Credit Insurance- Common Misconceptions and can it be a useful tool?

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Quick Introduction Tenzor Ltd www.tenzor.co.uk

- We provide consulting on all aspects of working capital financing and management to both corporates and financial institutions
- Previously had senior finance roles in Dell, Citibank, Commerzbank and Daiwa, as well as partnered with John Sculley in a supply chain finance boutique
- Designed and managed large scale cross border programs utilising, among other tools credit insurance with all major players
- Sloan Fellowship distinction from London Business School- thesis on receivable financing

What is Credit Insurance

- Insuring risk of loss due to customer default
- Covers credit (sometime also political) risk only- not commercial disputes or invoice validity
- Can be for whole turnover or specific risks, nationally or internationally
- Typically includes some form of risk sharing- % of each invoice covered, aggregate first loss, each and every loss, etc.

Who are the Players

- Market is dominated by three major specialised players – EulerHermes, Atradius and COFACE- all European headquartered with global presence
- Some large global insurers (AIG, ACE, QBE, etc.) also have small credit insurance divisions
- There are also niche specialised players coming from Lloyds market, Bermuda and other places
- Some companies also manage government programs in their countries as a separate line

Credit Insurance and Receivables Financing

Trade Receivables	% Insured	% Financed
Europe	35	5
UK	30	6
US	5	4

- In Europe, credit insurance is extremely important (domestic and export), and is larger than all forms of receivable financing (factoring, invoice discounting, SCF, trade receivable securitization) together
- In US penetration is significantly smaller and also is more focused on export deals

Core benefits to corporate user

- Velocity
  - Higher credit limits allow to put more business through without hitting the limits of company's own risk appetite
- Terms
  - The company can use longer terms with the customers (investing its own or third party capital) without increasing exposure
- Financing
  - Insured receivables can be financed in either "true sale" or ABL structure

Why Low Usage- some typical concerns

- "Unlike Europe, we have good quality of information and decision process in US, so if anywhere we can only consider it in some niche export markets"
- "Insurers are trying to avoid paying claims"
- "Insurers withdraw cover all the time- what is the benefit?"

Misconception 1 – Insurance as outsourcing of credit process

- Two types of business- transactional vs. relationship
- In transactional business credit may be outsourced (to external agency or credit insurer), in relationship it can not
- In well integrated industry vertical if outside party (such as credit insurer) knows its customers better than a credit manager it is probably wrong credit manager
- Insurance shall not substitute own credit process in relationship business

Insurance as outsourcing of credit process- cont.

- Competent own credit process provides advantages
  - Mitigation of effect of withdraw or non-granting the limits-making own decisions allows to trade even without cover
  - Educating underwriters-sharing information and credible insights allow to significantly change outcomes on key limits. Especially true for global policies with defined escalation path
  - Cost. Competent credit process reduces losses and can be transformed to substantial cost advantage when negotiating policies

Misconception 2- claim payment experience

- Insurer will use valid excuse IF it is given to them
- Core reasons for claim not being paid:
  - Contractual dispute-non-payment is not due to customer credit, but performance issues
  - Non-compliance with the policy (such as breaching time limit for notification)
  - Wrong customer (for example invoicing different subsidiary)
  - Highest ambiguity relates to discretionary limits- cautious needed in both wording and general use

Claim Payment Experience- cont.

- Mitigation claims non-payment risk
  - Good process and discipline- companies with week processes are far more likely to suffer
  - Technical solutions (with ledger audit, automatic triggers, etc.) to control each of likely causes
- Supply Chain Finance like techniques
  - Buyer as oppose to supplier confirmation eliminates performance risk, risk of customer misidentification and a number of others, making credit insurance extremely effective tool comparing with "normal" invoices

Withdrawal of cover

- Insurers can reduce or cancel limits on some buyers (some specialised policies offer "non-cancellable" limits, but in fact these also have conditionality- read the "small print")
- Cancellation of the limit does not affect sales done before it (and in some policies have various forms of grace period after)
- Cancellation normally does not prevent sales after the limit is cancelled (if no notification due), but watch for recoveries wording

Withdrawal of cover- cont.

- Withdrawals are typically small % wise (something like 10% in the midst of the crisis) but may have severe effect IF relationship driven company does not operate own credit process (and therefore stops supply whenever limit is cancelled)
- With efficient credit process, part of cancellations is no-choice (very high risk), part can be reversed talking to underwriters, and some can be taken on unsecured basis re-approaching insurer after some time
- Understand the drivers of withdraws
- Change insurers periodically to avoid complacency

Structural features- common misconceptions

- Whole turnover vs. selective policies
  - For credit insurers main model is whole turnover- many companies want to use insurance only to cover companies where they have limited appetite
  - In reality, covering all the rest of the ledger often represent exceptional value for money, as selective and single risk relative pricing is significantly higher then whole turnover

Structural features- common misconceptions cont.

- Aggregate first loss and excess of loss
  - Companies often believe that it is more efficient not to cover the aggregate level of loss they are willing to take, only covering excess. This takes two forms- relatively low AFL (normally below historic claim level) or very high threshold (excess of loss)
  - In most cases, taking AFL is not cost efficient as reduction in premium is significantly less than AFL, meaning that unless claims are going down massively company is overpaying on overall basis

Structural features- common misconceptions cont.

- Excess of loss level is often calculated using securitisation like methodology to A1/P1 level (without liquidity backstop, but insurer is not providing it either), while pricing at far higher implied probability
- If available, trade receivable securitisation is preferred option there as it combined transferring (very unlikely) loss with highly effective funding.
- Value for money- key consideration for specialised products

Specific Issues for Financiers

- Client vs. financiers policy
  - Two approaches- client takes the policy and assign benefit to FI (loss payee, bankers endorsement, co-insurance, etc.) or financial institution takes policy themselves
  - Advantages of clients policy- normally cheaper, compliance covered by reps and warranties (worth a lot for a strong customer), while controls may be executed at both contractual and technical monitoring levels
  - Lender controls need to be in place to ensure compliance

Some Niches for Financiers

- Transformation
  - Moving form insurance contract to purchase or guarantee transforms the pricing
- Single to portfolio risk
  - Accumulating single risks (such as SCF) and packing it into portfolio can open large arbitrage, but the portfolio building criteria need to be clear to avoid adverse selection
- Let insurers do what they do, and convert it to what customer wants at a price

Some Niches for Financiers cont.

- Uninsured portion
  - Taking residual risk on say 10% uninsured portion (pari passu, not first loss) at attractive pricing
- Combining Insurance with own risk taking
  - Differential pricing for risk on uninsured buyers and toping up the limits.

Conclusions

- Credit Insurance is extremely valuable tool both on its own and as part of wider financial solutions
- Underutilisation of credit insurance in some markets, such as US is mainly due to misconceptions and inefficient use
- Understanding the purpose, diligent structuring and robust implementation/control shall lead to significant increase of its use
- Understanding the product, its uses and limitations creates profit opportunity for fiannciers

Thank You and Good Luck!

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