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CREDIT INSURANCE DURING THE FINANCIAL CRISIS

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Abstract

In international economic relations, credit is an indispensable element, being viewed by most specialists as the engine of a national economy, due to the role of the driving investments and based on them, the employment, the increase in the production, etc., the use and typology according to the duration and nature of the operations performed. Export credits are, along with the other types of loans, part of the specialized loan category held in the portfolio of most commercial banks. Export credits or export pre-financing credits are loans granted by banks to business entities with production made for export in order to support or promote it, or to cope with exceptional needs occurred in the period of making the export production. This paper describes recent trends noticed in export credit insurance, especially from 2008 to 2011.

1. INTRODUCTION

In international economic relations, credit is an indispensable element, being viewed by most specialists as the engine of a national economy, due to the role of the driving investments and based on them, the employment, the increase in the production, etc., the use and typology according to the duration and nature of the operations performed. Export credits are, along with the other types of loans, part of the specialized loan category held in the portfolio of most commercial banks. Export credits or export pre-financing credits are loans granted by banks to business entities with production made for export in order to support or promote it, or to cope with exceptional needs occurred in the period of making the export production. This paper describes recent trends observed in export credit insurance, especially from 2008 to 2011.

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Credit insurance protects the insured party (normally the seller), in exchange for a premium, against a range of risks that result in non-payment by the buyer. In domestic cover, only commercial risks are involved. In export credit cover, both commercial and political risks are normally involved. However, the term can include both export credit insurance and domestic credit insurance (i.e., insurance on sales within a country) (Malcolm Stephens, 1999).

2. CONSIDERATIONS CONCERNING EXPORT CREDIT INSURANCE

Most trade agreements are concluded in circumstances in which payment is partially or completely made after the delivery of the goods or services covered by the agreement. The delayed payment has led to credit insurance, but this insurance cannot eliminate the seller's fear concerning the buyer's payment of the amounts due to him providing protection for the risk of default, due to the financial situation of the buyer or if the sale takes place in a country other than that of the seller, causes related to the situation of the importing country.

Credit insurance is therefore a direct protection against the risk of not collecting of the sellers and at the same time, as a guarantee to the bank, and it is also a possibility to access finance. In other words, to ensure credit is to protect against financial loss resulting from default, insolvency or insolvency buyers who purchased goods on credit or insolvency of credit beneficiaries.

The credit insurance contracts are substantially protected incomes from trading in terms of not collecting on the insurance risk transfer and consequently can increase turnover.

Export credits are, along with the other types of loans, part of the specialized loan category held in the portfolio of most commercial banks. Export credits or export pre-financing credits are loans granted by banks to business entities with production made for export in order to support or promote it, or to cope with exceptional needs occurred in the period of making the export production.

The export activity is treated with the utmost care by all countries, and exporters benefit from a system of stimulating policies and techniques represented by export credits, granted on favorable terms, guaranteeing and securing these loans by the state, tax facilities, etc.

In the European Union the harmonization of the rules on the insurance and collateral security of export credit is a first step towards the convergence of the public insurance systems of the member states. Moreover, on 27 September 1960, the European Commission decided to establish a coordination group which has as main objective the development and monitoring of the policies on loan collateral securities and insurance.

The supplier-credit and the buyer-credit are the main operations covered by Directive 98/29/EC of the European Council of 7 May 1998, concerning goods and/or services exporting companies established in the European Community space that have a commercial relationship with public or private debtors. In the case of the buyer-credit, the debtor quality is assimilated to the credit guarantors involved in the insurance process.

The European Commission (the "EC") sets out rules on State involvement in short-term export credit insurance, in the form of a communication of the Commission to the Members States applying Articles 92 and 93 of the EC Treaty (the "Communication") established in 1997 (OJ C 281, 17.9.1997, p. 4.). The Communication was subsequently amended and its validity extended in 2001 (OJ C 217, 2.8.2001, p. 2.), 2004 (OJ C 307, 11.12.2004, p. 12.) and 2005 (OJ C 325, 22.12.2005, p. 22.) and 2010 (OJ C 329, 7.12.2010, p. 6.) and is to expire on 31 December 2012.

The supplier-credit occurs in a commercial transaction performed, based on a loan agreement, by one or more suppliers and one or more public or private buyers, and the latter undertake to pay the debts as term payments.

The buyer-credit constitutes the object of a loan contract concluded between the importer, public and/or private, and one or several financial institutions, in order to finance the export commercial contract; the financial institutions involved becoming direct debtors in relation to the exporter, from the perspective of an unconditional commitment to pay the debts.

The decision to guarantee and insure export credits belongs exclusively to insurers and is made following analyses on a statutory, legal, economic and political basis.

Thus, it is considered that public debtors, public or local authorities, benefit from maximum reliability in comparison with a private loan, given the sources of their funding and incomes, along with the control institutions contingency that provides safety to the reinforcement of the guarantee decision. The undertaken risks are political, credit risks, commercial and manufacturing risks, and the compensation, in the case of the occurrence of the covered event, is made in the insured currency.

Credit collateral securities in terms of covering political risks, take into account several circumstances that may occur in a country other than the exporter's country, or the insurer's country, whose effect could be substantiated in the impossibility of completing the commercial contract or of the loan contract in progress, but also the decision of the country of the insurance policy holder or of that of the insurer to require interdictions concerning exports to third states outside the Community.

The risks occurred both as a result of economic imbalances or legislative or administrative changes which adversely affect the transfer of funds related to the respective contracts, as well as the decisions of the countries of origin of the borrowers to deem as liberating their payments in own currency, increasing the likelihood of the occurrence of the currency risk by failing to cover the debt value following the conversion into the insured currency are also taken into account. General moratoriums set by the debtor's country or third countries can also have negative consequences on the maturities, and therefore on the integrity of the contracts.

The country risk can take the form of natural disasters, nuclear accidents or war, including riots, revolutions and social unrest, in which case the insurer takes responsibility only in the conditions of the inexistence of the coverage of the consequences by other means.

The coverage of the commercial risks takes into account the cases when the debtor or its guarantor is insolvent, leading to the impossibility to partly or fully fulfil the payment obligations, and also to its failure to fulfil its obligations, for any reason, or to the refusal to take over the contracted goods and/or services, without prior authorization and unilateral termination or suspension of the commercial contract.

The payment of the damages arising from the occurrence of the credit risk is made while the claims relating to commercial contract or loan cannot be recovered in any way, by the insurance policy holder in a period of three months until maturity, and this impediment derives from the events described under the coverage of the policy risk.

The amounts guaranteed for the credit risk are those related to the commercial or loan contract, namely the principal, the related interest and also interest payable after maturity (default interest). The penalties and damages, compensatory and / or default, due to the debtor, are not included in the guaranteed amounts.

The same events referred to under the policy risk must also concur to the occurrence of the manufacturing risk covered by the collateral security, the result being the insurance policy holder to pay its contractual obligations or to perform its activities related to the production of the activities covered by the contract, for a period of six consecutive months.

In the case of this risk, the amounts guaranteed are the expenses imputable exclusively to the contract, namely those incurred for the production of the goods dedicated to the export and those allocated to the debts related to the contract, with the exception of the amounts depending on the security employed by the insurance policy holder, within the contract and of the amounts related to the payment of penalties and damages to the debtor.

Export credit collateral security is made on the principle of proportionality, the amounts covered by the collateral security being divided into shares. The guaranteed share is up to 95%, unless the insurer wants to increase this share, having the obligation to notify, in this respect, the Council and the other insurers at least seven days before the initiative takes effect. Moreover, the more favourable conditions undertaken and offered by the insurer must not violate the provisions of the law on welfare. The non-guaranteed share can be transferable, if the insurer allows this, and is fully supported by the policyholder.

The collateral security is automatically extended over the subcontracts from EU member countries or third countries, their coverage being limited according to the value of the contracts, as follows:

- 40 % for contracts worth less than EUR 7.5 million;
- 3 million for contracts between € 7.5 million and € 10 million;
- 30 % for contracts worth more than € 10 million.

The above-mentioned percentages and values are calculated following the rules below:

1. Costs related to the export, namely the transport costs and insurance costs are included in the value of the contract based on which these percentages and values are calculated;
2. The financial costs are completely excluded from the value of the contract, whether they are individualized or not;
3. The non-returnable part of the local costs related to the delivery is not usually deducted from the value of the contract, but it is however agreed, if this part exceeds 15 % of the value of the contract from which the financial costs are deducted, to deduct the surplus.

The collateral security takes effect when the commercial contract becomes effective, in the case of the supplier-credit, and of the loan agreement, respectively, in the case of the buyer-credit, because it is necessary to fulfil the terms stipulated in these contracts.

For the credit risk the effects of the collateral security can occur with the completion of every export or partial delivery, as the holder is entitled to the payment of a fixed and irrevocable amount corresponding to the value of the traded goods or services. The holder should also be free of debt from the point of view of the contract and, as mentioned before, the stipulated terms should be strictly observed.

The insurer is relieved of liability in the case of omissions of the holder or of its proxy or if its rights are limited following a decision attached to the commercial or loan contract, related including to bails or pledged collaterals. The disclaimer of liability is also made as a result of the conclusion, after the commercial or loan contract, of an agreement between the creditor and the debtor, which agreement can postpone and even terminate the payment of the debts. Another cause of the relief from liability is the subcontractors' and/or co-contractors failure to fulfil the undertaken commitments, for any other reasons than those listed at the coverage of the policy risk by the collateral.

The rights of claim corresponding to the loan contract, or to the commercial one respectively, are assigned, by the policyholder, to the insurer.

In relation to granting the indemnity, it must not exceed the value of the actual loss arising from the occurrence of insured risks or the value of the debts justified by the loan agreement or by the commercial contract. In the calculation of the indemnity, the additional costs are included too, such as the legal ones or those for legal actions, incurred in order to avoid or limit losses, and if these costs correspond to non-guaranteed amounts or maturities, they will be proportionally included in the shares specified in the policy.

Its payment is made within 30 days from the occurrence of the risk and it is subject to the submission by the policyholder of grant application accompanied by evidence of the validity of the claim. If, however, the damage covered by the application for the indemnity is affected by the existence of a challenge, the insurer may decide to postpone the payment to the owner until court or an arbitration body specified in the contract decides in favour of the creditor.

The indemnity payment period lapses only if the private debtor is deemed insolvent or in the case of a bilateral consolidation agreement concluded between the governments of the countries of origin of the parties involved in the commercial contract or in the loan agreement, and the policyholder has the obligation to cooperate with the insurer for the fulfilment of the respective consolidation agreement.

In the case of insuring export credits the level of the *premium* must, first of all, express, in a realistic manner, the degree of coverage of the insured risks, especially the country risk, assessed depending on the category of every country, the quality of the collateral security and its scope, and the determined value must fully cover the long-term management expenses and losses. The insurer also determines the level of the premium and based on an analysis of the public or private debtor's solvency and the length of the risk, the reimbursement system and the related interest are also taken into account.

The premium is calculated in correspondence with the security whose value is equal to a reference amount, at the credit risk it is at least equal to the level of the principal or of a (re)financed share of the commercial contract, while in the case of the manufacturing risk - with the minimum value of the loss specified.

The payment of the premium can be made in instalments or in the form of an interest rate or of a margin, on the date stipulated in the insurance policy or in the guarantee period or when the commercial contract or the loan agreement takes effect.

The assessment of the country risk is at the discretion of the insurer, who makes a classification on risk categories of each country and determines its own coverage policy by a brief formula, taking into account specific elements, reserving its right to initiate actions according to the peculiarities of the operations carried out in one country or another.

Thus, it can proceed to the limitation or refusal to cover operations, irrespective of the classification of the countries but, in principle, the disclaimer of liability occurs in the case of countries with a high risk. The insurer's implication into the operations with these countries is proportional to the own portfolio of securities granted, with the total risks, determined as likely, in a country, with the number and value of the contracts that will be guaranteed, as well as with the maximum value of each guaranteed amount. Depending on these aspects, the insurer is entitled to increase the level of the premium.

The insurer can also stipulate certain conditions for the coverage, requesting in addition, irrevocable letters of credit, bank guarantees, payment or transfer guarantees from the competent authorities (the Ministry of Finance and the Central Bank) or may extend, sine die, the payment term of the indemnity. In addition, it also reserves the right to reduce the guaranteed share or to limit the coverage for certain types of projects, or sectors of activity, respectively.

For the notification of other insurers and of the European Council, the insurer applies a number of four procedures for consultation and information, which are confidential:

a. the annual notification for information, consisting of a retrospective report of the activity carried out throughout the previous year, presented at the end of each year and no later than on 30 April of the following year. This report includes information about all the debtor countries, revealing the level of the insurer's guarantee promises, the total existing risks covered, the determined premiums, the value of the re-coverage made and the value of the indemnities paid. At the same time, at the end of each year and no later on 31 January of the following year, the insurer must notify the Commission and also the other insurers, both in relation to its coverage policy, as well as with the conditions it believes it can express, in relation to granting collaterals.

b. the notification for decision, which is a prompt exchange of information among insurers, regarding the status of one or more borrowers, and, in case of divergence, the Commission takes knowledge of the situation, by arbitration, settling the case;

c. ex ante notification for information, by which an insurer announces that it wishes to provide the most favourable coverage conditions or to grant guarantees to a debtor in a country that is not usually in its interest area, according to the adopted policy. This notice must be sent at least 7 days before the decision takes effect, specifying the reason for the decision. The same thing must be performed by the second insurer who intends to provide more favourable coverage conditions than the first insurer with a similar intention in this respect.

d. ex post notification for information, by which an insurer announces a change, in the negative direction, brought to the coverage policy at the level of a country, sent annually for information, but also the negative correction, of the conditions for granting a guarantee, no later than at the end of January for the previous year. Such a similar notice must also be sent by the second insurer who made the decision to grant the same guarantee conditions as the first insurer.

Export credit insurance allows exporters and trade banks to safely extend credit to buyers abroad, thus enabling trade transactions that would not happen otherwise.

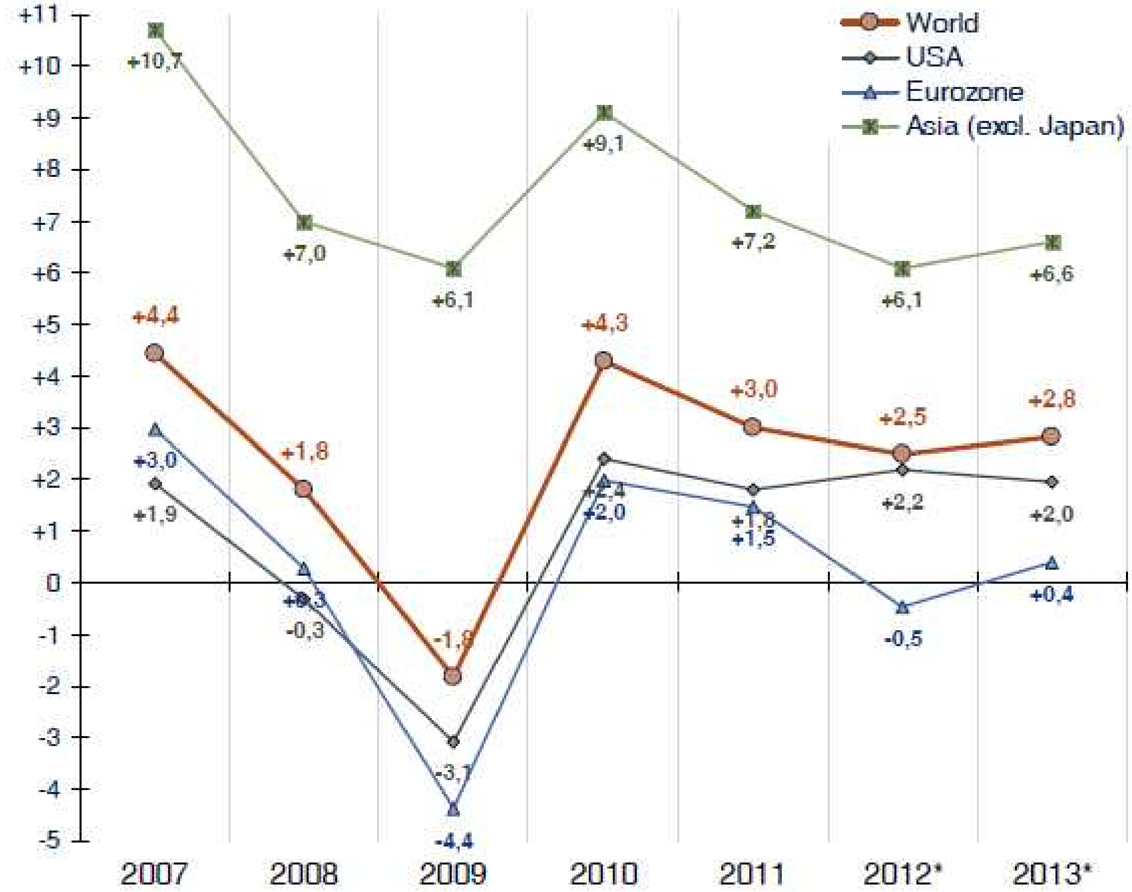
3. EVOLUTION OF INSURANCE CREDIT MARKET

The ensuing period of global economic slowdown because of the financial crisis with its origin in 2007 in the U.S. has lead our business world to focus on credit insurance and surety, a service with less visibility and recognition during better times. Large companies and not only, have become aware of the urgency to secure trade. Several European governments offered additional insurance or reinsurance solutions in cooperation with the private credit insurance market, so the credibility and reputation of credit insurance were at stake.

Credit insurance losses occurred mostly for the underwriting years 2007 and 2008, when the world economy started to deteriorate, but had not yet entered a recession. The increase in the loss ratio was on a relative basis above the increase in number of business insolvencies, mainly driven by the eroded premium rates.

Credit insurance loss ratios substantially vary between credit insurers, due to different portfolio compositions in terms of sectors, countries, risk quality as well as policy terms & conditions.

Chart no. 1. World economic growth 2007-2013
Annual percentage change of gross domestic product



* Euler Hermes forecast
Source: IHS Global Insight, Euler Hermes; as at 09-2012

For 2013, the credit insurance market trends are:
- increased demand for trade credit insurance and surety expected to continue
- new growth markets are recognised and offer new opportunities
- 15% of global trade is credit insured
- high retention rates confirm customer satisfaction in the product
- competition is increasing
- concern about deteriorating risk environment
- concern about the uncertainty regarding Solvency II implementation

Credit insurance is cyclical in its nature, with the different cycle periods varying in tenor and intensity and driven by the economic environment to a large extent. Active monitoring and assessment of economic/market conditions and portfolio indicators (GDP, insolvencies rate, payment overdue, relation exposure/premium) is crucial to mitigate negative impacts when the cycle turns.

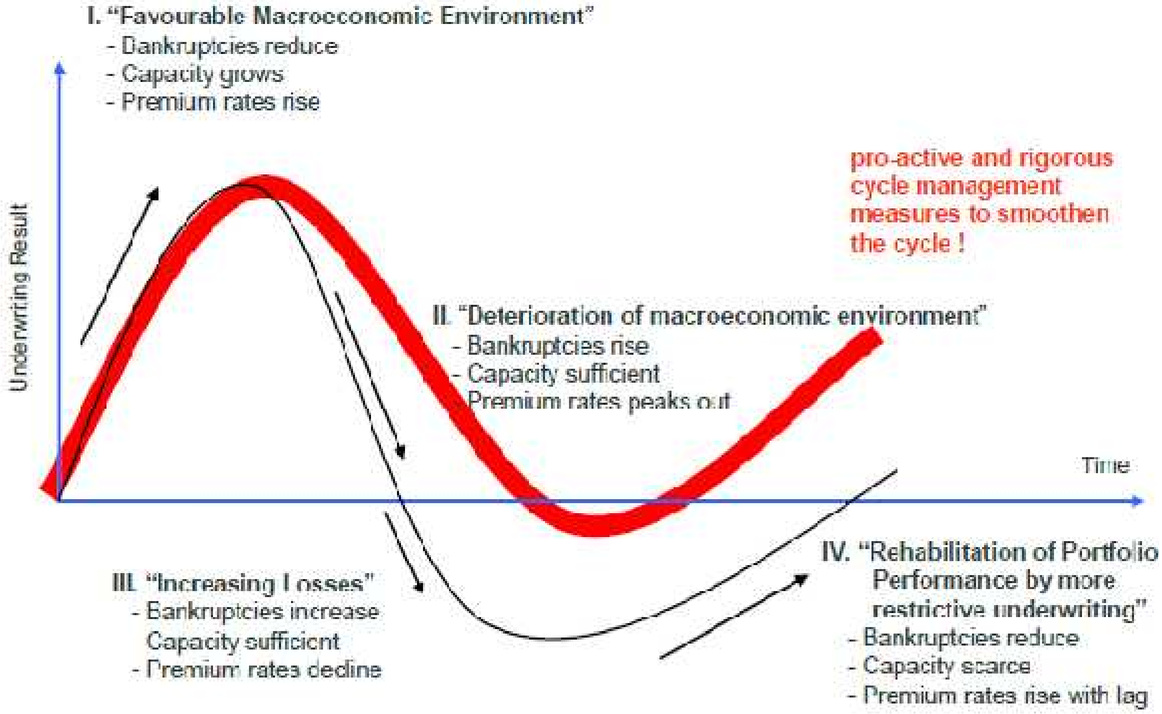
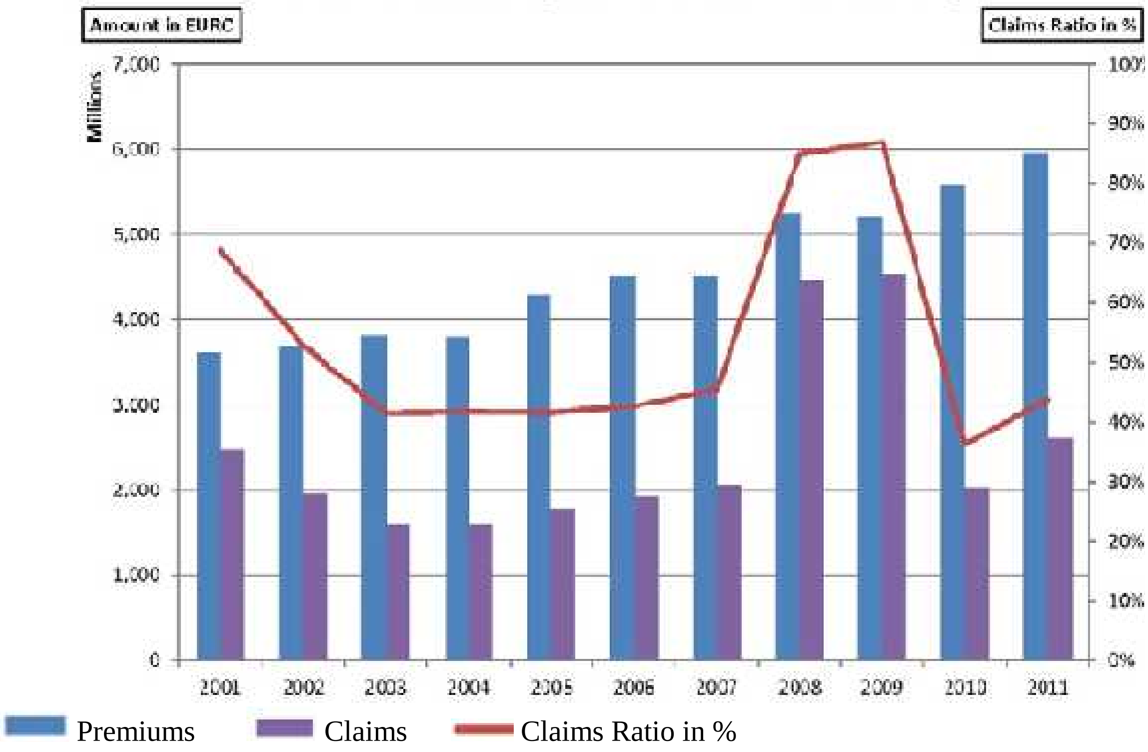


Figure 1. Underwriting result of credit insurance in time
Source: Adrian Kärle, Credit Insurance in the Crisis - A Reinsurer's View - PASA Conference, Lima, 8-10 May 2011

Chart no. 2. Trade Credit Insurance – Premiums, Claims and Claims Ratio ICISA Members (excl reinsurance members)



Customers benefiting from credit insurance or from surety solutions were better able to navigate through the recent period, and have demonstrated remarkable stability and resilience.

Demand for trade credit insurance and surety bonds is on the rise, as a result of increasing trade flows, mostly from high-growth markets, in an overall ongoing deteriorating risk environment. Capacity is expected to remain ample, while conditions for trade credit insurance may harden in some markets. Major resources and skilled underwriting are needed to meet the demand for surety bonds in the ongoing poor conditions of the construction and transportation areas. Concern is raised about availability of adequate trade finance.

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