NewGen ISS Global Default Insurance

Briefing document

September 2016

NewGen ISS Global Default Insurance Briefing Document

Table of Contents

1. Background

A requirement of IATA accreditation is for travel agents, where applicable, to provide a Financial Security that is acceptable per Resolutions, generally via bank guarantees or insurance. This provides protection to airlines in the event of default by the travel agents. The current both insurance and non-insurance Financial Security types are not optimal for some or all of the following reasons:

- Uncertain levels of default recovery.
- The cost to travel agents is high with no benefits of economies of scale derived.
- There is a lack of global control and consistency creating a significant administrative burden.
- Allow sub-optimal security to take these risks.

Following the NewGen ISS presentation to the Passenger Agency Conference in October, 2014, a technical feasibility study was completed by insurance brokers AON and Marsh to obtain visibility into potential design, availability and market capacity of a new Financial Security type to address the aforementioned drawbacks in light of the NewGen ISS framework.

The feasibility study recommendations were presented to the PSG in the meeting held in February 2015. PSG requested to further elaborate on the content presented and nominated an airline Task Force to this objective. This Task Force was composed of PSG and FinCom members and provided recommendations to PSG on the development of the Global Default Insurance.

An initial set of Task Force recommendations was presented and endorsed at the joint PSG/FinDev session in June 2015. PSG also endorsed the development of an Industry Business Case considering the cost of the Global Default Insurance for agents in relation to the cost of current acceptable financial securities and impact on default recovery. In order to prepare this Industry Business Case, PSG endorsed obtaining non-binding price and terms from insurance companies through the brokers.

The outcome of the Industry Business Case was presented to PSG in September 2015 and to PaConf in October 2015. PaConf approved moving forward with the Request for Proposal (RfP) exercise which has been developed during the following months.

Fundamentally, this additional Financial Security type consists of a standardized global default insurance policy that will be brokered to a top credit insurance company and made available for travel agents to be listed on a voluntary basis.

2. Financial securities and NewGen ISS

In order to contribute to the promotion of Safer Selling, NewGen ISS will introduce a new and voluntary Financial Security type in the form of global insurance. A global insurance policy will be brokered with a top credit risk insurance company whereby Agents may voluntarily list themselves under the policy for a defined cover amount.

For Agents, the introduction of the Global Default Insurance will amount to a greater choice of available Financial Security types. Agents will be able to assess for themselves the commercial terms offered by the insurance provider and determine whether or not to opt for this product. The main benefits of the Global default Insurance is that it does not require collateral compared to most bank guarantees and bonds and the cover amount can be easily adjusted while being competitive in price.

Under the NewGen ISS Remittance Holding Capacity framework the Agent, at any point, may increase or decrease its Remittance Holding Capacity by amending the Financial Security amount provided. This allows an Agent undergoing rapid expansion to raise its Capacity. The introduction of Global Default Insurance makes this option become more efficient as the Agent can obtain a higher cover under insurance within a very short timeframe compared to other Financial Security types, particularly Bank Guarantees.

As the insurance provider is a top-rated credit insurance company, the benefit of the Global Default Insurance for Airlines is that it offers greater certainty of claims and improved default recovery rate.

3. Development of the concept

A feasibility study was contracted with brokers AON and Marsh in July 2015 to assess potential structures to provide a Financial Security aligned with the NewGen ISS environment contributing to the Safer Selling principle and addressing the root causes of low default recovery rates, lack of global controls and high administration cost for both Airlines and Agents. The cost of this study was borne by IATA. For reference, key facts and figures about AON and Marsh may be found in Attachment A.

The feasibility report delivered proposed a global insurance solution provided by the international trade credit insurance market in order to address IATA's objectives as well as providing active risk management and infrastructure for the benefit of IATA, its member Airlines and Agents.

The feasibility study also considered the current arrangements and sought optimal solutions in which the key elements are:

- Global controls
- Certainty of recoveries following agent default
- A simple process
- Quality security providers
- Competitive pricing

The main recommendation of this feasibility study is that the Trade Credit insurance market is capable of providing global solutions for its clients and that a global trade credit policy will provide IATA, the Airlines and Agents with all of the key elements highlighted above and address all of the issues cited in Section 1.

Also, within the feasibility study, a number of alternatives were considered and disregarded:

- A change to the current criteria for approving providers to reflect best practice, without any global insurance solution, could help to improve default recovery rates but would not achieve any economies of scale and would be likely to increase costs to travel agents.
- The use of a Managing General Agent or Insurer Appointed Representative to assist with the administration of a global insurance programme. However, this is not a discrete alternative, as insurance market capacity would still be required. There appeared to be no additional benefits from the use of a Managing General Agent or Insurer Appointed Representative compared with the global insurance option.
- The use of a captive insurance vehicle (a separate insurance subsidiary) was not considered appropriate by IATA.

The feasibility study recommendations and proposed solution were presented to PSG in February 2015. PSG nominated a Task Force composed of PSG and FinCom representatives to assess and develop the recommended solution.

Following PSG endorsement of the Task Force recommendations presented in June 2015, the Global Insurance Solution Task Force continued work reviewing the responses from credit insurers engaged by brokers AON and Marsh. PSG also requested an Industry Business Case be prepared to obtain visibility on the key objectives of improving default recovery rates and the Global Default Insurance price competitiveness versus other Financial Security types.

The Industry Business Case was presented to PSG in September 2015 and to PaConf in October 2015. The key elements to assess the benefits for airlines and travel agents from the introduction of this additional Financial Security type are the potential contribution to reduce net default losses and its pricing relative to other acceptable financial securities under 850p, as agents bear the cost of providing IATA a Financial Security when required.

Regarding the potential reduction of net default losses, the industry business case showed the following:

- Should the Global Default Insurance had covered 80% of the monetary value of defaults the Industry would have saved USD 354.8 million from 2008 to 2014, improving the net default rate from an average of 0.036% to 0.015%

  For a more conservative scenario, savings would have been USD 124.3 million and average net default rate would have fallen to 0.029% in the same time period.

- A projection into the 2017-2020 period showed that should the Global Default Insurance cover 50% of the monetary value of defaults, a significant reduction of net default losses of USD 82.9 million would result.

Thus, results indicated that the Global Insurance Solution would contribute to reduce net default losses both in dollar value per year and as a percentage of Gross Sales.

The second key objective is to reduce overall costs of providing risk coverage for Travel Agents when compared to current acceptable financial securities. To this extent, a price comparison based on premium indications provided by four leading credit insurers showed:

- The Global Insurance Solution is price competitive for the vast majority of agents (~ 90%) when compared to Bank Guarantees; the most widely used Financial Security, even when the highest premium rate indication is considered.

- The most significant reduction in cost between a Bank Guarantees and insurance premiums result for small agents, which facilitates their access to a Financial Security reducing their cost of being accredited.

Through this Governance driven process, the key aims laid out for the Global Default Insurance are the following:

- Airline members are seeking to achieve the highest level of default recoveries worldwide via an internationally A-rated security, thus improving current rates of default recovery worldwide.

- In order to ensure attractiveness for agents, the Global Default Insurance is to provide very competitive pricing with no requirements for an agent to provide collateral, thereby actively supporting global sales growth and lowering barriers to entry.

- Greater level of global control, transparency and consistency together with significant reductions in administration worldwide.

4. Approaching the insurance market

Following PaConf approval in October 2015 to move forward with the Request for Proposal (RfP) exercise, insurance brokers AON and Marsh were instructed to perform the RfP process.

The Global Credit Insurance Market covers in excess of USD 2,500 billion of receivables and is led mainly by three credit insurers together with some general insurers.

Brokers approached the three major credit insurance companies worldwide and a major general insurance company with a strongly established credit risk practice. All four insurance companies provided non-binding price indications to establish a global insurance policy to cover travel agent default and insolvency risk.

The general requirements communicated to the qualified insurers were:

- Price: Maximize purchasing power to achieve a premium rate structure that offers cost savings to those agents that currently provide security so that it is attractive for them to join the program.

- Cover: Maximize leverage to get the highest levels of cover possible and most favorable policy structure and seeking a minimum acceptance rate of 80% of the agents that request cover.

- Service and premium collection: to ensure minimal administration, particularly with regard to premium collection and payment. Premium payment will be the responsibility of the agent and cover will only be effective once the premium has been paid.

- Management Information Systems: detailed online management information available to IATA regarding program/policy performance, cover, aggregations, risk profile, claims and over dues etc.

- Collections and claims: access to a uniform collection service to maximize recoveries and minimize costs.

After launching the RfP in January 2016, the focus has been on presenting the requirements to the insurance companies through a series of meetings held by the brokers, review of proposals, product development, regulatory and compliance reviews and ongoing negotiations.

All three insurers presented their capabilities and intended solutions for the Global Default Insurance to IATA and the brokers.

As a result of these presentations, a set of additional specific requirements and clarifications prepared by IATA and the brokers was sent to the insurers. Updates on the progress of the RfP and negotiations were provided to PSG in February and April.

5. Global Default Insurance features

Under the Global Default Insurance, IATA is the policyholder, beneficiary and named insured on behalf of the airlines and therefore is also to comply with the obligations of the policy, in particular paying the insurance premium.

The Global Default Insurance will be an additional Financial Security type to those currently acceptable under Resolution 850p and will not replace any of the current Financial Security types included in the aforementioned resolution. Therefore agents may, in order to comply with a request from IATA to provide a Financial Security, voluntarily choose the Global Default Insurance or any other of the Financial Security types acceptable under Resolution 850p - being bank guarantees, bonds or a Default Insurance Program (DIP).

The requirements put forward by the Industry for the Global Default Insurance have meant that a standard Global Credit Policy is inadequate, thus extensive negotiations have taken place with the Market leaders via the brokers in order to achieve enhanced policy terms and conditions in the best interests of IATA, its Members. These negotiations have also contributed to bringing in features to make the Global Default Insurance attractive to agents.

Euler Hermes, part of the Allianz Group and the largest global credit insurer, has met IATA and its Members' requirements to a significantly greater extent than other potential insurers. For reference, key facts and figures about Euler Hermes may be found in Attachment B.

The established structure whereby the agents are the risk and, in case of agent default, the Members are settled the claim payments via IATA, results in a model which makes IATA unlike other credit policy holders.

The following terms have been agreed by Euler Hermes and are uniquely tailored for the Global Default Insurance:

- 100% indemnity.
- Premium is charged on the required limit to be insured. This enables the agent to compare the Global Default Insurance quote against other Financial Security types on a level playing field.

- Application fees are waived. While it is normal in this market to charge an application fee of around USD 125 per quote, it has been agreed that travel agents can apply for quotes at zero cost.
- There is no commitment to a minimum premium payable by IATA.

Additional key features of the Global Default Insurance:

- Limit available globally except Congo, South Sudan, Zimbabwe and countries under sanctions.
- Limit provided in local currency.
- Premium paid by agent in local currency.
- Policy threshold of USD 5,000. Agent defaults under USD 5,000 will not be indemnified by the insurers, but defaults above USD 5,000 will be settled in full.
- Adjustable limit: each individual agent's agreed limit may be amended if required via the Global Default Insurance, subject to no negative information.

The usual timeframe to amend an agent's limit ranges from 2 to 8 working days with most agreed within 2-3 working days.

- Discretionary Limit based on IATA accreditation process and no negative information is being considered.

  A Discretionary Limit means that agents requesting a limit at or below the agreed Discretionary Limit can be included in the scheme at global rates based on having been accepted by IATA's accreditation criteria alone without additional checks performed by Euler Hermes but subject to Euler Hermes having no negative information about an individual agent. This facility allows increased cost efficiencies and thus contributes to lower overall premium rates for the agents.

Premium rates will be quoted based on the agent's grade (i.e. low risk, average risk, above average risk…), the country's grade (i.e. AA, B, C…) and as assessed by the insurer.

The brokers have confirmed Euler Hermes' premium rate indications are competitive relative to the Global Credit Market per se and relative to other indications tabled.

As the Global Default Insurance is an additional Financial Security under 850p, an agent may choose whether to obtain cover under the Global Default Insurance or via any other type of acceptable Financial Security (e.g. bank guarantees, bonds, letters of credit, Default Insurance Program etc).

The decision as to the competitiveness of the insurance premiums is thus left to the market at the level of an individual agent.

The agreed terms with Euler Hermes and the brokers do not include any commissions of any type payable to IATA.

In addition, all global programs work via a proven statistical model whereby the greater the number of Agents who participate in a program, the lower the costs for any individual participant Agent as this generates economies of scale relative to all aspects of the program (administration, larger financial base to absorb all losses, statistical "spread" globally etc). Euler Hermes and the brokers advise during roll out, the Global Default Insurance will apply global rates from the outset.

In summary, the Global Default Insurance is sustainable by design through delivering lower costs to the Agents, delivering global controls and reduced administration to IATA with certainty of claims paid to the Airlines - all in both the short and long term.

6. On boarding process

The on boarding process is that by which an Agent may apply for, obtain a quote for the required cover amount and potentially accept and receive confirmation of cover from the insurer.

Under the Global Default Insurance, the main steps of the boarding process are as follows:

- Step 1: Travel Agent wishes to evaluate GDI as security option. This may be done by the Travel Agent either by contacting the local broker with regards to the global Default Insurance or accessing the Euler Hermes dedicated on-line portal.
- Step 2: Travel Agent make application to Euler Hermes. This may be done through the broker or the Euler Hermes dedicated on-line portal.
- Step 3: Euler Hermes assesses the Travel Agent. Euler Hermes advises the Travel Agent of the decision and, if applicable, quote, terms and conditions as well as the timeframe to accept the offer. The broker will answer any questions from the Travel agent with regard to the offer and features of the Global Default Insurance.
- Step 4: Travel Agent confirms to Euler Hermes that they accept cover to join the Global Default Insurance. Euler Hermes validates the cover as soon as they have received confirmation
- Step 5: IATA invoices the amount paid to Euler Hermes in insurance premium to the Travel Agent on a cost recovery basis.

Attachment A

Facts & Figures about AON:

- Income 2015 of USD 11.7 Billion.
- 500 owned offices worldwide.
- 120 countries with owned or 100% controlled offices.
- 72,000 employees.
- Over 200 credit risk specialists plus support staff.
- Wholly owned subsidiary of Aon plc (NYSE: AON)

Facts & Figures about Marsh:

- Income 2015 of USD 11.9 Billion.
- 400 owned offices worldwide.
- 130 countries with owned or 100% controlled offices.
- 54,000 employees.
- Over 200 credit risk specialists plus support staff.
- Wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC)

Attachment B

Facts & Figures about Euler Hermes:

- World leader in trade credit insurance, 34% market share globally.
- Rated AA- by Standard & Poor's.
- EUR 890 billion business transactions protected worldwide.
- 55,000+ clients worldwide.
- 1,700 claims indemnified per week.
- 20,000 limits requests received per day.
- Consolidated turnover of EUR 2.5 billion and net income of EUR 302.1 million.