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RIMS Monte Carlo - New Uses for Captives - Trade Credit

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My presentation today aims to demonstrate some of the ways in which captive insurance or reinsurance companies can be used to manage credit risks, and why using a captive as a tool in this process can make sense for certain industrial and commercial European companies.

I will first make some general comments on the advantages of managing credit risks in this fashion, and then focus on the technical approach with the help of some slides.

By your attendance at this particular session of the conference you have demonstated a certain interest and familiarity with captives. I am not the best person to try to further your knowlege of this area, and will rather focus on my area of specialisation, the management of credit risks. On the subject of captives I think it suffices to note that in Europe over the past few years there has been considerable growth in the level of interest in captive risk management solutions, which has been followed after a relatively short delay by a strong rate of new captive formation in the two principle EC domiciles, Luxembourg and Dublin.

Whereas in the United States some time ago strong rates of captive formation resulted largely from the well known difficulties faced by American companies in purchasing liability insurance, European interest in captives has been primarily focused on Property programs. At present however, premium rates available from the insurance market for Property and related coverages are so low that it is frequently more interesting for companies to purchase the coverage in the market than to self-insure. Indeed if one looks at the results of major European insurers in the commercial/industrial sector it becomes apparent that the market is currently losing money even after investment income. Thus almost by definition it is more interesting to purchase insurance outside than to self-finance Property risks.

Advantages of Captive Credit Programs

This situation has naturally helped to reinforce interest in captive credit programs. I can think of at least five reasons why credit insurance is well suited to captive treatment. Captives are frequently called the most sophisticated risk management tool. As such they are well suited to credit, which has several sophisticated characteristics.

1. First of all, most companies are faced with a certain frequency of bad debt losses, typically for rather small amounts. This type of loss poses primarily an administrative problem, which can perhaps best be handled internally rather than through an outside insurer;

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2. In addition to the problem of frequency, there is also a severity problem. The accounts receivable or Debtor item on a company's balance sheet can frequently account for more than 40% of current assets. Individual risks within this item, on for example, a company's top ten Buyers, can take on catastrophic proportions. Indeed, there have been a number of well documented cases of companies being forced to file for bankruptcy due simply to the fact that some of their Buyers had ceased payments;

3. Furthermore, credit risk has certain cyclical characteristics that make it ideal for long term funding solutions. Credit losses are of course closely linked to the economic climate, which over the course of the past twenty years can be seen to move in cycles. At the beginning of the 1970's the world economy was in a period of expansion, until the sudden oil price shock of 1973 had the effect of greatly increasing the number of insolvencies. Related economic problems were not even entirely resolved when a second shock in 1981 produced more difficulties. The period since 1983 has seen a strong level of growth, until last year when recession in the United States and Great Britain caused considerable bad debt experience in those two countries which may be making its way over to some of the continental European economies. What better way to provide for this type of cyclical exposure to bad debts than to build up funds in a captive?

4. Despite these aspects of frequency, severity, and cyclicality of loss experience, which clearly demand a prudent and sophisticated reserving policy on the part of companies, European legislation on balance sheet provisions for bad debt losses is complex and by no means uniform. Certain countries such as the Netherlands permit companies to make provisions based on their actual experience in previous years, whereas others, notably Belgium and France, permit reserves only when a company has evidence of a specific doubtful debt. A captive credit program permits reserves to be built up in a simple and consistant fashion no matter how geographically diverse a company's operations;

5. Finally, another advantage of using captives for credit risk is the fact that policy limits do not need to be terribly high to provide adequate protection, and thus do not need to overly expose a new or lightly capitalised captive to losses. Conversely, the amount of premium normally paid for credit insurance, expressed as a rate on line of the policy limit, is significantly higher than for most other lines of insurance. This obviously makes the funding aspects of a captive credit program much more interesting.

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Technical Approach to Program Structure

Having looked at some of the advantages of captive credit programs I would now like to develop a technical approach to putting an actual program together, with the help of some slides.

Limits and Deductibles

First of all a graphic representation of a sample program. This shows the three main elements of any structure, which are as follows:

1. A small level of deductible set in such a way as to eliminate the administrative burden of frequent small losses. In contrast to the other limits proposed in the program, this deductible would apply on an 'each and every' loss basis;

2. After excluding the small losses, an amount level is set for the captive retention. This will normally be set in such a way as to be higher than the level of losses which can be predicted based on past experience. An insurance policy would be issued covering this amount and reinsured in the first instance to the captive;

3. Finally, after determining an appropriate level of funding for the retention, the captive would purchase from the insurance market an excess retrocession to protect against large unexpected losses.

Coverage Options

Using this relatively simple system for the program structure, a company is then faced with a decision as to what sort of risk to cover. The following slides deal with the usual categories of available coverage:

1. Insolvency - This is the simplest possible coverage as the insuring clause is tied directly into the legal status of insolvency or bankruptcy in the country of the Buyer. As such there is not too much possibility for disputing whether losses are covered or not covered, and the program can be kept administratively simple. Typical policies available on the market offer 100% coverage as compared to the 85% traditionally offered, and very short or non-existant claims waiting periods.

2. Protracted Default - In some countries however the legal procedures for having an insolvency officially declared can be rather cumbersome and inefficient. In this regard one thinks immediately of the Southern European countries, where insolvency proceedings can take months if not years to be resolved. In this case a company would be well advised to subscribe the more traditional Protracted Default coverage, which reimbourses any debts which have not been paid by the Buyer during a certain period of time, normally six months after the due date in Europe.

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3. License Cancellation - in addition to the commercial coverages against non-payment, it is possible to add certain Political Risks, such as the arbitrary cancellation of import or export licenses and permits. As you can imagine, at the time of the Gulf Crisis there were a number of European companies who regretted that they had not subscribed this coverage, as well as several insurers who regretted they had not charged higher premiums for the exposure.

4. Political Risk for Export Transactions - It is also possible to put together a program which includes a full range of political risk coverages, including license cancellation and transfer risk, but no commercial credit risk coverage. This is interesting for companies which sell to their own network of subsidiary companies in different parts of the world. Selling to subsidiaries they have no need of non-payment coverage, but are still exposed to related political risks.

5. Finally there is a comprehensive program which includes both commercial and political risk coverage. In other words, a program which in terms of coverage is very similar to the type of whole turnover export credit coverage provided by state agencies such as COFACE in France and ECGD in Great Britain.

In addition to the flexibility of coverage which can be obtained for a captive credit program, certain other aspects of the program can also be very flexible:

Eligible Losses

First of all, the notion of eligible losses. The program can be designed so that coverage attaches in one of three ways:

1. Due Dates - Coverage applies to invoices for which the due date falls within the policy period, no matter when the goods were actually shipped. This system has the advantage of picking up the full weight of a company's outstanding exposure at the outset of the program;

2. Shipments - More traditionally, coverage can be fixed to apply to shipments made during the policy period. In this case, there will be a tail on the program related to goods shipped near the end of the policy period for which the due dates fall after the expiry date;

3. Insolvency - Finally, coverage can be set to attach only to cases of declared insolvency which arise during the policy period, without regard to shipment dates or due dates.

Premium Calculation

Another area of flexibility is the premium calculation. Again, three possibilities can be envisaged:

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1. Flat Premium - A flat program premium can be fixed at the outset of each policy year. This has the advantage of being very simle to budget.

2. Rate of Sales - Premium can be calculated as a rate on the annual sales volume, which may be interesting for companies in sectors where there is a considerable level of price fluctuation and thus change in the monetery value of annual turnover.

3. Rate on Outstandings - Finally, premium can be fixed as a rate on the average outstanding receivables of the company during the year. This system has the advantage of yielding premium levels that closely reflect the actual exposure.

Credit Management Services

Coming back now to the original graphic representation of a captive credit program structure, a final important point has to be considererd before a program can be finalized. That is, who will provide the credit management services for the company?

Credit management services can be fairly complex, as they involve a whole range of different activities ranging from financial analysis, setting credit limits for individual Buyers, making sure that the limits are kept up to date and not exceeded by overzealous sales people, and eventually making collections, pursuing overdues, and working on recoveries.

In the traditional credit insurance system many of these services were provided by the insurer, but of course at a price. In view of the limited penetration of credit insurers in the market it has to be admitted that most companies are carrying out these functions, whether formalized or not, by themselves. More recent innovations in the credit insurance market have seen insurers offer credit management policies which are designed to support companies with good existing credit management with a stop-loss protection.

So eventually the company contemplating a captive credit program will have to decide whether it needs to purchase some level of credit management service or whether he can manage the risks himself. This will obviously have a large impact on the company's negotiations with the excess retrocessionaire.

Administration

nally, once the program is in place, it is important for all parties concerned that administration be kept to a minimum. Some of the reports which will eventually be rquired to keep the program moving include a quarterly notification of outstandings, and immediate notification of Buyers in difficulty or excessive payment delays. Other elements can be determined with the parties involved.

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This covers the technical approach to setting up a program, and I would now like to comment on the type of company which could derive the most benefit. Firstly, the company should sell to a reasonably large number of different Buyers on payment terms of less that 180 days. This will ensure a decent spread of business in the captive. Second, if export sales are involved, there should similarly be a reasonable spread of risk amongst different countries. It is no good using this type of sophisticated long term tool just to handle exclusively immediate problems in say Eastern Europe or Africa. Finally, the company should have a sufficient size to make the economic aspects of the program feasible.

On the other side of the coin, with which partners in the insurance industry should a company work to set up such a program? The main criteria of course has to be financial strength, but this is closely followed by the need to find an insurer who combines a knowlege of credit risks with capabilities and expertise in the field of captives. Additionally, in the interest of smooth communications, it helps to have an insurer who is physically represented in the country or countries which are to participate in the program.

Thank you.

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