Soaring demand, shrinking supply

With the economic downturn likely to endure into next year, the topic of credit insurance is set to continue occupying headlines for months to come. While most recent UK economic activity has offered the occasional glimpse of a green shoot, the availability of trade credit insurance appeared to deteriorate even further over the first three months of this year after a sharp fall in 2008.

According to the CBI's latest manufacturing survey, 72% of respondent companies are finding it more difficult over the period to obtain cover. The picture has been confirmed by the ACT's own recent survey of how the downturn has affected the treasury departments of FTSE 350 companies. Some companies can now access credit only if credit insurance continues to be available to their suppliers.

Figures issued in late April by the Association of British Insurers made it clear why the market is tightening. The value of credit insurance policy claims rose 40% to £360m last year, from £257m in 2007, as more companies failed to pay their suppliers. The 8,366 claims recorded in the final quarter of 2008 was 51% higher than in the same period a year earlier.

In the sectors worst hit by recession – principally retail, construction and property – there have been a string of casualties where suppliers have found themselves either paying much higher premium rates for credit insurance or unable to buy any cover at all. The contraction in the credit insurance market was acknowledged in April by the chancellor, Alistair Darling, whose Budget measures included a provision of £5bn to assist businesses where trade credit cover has been either withdrawn or cut back.

To date, the most high-profile credit failure has been Woolworths. The high-street chain's demise at the end of 2008 followed a lengthy period of sluggish sales growth and poor earnings. The retailer's problems deepened last autumn when two of the major players in the credit insurance market, Atradius and Euler Hermes, withdrew cover for its suppliers and their lead was followed in October by Coface.

Their move put the onus on the group's suppliers to insist on earlier payment for goods. While Woolworths continued to insist towards the end of last year that it was confident of "a successful Christmas for our suppliers and customers", it quickly became clear that the group's days were numbered.

Executive summary

- In the face of the credit insurers' increasing reluctance to write business, the government is expanding its business support schemes and new credit insurance models are starting to emerge.

With a number of other high-street names also shutting up shop, the credit insurers' harder line has gained them many critics. Among them is Bill Grimsey, chief executive of DIY chain Focus, who dubbed them "fair-weather friends" and called on the government to eventually take over the credit insurance market and appoint a regulated credit assessor.

"We need to put credit insurers out of business," Grimsey said recently. "Their product is out of date and should be reassessed."

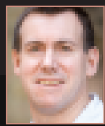
Bodies such as the Forum of Private Business and the Federation of Small Businesses have also expressed outrage at what they regard as insurers' willingness to court new business in good times but their haste to quit the market as soon as conditions worsen.

LOST APPETITE The main players in the credit insurance market admit they have become more reluctant to write the business.

"It is fair to say that, compared with six months or a year ago, small businesses will find it more difficult to get credit insurance," admits Shaun Purrington, a regional director at Atradius. "I'm afraid that the appetite of credit insurers to write new policies has declined.

"Companies that come to us and ask for cover on firms that are clearly in financial difficulties, or that are operating in very difficult sectors, will find it nearly impossible to get cover."

The impact of the tougher market has extended beyond the most obvious sectors. In February, steelmaker Corus became the first major UK industrial company to be affected. Euler Hermes announced that,



AS THE RECESSION BITES, MORE COMPANIES ARE SEEKING CREDIT INSURANCE, BUT INSURERS' APPETITE TO OFFER COVER IS WANING. **GRAHAM BUCK** REPORTS.

following a drop in global demand for steel, it was reducing the amount of cover it was willing to provide for the group's suppliers.

A number of trade bodies, such as the British Shops and Stores Association (BSSA) and the British Clothing Industry Association (BCIA), maintain that the situation is serious enough for the government to act itself as underwriter of credit insurance.

The BCIA has been lobbying Lord Mandelson over recent months for government assistance. The business secretary admits that the government was wrong in scaling back the role of the Export Credit Guarantee Department (ECGD) in the years of easy credit, and the time is right to expand its role as provider of state-backed insurance and credit guarantees to UK exporters.

While the government is unlikely to act on Grimsey's call for outright nationalisation, it has heeded calls to step into the credit insurance market. In the Budget, Darling announced that for the remainder of this year businesses could apply to the government for six months' top-up insurance if their cover was withdrawn or reduced by the three biggest trade credit insurers, Euler Hermes, Atradius or Coface. As the FT remarked, the premiums for this cover do not come cheap, but as business confidence starts to improve it provides an important safety net should the supply chain seize up again.

And the government is evidently reluctant to expose taxpayers to what could be substantial additional liabilities by taking over the risk entirely. As a prime example, the collapse of Woolworths was instrumental in bringing down Zavvi, despite the music and entertainment retailer being seen as a much more viable business.

However, the government has agreed to offer up to £5bn of support for credit insurers as part of its efforts to get credit flowing again. Announced by Lord Mandelson in January, the plan is targeted at medium-risk companies and offers a guarantee of up to 50% for certain businesses that have suffered a reduction in their cover but not had it withdrawn completely.

There have also been several initiatives launched over the past few months to support SMEs experiencing difficulties. They include:

- **Enterprise finance guarantee:** Originally announced in last November's Pre-Budget Report (PBR) as a £1bn small business finance scheme, this initiative has subsequently had its funding raised to £1.3bn.
- **Capital for enterprise fund:** Announced in the PBR as a £50m debt for equity fund, it now provides £75m of equity (comprising £50m of government funds and a further £25m from the Big Four high-street banks).
- **Working capital scheme:** Also launched in January as a scheme for smaller exporters, this initiative has subsequently expanded to working capital guarantees for all SMEs with annual turnover not exceeding £500m.
- **RDA transition loan funds:** Accessed via the Real Help for Business portal and totalling £25m, these funds are available to viable SMEs encountering short-term financial difficulties.

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BACK TO FRONT While the shrinkage of the credit insurance market has attracted media attention, Stuart Lawson, head of Aon Trade Credit, says that reports have been largely "buyer-centric" with a focus on the company seeking either to maintain or increase its credit lines from its supplier network. But he points out that credit insurance is essentially a protection for suppliers against the financial impact of bad debt, and the vast majority of companies purchasing credit insurance are suppliers rather than buyers.

Expressed succinctly, credit insurance provides insurance to suppliers against the financial impact of bad debts, and adds further value by providing a supplier with a credit evaluation on its customers; it may also be used to support or enhance working capital facilities.

So the purchase of credit insurance is very much a decision made as part of a company's overall business and risk management strategy. This is reflected in the fact that, despite the recent increased interest, the penetration rate of credit insurance is still no more than 25% of the potential market.

With global GDP currently forecast to contract by 2.1% in 2009, reports suggest there will be a 55% year-on-year increase in company insolvencies. Aon says the trend is reflected in credit insurance claims frequency; its own experience shows a 30% increase on this time last year.

Putting recent trends into perspective, Lawson says that over the previous five years, premium rates for credit insurance typically reduced by 35% to 40% regardless of sector, while insured exposures rose by around 45%. Many of the leading insurers clearly focused on top-line revenue growth and, in hindsight, underwrote credit risks for commercial reasons instead of basing it on actual risk assessment.

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As a result, the downturn has come too swiftly and sharply for the insurance market to react in a measured fashion, while the impact of the recession on company failures has required its main players to review and, in most cases, remodel their risk underwriting approach.

Traditionally, a company's creditworthiness was assessed by negative vetting, under which an insurer used an absence of negative information to infer that the risk was a good one. But credit insurers can no longer rely on historical financial data to evaluate a company's current financial strength. The focus has therefore shifted to a company's cashflow, access to funds and ability to adapt its business model and strategy to the changed market conditions.

The result, says Lawson, has been more stringent underwriting criteria and restrictions in cover. At the same time, premium rates have risen and are set to increase further to reflect heightened risk exposure and the greater reinsurance costs borne by insurers. His group's experience suggests that premium increases are averaging 25% but can be much higher for companies in sectors regarded as high risk. A number of sectors report that rates are more likely to be 30% to 40% up on a year ago.

In addition, Atradius has warned that smaller businesses renewing their cover must expect to self-insure a greater percentage of the risk, with the typical retention figure of 10% rising to 15% and even 20% for some companies.

Aon's own response has been to ensure that insurers' credit limit decisions can be justified, based on the information to hand, and that sufficient information is passed back to suppliers to enable them to make informed decisions on how to trade with their customers and buyers.

Aon also reports there is evidence that companies are willing to retain more of the credit risk if, in return, insurers are willing to guarantee non-cancellable credit limits. Finally, despite the reports of reduced capacity and unavailability of coverage, Aon has recorded a 30% rise in new business enquiries since last year "due to the heightened awareness of the impact of bad debts on profitability and business viability".

Interestingly, demand for credit insurance has also risen sharply in the US. One in 10 firms now buys this cover, which represents a doubling of the rate over the past year. The North American market is also dominated by European insurers, which moved in there after becoming well established in their home regions. Coface reports that it saw a 60% rise in applications for cover from US companies in 2008.

Lawson's colleague at the group, Susan Ross, adds that the major credit insurers are unable to review each individual buyer of credit insurance when they have concerns about a business sector or country. In consequence, there are "a lot of machine-driven decisions".

INSURE YOURSELF One option being suggested for companies in the retail sector is to collaborate with key suppliers in developing a self-insurance programme. Neil Gillis, chief executive of Blacks Leisure, suggests this could be accomplished fairly simply by both parties putting aside money each month and placing it into an escrow account.

Over time, he suggests, these contributions would be sufficient to cover the supplier inventory and could be suspended. If the retailer subsequently ran into difficulties, the money would be there to cover the inventory; and if the supplier ceased trading with the retailer, its share of the fund could be transferred to another retailer operating the same scheme.

In its defence, the insurance industry has admitted that the speed and severity of the downturn has caught it by surprise. "What was seen as a good risk quite recently has deteriorated very swiftly indeed. It's a deep and abrupt adjustment," explains Coface director Phil Prunty. "Policyholders are saying that their customers are not going bust but are going delinquent, paying their bills a lot later than they should."

And Fabrice Desnos, chief executive of Euler Hermes UK, which has seen a sharp increase in the number of potential new clients, has defended the group's stance in declining many of these proposals.

"A lot of businesses that didn't care about credit insurance a year ago suddenly think it is a good idea," he points out. "When we receive such an increase in demand, we are rightly being very selective about the types of clients that we think we can accommodate and the type of clients who will buy into our ethos of risk management as well.

"We are not there to swap debts and suddenly be there to pick them up at the worst possible economic time. Sometimes there is demand that cannot necessarily be catered for because some of the risks are uninsurable."

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