More of the same or new era?

Ruslan Kharlamov and Christian Gabriel ask if post-crisis trade credit insurance can become more clientorientated and more innovative

Among suppliers selling goods and services on open account terms, trade credit insurance is regarded as indispensable by some and useless by others. What accounts for such a polarity of opinions?

International credit insurance is a relatively young industry. Having evolved from government-backed export promotion schemes in the OECD countries, it underwent rapid growth and consolidation in the 1990s. The modern credit insurance market has been shaped by the 'big three' service providers, all headquartered in Europe but increasingly operating on a global scale.

After the crisis

All oligopolies attempt to control the supply side of the market, and private credit insurance market was no different. The industry's shortcomings became evident during the last economic crisis. When demand for credit insurance was at its highest, many limits were reduced or cancelled, wreaking havoc on international trade. Many clients were forced to rethink the usability of credit insurance as a risk management tool. For the first time, the big three international credit insurers experienced a net outflow of customers.

The disappointed market craved alternatives. For most suppliers, credit default swaps and the London market were out of reach. To address their concerns, several European governments started to contemplate the expansion of export credit agencies into segments traditionally controlled by the private sector. Finally, a push into credit and political risk insurance from several new players, which the market saw recently, has been a logical response to unsatisfied demand around the world.

These developments have already shaken things up, but will they result in more dependable solutions going forward?

Why trade credit insurance?

As international trade is becoming more competitive, suppliers are increasingly required to provide their customers with trade credit. For retailers and industrial consumers, this has become an important source of capital, sometimes exceeding all other sources of capital combined. Suppliers, therefore, must minimise the risk of not being paid for goods and services sold on open account terms. This is especially important when banks are engaged in financing the trade credit.

The apparent simplicity of credit insurance has made it a staple risk management solution for suppliers and financiers alike. For some, it has become the only risk management tool, directly affecting the ability to sell on open terms. Such reliance, however, may be justified if three conditions are met:

- the insurance coverage cannot be reduced or cancelled within the agreed timeframe;
- the insured understands his obligations to the insurer and is able to satisfy them; and
- the insured understands the limitations of credit insurance and can manage related implications.

Each of these conditions is explored below.

Revocable v. guaranteed coverage

Imagine that you are offered a health insurance contract with a provision that it may be modified or cancelled after every medical exam. Would you go for it?

The principles of trade credit insurance are no different, yet many clients pay for 'protection' that may be changed or terminated at any moment. By offering such insurance coverage, we believe that underwriters lend an umbrella in sunny weather and claim it back when it starts to rain. A case in point is turnover-based policies, where clients must pay a minimum annual premium without any guarantee of insurance coverage.

Underwriters contend that revocable coverage helps control the debtors' financial condition and prevents losses.

This argument has little merit because a well-established credit monitoring industry does just that – provide financial insights, analytics, and credit recommendations for a fraction of credit insurance cost. Indeed, suppliers pay a premium to be insured against bad debts and not for recommendations on sales terms with their customers.

Fortunately, more insurers start offering limits that cannot be reduced or cancelled within the agreed period, usually up to one year. The guaranteed coverage requires a deeper analysis and closer cooperation between the underwriter, the client, and the debtor, which may lead to a longer assessment of each risk and a higher premium. In return, the supplier receives real protection against bad debts, which is particularly important for insuring receivables under long-term contracts.

For the time being, guaranteed coverage is mainly confined to single-risk insurance, but clients can already synthesise whole or partial turnover policies by bundling together several single risk policies. In our opinion, the industry should now offer to the market turnover-based policies where at least some limits would be irrevocable within the agreed period of time.

The insurance of binding contracts is also gaining momentum. Once the binding contract or purchase order is issued, the underwriter cannot reduce or cancel the agreed coverage, even if the debtor becomes insolvent before delivery of goods or services. When you look at it this way, such a solution lies halfway between revocable and guaranteed insurance coverage.

Legal compliance – the small print

Even though the principle of credit insurance is simple, credit insurance contracts are certainly not. Unless the insured satisfies his obligations promptly, the insurer retains the right to deny loss indemnification.

Which obligations of the insured are paramount? Of primary importance is the obligation to declare overdue accounts receivable, usually within 30–60 days after maturity. Other obligations include the following:

- timely invoicing of goods and services supplied (usually within 30 days after delivery);
- timely declaration of insured turnover or maximum exposure at risk;
- timely declaration of binding contracts and purchase orders, if applicable; and
- timely payment of insurance premiums.

Sometimes, the insured is not allowed to disclose the name of his underwriter to the debtors. In case of debt recovery, the insured is obliged to follow his underwriter's instructions in all respects.

However, some obligations of the insured are less explicit, which leaves room for arbitrary interpretations of their compliance with policy terms. For example, the insured is usually obliged to inform the underwriter about any deterioration of the debtor's payment discipline and financial situation or developments that may adversely affect the debtor's business. Such obligations create an obvious conflict of interest, which the industry has failed to reconcile to date.

Other compliance issues include the following:

- ensuring compliance of legal entities and countries with policy conditions;
- ensuring compliance of policy conditions with goods and services to be sold on open terms;
- ensuring compliance of payment terms and credit limits with policy conditions; and
- ensuring compliance of risk origination with inception and duration of insurance coverage (risk attaching vs. loss occurring policies).

Any omission by the insured may cost them insurance coverage. To avoid this situation, buyers of credit insurance coverage should invest in internal control systems and continual staff training to comply with policy requirements. They should pay particular attention in case the insurance policy incorporates the insurer's standard terms of business, which may be heavily skewed in his favour.

"Underwriters lend an umbrella in sunny weather and claim it back when it starts to rain"

Limitations of trade credit insurance

Even guaranteed credit insurance coverage has limitations, which should be understood and addressed by the insured.

Many suppliers confuse non-payment risk with counterparty performance risk, which relates to various forms of repudiation of a sales contract by the debtor. As a rule, insurers do not cover performance risk. The payment obligation of the buyer to the seller arises only after:

- the seller has fully performed his contractual obligations to the buyer; and
- the buyer has taken delivery of goods or services from the seller.

Repudiation of a sales contract

The instances when the buyer refuses to take delivery of goods or services or lodges a claim as to their quality and marketability are not considered as insured events. In the latter case, any bad debt may be ascertained and loss indemnified after the buyer's claim is found groundless by a court or through arbitration, with all legal costs being paid by the insured.

If the supplier needs protection against insolvencies, acts of state, and force majeure events that may prevent delivery and payment for goods or services, he should seek extended coverage of political and other risks. Many insurers offer such protection for an additional premium, but again the risk of repudiation of a sales contract is usually not insured.

Maximum liability

As a rule, turnover-based policies cap the maximum amount of annual indemnification in relation to the payable insurance premium. What does this mean in practice? As soon as the insured is indemnified up to such maximum amount, he loses protection against bad debts until the beginning of the next insurable period.

This aspect of turnover-based policies is sometimes overlooked by the insured. We recommend the following remedies:

- bring the amount of minimal premium in line with contemplated credit exposure;
- maximise the ratio of annual indemnification to payable insurance premium;
- negotiate a possibility to increase the amount of annual indemnification during – and not only before – the insurable period, bearing in mind that such option may incur an additional insurance premium.
- The ratio of annual indemnification to the payable insurance premium may vary a lot, which necessitates thorough market research and negotiations to secure optimal conditions.

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Top-up insurance coverage

In the current economic climate, many suppliers struggle to obtain sufficient limits to protect sales on open account terms. Refusing to provide required coverage may be driven by both objective (the debtor's credit rating) and subjective (the insurer's financial capacity and prior limits for the same debtor) reasons.

If the insurer cannot provide sufficient coverage, the parties may seek additional (top-up) insurance coverage in the secondary market. Top-up coverage enables the insurer to support his client's business while sharing risk with acceptable third parties. It may be implicit, when part of risk is reinsured, but the supplier maintains one policy, or explicit, when the supplier has a separate policy based on a tripartite agreement between the parties. One policy is easier to manage, while two policies help the supplier diversify the insurers' counterparty performance risk.

Watching the watchdog

The insured should not forget that underwriters are a source of counterparty performance risk in their own right. Even though no major insurer followed the fate of Lehman Brothers and MF Global, some would have certainly collapsed during the financial crisis without state intervention. The reputation of credit rating agencies, and trust in their credit ratings, has also been dented. In this new world, buyers of credit insurance should exercise due diligence over debtors and insurers alike.

Reinsurance allows underwriters to spread risk but does not provide further security to the insured. Cut-through provisions in reinsurance agreements may offer the insured additional protection, though legal effects of such provisions may vary from one jurisdiction to another.

Building a portfolio

Credit insurance implies spreading risk across a portfolio of debtors, but what if such a portfolio does not yet exist? In fact, all suppliers starting to offer trade credit are confronted with this dilemma.

The answer lies with single-risk policies. Originally, these policies were developed for supplies of capital goods and infrastructure projects but later spread to other goods and services. By insuring individual debtors and contracts, they facilitate market entry for new suppliers. The bundling of several single risk policies allows a portfolio of debtors to be built and then, if appropriate, switched to a turnover-based policy. This approach offers aspiring suppliers – for example, producers from emerging markets – a good opportunity to move up the global value chain.

Other limitations

Other limitations of standard credit insurance policies are self-explanatory. They include the following:

- exclusion of government-related risk (otherwise, political risk insurance should be applied);
- exclusion of intragroup risk;
- exclusion of indirect risk, such as interest, penalties, and consequential damages; and
- exclusion of private individual-related risk.

To summarise, it is wasteful to buy credit insurance coverage unless the insured is able to fully comply with policy terms and requirements. Suppliers that have no resources to ensure such compliance should outsource policy management to a specialised broker or consider factoring and other risk management tools, if available.

What next?

The processes discussed in this article should foster the emergence of a less inward-looking, more client-oriented credit insurance industry. A lot will depend on new challengers of the incumbent players – their commitment, underwriting skills, financial capacity, and willingness to innovate. The big three credit insurers will have to adapt their business models to market realities or lose market share.

For good or bad, we will see important developments in the credit insurance market in the years ahead. TFR

Note

For other opinions on credit insurance see David Neckar's article 'An adaptable species: how credit insurers have adopted the colours of trade financiers' at www.tfreview.com/node/8597 and the insurance roundtable on page 20

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