Turbulence in the credit insurance market

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Potentially significant credit insurance losses arising from the financial struggles of a domestic airline have seen the Insurance Regulatory and Development Authority (IRDA) take steps to regulate more closely and restrict the transaction of credit insurance business in India.

Background

Paramount Airways was a domestic airline. In March 2010 three of its aircraft were grounded because it had failed to pay the lease amounts due. This left Paramount short of the five available aircraft required to obtain and sustain an aviation licence under rules issued by the Directorate General of Civil Aviation, which promptly suspended Paramount's aviation licence.

Paramount had been relying on bank financing to pay its debts to suppliers of aviation fuel. Following the suspension of Paramount's aviation licence, it defaulted on its repayments to the banks. It owed in the region of $90 million.

The banks which financed Paramount had taken out different credit insurance policies with a state-owned insurer, Oriental Insurance Company. The policies in question were reportedly sold through various branches of Oriental and there was no system that allowed Oriental to monitor its aggregate exposure to Paramount-related risks. Oriental also reportedly had no reinsurance cover for its exposure.

Shortly after the default and the news of the claims made on Oriental’s policies, the IRDA announced a blanket ban on the sale of new credit insurance policies to banks and financial institutions with effect from the end of September 2010. The link between the ban on new sales and the Oriental claims was never expressly made, but it is commonly understood that the two were related.

Furthermore, on November 2 2010 the IRDA banned sales of all forms of credit insurance, even though credit insurance policies issued up until that point would have been vetted and approved for sale by the IRDA under its ‘file and use’ procedure.

The ban was to remain in force until the IRDA had formulated and issued new guidelines to govern the conduct of credit insurance business. The Guidelines on Trade Credit Insurance were issued on December 13 2010 and came into force with immediate effect. Under the guidelines, all live policies can run their course without extension, but any insurers wishing to sell new trade credit insurance must amend their products and then submit them to the IRDA for vetting and approval under the file and use procedure.

Key features

The key features of the guidelines are as follows:

- A credit risk must have a direct link with an underlying trade transaction - that is, the supply of goods or services.
- A trade credit policy can be issued only if:
  - the loss is the non-receipt of a trade receivable from a buyer of goods or services supplied by the policyholder;
  - the policyholder is a supplier of goods or services in consideration for a fair market value (undefined); or
  - the policyholder's trade receivable does not arise out of factoring, reverse factoring, bill discounting or any similar arrangement.
- Insurers cannot issue financial guarantees, and cannot issue a trade credit policy to banks, financial institutions or other lenders where they are the beneficiaries/assignees of claim proceeds or where the buyers are governmental or quasi-governmental agencies.
- An insurer cannot issue more than one trade credit policy to any policyholder.
- Trade credit policies are to be issued on a whole turnover basis.
- The insurer must pre-set a credit limit for each buyer insured; it must specifically assess the credit risk of buyers which contribute more than 2% of the overall turnover and a policy must specify an aggregate limit.
- A policy covering only one shipment is not allowed, and no policy can be sold if there are fewer than 10 buyers.
- Every trade credit policy must contain a subrogation clause and "no waiver under any circumstances shall be allowed".
- The indemnity offered is not to exceed the lower of 80% of the trade receivable and 90% of the cost incurred by the seller for the previous year.
- Insurers must have well-defined underwriting, risk management and claims settlement guidelines approved by the board of directors, and qualified, experienced and trained employees to deal with credit insurance.
- An insurer's net retention is not to exceed 2% of its net worth. Further, insurers must submit details of their reinsurance arrangements to their boards of directors and to the IRDA. The reinsurance arrangements must not permit a reinsurer to deny liability for a trade credit claim, except by using clauses in the underlying policy.
- Insurers must appoint a credit management agency (which has no conflict of interest with the policyholder) to assess the creditworthiness of a policyholder.

The IRDA has reserved the power to inspect, investigate and suspend the trade credit insurance business of an insurer if it believes it would be detrimental to the interests of the insurer or the market to allow that insurer to continue writing business.

Comment

The implications of the guidelines are far-reaching. The withdrawal of cover to banks, financial institutions and factoring companies is expected to lead to several banks and financial institutions ceasing their factoring and bill-discounting operations altogether. At the other end of the spectrum, small and medium-sized enterprises with cover for only single or large debtors will find they can no longer obtain trade credit cover. The absence of the flexibility to set discretionary credit limits is also causing consternation.

The reaction of insurers and brokers seems to be that the guidelines attack the product, when the focus should have been on the risk management practices that initially gave rise to concerns. It seems that certain insurers have submitted requests for clarification and reconsideration to the IRDA and that others are planning to do so - some individually and others as part of a coordinated group. The outcome of those representations is awaited; but for the time being, the turbulence looks likely to remain.

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