Trade credit insurance

Robert Nijhout says trade credit insurance is adapting to new markets and new trends in trade, ensuring its continued relevance to traders in facilitating trade

Trade credit insurance protects suppliers against the risk of unpaid receivables. It is a trade facilitator, insuring around 15% of global trade, as well as an instrument for hedging risks and preventing the risk of class claims.

Trade credit insurance is more than insurance:

- Banks lend more capital against insured receivables
- Trade credit insurance contributes to increased sales and supports in opening up new markets
- Trade credit insurance saves costs for information, analysis and collection
- Premiums are a tax deductible expense under IFRS
- Trade credit insurance improves the policy holder's credit rating

Policies normally insure all receivables whether these concern exports or domestic sales. Clients can opt for political risk cover, depending on the country. It is further possible to insure selected risks or single risks, as well as the risk that a manufacturer has in case a buyer goes bankrupt before the goods are delivered. This is particularly helpful in case of custom made goods. Although the majority of underwritten trade credit insurance risks concern short-term credit, there is an increase in private medium term cover which can go up to 5 or 7 years in some cases.

ICISA members, who account for more than 95% of the private global credit insurance market, insure around USD 3 trillion of exposure, against some USD 8B premium income. These totals refer to both export as well as domestic transactions. In fact, the majority of insured business concerns trade between a buyer and a seller situated in the same country.

Backed by ample reinsurance capacity, underwriters are trying to attract and keep policyholders in an increasingly tough competitive environment. And as is the case in other sectors, competition often leads to lower rates, in spite of a risk environment that has stayed the same and in some cases has increased.

Market trends

This mismatch between risk and price is one of the current trends in trade credit insurance. Particularly in markets where the product is well known the average premium rate should be higher. It is a buyer's market and as long as capacity remains ample and risk appetite continues, this trend is not likely to change anytime soon.

However, Western Europe and some Asian markets are experiencing a hardening of the market, although it is still too soon to call these markets hard. Competition not only comes from established players but also from a number of new market entrants. In an industry where the entry level for new underwriters was always an obstacle as investments needed were very high due to complex IT support systems and information infrastructures, these hurdles are now much lower, thanks to great advances in IT support as well as dedicated specialist service providers that facilitate these requirements against acceptable costs.

On the reinsurance side new entrants continue to be announced. In spite of current consolidation in the sector, there remains a need to diversify and trade credit insurance is an attractive line to consider for many reinsurers.

Perhaps the most relevant market trend is the change in client's expectations compared to say a decade ago. Policyholders are better informed, have more access to more data and information, and rightfully expect to get value for money.

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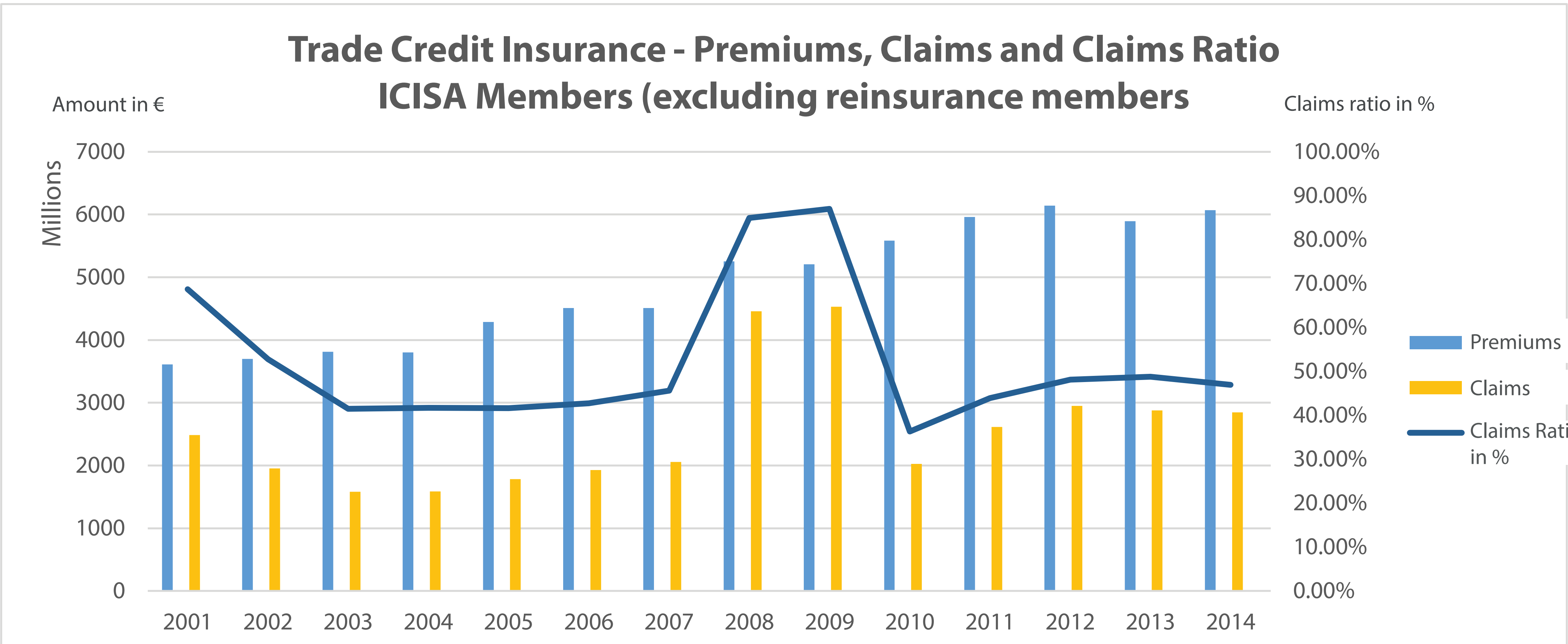


Source: ICISA

This has created a change in how underwriters interact with their policyholders. Trade credit insurance has always been a product with frequent contact between the client and the insurer. The industry promotes this and while this communication has been streamlined, policyholders receive much more information now than they used to. New products such as non-cancellable limits as well as pro-active information sharing by the underwriter have led to a closer relationship. The success of this is measured among others by retention rates. Policies are typically annual and renewed each year. It is the goal of every underwriter to retain as many policies as possible and retention levels of more than 90% in many cases are encouraging.

Claims

During the recent financial crisis, trade credit insurance proved its added value. Over EUR 9B in claims were paid in the course of two years on unpaid receivables that otherwise would not have been compensated. Many insured companies would not have survived had it not been for this trade credit insurance compensation.

Claim levels dropped sharply in 2010 but have been rising since. The claims ratio is currently at an acceptable level of around 45%, although this is expected to rise in the near future. A rise in claims is noted in Asia, and in particular in China. This is partly the result of a higher involvement in Asian trade by the sector. After years of very benign claims figures, an increase is to be expected in the region.

Solvency II

The most important market development at this moment is the introduction of the Solvency II regime in Europe. Solvency II is as important to insurers as Basle II and III are for banks. This introduction is arguable the biggest change in the TCI world for decades.

Despite a number of hurdles still to be taken, Solvency II will enter into force on the 1st of January 2016. But this will not be the end of the long journey that has led to this implementation date.

A little history

After 13 years of deliberations and alterations, companies have now less than 6 months to become Solvency II compliant. The implementation process was marked by delays and set-backs. Although the original Directive on Solvency II had already been approved in 2009, the Omnibus II Directive, containing a lot of modifications to the original Solvency II Directive, was only approved late 2013.

Negotiations between Parliament, Commission and Council to reach a Trialogue agreement took quite a while and saw a couple of delays. Not unimportantly, Omnibus II was further developed in light of the 2008 financial crisis and its aftermath, resulting in the introduction of detailed measures presumably leading to a more risk-averse approach to supervision. The further development of the Level 2 legislation based on the SII Directive was more or less frozen, but is now, finally, taken out of the fridge.

The latest draft now called Delegated Acts have been sent out to the Member States for their feedback before they will be presented to the European Parliament for approval. On the 1st of January 2016 Solvency II will enter into force. This implicitly means that some insurance companies in Europe will have to accelerate their efforts in order to be compliant by 2016, but most companies are already acting as if Solvency II was already in force.

A voyage through uncharted waters

An informal survey by ICISA among its members last year, showed that in terms of readiness for Solvency II most companies are only partly comfortable with the Solvency II regime. They feel comfortable with Pillar I (the quantitative part), despite the fact that not all details of the expected calculation methodology have been published. Compared to Pillar I, many companies feel less at ease regarding Pillar II (principles-based approach).

Regarding Pillar III (reporting to the Supervisors and the Market), delivering information to the Supervisors in an electronic format called Quantitative Reporting Templates (QRT), might seem to be a mundane topic, but simply approaching it as an IT challenge may turn out to be costly mistake.

Once SII has entered into force changes, amendments and recalibrations will take place. We can only hope that these future improvements will be more simplification. The complexity of Solvency II is of such an extent that only a few will have a comprehensive overview of the legislation among a sea of experts on parts of the directive. This can be particular challenging for top management as supervisors are demanding more and more from them in terms of knowledge. Equally so, companies that in general consider Solvency II a merely administrative topic, only seen as a compliance issue, will miss out on a strategically important opportunity to overhaul the way they look at and manage different types of risk they encounter.

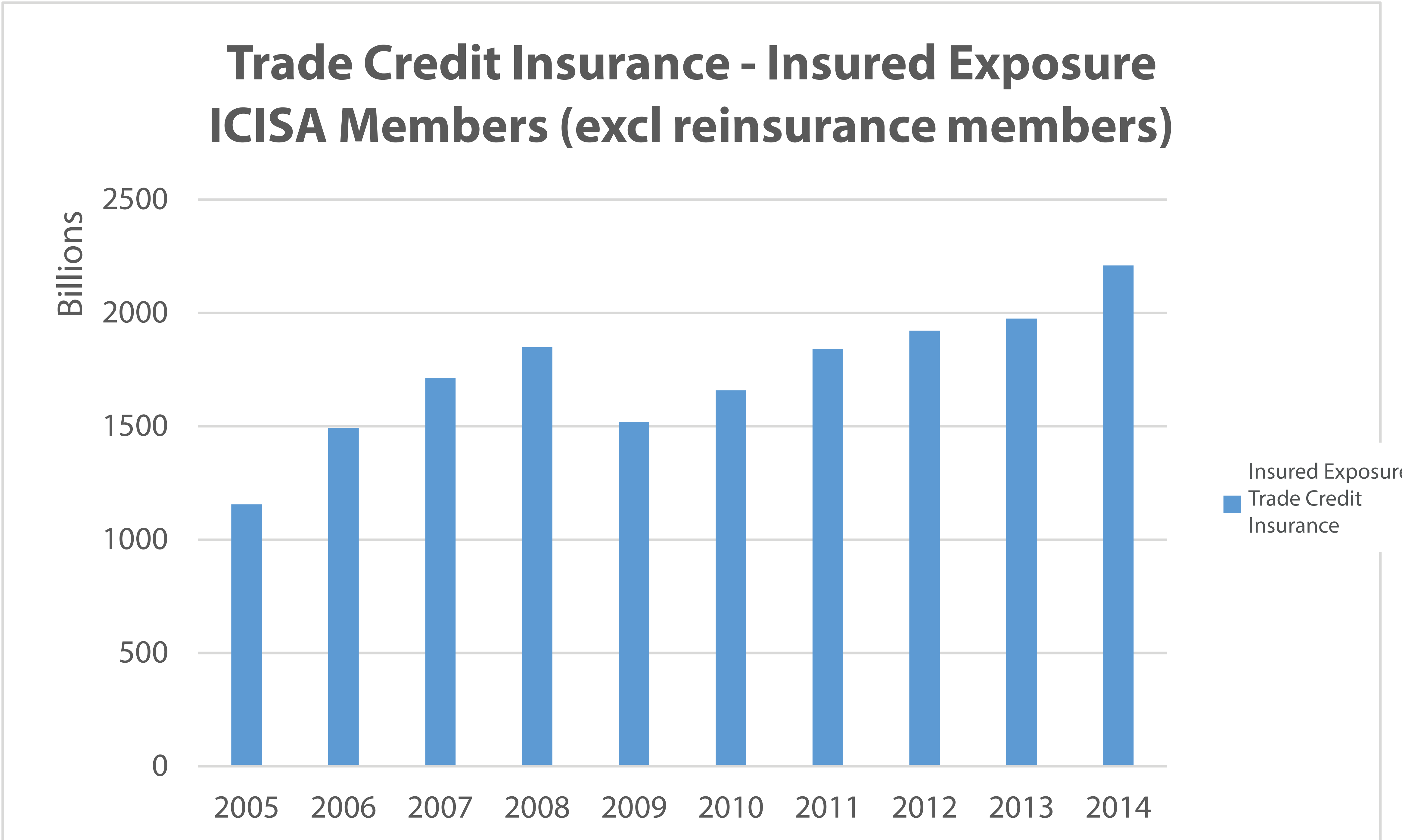
Overall, it is clear that Solvency II should be regarded as a strategically important project supervised at Management Board level and by no means as a compliance/IT project. If seen from the latter perspective a company will spend a lot of money without getting a decent return on its investment.

Catastrophic Risk concerns

The main concerns among members of ICISA are the still the Standard Formula in general and the Premium and Catastrophic Risk part in particular. This flawed formula could erroneously lead to regulatory undercapitalization of companies or in other words, failure to meet the new regulatory capital requirements. Consequences may be serious. It may force them to withdraw from certain markets, underwrite less risk or offer less coverage to their clients. Reduced return on capital may prevent investments or could force management to pull out certain lines of business.

An important area of focus is the definition of Cat Risk, the definition of recession risk and the split between frequency, large claims and recession claims.

There is also concern about two additional aspects. First of all the changes to the legislation, e.g. calculation of Standard Formula, having become effective beginning of the year, could have an impact on the readiness of the industry, in particular as recalculations may result in unexpected results based on the enforced rewritten calculations.



Source: ICISA

Secondly, it turns out that the principle-based approach still leaves room for legislation and entity specific interpretation, which may lead to misalignment of insurer interpretation with regulator interpretation.

Solvency II matter outside of the EU

Solvency II is not 'only' an EU affair, but it matters to the rest of the world as well. Other jurisdictions have or are introducing similar regimes. Many insurance companies are multinational operating in different jurisdictions, each with their own capital adequacy rules.

A situation can arise where capital adequacy rules differ or worse, conflict. This should be avoided and it is hoped that lawmakers consider existing regimes when drafting new capital adequacy rules.

Outlook

Trade credit insurance underwriters have concerns for the future. The political instability in parts of Europe and the Middle East are worrying. The same applies to the situation in Greece and in parts of Latin America.

There appears to be a rise in new protectionist regulations in some developing economies which is another reason for concern. There are wishes for better buyer information in Asia, especially in China. Effective insolvency legislation in countries in the MENA region that still lack this is also welcomed.

In spite of these concerns and wishes, the outlook is positive. Growth is expected in Asia, Europe, MENA and North America. Africa is also developing as a new market for trade credit insurance. Trade credit insurance adapts to new markets and new trends in trade, ensuring its continued relevance to traders in facilitating trade, which is the oil of the global economy. ■

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