Global Trade's Little-Known Comfort Blanket Slips

Banks and insurers say the private credit insurance market, which plays an important role in global trade, is contracting.

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LONDON—Cargo ports are thinning out as the coronavirus pandemic pummels global trade. Banks and insurance companies say trade could be squeezed even more if a key financial product used to facilitate it isn't restored to health.

The product is private credit insurance, a kind of guarantee that companies and their banks use when they trade goods. In good times, this little-noticed financial tool reassures both sides in case someone defaults. About €600 billion ($650 billion) of trade-related loans were facilitated this way in 2018.

"We are witnessing a troubling contraction in the credit-insurance market," said Luciano Lucca, president of insurance broker Assiteca SpA. "This is causing a lot of difficulties for companies."

Trade finance shriveled up and global-goods traffic nearly collapsed during the 2008-09 financial crisis. Industry participants say the situation is much worse now.

During the last crisis, U.K. gross domestic product dropped by 4.5%, and defaults, or non-payments, increased by more than 50%, according to credit insurer Coface. Economists now estimate the U.K. economy will shrink between 6% and 13% this year, which will drive insolvencies, said Frédéric Bourgeois, managing director of Coface's U.K. and Ireland business.

The pandemic has already yielded late payments on trade transactions, defaults and a pullback by credit-insurance providers, according to banks and insurers. Defaults are expected to rise as lockdowns drag on. Tradefinance deals tend to last 60 or 90 days.

Companies have delayed payments in the leisure, entertainment, transportation, retail and hospitality sectors, said James Binns, Barclays PLC's global head of trade and working capital.

Trade-finance deals are private, and there is little data on pricing. The cost of credit insurance has gone up several times recently, said Ebru Pakcan, global head of trade at Citigroup Inc. She said that trend will continue or insurers will be more selective about coverage if governments don't step in.

The price of credit insurance is rising as much as 30%, said an employee at a European insurer who asked not to be named.

The biggest providers of credit insurance include Euler Hermes Group SA, a subsidiary of Allianz SE; Coface, backed by French bank Natixis SA ; and Atradius NV.

Some credit insurers could be forced to take drastic steps to protect themselves from increased risk, such as reducing as much as a quarter of coverage they extend, said the employee at the European insurer. "That will leave a lot of suppliers high and dry and a lot of buyers nobody wants to sell to," the employee said. Governments in Europe, where trade credit insurance is most prevalent, have begun to cushion the market. In France, a €12 billion program will reimburse insurers for payments to suppliers whose buyers have defaulted.

In Germany, credit insurers will pay €500 million of the first €5 billion in claims, and the government will reimburse them for a further €25 billion.

Credit insurance works like this: A French company wants to sell equipment to an overseas buyer. The French company could buy credit insurance directly from an insurer to cover the risk the buyer might not pay. Or, the bank could buy the invoice for the equipment and take out credit insurance against the buyer's payment due, known as a receivable.

Defaults have historically been rare in trade finance, partly because the lending is short term. Between 2008 and 2017, 0.4% of letters of credit issued by banks on behalf of importers defaulted, according to the International Chamber of Commerce. Letters of credit, a common form of trade finance, are a payment guarantee.

When borrowers default, creditors lose around 30% of what they lent, the ICC says. This is partly because letters of credit are often used by companies trading across challenging jurisdictions, said Tradeteq Chief Executive Christoph Gugelmann.

Some worry that state-backed insurance relief could create an asymmetric playing field. A firm might be more likely to buy goods from a German exporter instead of a company in the U.K., where the government has no relief plan. The Association of British Insurers and the U.K. government are discussing a proposal, representatives said.

The International Trade and Forfaiting Association, a group representing financial institutions and law firms involved with trade, wants a coordinated approach by EU regulators, said board member Silja Calac.

- *Simon Clark contributed to this article.*