Basic concepts of CREDIT INSURANCE

PASA APF

Asociación Panamericana de Fianzas
Panamerican Surety Association

Conceptos básicos del **SEGURO DE CRÉDITO**

Basic concepts of ***CREDIT INSURANCE***

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English

Inglés

Table of contents

Introduction

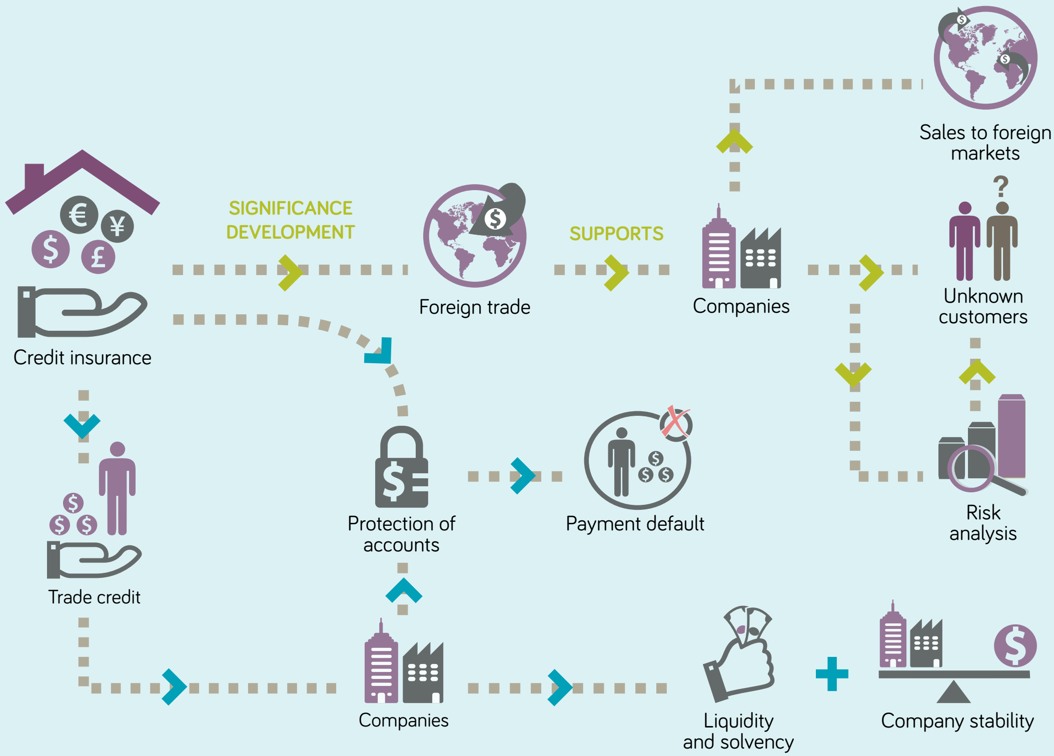
With this booklet, the Panamerican Surety Association (APF-PASA) wishes to offer a brief description of credit insurance and, at the same time, spread information about the importance of this tool for the improvement of the business activity, particularly in relation to credit risk management in trade transactions between enterprises.

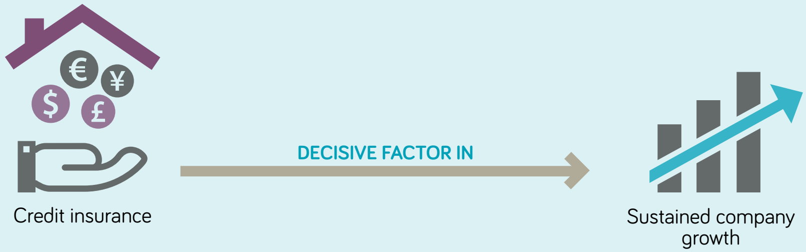
In addition to providing simple and practical information on credit insurance, this work aims to promote its use in Latin America. It is addressed to all those who are curious about this tool and wish to learn about it to start using it.

This important trade credit management tool favors the optimization of the companies' risk management by protecting their trade accounts from possible customer default. In this way, credit insurance provides certainty of credit collection and mitigates the impact of defaulted credits on the companies' results, liquidity, solvency and, consequently, their stability.

Its importance to international trade development is also worth mentioning, as it supports all those companies which have made the strategic decision of directing their sales to foreign markets and unknown customers, which involves higher and more complex risks.

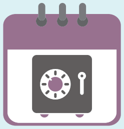
Then, it is convenient to reinforce the role of credit insurance as a key factor in the companies' sustainable growth.


Credit insurance
SIGNIFICANCE DEVELOPMENT
Foreign trade
SUPPORTS
Companies
Sales to foreign markets
Unknown customers
Risk analysis
Trade credit
Protection of accounts
Payment default
Companies
Liquidity and solvency
Company stability


Credit insurance
DECISIVE FACTOR IN
Sustained company growth

What is credit insurance?

It is a tool/contract intended for optimizing the companies' risk management by protecting their trade accounts against possible customers' protracted default and insolvency.



It eliminates uncertainty about the achievement of business targets, facilitates adequate treasury planning, substantially reduces revenues volatility arising from customers' default, and supports sustained growth goals.

It provides all the necessary tools to support companies' growth, contributing to agility and efficiency in credit risk management aspects.

If the customers reside in the same country as the insured, it is called local or domestic credit insurance. If the company and the customers reside in different countries, it is called export credit insurance.

It is much more than an insurance policy. It is an important integral trade risk management tool with multiple value added services, which make it an essential tool for any company with future perspectives.

Credit insurance functions

1

Prevention: Analysis and credit rating of trade risks and continuous surveillance of the buyers' solvency.

The insurer analyzes and classifies the current and potential customer portfolio and selects those who deserve credit according to their economic position. It also sets the adequate limits and credit conditions. During the life of the policy, the insurer constantly monitors and dynamically manages the customer portfolio.

Prevention involves the analysis by the insurer of the actual company solvency and the report to the insured before the customers start bankruptcy proceedings and default situations arise.

2

Recovery: Recovery of defaulted credits by the insurer.

The insurer offers their credit management and recovery services so that when a default occurs, the money may be recovered according to the circumstances of each particular case and the legal regulations of each country. The recovery process may be started before or after the indemnification payment. The companies benefit from being able to continue their traditional activities, and leave collection management and legal and judicial aspects to the insurer. The insurer may act on behalf of the insured or in their own name, when they are subrogated to the rights of their insureds to recover the defaulted payment.

3

Indemnification: It is a type of agreement where the insurer assumes responsibility to compensate for a loss when one of the risks covered by the policy occurs.

The insurer indemnifies its customer in case a loss event occurs, i.e., when the defaulted customer is declared insolvent (due to bankruptcy, suspension of payments, etc.) or when the period agreed for protracted default lapses (normally between 3 and 6 months from the notice of claim). The actual indemnification will result from the application of the guarantee percentage agreed in the insurance contract, generally between 80% and 90% of the previously insured amount.

FEATURES

PREVENTION

RECOVERY

INDEMNIFICATION

How does credit insurance work?

Credit insurance is based on firm credit sale transactions of goods and services between companies under the conditions established in the respective sales agreements and the cover agreed in the credit insurance policy, which protects from short- and medium-term trade risk.

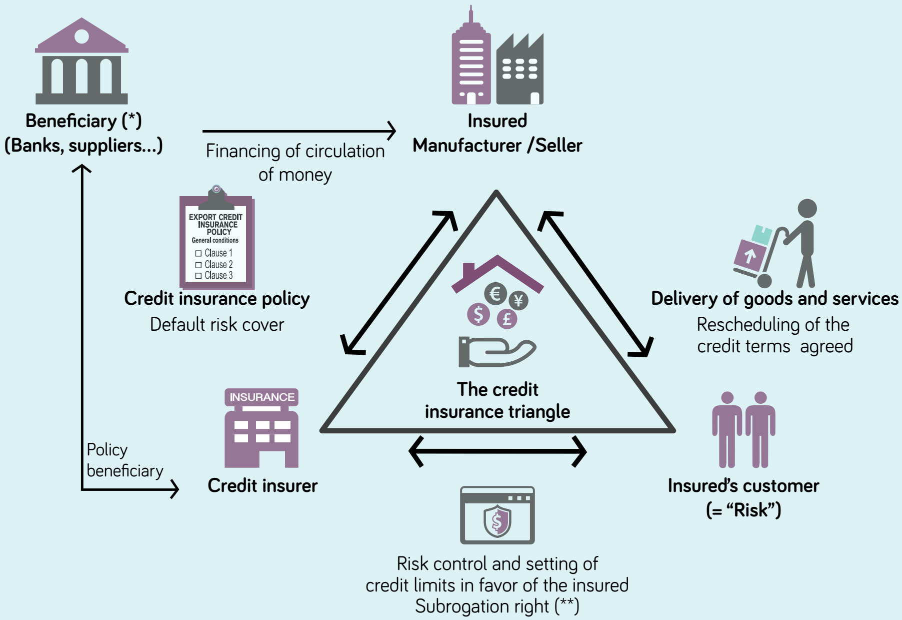
Once the company takes out the policy, they send their customer portfolio to the insurer for their analysis and rating. The company shall be obliged to submit to the insurer's analysis every new customer who has been granted credit, both in the domestic and export markets.

The insurer constantly monitors all customers, and the credit limit granted to each of them may vary according to their risk evolution. Then, the company usually delivers to the insurer a monthly report on the credit sales closed the previous month. The insurer will make an in-house calculation of the insurance premium based on the declared turnover.

The company shall also give notice to the insurer of the current defaulted credits and risk aggravation. If direct collection by the company fails, they shall have to inform the insurer that the defaulted credit led to a loss event. Payment defaults shall have to be reported to the insurer according to the terms established in the policy.

Normally, when the policy comes into effect, the insurer calculates a *deposit premium*, based on an estimated turnover, and at the same time, a *minimum premium*. At the end of the year, and according to the credit sales really made and covered, the insurer calculates the premium adjustment. This adjustment may benefit any of the parties, but shall not have an impact on the minimum premium.

THE CREDIT INSURANCE TRIANGLE



(*) Beneficiary: The insured may appoint a natural or artificial person as indemnitee under the policy.

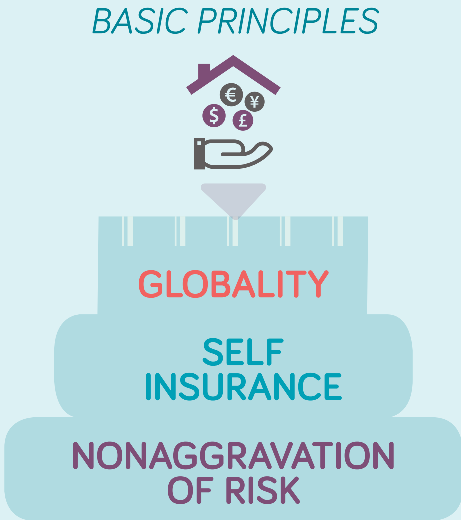
(**) Subrogation rights: The insurer may be subrogated to the insured's rights to collect its share of the indemnification directly from the buyer.

Basic principles of credit insurance

- Principle of globality: The insured commits itself to inform the insurer of the total number of customers who purchased on credit and the total amount of those sales. The insurers avoid all kinds of adverse selection or antiselection of the risks to be covered.

- Principle of self insurance or coinsurance: Insurers never cover 100% of the insured amount. The indemnification shall cover the insured losses but not their benefits. In short, the insured's coinsurance of the risk is desirable, and also that they show a sensible and sound management of their customer portfolio credit risk.

- Principle of nonaggravation of risk and data reciprocity: The insured is obliged to give notice to the insurer of all protracted payments, rescheduling and any other negative circumstances in the customers' track record which may aggravate the risk assumed by the insurer.

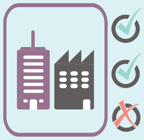


Benefits of credit insurance

Those companies that do not make cash sales should consider taking out credit insurance. Most of the companies arrange a certain payment term (30–120 days) with their customers for the provision of goods or services, which generates uncertainty about collection within that period.

A high percentage of this risk can be minimized by credit insurance, whose objective is to provide a reliable safety net. In this regard, this type of insurance gives companies a series of major benefits, such as:

Support to customer portfolio selection and management: The preventive role played by insurers is often an additional asset for the companies, especially for those seeking to expand into unknown foreign markets (safe expansion). Consequently, there are fewer risks due to an adequate selection of customers.



Improvement in customer portfolio quality: The insurer gives a rating of all the company's current and potential customers, based on solvency criteria, payment behavior and needs. So, the company knows who is who in its customer portfolio and may select and manage it more efficiently.

Active risk surveillance (debtor): In most of the cases, a close follow-up of at-risk customers and timely information about their problems are a key safety factor.

More efficient credit management: It is achieved by more effective risk management involving credit rating and follow-up of customers' credits, as well as the management of payment terms and probable rescheduling.

Risk prevention and control at low cost (lower expenses): Expenses may be cut down when you have the information required to get to know existing and potential customers and assess credit risk, which demands a strong investment in staff, localization services and information technology development for the adequate treatment and communication of such information.

Credit recovery management: Companies may focus on their own business only, leaving the recovery of probable losses to the insurer. In exports, for example, the knowledge of local laws and customs, and the insurers' experience allow companies to obtain better results, maximizing efforts and minimizing expenses.

Asset protection (customer account): By protecting their business with adequate credit risk cover, the insured companies protect themselves against financial losses due to defaulted credits and insolvencies. Companies thus secure their financial strength and solvency.

Better treasury management: The cover reduces revenues volatility due to customers' default and thus facilitates treasury planning with optimum and permanent cash flow.

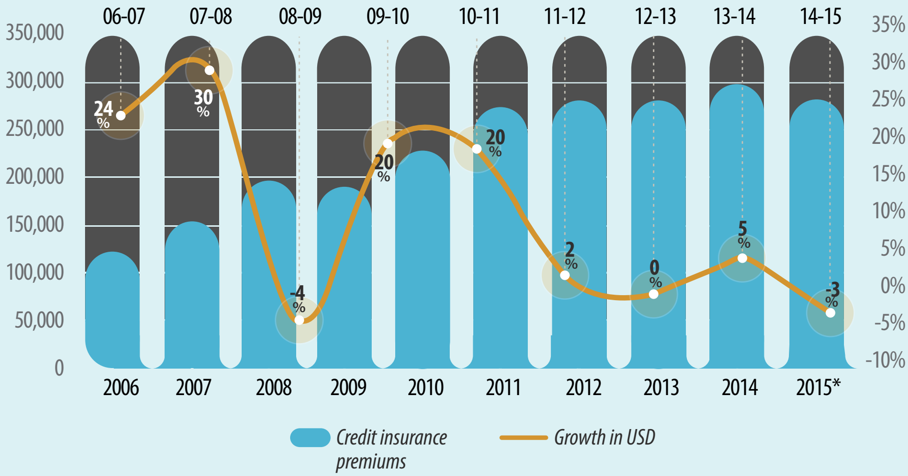
Reduction in financial reserves: With credit insurance, companies do not need to create a specific reserve for contingencies of this type and may make a more profitable use of those assets.

Improvement in the company's financial position and results: Credit insurance enhances the companies' capacity to boost their sales to both existing and new customers, thus increasing their profitability. Companies achieve greater solvency and autonomy to manage their credit capacity, a key issue in the negotiations with banks and suppliers.

Possibility of providing an additional guarantee in favor of financial institutions: This is feasible through the subrogation of rights. In this sense, the possibility of having access to bank financing or even to credit enhancement, usually under better conditions, is noteworthy.

Latin American market statistics for credit insurance

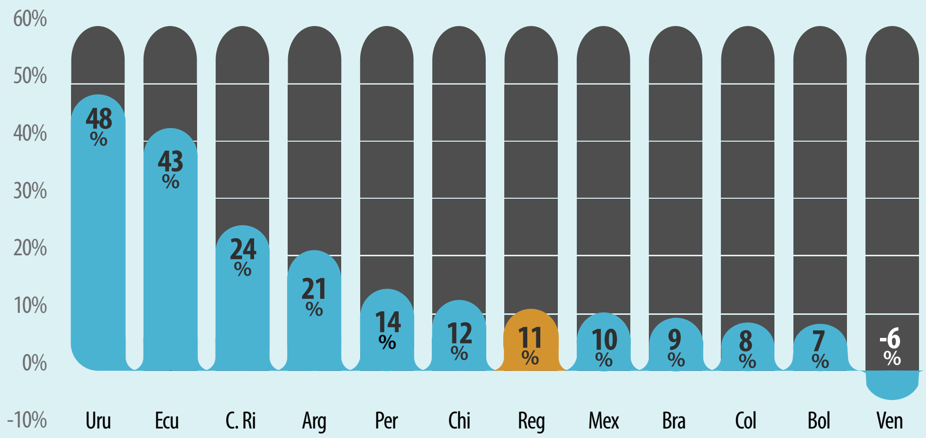
Latin America – Credit insurance: Premiums and growth



** Figures at September 2015, 12 months.*

In the last ten years, credit insurance volume increased by more than 100% in Latin America. This growth rate, higher than 134% in that period, declined only in 2008 when it dropped by 3.7% due to the economic crisis. This situation will likely be the same at the end of 2015.

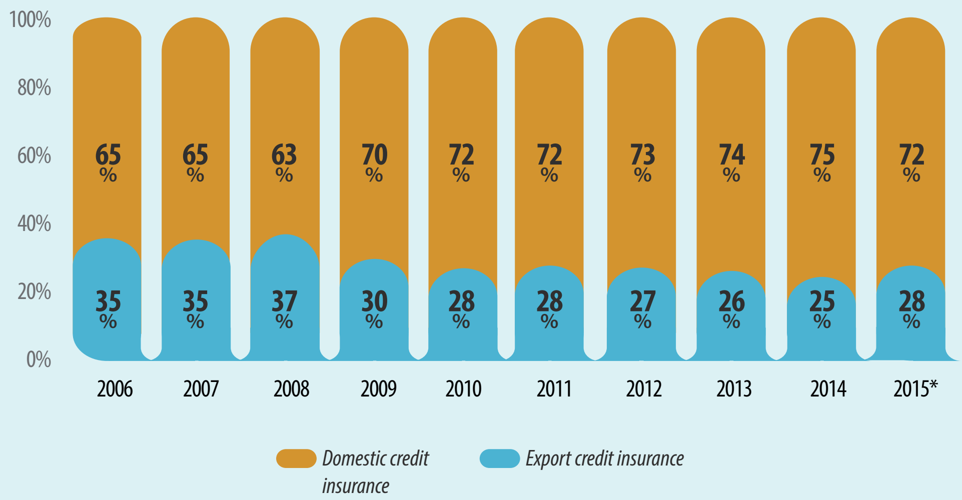
Latin America – Credit insurance
2006-2015* average growth - premiums per country



** Figures at September 2015, 12 months.*

Since 2006, the region had an 11% average growth in US dollars, although some countries like Uruguay and Ecuador expanded by more than 40%. Local currency depreciation impacted on this growth.

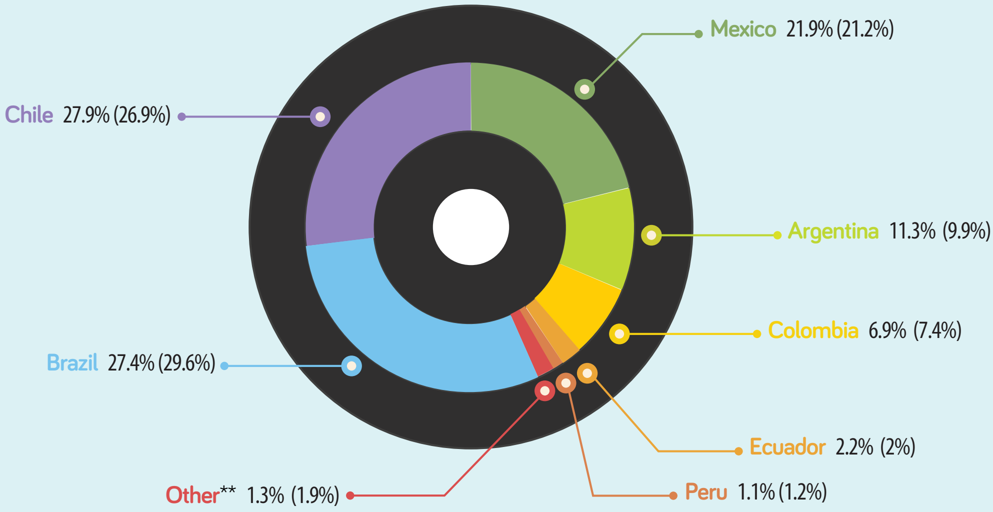
Latin America: Export and domestic share



* *Figures at September 2015, 12 months.*

In 2015, the trend started in 2008 (the year of the crisis) in the export credit insurance share was reversed. That year, unlike the previous ones, this line increased by three percentage points compared to 2014.
The need of each country to increasingly support the exports of goods and services to boost the local business encourages credit insurance demand. This growth trend is expected to evolve positively.

Latin America – Credit insurance: 2015* (2014) market share by country (USD 286.4 million)



** Figures at September 2015, 12 months.*

*** Includes: Bolivia, Peru, Uruguay, Venezuela.*

As to each country´s market share, Chile became the market leader with 28% share and beat Brazil, which ranked first until the previous year. Chile, Brazil and Mexico together concentrate almost 80% of the regional market. Furthermore, Chile has the highest credit insurance penetration ratio compared to the country's GDP.

Frequently asked questions

How do we get information about the policies?

All credit insurers provide information about their products on their Web sites. Quotes and policy wordings may be obtained online or directly from the insurer. Brokers, particularly those specialized in credit insurance or who have a dedicated credit insurance department, also provide nonbinding advice on demand. To know all the credit insurers offering these products in each country, please visit the Web site *www.apfpasa.ch*.

When is the indemnification collected with a credit insurance policy?

There are many options. It is advisable to buy the type that covers protracted default, i.e., between 3 and 6 months from default.

How much does a credit insurance policy cost?

The product cost is calculated on the basis of the services included and the conditions previously agreed to (e.g., percentage of coverage/retention, protracted default, among others). In general, the price depends on several factors: the activity sector the company operates in, risk profile of the customer portfolio, loss experience, etc. Once the policy has been designed, and according to the risk parameters identified, the premium rate is calculated based on the company's budgeted annual turnover. This is how the deposit premium is determined, which will be adjusted at the end of the year depending on the actual turnover.

What risks are covered by a credit insurance policy?

This policy covers trade risks: Bankruptcy or insolvency declared by court or any other similar situation as provided for by local legislation; court or out-of-court debtors' reorganization plans, which involves a reduction or partial acquittance of the insured credit amount; and debtor's protracted default for a term previously defined in the policy.

Likewise, political risk may be covered: Money transfer restrictions (capital control and/or public buyer default); nationalizations and expropriations; wars, annexations, civil riots; revolutions and uprisings; enactment of laws.

Does the indemnification cover 100% of the defaulted credit?

No, the company should also cooperate to have a quality customer portfolio. To demonstrate its commitment, the company retains part of the risk, which generally ranges from 10% to 20%.

What risks are not included in the cover?

Credit insurance does not cover risks related to credits for sales to the public administration or its agencies; to individual customers; to affiliates, branches or agencies, and/or entities having common partners.

The credit-related risks for transactions that have no direct link with the insured business; advance payment or cash transactions; operations with nonrated customers, etc., are not included either.

Can only those risks worrying the company be covered?

No, the customers that worry the company usually also worry the insurer. This is the reason why prevention is so important. The company, with the insurer's advice, selects the customers it may give credit to. The insurer provides the company with all the human resources, information, and IT systems required to set the credit limit and conditions, and makes a commitment to indemnify it in case of default, i.e., a loss.

Credit insurance terminology

- **Annual maximum liability** (of the insurer)
  The maximum amount that the insurer is liable to pay in respect of all losses during a policy period.

- **Claim** (notice of claim, notice of loss)
  An application by the insured for indemnification of a loss under the policy.

- **Commencement of cover** (transaction date)
  Beginning of taking effect of the insurance (at date of order or transaction, at date of delivery or shipment, at date of completion of performance of services) for each individual trade transaction covered under the policy.

- **Credit limit**
  The maximum exposure specifically approved or otherwise authorized by the insurer in respect of a buyer.

- **Customer** (buyer / debtor)
  The business entity to which an insured sells their goods or services. (See *Unspecified customer*).

- **Declaration of outstanding balances**
  The specification of outstanding balances (typically at end of the month) on the buyers covered under the policy for the purpose of premium calculation.

- **Declaration of turnover**
  The specification of the turnover on the buyers covered under the policy for the purpose of premium calculation.

Deposit premium

Installments of premium paid in advance, to be adjusted on receipt of the declaration of turnover or outstanding balances.

Indemnification

Compensation for a loss. (See *Annual maximum liability*).

Insolvency (bankruptcy)

A judicial or administrative procedure whereby the assets and affairs of the buyer are made subject to control or supervision by the court or a person or body appointed by the court or by law, for the purpose of reorganization or liquidation of the buyer or of the rescheduling, settlement or suspension of payment of its debts.

Maximum credit terms (maximum payment terms)

The longest credit period approved for a buyer under the policy.

Minimum premium

The agreed minimum amount of premium to be paid for a specified period regardless of the volume of declared turnover or outstanding balances.

Partial acceptance of a limit

The decision of an underwriter not to grant in full the credit limit amount applied for by the insured for a debtor.

Payment default

The failure by a buyer to pay for delivered goods or services by the due date specified in the invoice or sales contract. A default is an event that could lead to a loss for the credit insurer, such as insolvency declared by court (bankruptcy, suspension of payments, debtors reorganization plans) and/or protracted default (failure to pay for a given term for any commercial reason) by the buyer covered by the insurance policy. (See *Protracted default*).

Percentage of cover (insured percentage, covered percentage, guaranteed percentage)
The percentage of each insured loss that is indemnified by the insurer. (See *Uninsured percentage*).

Premium
The premium is the insurance cost. It is calculated by applying a percentage or premium rate based on the turnover declared and covered by the policy. (See *Deposit premium* and *Minimum premium*).

Protracted default
The failure by a buyer to pay the contractual debt within a predefined period calculated from the due date of the debt.

Recovery (salvage)
Proceeds received from the buyer or a third party, whether before or after a claim has been indemnified.

Risk analysis (credit underwriting)
Assessment by the credit insurer of the financial position of buyers prior to setting a credit limit.

Uninsured percentage (coinsurance, retained risk, retention, self insured percentage)
The percentage of each insured loss that is not indemnified by the insurer and that the insured has to bear for its own account.

Unspecified customer (DLC buyer/debtor, unnamed buyer/debtor)
A buyer for which, according to given guidelines, the insured may set a credit limit without specific review by the insurer.

Credit insurance at the Panamerican Surety Association

Credit insurance was first presented at the II General Assembly of the Panamerican Surety Association, which was held in Caracas, Venezuela, in January 1974. The title of the paper was "Domestic Credit Insurance in Spain," by Francisco Javier Gutiérrez Sánchez, from the Compañía Española de Crédito y Caución. At the beginning of his presentation, the author mentioned César Ancey, who is known as the patriarch of credit insurance. Ancey said: "There is no trade without credit and no credit without risk." Therefore, this kind of protection is needed.

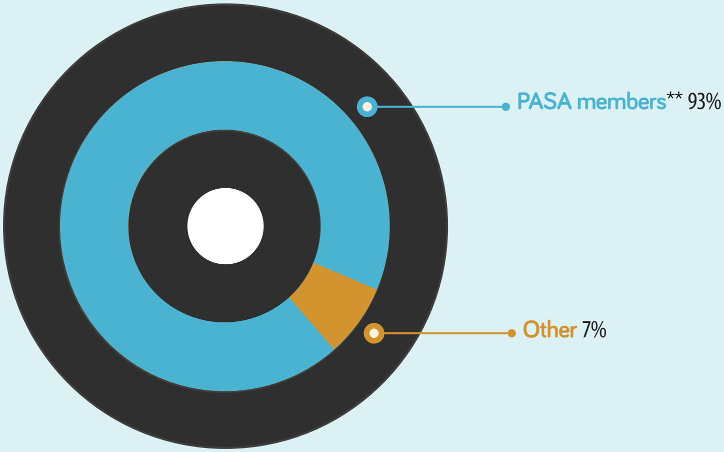
At that time, PASA Executive Committee decided to incorporate credit insurance as a subject of study. Although this type of insurance is regulated by the general insurance law, it has, like surety bonds and surety insurance, specific characteristics. It is an accessory contract: surety bonds and surety insurance derive from the main contract entered into with a third party; credit insurance is based on a sale transaction.

In 1991, Dr. Jean Bastin published *La défaillance de paiement et sa protection, l'assurance-crédit*, which was translated and published in 1993 by Mapfre Publishing Company as *El seguro de crédito: protección contra el incumplimiento de pago*. As proposed by Dr. Bastin and Dr. Kozo Kusakari, the PASA Credit Committee was set up, and they both gave excellent lectures at PASA assemblies and seminars.

The present Credit Committee, chaired by Dr. Paulo Morais, is presenting today this booklet on credit insurance. This proposal meets PASA goals, identified 44 years ago: to disseminate information on a specific type of insurance which, at the same time, serves to enrich the Association's editorial heritage.

Jorge Orozco Lainé
Former president of PASA (1984-1986)

Latin America - Credit Insurance:
PASA members' share in premiums issued in the region*



Source: LatinoInsurance - APF-PASA.

** Figures at September 2015, 12 months.*
*** Direct or indirect participation.*

The premiums underwritten (directly or indirectly) by PASA credit insurers represent 93% of the total volume of the Latin American region.

The Panamerican Surety Association is a not-for-profit organization which was founded in 1972 by a group of sureties from the American continent.

Today, with members from more than 30 countries in three continents, PASA represents the world market of suretyship, surety insurance, guarantees, credit insurance and their reinsurance.

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