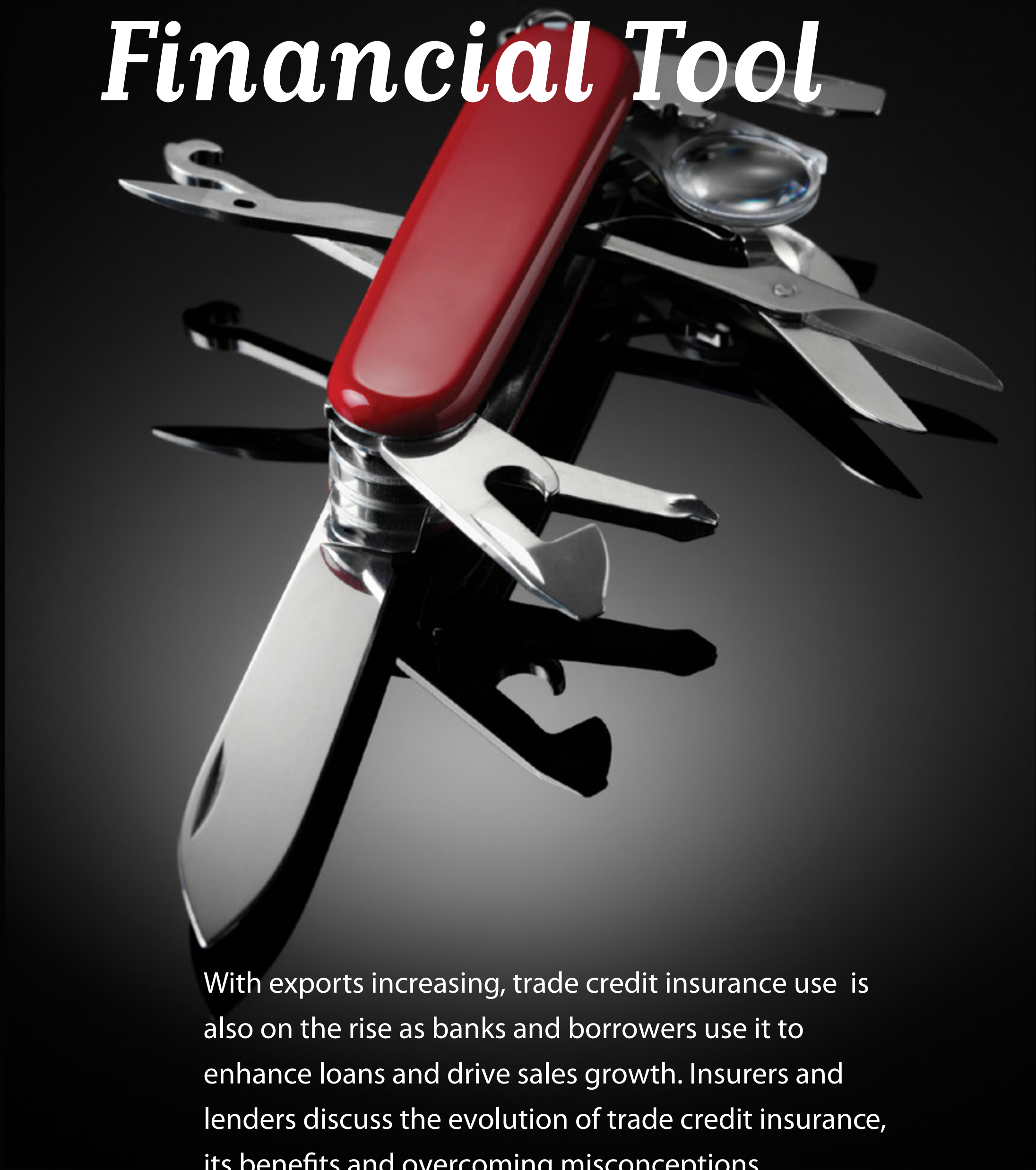
Trade Credit Insurance Proves to be a Useful Financial Tool



With exports increasing, trade credit insurance use is also on the rise as banks and borrowers use it to enhance loans and drive sales growth. Insurers and lenders discuss the evolution of trade credit insurance, its benefits and overcoming misconceptions.

BY EILEEN WUBBE

Originating in 1893 and used heavily in Europe after World War II as a way to boost the economy and drive exports, trade credit insurance is reportedly used by 50% of European businesses, with the U.S. coming in at 10%. Credit insurance offers protection against credit risk and political risk. It can strengthen corporate governance and risk control, debt collection and allows access to new markets through insurers' comprehensive databases. While several decades ago self-insuring may have made sense when most U.S. business was domestic, bankruptcies were rare, the economy was stable and markets were less vulnerable to global financial shocks, that approach is now much riskier, as all it can take is one unexpected default to drive a company out of business.

Trade credit insurance has seen increased growth in emerging markets and in the United States during the past 20 years. With U.S. export levels on the rise, trade credit insurance usage is also increasing, as lenders and business owners discover its benefits and new ways to use it as a financial tool.

Todd Lynady, vice president at Euler Hermes Americas' World Agency, said U.S. exports are expected to grow 5% in 2015, which represents a net gain of $88 billion, with the biggest gains coming from Mexico, China and Canada. Trade credit insurance can be particularly important for exporters.

"It helps them remain competitive by offering open terms when letters of credit or prepayment may have previously been the only safe way to do business," Lynady explained. "Foreign companies buy an average of 40 percent more when they are offered open terms, according to the World Trade Organization. Sales can also be protected from political risks, including import/export changes and foreign government intervention."

"While credit insurance started out as a risk transfer vehicle, it is increasingly evolving into a consultative, sales growth instrument," said David Huey, president and regional director, NAFTA, Atradius Trade Credit Insurance, Inc. "Banks are embracing credit insurance more than in the past and more and more are suggesting its usage to enhance loans. Credit insurance supports safe revenue growth by allowing companies to expand their sales base to new unknown markets and buyers. It allows smaller companies the opportunity to develop sound credit procedures in absence of a large credit shop."

The Evolving Landscape

The trade credit insurance industry's changes are categorized broadly in three areas: players, internal structure and products.

"After multiple mergers over a few decades, the industry is highly concentrated, with Euler Hermes and Atradius being the result of multiple mergers of national insurers, while Coface had more of an organic growth supplemented by smaller mergers," explained Igor Zax, CFA, Sloan Fellow and managing director, Tenzor Ltd., a provider of consultancy and interim management for corporate restructurings, financial and risk management, working capital and supply chain strategy.

"Management structure has changed significantly, moving from competing local units to centralized units, offering to global clients with various degree of success. As far as product innovation goes, credit insurance, as in many other areas of financial services, is quite slow, although the marketing of 'alternative' products, such as excess of loss, increased significantly by some mainstream insurers. Still, the core model did not change and such products (XoL, single risks, etc.) are often priced very differently, making them less attractive."

"Trade credit insurance has shifted from being primarily a government-dominated business, through the Export-Import Bank, to the private sector during the past 20-30 years," explained Alan Beard, managing director at ExWorks Capital's Washington, DC office. "We now have large insurers with multiple products to insure accounts receivable."

"For years the U.S. has been risk-averse to international transactions. As the world moved away from letters of credit, trade has evolved from letters of credit and cash on the barrel. American companies changed in order to offer the same terms as European and Asian companies over the past 20 – 30 years. As that has happened, the need to extend credit on traditional trade, meaning open account or something less than a letter of credit, has required credit insurance.

"As the world globalizes, it's becoming commonplace for smaller U.S. companies to export out of necessity. In the past, if you were a $20 million company, you maybe got an occasional deal out of Europe. Now, if you are a $20 million company, you may have 10, 20, or 30 percent of your business overseas. So you have to offer terms that are acceptable to these foreign companies. You can't just say, 'I need a letter of credit'.

"In Europe today if you want to insist on a letter of credit, you better have a unique product that only you can source or the company you are selling to is not very high caliber and you can demand it," Beard continued. "The difficulty in getting a letter of credit has now spilled out into other parts of the world. So credit insurance has filled the void. If I am a U.S. company, and I have a bank that is lending to me, they are not going to accept that European receivable unless I have credit insurance, because the regulators are going to make that problematic. Regulation, to some degree, is driving this. An overseas receivable that doesn't have insurance is viewed negatively by a regulator."

Lynady reports seeing an evolution in customers and insurers in the credit insurance industry. On the customer side, he is seeing larger domestic and multinational companies investigating the use of, and ultimately purchasing, trade credit insurance. He's also seeing banks and non-bank lenders using trade credit insurance for asset-based lines of credit as well as more structured financing arrangements, such as securitizations and receivable purchase programs.

"In addition to the risk-mitigation benefits of trade credit insurance, borrowers and lenders are also realizing that trade credit insurance can help facilitate more attractive lender terms," he added. "This is especially evident when there is an excess concentration of foreign receivables, which have historically been either limited or excluded from a borrowing base."

Michael Kornblau, US trade credit practice leader, Marsh USA, has observed increased capacity stemming from new entrants in the credit insurance industry, post-credit crisis, which has been helpful from a pricing standpoint.

"It's also a bit unusual in the sense that, if you look at the past couple of years, on a general or broad basis, the losses in the industry have been going up a little and, typically, you would expect the capacity to go down or stay the same in that circumstance. It's put a lot of pressure on the price, so the price has come down quite a bit, but it's also been good on the policy wording side. The underwriters, post-credit crisis, have been more flexible, which has benefited financial institutions and corporates and allowed us to offer more products and better wording on those products. In the past few years, there have been more transactions where, in addition to receivable deals and payable deals, we're looking at longer-tenured transactions, so the medium- term market has developed a bit more. We're also seeing companies using multiple carriers, whereas before they might only have had one policy with one insurer."

Inwha Huh, managing director at GE Capital, echoed Kornblau's statement, noting the increasing benefit of insurance syndicates as well as additional coverage offered through top-up limits, which covers the amounts over the limits set by a traditional credit insurer and potential protection against protracted defaults.

"Whether it is a retail sector credit that is tight on capacity due to large concentrations, or certain emerging market countries that are tough to cover, insurance syndicates can provide a tool where multiple insurers can cover needs of large local or export sales," Huh explained. "It would help both exporters and financing companies if insurance underwriters collaborate and develop syndicate models or other structures. In addition, it would also help the growth of the trade credit insurance market if the underwriting focus was also on unrated, smaller credits."

Reaping the Benefits of Credit Insurance

With U.S. exports on the rise, credit insurance is a valuable tool because foreign receivables are insured and are an acceptable form of collateral. Lenders are able to increase the amount they loan at a lower risk. Businesses with credit insurance tend to generate more revenue. With more generous credit terms, salespeople can take larger orders and make more sales, relying on the insurer to track payment history and cash flow through their extensive systems and predict issues long before they become critical.

Accounts receivable can represent up to 40% of a company's assets and yet are most often left uninsured. Non-payment can become a serious financial and operational threat to an enterprise.

"There would be great advantages to the U.S. businesses that begin insuring their receivables," said Lynady. "About 95% of global trade flows can be insured through trade credit insurance. It also helps strategically expand a company's client base in sectors or geographies that are outside its normal geographic market."

"As a former asset-based lender, I see the benefits of trade credit insurance for not only the borrower, but also the lender," Lynady continued. "The ABL industry is very competitive. In order to differentiate, lenders need to provide solutions others may not be willing to offer in the initial proposal stage. This may be in the form of increasing the 20% single account concentration threshold or adding foreign receivables into the borrowing base. The reason why lenders have historically excluded or limited these types of receivables is due to the inherent risk to the borrower and lender if the borrower's largest customer defaults or if there is a political event internationally which disrupts payment due to the borrower. One of these events can put a borrower into default quickly. With trade credit insurance, the political and commercial risk associated with these receivables is mitigated, which enables the lender to be more comfortable lending against them, thus offering a solution which would have been otherwise not available without insurance."

"As a financial institution, we are comfortable if we can get credit insurance to take some of the global risks that a company may not be prepared to take including documentary risk, the chance of disputes and the chance of fraud," explained ExWorks Capital's Beard. "We are comfortable that we can underwrite those risks ourselves. If we can use credit insurance to mitigate some of the macro issues that give us discomfort, then that allows us to provide financing to small or large transactions that the exporter themselves would not ordinarily do because of their discomfort with the risks. ExWorks can buy products from a company's factory and make it a completely domestic transaction from its point of view, while at the same time satisfying the demand of their foreign buyers. If they give us net 30-day terms, we are even happier. We then turn around and take whatever risk we need to get the product to the UK or France or Mexico."

Kick Baesjou, commercial director, Coface Global Solutions, reported that, once U.S. companies become insured, they are quick to see the benefits, but stresses that it is a product whose benefits really have to be explained and properly marketed.

"Credit insurance is a product that we really have to knock on doors to explain its benefits, as companies did without it before; but, once our clients buy it, including banks that have to comply with capital allocation requirements, they see great value for the money. Banks may not even buy it in the first place for the potential claim payment; but, because they buy receivables or finance receivables from their clients, they want to change the receivable, for example, from a B-rated receivable into an AA-rated insured receivable. They really like to buy the credit insurance on the back end. For them the quality of this buyer pool changes from a B to an AA rating. Then, for their BASEL III requirements, they can enjoy more favorable capital allocation requirements, as they would have had were these receivables from a worse quality."

Clarifying Misconceptions

While trade credit insurance offers many benefits and options for lenders, insurers caution there are areas to be wary of, namely, proper implementation and use. Many cited the Argentinean credit crisis in

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the late '90s and early '00s as creating some bad faith among credit insurers due to lack of understanding of what was, and wasn't, covered.

"Trade credit insurance is often viewed as a guarantee and it is not. It doesn't cover disputes, fraud, or operational risks, such as a customer handling paperwork appropriately," said Beard. "There are holes in trade credit insurance. That is one reason you would want a decent broker so that you ensure the paperwork is handled correctly; because, if it isn't, you do not have insurance."

"Financial institutions purchased a lot of political risk insurance (PRI) cover in the '90s, particularly involving Argentine risk," said Don Harkey, managing director, Trade Credit and Political Risk, Arthur J. Gallagher & Co. "When the losses piled up and the insurers labeled the cause of loss as devaluation, the insureds had no claim. At that time, it seemed like the perfect storm, whereby our products were in demand, the insurers had a solution and the product was placed without proper orientation—so it seemed. Having been an operations banker and a broker, I look at these products a bit more technically, as I want to make sure that the client understands precisely what is being bought and what risks are being assumed that might fall outside of that coverage. Understanding the differences in political risk cover versus comprehensive failure to pay cover is of material importance."

"In an ABL transaction, there's still a little bit of a gap between the insurance companies and the lenders. At the end of the day, sometimes lenders want to protect all the collateral they have and may not like sharing it with third parties. Yet the underwriters have the expectation that, presuming that collateral is on the table, it needs to be shared proportionately with the underwriters," said Chad Cascadden, commercial insurance vice president, Arthur J. Gallagher & Co. "It is just so important to make sure, technically, that you address every aspect when insurance gets involved in secured lending."

"I think the financial institution market has viewed and used trade credit insurance in different ways and therefore, different ways of booking it internally," said GE Capital's Huh. "Some banks have viewed it as a replacement of the credit risk they're taking, whether it's a borrower or a debtor in the receivable purchase case, therefore booking it as a replacement of the risk in their system. This led to lack of underwriting the actual credit risk. With some of the major defaults that happened in the past 10-15 years, Argentina as an example, the view is transitioned to using credit insurance as a catastrophic backstop. Underwriting the underlying risk is critical and sound risk management behavior."

"Another misconception is closing a program with an insurance company and feeling you are 100 percent covered, walking away and the insurance company will take care of everything, when, in fact, there is a lot more to it in terms of managing the program," notes Ansgar Kugelstadt, risk director of GE Capital. "You still have to be involved in areas such as monitoring and checking insufficient credit limits over time. It is a revolving process, reporting overdue AR and other obligations under the contract and as part of portfolio management. But that has not been the case; I think for that reason some of the banks backed out of using trade credit insurance, given the lack of knowledge and resources dedicated to manage properly."

"While far from believing the credit insurance industry is ideal, I think many problems and misconceptions are, and have been, the result of incompetent use as opposed to an inherent problem," Zax said. "In a relationship business, the ability to make credit decisions on your partners is critical. If one sees insurance there as the simple outsourcing of a credit function, they are highly likely to have issues. If insurance is one of the tools in a well-designed parallel credit management process, it may be a far better experience. Similarly, well-established processes to address common reasons for claim rejection (like making sure the correct entity is covered or time limits are complied with) addresses a very large proportion of such issues; again, insurance is not a substitute for internal process/compliance. With all of the criticism of credit insurance, there is a significant price arbitrage as credit insurers are calibrated on actual loss data, that stayed manageable even at the worst part of the credit crisis, while banks rely on models designed for long-term risks, as short-term financing is still viewed as a marginal product, making it worth it to put effort in its competent use," added Zax.

As for the future of credit insurance, the possibilities seem endless.

"Trade credit insurance can be a fundamental part of prudent working capital management for companies, borrowers and financial institutions, if managed properly" said Huh.

"We need to have more noise around credit insurance in the U.S.," added Baesjou. "We see a lot of potential to grow with very sophisticated companies."

Marsh's Kornblau noted technology improvements in the industry can help further develop credit insurers' product line, including increased transparency into what actual risks are in the portfolio, allowing for a global view on what their total exposures are.

"Better technology has been a huge help to everybody," Kornblau said. "It's helped with compliance and information flow. It's a big trend that I think is very positive for clients." TSL

Eileen Wubbe is senior editor of *The Secured Lender.*