

October 2014

Trade credit insurance & surety: taking stock after the financial crisis



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Executive summary

Europe is the largest trade credit insurance market but other regions are catching up.

Global trade credit insurance premiums were USD 10.6 billion in 2013. Europe has traditionally been the most important trade credit insurance market. While this remains true today, the share of emerging markets, particularly China, has increased significantly over the last decade.

Credit insurers experienced high losses during the crisis, but returned to profitability relatively quickly.

Trade credit insurers' profits were hit during the financial crisis of 2008, with the spike in business insolvencies causing a sharp increase in losses. However, due to effective use of their risk management tools, including limit adjustments, credit insurers returned to profitability relatively quickly despite the continued high number of business insolvencies in Europe.

Credit insurers' product offering has changed since the crisis.

Partly as a consequence of the crisis, the demand for top-up covers and policies with non-cancellable limits has increased. In addition, credit insurers are increasingly offering single-risk and excess-of-loss covers outside of the US where these products have traditionally been most prominent. Recently, there have been discussions around the role of credit insurers in developing solutions to alleviate the current funding squeeze for many European small and medium-sized enterprises (SMEs).

The US is by far the largest surety market, followed by South Korea.

Global surety premiums totalled USD 13 billion in 2013. The US is the largest market accounting for about 40% of global premiums. Surety is also important in many Latin American markets where – like in the US – there are legal bonding requirements. Mexico remains the largest surety market in Latin America but others have caught up over the last decade, Colombia and Brazil in particular. South Korea is Asia's largest surety market with premiums of USD 1.4 billion in 2013.

Sureties compete with banks in many markets.

Sureties compete with banks for bonding/guarantee business in many markets. In the US, the banks' role is restricted by law but in many European markets, banks are the dominant players. In Latin America banks compete also, but to a lesser degree than in Europe.

The surety loss cycle is not always related to the economic cycle.

Overall, surety companies have weathered the financial crisis relatively well. After the crisis, profitability has remained satisfactory, despite some recent large losses outside the US. In contrast to credit insurance, the surety loss cycle is not always aligned with the economic cycle. Because of this and due to the longer average duration of the business, cycle management is not as effective in surety as it is in credit insurance. By contrast, the lesson from past surety loss cycles is that avoiding erosion of underwriting standards and "product glitches" is key to preventing large losses. Product glitches refer to surety bonds where the underlying risks prove to be different from what was originally assumed. In fact these products often turned out to be financial guarantees.

Traditionally a local business, the surety business has become more global.

Surety has traditionally been a local business requiring good local market knowledge. However, the sector is increasingly globalised with a greater number of large insurance firms setting up foreign operations. Due to government spending cuts in many advanced economies, the demand for contract surety with public beneficiaries has been subdued in recent years. Public-private partnerships present an alternative growth opportunity.

This paper provides an overview of the global trade credit insurance and surety markets.

This publication provides a global overview of the trade credit insurance and surety markets, explores how credit insurers and sureties fared during the financial crisis of 2008 and how those markets have evolved since then. It also explains how credit insurance and surety work, describes the different types of policies and discusses the underwriting and risk management tools available in the two lines of business.

Trade credit insurance

A seller of goods or services can buy credit insurance to protect against the risk of non-payment by a buyer.

The risk of non-payment due to government actions is also covered.

Credit insurance policies typically provide cover for 60 to 180 days. Medium and longer-view products are available also.

What is it?

Trade credit insurance protects sellers of products and services against the risk of non-payment by the buyer due to commercial and, in the case of export trade, political risks. The commercial risks usually covered are buyer insolvency and extended late payment (failure to pay within a set number of days of the due date). And extended late payment constitutes protracted default.¹

Political risk cover is for non-payment on an export contract or project due to actions by the government of one of the trading partners. These may include state intervention to prevent transfer of payment (capital controls), cancellation of a license, acts of war or civil conflict, or local government enactment of laws or other measures. Credit insurers originally covered only commercial risk but short-term political risk cover is now normally included as well.

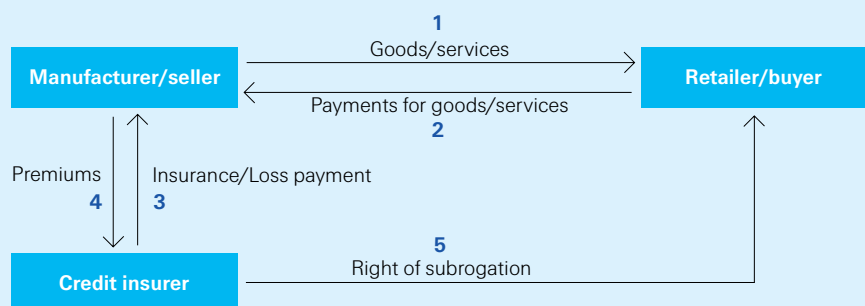
Private credit insurers usually cover short-term commercial and political risk with a tenor of 60 to 180 days. Short-term policies are typically issued in the consumer goods, spare parts and raw materials sectors and account for the bulk of credit insurance premiums. Medium-term covers of one to three years are available, typically for capital goods. Products for longer-term credits (greater than three years) have traditionally been the purview of public Export Credit Agencies (ECAs). Some of the major credit insurance groups occasionally cover longer maturities, too.

Figure 1

The workings of credit insurance

How credit insurance works – example

1. A cosmetics manufacturer sells its products to domestic and foreign wholesalers and retailers (the “buyers”, or buying clients) on credit.
2. Clients can pay for the products later, usually between 60 and 180 days, which is very common in commercial transactions.
3. Having had prior experience of late payment by clients, the manufacturer seeks protection against payment delays and/or non-payment from a credit insurer.
4. The credit insurer offers the manufacturer a protection policy in exchange for a premium. The size of the premium is dependent on the manufacturer’s (the insured’s) turnover and the credit quality of its client portfolio.
5. In case of a loss, the credit insurer has the right to reclaim payment directly from the buying client who failed to pay the manufacturer for the products.



Source: Swiss Re Economic Research & Consulting.

¹ Parts of this publication draw on *sigma* 6/2006 – Credit and surety: solidifying commitments, Swiss Re.

Credit insurers have the right of subrogation.

Credit insurers have the right to recover loss payments directly from the buying client of the insured. This right of subrogation, which allows them to “stand in the shoes” of the insured and bring a suit against delinquent buyers, helps insurers contain losses.

Credit insurers typically grant limits on individual buyers...

Trade credit insurers normally grant credit limits on the policyholder’s existing and potential new buyers. These discretionary limits allow the insured flexibility to transact business with a new buyer or temporarily increase the level of business transacted with an existing buyer. As such and unlike a bank, a credit insurer is not always aware of all the risks in its portfolio.

... and can manage those limits dynamically.

Subject to the credit insurer’s approval, the insured can obtain a higher limit for a particular buying client. The insurer retains the right to reduce or remove the limit if the financial situation of that buyer deteriorates. This adjustment applies to future deliveries only: previously closed transactions remain covered.

A standard “whole turnover” policy covers all of the firm’s trade receivables.

Types of credit insurance policies

Credit insurance contracts are typically concluded on a “whole turnover” basis, covering all of a company’s trade receivables. The insurer may exclude or limit cover for individual buyers it deems not creditworthy, but the insured cannot select which risks to cover. The premium reflects the creditworthiness of the insured’s buying clients.

It is typically based on the insured’s revenues...

Credit insurance policies are typically renewable annually, with premiums based on the insured’s expected turnover for the cover period.² The insured company declares its turnover either monthly, quarterly or annually, depending on the policy, with premiums charged accordingly.

... and includes a policyholder retention clause.

Most credit insurance contracts have a policyholder retention, meaning that the insured has to carry a proportion of a potential loss. The policyholder retention, usually between 10% and 20%, depends on the quality of the firm’s trade receivable accounts and the state of the economic cycle. It is set so that the insured has an incentive to manage its trade credit risks efficiently.

Credit insurers also offer named-buyer, single-buyer and excess-of-loss policies.

Credit insurers generate most of their revenues from whole turnover policies. Over the years, they have also developed a range of products to meet demand for more specific covers, including:

- named-buyer policies, covering the non-payment of a limited number of buyers;
- single-buyer policies, covering the non-payment of a single buyer; and
- excess-of-loss policies, protecting the insured from large losses exceeding an agreed deductible.

² Some credit insurers apply variable premium rates depending on the credit quality of the portfolio.

The trade credit product offering is becoming more diverse.

Credit insurers offer tailored services to multinationals.

There is a renewed drive to grow the SME segment.

A lack of credit to SMEs has been a critical challenge in Europe since the financial crisis.

Credit insurers can facilitate bank lending to SMEs via insurance of SME trade receivables.

Securitisation of insured trade receivables could also alleviate SME funding constraints.

Recent trends in trade credit insurance

Changes in policyholder preferences, economic conditions and competitive influences have made the trade credit insurance product offering more diverse.

Addressing the needs of different client segments

With rising globalisation, there has been growing demand for products addressing the specific needs of multinational clients. For such clients, credit insurers offer a global policy service to the group covering all regional business units.

To date, SMEs have made limited use of credit insurance. Smaller exporters have used government-supported insurance or financing schemes (eg, export credit agencies) for risk transfer. This segment hence offers growth opportunities for private credit insurance.³ SMEs do not have the resources to handle complex insurance documentation and procedures of traditional credit insurance policies. They prefer simple products, and credit insurers have recently launched more targeted products with features like the ability to pay premiums in instalments, buyer monitoring, collection services and simple online application procedures. With technical innovation, credit insurers are better placed to offer accessible and competitively priced short-term credit insurance to SMEs.

Can credit insurers help alleviate European SMEs' funding squeeze?

One of the consequences of the 2008 financial crisis has been scarcity of credit available to SMEs, particularly in Europe, due to restrained bank lending. In June 2014, the European Central Bank (ECB) announced that low-cost funding would be made available to banks under a targeted long-term refinancing operation (TLTRO) to help spur lending to the real economy, including SMEs.

Recently, industry players and policymakers have been looking at trade credit insurance as a potential instrument to facilitate credit to SMEs. For example, a company can improve its access to finance by posting its trade receivables as collateral. If these receivables are protected by trade credit insurance, the company may obtain bank financing at improved terms. Another option is a factoring arrangement whereby a company sells its trade receivables to a financial institution on a non-recourse basis.⁴ By buying credit insurance on those trade receivables, the company gets better pre-financing conditions compared to a factoring arrangement of an uninsured portfolio. In some countries, companies can obtain factoring at potentially better terms for individual invoices that have been specifically approved and covered by a credit insurer.

Policymakers have also explored securitisation as a means to facilitate lending to SMEs. Securitisation converts assets such as loans into securities, where investors of the notes receive a revenue stream from the assets, while the bank that originated the assets frees up capital and receives funding for originating new assets. The European asset-backed securities (ABS) market has shrunk markedly since the financial crisis. To alleviate SME funding constraints, the ECB recently announced a purchase programme of ABS, including ABS backed by bank loans to SMEs. Instead of bank loans, it is also possible that the underlying pool of assets consists of trade receivables of SMEs. By providing credit insurance on those receivables, trade credit insurers could facilitate securitisations and help SMEs access much-needed working capital.

³ According to Bain & Company, only about 10–20% of SMEs in Europe currently use trade credit insurance (or approximately 30% of SME trade receivables are insured). *Restoring financing and growth to Europe's SMEs*, Bain & Company, 10 October 2013.

⁴ Factoring allows a company that sells on credit to pre-finance its receivables. In non-recourse factoring, the pre-financing involves the transfer of credit risk and the right to initiate debt collection. Thus, the financial institution (the "factor") would only have access to the value of the receivables, not further access to the assets of the company. In full recourse factoring, the factor will reclaim the money from the seller if the buyer does not pay.

Single-risk and excess-of-loss policies are becoming valid alternatives to traditional whole turnover policies.

While non-cancellable covers suggest coverage certainty, they may come with additional conditions.

Top-up covers provide supplementary insurance on the uninsured portion of the original insurance.

The insured normally has to secure authorisation from the primary insurer before buying top-up cover.

Trade credit re/insurers are deploying greater capacity in the trade finance business.

Product trends

In addition to traditional whole turnover policies, many credit insurers offer single-buyer policies and excess-of-loss covers on a single buyer or basket of buyers, to protect the insured against exceptional trade credit losses. Excess-of-loss policies have been most prominent in the US, but there is increasing demand from large companies that form captive insurance companies and buy reinsurance for their peak risks from trade credit insurers. These policies are more customised and are suitable for large corporates with in-house credit management departments.

In the last several years credit insurers have begun offering non-cancellable limits in the single-buyer and excess-of-loss segments, and more recently in the whole turnover space. The product suggests coverage certainty for the insured. However, the policyholder may need to comply with additional conditions if a deteriorating receivable is to remain covered and for a claim to remain valid (eg, new conditions regarding future shipments to buyers with a delinquent payment record). Many credit insurers offering whole turnover policies with cancellable limit covers have responded to this development by granting policyholders longer periods of notice on limit withdrawals and by allowing exemptions and appeals when reducing or cancelling limits.

Over recent years, there has been increased demand for “top-up” covers. The insured can purchase top-up covers on one or more of its buying clients when the primary insurer is unable to provide full coverage under a policy’s existing terms and conditions, due to capacity constraints or credit risk concerns. These covers, provided by specialised insurers, have become more commonplace since 2008, when credit insurers began to cut credit limits during the economic downturn. In certain instances, government-funded protection schemes took the form of top-up covers where private insurers withdrew capacity.

A top-up insurer may require the insured to purchase supplementary coverage for all, not just individual, names of the uncovered portion of the whole turnover policy. The wording of the primary policy normally stipulates that prior authorisation must be obtained from the insurer before the insured purchases top-up cover. Recently credit insurers have begun offering top-up covers over their own insurance policy as a way to cope with competition and retain clients. This, however, raises a number of risk management issues, such as:

- how is an insurer able to offer capacity where it was not possible under the existing primary policy?
- how does an insurer manage peak risk accumulation?
- how is the alignment of interest between the insurer and policyholder upheld?
- does the non-cancellable characteristic reduce the effectiveness of dynamic limit management as a risk management tool?

In recent years, trade credit insurers have been getting more involved in the trade finance sector. In traditional export credit insurance, an exporter is protected against non-payment by an importer. In a trade finance transaction, an insurer typically provides protection to a bank that finances or facilitates cross-border trade with importers or commodity producers in emerging markets. For example, in a commodity trade finance transaction, a US bank pre-finances a Brazilian producer’s exports of soybeans to international food companies. The financing is secured by the proceeds of the commodity shipment. The insurer assumes part of the credit and performance risk related to the Brazilian exporter, while the bank retains the remaining risk and provides the funding. Trade credit insurers have become increasingly active in this space alongside global insurers that underwrite political risk insurance, Lloyd’s syndicates and reinsurers. Banks now recognise insurance as a risk distribution tool in the trade finance business.

Risk management and underwriting

Risk management is key for profitability.

Risk management is key for credit insurers to steer their portfolio and maintain profitability over time. Risks can emerge from major idiosyncratic events (eg, a large-scale corporate default) or a broad economic crisis. The latter is especially perilous for credit insurers as a large number of buyer defaults could rapidly result in significant claims payments.

Risk management involves identifying, measuring and managing risks.

Credit insurers perform risk management by identifying, measuring and managing risk from various angles including analysing economic trends, portfolio monitoring, limit management and enforcing policy features for loss mitigation. Risk management ensures all measures are taken to keep aggregate risk in line with the insurer's capital and risk tolerance. Risk can also be managed through reinsurance and capital market instruments.

Risk management toolbox

- Exposure measurement including country, industry and single name distributions and peak risk controls.
- Policy features including policyholder self-retention, loss cap, co-insurance, limit setting, tenor limitations and policyholder reporting requirements.
- Fundamental corporate credit, sector and country analysis.
- Obligor and country rating tools, and portfolio loss models.
- Key performance and early warning indicators to identify business cycles and trends to support decisions on risk appetite, policy provisions and limits as well as potentially problematic portfolio "hot spots".
- Dynamic limit management during the life of the policy period.
- Transfer of frequency and excess risk the credit insurer is unwilling or unable to carry on its own books to reinsurance or the capital markets.

Credit insurers manage peak and accumulation risks through country, sector and buyer limits.

Credit insurers monitor their portfolio distributions and concentrations along buyer, industry sector and country accumulation profiles. Leading credit insurers' portfolios contain several million individual names, meaning the risk is spread across many sectors and countries. By diversifying its risk, the insurer reduces the volatility in the performance of its portfolio and also its vulnerability to economic downturns. Country, sector and buyer limits can further reduce peak and accumulation risks.

Policy features ensure alignment of interest between insurer and policyholder.

Insurance policy features safeguard the alignment of interest between insurer and insured and help mitigate ultimate losses to the insurer. In addition to rigorous risk selection and premium rate adjustments, credit insurers can adapt terms and conditions to manage loss ratios during a credit down-cycle. Key policy features include:

- policyholder self-retention
- annual aggregate deductible
- loss cap/indemnification limit (usually expressed as a multiple of annual premium)
- credit limits
- maximum tenors
- declaration requirements (eg, new buyers, late payments)

Credit insurers possess sophisticated tools and expert skills to price and select risks.

Credit assessments are used to establish credit limits and to review portfolio quality.

Performance and risk indicators are used to identify inflection points and prompt timely underwriting actions.

These analytical capabilities benefit the insured as well as the insurer.

Risk modelling and early warning indicators

Pricing and risk-selection models are an integral part of underwriting. They allow credit insurers to model a broad range of risks and account for correlations between them, while incorporating expenses, forward-looking default probabilities, expected loss patterns and also compensate for capital costs. Over the years, credit insurers' statistical modelling tools have become increasingly sophisticated, leading to more accurate pricing and portfolio risk assessment.

Credit insurers ordinarily have an in-house credit rating tool and analytical capabilities to assess individual buyer as well as country risks. These rating tools are used to evaluate an insured's portfolio of buying clients and to establish credit limits, and can be applied in the policy pricing process. Ratings are also important to provide transparency on the quality of the credit insurer's overall portfolio. These tools and underwriting expertise help credit insurers assess their portfolio and forecast insolvency developments.

Performance and forward-looking risk indicators support credit insurers in identifying stages of the business cycle, detecting problematic exposure spots and determining appropriate risk capacity. This involves monitoring economic indicators, bankruptcy statistics, loss ratios and late payment notifications.

Policyholders also benefit from credit insurers' risk information capabilities by receiving credit information that supports them in decision-making and the credit management of their existing and prospective business transactions. A credit insurer is often the first to discern country, industry or buyer risk. Notifying the insured and taking early action can limit losses for both insurer and policyholder. This risk management capability is one of the key value propositions of credit insurers in addition to the actual insurance cover.

Today credit insurers apply risk-based pricing.

The premium rate is either applied to forecast turnover or outstanding balances of trade receivables.

Risk-based pricing should reduce the need for limit cancellations.

Risk-based pricing

In the past, pricing models were almost exclusively backward-looking, linking premium rates to the portfolio's loss experience. Today, credit insurers in addition apply a risk-based approach by pricing each individual buyer in the covered portfolio based on their credit ratings. The policy's premium rate is a weighted reflection of the credit quality of the buyers in the insured portfolio and incorporates forward-looking probabilities of default and the business cycle.

A provisional premium rate is normally charged based on the insured's forecast turnover during the policy period. The provisional amount is later adjusted according to actual declared turnover. Alternatively, the premium rate is charged based on the value of outstanding balances which the insured is obliged to declare periodically (eg, monthly). Short-term trade credit premium rates charged are typically 0.2–0.4% of the insured's turnover.

Risk-based pricing increases transparency and the insured's portfolio awareness. Ideally, it also reduces the need for credit insurers to reduce or cancel limits due to credit deterioration of a buyer in the covered portfolio. This means less disruption for the insured and greater likelihood of being able to hold on to full coverage.

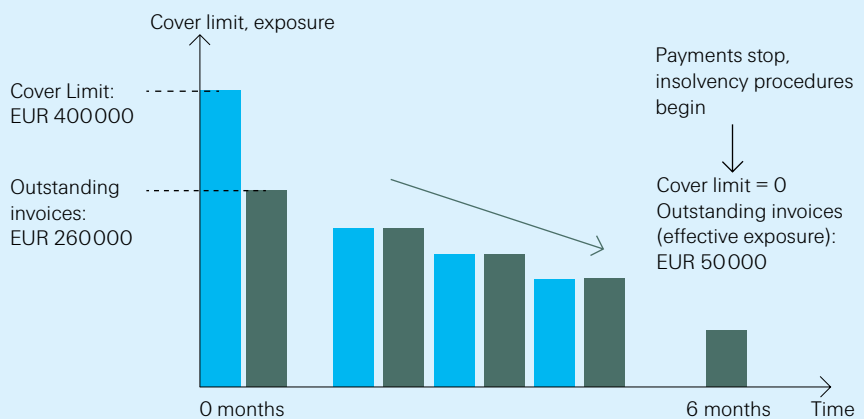
Limit management mitigates losses due to credit events and credit cycles.

Dynamic limit management in response to event risk and credit crises

The credit insurer’s ability to set and manage credit limits gives it a degree of control over its risk exposures that distinguishes it from other kinds of insurers, and other credit risk transfer instruments. The short-term nature of credit insurance enables insurers to react to problems that can affect a buyer’s credit quality before the issues become severe. As already mentioned, limit adjustments apply to future transactions. Previously-accepted risks remain covered. Dynamic limit management helps the credit insurer navigate both idiosyncratic risks and more systematic economic crises.

Example of dynamic limit management

Figure 2
Loss mitigation through dynamic limit management



Source: Swiss Re.

Insurers may need to limit their exposure to some buyers.

A French cosmetics manufacturer has secured a credit limit of EUR 400 000 from a credit insurer to cover the risk of late or non-payment by a key buying client. The credit insurer is notified that the buyer, whose account balance is EUR 260 000, is overdue on its payments. After looking at the buyer’s deteriorating financial situation, the credit insurer reduces the credit limit to the amount of the buyer’s outstanding invoices on all credit insurance policies that are in-force at the time.

In case of bankruptcy, a claim will be paid and the insurer will try to recover the outstanding payments due.

The cosmetics company informs the buyer that it will stop trading on open account terms “against invoice” and seeks to find an agreement on how to pay down the outstanding invoices. Shipments may continue, such as with payments in advance, so that the buyer can continue to operate and pay its suppliers, including the cosmetics company. As the old invoices are paid, the credit limit declines in lockstep and after six months, the account balance of old invoices has declined to EUR 50 000. At this point, the buyer stops making payments and files for bankruptcy. The credit insurer pays the cosmetics company according to the terms of the policy and initiates legal proceedings to recover as much of the EUR 50 000 paid claim as possible from the bankrupt buyer.

Reinsurance is a well-established risk transfer tool for risk and capital management.

There are proportional and non-proportional reinsurance treaties; non-proportional agreements protect against exceptionally large losses.

The share of emerging markets in global trade credit premiums has increased sharply in the last decade

... mostly due to growth in emerging Asia.

The role of reinsurance

Reinsurance is a well-established risk transfer tool for credit insurers to reduce earnings volatility and efficiently manage their cost of capital. By sharing risk with reinsurers, credit insurers are able to provide greater capacity to their clients, particularly on large risk names, while still meeting regulatory capital requirements. Reinsurance provides access to capital that might not otherwise have been available, and is an alternative to the issuance of equity, debt or hybrid securities.

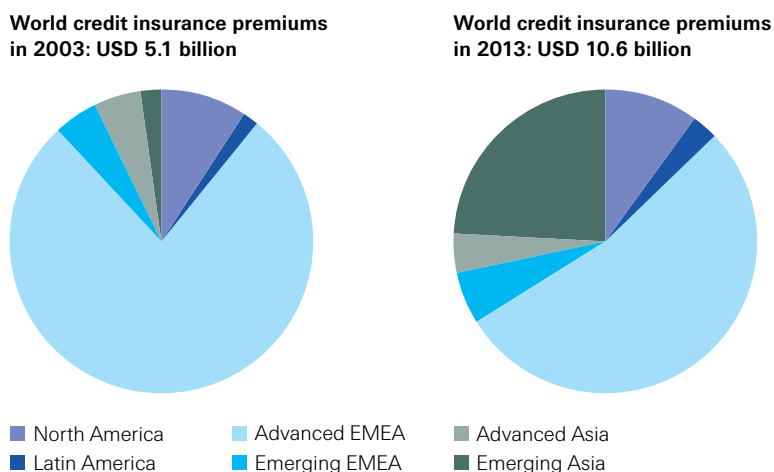
There are two basic types of reinsurance: proportional and non-proportional. Under a proportional reinsurance treaty, the direct insurer and the reinsurer share premiums and losses at a contractually defined ratio. A non-proportional reinsurance treaty sets an amount up to which the primary insurer will retain all losses. The reinsurer pays all or a pre-determined percentage of losses above this amount, up to a cover limit. Non-proportional reinsurance protects against exceptionally large losses. Other forms of risk transfer for credit insurers include hedging instruments such as credit default swaps (CDS) on single names, baskets of names or indices; and securitisation via the capital markets.

Market size and structure

Global trade credit insurance premiums were USD 10.6 billion in 2013. Of this, 59% came from EMEA (the bulk from Western Europe), 28% from Asia and 13% from Americas⁵ (see Figure 3). This is in sharp contrast to 10 years ago when EMEA accounted for 80% of global premiums.⁶

The main driver behind the regional shift is emerging Asia, where annual premiums on average grew by 38% between 2003 and 2013.⁷ In Latin America the average annual growth rate in the same period was about 15%, in North America and emerging EMEA 9%, and in advanced EMEA it was 4%. The overall share of emerging markets in global trade credit premiums increased from below 10% to one third. The main driver was China, with premiums rising from USD 100 million in 2003 to USD 2.5 billion in 2013.⁸

Figure 3
Geographic distribution of credit insurance, 2003 and 2013



Source: Supervisory Authorities, Insurance Associations, Swiss Re Economic Research & Consulting.

⁵ North America includes US and Canada; Latin America includes: Brazil, Argentina, Mexico, Chile, Colombia and Venezuela; Advanced EMEA includes UK, France, Italy, Switzerland, Spain, Austria, Portugal, Luxembourg, Netherlands, Germany, Belgium, Sweden, Denmark, Finland and Ireland; Emerging EMEA includes: Poland, Czech Republic, Hungary, Slovenia, Bulgaria, Croatia, Estonia, Romania, Turkey and South Africa; Advanced Asia includes: Japan, South Korea, Taiwan and Hong Kong; Emerging Asia includes: China and Philippines.

⁶ See notes to the Appendix table for the market data sources

⁷ All growth rates in this chapter are in nominal USD terms.

⁸ See note to the Chinese premium statistics in the Appendix.

Trade credit insurance

Credit insurance is well-established in Europe, but penetration rates have been declining in recent years.

Penetration rates have increased only marginally from low levels in North America.

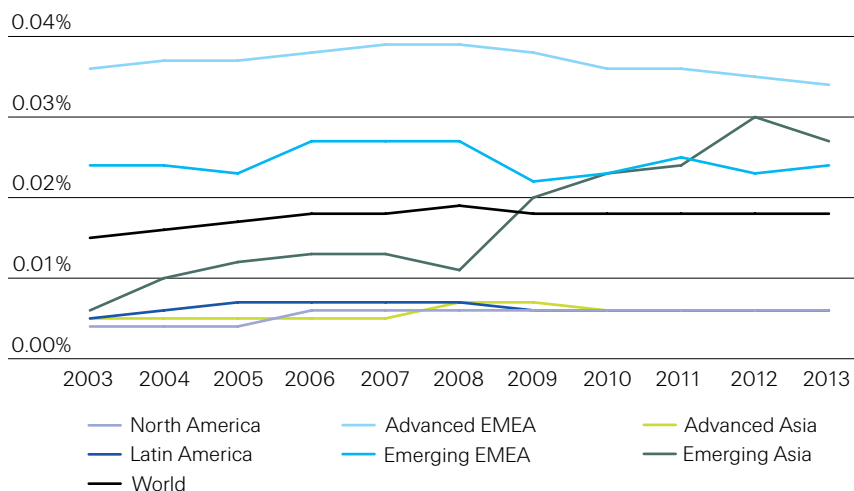
Penetration in emerging Asia increased rapidly but remains below average in advanced Asia and Latin America.

Figure 4
Credit insurance penetration rates (% of GDP) by world regions, 2003-2013

Global penetration rates, defined as the ratio of premiums to GDP, have been fairly stable over the last 10 years, except in emerging Asia where they have risen. Credit insurance is well established in Europe and penetration rates have traditionally been relatively high. Aggregated premiums for EMEA amounted to USD 6.2 billion in 2013. However, growth of credit premiums has not kept pace with GDP growth since the financial crisis, leading to a modest decline in penetration rates over recent years (see Figure 4).

In North America, where excess-of-loss products are more prevalent, penetration rates were very low in the early 2000s, and have increased only marginally since. The size of the North American market was USD 1.1 billion in 2013.

Emerging Asia saw a rapid rise in premiums over the past decade, largely driven by China. However, the premiums of USD 2.5 billion may be inflated due to the potential inclusion of some financial guarantee business. Penetration rates in advanced Asia (market size about USD 400 million) and Latin America (about USD 300 million) remain below the global average. These markets have caught up only a little.

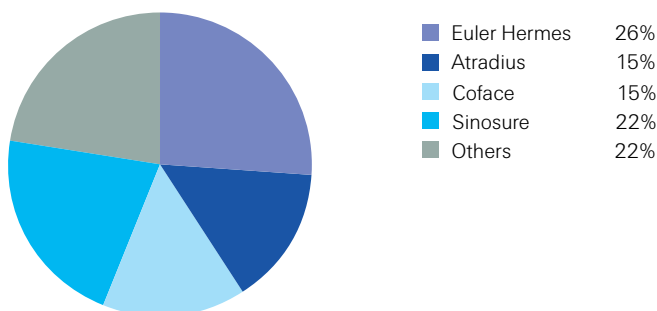


Source: Swiss Re Economic Research & Consulting.

Four insurance groups dominate the global trade credit insurance market.

Four groups – Euler Hermes, Atradius, Coface and Sinosure – dominate the global credit insurance market with combined premiums of USD 8.2 billion in 2013. The first three are Europe-based, long-standing and privately-owned. China's Sinosure began operations in 2001. It is funded by the government and has fostered the rapid expansion of Chinese export credit insurance. Its share of that market is about 90%, according to data from China's insurance regulator.

Figure 5
Market shares of the largest credit insurance groups, 2013



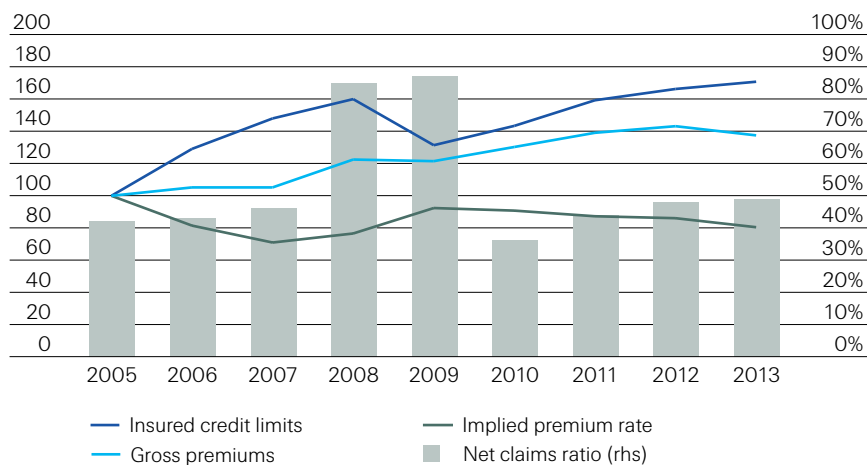
Source: Company financial statements, China Insurance Regulatory Commission (CIRC), Swiss Re Economic Research & Consulting estimates for total market size.

Insured exposures expanded more than premiums in the run-up to the financial crisis.

Market developments since the financial crisis

There was a rapid increase in insured trade credit exposures in the years before the financial crisis of 2008, according to data from the International Credit Insurance & Surety Association (ICISA).⁹ At the same time, premium income expanded only moderately as premium rates declined in an environment of benign claims and fierce competition (see Figure 6). In 2008 and 2009, claims surged as the financial crisis led to a sharp increase in corporate defaults. Due to the changed risk environment and collapse in global trade, credit limits declined from their 2008 peaks. At the same time, premium rates increased so that premium volumes remained roughly unchanged. From 2010 to 2012, premiums expanded again while claims remained moderate.

Figure 6
Gross premiums, insured credit limits, implied "premium rate" (indexed to 2005 = 100) and net claims ratio (%) in trade credit insurance, 2005–2013



Note: The implied "premium rate" shown in the chart is not a proper premium rate measure as it refers to the ratio of premiums to insured credit limits. The proper premium rate measure, by contrast, refers to the ratio of premiums to insured turnover during the policy period. Due to the lack of comparable turnover data, the former measure is used as a proxy.

Source: International Credit Insurance & Surety Association (ICISA).

Insurers' claims ratios declined in 2010 despite persistently high insolvencies.

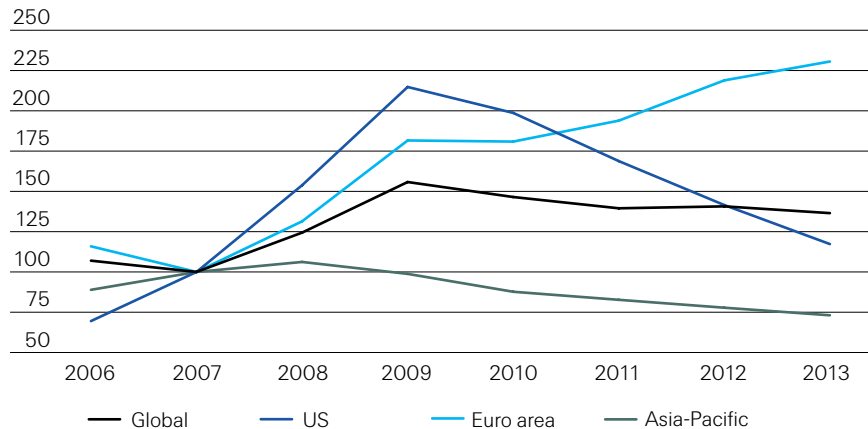
The sharp increase in claims ratios during the financial crisis was due to the rise in business insolvencies, which led to a surge in non-payments. The global insolvency index provided by Euler Hermes increased by over 50% between 2007 and 2009 (see Figure 7). While insolvencies remained relatively elevated thereafter, insurers' claims ratios dropped sharply as early as in 2010 due to credit insurers' ability to adjust their limits, and terms and conditions.

⁹ According to ICISA, their members account for over 95% of the private trade credit insurance business. Export credit agencies, which play an important role in the short-term trade credit insurance market in some emerging economies, are not represented.

Trade credit insurance

Insolvencies have diverged across different regions since the onset of the financial crisis.

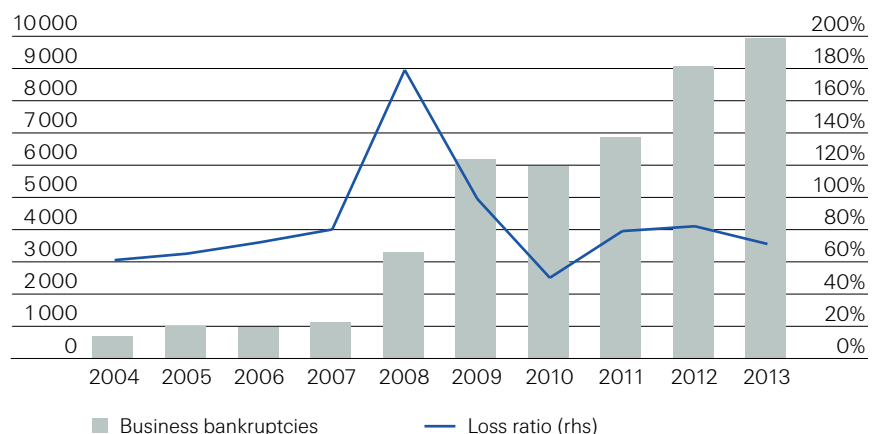
Figure 7
Business insolvencies for select regions (indexed to 2007 = 100)



Source: *Economic Outlook*, number 1194, April 2013 and number 1207, May 2014, Euler Hermes, Swiss Re Economic Research & Consulting.

Despite the continued increase in business bankruptcies, insurers' loss ratios in Spain have fallen again.

Figure 8
Number of business bankruptcies and trade credit insurance loss ratio (%) in Spain, 2004–2013



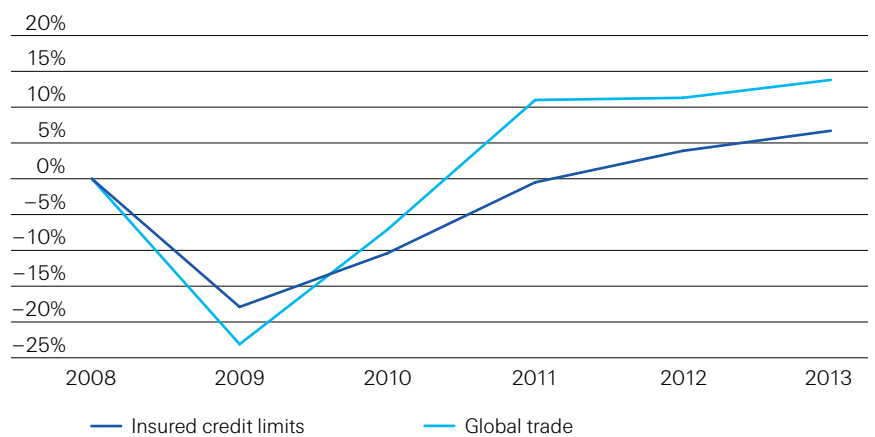
Source: National Statistics Institute (INE) Spain, Dirección General de Seguros y Fondos de Pensiones, ICEA, Swiss Re Economic Research & Consulting.

Trade credit insurers have been criticised for aggravating the crisis.

Credit insurance limits were cut during the crisis and trade dropped.

Figure 9

Cumulative decline/increase (in %) in global trade and insured trade credit limits, 2008–2013



Source: International Credit Insurance & Surety Association (ICISA), IMF.

However, the direction of causality between the limit reductions and decline in trade is not clear.

The sharp increase in premium rates of 2009 came after a gradual decline over several years.

Did credit insurers aggravate the financial crisis?

Trade credit insurers have been criticised for aggravating the drop in trade activity during the financial crisis. Specifically, insurers have been accused of cancelling limits across the board, raising premium rates excessively and of not communicating these changes adequately to their clients.¹⁰

Figure 9 shows that credit limits dropped by 18% from 2008 to 2009. Over the same period, global trade declined by 23%. The two are linked but the direction of causality is not clear. Some insureds claim that limit reductions for important buyers during the crisis hampered their trading activities. This left policyholders the choice of: (1) shipping without insurance cover (ie, “self-insurance”); (2) delivering only against cash in advance; or (3) stopping shipments.

At the same time, however, demand for trade credit insurance fell in the crisis as order books declined. Short-term exports covered by “Berne Union” members,¹¹ who include both private and public suppliers of export credit insurance, fell by 13% between 2008 and 2009.¹² This was around half the 23% contraction in global trade observed during the same period. Assuming that the regional distribution of exports insured by Berne Union members is roughly in line with global trade, this suggests that the proportion of trade insured effectively increased at the height of the financial crisis. This weakens the argument that credit insurers’ capacity withdrawal was the key driver of declining insurance cover. Overall, it is likely that both lower demand and a decline in insurers’ risk appetite played a role in explaining the sharp drop in trade credit insurance during the crisis.

The development of premiums and credit limits in Figure 6 implies a gradual erosion of premium rates (premiums per unit of exposure) between 2005 and 2007, followed by a sharp reversal in the second half of 2008 and early 2009. The premium rate increase of 2008–2009 as implied by the ratio of total premiums to total limits may well overstate the “genuine” premium rate increase (defined as the ratio of premiums to actual turnover). This is because the share of credit limits being used by policyholders likely increased during the crisis. On the other hand, the global

¹⁰ See, for example, *Study on short-term trade finance and credit insurance in the European Union*, European Commission, February 2012.

¹¹ Note that exports covered provide an ex-post view of trade flows that have actually been insured during a certain period of time, whereas credit limits provide a point-in-time indication of an insurer’s maximum commitment.

¹² *Credit insurance in support of international trade: Observations throughout the crisis*, Berne Union, October 2010, p 7.

Trade credit insurance

Many credit insurers improved how they communicate with their clients after the crisis.

The importance of public ECAs increased during the crisis as they reduced their credit limits less than private insurers.

In the EU, ECAs were temporarily allowed to offer insurance in the traditional private market segment.

The Chinese ECA expanded its business sharply during the crisis, supporting Chinese exporters.

aggregate of premium rates masks significant differences across markets. Whether the rate adjustments were excessive in individual cases is, however, uncertain. Nevertheless, Figure 6 suggests that the rate increases were a necessary reversal of the unsustainable rate erosion seen prior to the crisis.

Clients have also criticised insurers for poor communication around credit limit reductions and cancellations during the crisis. According to ICISA¹³, many of its members have introduced changes in how they communicate with insureds on credit limit decisions in the aftermath of the financial crisis.

The role of the government during the financial crisis

The above-mentioned reductions in credit limits between mid-2008 and early 2009 were implemented not only by private, but also by public providers of short-term trade credit insurance, with few exceptions. However, while private Berne Union members continued to reduce their credit limits, public ECAs started to raise them starting from the second quarter of 2009. This came because governments specifically asked their ECAs to fill the perceived gap in export credit insurance supply. Data from the Berne Union shows the share of short-term trade credit limits provided by ECAs rose from 15% between 2006 and 2008, to 21% in 2009 and to 28% in 2010.¹⁴

To further alleviate exporters' difficulties in obtaining insurance cover, the European Commission temporarily allowed ECAs from EU countries to be active in the so-called "short-term marketable risk business", which is defined as the short-term export segment to OECD countries.¹⁵ EU regulations normally restrict this market segment to private players. As a consequence, the activity of EU ECAs increased in this area, but remained small with a market share of 2%.

In China trade credit insurance cover did not contract during the financial crisis. On the contrary, premiums surged in 2009 despite a sharp contraction in exports¹⁶ (see Figure 10). This was a deliberate move by the Chinese government to increase Sinosure's business and support China's export industry. This led to an increase in credit insurance penetration in 2009, which has subsequently continued to increase.

Figure 10

Growth of Chinese exports and trade credit premiums (CNY, %), 2005–2013



Source: IMF, China Insurance Regulatory Commission (CIRC).

¹³ *Study on short-term trade finance and credit insurance in the European Union*, European Commission, February 2012.

¹⁴ *Credit insurance in support of international trade. Observations throughout the crisis*, Berne Union, October 2010.

¹⁵ For an overview of countries asking for these temporary exemptions, see EU Commission study quoted above.

¹⁶ According to market sources, the sharp increase in premiums was driven by an expansion of exposures and not by rising premium rates.

Surety

A surety bond is a tripartite contract involving insurer, principal and beneficiary.

Unique features of suretyship include its tripartite structure and...

... the indefinite tenor of a bond.

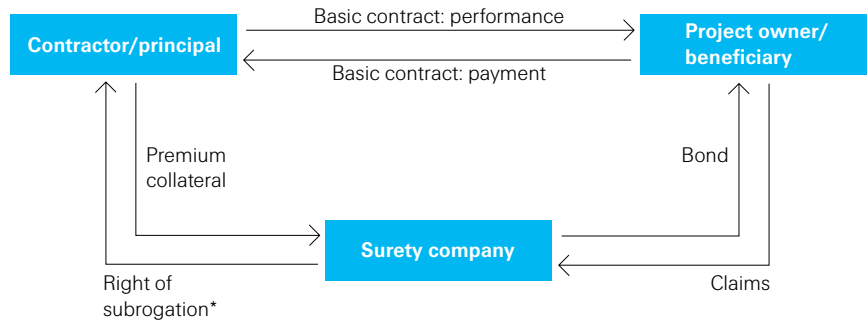
What is surety?

Suretyship reduces large-scale uncertainties by guaranteeing that commitments will be met.¹⁷ A unique feature of surety is that the policyholder purchasing coverage (called a “surety bond”) is not its direct beneficiary. A surety bond is an insurance contract in which the insurer provides a guarantee to the beneficiary that a third party – the principal – will meet its contractual, legal or regulatory obligations.

Suretyship is generally subject to the same regulations and laws as other lines of insurance. In some other ways, it is distinct, such as in its tripartite structure. Most other types of insurance offer protection to the policyholder. A surety bond, by contrast, is purchased by the principal but benefits the beneficiary (see Figure 11).

Another special characteristic of surety bonds is that they are normally of indefinite duration and non-cancellable. If there is a delay in the underlying obligation between principal and beneficiary, the surety remains liable subject to the terms of the bond until it is completed. Even the failure of a principal to pay premiums does not release the surety from its obligation to the beneficiary.

Figure 11
How surety works



*Note: The right of subrogation provides a surety that has paid a claim with the contractual right to recover loss payments directly from a principal who has failed to perform.

Source: Swiss Re.

This chapter explains how surety works, compares surety bonds to competing products and explores the global surety market.

Types of surety bonds

There is a wide variety of surety bonds designed for different roles. The bonds fall under two broad categories: contract bonds and commercial bonds.

There are two broad categories of surety bonds: contract and commercial.

Contract bonds account for around two-thirds of global surety premiums.

Contract surety

Contract bonds assure the performance of contractual obligations, mainly in the areas of public and private construction projects. They account for around two-thirds of the global surety market. Contract bonds:

- guarantee that a contractor has submitted a bid in good faith and intends to enter the contract at the price it bid (bid bond);
- offer protection from financial loss should a contractor fail to fulfil the terms and conditions of the contract (performance bond);
- guarantee that the contractor will repay the project owner any funds received in advance (advance payment bond);
- assure workers, subcontractors and suppliers that the contractor will pay them (labour and material payment bond); and
- guarantee against defective workmanship or materials (maintenance bond).

¹⁷ Suretyship refers to the tripartite relationship, surety bond to the policy agreement and surety to the insurer (usually “the surety”). Surety is also frequently used as a short form of “surety line of business”.

Surety

Premiums depend on project type, size and duration, collateral and creditworthiness.

The annual premium for a surety bond is typically between 0.5% and 2% of the bond amount.¹⁸ The premium rate depends on the size and type of project, the contractor's creditworthiness, the level of collateral (if any) posted with the insurer and the project's anticipated duration.

If the principal defaults, the surety company must satisfy its obligation to the beneficiary.

When a principal (contractor) fails to fulfil its obligation, the beneficiary (project owner) must formally declare the contractor in breach of contract to qualify for payment under a surety bond. The surety company will then investigate and assess the merits of the claim. If the beneficiary improperly declared the principal to be in default, or if its claim for compensation is excessive, the surety company will protect the interests of the principal. If default has occurred, the surety company must satisfy its obligation to the beneficiary by doing one of the following: (1) assist the original contractor in completing the project; (2) hire another company to complete the work in progress; (3) pay the additional costs to the beneficiary (up to the bond amount) if the beneficiary chooses to complete the project; or (4) pay a penalty, as specified in the bond, to offset completion costs.

Example of the workings of a contract (performance) surety bond

The following example illustrates how a performance bond kept a manufacturer of rail rolling stock in business. In the example, the railway operator is the beneficiary and the carriage manufacturer the principal.

A surety company issued a performance bond guaranteeing a manufacturer's delivery of rolling stock to a railway company.

A state-owned railway company awarded a USD 150 million fixed-time contract to a manufacturer to build and deliver rolling stock over a two-year period. For the benefit of the railway operator, an insurer issued a USD 150 million performance bond guaranteeing that the manufacturer build and deliver the ordered rolling stock in accordance with the terms and conditions of the underlying contract.

As the manufacturer ran into liquidity issues, threatening the timely delivery of rolling stock ...

Soon after, the manufacturer was taken over by another company. The new owner forced the manufacturer to double its dividend payment in order to facilitate timely repayment of the financing obtained for the takeover. This caused a liquidity shortage affecting the manufacturer's ability to pay workers and suppliers, and causing a delivery delay of further materials used to complete the contract. With these problems mounting, the railway operator approached the insurance company with its concerns on the high likelihood of delayed or even non-delivery of part of the rolling stock.

... the surety provided interim financing to the manufacturer, which was paid back after timely completion of the order.

To prevent a potential high two-digit million claim under the performance bond, the insurance company decided to provide interim financing of USD 30 million, providing liquidity so that the manufacturer could complete the contract on time. The manufacturer did indeed build and deliver all rolling stock by the end of the second year. Upon receipt of the payment from the railway company, the manufacturer repaid the USD 30 million interim loan to the insurance company.

¹⁸ Premium rates have fallen below these levels in some markets recently because of fierce competition and good loss experience.

Commercial surety bonds secure the performance of legal or regulatory obligations.

A customs bond eases administration and has a positive impact on liquidity.

A surety bond benefits the principal and the beneficiary ...

... and facilitates a project's successful completion.

Bank guarantees are used as a substitute for surety bonds.

Commercial surety

The second category of surety bonds is known as commercial (or "non-contract") surety. Commercial surety bonds secure the performance of legal or regulatory obligations. They likewise serve a variety of purposes including:

- assuring customs authorities that an importer will pay the import duties required (customs bond);
- ensuring the proper declaration and timely payment of taxes (tax bonds);
- enabling governments to secure compliance with laws protecting community safety and welfare (license and permit bonds); and
- securing the performance of fiduciaries' duties and compliance with a court order (court bonds).

The following illustrates the workings of a customs bond. Customs duties on goods imported from another country are due immediately when they cross the border. A deferred duty payment bond allows the importer to defer payment for up to two months. This not only eases administration but also has a positive impact on the importer's liquidity position.

Rationale for surety

Counterparty risk and its mitigation are key to deciding whether and with whom to undertake a project. The surety company's value proposition is that it writes bonds benefitting both principals (contractors) and beneficiaries (project owners) by reducing uncertainty.

A surety bond increases the likelihood of a project being completed as initially agreed.

- The surety bond enhances the principal's creditworthiness, up to the credit rating of the surety.
- The surety company's expertise in pre-qualifying the principal assures the project owner that the contractor has the financial and technical capacity to complete the project.
- Purchasing a surety bond also benefits the principal because without it, the beneficiary (especially if it is a public entity) might be unable to award the contract to the principal, or might demand stricter terms.

Bank guarantees: a competing product

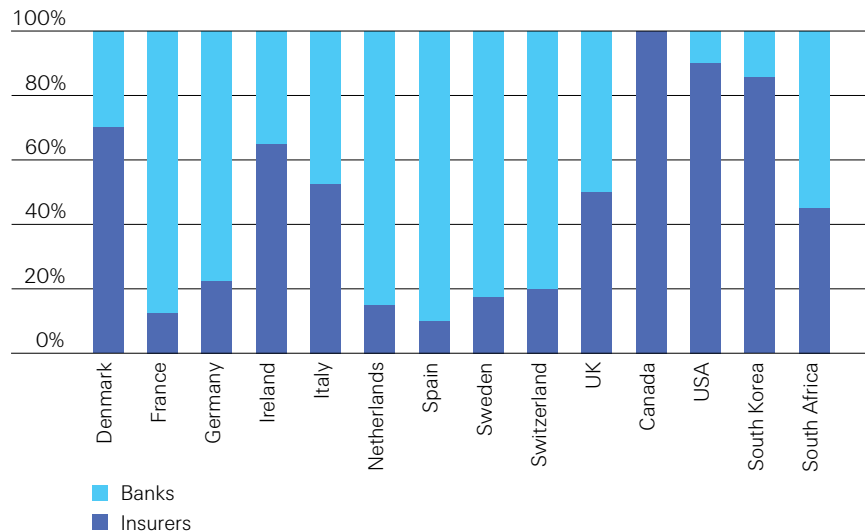
Bank guarantees are often used as a substitute for surety bonds. Like surety bonds, guarantees promise a sum of money to a beneficiary if a third party fails to fulfil its contractual obligations. A guarantee is "abstract" in the sense that it is legally independent of the underlying contract or obligation. By contrast, surety bonds are "accessory" to the main contractual, legal or regulatory obligations between beneficiary and principal. That is, the existence of the responsibility of the surety depends on the existence of an underlying obligation (resulting in the above-described tripartite structure of a surety bond, involving surety, beneficiary and principal). Moreover, bank guarantees are typically payable "on demand" whereas surety bonds are often "conditional" (see box on page 21).

Surety

In practice, the distinction between surety bonds and guarantees is not always clear.

In practice, the difference between guarantees and surety bonds can be difficult to determine, and is often complicated by the confusing terminology used. As there are no international conventions, different names for various surety bonds and guarantees have emerged in individual markets. Banks compete with insurers in the surety and guarantee markets. In some markets such as in the US and Canada, insurers hold a dominant market position due to regulations restricting banks' role. However, in many European countries, the banks' market shares exceed that of insurers (see Figure 12).

Figure 12
Market share of banks and surety writers in selected countries, 2013



Source: International Credit Insurance & Surety Association (ICISA).

Underwriting and risk management by surety companies

Robust underwriting discipline is key to effective risk management.

Sound risk management in a surety company involves disciplined underwriting, the use of reinsurance and avoiding "product glitches." Actively trying to manage the economic cycle is considered less effective in surety than in trade credit insurance because of the long-term nature of the business.

Risk management begins by assessing ...

Underwriting

The key credit underwriting criteria can be categorised as the "six Cs": capital, capacity, character, conditions, confidence and collateral.

...a principal's capital (financial) strength ...

"Capital" refers to the financial strength of a principal, which a surety company assesses by examining:

- financial statements for the past three to five years, including the balance sheet, income statement, statement of cash flows and statement of owners' equity;
- a summary of completed contracts and schedule of work in progress listing the name, contract price and anticipated completion date of each job;
- cost records accounting for the financial status of the contractor's jobs;
- credit reports on the contractor; and
- a bank line of credit showing unsecured credit that can be used as short-term working capital.

... and capacity (ability to perform).

“Capacity” refers to the ability to perform, which the surety company assesses by reviewing:

- the résumés of the contractor and key personnel;
- the contractor’s history of completed works;
- the adequacy of the contractor’s equipment and tools for the job;
- a contingency plan illustrating how the company would operate were key personnel to depart; and
- the contractor’s future business plans, goals and growth strategies.

Another important factor a surety company considers is character, its reputation.

Regarding “character”, a surety company may review references from owners, architects, subcontractors, general contractors and suppliers with whom the contractor has worked to assess its reputation for fair, business-like dealings. A newly founded, speculative property developer for example poses a higher risk than a general contractor with many years of experience.

Conditions need to be looked at carefully.

It is important to verify the “conditions” of a surety transaction. What is the state of the economy and industry of the principal? Are the terms and conditions of the underlying contract fair and realistic? What do the surety bond wording and indemnity agreement look like?

Confidence relates to the “soft factors” involved in a transaction.

“Confidence”: There are many aspects to be considered when underwriting surety bonds and it can be a challenge to gain clarity on each and every detail of a transaction, as evidence is partly based on soft factors. In reality there are often arguments for and against a proposed transaction. A surety underwriter will take an educated decision based on facts and experience. At the same time, however, the so-called “gut feeling” should not be underestimated. If, for whatever reason, the underwriter does not gain a comfortable level of confidence in a transaction, the right decision may well be not to enter into the agreement.

Collateral can substantially mitigate the risk.

With respect to “collateral”, a surety company typically asks the principal to sign an indemnity agreement before a bond is issued. If the balance sheet of the principal is deemed too weak, the surety may in addition ask for a parental guarantee or even for hard types of “collateral” such as cash or the pledge of assets. Strong collateral considerably mitigates the risk for the surety company as it enhances the likelihood of recovery of a claim paid.

Cedents’ opinion and expertise matter for reinsurers.

Role of reinsurance

In addition to the six Cs of credit criteria, from a reinsurer’s perspective a seventh can be added: the “cedent”. As in credit insurance, reinsurance is also available to surety companies as a risk management tool. Reinsurers are less familiar with the local conditions and particularities of an individual surety market than their clients, and they must feel comfortable to rely on their clients’ expertise, opinion and underwriting skills. Thus, it is important that reinsurers maintain a close relationship with cedents. When reinsurers are comfortable that their cedents have taken care of the six Cs described above, they will be more inclined to provide reinsurance capacity.

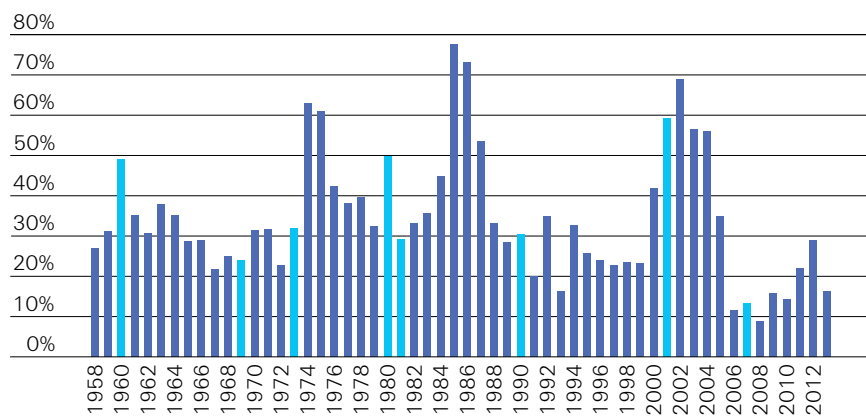
Sureties buy proportional and non-proportional reinsurance cover separately or combined.

Proportional and non-proportional reinsurance contracts are used separately and combined to help smooth the loss development of primary surety companies. Non-proportional reinsurance contracts have traditionally been more prevalent in the US than in other markets. Outside the US, companies have typically used proportional contracts, often in combination with non-proportional cover on their retention. Recently, however, the larger providers of surety bonds have become more willing to retain more risks on their own books and increasingly only seek non-proportional protection for very large losses.

Surety

Surety losses are sometimes, but not always, related to the business cycle.

Figure 13
US surety industry's loss ratio (%),
1958–2013



Note: Light blue bars denote years in which recession began.

Source: The Surety and Fidelity Association of America, National Bureau of Economic Research, Swiss Re Economic Research & Consulting.

It is difficult to actively manage the economic cycle in surety business.

Even when surety losses arise from the economic cycle, it is very challenging to actively manage a surety portfolio because it is difficult to anticipate economic downturns two to three years ahead, the typical duration of a surety contract. Hence, the likelihood of catching the right point in time to reduce or increase exposure in a surety portfolio is low. When an economic downturn becomes obvious, it is usually too late to take actions to reduce future losses. By contrast, such actions may even turn out to be pro-cyclical as a restrictive approach to new business results in missed opportunities to generate profitable business.

Maintaining underwriting discipline and avoiding “product glitches” are key for avoiding large losses.

“Product glitches”

Strict underwriting discipline and avoiding “product glitches” have proven to be a more effective strategy in loss mitigation than actively trying to steer the business cycle. Product glitches refer to surety bonds where the underlying risks turn out to be very different from what was assumed at the time of underwriting, and from what the product name would suggest. As the terminology for surety bonds and guarantees is not standardised internationally, similar names are used for completely different products. For example, instruments called “contract bonds” have turned out to be pure financial guarantees once the claim occurred.

Surety companies must know exactly what a surety bond guarantees.

Surety companies must examine what exactly constitutes the underlying contract, law or regulation and their inherent obligations covered by the surety bond independent of what the name of the surety bond is. Only when the surety knows exactly what the surety bond guarantees can a proper assessment of all risks involved be undertaken. If the necessary information cannot be obtained, this is usually a warning sign to the experienced underwriter.

Weak underwriting discipline and product glitches led to a spike in losses in the US in 2001.

The spike in US surety loss ratios during the economic downturn of 2001 is an example of eroding underwriting discipline and product glitches. The US surety industry incurred a major part of its losses in the area of non-traditional surety business, which was written based on insufficient information during the boom years before the downturn. As a result, the sureties were forced to change their strategy and again focus on traditional surety products for fully transparent underlying transactions. This underwriting discipline, which has to a large extent been maintained until today in the US market, is probably the major reason why the US surety industry weathered the 2008 crisis quite well.

Recent market trends

Traditionally a local business, surety is becoming increasingly global.

Globalisation

Surety has traditionally been a local business, based on local market knowledge. However, the business is becoming increasingly globalised, with more large insurance firms setting up operations in emerging markets (eg, Latin America) or surety markets dominated by banks (eg, Australia). It is challenging for surety companies to acquire the expertise on the local regulatory and political landscape. Global players, however, have the capacity to hire experienced local underwriters and lawyers. Existing surety insurers with a more global focus include, amongst others, ACE, AIG, Euler Hermes, Liberty Mutual, Travelers and Zurich Insurance.

Public-private partnerships in infrastructure generate demand for surety cover over the whole lifecycle of a project.

Public-private partnerships

The financial crisis led to increased public debt burdens and many governments, particularly in advanced economies, had no option but to decrease spending on public infrastructure projects. This reduced demand for contract surety with public beneficiaries. Instead, governments have either been selling concessions to private companies or tackling large projects in joint-ventures with private suppliers through public-private partnerships (PPPs). Public sector construction typically requires surety cover in the planning and building phases of projects. The new public-private structures often also create demand for surety bonds in the operating, maintenance and transfer stages of projects.

The long tenor of projects can add to the complexity of underwriting in surety.

While this trend may offer new business opportunities, it also comes with a few challenges. Complex projects with long tenors (up to 30 years) require a strong underwriting framework to properly assess all inherent risks. Not all surety providers have this expertise. In addition, the banks can offer a competitive alternation in the form of guarantees or letters of credit. At present, these tend to be the preferred option for project beneficiaries, especially when a ratings agency assessment is required.

Increasing use of “on-demand” bonds

Surety bonds may be “on demand” or conditional.

Conditional vs. unconditional surety bonds

Surety bonds may be “conditional” or “on demand”. Under a conditional bond, the beneficiary must provide evidence that the principal is in breach of contract to qualify for payment. The surety company might then investigate and assess the merits of the claim. Only if the claim is deemed rightful will the surety company reimburse the beneficiary.

With unconditional bonds, the surety typically has to pay out whenever the beneficiary makes a demand.

In the case of an unconditional “on-demand” bond, the surety typically has to pay out the required sum up to the bond amount whenever the beneficiary demands payment, irrespective of whether or not the principal is really in breach of the underlying contract. If it turns out that the surety bond was called unfairly, the surety can claim its money back. Bank guarantees are typically payable on demand.

Surety

The use of “on-demand” surety bonds is on the rise.

In many markets, conditional surety bonds have been the typical product offered by insurers. However, recent trends point to a rise in the use of unconditional bonds. On the one hand, beneficiaries are increasingly asking for unconditional bonds. On the other, surety insurers are looking to secure a stronger foothold in markets traditionally dominated by banks providing (unconditional) guarantees.

The surety and the principal prefer conditional bonds while the beneficiary favours “on-demand” bonds.

Beneficiaries often have a preference for on-demand surety bonds as they grant them the right to call the bond before it is proved that the principal is in breach of contract. In contrast, sureties and principals prefer conditional surety bonds as their position is stronger in case of a dispute between principal and beneficiary. The surety can typically take active steps to remedy a critical situation to prevent it from escalating and resulting in a total loss. While such active loss mitigation is still possible with on-demand bonds, it may happen only after the beneficiary has already called the bond. In the case of abstract guarantees, the guarantor becomes a mere contingent creditor to the principal rather than a trusted partner aiming to enhance the likelihood of proper project completion.

When issuing on-demand surety bonds, insurers also need to assess the “character” of the beneficiary.

When issuing on-demand surety bonds, an additional “C” underwriting criteria has to be considered, over and above the seven Cs mentioned above. The surety company also needs to assess the “character” of *the beneficiary*, in terms of how it is likely to behave in the event of a project getting into troubles. Will the beneficiary support all efforts to ensure project completion and be willing to contribute to a solution via mediation or dispute resolution? Or is it more likely to call the full amount of the surety bond, even in the case of the slightest of issues arising?

Market size and structure

The US is the largest surety market, but Latin America has become increasingly important over the last decade.

Global overview

Worldwide surety premiums were USD 13.0 billion in 2013.¹⁹ The US surety market is the largest, accounting for about 40% (USD 5.3 billion) of global premiums. However, premium growth in North America has been sluggish, particularly since the financial crisis, averaging 3% over the last decade.²⁰ This is in sharp contrast to Latin America where annual nominal premium growth averaged 15% (although growth has slowed in more recent years). The Latin American market share of global surety premiums rose from 7% in 2003 to 17% in 2013.

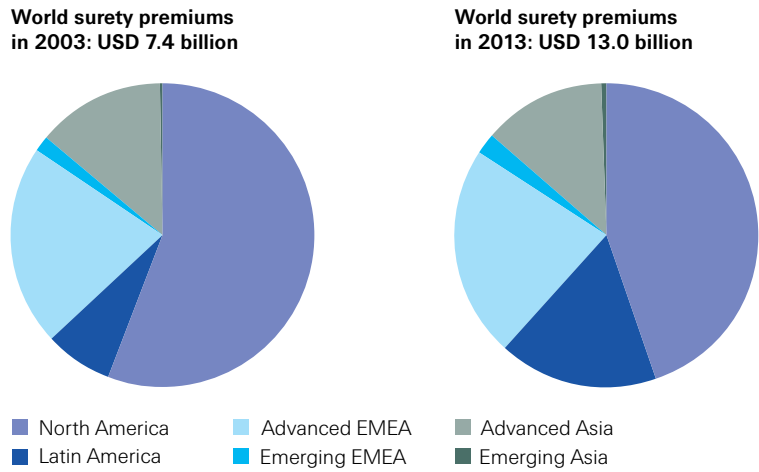
South Korea is the second largest surety market and has grown rapidly.

Among the other regions, emerging EMEA has also seen above-average annual growth of 8%. However, with total premiums of about USD 300 million in 2013, its market remains small. Annual growth in advanced EMEA and advanced Asia has been around 6% from 2003 to 2013. In advanced Asia, the bulk of surety premiums stems from South Korea, the second largest market worldwide with a premium volume of USD 1.4 billion in 2013.

¹⁹ See notes to the Appendix table for the market data sources.

²⁰ All growth rates in this chapter are in nominal USD terms.

Figure 14
Geographic distribution of surety premiums, 2003 and 2013



Note: For a list of the countries included in the sample, refer to Footnote 5 on page 9.
Source: Supervisory Authorities, Insurance Associations, Swiss Re Economic Research & Consulting.

Italy and Germany are the two largest European surety markets.

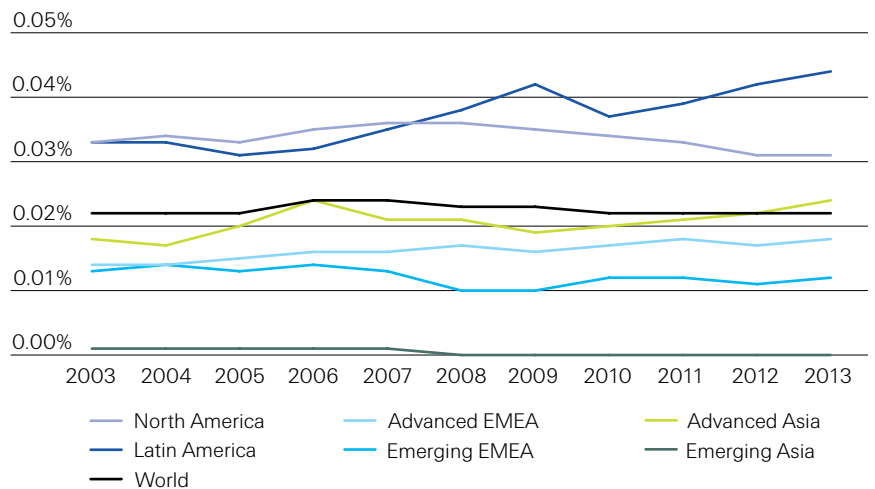
In Italy, the surety market is split between banks and insurers, while in Germany the banks dominate.

Europe

Surety penetration in Europe is below the global average (see Figure 15). Traditionally banks have been the leading players in European surety/guarantee markets. Therefore, penetration rates are lower than in other regions of the world. Italy and Germany are the largest European surety markets with premiums of about USD 650 million each in 2013.

In Italy, contract bonds account for about 60% of the total surety market with the rest coming from customs bonds, value added tax bonds and a variety of other commercial bonds (eg, related to waste management). The Italian surety market is about evenly divided between banks and insurers, according to ICISA. Among the largest surety providers, there are a few specialised companies as well as some multi-line insurers. The German surety market is dominated by banks which hold a 75–80% share. The insurance segment is quite concentrated with a few specialised companies and multi-line insurers dominating the market.

Figure 15
Surety penetration rates (% of GDP) by world regions, 2003–2013



Source: Swiss Re Economic Research & Consulting.

Surety

Surety is important in North America due to legal requirements for public project bonding.

US contract surety premiums have been contracting since 2008 due to the slowdown in public construction.

Loss ratios in US contract surety remained relatively low during the crisis.

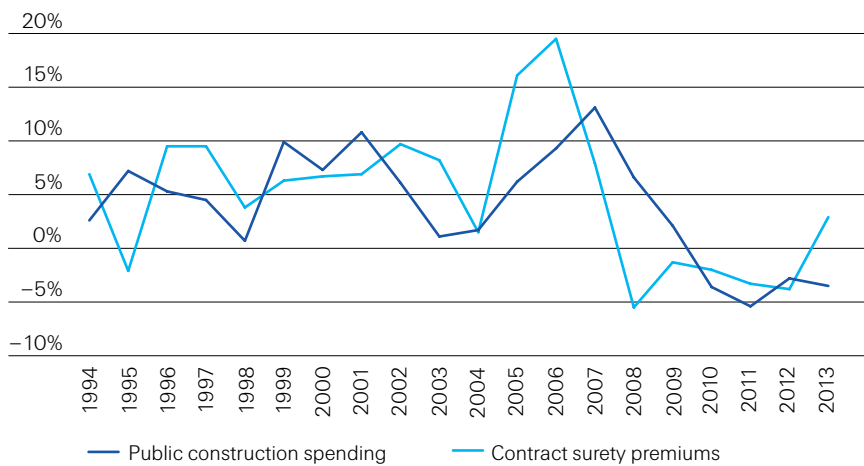
Figure 16
Growth of US public construction spending and US contract surety premiums written (% yoy), 1994–2013

North America

Surety penetration rates in America are higher than in other markets. In the US, this is because the federal and most state governments are by law required to post performance and payment bonds on all public works in excess of USD 100 000. Surety bonds are also recommended on contracts exceeding USD 25 000. The US and the Canadian surety markets are dominated by insurers, with banks playing only a minor role.

Contract surety accounted for two thirds of total surety premiums in the US in 2013, in line with the long-term average, but down from almost 74% in 2007. Contract surety premiums expanded rapidly between 2004 and 2007, profiting from rapid growth in public construction spending (see Figure 16). Between 2008 and 2012, US contract surety premiums fell as public sector spending on construction was cut to reduce the deficit. By contrast, commercial surety premiums grew steadily throughout the crisis with average annual growth of 3.6%. The overall contraction in US surety premiums since 2008 has led to a fall in the penetration rate.

Despite sluggish top-line growth, profitability in the US contract surety business held up well throughout the financial crisis. Loss ratios averaged 20% between 2008 and 2013, below the 20-year average of 34%.



Source: Surety and Fidelity Association of America, US Census Bureau, Datastream.

Surety plays an important role in Latin America, bolstered by legislative mandate.

Mexico remains the largest market, but Brazil and Colombia have caught up.

The Mexican surety market is strictly regulated.

Eroding underwriting discipline has become a challenge in Brazil.

South Korea is the largest surety market in Asia and the second largest in the world.

The state-owned SGIC specialises in financial guarantees and surety.

Latin America

Surety is widespread in Latin America. Like in the US, demand is supported by legislation mandating surety/guarantees for public construction projects and also for a variety of commercial bonds, including judicial and tax bonds. Different to the US, banks are allowed to compete with insurers. However, banks' presence is weaker than in Europe and insurers typically have a strong market position.

Ten years ago, Mexico was by far the largest surety market in Latin America. Annual average market growth has been about 7% over the last decade and in 2013, it was still the largest market in the region with premiums of about USD 600 million. Other markets, however, have been growing much more rapidly. In particular, the Brazilian market grew by an annual average of 28% from 2003 to around USD 500 million in premiums in 2013. Surety premiums in Colombia were USD 470 million in 2013, with annual growth averaging 17% over the last decade.

According to the Panamerican Surety Association (PASA), local insurers have a 57% share of the regional surety market. The remainder is split between global (33%) and regional insurers (10%). Market concentration varies across countries. In Mexico, the market is concentrated with five companies holding 80% of market share. This is because the market is heavily regulated and capital requirements pose a serious barrier to entry.²¹

The Brazilian market is more open and fierce competition has led to a significant decline in premium rates over the last few years. The rapid market growth has been mainly driven by the more risky judicial bond segment. According to market sources, underwriting discipline in Brazil as well as Colombia has eroded markedly over the last few years.

Asia

South Korea is the largest surety market in Asia and the world's second largest with premiums of about USD 1.4 billion. Both banks and insurers offer a variety of surety and guarantee products. The market's large size can be explained by legal bonding requirements for public and infrastructure construction projects. In addition, there is a large commercial surety segment including customs and tax bonds, which also benefits from mandatory bonding requirements.

The South Korean surety market is dominated by Seoul Guarantee Insurance Company (SGIC), a government-owned company specialising in financial guarantees and surety. Japan also has a developed surety market with estimated premiums of about USD 130 million.²² Surety premiums in most other markets are modest.

²¹ Mexican regulatory requirements will change in 2015. However, the regulations are likely to remain fairly restrictive.

²² Swiss Re Economic Research & Consulting estimate.

Conclusion

Trade credit insurers suffered during the crisis, but effective risk management restored their profitability.

Trade credit insurers' profitability was hit hard by the 2008 financial crisis. While some policyholders blamed credit insurers for cutting limits excessively in the crisis, limit reductions and premium rate increases were key for sustaining insurers and the industry. Indeed, some trade credit insurers have only been able to continue to write business because they made effective use of their risk management tools during the crisis years.

Product developments since the crisis have benefitted policyholders.

Following the financial crisis, insureds have been increasingly demanding products with non-cancellable limits. These products may not always deliver what their name suggests, but they are influencing the development of more traditional credit insurance products. For example, many policies now include longer notice periods and appeal processes, which benefit the insured. Credit insurers also increasingly offer excess-of-loss policies to meet changing client needs.

Further product innovations, in particular in the SME segment, may be needed.

Nevertheless, credit insurance penetration rates in Europe have fallen since 2008. This suggests that it remains challenging for credit insurers to acquire new clients and prevent existing ones from reverting to self-insurance. The SME segment in particular has further room for penetration. There may also be a role for credit insurers in combined credit insurance/funding structures that help alleviate the current funding squeeze of many European SMEs.

In surety, the competitive market environment could lead to erosion of underwriting standards and to product glitches.

Surety companies have weathered the financial crisis and subsequent recession well, particularly in the US. With demand for contract surety in advanced markets still subdued due to government spending cuts, surety firms are looking for new growth opportunities. The share of emerging markets in global surety premiums has increased significantly in the last decade, particularly in Latin America. At an aggregate level, market discipline appears satisfactory, notwithstanding some recent large losses in a few markets. However, there is a risk that the current fierce competition both on the primary and reinsurance side will lead to gradual erosion in underwriting standards. Indeed, the lesson from past surety loss cycles is that lax underwriting and product glitches are the biggest dangers.

Cycle management remains key for credit insurers.

In trade credit insurance, the monitoring of potential early warning signs remains essential. While the major credit insurers have de-risked their portfolios since 2008, ample capacity from both primary and reinsurers has led to a gradual decline in premium rates. These signals should not be ignored. Cycle management is as important today for credit insurers as it was prior to the crisis.

The current economic environment presents challenges and some opportunities.

The economic environment remains challenging for both credit insurers and sureties, but also presents some opportunities. For example, surety insurers may benefit from the reduced risk appetite of many European banks and secure some of the surety market share that has traditionally been in banks' hands. Meanwhile, trade credit insurers are strengthening their presence in economies with high growth potential and scope for deeper credit insurance penetration in response to the still-strained conditions in Europe, their largest market.

Appendix: premium statistics

Country	Credit Insurance							Surety						
	Premium volume (in USD m)		Share of world market		Premium volume in % of GDP		Avg. growth rate (in USD) 2003–2013	Premium volume (in USD m)		Share of world market		Premium volume in % of GDP		Avg. growth rate (in USD) 2003–2013
	2003	2013	2003	2013	2003	2013		2003	2013	2003	2013	2003	2013	
North America	478	1065	9%	10%	0.004	0.006	8%	4 150	5 840	56%	45%	0.033	0.031	3%
Canada	67	263	1%	2%	0.008	0.014	15%	186	523	3%	4%	0.021	0.029	11%
United States ²⁾	411	802	8%	8%	0.004	0.005	7%	3 963	5 317	53%	41%	0.034	0.032	3%
Latin America	82	314	2%	3%	0.005	0.006	14%	540	2 210	7%	17%	0.033	0.044	15%
Argentina	5	18	0%	0%	0.003	0.004	15%	54	217	1%	2%	0.041	0.044	15%
Brazil	41	130	1%	1%	0.007	0.006	12%	45	508	1%	4%	0.008	0.023	28%
Chile	14	77	0%	1%	0.019	0.028	18%	11	64	0%	0%	0.014	0.023	20%
Colombia	4	23	0%	0%	0.005	0.006	18%	94	473	1%	4%	0.100	0.124	17%
Mexico	17	61	0%	1%	0.002	0.005	14%	308	603	4%	5%	0.043	0.048	7%
Venezuela	1	4	0%	0%	0.001	0.001	16%	28	345	0%	3%	0.034	0.091	28%
Advanced EMEA	3 942	5 647	77%	53%	0.036	0.034	4%	1 569	2 936	21%	23%	0.014	0.018	6%
Austria	78	138	2%	1%	0.030	0.033	6%	0	3	0%	0%	0.000	0.001	65%
Belgium ¹⁾	121	128	2%	1%	0.039	0.025	1%	13	14	0%	0%	0.004	0.003	1%
Denmark ¹⁾	18	20	0%	0%	0.009	0.006	1%	43	46	1%	0%	0.020	0.014	1%
Finland ¹⁾	11	12	0%	0%	0.007	0.005	1%	27	28	0%	0%	0.016	0.011	1%
France ³⁾	747	833	15%	8%	0.040	0.030	1%	238	588	3%	5%	0.013	0.021	9%
Germany	919	1 145	18%	11%	0.038	0.031	2%	233	639	3%	5%	0.010	0.018	11%
Ireland ¹⁾	66	104	1%	1%	0.040	0.045	5%	7	12	0%	0%	0.004	0.005	5%
Italy	341	492	7%	5%	0.022	0.024	4%	551	658	7%	5%	0.036	0.032	2%
Luxembourg ⁴⁾	12	81	0%	1%	0.039	0.134	21%	48	409	1%	3%	0.165	0.678	24%
Netherlands ⁴⁾	396	1 089	8%	10%	0.073	0.136	11%	70	169	1%	1%	0.013	0.021	9%
Portugal	38	47	1%	0%	0.023	0.021	2%	10	8	0%	0%	0.006	0.004	-2%
Spain	589	778	12%	7%	0.066	0.057	3%	82	72	1%	1%	0.009	0.005	-1%
Sweden ¹⁾	29	24	1%	0%	0.009	0.004	-2%	67	56	1%	0%	0.021	0.010	-2%
Switzerland	62	215	1%	2%	0.019	0.033	13%	75	120	1%	1%	0.022	0.019	5%
United Kingdom	515	541	10%	5%	0.027	0.021	1%	104	112	1%	1%	0.006	0.004	1%
Emerging EMEA	244	596	5%	6%	0.024	0.025	9%	133	285	2%	2%	0.013	0.012	8%
Bulgaria	1	5	0%	0%	0.004	0.009	19%	4	1	0%	0%	0.019	0.001	-16%
Croatia	10	26	0%	0%	0.028	0.043	10%	0	1	0%	0%	0.000	0.002	22%
Czech Republic	34	124	1%	1%	0.036	0.058	14%	6	10	0%	0%	0.006	0.004	6%
Estonia ¹⁾	2	9	0%	0%	0.019	0.036	17%	0	0	0%	0%	0.000	0.000	17%
Hungary	n/a	n/a	n/a	n/a	n/a	n/a	n/a	2	17	0%	0%	0.002	0.012	24%
Poland	53	166	1%	2%	0.024	0.031	12%	29	93	0%	1%	0.013	0.018	12%
Romania ¹⁾	9	23	0%	0%	0.015	0.013	10%	21	55	0%	0%	0.036	0.030	10%
Slovenia	30	57	1%	1%	0.101	0.117	7%	1	2	0%	0%	0.002	0.005	13%
South Africa ¹⁾	106	145	2%	1%	0.063	0.041	3%	71	97	1%	1%	0.042	0.027	3%
Turkey	n/a	41	n/a	0%	n/a	0.005	n/a	n/a	10	n/a	0%	n/a	0.001	n/a
Advanced Asia	258	437	5%	4%	0.005	0.006	5%	1 005	1 726	14%	13%	0.018	0.024	6%
Hong Kong ¹⁾	48	95	1%	1%	0.030	0.036	7%	48	95	1%	1%	0.030	0.036	7%
Japan ¹⁾	198	241	4%	2%	0.005	0.005	2%	100	128	1%	1%	0.002	0.003	2%
Singapore	n/a	97	n/a	1%	n/a	0.033	n/a	n/a	97	n/a	1%	n/a	0.033	n/a
South Korea	n/a	n/a	n/a	n/a	n/a	n/a	n/a	790	1 377	11%	11%	0.123	0.106	6%
Taiwan ¹⁾	12	5	0%	0%	0.004	0.001	-8%	66	28	1%	0%	0.021	0.006	-8%
Emerging Asia	102	2 540	2%	24%	0.006	0.027	38%	11	44	0%	0%	0.001	0.000	14%
China ⁵⁾	100	2 533	2%	24%	0.006	0.027	38%	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Philippines ¹⁾	2	8	0%	0%	0.002	0.003	14%	11	44	0%	0%	0.014	0.016	14%
World	5 107	10 599	100%	100%	0.015	0.018	8%	7 408	13 041	100%	100%	0.022	0.022	6%

- 1) Swiss Re Economic Research & Consulting estimate of the split into credit and surety. Published data refer to combined credit & surety premiums
- 2) Swiss Re Economic Research & Consulting estimate for credit insurance premiums
- 3) Premiums overstate the true size of the surety market as they include some mortgage guarantee business.
- 4) Premiums overstate the true size of the domestic market significantly as foreign operations of domestic insurers are included.
- 5) About 90% of reported premiums come from Sinasure, the government-owned ECA. A part of Sinasure's premiums is likely related to the long-term export credit business typical to ECAs. In other markets ECAs are often not included in the reported premiums. As a consequence, the size of Chinese premium figures may be overstated relative to other markets. In addition, the figures may include some financial guarantee business.

Notes: The validity of individual country data for European Economic Area (EEA) markets (particularly for credit insurance) has deteriorated over the last few years. This is because multinational insurers are increasingly writing business in all EEA markets out of their domicile under the freedom to provide services. Typically, the premium data captures all business written in a specific market by domestic and foreign companies (eg via branch offices). Occasionally, EEA premiums may be double-counted or omitted due to inconsistent reporting concepts across countries.

Surety premiums in several markets may contain some financial guarantee business.

Source: Swiss Re Economic Research & Consulting estimates based on national data from supervisory authorities or insurance associations.

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