CHAPTER 10

INTRODUCTION TO CREDIT INSURANCE.

It is necessary to give a brief explanation of credit insurance in order for the reader to understand the circumstances in which major ethical questions arise and also to enable him to critically evaluate the questions and any solutions.

WHAT IS CREDIT INSURANCE?
Credit insurance indemnifies the policyholder against loss resulting from the non-receipt of payment in respect of a transaction approved by the credit insurer. Such transaction must provide for the supply of goods or services on credit terms by the policyholder to a buyer. The non-receipt of payment must be due to the buyer’s insolvency/liquidation or protracted default or, where export transactions are involved, can also be due to repudiation or political causes of loss. A simple example: A yarn manufacturer supplies his product to a textile-mill on 120 days terms of credit. The credit insurer has insured the transaction. The textile-mill goes insolvent. In terms of the credit insurance policy the non-receipt of payment is due to the buyer’s insolvency.

38 Protracted default means non-receipt of payment after a specified period from due date. Repudiation refers to the importer’s unlawful refusal to accept the goods/services supplied by the exporter. Political causes of loss consist of: a) the refusal of the importing country to allow the exported goods to enter unless such import prohibition already existed at date of export; b) the inability of the importer to transfer the purchase price to the exporter due to the importing country’s shortage of foreign currency or other regulation disallowing the transfer which came into force after shipment of the goods; c) non-receipt of payment due to strike, civil commotion, war or other similar disturbances.
credit insurer must pay the amount owed to the yarn manufacturer who has as a result avoided a bad debt loss.

WHY IS CREDIT INSURANCE OF NATIONAL AND INTERNATIONAL IMPORTANCE?
The decisions made by a credit insurer influence the business of many parties. By granting cover, credit transactions are made possible. By declining or withdrawing credit insurance facilities, suppliers’ businesses are curtailed and buyers’ businesses may be forced into liquidation. The wrong decision by the credit insurer may lead to overtrading or loss of business with the concomitant negative effects on the micro and macro economy. Many export transactions would not take place without credit insurance. Credit insurance helps in channeling limited resources towards worthwhile and healthy enterprises; it promotes the earning of foreign exchange and thereby effects job creation. Internationally, credit insurance is often used for political purposes. By underwriting major capital goods/services projects, the economy of the importing country can be significantly influenced (e.g. Lesotho Highlands Water Scheme or the Mozal aluminium smelter project in Mozambique). The withholding of credit insurance facilities can be used to send a political message to the applying (importing) country. Through its international associations, credit insurers have a considerable influence on international credit terms and conditions. Thus the credit insurer’s activities influence the national economy and can play an important role in international relations. The credit insurer’s indemnity has not infrequently saved policyholders’ businesses which would otherwise have been forced into insolvency due to major bad debts.

HOW IS CREDIT INSURANCE BEING PRACTICED?
Credit insurance is usually underwritten by comparatively small mono-line insurance companies (as opposed to the large multi-line insurers) due to its specialized nature. Credit underwriting is not done actuarially but on an individual risk assessment basis.

39 The International Credit Insurance and Surety Association and the Berne Union.
This class of business is presently available in 72 countries\(^{40}\) with between one and three credit insurers per country. Most credit insurers writing domestic and short-term export business (see below for a description of the credit insurance products) are privately owned, some of the large European companies being listed. Government departments mainly conduct medium-/long-term capital goods/services export credit insurance or this business is supported via re-insurance facilities from government. The reasons for government involvement are: a) the long credit terms (up to and in excess of 10 years) for which it is often impossible to obtain re-insurance in the private market; b) government’s desire to promote exports, particularly of large projects and c) the political implications of such business.

THE CREDIT INSURANCE PRODUCT.
The following is a very brief description of the major products usually offered by a credit insurer:\(^{41}\)

- **Domestic credit insurance.**
  
  This type of insurance provides cover against a loss caused by the non-receipt of payment of amounts due and payable as a result of the sale of goods or services by a seller (the policyholder) in one country to a buyer (the risk) situated in the same country. The payment terms will usually not exceed 6 months and the insurance normally incepts immediately after delivery.\(^{42}\) Non-receipt of payment must be due to the buyer’s insolvency (or deemed insolvency) or protracted default.

- **Short-term export credit insurance.**
  
  Exporters selling goods or services on short credit terms (not exceeding 12 months from date of shipment) can purchase export credit insurance, which provides for an

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\(^{40}\) Credit insurers exist in almost all developed and developing countries. Underdeveloped countries’ economies usually do not lend themselves to writing this business on a profitable basis because demand for the service in such countries is generally non-existent or very low.

\(^{41}\) Although other types of specialized policies and specifically designed covers are available from some credit insurers, this report will confine itself to ethical issues relating to the described products.

\(^{42}\) Credit insurance usually incepts when the seller loses control over the goods – notwithstanding that the sales contract may incorporate a transfer of ownership clause, providing that ownership of the goods passes only to the buyer on receipt of payment by the seller.
indemnity of a bad debt loss emanating from the sale of goods or services by the exporter to an importer. Cover comes into effect as soon as the exporter loses control over the goods – usually on loading of the goods on board a ship/aircraft or when the goods have been sealed into a container. In addition to covering losses resulting from the insolvency or protracted default of the importer, an export policy can also indemnify in cases of repudiation or political causes of loss.

- Medium-/long-term contracts cover.

Policies of this nature are specifically designed to credit insure a particular transaction involving the export of capital goods/services\(^{43}\) on medium (1 to 5 years) or long (5 to 10 years) credit terms plus an additional pre-shipment/delivery period\(^{44}\) depending on the terms of the export contract. In addition to the causes of loss covered under a short-term export credit insurance policy, these types of policies can also provide for indemnities against foreign exchange risks and certain other possible losses. Projects sold on such credit terms are usually very large and as it is impossible for an exporter to carry such a substantial credit on his books for the long period involved, credit insurance is vital because it allows the exporter to lay off or sell the credit risk and re-finance himself. There are two methods that are internationally used for this purpose:

a) Supplier’s credit, which means that the exporter obtains promissory notes from the importer for the purchase price, which notes fall due in six monthly installments over the agreed credit period (usually not longer than 5 years). The payment risk inherent in these promissory notes is credit insured and that enables the exporter to sell the notes (together with the credit insurance cover) to a bank on completion of the project and so receive cash for the export project on final delivery.

b) Financial credit, which entails the importer entering into two contracts, the export contract with the exporter and a loan agreement with a financial institution. The importer will draw down the loan by instructing the financial institution to pay the exporter in cash against completion certificates. Financial institutions will

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\(^{43}\) Capital goods/services refer to such items as major machinery/equipment, construction or building contracts, technical installations, infrastructure projects etc.

\(^{44}\) A pre-shipment/delivery period is the construction, manufacturing or building period before the project is handed over in whole or in part to the purchaser.
normally only be prepared to provide such loans provided the repayment risk is credit insured.

Credit insurance is usually written on the basis of co-insurance. This means that the insurer does not cover 100% of a loss so that the policyholder always retains some interest in the risk, inducing him to handle credit giving with care even though he carries insurance. The uncovered portion of the debt can be anything between 5% and 50% (usually it is around 20%).