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Credit Insurance: Lessons from the crisis

by Igor Zax | 19 Mar 2013 | Be the first to comment

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Credit insurance may have fallen out of favour during crisis years, but if used correctly it remains a vital tool for European corporates, according to Igor Zax.

Throughout the crisis, much attention was turned to credit insurance, both positive as the need for risk mitigation became more obvious, and negative as many insurers withdrew limits, and a lack of insurance played a role in corporate collapses.

With around 35% of total receivables being insured in Europe, it is important to understand why companies are using it and what the implications are.

Credit insurance offers three discrete elements: credit risk mitigation, 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.

"The main declared purpose of credit insurance is in transferring credit risk, however the perceived value of such a transfer depends significantly on the nature of the company's business."

Risk Mitigation

The main "declared" purpose of credit insurance is in transferring credit risk, reflected in both real loss mitigation, i.e. claims paid, and reduction of corresponding provisions. However, the perceived value of such transfer depends significantly upon the nature of company's business.

The experience of the crisis for firms with highly diversified sales portfolios, was that there was no sudden catastrophic increase in general defaults and the insurance industry tracked graduate change through both premium and cover level adjustments.

Companies with diversified sales generally were not massively affected by default levels and while risk mitigation was a factor, their use of insurance was often driven by other reasons.

On the other hand, for companies with significant concentrations, which generally saw value in credit risk mitigation, obtaining cover was challenging, as costs are high, maximum liability limit seriously affects cover and effect of cancellations is very significant.

"It is for companies with medium concentration that credit risk mitigation has so far proved to be most valuable."

It is for companies with medium concentration that credit risk mitigation has so far proved to be most valuable as it prevents significant (but not catastrophic) fluctuations of losses that are acceptable to insurers (on an overall portfolio basis) but may be undesirable to companies.

Outsourcing the credit process

Another important driver for the use of credit insurance is that it gives corporates the ability to outsource the credit process and related costs.

The key question is whether a company is using insurance as a substitute or complement to their own processes. In some cases it is used as a substitute to external ratings/systems. Using credit insurance as alternative to say D&B or other reference agencies) makes sense in case of highly diversified, relatively small, exposures as the company feels better relying on somebody who is risking their own capital on the back of their decisions.

Admittedly, some companies have taken this to an extreme, letting go of in-house credit analysis resources and instead following 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 decisions, 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."

Relinquishing control

Moreover, if the company relies totally on the insurer for its credit risk analysis process, it is potentially exposed to a lower quality of underwriting.

For instance, if the 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.

It is also possible that the insurer's decisions are not necessarily driven by unbiased opinion on the quality of the buyer 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.

Self-fulfilling prophecy

One significant factor to keep in mind is that views of insurers became an essential part of credit analyses; in similar way as rating agencies, as recent experience (particularly in retail) shows that such views may become trigger of insolvencies. Previously, conventional wisdom suggested these were driven mainly by banks, so their decisions could become a self-fulfilling prophecy, particularly where the buyer did not notice they need to work with insurers.

The last, and surprisingly most underutilised (the amount financed is only about 15% of amount insured) area of use of credit insurance is as part of receivable finance solutions.

"Such solutions present good value when compared with offerings from financing providers and give companies a significant value driver on top of risk mitigation."

With the crisis there was reduction of supply from some banks on credit-insurance backed invoice discounting, but such solutions still present good value when compared with "one stop shop" offerings from financing providers, and give companies a significant value driver on top of risk mitigation.

The need to finance may be general working capital funding (particularly for weaker suppliers) or ability to offer/accept longer terms from the buyers without increasing credit risk (by using insurance) or consuming working capital (compensating through receivable financing). Flexibility in offering payment terms became extremely important through the crisis, where terms are sometimes even more important to buyer than the price and other factors.

Vital tool

Effective use of insurance-backed invoice discounting solutions require monitoring and management of two key risks - policy compliance (buyer identity, timing claims and declarations) and clear distinguishing between credit and performance risk - it is essential for companies to establish processes and systems to support these.

Credit insurance remains vital tool for corporate customers. It serves multiple purposes and its value depends a lot on the way company is using it. Understanding this process is equally important for corporate users and the insurance industry.

Igor Zax is managing director at Tensor, a corporate restructuring consultancy.

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