SPECIAL REPORT:

TRADE CREDIT RISKS

Five years after the crisis

The trade credit insurance market has had to rebuild its reputation in the aftermath of the banking crisis, so credit insurers are focusing their attention on product innovation

SINCE THE HEIGHT OF THE financial crisis, capacity has steadily returned to the trade credit insurance market and demand for these products has risen. But memories of an extremely difficult market remain. When claims increased, some credit insurers cancelled policies and retracted their involvement in many segments of the market.

The credit insurance market is different today from what it was before the crisis. "There's lots of capacity and competitive pricing for risks in most sectors," says Willis Financial Solutions executive director Richard Talboys. "There is caution about some sectors, however. You find some insurers show a lack of interest or capacity in, say, consumer electronics or retail or construction risks."

Premiums have recovered and are back at £334m – the same level of GWP written by the market in 2007. Claims have also reduced substantially, from nearly 22,000 at the height of the crisis to nearly 11,000 in 2012, according to statistics from the ABI. However, the total number of policies was 10,550 in 2012, down from 14,086 in 2008.

"As a consequence of the banking crisis, the credit insurance market lost some 4,000 policyholders and even today we've barely been able to get them back – they look almost lost to the industry," says AIG head of UK trade credit William Clark. "In 2008, the major credit insurers cut cover rather arbitrarily and that really has had a knock-on impact. Clients have looked at the value of credit insurance and sought something different, something more consistent."

The drop in policyholders could also be because of other factors. Mergers and acquisitions have shrunk the number of insureds, while some companies may have gone out of business. Others, feeling the pinch, may have opted to take the risk on to their own balance sheet.

"I suspect the reason some policyholders left was because of capacity," says Clark. "They saw capacity being reduced and started to question the premium being paid."

The ABI statistics reveal the distribution of trade credit insurance, and it is clear that the biggest drop in policyholders has come from SMEs (customers with profits of up to £3m). Those with turnover of more than £100m, meanwhile, increased their share, and account for 42% of the market today.

The statistics also tell another story. They show how trade credit insurance markets absorbed a substantial amount of claims during the crisis years. Insurers paid out more than $6bn of claims worldwide. As loss ratios recovered and competitive forces returned, the need to innovate was obvious. Policyholders began to demand non-cancellable cover. "AIG has long been a proponent of non-cancellable limits and this is now part and parcel of almost every trade credit insurance house," says Clark.

'A lot of zombie companies may be trading, but can never pay down their debts'
Richard Talboys Willis

While the worst of the downturn is over, the European sovereign debt crisis rumbles on and insurers have seen an uptick in notifications of overdue accounts in Europe, a potential precursor to claims. "There is a concern, expressed more by the insurers, that there are a lot of potential failures out there – zombie companies that may be trading profitably, but can never pay down their enormous debts – which are paying the price of excess leverage," says Talboys.

Unease about the creditworthiness in some European countries (Greece in particular) led to a deterioration of insurer credit limit underwriting in the eurozone markets last year, according to a survey of Marsh's trade credit insurance experts. The decision by many European banks to stop trade financing increased the risk of default among importers and exporters seeking trade credit cover.

"Southern Europe is still under the gun as far as its prospects are concerned, although there does seem to be some better news coming out from southern Europe in terms of GDP expectations from 2014 onwards," says Clark. "Europe is seemingly set for recovery, but it is not going to be without bumps along the way and it's going to be a long road to get to pre-2008 levels."

Out of the ashes

Should the eurozone troubles escalate, Talboys thinks credit insurers and policyholders will be better prepared than they were during the financial crisis. It is clear that a different credit insurance market has emerged from the downturn – one that is increasingly innovative and invests in getting close to the risk in order to better underwrite it.

Banks drive demand

While the reasons for purchasing trade credit have not changed dramatically, there is a new impetus for policyholders to take out credit insurance owing to more stringent regulation of the banking sector. Under Basel III, Europe's new regulatory framework, banks' capital requirements have risen substantially. Trade credit insurance is a form of contingent capital that allows banks to grow their asset-backed lending portfolios in this more restrictive environment.

Trade finance is driving the biggest growth in demand for insurance, notes AIG's Neil Ross. "The amount of regulatory capital banks have to allocate has gone up under Basel III and they are now looking to minimise that credit exposure they have on their own balance sheets, so they're looking to insurers to partner with them for that."

While a bank may have a ceiling on how much it can lend within a certain territory or to a specific counterparty, the purchase of trade credit allows it to extent its credit and go beyond that cap.

This is helpful at a time when the amount of capital a bank can use to support its lending activities is finite and at a time when it is difficult to raise additional capital.

"Banks are looking to insurance to provide some regulatory capital benefits for them, using the underwriters' financial strength to derive the amount of capital being used to support trade finance transactions," explains Ross.

"The margin is now nowhere near sufficient to give the bank the return on capital under Basel III, so they either have to push up their margin or work with insurers to help provide more efficient capital structures for the bank."

"The view from the industry is that the big three insurers are much better prepared if a crisis recurs because they were underwriting a lot of risk pre-2008 based on fairly sketchy information, so they had too many risks on their books and, due to over-competitive premiums rates, not enough fat in their reserves to pay significant losses," he says.

The biggest shift since the financial crisis has been the introduction of excess-of-loss products. Unlike traditional whole turnover insurance, excess-of-loss products are non--cancellable. They also require insureds to take on a certain level of risk, and responsibility for risk mitigation, before the insurance will pay out. As the name implies, excess-of-loss products are designed for claims above a certain expected level.

"A traditional policy would be a whole turnover product where every single customer on a debtor portfolio is covered," explains Marsh's trade credit practice leader in Europe the Middle East and Africa Tim Smith. "With excess-of-loss, a company agrees to lose a certain amount of losses through bad debts, each year. That might just be frictional business losses, and a catastrophe insurer will say, if that's your normal level of losses we will insure you above that. It's recognising that there is a risk in your business and covering you for catastrophe losses."

"Some companies are conservative and want first dollar cover," he adds. "They don't mind paying more for their insurance, but if they have a loss they want to claim. Other companies understand they can sustain a certain level of losses, but want to be covered for losses that would hurt their balance sheet. Post-crisis insurers are more likely to allow you to focus on where a company perceives risk and where a company can be hurt through financial trading risk."

The shift towards excess-of-loss products is affecting the market. The big three traditional whole turnover credit insurers – Euler Hermes, Atradius and Coface – have begun to offer a mix of cancellable and non-cancellable limits. Last year, Euler Hermes launched an excess-of-loss unit.

By investing in credit management, insureds can lower their premium spend by taking some "skin in the game", says Willis's Talboys. "If you've got a good industry-leading credit management team and you've taken a big chunk of risk, then you align your risk with an insurer that can effectively sit alongside you. It will then pick up the catastrophes, but won't over-control you by telling you how much you can sell to which companies, provided you follow your own credit procedures and conduct appropriate due diligence."

"The more we encourage companies to align their interest with the insurer, the better responses you will ultimately get, because the insurer can see that everyone is driving in the same direction," he adds.

"More companies see they need to start investing in their own credit management capabilities, so are becoming more suitable for an excess-of-loss product," says AIG Europe trade credit regional manager Neil Ross. "It has provided a more consistent underwriting approach throughout the economic cycle, providing organisations with greater certainty from non-cancellable limits – it doesn't seem to be as volatile. There is a level of risk-sharing between the policyholder and the underwriter. Clients find overall it gives them greater coverage across the whole portfolio, although they are taking a deductible."

Innovation is one way insurers have been attracting customers back into the credit insurance market.

"We've probably seen more product innovation in the past three or four years than in the past 20 years. Part of that is because there is better technology now, which gives you more capabilities to develop new products," says Ross.

Long road ahead

But despite bouncing back from the downturn, credit insurers must not rest on their laurels, says Ross. "Market loss ratios have been relatively stable, but there is a lot of potential for risk volatility: conflict in the Middle East and North Africa, southern European countries still in recession and South-East Asia slowing down," he says.

"As an industry we've got to develop products and solutions to attract more companies to buy credit insurance. We have to look at new ways to broaden the appeal." SR

Sending a strong message

AIG has just opened a trade credit office in Germany, where the company already offers a wide range of other insurance products in the market.

"Setting up a trade credit hub from scratch in the leading trade credit market in a mature environment sends a strong message," says AIG Trade Credit's head in Frankfurt, Christian F Vollbehr. "We have to educate the proponents of traditional German credit insurance that the excess-of-loss underwriting philosophy successfully deployed by AIG in many other countries is a viable option for sophisticated companies.

He adds: "Executives who actively manage their trade receivables book based on clear internal procedures and with a strong focus on the bottom-line will appreciate the freedom to take their own credit limit decision without interference from an insurance company."

German companies have not fled from trade credit insurance as recent statistics indicate, but they are on the lookout for alternatives since the broad culling of limits by the traditional underwriters has left a bitter taste.

A view from Germany, the continental engine – what's next?

For the German credit insurance market, 2012 has been a mixed year, with slim growth on the premium side (+2%) and an increased number of policies. However, the loss ratio has doubled from 47.5% to more than 80%, creating a strong impact on the combined ratio, which moved up to 98% – after 67.3% the previous year. It is important to notice that the world's largest trade credit market is suffering from a declining premium rate development and a number of large domestic claims despite an overall fairly robust economy.

AIG head of trade credit in Germany Christian F Vollbehr says: "Going forward, the underwriters are expected to support growth and will become more flexible in terms of product developments and services provided."

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New markets, new risks

Credit insurers could provide comfort abroad

ORGANISATIONS MOVING into emerging markets often lack insight into their new customer base. By partnering with credit insurers they can get valuable support.

The macroeconomic shift from West to East is expected to shape trade finance and demand for credit insurance over the coming years. "With traditional markets stagnating, organisations have to extend further into new territories," says AIG Europe trade credit regional manager Neil Ross. "These are markets they don't know well, so they have to deal with new buyers and compete by extending payment terms."

Sixty-three per cent of respondents to AIG's International Trade Survey predicted their dependency on export would rise over the next five years. While Europe is still the UK's main export market, it is followed by Asia, China, the Middle East, Eurasia and North America.

Dealing with new customers is one of the biggest risks when trading in new markets and this is where trade credit insurance comes in. "There are areas of the world that are more difficult to trade in," says Marsh's trade credit practice leader in Europe, the Middle East and Africa, Tim Smith. Many countries do not have transparency rules that allow exporters to access details on how their customers are performing, so trading could be risky.

"People buy trade credit to cover their key and principal customers," says Smith. "Rather than going into a new market blind, they would use an insurer with experience trading there for support. Some companies use trade credit insurance to vet potential new customers and establish which ones are low risk."

To provide this insight, credit insurers have to get closer to the risk. With offices in emerging markets around the world, they meet and vet thousands of companies. This information is analysed to sort the good risks from the bad.

"Insurers are investing in these markets and getting closer to companies that want to be supported for trade credit," says Smith. "As companies become more sophisticated in emerging markets, they will need to purchase credit insurance."

Insurers are also in a position to gain new policyholders as South-South trade continues to grow. "Many of these markets haven't had trade credit insurance businesses there for very long. These markets are becoming far more significant in world trade terms than they were 10 years ago and they will continue to become more so," says AIG head of UK trade credit William Clark. SR

AIG's International Trade Survey

Overseas demand for UK products is driving export growth, according to the 2013 survey results. Most firms report that their international turnover grew between 2012 and 2013, and over 50% of companies with a turnover above £1m a year have an export strategy, a significant growth compared with previous years. Factors holding them back are a lack of experience, finance, or confidence in obtaining finance. Forty per cent of respondents protect their credit risks, a fall of 13% since last year. Firms in the higher turnover bands are more risk-averse than smaller ones. Firms with turnover of £25m use credit insurance. Those with turnover of £1m-£5m use advance payments rather than other risk models.