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Article abstract

Quite recently I wished to obtain details with regard to Credit Insurance and was surprised to find how little information has been published, in comparison with the abundance of books and other writings relative to many other classes of insurance. For example, the most recently published text book seems to have been written as long ago as 1957, by Hans Karrer of Zurich, under the title *Elements of Credit Insurance*. It has not been re-published or brought up to date. Nor so far as I could ascertain, are there Study Courses or Reports by Student Groups. These notes are based on the practices which pertain in England, but will, I think, be of interest to readers in other countries where similar insurance principles apply.

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Credit Insurance [1]

collected by

ERIC A. PEARCE, F.C.I.I.

Quite recently I wished to obtain details with regard to Credit Insurance and was surprised to find how little information has been published, in comparison with the abundance of books and other writings relative to many other classes of insurance.

For example, the most recently published text book seems to have been written as long ago as 1957, by Hans Karrer of Zurich, under the title Elements of Credit Insurance. *It has not been re-published or brought up to date. Nor so far as I could ascertain, are there Study Courses or Reports by Student Groups.*

It was this which encouraged me to collect together sufficient details to provide the general reader with the basic elements of this highly technical and complex form of insurance.

[1] Nous avons demandé à M. Pearce de réunir les éléments d'une assurance-crédit. Très aimablement il s'est rendu à notre prière. Voilà le texte qu'il nous a fait parvenir comme une nouvelle contribution à notre revue. Nous l'en remercions. A.

These notes are based on the practices which pertain in England, but will, I think, be of interest to readers in other countries where similar insurance principles apply.

1. The nature of Credit Insurance

Quite simply the intention of this form of insurance is to protect the Insured against loss as the result of the inability of his customers to pay their debts.

It is important for the reader to remember that although it is the Insured who applies for the insurance and pays the premium, it is the ability (or inability) of his customer to pay which is the risk covered by the Credit Insurer.

Thus, Credit Insurance is principally concerned with those involved in a trade, business or profession, insuring against losses due to the "insolvency" or "protracted default" of the buyers of goods and services, to whom goods have been delivered (or are due to be delivered) or for whom work has been undertaken.

As will be seen, the definitions of the two terms used above, namely "insolvency" and "protracted default" are important, because the failure on the part of the customer to pay merely because there has been a dispute between the parties does not constitute a claim under the policy.

In most cases there must be bankruptcy or insolvency in the legal sense, and when the Insured's claim has been paid by the Credit Insurer, the latter has the right of subrogation, which enables the Credit Insurer to take all measures necessary to recover the debt.

The sum insured is based on the full invoice value of the goods and services involved, which will include the Insured's profit, but cover is given for a percentage of the loss, that is 75% or 80% for example. The Insured is required to take a part of the risk for his own account so as to ensure that he will take reasonable precautions not to become involved with customers who are not credit-worthy, that he will maintain proper accounting control and follow up, and will pursue normal debt collection with proper care.

It can be assumed that a defaulting customer has been in some sort of financial difficulty for a considerable time before the inability to pay becomes manifest. For this reason the creditor who exercises strict control on outstanding accounts is less likely to be seriously affected by the insolvency of a customer, than creditors who allow debts to run on, far beyond the normal period of credit recognised in the particular trade or business.

It has been found that the spectacular and unexpected collapse of a well known firm, greatly stimulates enquiries and proposals for Credit Insurance. It is also likely to encourage all members of the business community in the area to review their credit control and accounts systems.

2. *The usual forms of cover*

There are various forms of policy available, any one of which may be selected by the Insured as most likely to suit his particular needs.

The following are examples:

(a) *Whole Turnover Policy*

This is generally applicable to the whole of the Insured's business. However, in some instances it will apply only to some of the Insured's activities in the case of a large firm with a number of different divisions.

(b) *The Specific Account Policy*

This is intended for the insurance of one or more individual accounts. It is particularly useful in the case where the Insured has only one or two important customers whose insolvency would be of major importance to him, and a large number of much smaller customers, the loss of any one of whom would not have any real impact on his business. This principle of selection may go much further and a policy may be issued to cover only one transaction at any given time.

(c) *The Work in Progress Policy*

This covers the risk of loss on work under a contract as a result of the insolvency of the firm for which the work is being undertaken. The loss may consist of the excess of expenditure over payments received and would probably include the Insured's liability towards any sub-contractors or suppliers with whom he had been in trade relationship on the contract in question, and to whom he must pay the debt, notwithstanding his inability to collect from his customer.

(d) *The Anticipatory Credit Policy*

This provides cover against the loss which would result if the Insured had paid for goods in anticipation of future deliveries, but the goods were not delivered because of the default of the suppliers.

(e) *The Resale Loss Policy*

The protection in this instance is for the Insured who finds it necessary to sell goods in the open market, when the original purchaser failed to complete the contract because of insolvency. The claim is, broadly speaking, the difference between the contract price and the price actually obtained on resale.

3. *Underwriting*

As mentioned above, the risk insured against is the default by the Insured's customers. Thus the information required by the Underwriter to assess the risk is very largely related to the customer.

The Insured will probably not wish to emphasise to his customer the fact that he is taking out insurance on the customer, because the mere fact of the existence of such insurance implies that the Insured has doubts as to the customer's ability to meet his debts.

Unless the customer is a very small firm or private individual, there is a good deal of information made available to Government Departments and to the public, in the form of annual returns, annual accounts, balance sheets and the like.

In the United Kingdom, such information is filed in a public office, which is part of the Board of Trade, and a Credit Insurer is likely to have several employees constantly at work there, collecting information.

Also, the financial press in various forms produces a great mass of detail in the course of a year, all of which must be read, analysed, indexed and stored by the Credit Insurer for present and future use.

The value of the organisation is to keep the records constantly up to date and readily available, and the skill of the Underwriter is the ability to assess the worth of the customer and to correctly interpret the meaning of any alteration in the general pattern of the customer's development.

Very simple examples are that a reduction in turnover may be an adverse factor, but too large an increase in turnover may indicate dangerous over-trading. Similarly, some small detail, such as delay in paying the annual dividend even by a few weeks or months, may indicate that there is a liquidity problem.

It will be appreciated that whereas the Fire or Accident Underwriter who is unsuccessful may refer to his "bad luck", the unsuccessful Credit Underwriter will probably be accused of poor financial analysis and insufficient knowledge of the market situation and conditions.

It is important that when considering any proposal the Underwriter should know where the Insured's account will rank in the event of the customer becoming insolvent. Normally taxes and employees' wages have priority, but thereafter there may be a number of debts likely to have the right of special treatment, such as bank loans and debenture holdings.

It is normal for the Underwriter to review each case afresh on each occasion that the policy comes before him for consideration, either at renewal date for the Whole Turnover Policy or the Specific Account Policy, or at any other time for those policies which apply to a particular event, such as new deliveries or providing new services. All the previous information will be re-read and due consideration given to further information which has become available in the meantime. There cannot be the easy assumption that because it is a "clean renewal" the risk continues to be a good one.

Above all the Underwriter must be well integrated into the business community which he serves. Close association with other business men, such as traders, merchants, bankers, accountants, all will add to his general background which is essential to successful underwriting of this complex class of insurance.

4. Premium

The premium required by the Credit Insurer, will of course, depend on many factors, including the type of policy, the trade business or profession of the Insured, the conditions which exist in the particular market, the general economic climate and the main customers with whom the Insured is in relationship. Also there is the share of the policy which the Insured is willing to retain for his own account, which may give a guide to his own appreciation of the risk.

In many — indeed most — industries, the same material changes hands a number of times from the original source to the ultimate consumer. At every stage there is a credit risk and risk is different and will attract a different premium. Usually it is considered that the closer the Insured (and so the customer) is to the source of the raw material, the better is the risk.

Very broadly the rates vary between one per mille and five per mille on insurable turnover. As an example one can consider a manufacturing chemist selling to heavy industry on a large scale, where the risk would probably carry a rate of 0.10% on the whole annual turnover, whereas a paint manufacturer selling to builders' merchants and decorators could be asked to pay four times that amount. The rate for firms dealing in textiles, cotton, rayon and silk would probably be in the region of 0.15% to 0.65% on turnover, according to the class of customer involved.

It is not usual for the Credit Insurer to require the Insured to provide collateral security, the object in general is to assist the Insured and enable him to develop his business not to hinder him by taking control of a part of his assets, which might be better used for raising a bank loan or working capital.

5. Claims and Recoveries

In the majority of Credit Insurance policies, the cover is restricted to the loss which may arise when the Insured's customer is declared insolvent.

There is "insolvency" when:

(a) an Order has been made against the customer for Winding-up by the Court, or

(b) an effective resolution has been passed for a Creditors' Winding-up of the customer, or

(c) a Receiver on behalf of debenture holders of the customer has been appointed.

Under these policies it is usual for the Credit Insurer to pay the claim within 30 days of the proof, usually a letter or declaration from the Liquidator or Receiver, that the debt will be admitted to rank against the insolvent estate of the customer.

It will however be appreciated that these legal procedures may take a considerable time and particularly in the case of a small trader the legal delay might be sufficient to put him out of business before he could obtain payment from his Credit Insurer.

For this reason there has been developed a much less rigid form of policy, which in effect takes over the Insured's debts, when he has exhausted the normal processes of debt collection. This is called "protracted default".

There is "protracted default" when:
a customer having accepted delivery of goods shall fail to pay an insured debt relating thereto within ninety days of the due date, provided that if the due date has been postponed, the said ninety days shall run from the postponed due date.

In both the above cases the Insured is required to inform the Credit Insurer as soon as the Insured has reason to believe that the customer is likely to default on any payment or payments due; or that the customer has failed to meet a payment on the due date.

From then onwards the Credit Insurer will co-operate with the Insured and will require that the Insured will take all reasonable steps to mitigate the amount of the loss incurred or likely to be incurred. At this point there must be close co-operation between the parties, bearing in mind that the legal rights are vested in the Insured and that any action must be taken in the name of the latter.

In due course the Insured's loss will be paid, within the terms and conditions of the policy, and from then onwards the Credit Insurer will take such action as seems most expedient for the recovery of the loss.

Obviously in some cases no recovery is possible and to endeavour to do so would be a mere waste of time and energy. However, in most cases there are assets, sometimes valuable assets, which can be realised over a period and distributed to the creditors.

In the case of insolvency, the Credit Insurer's Claims Department must keep in close touch with Liquidators and Receivers so as to ensure that the liquidation is pursued as a matter of urgency, and that money which becomes available is distributed as rapidly as possible and in the correct sequence.

As regards protracted default, it may be found preferable not to force the customer into liquidation but to carry through the processes of normal debt collection. In such cases (usually small traders or contractors) it is sometimes found that the financial difficulties are only temporary, and if the firm is suitably handled full recovery can be obtained.

Also, there are apparently many instances where a company is insolvent, but the Receiver continues to trade and finally pays all creditors in full. In a spectacular insolvency of recent years, the two main Credit Insurers in the United Kingdom were heavily involved at the outset, but have since made a full recovery.

From this very brief review it will be seen that, exactly as for the original underwriting, careful records must be set up and efficiently maintained. In some trades a liquidation will take twenty years to complete and the Credit Insurer must keep the matter under regular review, to ensure that Creditors' meetings are properly held and attended, that the liquidation is properly conducted and that the Credit Insurer obtains his full share of the proceeds distributed from time to time.

It is vitally necessary in this class of business, that the Credit Insurer should have a Claims Department comprising highly professional, experienced and tenacious personnel, as it is here that it is likely to be determined whether there will be a profit or a loss, over a period of years.

6. Domestic Credit and Overseas Credit

From the paragraphs above with regard to underwriting, it will be appreciated that the Underwriter must have intimate knowledge of the business community and market trends. Thus it is why with few exceptions the commercial Credit Insurance companies accept insurances relating only to their own communities. In some instances they do accept business in a limited number of foreign countries, but in such cases they are always in the foreign community and have built up their records and underwriting routines exactly as in their country of origin.

In any case the commercial insurer will accept only the insolvency risk, excluding the political or economic risks, such as cancellation of import licences or the decision by Governments to refuse the transfer of currency.

For this reason many countries now have Government departments or companies which accept the full scale of risks, which they are in any case well able to judge from information provided through normal diplomatic channels.

In the United Kingdom, the Export Credit Guarantee Department has been operating for more than 50 years and has greatly assisted the British exporter during that time.

7. Trade Organizations

One of the main dangers of Credit Insurance from the Credit Insurer's point of view is the possible, almost probable, accumulation of insolvencies during times of depression, which coming together within a relatively short period of time may in turn involve the failure of the Credit Insurer.

In Europe there were numerous such bankruptcies in the years of depression from 1929 onwards, and it is this which probably accounts for the very small number of Credit Insurers, when compared with the vast number of insurers involved with Fire, Accident, Marine and general classes.

This is demonstrated by the rather small membership of the Insurance Trade Organisations, thus:

(a) *International Credit Insurance Association*

This is an association of companies dealing mostly, if not exclusively, in domestic credit. The object is to promote international co-operation as regards information on and supervision of credit risks as well as the elaboration of underwriting principles.

The list of companies dated 1971, which has not greatly changed, shows that there are 31 members. Of these two are from the United Kingdom, the Trade Indemnity and the General Security and Guarantee Company; two are from the U.S.A., the American Credit Indemnity Company of New York, and the Federal Insurance Company; and two from France, the Sté Française d'Assurance pour favoriser le Crédit and Sté Française d'Assurance pour le Commerce Extérieur.

(b) *Union d'Assureurs des Crédits Internationaux*

The major export credit insurers (including State owned and semi-State owned) are members of the above, usually known as the Berne Union. They bind themselves in a gentlemen's agreement to observe certain conditions for covering credit risks. There are 29 companies, of which the Canadian company, Export Development Corporation is a member, as are the United Kingdom companies, Trade Indemnity and the Export Credit Guarantee Department; two U.S.A. companies, Export-Import Bank of the United States and the Foreign Credit Insurance Association; and two French Companies, Sté Française d'Assurance pour le Commerce Extérieur and Sté Française d'Assurance pour favoriser le Crédit.

8. *Reinsurance*

The Credit Insurers are generally heavily reinsured, usually on a quota share basis. Excess of loss reinsurance is rarely used. In principle, Reinsurers will provide non-proportional reinsurance only when they have an important interest in the whole portfolio. In such cases they will provide excess of loss reinsurance to reduce the Credit Insurer's theoretical liability on a few large policies.

Facultative reinsurance is rarely resorted to, and indeed, the market as a whole, which is very closely knit, seems opposed to the idea of outsiders giving facultative cover. The view expressed is that if there were a sudden expansion of reinsurance facilities, there might be over-trading and eventually financial difficulties.

The large professional reinsurers have over the years built up a close relationship with the Credit Insurers of standing, and provide them with the facilities which they need. Nevertheless, for the well established and profitably managed Credit Insurers, reinsurance facilities are available from non-specialist reinsurers, but the latter are very careful how and with whom they operate and limit themselves to very small lines.

Credit Insurance is constantly subject to the possibility of accumulated loss which could arise from the insolvency of one customer, involving a number of different Insureds, or more generally resulting from trade depression.

One would have thought that this would have created the necessity for some broad form of catastrophe cover, either on a loss per customer basis or for a stated loss in the year. However, it seems that such reinsurances have not been used up to the present, and the suggestion that such facilities should be made available might be treated very coldly by Reinsurers.

It should perhaps be mentioned that at Lloyd's only two syndicates are authorised to write Credit Insurance. There are however, several syndicates permitted to accept Credit Reinsurance. The amount of business written is believed to be very limited.

9. *Intermediaries*

In so far as the London market is concerned, there are very few brokers dealing with Credit Insurance, probably not more than five or six. Such brokers as there are operate on a strictly specialist basis, and some of the important brokerage houses have established separate organisations to deal with the business.

10. *Other Allied Classes of Insurance*

In some instances it is found that Credit Insurers (or the Credit Department of composite companies) also deal with the undermentioned types of credit undertaking:

(a) *Guarantee*

Although Guarantees cover a very wide range of commercial activity, each is, perhaps, more specific in scope than the forms of Credit Insurance described above, tend to be.

Whereas the latter might be termed "customer default" in a great variety of circumstances and businesses, Guarantees are intended to protect the Insured against the inability of an individual or firm to complete a contract.

There is the well known form of Guarantee required by a municipal or other Authority, that building contracts and similar forms of undertaking will be duly completed. There are also a number of other forms of Guarantee, of which the following are examples:

(i) The Insured allows another firm to operate or manufacture under certain patent rights. The Guarantee ensures the due payment of royalties and that the firm will not breach the contract by selling or operating outside the countries agreed under the terms of the contract.

(ii) The Insured sells his business to another firm, and it is agreed that the purchase price will be spread over a period of years. This is the arrangement sometimes made in the case of the sale of a family business. The Guarantee ensures that the purchase instalments will be paid to the vendor on the due dates.

(iii) The Insured is the secretary or other official of a club which arranges holiday Charter Flights for the members. If the Charter Company fails to provide the necessary aircraft for the outward and/or return flights, the Guarantee will cover the cost of providing such aircraft from firms able to make the journeys.

(iv) The Insured may be an Airline Charter Company which is granted the licence to fly to a particular country only if the Government of that country is given a suitable undertaking that aircraft will be available to complete the return flight at the end of the stated period. The Guarantee will cover the cost of such return flight, should the Charter Company not be able to fulfil its contract.

(v) The Guarantee may provide suitable security to a bank, as collateral for a loan to the Insured.

There are in operation a wide range of such guarantees but the above will be sufficient to give a general idea of their scope.

(b) *Retail Credit*

This is sometimes known as Consumer Credit or Hire Purchase, and it is probably the largest source of credit trading in the Western World.

In the United Kingdom and probably also in the North American continent, this business is almost entirely in the hands of a relatively few, very important Acceptance Credit companies. Such firms are fully geared to assess the credit rating of firms and individuals and over the years have built up their sources of information and debt collecting organisations which have made them entirely independent of the Credit Insurance companies.

Some of the smaller Acceptance Credit companies may have arrangements with Insurers, but this is doubtful because of the close association of the Acceptance Credit companies with the distributors and retailers. The latter provide the Acceptance Credit companies with information and facilities, such as the resale of goods, not likely to be readily available to the Credit Insurers.

(c) *Factoring*

This is the method by which the factor (Credit Insurer) purchases the whole of a firm's debt at a discount, so as to make cash immediately available to the firm for use in the expansion of its trade or business.

There are two standard methods:

(i) Without recourse. This is the form of operation which includes Credit Insurance, so that the Insured is relieved of all further liability.

(ii) With recourse. In this form Credit Insurance is not incorporated, so that debts which cannot be recovered from the debtor are re-assigned to the firm and a refund is made by the latter to the factor.

The terms and method of Credit Insurance vary from case to case and depend on numerous considerations, such as the average size of the debts, past record of the Insured as regards bad debts, and the credit worthiness of the debtors.

Factoring may be on a "once for all" basis, to provide the Insured with an immediate injection of cash, or it may be organised in a continuous form, so that the factor becomes, in effect, the debt collection agency of the Insured.

11. Conclusion

As one studies the scope and activities of a Credit Insurer, one becomes increasingly aware of the absolute necessity for the Insurer to form and maintain a team of able and knowledgeable men, as much on the underwriting side as on the claims side. Such an organisation will involve high, fixed administrative cost with relatively small premium income.

In addition, there is almost permanent selection against the Credit Insurer, whilst the insurance is difficult to sell, except when times are bad.

Nevertheless, Credit Insurers and Reinsurers alike seem to agree that in the long run profits can be made, but the Insurer must have resources to withstand the blows which the Insurer is certain to suffer in times of depression or difficult trading.