

## Credit Insurance in the Supply Chain Finance market

### Credit Risk in Supply Chain Finance

In general terms, credit risk can be defined as the risk of loss due to non-payment by an Obligor or Buyer of an obligation towards a Creditor or Supplier. In the case of Supply Chain Finance (SCF), where a third party is introduced to finance payments from a Buyer to a Supplier, the credit risk is typically borne by the third party Funder.

In Accounts Receivable (A/R) based SCF programs, where the originating company (Supplier) sells its A/R to a Funder, the credit risk related to the Buyers' non-payment is mainly carried by the program Funder. There can be an element of credit recourse retained by the Supplier which partially offsets the credit risk for the Funder, however this is usually limited to a low percentage so as not to hinder the achievement of true-sale or the off balance sheet treatment of the A/R by the Supplier.<sup>(1)</sup> It is important to note that the servicing of such A/R programs is a key element, with Suppliers having a higher chance of achieving true-sale if the management of the sold A/R is handled by the Funder, which can do it in-house or outsource it to a third party service provider. The credit risk profile in A/R programs is determined by the credit worthiness of the individual Buyers in a portfolio of Buyers as well as the diversification within the portfolio. Other important risk elements are the financial strength of the Supplier, due to the potential dilution, and the strategic importance of the Buyers for the Supplier, determined by the length, size and relevance of their commercial relationship (interdependency).

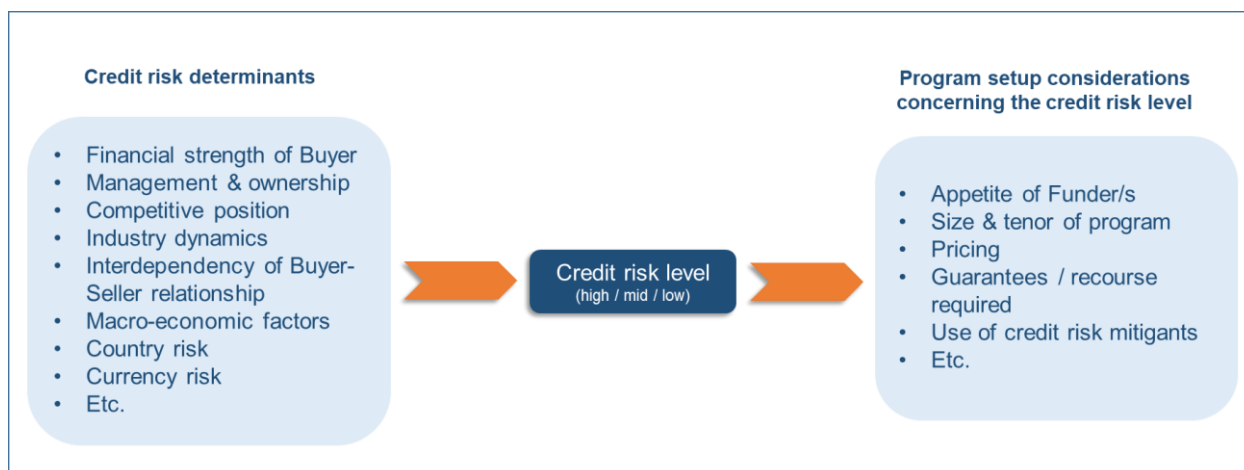
In Accounts Payable (A/P) based SCF programs, there are two types of structure:

- Trade Payables Financing through which a Buyer finances the extension of payment terms of its purchases from key Suppliers via mandating a Funder to pay them on its behalf and paying the Funder at a later date agreed. The Buyer and Funder sign a settlement services agreement and the Suppliers issue a non-legally binding letter of acknowledgement. The credit risk related to the Buyer's non-payment is fully borne by the Funder, which at times may require that Buyers provide a letter of credit or cash collateral for a portion of the program's credit limit.
- Supplier Financing or Reverse Factoring, whereby a Buyer extends payment terms towards a group of Suppliers that are individually onboarded onto the program. These Suppliers sell the Buyer-related A/R to the Funder, which anticipates the collection of such receivables to them. The agreement that Buyer-Funder sign in Supplier Financing is substantially weaker than in the case of Trade Payables Financing. Hence, the Funder who bears the Buyer credit risk, needs to have access to the Buyer's payment obligation by purchasing the Suppliers' receivables towards the Buyer.

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<sup>1</sup> The true-sale treatment of A/R by companies is defined in accounting standards IAS 39 and FAS 140/FAS 166.

The level of credit risk in a SCF program is very important for the Funder who bears it. The figure below lists the elements most commonly considered when assessing the credit risk in a SCF program, as well as the aspects of the SCF program that are determined by its riskiness.



Factors that determine the level of credit risk involved in a SCF program, and how this level of credit risk impacts the program set-up from the Funder's point of view

### Credit Insurance as risk-mitigation tool

Credit risk can be mitigated in numerous ways. Credit insurance is a credit risk mitigant (CRM) largely used in the market, both by companies selling to Buyers in an open-account manner and by trade financing entities. The importance of credit insurance has grown substantially since its origin in the nineteenth century, now reaching almost EUR 3 trillion of trade receivables insured globally.<sup>(2)</sup>

In SCF, there are various types of Funders including banks and non-banks with different credit risk preferences. In the case of banks with over USD 10 billion in assets, which fall under Basel III regulation, the credit risk of a transaction defines the amount of capital that the bank needs to allocate to it, which is a percentage of risk-weighted assets under the Basel III framework. Hence, finding credit risk mitigants that can be used to reduce bank capital requirements is of key importance for these banks. Although the Basel text does not refer to insurance policies as eligible CRM for capital relief benefit, banking regulators in Europe and the United States have accepted credit insurance policies as long as they comply with the eligibility criteria set for guarantees,<sup>(3)</sup> which amongst other conditions, establishes that the policy must be in favor of the bank (direct) and issued by an eligible rated insurance company.

Although fairly new in the US, the banks' **use of credit insurance for capital relief in supply chain finance** and receivables portfolios within trade finance is growing. This has contributed to the 43% YoY increase in the funds in use in SCF globally, which reached USD 168 billion in 2016.<sup>(4)</sup>

<sup>2</sup> Data from ICISA - the International Credit Insurance & Surety Association founded in 1928, with over 60 members that represent 95% of the world's private credit insurance business. Members include Atradius, AXA, COFACE, Euler Hermes, Swiss Re, and Zurich.

<sup>3</sup> Jerry Paulson, Credit Risk Mitigation, Capital Relief and Insurance Guarantees, The Secured Lender, Mar 2017, p. 17-19

<sup>4</sup> World Supply Chain Finance Report 2018, BCR, p.4

Another important benefit achieved by Funders by using credit insurance is the **improvement in competitiveness** with existing clients and the possibility to access certain Buyers and Suppliers that otherwise they could not.<sup>(5)</sup> However, there is a big challenge for Funders which is securing sufficient insurance capacity from well-rated Insurers.

Within SCF, credit insurance is mostly used in A/R based programs and Trade Payables Financing programs with credit coverage ranging from 80 – 95%.

### **Importance of SCF programs' Servicer for maximizing credit insurance benefits**

The way to maximize the benefits of having credit insurance in SCF for Funders is to have in place a Basel III compliant credit insurance policy that ensures capital relief, together with a solid process of policy maintenance. Credit insurance policies are usually complex documents that include a substantial amount of conditions that have to be met in order for the credit cover to apply.

It is for this reason that the **selection of the right Servicer** for a SCF program needs to incorporate the assessment of its ability to manage program processes in accordance with credit insurance conditions for accepting a claim.

At present there are some providers in the SCF space that service programs on behalf of Funders, with a diverse range of experience in managing programs covered with credit insurance. Alternative Distribution Financing Ltd. (ADF)'s parent company Global Supply Chain Finance Ltd. (**GSCF**) is one of the Servicers with the most profound understanding of credit insurance, having technical interfaces established with the leading Insurers in order to facilitate and streamline the credit limit decision process, amongst others. With its advanced technology, GSCF is able to track and control the parameters of all conditions under the insurance policies, benefiting from independent, program-specific automated processes, covering alerts and notifications. Furthermore, GSCF's credit risk management features ensure real-time payment monitoring, credit rating of Buyers and online management of credit limits, accessible by Credit Insurers.

Going forward, the importance of partnering with a Servicer that counts with innovative and robust technology that can handle credit insurance is expected to grow, as Funders increase the use of credit insurance coverage in their SCF programs. The role of the Servicer is also important for Suppliers, as they are required to monitor the performance of their portfolio of Receivables in a more accurate, flexible and dedicated manner.

ADF, the non-bank Funder specialized in SCF transactions credit insured with tailored policies from well-rated insurance companies uses GSCF as Servicer of its programs, thus being ideally positioned to maximize the benefits obtained from credit insurance in SCF.

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<sup>5</sup> Darryl Yu, Why credit insurance is important in supply chain finance, [www.theasset.com](http://www.theasset.com), 2018