Cancelability in Trade Credit Insurance

Dr Alex Yang
Management Science and Operations Department
London Business School

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Abstract: Trade credit insurance (TCI) is a risk management tool commonly used by suppliers to guarantee against payment default by buyers. Unlike insurance policies in other sectors, TCI policies often allow the insurer to cancel this "guarantee" during the insured period. A guarantee that can be canceled is both paradoxical and controversial. This paper explores the role of cancelability in TCI and its operational implications. Using a game-theoretic model to capture the strategic interaction between insurer and supplier, we find that the utility of cancelability in TCI is linked to the two roles that the insurer plays in this setting: The (cash flow) smoothing role (smoothing the supplier’s cash flows), and the monitoring role (tracking the buyer’s continued creditworthiness during the insured period, which enables the supplier to make more efficient operational decisions regarding whether to ship goods to the buyer on credit). Non-cancelable contracts are static (determined ex ante) and rely on the deductible to implement these two roles, which results in a conflict: A high deductible inhibits the smoothing role while a low deductible weakens the insurer’s incentive to fulfill the monitoring role. In contrast, cancelable contracts are dynamic: The insurer can cancel coverage after acquiring new information about the buyer’s default risk. The right to cancel coverage ensures that information acquired through monitoring is reflected in the supplier’s shipping decision. Thus, the insurer has adequate incentives to perform his monitoring function without resorting to a high deductible. Despite this advantage of cancelable contracts, we find conditions when they induce the insurer to exercise the cancelation option too aggressively; thereby restoring a preference for non-cancelable contracts. Our findings help explain the historical dominance of cancelable contracts in TCI, and they also offer insight into the recent industry trend of offering non-cancelable TCI coverage.

The full paper is available for download at http://ssrn.com/abstract=2735907.

Bio: S. Alex Yang is an Assistant Professor at the Management Science and Operations Department of London Business School, where he teaches MBA, executive MBA, and executive education programs. Alex holds a PhD in Operations Management and an MBA from the University of Chicago, Booth School of Business, an MS in Management Science/Financial Engineering from Northwestern University and a BS in Automatic Control from Tsinghua University. His main research focus is operations management under financial frictions, and his other research interests include supply chain management and risk management. His work has appeared in leading operations journals, including management science and MSOM and finance journal. Alex has working and consulting experience in companies including Citadel Investment Group and United Airlines.