Credit insurance

The current economic climate is exposing the shortcomings of traditional credit insurance as a way to raise finance. Next-generation policies are emerging, but companies have to work hard to ensure they are getting secure protection. By Tony Dowding

Up until the recent onset of the financial crisis, companies could be very creative with the ways in which they raised finance, with many opting for an asset-backed securities programme, for example. But that route has largely been closed over the last few months, and as a result many companies are increasingly resorting to traditional syndicated loans.

In terms of security, the main asset for companies is often trade receivables, but the banks are asking more and more how secure these receivables are. One solution is trade credit insurance, which provides cover for non-payment or late payment of those receivables.

Buyer beware

However, a traditional whole cover, ground up credit insurance policy does not provide a 100 per cent guarantee because credit lines can be cancelled and there may be other conditions, warranties or exclusions. Nick Hedley, Chairman of Jardine Lloyd Thompson's Financial Risks Division, explains that what the banks are looking for is something much more akin to a guarantee for the portfolio of receivables, and traditional credit insurance does not offer that.

"The biggest problem," he says, "is that insurers have the right to cancel cover at a moment's notice whenever they think that the credit position has deteriorated on that particular customer. Cover is in effect on a cancellable basis and we are now seeing this being practised with a vengeance." He explains that many insurers have taken fright as to what is going on in the financial world and what that will mean for the corporate sector. As a result, many are reviewing, changing and cancelling cover.

Another major problem, according to Hedley, is that these policies are generally 12-month annual contracts. "But it normally takes 12 months before you really see the full severity of the financial crisis," he argues, "so that just when you start to need the cover, the renewal is on you, and premiums may double, the deductible may be increased, or there may be no cover at all."

In response to this lack of continuity and lack of certainty, clients should, wherever possible, go for a multi-year policy – perhaps three years – with the agreed credit limits endorsed under the policy agreed on a non-cancellable basis for at least 12 months (where there is nothing that is outside the control of the bank or the assured that would give the insurer the right to deny liability).

Next-generation policies

There are a handful of insurers in the credit insurance market – including Atradius, AIG and ACE – that will consider policies such as that adopted by Ameropa (see box left), generally through a special division. "I agree that traditional credit insurance needs to be adapted to make it ideal for financing," says Mike Holley, Head of Special Products at Atradius. However, he adds that in the current economic environment it is less likely that a credit insurer would offer a multi-year policy, at least until the cycle turns again.

Glenn Sexton, Senior Underwriter, AIG UK Trade Credit, agrees that policies are not guarantees. "It is a conditional contract and the traditional offering would struggle to be accepted as a credit risk mitigant under Basel II. However, credit insurance is stepping up to meet the framework with new wordings."

He says that some of AIG's products are designed to provide credit limit certainty and policy compliance, and to allow conditionality in the wording to be addressed. For insurers to provide such policies, insureds have to offer something in return. Therefore, an alternative approach to the market is required by the broker, which normally comes down to a risk-sharing relationship.

"Deductible is the key," Hedley points out. "It is saying to the insurer, the level at which you are expected to participate is way out of line with the historical losses." There are a number of programmes where the deductible is much greater than any loss the insured has had in the past ten years.

Kadanik at Ameropa says that in his company's case, "the deductible fits with our overall risk management profile and keeps the cost of the package at a reasonable level at the same time. And, given what we see happening in the last few months, we are certainly glad we have catastrophe cover."

However, Sexton at AIG believes it is not just about deductibles: "Insurers should always assess risk and establish price and conditions accordingly. We are unwilling to rest on deductible alone, but we can offer valuable support for loan agreements with our products, after proper due diligence and specially drafted contractual documents."

> **"Traditional credit insurance is not ideal. In an adapted form, however, it can be the perfect instrument."**
> Mike Holley, Atradius

It may also be necessary to include some flexibility for underwriters in the terms and conditions. This might be, for example, a clause that states that the insurer has the right to adjust the deductible within pre-agreed limits if the loss ratio is a certain amount for any one year, perhaps 120 per cent. "Our view is that within a three-year deal, there should be agreements providing a reasonable and proportionate response to an increase in losses," Hedley contends.

Satisfying the banks

As for the banks, the current financial market problems have caused many of them to put new deals on hold. Sexton, however, believes this is a short-term issue and that demand for the product is likely to increase as central banks attempt to re-stimulate lending to corporates. "Banks in the current climate are generally risk averse and any opportunity to remove credit risk is being explored," he maintains. "Banks have always preferred their customers to have credit insurance."

In the end it comes down to the wording of the policy, and Holley believes that wording can satisfy the banks. "The key requirement is to ensure that compliance with the policy is entirely within the bank's control," he says. "So any exclusions or warranties that would give the insurer the right to decline a claim for reasons that are outside the bank's control need to be carefully looked at and adapted." RS

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SECURING FINANCING AT AMEROPA

Ameropa, a privately-owned Swiss international grain and fertilizer trader, historically had a 12-month annual cancellable contract. But in order to secure financing, rather than for balance sheet protection, it has moved to a three-year fixed policy.

"Given our credit risk default track record, the policy we had was much smaller than would be appropriate for the financing package," says Jan Kadanik, Chief Financial Officer at Ameropa. "So we had to raise the size dramatically and at the same time adopt a policy which worked with the requirements of the bank."

The aim was to get as close as possible to a financial guarantee. "What we are working towards is a situation where the policies that the bank gets offered to secure the receivables are as close as possible to the Basel II definition of guarantee," says Nick Hedley at Jardine Lloyd Thompson.

Kadanik points out that there is not a huge underwriting market for such a complex and customised product, "so it is more about taking the underwriter on board early in the process and making him a part of the deal, rather than running the process too competitively".

KEY REQUIREMENTS OF A CREDIT INSURANCE POLICY TO SECURE FINANCE

1. **Security of insurer** – there is no point insuring with a company that is not secure; both Independent and HIH, which collapsed in 2001, were active in the credit insurance market.
2. **Establish a relationship with the insurer** – strong, long-term established relationships are important. Companies that have stuck with an insurer tend to get their claims paid less contentiously and get better treatment at renewal.
3. **Look for insurers with a track record** – there will be some insurers that enter the market, but for which credit insurance is not core. In times of trouble, they may simply pull out of the market.
4. **Multi-year deal** – an annual policy is not suitable (go for a three- or five-year deal).
5. **Non-cancellable** – allows the policy to better meet bank guarantee requirements.
6. **Minimal conditions** – conditions can result in a policy effectively being cancelled.
7. **Basel II wording** – ensure that wording can be treated as a guarantee under Basel II rules.
8. **Use a broker that understands the market** – a broker will ensure that you are not just sold a standard product by a credit insurer. A broker will know what can be done, and can offer greater purchasing power.