CREDIT INSURANCE - An Introduction

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What is credit insurance all about and what do we do as credit insurance brokers? What is the reality? I have just returned from a visit to the States and therefore I would like to share with you some thoughts on credit insurance.

I will do this in the following way, firstly by defining what I mean by credit and political risk insurance, secondly by talking about some of the underwriters who are involved in this marketplace, and thirdly by giving you some examples of the way in which credit insurance can be used. Finally I would like to share with you my thoughts on what relevance credit insurance now has for lawyers.

WHAT IS CREDIT INSURANCE?

Credit insurance is insurance against the risk of non-payment. I am going to confine my talk to a discussion of corporate non-payment and not to encroach on that other allied field which is creditor insurance, the type of insurance that you may take out on a loan as an individual to protect the lender against your individual risk of default. This is particularly popular with credit cards, store cards, etc.

There are two main types of credit insurance cover:-

i) Whole turnover cover, normally a form of cover under which the manufacturer insures most or all of his turnover, both good and bad risks, and is protected on individual buyers by credit limits which are set by the underwriter, or

ii) Excess of loss, aggregate first loss or catastrophe cover. These three names are all used almost interchangeably for a type of cover that depends on the manufacturer having excellent credit management, agreeing to take a substantial first loss on his business before the underwriter is liable to pay him an indemnity under the insurance policy. This type of cover is normally taken out by larger companies and often does not carry with it the benefit of individual buyer credit limits.

The marketplace for credit insurance, particularly in the UK, is extremely competitive. There are more than 15 underwriters currently competing for your business, which is very small by general insurance standards, but given the size of this specialist marketplace is real competition. One of the effects of competition has been to blur some of the distinctions between the different types of products on offer and therefore you will now find excess of loss or catastrophe cover with the full credit limit service and underwriters who traditionally only underwrote whole turnover cover competing directly with those underwriters who traditionally only underwrite excess of loss.

We are increasingly seeing a trend towards more sophisticated use of credit insurance. For example, companies which are happy with the aggregate first loss concept can of course insure or reinsure this first loss through a captive insurance company and thereby participate in the profit (or losses), and get the advantage of a premium rate associated with a catastrophe type policy while providing full cover to their line companies through the captive.

Some statistics: What is the size of the UK market? It is difficult to be entirely accurate, but we estimate that about £25 billion of UK exports are insured which is approximately 20% of the total. Why is it so small? Well a great deal of business is inter-company business. We export, still, a lot of oil and other commodities which have very fine margins and therefore may not be suitable for credit insurance, ie there is simply not enough profit to be able to pay a premium which an insurer would find attractive.

About 10% of the UKs domestic product is insured, which is quite low by international standards, Germany, for example, insures about 30% of its domestic business. Why is this? Well it is partly because German banks encourage manufacturers to credit insure, whereas UK banks traditionally have not been terribly interested particularly in relation to UK domestic business, although they are showing much greater interest in the insurance of exports.

The total premium income for the UK is somewhere around £250 million, it is therefore a relatively small but an important market in terms of UK business. Internationally credit insurance is spreading. Most emerging nations wish to set up either export credit agencies, state funded export credit insurers or encourage private credit insurers to take on this risk, and we as a company have been involved in providing advice to many of them both in Central and Eastern Europe

and also in the Middle East and South America. Internationally credit insurers operate through two organisations, the Berne Union of Credit Insurers and the ICIA (The International Credit Insurance Association).

The EU has also taken a keen interest in the harmonisation of credit insurance within Europe and we are awaiting a revised draft of a Directive on medium term and long term export credit insurance which it is intended should reduce the differences in the types of cover, premium rates and country policies that can be offered by the various Member States of the European Union.

Short term credit insurance is in the process of being dealt with under a Communication which has been somewhat delayed because of a disagreement on the way in which reinsurance should be provided for political risk within the EU. The UK has led the way by privatising its short term arm by selling ECGD to NCM of Holland. The UK now places virtually all its credit and political risk reinsurance into the reinsurance marketplace but most Continental countries only reinsure credit risks on short term business in the marketplace, leaving governments to pick up the insurance and/or reinsurance of political risk.

The likely outcome is that both systems will be allowed to continue in parallel for the time being. A review will then take place to see whether the international marketplace for reinsurance can provide the capacity that would be required for all Member States to reinsure their political risk in the market.

WHAT ARE THE RISKS?

The risks are divided into credit risks and political risks. Traditionally credit insurers have split out individual risks and insured them. One credit insurer, AIG, has simplified matters by stating that the risks are either non-payment for any reason, credit or political, and optionally transfer delay, that is the inability of a country to remit foreign currency due to lack of foreign exchange. Traditionally therefore the credit risks are:

i) Insolvency and

ii) Default

Default is usually defined as the failure to pay within six months of due date for goods delivered to and accepted by the buyer.

Insolvency can be defined in different ways, for example NCM does not specifically cover Chapter 11 insolvencies in the USA in its policy. If you are therefore insuring with NCM you would have to wait in the event of a Chapter 11 situation until the period of six months had passed and then claim under default. Other underwriters such as Trade Indemnity include Chapter 11 in their definition of insolvency. This illustrates the importance of looking closely at policy wordings.

THE POLITICAL RISK

The main political risks are war, transfer, import export embargo, public buyer, default, natural disaster, and with some underwriters, notably the Export Credit Agencies (government underwriters), any action by the government of a foreign country which frustrates the contract. In addition to these primary covers you can also insure against the unfair calling of on-demand bonds and against the confiscation of plant and equipment.

INVESTMENT INSURANCE

Investment insurance is becoming increasingly popular and ECGD, as the UK government agency, has recently revamped its investment insurance schemes and reduced the cost. Investment insurance is primarily against the political risks of confiscation and expropriation or creeping expropriation. The main insurers involved in investment insurance are ECGD in the UK, MIGA the Multi-National Investment Guarantee Association part of the World Bank, Lloyd's in London, and AIG.

The major underwriters involved in credit and political risk insurance in the United Kingdom are NCM, Trade Indemnity, AIG, Coface, Namur, Lloyds, FCIA and TUA (both based in the United States), Exporters Insurance Company (resident in Bermuda but underwritten in New York). In addition other insurers such as Hermes in Germany, CESCE in Spain, and UNISTRAT in France, to give cover to international companies.

HOW CAN CREDIT INSURANCE BE USED:

Example 1 -

In the UK companies sometimes go bust because of the domino effect, in other words they are trading with a company which in itself is not a

particular credit risk, but that company has a bad debt from one of its buyers and therefore cannot pay them. This can lead to your "good buyer" going bust. Credit insurance will protect against this unexpected form of risk.

Example 2 -

Another more unusual way in which credit insurance has been used is when companies are involved in management buyouts or companies are selling subsidiaries on credit terms. The vendor will want to protect himself against the risk of the MBO or the new purchaser being unable to complete the sale because it goes insolvent. Credit insurers can sometimes step in to provide the sort of insurance that the vendor wants. How do they do this? It clearly is very difficult to underwrite the credit risk on an MBO when nothing is known about the company. However, the credit insurer can look at the companies to which the MBO will be selling and can take a view on the credit risk of its buyers. If that is reasonably favourable, then they can provide the security the vendor wants. This is a particularly useful arrangement for the vendor.

Example 3 -

In export business, credit insurance policies are often assigned to banks or other institutions providing finance as a form of security. The marketplace is now becoming more sophisticated and we have recently been involved with major schemes under which manufacturers have arranged finance on behalf of their dealers or distributors at very fine rates of interest, the bank being secured by credit insurance taken out by the manufacturer. By arranging cheap finance for its dealer network the manufacturer hopes to be able to increase sales by enabling the dealers to hold more stock while the banks are pleased to be involved in secure lending even if it is at low margins.

Example 4 -

Another example of how credit and political risk insurance can be used is a case we are dealing with at the moment of a major pharmaceutical company that wishes to increase its sales in the difficult markets of the world

including Iran. It sets its own internal limit on the volume of business it prefers to take in Iran, but is looking to transfer risk to an insurer or group of insurers so that it can increase its turnover and sales. In spite of Iran being such a difficult market, insurers are looking at this proposition and we expect to achieve a solution acceptable to all parties.

In summary credit and political risk insurance can be used to achieve the following:-

i) Profit protection - The balance sheet is secured by the receivables being insured.

ii) Access to finance - Credit insurance can enhance or securitise risks for banks and other lenders and enable them either to lend where they might have been unwilling to lend or to lend where they are willing to lend at finer rates of interest.

iii) Market information - Traditional credit insurers have large databases of buyer and market information and this can be used to assist manufacturers who are dealing with new trade sectors or going into new markets. It is always advisable to sell to those companies that can and will pay as opposed to those companies that have the ability to pay but for one reason or another may not. The type of information that credit insurers hold on buyers enables them to advise the insured on the best companies to deal with in particular markets.

iv) Control - The fairly basic disciplines that traditional credit insurers impose on their clients, such as reporting buyers and turnover on a monthly or quarterly basis, are useful forms of control for large groups of companies. It sounds terribly obvious and you would think that all companies would know exactly what their sales and turnover figures were by buyer and by market on a monthly basis. It certainly is not always the case and being able to say to salesmen that our credit insurers require us to do this is quite often a very useful excuse for those involved in finance and credit management.

WHAT THEN ARE THE DISADVANTAGES OF CREDIT INSURANCE?

The three most common problems that we encounter are:-

i) Its cost - we are told it is too expensive.

ii) Its complexity - the policy wordings can be very long and complex.

iii) They haven't got the capacity to insure our business.

COST

People seem to think that credit insurance costs about 1% of turnover because most companies have a bad debt reserve of between 0.5 and 1%. Credit insurance nearly always costs less than 0.5% of turnover and for large companies with large turnovers considerably less than 0.5%. It is not therefore expensive in terms of what it can achieve particularly if it is allied through a finance package from a bank in support of domestic or export receivables. The saving on the interest rate will quite often pay for the cost of the insurance.

COMPLEXITY

Yes most of the policies currently in circulation are complex. NCMs International Guarantee runs to 36 pages but they are in fact today launching a new Compact Policy which is only 6 pages long. Most other underwriters are too moving, thank goodness, in the direction of simple English policies and so the issue of complexity will be resolved over time. There is however, of course, one difficulty in that we now have 15 competing underwriters. They all have slightly different policy wordings, so from our point of view as brokers it still remains complex and it certainly can be difficult for manufacturers to understand all the nuances of the different policies without having an expert to help them.

CAPACITY

Capacity has proved to be something of a hindrance in relation to political risks given that some of the major European reinsurers, such as Munich Re and Swiss

Re, are still unwilling to reinsure political risk on its own. This is the reason that the UKs reinsurance treaties are combined credit and political risk treaties. Capacity is therefore limited in relation to political risk and can be a hindrance in relation to the largest contracts.

However, most underwriters can offer very significant credit limits on individual buyers, and where capacity is short for credit insurance facultative reinsurance can sometimes be arranged. In my experience as a broker, it is surprisingly seldom that we can't place a risk in the credit insurance market because of a lack of capacity. As I indicated earlier, with political risk it is rather more difficult except in the field of investment insurance where there seems to be adequate capacity at the present time.

WHY SHOULD ALL THIS BE OF ANY INTEREST TO LAWYERS?

Well unfortunately, the field of credit insurance seems to be getting more litigious. Perhaps it is the existence of the 15 competing underwriters, perhaps it is the effect of the recession and insurers becoming somewhat more reluctant to pay claims for "commercial reasons". I certainly see a big increase in litigation. It seems that all of you lawyers are telling insureds that have claims rejected by underwriters that if they have a broker they can probably sue the broker because there is bound to be something that they have not got right. I am only too aware the position of brokers is a difficult one in law and our duties and obligations to our clients and to underwriters sometimes appear huge relative to the remuneration that we receive from underwriters, certainly in respect of our smaller clients.

It is equally understandable that underwriters who are seeing fierce competition for their business are now less willing to rely on a long term relationship with the client in order to resolve any problems, but should look to policy wordings to reduce their risk in relation to claims. This has made life more difficult for us as brokers but it appears to be an inevitable consequence of competition in the marketplace. I personally hope that the increasing use of simple wordings in policies will help to eliminate some of the opportunity that there has been in the past for underwriters to wriggle out of claims on the basis of onerous undertakings which were well disguised in the policy wording.

So there are certainly opportunities for lawyers to get involved in litigation in relation to credit insurance as the market becomes increasingly competitive and increasingly complex. There may also be the opportunity for some of you to insure yourselves in that you could have bad debts too and the spread of business that some of you will have will be rather similar to the large book of advertising agency business that we currently credit insure.

Our only concern would be that perhaps the credit management that lawyers traditionally exercise has not been quite as strict as that operated by manufacturing companies for example.

I hope that in the very short time available I have been able to give you some idea of what credit insurance is about and some of the ways in which it can be used to protect corporate profits.

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