Credit Insurance

A Key Instrument in Credit Risk Management

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Berta Cunha
with the collaboration
of **Marcos Polónia**

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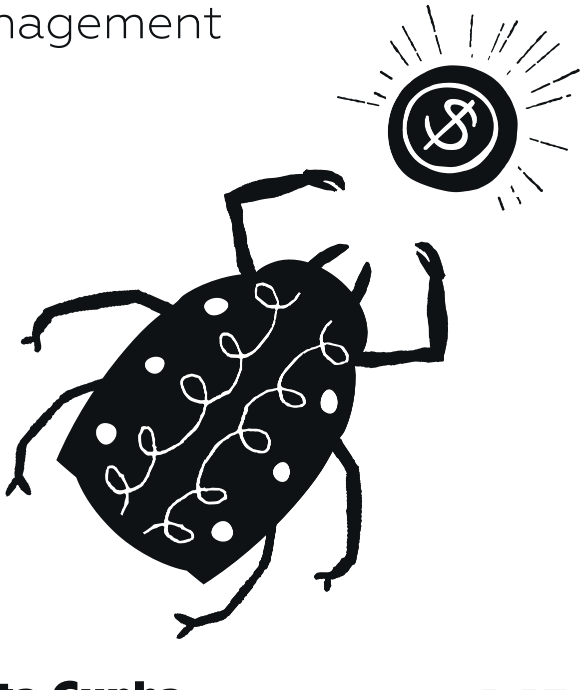

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Book Title: Credit Insurance —
A Key Instrument in Credit Risk Management

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Collection: Keep It Simple

Publisher: MDS Group

Print run: 300 copies

Date of first printing: August 2021

Legal deposit: 488037/21

ISBN: 978-989-54810-2-6

Printed by: Lidergraf, Sustainable Printing

Summary

More security, more capacity to grow your business, detailed, up-to-date information and specialized support are some of the benefits that companies get when they purchase credit insurance policies.

With the pandemic crisis impacting lives, health and finance for people, companies and organisations around the world, we've witnessed a rise in bankruptcy filings and default on payments. Under a global and unprecedented economic recession, credit insurance has become a key tool to manage and protect company assets and sustainable corporate growth.

Berta Cunha, MDS consultant for Credit Insurance, a wellknown professional in the sector, in collaboration with Marcos Polónia, Director of Credit and Surety at MDS Portugal share and explain essential concepts in credit insurance, its main advantages and coverage, the impacts of political risk, and its historical evolution up to the present day, among other matters of interest.

Berta Cunha *Marcos Polónia*

> CREDIT INSURANCE IS AN INDISPENSABLE TOOL IN SUSTAINABLE MANAGEMENT OF CORPORATE BUSINESS. SERVICES ASSOCIATED WITH CREDIT INSURANCE MAKE IT COMPREHENSIVE AND HIGHLY RELEVANT TO THE MANAGEMENT OF BUSINESS ACTIVITIES AND CORPORATE AFFAIRS.

I. Insurance

How can we shield companies from adverse economic developments?

Trade debtors are among companies' main assets, representing, on average, a third of their total assets. Given that significant quantity, it becomes indispensable to cover risk on an asset as important as that one. One of the main reasons why companies become insolvent is customers going into default, which, by itself, demonstrates how necessary it is to put this kind of protection in place by buying credit insurance policies.

Credit risk for companies and countries increases under adverse economic contexts arising from a number of factors, such as the Covid-19 pandemic, although it does so in varying manners. Some countries and economic sectors face greater exposure and increased adversity.

One of the main reasons why companies become insolvent is customers going into default

Credit insurers have enhanced technical expertise that allows them to anticipate global economic trends within countries, as well as main business sector impacts, and identify main points within companies that may lead them to insolvency, so that the insureds can best assess what kind of credit risk they may, at a given moment, grant their customers.

Does credit insurance aim to cover credit risk granted by companies to their customers, then?

Yes, but it goes beyond that. Credit insurance is a management tool that has become essential to sustainable business management.

Services associated with credit insurance lend it comprehensive scope and relevant impact on business management. Four major components stand out:

- Identifying new customers: insurance management supported by a digital platform allows real-time assessment of new customers and therefore conduct a triage of customers to invest in.

- Monitoring customer risk: the insurer monitors risk over time proactively, which allows companies to know how their customers are rated and increase or expand their business with the customer in light of that assessment.

- Coverage of business transactions: through warranties provided by the insurer, the insured can safely sell to its customers.

- Collection and indemnification: when a customer defaults, collection mechanisms are set in motion to collect the amount owed. Should collection not be possible, the claim will be paid out. The insured can also benefit from credit recovery services for the amount not covered by the insurer.

What are the main advantages to credit insurance?

The main advantage is the **peace of mind** it brings to the business management. It provides ways to avoid unpleasant surprises and disruption to cash flows.

This coverage improves **profitability** as it supports more efficient management of the internal resources necessary to monitoring customer risk, as well as collection processes, be it on national or foreign markets.

The main advantage is the peace of mind it brings to the business management

Securing new customers and growing business in new markets, in a secure manner, brings significant increases in **competitiveness** for companies and allows them to focus on managing and developing their business.

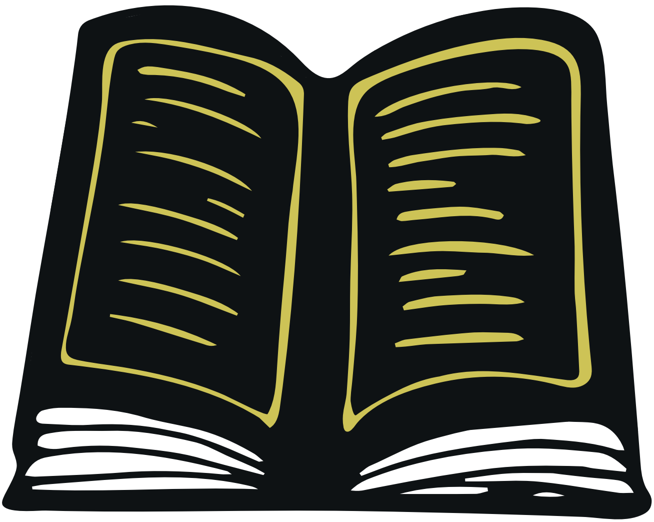
Companies that purchase credit insurance policies reduce their risk exposure and increase favourable perception with their creditors, which improves **access to funding from banks**, making it possible to implement counter-guarantee schemes through the assignment of the right of indemnity to the funding bank.

Companies that purchase credit insurance policies reduce their risk exposure and increase favourable perception with their creditors

What kinds of risk does credit insurance cover?

Typically, covered risk includes bankruptcy or insolvency, late payment, out-of-court arrangements or debt moratoriums with customers, and lack of means of payment on amounts owed by clients for whom the insurer has approved credit coverage.

As a complement, one can purchase additional, specific coverage, such as political risk for sales in higher risky countries, pre-shipment cover, defaults arising from technical conflict/ litigation and others.



II. Origins and market

How did this kind of insurance emerged, and how has it evolved?

The first policies of the kind were created by an Austrian company, Assurances Générales de Trieste, in 1837. However, following several failures to exploit this kind of insurance, almost a century went by before England, Germany, the US and France had credit insurance companies of their own, which are now part of major international groups. American Credit Indemnity (USA), Hermes (Germany), and Trade Indemnity (England) are a few of the oldest and most reputable.

In the early 20th century, after WWI, the knowledge that sustains credit insurance evolved a great deal. Trade Indemnity stands out, here. They consolidated the concept of globality and payment of claims only at the time insolvency is declared. However, a few insurers still offered the payment right after the customer defaults.

With the 1929 economic crisis, those who upheld indemnity right after non-payment (“guarantee insurance”) had to face significant financial impacts that made them feel just how high-risk this option can be.

Only during the latter half of the 20th century was a middle-of-the-road solution created, based on the concept of insolvency presumption. This option involved the definition of a post-default moratorium during which the insurer and the insured would seek to recover the amount owed. If neither of them could, one would “presume” insolvency. These basic concepts are still in place.

In the late 20th century, insurance business displayed a tendency for global accretion and consolidation, no less notable with credit insurers. Major international groups formed through that.

Note: for more detail on the history of insurance credit, please see infographic on pages 45-49.

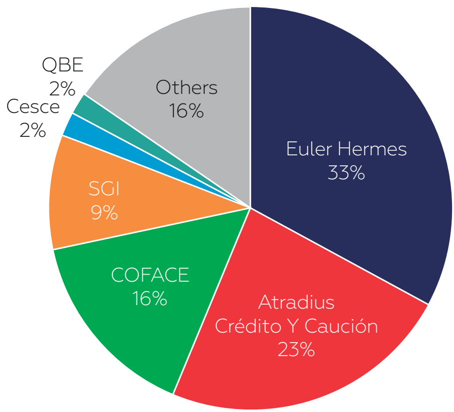
How would one describe the global credit insurance market?

By virtue of this concentration trend, the world market is now dominated by international groups: Euler Hermes, Atradius Crédito Y Caución, and Coface. Together they represent over 70% of the world market for credit insurance.

Two of these groups emerged from mergers and acquisitions among several insurers. In the 1990s, the three groups pursued internationalization strategies which gave them the global scope they have now, with their presence in all countries relevant to international trade.

	Establishment	Group development	Current
EULER HERMES (Allianz group)	1883 - ACI (USA) 1917 - Hermes (Germany) 1918 - Trade Indemnity (UK) 1927 - SFAC (France) and SIAC (Italy) 1929 - COBAC (Belgium)	1990s - Establishes international group through merger and acquisition of several companies	One brand: Euler Hermes, world leader, present in 50 countries
ATRADIUS Crédito Y Caución (Catalana Occidente Group)	1925 - NCM (Netherlands) 1929 - Crédito Y Caución (Spain) 1954 - Gerling Credit (Germany)	1990s - Companies go international Early 21st century - merger/consolidation of founding companies	Atradius is one of the largest credit insurance groups, present in over 50 countries
COFACE	1946 - COFACE (France)	1990s - companies go international, especially in Germany, Austria, UK and Italy	COFACE is a key player in credit insurance and operates in over 100 countries

Over the past years, their market share has remained relatively stable, with Euler Hermes in the lead, commanding 33% of the market; Atradius Crédito Y Caución, 23%, and Coface, 16%.



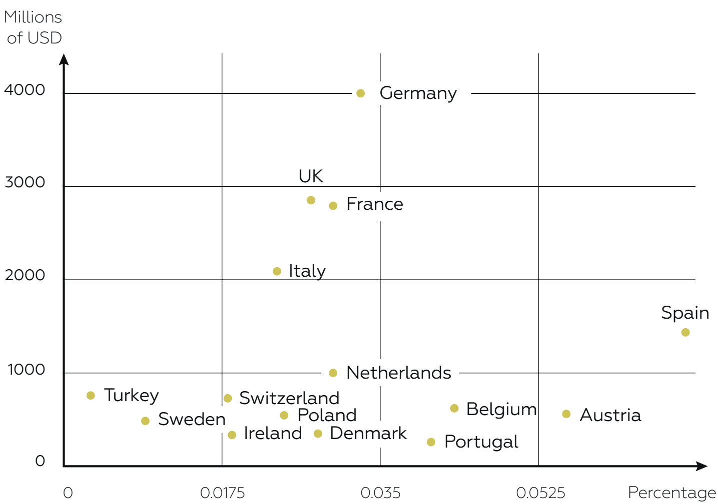
Source: ICISA, 2018

It would also be relevant to highlight CESCE because, although it only commands about 2% of the global market, it is a relevant player in Spain, Portugal and Latin America, which is to say, the markets where MDS operates.

Major growth for credit insurance in Europe, during the latter half of the 20th century, has given this kind of insurance more considerable weight in the GDP of European countries than it has done in America, Asia or the Middle East.

Spain has the highest penetration rate in the world, far ahead of other countries, with Portugal coming up in fourth place.

Penetration in GDP*



** GDP penetration = credit insurance premiums / Gross Domestic Product*

Source: ICISA, Pordata, MDS

How has credit insurance evolved in countries where MDS operates?

Portugal, Spain and Brazil are a group of countries where credit insurance is often relied on. As stated earlier, Spain and Portugal are among the countries that most often resort to this kind of risk coverage, presenting the highest GDP penetration rates for it.

CESCE and the 3 major international groups are the credit insurers currently operating in these markets.

The credit insurance market is still growing and the 3 lead operators are:

Market Ranking	Portugal	Spain	Brazil
1st	COSEC*	CREDITO Y CAUCIÓN**	EULER HERMES
2nd	CREDITO Y CAUCIÓN**	SOLUNION*	COFACE
3rd	CESCE	CESCE	ATRADIUS CREDITO Y CAUCIÓN
4th	COFACE	COFACE	CESCE

** Euler Hermes Group* *** Atradius Credit & Caución Group*

MDS is also present in Angola and Mozambique, but there are no credit insurers operating in these markets. It is only possible to cover the risk of export to these countries, namely through Export Credit Agencies (ECA), which offer coverage solutions for countries with higher political risk.

How can companies purchase credit insurance?

The range of services included in credit insurance and the option to adjust coverage to a company's specific needs advises that the purchase and follow-up of the policy be carried out by brokers who can provide specialized teams in this kind of insurance. That way, one can optimize the benefits of this coverage to the company, adjusting it as much as possible to the company's traits and/or the sector it operates in.

III. External Markets

When a company sells in external markets, or is considering an international path, how should it cover risk in such markets?

Credit insurance is very important to internal market sales but is without a doubt indispensable in sales to any external market. Knowledge of markets and their economic history, as well as risk assessments on importing companies, which the credit insurer makes available to its clients when they purchase this credit risk coverage, are absolutely critical if one wishes to avoid unexpected and irreparable damage to their cash flow and reserves.

Companies find it more difficult to know the risk their current and prospective customers represent in external markets. So credit insurance is an essential management tool in any internationalization strategy.

If the company has associated companies in other countries, how can it manage group credit risk?

There are credit insurance programs with multinational coverage, including both the head company's country and any others where the group may operate. Those programs may be under centralized management but enjoy local support geographically, namely regarding risk assessment on local customers and credit recovery in case of default.

Just how centralized management is depends, essentially, on the customer's decision.

Those programs may be under centralized management but enjoy local support geographically

IV. Political Risk

How does this coverage work in countries that present higher risk?

Credit insurance for external markets normally covers commercial risk arising from defaults of the importing company. Where countries present higher political risk, even if commercial risk does not occur, because a given company has the financial resources to make payments as needed, default may arise due to political reasons, such as the impossibility to conduct international money transfers, war or nationalization.

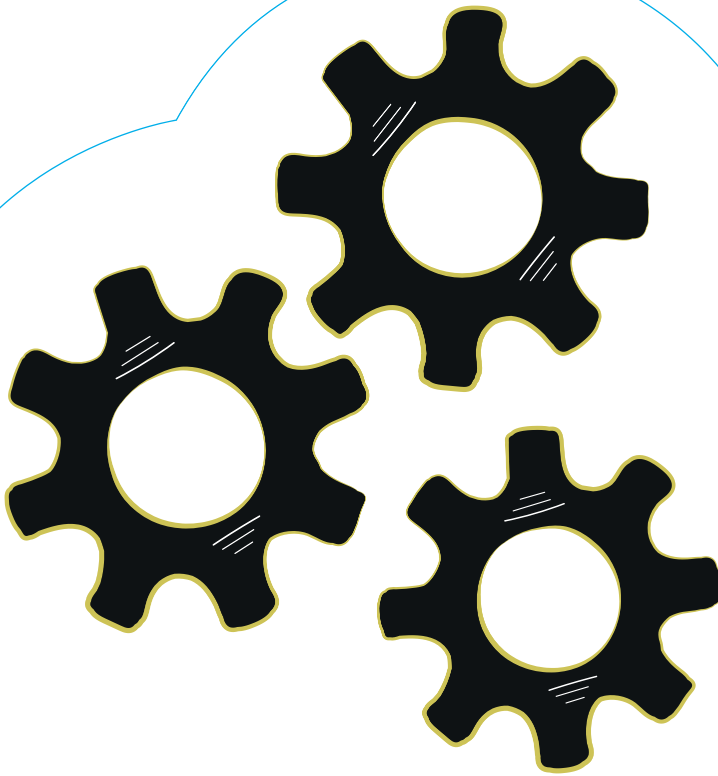
Credit insurers give each country a risk rating, and that rating determines the terms for political risk coverage in those countries. Should customers purchase this option for their credit insurance policies, short-term commercial transactions may include the coverage of political risk.

Transactions and investments in countries with high political risk with extended time windows (medium-term), where the importer often is a public entity, can be covered by Export Credit Agencies (ECA). These agencies are guaranteed by their respective governments and the coverage policy is defined on the basis of the economic policies of the country at stake.

ECAs provide that kind of coverage under specific conditions and in accordance with their own criteria

ECAs provide that kind of coverage under specific conditions and in accordance with their own criteria as framed by OECD consensus. In Portugal and Spain, the Export Credit Agencies are COSEC and CESCE, respectively.

In addition to ECAs, there are a few private international insurers that cover special operations, usually investments or individual transactions for high amounts and extended risk periods but they are not obliged to uphold national interest as do State agencies with their underwriting policies.



V. Operational functioning

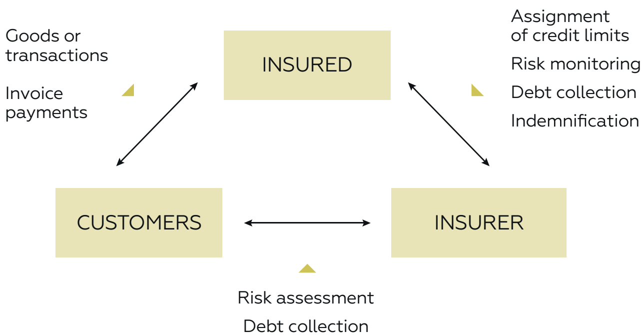
What kind of company should purchase these policies?

Any companies that sell their products or services on credit, meaning, any who run B2B transactions. This coverage excludes credits to affiliated companies or state-owned companies.

All companies can purchase these policies regardless of their scale or line of business, as there are offers to suit each kind of company or business, from simplified or standardized terms for SMEs to more specific, complex solutions for larger clients.

How does credit insurance work?

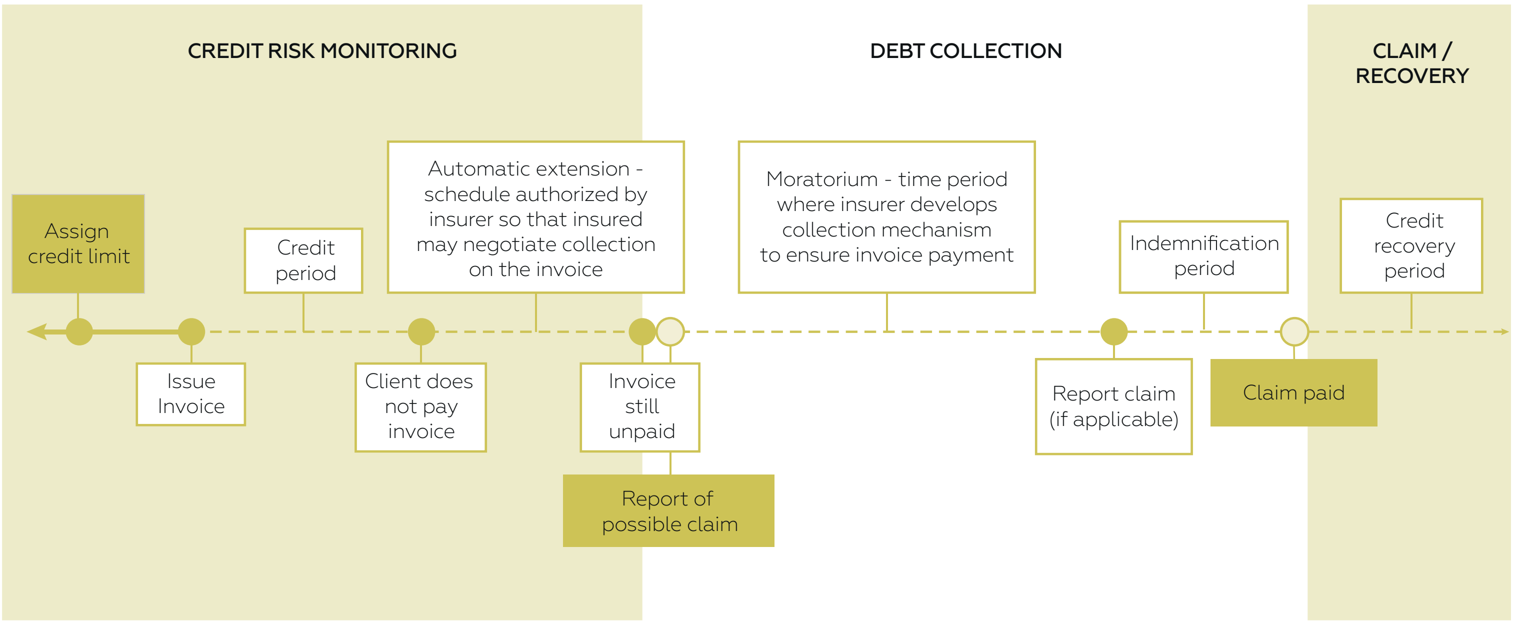
A credit insurance policy unfolds through a triangular relationship that links the insured, the insurer and the insured's customers:



Most policies uphold the principle of globality, which means the coverage of the whole turnover, so as to avoid selecting only clients deemed to be higher risk. However, there are market solutions that allow individual coverage for customers, typically called single risk coverage, or a select group of customers, where bespoke solutions are configured to serve companies with specific traits.

The product cycle begins with issuance of a credit guarantee and extends to claim and recovery:

CYCLE OF CREDIT INSURANCE



GET TO KNOW THE CREDIT INSURANCE CYCLE

What measures should companies deploy to take full advantage of all the potential in their credit insurance policy?

It's important to adjust guarantee amounts for each customer to the amounts owed to avoid insufficient coverage when a claim arises. It is also highly relevant to stay within the specified time windows for reporting delays or defaults, as specified under contract, to forestall penalizations or disclaimers from the insurer. Companies can easily manage these matters with the support of their insurance brokers.

VI. Examples

I - Diversifying markets and customers

A medium-sized textile company defines a business strategy for growth with ambitious commercial diversity goals for the markets where it plays, along with plans for expansion of its customer base, to avoid overreliance on its current customers.

The company purchases a credit insurance policy and, given the company's size, annual cost is in the order of twenty thousand euros. The policy allows current customers sales coverage as well as new ones.

At an international trade fair, the company makes contact with potential customers from European countries and from the Middle East. The Insurer assigns credit limits to some of those potential customers. Assuming a profit margin of 15%, 150.000€ of sales coming from these new clients would be enough to cover all the cost of the policiy, which covers the entire client portfolio.

New customers	3
Credit limit per customer	25.0

Annual sales per customer (2 orders)	50.0
Annual sales new customers (50 X 3)	150.0

Policy cost	20.0

Profit margin (15%)	22.5

II - Access to funding from banks

A very successful start-up, with great customers, is having trouble securing the bank funding it requires to develop their business, specifically to fund their growing working capital. The bank needs counter-guarantees but these are not at the company's disposal.

The start-up decides to purchase a credit insurance policy and assigns its indemnity rights over to the bank. Under such terms, the bank opens a credit line at an advantageous rate, given the good level of coverage on its customer portfolio and reduction of the risk posed by the start-up itself, which now has a more secure balance.

Are there complementary risk management services that can help companies manage their credit risk?

Yes. Whatever the challenge, or economic environment they operate in, companies of any size can come to MDS for support in consulting, negotiation and implementation of modular and/or complementary solutions for their credit management needs.

In a market with constant specialised staff turnover, changing contact information and customer data require ongoing updates, we have highly experienced and knowledgeable teams covering:

- Financial marketing — data base and search of customers based on score ratings (measurement of solvency)
- Credit information and ratings reports

- Invoicing / Debt collection management

At the level of risk, cost and coverage management for a credit insurance program, captive solutions may be especially relevant. These are insurers or reinsurers that only deal in risk from their parent company. Traditionally viable only for large companies that take on correspondingly large risk, for the significant capital investment that entails the creation of an insurer, a new kind of company — Protected Cell Companies (PCCs) — allow SMEs access to these risk retention solutions. HighDome pcc, an MDS Group company, has a specialist team that carries out risk and benefit assessment for this option and puts together the solutions that best fit each company.

VII. Conclusion

How will the credit insurance market evolve in the future?

Growth in world trade, globalization and greater unpredictability in assessments of credit risk have contributed to the sustained growth of the credit insurance market.

Where Portugal and Spain are concerned, the credit insurance market should keep growing modestly. The Brazilian market might see more emphatic growth, staying on trend as seen these past years.

In terms of economic policy, Portugal seeks to significantly increase export weight in GDP, so credit risk coverage in export transactions is an indispensable tool to the successful conduction of that strategy.

Either because of good practices in corporate governance and/or matters to do with regulations, companies are under mounting pressure to identify and mitigate all risks associated with their line of business. Credit risk management is one of the most important and indicative aspects of a company's solvency and ability to compete, so credit insurance will become an increasingly significant part of methodical and professional management.

Credit risk management is one of the most important and indicative aspects of a company's solvency and ability to compete

What advice do you have for companies taking on credit risk?

Multinationals and other large companies in general already have mechanisms to cover credit risk. The questions is whether this coverage can or should be extended to SMEs.

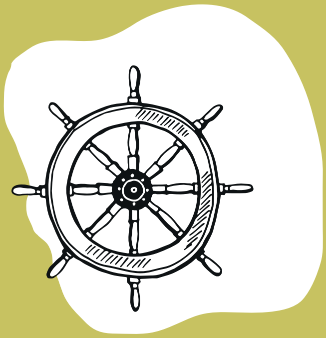
As company management becomes more and more professional in small and medium-sized companies, insurance has penetrated this segment further and further. Insurers have also created specific offers that best accommodate these customers, through simplified, digital solutions.

Companies should not engage in unnecessary risk and miss out on opportunities to grow their business safely and competitively!

Historic evolution of credit insurance as a concept

- The first policies to cover credit insurance were issued in 1837 by the Austrian company Assurance Générales de Trieste (at the time Trieste belonged to the Austro-Hungarian Empire). However, such coverage would be discontinued within four years.

- Before 1850, three companies pioneered credit insurance: Generali of Trieste, Commercial Insurance of London and Union du Commerce, in Paris. Each one had its own principles and techniques. Whereas Commercial Insurance only made disbursements in case of bankruptcy, the other two paid out their claims once credit was found unpaid and default was established.



- Before the close of the 19th century, Ocean Accident and Guarantee Corporation introduced some basic concepts we still employ today. It was the first company to sense the danger in making disbursements right after default and so its policies only covered declared insolvencies. It introduced the concept of globality out of fear of the anti-selection associated with the coverage of individual operations. Ocean Accident and Guarantee Corporation also created branches abroad in support of coverage for exports. Additionally, having understood the importance of commercial information on trade debtors, insurers went on to demand that the insured gather favorable commercial reports on their customers.

- Again, before the close of the 19th century, some French companies took a major step forward in the concept of risk evaluation, by resorting to commercial information, and recovery management to increase recovery rates for the claims indemnified.

- In the early 20th century, after WWI, the knowledge that sustains credit insurance evolved a great deal. Trade Indemnity stands out, here. They consolidated the concept of globality and payment of claims only at the time insolvency is declared. However, a few insurers still offer guarantee insurance, that pays out right after the customer defaults.

- With the 1929 economic crisis, those who upheld indemnity right after non-payment (guarantee insurance) had to face significant financial impacts that made them feel just how high-risk this option can be.

- Only during the latter half of the 20th century was a middle-of-the-road solution created, based on the concept of insolvency presumption. This option involved the definition of a post-default moratorium during which the insurer and the insured would seek to recover the amount owed. If neither of them could, one would “presume” insolvency.

- In parallel with private initiative, nation-states evolved in their concern with coverage for credit risk. This kind of coverage is not based on the mutuality principle, as usual with credit insurance, given that it can access funding pools backed by governments and aims to pursue economic policies, namely in support of exports.

- The state of Prussia was the first to articulate coverage for credit risk, but it did so in isolation, and this initiative was discontinued.

- After WWI, nation-states tried to relaunch international trade, taking an interest in credit guarantees granted to export operations. In 1919, Great-Britain was the first to create a department to cover the risk of exports to Soviet Russia and a few other countries in Eastern Europe. Belgium followed in 1921, and Germany in 1926. As to the latter, for the first time a government assigned that duty to a private company, Hermes. The following years, other countries in Central Europe followed suit. Coverage initially focused on political, rather than commercial risk but, later on, a few governments would include both coverages.

About the Author

Berta Cunha has been an executive consultant with MDS for Credit Insurance since 2019.

Between 2001 and 2018, she served in a managerial role at COSEC, the Portuguese market leader for credit insurance and bonds. As part of her duties, she oversaw the launch of new products, the ongoing improvement of customer service, based on innovation and digital transformation, and managed relationships with distribution channels with a focus on the banking channel.

Previously, she had worked in Corporate Finance at BPI Bank, where she acquired a vast experience in mergers and acquisitions, restructuring and privatization, as well as the organization of capital market operations.

In 2018, she became non-executive administrator and a member of the Audit and Finance Committee and the Appointment and Compensation Committee at Sonae Indústria.

She holds a diploma in Economics from the University of Coimbra and has attended training programmes at the INSEAD school of management and Stanford University.

With the collaboration of:

Marcos Polónia is Director of Credit & Surety.

He came to MDS in 2009, where he took over the helm for Credit and Financial Risk. He was involved in getting COFACE established in Portugal. COFACE is one of the leading credit insurance companies in the world. Marcos served as Commercial Consultant, Head of Commercial Development, Assistant Territorial Deputy and National Sales Coordinator.

He holds a degree in Business Management from Universidade Portucalense Infante D. Henrique and completed the AESE/IESE Business School Management and Leadership Programme with honours.

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