Export credit insurance
Munich Re

The functions of export credit insurance

Functions for the individual exporter
– Credit insurance's main function is to protect against the risk of non-payment.
The exporter is protected against losses or prolonged lack of liquidity caused by protracted failure to pay on the part of the buyer or buyer's country, which of course gives the exporter an instrument to protect his own financial position.
– Obtaining sufficient working capital is a crucial factor for exporters to take full advantage of the opportunities in the international market. Lack of information and lack of collateral cause lenders to refuse financing to the exporter, or alternatively charge higher interest rates, thus increasing export prices, and hampering exporters' competitiveness.
If the exporter's assets are protected by credit insurance, the insurance policy is of great assistance in facilitating
the mobilization of working capital to finance transactions.
– In order to expand, or even to maintain, existing business, companies can be forced to grant export credit. Capital is scarce and many companies are only willing to buy when offered finance. Exporters can safely offer credit lines and thus increase sales volumes only.
by securing the credit risks involved. This may also create a competitive advantage towards other suppliers of the exporter's products or services, as the insured exporter may, because of his credit insurance cover, be in a position to grant supplier credit, while other exporters may not have this possibility.
– Many firms lose more money from delayed payments than from bad debts. Credit insurers offer collection services and can use the economies of scale in this respect to their advantage. The accumulation of claims with an insurer, through the insurer's international standing and contacts, places it in a stronger position to collect overdue debts than any of the individual creditors separately.
– Credit insurance companies will also play an important role with respect to developments in the exporter's buyer portfolio. Potential clients can at any time be checked by the credit insurer with regard to their creditworthiness, as a consequence of which the exporter will be in a position to be more pro- active towards new clients and/or potential business partners. Furthermore, because the credit insurance company constantly monitors the risks in its port- folio, the exporter will be informed immediately if the financial situation of one of his buyers deteriorates.

Functions for the exporting country
The additional uncertainties in international trade bring additional risks and greater transaction costs than found in domestic trade. If exports to markets with excessive credit risks can be prevented, the country benefits. Exports for which no payment is received as a consequence have a negative impact on a country's assets. On the other hand, the opposite is also true. If better information makes exports possible to buyers in countries with a sound credit risk, the country gains in terms of production capacity, employment and foreign-exchange earnings.
Credit insurance ensures the continuity of industry against hazards from external factors: for example, non-payment from one country will not cause failure and bankruptcy throughout the home industry. Although no hard and fast rules can be given regarding the effect export credit insurance will have on export volumes,
it is clear that export credit insurance pro- vides exporters with an instrument to facilitate their international business.

Basics of credit insurance

Distinctions in credit insurance

The following distinctions in credit insurance can be made:

1 Short-term/Medium- and long-term credit
Short-term credits are considered to be credits up to one year. Usually the products offered by credit insurers for medium- and long-term credits, like capital goods and construction works, are

quite different from those available for short-term credit. As medium- and long-term credits are usually not considered to be marketable in the private reinsurance market, we will concentrate in this paper on short-term credit insurance.

2 Turnover insurance/insurance of specific transactions

It is one of the most important principles of credit insurance that as a rule short- term credit insurance should be offered on a whole turnover basis. Experience has shown that credit insurance companies should insist on this item towards their
(potential) policyholders. Even though the credit insurer will underwrite and evaluate each individual risk and may even require an additional premium for selected risks, every effort should be made to avoid anti-selection as much as possible.

3 Commercial risks/political risks

Commercial risks are the risks relating to the buyer, to its ability to pay. Political risks relate to events or situations that may arise in the buyer's country preventing the buyer from paying or preventing the transfer of payment to the exporter's country. Political risks are always outside the sphere of influence of both the buyer and the exporter.

4 Pre-shipment risks/post-shipment risks

Once the exporter has sent the goods, usually all it can do is wait and see whether payment of its invoices is received. The goods are already out of its control. These risks are called post-shipment or credit risks. However, in several lines of business, the exporter may also have a financial risk in respect of the buyer or on the buyer's country before the goods have actually been sent. These risks, pre-shipment or fabrication risks, arise when goods are specifically produced for a certain buyer.
In those cases the exporter may suffer a loss when it cannot deliver the goods (finished or still in production) to its client, as it may be impossible to find an alternative buyer willing to pay a similar price. In the insurance of pre-shipment risks, the focus is on "costs" incurred by the exporter.

Some principles of credit insurance

Credit insurance covers the inability, not the unwillingness, to pay.
Usually, short-term turnover policies have a standard duration of 12 months from the date of inception, insuring a maximum of 80–85% of the invoice value of the delivery (whereby for the sake of simplicity it is assumed here that the value- added tax is not covered). A claims waiting period of six months is common. The policy can be endorsed, amended and varied to provide both pre- and postshipment cover as well as post-shipment cover only. The endorsement can be used as a collateral to banks for pre- or post- shipment financing.

Furthermore, the turnover character of the policy is compulsory, obliging the exporter to insure its whole turnover or objectively specified parts of its turnover in order to obtain a reasonable spread of risk and to protect the insurer against anti-selection.

Types of risk

Export credit insurers concentrate on the cover of the following risks:

The commercial (or buyer's) risk

The risk that a foreign buyer will fail to meet its payment obligations to its sup- plier due to default or insolvency (insolvency risk), including the risk of protracted default, i.e. the risk that without the occurrence of a commercial or political cause still no payment from the foreign buyer is received within a certain period (waiting period).

The political (or country) risk

– The transfer and convertibility risk that a buyer with adequate local funds avail- able to meet its obligations is unable to obtain the foreign exchange required to meet those obligations;
– The risk of political events which pre- vent or delay payments due to:
· a general moratorium on external debt decreed by the government of the buyer's country or of a third country through which payment must be made;
· any other action by the government of the buyer's country which prevents performance of the contract;
· war or similar events preventing performance of the export contract, including strikes, riots

and civil com- motion;
· cancellation or non-renewal of an export licence;
· contract repudiation or cancellation;
· insolvency or protracted default of a public buyer;
· confiscation, expropriation, nationalisation and deprivation.

Premium systems

In fixing the premium a distinction should be made between the insolvency risk and the political risk. This premium is usually calculated as a pre-set percentage of the invoice value of deliveries. The following basic criteria could be used for the calculation of the insolvency premium:
– Trade sector of the insured
– Average terms of payment used by the insured
– Size of turnover and number of accounts
– Percentage of cover
– Loss experience from bad debts in the past

Underwriting

Buyer underwriting (commercial risks)

Essential questions in this respect are:

– Why is buyer underwriting necessary?
– What are important elements to look at?
– Which procedures, skills and IT aspects are required?
– How does constant review take place and how are changes implemented?
The basic principle for the assessment of credit insurance risks (as for any other type of insurance risk) is that the risk to be covered should be a sound one at the moment it is underwritten.
In this respect it should also be mentioned that there may a certain accumulation of risks on one and the same buyer.
If several policyholders do business with the same buyer, and thus apply for a credit limit on this buyer.
Credit insurers keep files which contain information on buyers obtained through various sources such as banks, information agencies, chambers of commerce, other credit insurance companies, embassies as well as information from press cuttings and other publications.

Country underwriting (political risk)

Essentially, the same basic questions apply to country underwriting as do to buyer underwriting. Underwriting country risks requires a continuous inflow of information regarding the political and economic situation and development of buyers' countries, in order to assess whether restrictive measures are necessary or earlier measures can be waived. There are different alternatives that can be used when underwriting country risks, of course next to the possibilities of pro- viding cover without restrictions or being off cover. Among others:
– A longer waiting period
– A lower maximum percentage of cover
– Maximising the total exposure on a country at the present level
· unconditionally or
· with a possibility for policyholders to get credit limits on new buyers in exchange for the withdrawal of (some of) their already existing credit limits on buyers in that country (up to the same amount)
– Requiring a letter of credit issued by a bank (in that country) that is acceptable to the credit insurer
– Requiring other types of guarantees
(bank, government, etc.)

Reinsurance

The function of reinsurance

– The provision of "soft" capital, in order to
– enable the insurance company to do more business, in order to
– increase the spread of business in the insurance company's portfolio, and
– to produce economies of scale, in order to
– produce better results for the insurance company.

Reinsurance of commercial risks

It may be useful to work with a small group of private reinsurers in order not to become too dependent on one company. Nevertheless, having some larger leading reinsurers, which can back the whole pro- gramme and who can control larger com- mitments on individual debtors is also of great importance.

In addition to some evident elements (like capacity and reinsurance strategy), the question whether or not (large) reinsurers are willing to support the programme, depends on a number of factors, like:

– the types of risks covered;
– the wording of the policies;
– the legal environment;
– procedures and experience of people/institutions handling the underwriting of buyer risks;

– countries that are being exported to;
and
– loss experience of the region involved.

Reinsurance of political risks

Historically, political risk underwriting was considered to be a government responsibility because of the difficulty of spreading the risk due to the limited number of existing countries and the concentration
of risks in a small number of countries. Nowadays we can also offer facilities for the reinsurance of political risks, and for most countries the capacity available is quite sufficient. Technically a credit insurance company's reinsurance scheme for political risks can be arranged in a similar manner to that regarding its commercial risks, and in fact in most cases the two types of risks will be combined in one treaty. Nevertheless, it should be borne
in mind that often reinsurers require the political risks to be offered to them together with the commercial risks, as most reinsurers are not prepared to rein- sure only the political risks.

Business Plan

It is common practice, when starting a new activity of business or when introducing a new product type in one's company, to prepare a business plan. Preparing such plan is useful for organising one's thoughts, but primarily forces one another to consider all aspects of the new
activity and to look at how these influence each other.

We would strongly recommend to also do this regarding the introduction or set-up of an export credit insurance activity.

One of the most difficult topics in deciding on whether or not to introduce an export credit insurance company or unit is to ascertain whether the new activity would have the potential to become profitable within a reasonable period of time. As one has to consider that – as in many types of business – the set-up of the unit
will cause relatively high costs and still little income, we suggest to take at least a period of three or five years into account in this respect. A relatively simple exam- ple of how this feasibility can be ascertained is given in the following chapter.

Of course, in a business plan, not only attention should be given to the financial elements like forecasts and capital structure, but also to topics like:

Marketing

– How will the product be sold?
– Which part of the market can be handled by the own sales force?
– What role can insurance brokers play?
– What kind of remuneration should they get?
– Can banks help in selling the product?

Buyer underwriting

– Where do we get our information from?
– What contracts should we negotiate with information sources?

Claims

– How do we manage claims and recoveries?
– Functioning of the insolvency laws in our major exporting countries.

IT

– What hardware/software do we have to acquire/develop?
– Where can we obtain/how do we devel- op a buyer database?

Personnel

– How can we find qualified personnel?
– What training do they need and who can give such training?

Legal

– Various details of the company, including capital requirements.
Clearly these are only some of the areas of attention. We would be more than pleased to assist you inpreparing such business plan or to provide you with a more complete list of items.

An important element involves the development of a flow chart regarding the timing and consecutive follow-up of the various activities. Such chart will help you in keeping control of the project, especially when the accepted time schedule is strictly adhered to.