Trade Credit Insurance: Best Practice and Lessons from the Crisis

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The financial crisis placed a spotlight on the trade credit insurance market among other things, highlighting not only its continuing importance - particularly in Europe - but also the pitfalls of excessive reliance on it.

Before the credit crisis, 35% of all European sales were credit-insured, while only 5% were financed, via a combination of factoring, invoice discounting and trade receivable securitisation. Similar data for the US showed just 5% insured, with 4% being financed. To understand the role of credit insurance and how it has been affected by the crisis, it is important to understand the principle uses and advantages of this product for its buyers. From my perspective, it offers three discrete elements: the transfer of credit risk, the out-sourcing of the credit risk management process, and a financial solution building block. These elements emphasise different aspects of insurance policies, and for that reason have had different impacts during the crisis.

Transfer of Credit Risk

The most obvious benefit of using credit insurance is to transfer the risk of a receivables book to the insurer. In particular, a ‘traditional’ (i.e. whole turnover) credit insurance policy has a number of special features, making it different to other forms of risk transfer (such as securitisation, first loss-based credit insurance, re-insurance via captives, credit default swaps (CDS), etc).

While a whole turnover policy only insures a proportion of the risk (typically 90%), it does cover 90% of each individual receivable, as opposed to 90% of the overall portfolio. This is an important distinction: if, for example, you have random losses of 10% on your portfolio, you would lose up to 10% (or first loss, whichever is the smaller) on first loss-based insurance or securitisation, but might only lose 1% on a whole turnover policy, as 90% of each individual loss (i.e. 90% of 10% loss) would be covered. Unlike a derivative-based product (such as a CDS), there is no basis risk - the insured instrument (receivable) is exactly the one the seller holds. Whereas, in the case of a CDS hedge, the designated reference event might or might not occur when a particular receivable is not paid.

Credit risk transfer is not necessarily static: i.e. what you are able to transfer can change over time, depending on the coverage limit issued/withdrawn by an insurer. So, if a limit were to be withdrawn, outstanding transactions would remain covered, whereas any new sales would not be covered.

Also, the insurer does not cover performance risk, so if the end customer does not pay due to some contractual reason (such as product quality, failure to meet a precise specification, etc), this would not be covered and remains the supplier’s risk. Similarly, a supplier’s failure to comply with specific terms of the insurance policy could invalidate a claim. Clearly, when the economic cycle is down and insurers tend to experience larger losses, they will have a stronger incentive to scrutinise claims more carefully than they might during a more benign economic environment. This means that it is important for the insured party to have good operational discipline, in both dealing with customer disputes and in ensuring continuing strict compliance with insurance policy terms and conditions.

While the use of first-loss policies and captive reinsurance normally allows more flexibility in maintaining the level of cover, they typically only transfer the risk of a large, cumulative loss.

The ability to transfer risk allows a company to increase the overall amount of risk it is taking. For example, this could enable longer credit terms to be offered, which could then be converted into margin if sold correctly. For example, at one stage of my career we introduced a stock keeping unit (SKU) for payment terms - it happened to be the highest-margin product we sold. Paradoxically, if the insurer’s underwriting quality is low or indiscriminate (i.e. the insurer more or less randomly picks a certain percentage of limit requests to decline) and the insured continues trading with all counterparts where they believe the risk is acceptable, then they may get a better deal from the risk transfer than if the insurer knows what they are doing (and therefore declines limits for higher risk end-buyers). This is because the proportion of total losses covered by the insurer would increase (although over time the premium for renewal would also increase). So far, I have not come across any reliable study of underwriting quality (i.e. if an insurer hypothetically declines 20% of limits, what percentage of actual losses do they thereby avoid on a given portfolio).

From a cost perspective, on a whole turnover policy, two distinct reasons can cause an increase in the effective rate (apart, that is, from a direct increase in premium by the insurer). The first reason is if there was a reduction (as opposed to a cancellation) of the limit for an individual buyer, with the result that the supplier is paying a premium based on all sales to that buyer, while being covered only for a percentage of the exposure (as they would constantly trade over the limit). The second reason is related to the minimum premium for the policy. A combination of limit cancellation (sales to non-insured buyers are often excluded from insurable turnover) and a fall in sales volume could potentially result in a significant increase in the effective premium percentage, once the insured turnover falls below the level specified in the minimum premium calculation, as the minimum premium would then represent a higher percentage than the nominal rate in the policy.

With respect to risk transfer, the impact of the crisis very much depends on any concentrations. While most insurers keep overall reductions of cover relatively small, they are often much more radical in approaching a particular industry, region or even a large individual buyer (irrespective of whether it might be argued that underwriters have only a limited understanding of such industries or companies).

Outsourcing of the Credit Process

Another important reason for corporates using credit insurance is the ability to outsource the credit process and the related cost. For small exposures, many companies do this even if not using insurance, by relying on various credit agencies, such as Dun and

Bradstreet. However, for large exposures, most companies undertake an in-house credit analysis. Credit insurance provides a strong temptation to outsource the credit risk analysis function to insurers, which in theory should have both good quality data and analytical resources, and are also able to back their decisions with their own funds, given that they are taking the risk they recommend. Admittedly, some companies have taken this to an extreme, basically letting go of their own in-house credit analysis resources and instead taking a policy decision to follow whatever decision their insurer makes. This is a very risky strategy, as the insured company gives up any ability to make an independent assessment and decision (meaning they lose control over their customer relationships). In addition, their ability to negotiate with underwriters, by presenting them with facts and analysis to support requests for coverage limits, is weakened.

If the company relies totally on the insurer for its credit risk analysis process, it is potentially exposed to a lower quality of underwriting (i.e. if insurer declines ‘good’ companies and approves ‘bad’ ones, the company will both lose perfectly good sales and suffer higher claims and future premium increases. This could be particularly important if sales are industry specific, in which case the company might well have better knowledge of the industry than the insurer. Also, it is possible that the insurer’s decisions are not necessarily driven by unbiased opinion on the quality of the buyer (in this case the company can help by providing better information and industry knowledge to the underwriters, assuming of course that they are willing to listen), but are perhaps influenced by other factors. Such factors might include the insurer’s own exposures at customer, industry and regional levels, possible re-insurance constraints, etc. In particular, companies with highly concentrated exposures (on a buyer, industry or regional basis) are at significant risk if the cover is withdrawn or materially reduced and if they do not have clear contingency plans.

A Building Block for Financial Solutions

Credit insurance has long been used as a building block for financial solutions. The most common use of a company’s own credit insurance would be for invoice discounting and/or factoring. These are still under-utilised: as mentioned above, out of 35% of receivables insured, only 5% was financed. The use of credit insurance in financing by a smaller or weaker company can be constrained by the bank’s view on the risk of that company’s ability to perform, which in this case could apply to both the underlying contractual performance (disputes, fraud, etc) and to compliance with the terms of the insurance contracts.

One way to mitigate such risks is through the use of buyer confirmations, particularly in areas like distributor finance, where the relationship is stable and a reasonable level of IT integration exists, allowing such confirmation to be relatively easily arranged and shared with the bank. The bank can also monitor compliance with the terms of the insurance policy (i.e. payment of premiums, timeliness of declarations, exact match of the buyer so that the limit is written on exactly the same entity as the sales contract and purchase order, etc), thereby allowing the seller to reach a risk profile on financing such sales that would be broadly similar to a traditional supply chain finance for a higher quality buyer. Again, better quality suppliers with robust operational procedures would find it easier to agree invoice discounting facilities.

The ability to finance an insured receivable book is a very important consideration for a supplier, especially in a credit-constrained environment, and (as outlined in the risk transfer section) the amount of such financing should remain reasonably stable as long as there is a diversified portfolio and no major sales decline (providing, of course, that banks are still happy with the insured risk). ‘Traditional’ whole turnover policies (no first loss, a percentage of each buyer’s exposure covered) are normally easier to finance, compared with first loss policies. The structure can also be clearer from an accounting standpoint, while the financing of captive structures can still be very difficult if they are not linked to a major corporate name.

Conclusion

Despite all the setbacks, credit insurance remains an important tool for suppliers in both risk transfer and financing, and is likely to be even more important as credit insurance capacity comes back to the market. In evaluating its appropriateness and benefits, a company needs to clearly define what its major objectives and priorities are (risk transfer, outsourcing of credit process and/or financing?), what the characteristics of its portfolio are (particularly any buyer, industry and regional concentrations), and to retain adequate processes and controls.

Finally, companies need to be very careful in taking a decision to completely outsource any core competence, such as the ability to undertake a credit assessment of its buyers. This can greatly affect their ability to make independent commercial decisions as to which buyer to supply and what risks to take.

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