Credit

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Agenda

- Definition and Purpose
- Types of risks covered
- Products
- Unique characteristics
- Pricing and Reserving

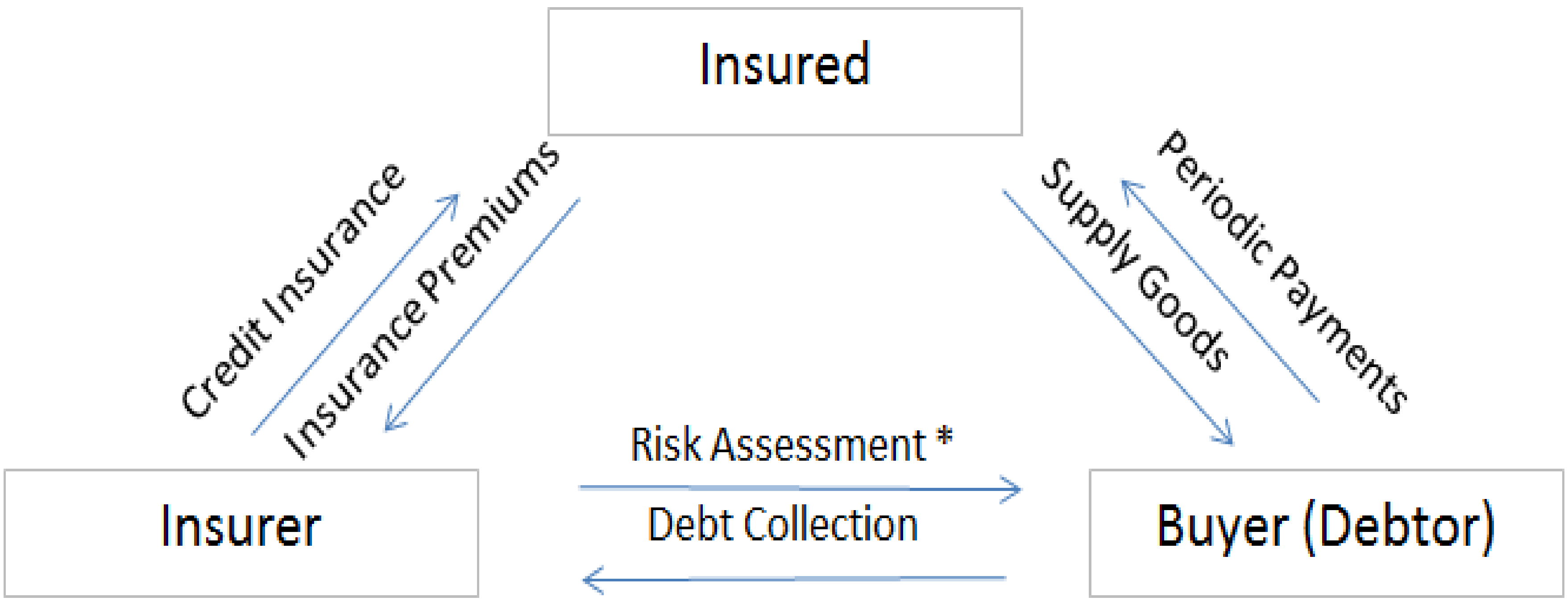
Definition

- **Credit Insurance** (also call Trade Credit Insurance) is an insurance product designed to protect businesses from loss due to credit risks of their customers. It's insurance that provides protection from bad debt.
- This is different from *credit protection insurance* which consumers purchase to ensure that their loan will continue to be paid in the event the borrower dies, becomes unemployed, etc.

Purpose

- In the absence of credit insurance many trade transactions would have to be done on a pre-paid or cash basis, or not at all.
- Credit insurance allows vendors to offer their customers the option to pay out their purchase(s) over time.
- Serves an important role in international trade.

Relationships Between Parties



*If the credit insurer is providing ground up coverage then they may also function as the credit department

If the credit insurer is providing excess coverage the risk assessment is probably limited to setting credit limits

Insurable Risks vs Non-Insurable Risks

- Insurable Risks:
  - Buyer does not pay
  - Buyer pays very slowly
- Non-Insurable Risks:
  - The insured has to have a direct link with an underlying trade transaction, i.e. the delivery of goods or services.
  - If no such direct link exists, the outstanding amount is not insurable.

Main Types of Credit Insurance

- Insurance that cover all buyers
  - Commonly called Whole Turnover Cover
  - This is the most common type
  - Because of the spread of risk, premium rates are usually competitive
- Insurance that covers one or a few of the buyers
- Single Transaction Insurance
  - Useful for companies that deal with only one buyer or that have very few transactions
- Political Risk Insurance

Political Risk

- Risk that a buyer cannot pay or that goods cannot be delivered due to circumstances outside of your or your buyer’s control.
- These circumstances usually include:
  - War, Terrorism and Riots
  - Actions taken by local governments such as Confiscation, Expropriation, Nationalization, and Deprivation
  - Risk that money cannot be transferred to another country

Examples

- A Brazilian farmer purchases tractors from Caterpillar.
  - Caterpillar finances the purchase and the farmer makes monthly payments.
  - Caterpillar obtains a credit insurance policy that will pay some portion of the farmers payments in the event the farmer defaults.
- Transocean provides drilling rigs to a drilling company in Mexico.
  - Transocean obtains a credit insurance policy that covers the risk that some (or all) of the rig contracts are terminated pursuant to Mexican law.

International Risks vs Domestic Risks

- International Risks
  - Insured is Domestic but the Buyer is in another country
  - Risks include:
    - Payment Risk
    - Political Risks
- Domestic Risks
  - Both the Insured and the Buyer are Domestic
  - Risk is generally just payment risk
  - Premium is usually lower and policy structure is simpler

Possible Reasons for Payment Delays

- According to the ICISA the most common reason for not getting paid is the buyer goes bankrupt.
- Other possible reasons:
  - Insufficient funds
  - Disputes over the quality of goods
  - Disputes over the goods delivered vs. what was agreed in the contract
  - Timeliness of the delivery of the goods
  - Flaws in the invoice

Waiting Period and Credit Limits

- Waiting Period
  - Default occurs when a payment has not been made by the due date.
  - However a claim cannot be submitted to the credit insurer until the waiting period has elapsed. Examples:
    - 90 days
    - 180 days
    - 270 days
  - Functions much like a deductible.
- Credit Limits
  - The insurer issues a credit limit for every buyer with whom the policyholder trades.
  - This is the maximum amount that can be owed by the buyer at any time.

Recoveries

- Since the insurer is insuring debt there are recovery options in the event of a claim payout:
  - Retain the debt for later recovery
  - Sell the debt on the secondary debt market
    - Speculators purchase the debt from the owner for a percentage of the face value of the debt.
    - The speculator expects to collect enough of the face value to offset the purchase price and the resources expended in collecting the debt.
    - This is the same as a collection agency purchasing defaulted loan or credit card debt from a lender.
- Recoveries in Emerging Economies

Pricing

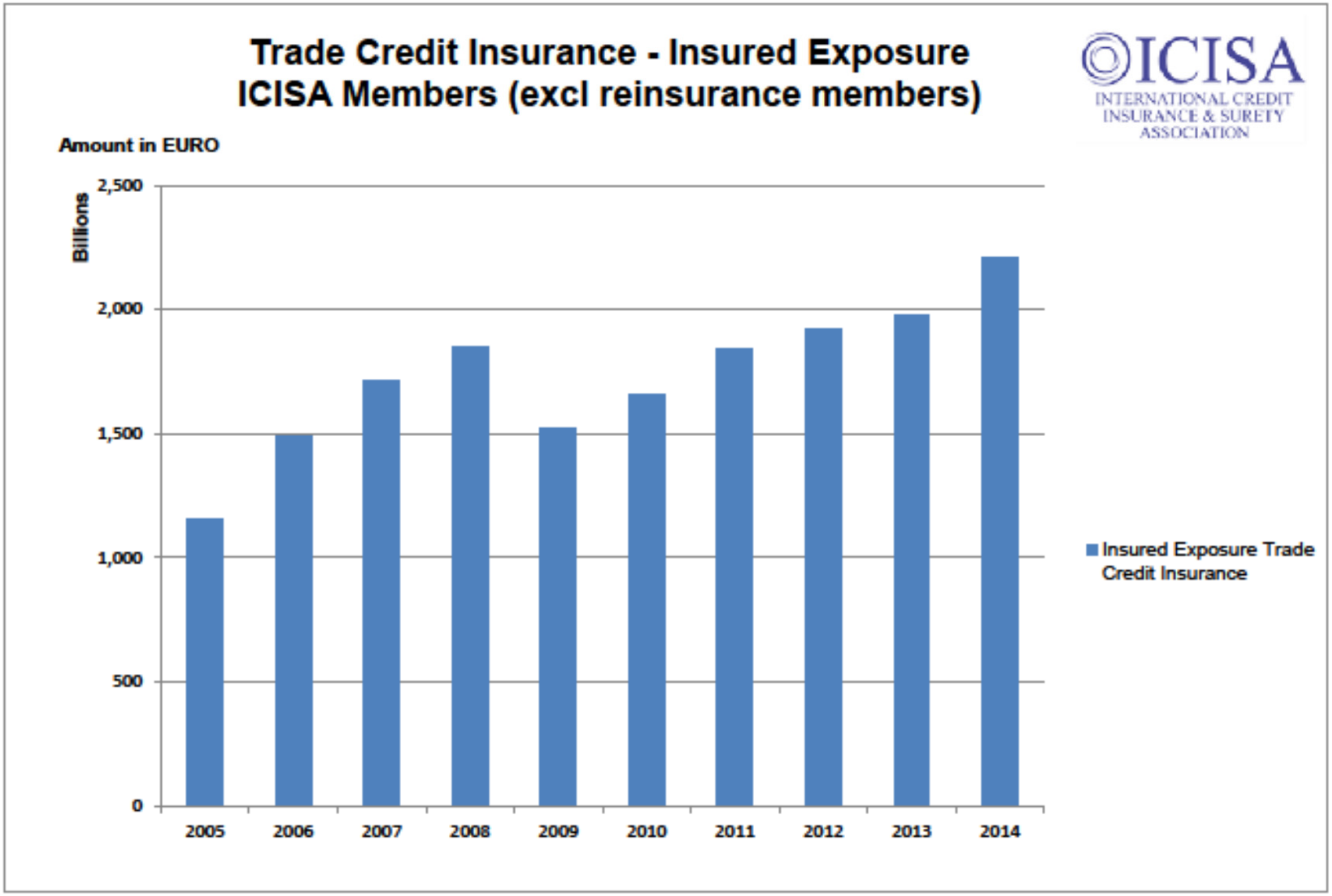
- Priced as a rate times sales (or turnover)
- There may also be a minimum premium
- Factors affecting the rate:
  - Credit limit
  - Term
  - Waiting period
  - Collateral
  - Prior experience
- Country rate (e.g. S&P score) can also taken into consideration

Reserving

- Triangles
  - Select ultimate losses using standard reserving methods as applied to most other lines of business.
- Use a Watch List to gauge IBNR
  - If a buyer is likely to experience an event that will cause them to default on the loan then that information is generally known.
    - Rating agencies, auditors and bond holders will be aware of the situation.
  - Rate the buyer's ability to avoid a claim (i.e., restructure the debt) on a scale from most likely to least likely.
  - Use that rating to estimate IBNR.

Watch List Severity Ratings

- Severity 1
  - Buyer is not in default (i.e., no missed payments)
    - However, there is news of the buyer's financial difficulties, major shake up in top management, political unrest, etc.
  - Loan was in default but has been restructured
    - Continued monitoring for a period of time.
- Severity 2
  - Buyer in default so the waiting period has started, but there is a high likelihood of restructuring.
- Severity 3
  - Buyer in default, but less likelihood of restructuring.
- Severity 4
  - Buyer in default and restructuring prospects look dim.



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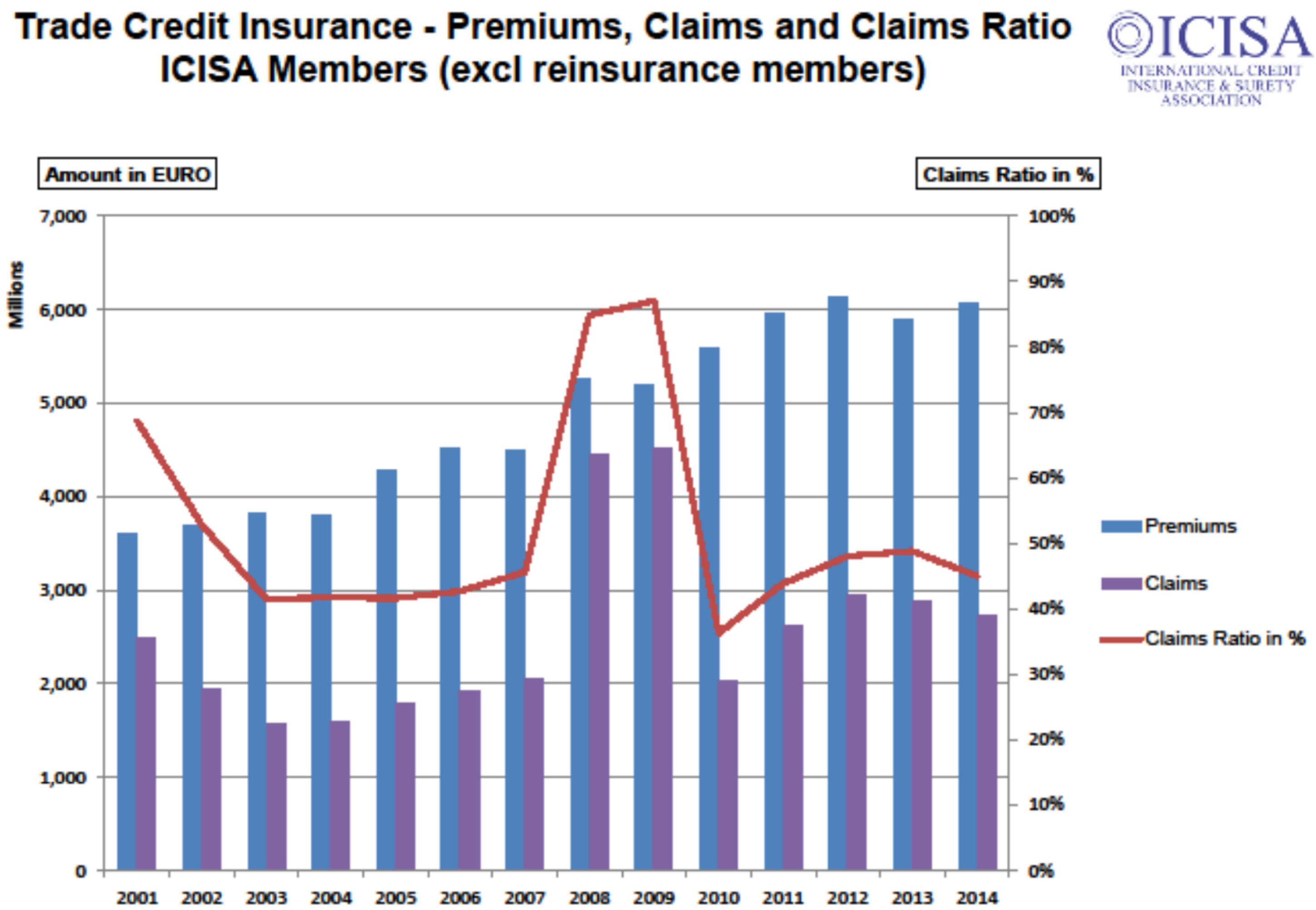

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