Factoring and credit insurance - strategic fit?

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Credit insurance has come into the spotlight quite often in recent years, with the Covid crisis and related measures, the Greensill crisis and the re-emergence of political risk (such as the current war in Ukraine and the multiple global ripple effects flowing from it) drawing attention to its features, risks, and benefits.

The receivables finance world is undergoing rapid transition, driven both by technology and available capital. To successfully compete in this evolving landscape, one needs to examine the strengths and weaknesses of all the different players, and see which combinations provide a strategic fit. While there is a long history of the factoring industry working with insurance, it is essential to understand how the two fit together and what opportunities it opens.

Credit Insurance - strengths and weaknesses:

Credit insurance has some unique advantages, making it different from most of the other participants in receivables market.

Strengths:

1. Global reach. Credit insurance remains one of the very few players that has a global presence and risk appetite. Even the most global banks have a lower geographic footprint by comparison with leading insurers, and this became even more the case after the 2008 financial crisis and to a lesser extent in the wake of more recent developments. Moreover, most of the insurers have subsidiary groups servicing global clients (including financial institutions) that allow them to combine global commercial underwriting (i.e. pricing and terms) with local risk underwriting –'boots on the ground' when it comes to risk assessment.
2. Risk appetite. Despite some fluctuations, the credit insurance industry has enormous appetite for credit risk, not pre-determined by other relationships that banks require. This can take the form of full risk underwriting (which benefits from having the resources of large and global credit teams to support it) or risk sharing mechanisms such as excess of loss.
3. Robust credit standing. The credit insurance industry has withstood the test of time having faced multiple challenges (the 2008 financial crisis, Covid, etc.) without a major impact on its solvency, unlike some other insurers such as monoline insurers. (providing just one specific type of insurance). In large part this success is a result of its ability to reduce exposure (limit cancellations and non-renewals), and its successful defence against fraudulence that has hit financiers. For example, financiers such as factoring companies advance funds and then have to look at the reasons for non-payment when this occurs, whereas a credit insurer examines such possibilities before advancing payment.
4. Pricing. Relatively low losses (partly caused by the above) and risk models calibrated by actual receivable losses (unlike bank risk models calibrated on longer term assets) allows insurance to be priced competitively.

Weaknesses:

1. Despite many improvements made in the policy wordings, most insurance contracts are dependant on policy compliance, with some parts being obvious (such as paying premium or claim submission deadlines) and some being more ambiguous (like "acting prudently as uninsured'

or duty of full disclosure). Some of these concepts have had relatively little testing in courts; the current litigation related to Greensill is likely to clarify some of these meanings.

2. Credit insurance covers just a credit risk - i.e. inability of the buyer to pay a valid invoice. This leaves out two key risk-supplier performance risks (i.e. supplier not completing its contractual obligations) and fraud risk (i.e. invoice not being valid, being sold multiple times, etc.). Normally, there is no incentive for the insurer to even access these risks, as these are not the risks they insure.

3. The individual risk cover can be terminated with some notice depending on the policy. If the limit is non-cancellable, it can often still be invalidated in case the insured has or ought to know adverse information.

4. While generally good (both in terms of pricing and consistency of cover as a percentage of the portfolio) on a diversified portfolio basis, credit insurance is expensive, and cover is limited for single risks or selective portfolios.

Factoring industry

1. Compared with many other financial institutions, factoring companies have deep expertise and culture to monitor contractual performance and dealing with ambiguity. This is different, for example with 'traditional' trade finance that is purely rules/documentation driven. Being able to go deep into the exact policy scenarios and multi-level mitigation makes all the difference.

2. Both fraud and supplier performance risks are core areas of expertise of factoring companies. Robust due diligence and monitoring allows them to minimise these risks, while legal structure provides seller recourse (effectively transforming this risk into supplier credit risk). I would argue that the ability to understand supplier related risks is even more important for a factoring company than the credit risks of the customers and constitute a key differentiator for successful players.

3. Collection outsourcing. While the insurance industry has well developed practices for late-stage collections (at the claim stage when it constitutes recovery) it normally does not provide early stage services. While such services can be outsourced (and some credit insurer's subsidiaries are among the providers), this is another core area of expertise of the factoring industry.

4. Funding. This is an area where different parts of the industry have performed differently, depending on ownership and size. Many factoring companies are bank subsidiaries- this allows access to treasury funding through the parent. Other companies (depending on their size) may have access to either funds (that have become a huge market for trade receivables) or capital markets. Each of these ways represent unique challenges, and each may utilise insurance products in their own ways.

Factoring and insurance - where is the synergy

As we highlighted, the core competence of factoring companies is assessing and monitoring a seller's and fraud related risks, as well as the collection process. The core competence of credit insurers is generic credit assessment (mainly for the big three insurers - Allianz Trade, Atradius and Coface) of the buyers and risk appetite at a reasonable price. This opens many opportunities for factors with the deep understanding of the sellers to extend and fund their business.

Utilising insurance allows factors to achieve three objectives: international expansion, reducing recourse and financing ability.

1. International expansion. The ability to take cross-border risks is a limitation for many factors. One of the trends now (post Covid, logistics challenges and now political events) is moving to more localised supply chains, which often means an opportunity for companies in many jurisdictions to win the business previously done in more far away markets. Often, the markets they are in have a well-developed factoring market, but local

factors lack international experience. Partnering with global credit insurers allows a factor to finance such deals when they have a good understanding of the supplier's business (both performance and performance risk). In such cases, there is a robust buyer verification process, but the factor lacks confidence in taking a credit risk in less familiar markets.

2. Reducing recourse. Both recourse and most non-recourse structures still make the seller responsible for contractual performance (this includes both the supply contract and their own credit insurance policy if used). Credit insurance allows the factor not to require recourse from the seller in the case of a credit event (such as insolvency or protracted default) happening to the buyer where a compliant claim is made. While the factor may still face some payment delay, this can be addressed in the funding structure without creating a recourse for such situations.

3. Funding ability. Principally, factoring companies can fund themselves in three ways: banks, private non-bank investors (funds, etc.) and capital markets (securitisations). Credit insurance may benefit each of the three, but in different ways. For bank facilities, this is a question of regulatory treatment, that varies between regulators and some specific policy requirements. Non-bank funders do not have such requirements, so these are more focused on actual risk mitigation efficiency. The recent Greensill events have highlighted several potential weaknesses in such structures: lack of due diligence from investors; utilising loss payee structure instead of more robust ways; lack of monitoring, etc. However, factors that can prove they have efficient controls should be able to access funds and differentiate themselves.

Conclusions:

Current market conditions open more opportunities given the long history of cooperation between credit insurance and factoring industries. Understanding core competences, the strengths and weaknesses of both industries allows them to develop a strategic fit and address multiple areas together such as international expansion, reducing recourse requirements and improving funding structures.