Close monitoring of risks essential in uncertain times

Effective risk identification and management lies at the heart of Credendo's business to ensure we can make wise underwriting decisions and support our customers' needs.

Credendo's business is all about risk and how to support our customers when operating in markets with varying degrees of uncertainty. In turn, we must also carefully manage our own risk exposure and make sensible underwriting decisions that ensure our company's long-term financial sustainability.

Underwriting risk is the most material risk for Credendo, where the premium should be sufficient to cover our expected losses and our expenses. The technical provisions should be sufficient to cover our insurance liability vis-à-vis our policyholders. Underwriting risk also captures catastrophic risk linked to extreme or exceptional events taking place in a specific sector or country.

Credendo assesses underwriting risk using risk-based capital models. Such models are part of a larger risk management framework that also includes risks that are not captured by the capital models, and risks that are hard to quantify.

Credendo also takes a more 'qualitative' approach – which is important to identify operational risks, for example. This approach is based on an annual risk survey we conduct across all departments within Credendo to help identify failing or ineffective internal systems and processes.

It captures risks that escape the model-based approach. Together, the more top-down model approach and bottom-up surveying approach give us a very complete picture of our risk profile.

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Country and sector risks

In terms of monitoring catastrophic risk, Credendo has developed various country and sector risk assessment models, some for long-term transactions and others for short-term ones.

The Risk Management department conducts a standard review of all short-term country and sector risks on a quarterly basis. Medium- and long-term risks are reviewed at least two times a year. Political risks are rated 1 to 7 – where a rating of 7 means a very high risk and the cover policy changing to 'off cover'.

If a big event happens that has a direct impact on country risk classifications, the Risk Management department conducts an immediate review. Credendo will either decide to adapt the cover policy and go 'off cover' on a country, or simply to adopt a more restrictive cover policy by lowering the percentage of cover for example. This ensures we have a cover policy that is fit for the risk we see.

We are constantly monitoring the economic and geopolitical situations in countries and sectors so that we can adapt our cover policy accordingly. For example, during the Covid crisis Credendo was quick to review classifications and adapt its cover policies.

Similarly, Credendo has been swift to revise the cover policies of Russia, Ukraine and Belarus following the invasion of Ukraine in February 2022. Moreover, on top of the internal monthly newsletter, the Risk Management department provided internal alerts and presentations about the global implications to keep everyone in Credendo up to date.

The Russian invasion of Ukraine is of particular concern for the Risk Management department, although

at the time of writing the conflict is still in its relatively early weeks, making it hard to judge the long-term impact of the conflict.

Credendo is not willing to take on new risks in Russia and Ukraine. However, we do have existing risk exposure in our portfolios, and we now have to build reserves for those increased risks.

Future risks

Looking to the future, Credendo sees some new risks as well as a continuation of already identified risks.

When assessing risk, the Risk Management department takes into account the underlying economic and geopolitical situation. The very high financial risk in emerging markets is a particular source of concern.

In 2008, emerging markets had better macroeconomic fundamentals and were able to withstand fallout of the financial crisis.

In contrast, they are now facing higher government debt and higher external debt. Hence, many countries have less room for manoeuvre to cope with external shocks such as a sharp increase in energy and food prices and sharp tightening of global financial conditions.

Other risks we will be keeping a close eye on are the likelihood of more pandemics following the Covid-19 outbreak, as well as the impact of climate change and its influence on the economic and political situation. The climate change risk is now embedded in Credendo's catastrophic risk models – which was not the case 15 years ago.

Cyber risk has been identified as a 'new' risk that is of increasing concern for insurers and their customers alike, with many corporates facing the risk of damaging cyberattacks that threaten the safety of company data and the day-to-day running of businesses. Credendo is in the process of accelerating cyber risk mitigation measures.

Risk mitigation strategies

As well as maintaining an effective risk monitoring model, Credendo also has measures to mitigate risk, especially its most material risk: underwriting risk.

We do this through three key procedures: the selection, the pricing, and the provisioning of risks.

We avoid too large concentration on single counterparties by putting caps on maximum exposure we want to take on a country and debtor, for example, and we cede a proportion of our underwritten exposure to the reinsurance market.

The pricing of risk is affected by the debtor, country, and sector risk ratings – the insurance premium is consistently higher if the risk is rated higher.

Credendo's Risk Management department further ensures there are sufficient provisions to cover any potential losses within the current portfolio.

Risk management is also embedded in the whole governance system of Credendo.

The risk management strategy is ultimately defined at parent company level, where the company's appetite for different types of risk is defined. This strategy is then translated into policies and rolled out throughout the company.

Risk management in unusual times

Also in 2021, Covid-19 was the dominant risk affecting the global economic recovery. The pandemic showed resilience, as more contagious variants of the virus continued to affect the global economy – albeit unevenly across regions and countries.

The gradual recovery of the global economy allowed for a partial reversal of the many risk rating downgrades of 2020. However, the economic and financial environment remained difficult due to persisting supply chain disruptions, rising inflation pressures, geopolitical tensions and very high debt levels. Most regions were therefore in an uncertain and fragile situation until the huge political and economic shock resulting from the conflict in Ukraine was about to hit.

A global economic rebound hampered by a persisting pandemic

As in 2020, Covid-19 remained the number one risk factor hitting the global economy and shaping its path. While 2021 was the year of global economic recovery (of 5.9%) after a deep contraction in 2020 (-3.1%), such recovery was lagging behind in many emerging countries. Several factors explained the large discrepancies across regions and countries. The vaccination rate indeed had a major influence, as a high rate often allowed for faster economic normalisation. Diverging fiscal and monetary support also mattered. Large fiscal expenditures and broadly accommodative monetary policies supported the recovery in advanced economies (e.g. the 'NextGenerationEU' recovery plan and the 'American Rescue Plan'), whereas many emerging countries started to tighten their policy mix amid low fiscal space and rising inflation pressures (e.g. Brazil, Mexico and Russia).

The impact of transmission channels and countries' different economic structures also explained the pace of recovery. The sharp increase in commodity prices had a positive impact on commodity exporters – notably oil exporters – particularly in Latin America, the Middle East, Africa and the CIS. On the other hand, they negatively affected commodity importers and contributed to inflation pressures along with supply chain disruption. Despite a recovery in countries with high vaccination rates, tourism remained weak and the sector is the most affected by the pandemic. On a positive note, global financial conditions remained broadly favourable and global trade rebounded significantly on the back of sustained external demand in the US, the EU and China, which benefited their trade partners.

In China, after a strong first half-year, economic performance gradually slowed down as a result of property market turmoil and energy shortages. Meanwhile, input shortages (goods and labour) and supply chain bottlenecks hampered the recovery of the global economy in several sectors, such as the car industry. Large supply and demand mismatches were exacerbated by a lack of shipping containers. Looking ahead, high energy prices and disrupted supply chains are expected to continue for some time. Those trends in combination with last year's depreciating currencies in some countries (e.g. Turkey) have pushed inflation to record levels for years worldwide. The threat of faster-than-anticipated monetary tightening in the US and the EU, leading to a sudden deterioration of global financial conditions and possible capital flight from emerging markets, represented a high risk in a context of historically high global debt. The latter nevertheless stabilised in 2021 and the debt-to-GDP ratio declined thanks to stronger GDP growth. However, for the many beneficiary low-income countries, the conclusion of the G20 Debt Service Suspension Initiative (DSSI) at the end of 2021 will raise debt repayment pressures. For countries that benefitted from the extension of the initiative to December 2021, their two-year grace period for the delayed repayment of debts will expire in mid-2023. In 2021, international financial institutions continued to ease balance of payment pressures of many countries. A notable example was the IMF's historical SDR allocation of USD 650 billion in August, which temporarily boosted the countries' liquidity.

Besides Covid-19 uncertainty, persistent inflation pressures and a high risk of public debt crises among low-income and middle-income countries, and their sociopolitical consequences are dominant downside risks. Indeed, heightened inequality and poverty, frustration with the handling of the pandemic, eroding trust vis-à-vis the authorities and high food prices in low-income countries create conditions for social unrest, populism and political instability. Policy short-termism and the poor outcome of the COP26 in another year of extreme natural disasters also makes accelerating climate change a rising risk contributor to the global economy and future country risks. Geopolitical tensions as well – first those resulting from the US-China

rivalry – have contributed to maintaining country risks at high levels globally. While Beijing restored order in Hong Kong, Taiwan was and will remain the top conflict risk between the two superpowers. The other major sphere of tension came from risks of an expanding military conflict in Ukraine. On the back of the Russian troop build-up on Ukraine's border as of November 2021, tensions grew to a new high between Russia and the US and Europe, until Russia invaded Ukraine on 24 February 2022. The conflict in Ukraine has a large impact on Russia – targeted by severe western sanctions – and Ukraine. More globally, seeing that both countries are important commodity exporters, the fallout is particularly acute for commodity importers and sectors reliant on commodities as input.

Evolution of Credendo's country risk classifications

In 2021, a slowly waning pandemic impact and a gradually improving economic outlook for many emerging and developing countries allowed for a partial reversal of short-term (ST) risk downgrades decided during the first year of Covid-19. With risks tilted to the upside, notably driven by strong commodity prices and the extraordinarily large IMF SDR allocation, Credendo upgraded the ST political risk for 30 countries (including two small islands) – among which Chile, by two notches. Latin America (eight countries) and Sub-Saharan Africa (eight countries) recorded the highest number of country upgrades, followed by Europe and the CIS region (six countries). A total of 10 countries were downgraded (including five very small economies), among which three countries in Sub-Saharan Africa and three in Asia. The number of changes was much more impressive for the business environment risk (which uses a more granular 7-grade risk scale, and has replaced the previously used 'commercial risk' since June 2021). Business environment risk was marked by a wave of upgrades, driven by improved economic prospects. Upgrades (126 countries, of which 38 for small economies) overwhelmed downgrades (four countries) with the biggest number of upgrades recorded in Asia and Latin America (21 and 26 countries respectively), followed by Sub-Saharan Africa (16 countries). For the medium- to long-term (MLT) political risk, the trend was completely different with downgrades still dominant, just as in 2020. The reason lies in the fact that, in most cases, the pandemic's impact further increased already high country risks. Hence, it led to the downgrade of seven countries, with four in Sub-Saharan Africa (Ethiopia and Rwanda to 7/7, Seychelles and Tanzania), two in Latin America (Aruba and Bolivia) and one in Asia (Sri Lanka). Only two countries (Guyana and Mauritania) were upgraded, for country-specific reasons (see below).

> Besides Covid-19 uncertainty, persistent inflation pressures and a high risk of public debt crises among low-income and middle-income countries, and their sociopolitical consequences are dominant downside risks.

Pascaline della Faille, Country and Sector Risk Manager at Credendo

Asia

Asia suffered from its worst pandemic waves amid low vaccination rates. Recurrent strict lockdowns disrupted economic activity and continuing travel restrictions slowed down Asia's strong recovery, particularly in Southeast Asia. Besides, the region was hit by supply chain bottlenecks, high energy prices combined with coal shortages in India and China, inflation pressures and a Chinese slowdown exacerbated by a real-estate crisis. Yet, the Asian economy grew fast, and the net annual evolution of risk ratings was positive thanks to a solid first half-year, which allowed for the upgrade of 10 larger economies – including India – for the business environment risk. Six countries were upgraded for the ST political risk (among which two small islands). One of those countries was Indonesia, partly as a result of stronger commodity prices. Myanmar and Sri Lanka (along with a small economy) were downgraded for both risks. 2021 was Myanmar's annus horribilis after a military coup in February led to economic chaos and frequent protests, bringing the country to the verge of a civil war.

In Sri Lanka, the economic and financial situation deteriorated further due to the persisting tourism and Covid-19 crises. Caught in a tricky circle of low growth, unsustainable public finances, high external debt and financing needs, shrinking foreign-exchange reserves and a weak currency, Sri Lanka was the only Asian country to be downgraded (to 6/7) for the MLT political risk. In a region prone to high war risks, notably in East Asia, the year was marked by the Taliban's return into power in Afghanistan. The rapid economic collapse and a failed state could become a risk to regional stability.

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Raphael Cecchi,
Country and Sector Risk Analyst at Credendo

Latin America

For Latin America, 2021 was a year of mixed developments. On the upside, th e region was among the fastest in the world to inoculate its population against Covid-19. This was a welcome development after the disastrous toll the pandemic took in 2020, when the region was the hardest hit in per capita and economic terms. Moreover, the region experienced a robust economic recovery of 6.8% in 2021 while current account revenues significantly increased, supported by US stimuli (mainly benefiting Central America) and a mini commodity boom (largely supporting South America). Nevertheless, the economic recovery was very uneven, with Caribbean islands particularly taking a battering in 2021 due to low tourism revenues. On the downside, most economies did not recover enough to reach pre-Covid-19 real GDP levels again. Furthermore, inflation surpassed targets in all countries due to the rising global energy and food prices while the exchange rates of Latin American countries depreciated and remained under pressure. As a result, monetary policy started to tighten in most countries as of the third quarter, which was forecasted to hinder economic growth in 2022. Additionally, unrest was on the rise (in Colombia, Brazil and Cuba for instance), as poverty and unemployment increased in combination with higher income inequality and the easing of lockdown measures.

Unrest risks will remain in the foreseeable future as governments will have difficulties tackling the root causes of the unrest since public debt is in general already elevated. For the ST political risk, eight countries (among which Brazil, Chile and Ecuador) were upgraded, mainly thanks to stronger commodity prices, with only four Caribbean islands (among which Antigua and Barbuda) highly dependent on tourism seeing a downgrade. For the MLT political risk, Aruba was downgraded to 6/7 – its high reliance on tourism revenues further deteriorated its macroeconomic fundamentals – while Guyana was upgraded to 5/7 as its increasing oil exports are positively transforming the economy.

Sub-Saharan Africa

In 2021, Sub-Saharan Africa partly emerged from its Covid-19-induced recession (-1.7%) of 2020, and reached a regional growth level of 4%. The economic recovery – mainly driven by the global trade revival – was uneven across the region due to great divergence in access to vaccines and medical equipment, but also in availability of fiscal space for policy support. Resource-intensive countries were hit the hardest by the 2020 crisis, but they also benefited from high commodity prices in 2021, although this is rarely a sustainable driver for recovery. The well-diversified non-resource-intensive countries were the best performers, while fragile and tourism-dependent economies were the worst performers (except for the highly vaccinated ones like Seychelles, Cape Verde and Mauritius). In 2021, Africa's disproportionate vulnerability to food insecurity, poverty and population displacement as a result of climate change only became more apparent. The risk for political

destabilisation has increased in a substantial number of countries, be it through exposure to terrorist attacks (Sahel countries and their border regions, Mozambique, Somalia and Nigeria), large popular protests (Sudan, Senegal and South Africa), unconstitutional power changes or military coups (Chad, Mali, Guinea and Sudan) or an expanding regional military conflict (Ethiopia). In addition to the fiscal challenges, public debt vulnerabilities continued to be a major concern and constrained the ability of African governments to develop a pro-active recovery strategy. According to the IMF, about 20 African countries are either in debt distress or at high risk of debt distress. The historical IMF SDR allocation in August did temporarily boost the liquidity position of an important number of African low-income countries and created welcome additional fiscal space. On the downside, the conclusion of the G20 DSSI at the end of 2021 will raise debt service pressures again.

In 2021, the business environment risk of 16 Sub-Saharan African countries was upgraded and only Ethiopia was downgraded. The ST political risk classification of Malawi and Ethiopia (and the Comoros) was downgraded and eight countries were upgraded thanks to an improvement of liquidity driven by the IMF SDR allocation, higher commodity prices and a general recovery in global trade. The MLT political risk classification was downgraded for Rwanda, Ethiopia, Seychelles, Tanzania and Mali, while Mauritania was upgraded from 7/7 to 6/7.

Middle East and North Africa (MENA)

In 2021, the MENA region began to recover from the significant contraction caused by the Covid-19 pandemic and the collapse of oil prices. In a turn of events, oil prices rebounded and reached high levels in the second half of 2021. The rapid increase of oil prices together with the gradual recovery of oil production under the OPEC+ agreement fuelled the economic recovery and improved fiscal and current account balances of oil exporters. Oil importers also began their recoveries in 2020, supported by a pickup in vaccination roll-outs in some countries (Morocco, Jordan, Tunisia), domestic consumption, and the recovery of key trade partners.

Nonetheless, real GDP remained significantly lower than pre-Covid-19 levels for several countries (Bahrain, Iraq, Kuwait, Tunisia, and United Arab Emirates) – countries with severe political crisis excluded. Moreover, the 2020 double shock still lingers on many countries' public finances (Bahrain, Egypt, Jordan, Lebanon, Morocco, Oman and Tunisia). As other regions, the MENA region experienced inflation pressures. The year was also marked by the resumption of negotiations on the Iran nuclear deal, which is key for regional stability.

As a result of buoyant oil prices, five oil exporters saw an upgrade of their business environment risk ratings (Algeria, Kuwait, Oman, Saudi Arabia and United Arab Emirates). Israel and Morocco were upgraded as well. For the ST political risk, only Oman was upgraded as a result of improved liquidity. MLT political risk ratings instead remained stable.

Emerging-market (EM) Europe and CIS countries

Geopolitical, political and social tensions persisted in the region, notably with heightened tension between Ukraine and Russia (as Russian troops amassed near the Ukrainian border as of November 2021), the imposition of sanctions on Belarus, spillover effects from Afghanistan, and still tense relations between Armenia and Azerbaijan. The heightened tensions between Russia and Ukraine in 2021 turned into an armed conflict in 2022. Fallout from the conflict would be large for the region in 2022, given the importance of Russia for many countries as a trade partner and a source of remittances. Following a sharp contraction in 2020, real GDP growth increased rapidly in 2021, but in some countries (e.g. Armenia, Moldova and Kyrgyzstan), it was not sufficient to put real GDP above its pre-pandemic level. The rebound was largely driven by higher commodity prices, robust external demand and – in some countries – higher domestic demand. Covid-19 continued to wreak havoc in the region given the large discrepancy across countries in terms of vaccination rates. In many countries, inflation rose sharply amid higher commodity prices and global demand/supply mismatches. As a result, many central banks in the region tightened their monetary policies. A notable exception was Turkey's central bank that eased its monetary policy despite fast-rising inflation. The latter along with the sharp depreciation of the Turkish lira, explained the downgrade of the business environment to category G/G despite Turkey's very strong growth performance (real GDP growth of 9.5% in 2021). Russia – the biggest economy in the region – continued to implement very prudent fiscal and monetary policies. Following a contraction in 2020 (-2.7%), real GDP growth increased by 4.5% in 2021. This along with a more stable exchange rate led Credendo to upgrade the business environment risk rating to E/G (from G/G in 2020) despite higher inflation and interest rates. In addition to Russia's, the business environment risk of 13 other countries was upgraded. The ST political risk of six countries was upgraded amid an improvement of liquidity driven by the IMF SDR allocation, higher commodity prices (Azerbaijan, Kazakhstan and Tajikistan) and moderate to strong recovery in EU countries (Albania, North Macedonia and Georgia). The MLT political risk remained stable in 2021.