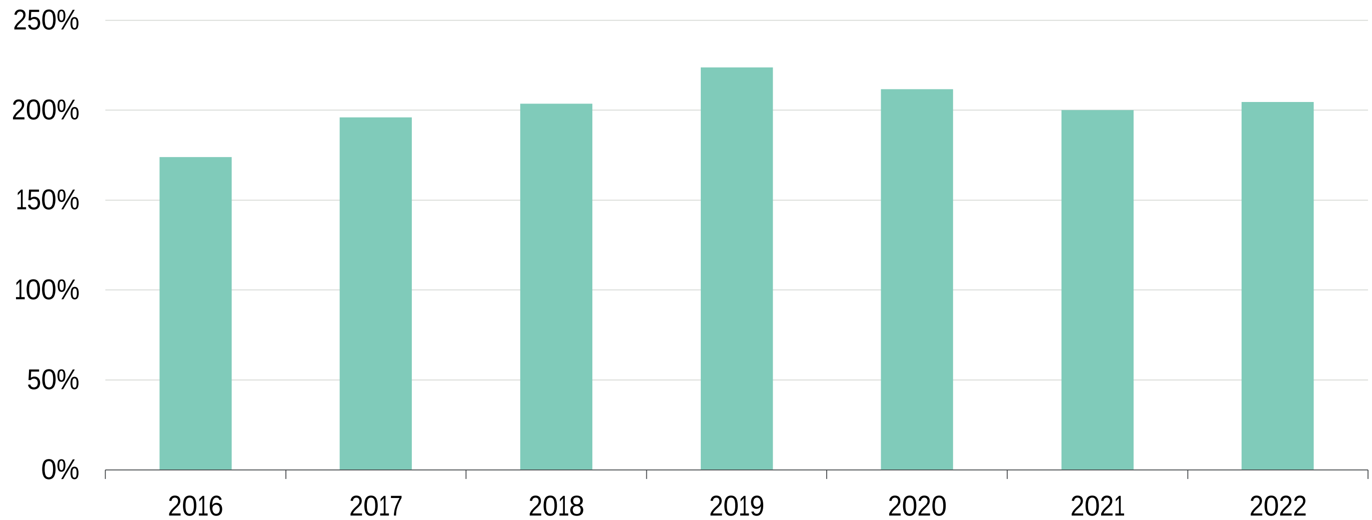
Financial buffers are strong

The trade credit insurance industry also benefits from strong financial buffers, including a high level of reserves and robust capital. The insurers have taken advantage of moderate claims volumes in recent years to build up additional claims reserve buffers. While reported combined ratios were low in 2022 and 2023, they in fact overstate the actual claims incurred during these years because they include precautionary contributions to reserves. The insurers may use these buffers to partly offset the anticipated increase in claims this year, limiting the negative impact on loss ratios.

Reserving buffers are however unlikely to survive the switch to the new IFRS 17 accounting regime, which requires the insurers to calculate their reserves on a best estimate basis. We however expect them to remain conservative in their best estimates, and hence retain some cushion going forward.

The industry's capitalization is also strong. As shown in Exhibit 4, Moody's-rated trade credit insurers had an average Solvency II ratio of around 200% in 2022. There was little change in their ratios in 2023.

Exhibit 4
Credit insurers' solvency ratios remain high
Average Solvency II ratios of large Moody's-rated credit insurers



Sample of rated insurers includes Atradius N.V., Cesce, Coface SA and Euler Hermes SA "Allianz Trade". Changes in solvency ratios include changes in computing methods for some companies, for example following the approval to use a partial internal model.
Sources: Companies' reports and Moody's Ratings

Finally, credit insurers were able to renew their reinsurance protection for 2024 at similar conditions to last year, further supporting their capacity to withstand higher claims. In 2023, policy renewals were marked by a significant increase in the price of property reinsurance as reinsurers responded to a series of large natural catastrophe losses. The price increase to varying degrees spilled over into other lines of business.

The price of credit and surety reinsurers rose slightly, and it took longer for credit insurers to place 100% of their reinsurance programs, despite their very strong combined ratios. For the January 2024 renewals, we understand that the process was smoother and credit insurers were able to place 100% of their programs at unchanged prices and conditions, helped by their good results and cycle management.

Industry faces geopolitical, cyber and social event risks

We currently identify three major event risks for the trade credit insurance industry:

» an escalation of geopolitical tensions

» a major cyberattack

» political or legislative constraints on credit insurers' ability to reduce their exposures if necessary

We estimate the probability of political/legislative constraints as low currently, while the likelihood of a cyberattack is hard to assess.

Escalation of geopolitical tensions would increase claims

While not part of our base case scenario, an escalation of geopolitical tensions leading to a material macroeconomic shock and a surge in corporate defaults would have a significantly negative impact on credit insurers. Geopolitical events, including the Russia-Ukraine war and the disruption of the trade route through the Red Sea pose a risk of slower growth and higher inflation. As shown in Exhibit 1, in alternative scenarios based on less favorable assumptions regarding interest rates and growth, the corporate default rate would increase significantly.

We would expect credit insurers to react by canceling some of the coverage they offer to clients and by raising prices. This could however prompt customers to question the value of their insurance policy, with some potentially opting for self-insurance instead. It would also raise the risk of political intervention.

A cyberattack would cause reputational damage

Credit insurers are exposed to cyber risk because they frequently exchange financial information with clients via digital channels. Their dependence on brokers for a high proportion of their business creates additional interconnection with multiple third-party networks, exacerbating this vulnerability.

We believe that financial institutions in general are well equipped to prevent or limit the impact of a cyberattack. However, we also expect that ongoing economic headwinds in the form of inflation and higher interest rates will constrain cyber budgets at a time when investments in new technology such as generative AI is competing with cybersecurity for funding.

Apart from its potential financial impact, a cyberattack would materially impair the reputation of a credit insurer. This would put it at a competitive disadvantage, especially given the very strong concentration of the industry and the narrow differentiation between products offered by the largest players.

Political/legislative constraints would be credit negative

Trade credit insurers benefited from government support in two ways during the pandemic. Firstly, measures to support the economy reduced defaults to a very low level, and, secondly, governments provided the sector with strong reinsurance protection.

The second measure reflects governments' acknowledgment of the importance of trade credit insurance in supporting trade flows and economic growth. However, we do not expect governments to reinstate reinsurance schemes for the sector in the event of a sharp economic slowdown, or at least not without a quid pro quo. They may for example seek to ease financial stresses by pressuring credit insurers to adopt customer-friendly measures, such as favorable pricing. They may also request that trade credit insurers commit to not withdrawing coverage too quickly when customer credit quality starts to deteriorate.

Governments have made such requests in previous crises, but as they did not follow up with legally binding measures, credit insurers were able to keep operating as normal. For example, French policymakers in 2022 discussed the possibility of legislating to prevent credit insurers from reducing limits too abruptly. While such measures do not appear to be a priority for governments, they could gain momentum if economic conditions worsen materially.

Endnotes

1 See for example https://group.atradius.com/publications/economic-research/insolvencies-adjust-back-to-pre-pandemic-levels.html or https://www.allianz-trade.com/en_global/news-insights/news/allianz-trade-insolvency-report1.html

2 The index published in the report is not directly comparable to the index published last year, as we incorporated additional data and we changed the method to aggregate the data collected from various companies.

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