Content

1. MOTIVATION: THE SHOCK OF THE CRISIS

1.1. Think Tank Credit management 2015

In July 2009 it was decided with the credit insurance broker CRiON to create a Think Tank on credit management: *Think Tank Credit Management 2015*. The purpose was to exchange ideas with the academic and business world on credit management, and how credit insurance can play a part in this. The perspective was future oriented as the crisis demonstrated that the credit insurance industry needed resourcing. This White Paper publishes the reflections made during the various meetings.

1.2. Financial-economic crises 2008-2009 and 2012

The financial-economic crisis that started in March 2007 and erupted in September 2008, scarred many industries.

Through the massive interventions of the public authorities via support measures and the very flexible monetary policy of the central banks (low interest rates and liquidity injections) the world economy, led by Asia, recovered surprisingly quickly. The nightmare of the thirties was avoided.
The crisis still clearly demonstrated that there was a system crisis, and that the world economy needed structural adaptations in its transitional process to globalisation. The advantage of crises is that they show us the shortcomings of a system, but you then need to learn the necessary lessons from them. We must admit, however, that the system crisis was and is so far-reaching that in our opinion it is too early to already present global solutions. This has become clear from the current debt crisis in Europe and the USA.
Indeed, the solutions provided to avoid an economic disaster carry the germ of additional problems: by saving the banks and implementing incentive measures, public finances in numerous countries come under pressure and the financial markets speculate on the '*default*' of a few PIGS countries[2], with Greece in the lead.

[2] PIGS: Portugal, Italy, Greece, Spain

1.3. Transition of world economy

Compared with earlier crises, the environment has considerably changed:

- in the past the world economy was mainly restricted to the OECD countries (North America, European Union, Japan);
- since the 1990s globalisation has come fully to the fore, and we see an increasingly greater interdependency between the various national economies.

The BRIC-countries[3] now act as the locomotive of the world economy, but that economy is still based on the principles of the older world economy, with its roots in the old Europe, and where, after the First World War, the centre of gravity progressively shifted to the New World of that time, the United States of America.
The United States, as the largest economy in the world (approx. 23% of the world GDP), actually abuse their position of power: the US 'drug' the economy with liquidity injections, the 'Quantitative Easing' programmes. Quantitative easing is an unconventional monetary policy used by central banks to stimulate the national economy. The Central Bank of the USA implements quantitative easing by buying financial assets from commercial banks and other private institutions with newly created money in order to inject the money into the economy.
In case of mismanagement the bill is presented sooner or later: money always has a price. It is difficult to exactly forecast how this will happen, but we can assume that the economic centre of gravity in the world will progressively shift to Asia. We more particularly have China and India in mind: both have a population of more than 1 billion people, and therefore these countries possess great potential.

1.4. Credit insurance unchanged

The bank industry, crucial to the economy, was first examined by the prudential and regulating authorities. Basel III aims to reinforce solvability requirements and now attaches a lot more attention to the liquidity position: the latter was neglected by Basel II.

[3] BRIC: Brasil, Russia, India, China

For the time being, the authorities are leaving credit insurance untouched, also on a European level. Nevertheless, credit insurance was not spared. In the past 10 years the industry was characterised by a consolidation process that led to an oligopoly of 3 global groups. The first decade of the twenty-first century was one of prosperity. As long as all goes well, there is not a cloud in the sky, and we are not aware of potential problems. The catharsis, however, came together with the crisis. It showed that the credit insurance industry had a few structural problems:

- there had been a considerable reduction or withdrawal of credit limits;
- the communication on this matter had not been optimal;
- the product is slightly outdated.

In essence credit insurance has not changed the last decennia, but the world underwent a deep metamorphosis.

Interview with Helmut Piplack

CEO, AON Trade Credit Germany

The credit insurers have to communicate better and have to share more and better information with the insured. Can you agree on that?

Steady communication between the credit insurer and the insured is vital for a successful credit insurance contractual relationship. Compared to other kinds of insurances the credit insured faces several reporting obligations during the time of contract, especially whilst discussing the prolongation or granting of limits or in case of claims. Insurance brokers usually take an integral part in facilitating this communication and finding solutions

How can a credit insurer contribute to higher sales/higher turnover of a credit insured?

Credit insurers may contribute in two ways. First of all they assist companies in considering the solvency of potential customers and rendering decisions to sell. Beyond this, credit insurers cover the risk of cash loss. This enables the insured to act more safely and to evaluate customer risks which stabilizes business.

Is paying premium based on outstanding instead of on turnover a better system?

There are legitimate reasons for both ways. Which one suits better has to be considered in respect of each insured's individual needs. A third way should be kept clearly in mind: 'The limit premium' based on capacity is the most effective one for all parties.

Economic resurgence and crises are expected to follow up each other rapidly. And now a new crisis is raging, the credit insurance sector will have to do more than streamline the internal business processes. They will have to reinvent themselves. Can you agree on that?

To keep up with the ever-changing requirements of the market is an essential task of credit insurers and brokers as well. Insurers come up with new modular policies, global solutions and top-up cover models for example to face current market challenges. From our point of view it is important to keep offering customized solutions.

Some risk federations believe that credit insurers should be obliged to develop anti cyclical buffers e.g. by law or through Solvency II, can you agree?

Whether credit insurers sign limits or not is no question of accumulated reserves or reinsurance capabilities. It is a question of being willing to take a risk or not. During the crisis in 2008 and 2009 the credit insurance industry lost their client's confidence but we think they learned a lesson and do better now.

2. IMPACT OF CREDIT INSURANCE

The intention of this chapter is to briefly explain the economic impact of credit insurance. The most important aspect is the influence of credit insurance on the working capital of a company.

The credit insurance industry does not have a 'sexy' reputation. However, we are convinced it does. Yet the sector should wake up from its winter sleep. Globalisation and the metamorphosis of the world economy provide an excellent opportunity.

For a clear understanding, we want to point out that the insurers have undergone important evolutions at an operational level. Thanks to new technological opportunities they now manage to work much more efficiently and are able to create economies of scale.

We will explain the main aspects of credit insurance below, mainly approaching the subject from an economic point of view.

2.1. Economic interest: the invisible ban[4]

Credit insurance covers the credit risk on trade receivables. The covered trade receivables are only one side of the coin. A trade receivable or trade credit granted by one company is a supplier debt or supplier credit obtained by the other. If the credit insurer acts restrictively towards a certain company, the suppliers of that company will insist on shorter payment terms, even on cash payment.

Consequently, this company will need an increase of its working capital. This situation will lead to more pressure on liquid assets.

For that reason the credit insurer has an immense (economic) impact on the funding cycle of a company. This impact has even increased as a result of the consolidation within the credit insurance industry. If a branch belonging to one of the three large credit insurance groups, acts restrictively towards a local debtor, this policy will in principle be adopted by the whole credit insurance group.

[4] BECUE, P., *Kredietverzekering. Uw bedrijf goed verzekerd?*, Leuven, Lannoo-Campus, 2011, p. 201-203; BECUE, P., *Handboek kredietverzekering. De onzichtbare bank*, Antwerpen-Oxford, Intersentia, 2008, p. 91-92 ('Manual of credit insurance. The invisible bank')

Formerly the debtor concerned could still try to trade with a supplier from another country, where the local foreign credit insurer was not that pessimistic about the financial situation of that debtor. Due to the sector consolidation things are different now. A negative attitude of the credit insurer will quickly be spread in the market among various suppliers.

The fact is, however, that this key position of the credit insurer is not always accepted by various other parties in the financial markets (a.o. the financial institutions) operating beside the credit insurers.

In this respect we could say that the credit insurer acts as an invisible bank, although no real funding in cash takes place. The credit insurer's negative attitude thus indirectly leads to a decreased supplier credit granted by the seller of goods and services.

2.2. Preventive role

The main role of credit insurance is prevention: it is the intention of a credit insurer not to take any risks on companies which can become insolvent at short notice (i.e. within one year). The knowledge and expertise thus acquired will be shared by the credit insurer with his insured companies. Clearly a company will not continue to supply a customer who we expect to go bankrupt with a relatively high degree of certainty. Turnover will only be realised as soon as the invoices are paid.

On the one hand the insured supplier is not happy with this situation because he will lose part of his turnover. Yet, on the other hand he is forced to search for prospects that he can start a new and healthy commercial relation with: the dynamics of the company are thus maintained. The credit insurer can assist the insured in that search: he has a rich database in which information of many companies is collected worldwide. Each company receives a rating. That rating is the yardstick for the solvability of a debtor and is based on several criteria, which more specifically enable assessment of the repayment capacity of a company within one year. With this rating instrument the supplier quickly knows on which companies he should focus his prospecting efforts on.

Let us finally point out that a credit insurer would not survive long without prevention. If he accepted all risks, even bad ones, he would quickly go bankrupt. This would be a disadvantage for all the insured companies who carry out a debtor management in good faith: they would not obtain indemnification from a bankrupt insurer. The added value of the insurer therefore consists in making a distinction, as accurately as possible, between the debtors showing high risk of bankruptcy within one year on the one hand, and those who are healthy on the other hand.

"We are selling prevention before selling insurance. Assessment is our business."
Xavier Denecker, Member of the Executive Committee, Coface Group

2.3. Pro-cyclical nature of credit insurance

The companies reproach credit insurance for reinforcing the crisis, instead of alleviating it. However, we should not forget that the crisis was not caused by the credit insurers. The air bubbles in the financial world dragged the economy into an economic malaise.

The role of the credit insurer consists of facilitating trade transactions. He takes over the debtor risk in exchange for payment of a premium. Yet, for some transactions the risk becomes too high compared with the premium an insured company pays. In this case there are two options:

- either the premium becomes so high that the profit margin the insured supplier makes on that transaction disappears;
- or the cover is decreased or cancelled.

It doesn't make sense that the credit insurers continue to cover all possible risks: they too must ensure that their balance sheet remains healthy.

If the insurers had a clear counter-cyclical effect, they would have to continue accepting covers which are actually uncoverable. Consequently, all their insured companies would have to put up with very high premiums, which is mainly to the disadvantage of those with a relatively healthy debtor portfolio. After all, in insurance everything turns on the mutualisation of risks.

2.4. Multiplier effect[5]

When the credit insurer decides favourably on the main part of the requested credit limits, and provides cover, this will promote business between the involved trade partners. This stimulates general economic activity.

This was confirmed by the Dutch Central Bank. It carried out research in 2010 which demonstrated that credit insurance had a positive multiplier effect of 2.3 on international trade. In other words: every euro covered by the credit insurer leads to an increase in international trade of 2.3 euro.

[5] VAN DER VEER, K., 'The Private Credit Insurance Effect on Trade', *Working Paper nr. 264/2010*, Amsterdam, De Nederlandsche Bank nv, October 2010, 43 p.

Interview with Stuart Lawson

Managing Director, Aon Trade Credit UK

Some CFO's doubt credit insurance is a good tool to improve working capital. What is your opinion?

I believe the key is ensuring that you have the right structure and programme to meet the specific needs of the business. If you get this right, then credit insurance can be a very effective tool in accelerating cash-flows and improving working capital.

How can a credit insurer contribute to higher sales/higher turnover of a credit insured?

Credit insurance can identify customers which are better credit risks and assist targeting of prospects. Personally, I believe major benefit of credit insurance in respect of sales growth is to allow companies to develop and penetrate new markets. In the UK, we have one major client who sees credit insurance support in new markets as the key to growth.

The credit insurers have to communicate better and to share more and better information with the insured. Can you agree on that?

Absolutely. Credit insurers are selling insight and knowledge as well as protection so it is essential insurers are able to deliver this to clients in the right way at the right time to enable companies to make informed business decisions. The Credit Insurer should be totally focused ensuring this is achieved.

Some risk federations believe that credit insurers should be obliged to develop anti cyclical buffers e.g. by law or through Solvency II, can you agree?

I remain unconvinced whether greater regulation supports or hinders business. However one thing is for sure, it is essential that a credit insurer has sufficient reserves, capital and reinsurance support throughout the economic cycle.

Globalisation feeds a growing need for syndicated credit insurance programs. Is it possible to work in an oligopoly with syndicated programs/syndicated credit limits?

Yes, you need an advisor who can ensure that this is built in correctly. We are certainly seeing more syndicated solutions at Aon to address the effects of globalisation and concentrated exposures that are just too big for one carrier. We also have the benefit of having access to Aon Benfield Financial Risks team to provide reinsurance solutions that facilitate access to additional capacity.

Economic resurgence and crises are expected to follow up each other rapidly. And now a new crisis is raging, the credit insurance sector will have to do more than streamline the internal business processes. They will have to reinvent themselves. Can you agree on that?

I believe the key to providing valued services is to ensure that you are totally committed to providing thorough and objective risk analysis capability which recognises the need to underwrite acceptable commercial risk.

Of course, the industry needs to adapt and evolve to ensure it is relevant and meaningful to its clients. Certainly at Aon, I believe innovation and product enhancements are key to our success. I am great advocate of Darwinism!