

# BCMA

Business Credit  
Management Association

April 2021

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*E~ Credit News*

# LAST CHANCE

Register  
Online



## BANKRUPTCY BASICS

What Every Credit Pro Needs to Know  
TWO One-Hour WEBINAR Sessions  
April 12 & 19, 2021

BANKRUPTCIES ARE OCCURRING MORE OFTEN - PREPARE

In this two-part program, we will examine:

- How to protect your company
- How to limit your risk
- Creditors' rights in bankruptcy
- Risks and benefits of selling to a bankrupt debtor
- Your reclamation rights
- Preference claims
- Proof of Claim form
- Mistakes creditors make when filing that Claim



**Monday April 12 | 9 - 10:00 AM CT**

**CLASS #1** – Your learning experience includes:

- Overview of the Bankruptcy process
- How to protect your company & limit your risk
- Explanation of the types of Bankruptcies and their role in your decisions
- Things to do after a Bankruptcy
- Priority claims
- Bankruptcy fast facts

**Monday April 19 | 9 - 10:00 AM CT**

**CLASS #2** – Your learning experience includes:

- Your rights in Bankruptcy
- Risks & benefits of selling to a Bankrupt debtor
- Reclamation rights
- Preferences in Bankruptcy
- The Proof of Claim form & common mistakes made with the form
- Myths about Bankruptcy

# WHAT HAPPENED TO MY CREDIT INSURANCE?

BY: STEVEN C. ISBERG, PHD

SENIOR FELLOW, CREDIT RESEARCH FOUNDATION

CHAIR, DEPARTMENT OF ACCOUNTING, TOWSON UNIVERSITY

Why is it becoming difficult, if not impossible, to buy credit insurance when I need it the most? It's not that the premiums are high: I can't even find it! Have things gotten to the point where credit insurers no longer want to take the risk of offering policies? Do they expect that so many accounts will fail to pay that they can't afford to insure them right now? Isn't there some premium at which the insurers will sell me a policy? When will I be able to find it again?

It seems like the answers to those four questions are: "Yes," "yes" "no," and "it may be a while!" What's happening in the credit insurance industry can be better understood in the context of two fundamental concepts of financial analysis and asset pricing: option theory, and the difference between risk and uncertainty.

## **Option Theory**

One way to look at insurance is as an option. In finance, the most basic options are the call and the put. The call is a contract that enables the contract owner (the long position) the right to buy a certain asset from the contract seller (the short position) at a predetermined price (the strike or exercise price) up to a particular point in time (the expiration date). The put is a contract enabling the contract owner (the long position) to sell a certain asset to the contract seller (the short position) at a predetermined price up to a particular point in time.

Options are exercised either up to or at expiration based on the difference between the market price of the asset on which the option is written and the exercise (strike) price of the option itself. For example, if I own (am in the long position) a call option to buy 100 shares of Alphabet stock at \$1,600 per share, I might want to exercise that option today because the market price of the stock is \$1,629. I could also wait to see if the price increases further prior to the expiration of the option. If I were to exercise the option, the seller of the option contract would be obligated to pay me the difference between the market and strike price of the stock. If the stock price were to fall below \$1,600 by the time it expires, the option would go unexercised.

A put option is the opposite in that it gives the owner of the contract the right to sell the underlying asset. In the case of a put option, I might own the right to sell 100 shares of Alphabet stock at \$1,600 per share. I would exercise the option if the market price were to fall below that level. If the price were to remain above the strike price in the case of a put, the option would expire unexercised.

Options are a zero-sum game in the financial markets. The price of a contract is paid by the long investor up front, and the option is exercised against the short investor when it closes out. If exercised, the long position gain is equal to the short position loss, as the contract seller must pay the contract buyer the difference between the asset and strike prices. If unexercised, the long position loses the price it paid for the option, which is the gain to the short position. The price of an option is based on a volatility model in which the contract is valued based on the likelihood that it will be exercised.

As a result of their structure, options have greater value in highly volatile asset pricing conditions. The greater the upside (prices increasing) volatility, the greater the value of a call option. The greater the downside (prices decreasing) volatility, the greater the value of a put option. A simple option pricing formula shows that the value of both call and put option contracts are determined by the same measure of asset price volatility, which ends up being a statistical measure of variance. The more predictable the statistical variance measures for the underlying asset prices, the greater the ability to accurately price an option.

## WHAT HAPPENED TO MY CREDIT INSURANCE (CONTINUED)

The price of an option is driven by the likelihood that it will be exercised. As the likelihood of exercise increases, so does the value of the option. As soon as it is realized that the option will not be exercised, the option value will fall. The price of an unexercised option will fall immediately to zero upon its expiration.

### ***Risk versus Uncertainty***

In common language, the terms of risk and uncertainty often become synonymous and interchangeable, but in the field of finance they have distinct meanings. These distinct meanings apply to how we are able to understand the nature of underlying asset volatility.

The use of statistics in asset pricing assumes that we know something about the nature of the pricing process that leads to the pricing outcomes we observe in a market. In statistical terms, this means that we understand the parameters of the probability distribution of the prices of assets. Such an understanding allows us to more accurately measure the statistical likelihood that asset prices will end up in a certain range, and I can assign a probability to each outcome. "Risk" is the condition in which we have enough data and experience to understand the parameters of the asset pricing probability distributions and therefore more accurately predict ranges of outcomes. This enables us to more accurately estimate variance measures (volatility). More accurate measures of volatility lead to more accurate option pricing measures as well. Under conditions of risk, we know that there will be volatility, but its effects become easier to predict and therefore manage.

A good example of an event taking place under conditions of risk would be the throwing of two six-sided dice in that we have a complete understanding of the parameters of the probability distribution of the outcomes. We know that the outcomes are limited to values ranging between 1 and 12. We know that the most likely outcome is a seven, and we know that the probability of that outcome is 1/6, or 16.67%. As the outcomes are predictable, I can also manage the risk incurred in throwing the dice.

Uncertainty describes a condition in which we do not have an understanding of the parameters of the probability distribution of future asset prices. Such a case usually arises when something completely new and/or different is happening in the markets or economy. In such a case, we don't have enough data to begin to form an understanding of the economic processes that lead to the probability distribution of financial economic pricing outcomes. In the absence of such understanding, it becomes difficult, if not impossible to measure expected outcomes and the volatility associated with each. Pricing becomes more difficult.

### ***Pricing under Risk and Uncertainty***

If we were to look at this on a continuum, we would start on one side with conditions of total certainty, and end on the other side with conditions of total uncertainty. What lies along the continuum would be conditions beginning with risk on the left and becoming more uncertain as we move toward the right. In regard to asset pricing, we tend to use expected cash flow models under conditions of risk. When we use discounted cash flow models, higher risk tends to reduce asset prices and lower risk increases them, as the cash flows become less or more volatile, respectively.

As we move toward greater uncertainty, we tend to rely more on option pricing models, which rely more on pure volatility parameters rather than expected cash flows. Under conditions of uncertainty, assets are usually priced under the assumption that higher volatility exists, even though we don't necessarily understand the statistical nature of that volatility.

A good example of asset pricing under uncertainty is the dot.com market of the late 1990s. While we had mountains of statistical data regarding the performance of bricks and mortar businesses, we had little or no

## WHAT HAPPENED TO MY CREDIT INSURANCE (CONTINUED)

data on which to base estimates of the potential performance of internet-based commerce. As a result, dot.com stocks were priced more like call options in which the upside potential was so great, the asset itself was worth a higher price. The five-year period of consistent price increases that we observed was the result of investors continuing to renew the option positions in the anticipation of that upside growth.

By the end of five years, it was becoming more apparent as to which dot.com companies were going to succeed, and which were not. In statistical terms, we began to understand the underlying dynamics of the probability distribution of outcomes and were more able to accurately value those outcomes. As with an unexercised option, values of companies that were not expected to succeed spontaneously fell to zero as investors declined to exercise the option to invest in the next level of corporate development. This explains the sudden and dramatic loss in value experienced in the dot.com sector. This created a contagion effect that unfortunately spread to the entire market, but from which the market eventually recovered as pricing realigned with the expected reality.

### **Credit Insurance as a Put Option**

When I purchase credit insurance, I am essentially taking a long position in a put option in which the underlying asset is my credit portfolio. In the event that my accounts become uncollectible, i.e., the value of the underlying asset falls, I exercise the put option which enables me to “sell” those accounts to my credit insurer. The value of the option, if exercised, represents the difference between the value of my credit portfolio (the underlying asset) and the dollar amount of coverage that I have paid for (which is essentially the strike price of the put option). If I don’t realize the full value of the portfolio by collecting the accounts, the insurer pays the difference up to a covered amount.

The premium charged by the credit insurer is based on the perceived volatility in my credit portfolio. The more accurately the insurer can measure that anticipated volatility, the more accurately it can set the price or insurance premium that I am paying for the put option.

The COVID outbreak has led us into a condition of greater uncertainty in the economic markets. This has made the process of accurately estimating economic statistical parameters virtually impossible. The inability to accurately measure these parameters makes it difficult, if not impossible to accurately price certain options such as credit insurance. Insurers have absolutely no idea what to expect, and therefore little or no idea how to accurately price and place credit insurance policies. Even if they could come up with a price, it would probably end up being so high that no one would be willing to pay it.

As conditions settle and we move back from the realm of uncertainty into conditions of risk, we should expect to see the credit insurance market stabilize and return to more of a normal state. In the meantime, we will be gathering more data to enable us to understand the impact of an event such as this pandemic on the economy, and we will be able to more accurately incorporate these expectations into market pricing in the future.

#### About the Author:

Steven C. Isberg is the Chair of the Department of Accounting at Towson University. He teaches graduate and undergraduate courses in corporate finance, financial analysis and valuation, and financial economic history. As Senior Research Fellow at the Credit Research Foundation, he conducts various research studies and delivers online financial analysis courses as part of the CRF Online Classroom™ program.

Steve has over 25 publications in academic and professional journals and has served as a professional business consultant to a variety of firms. He frequently appears or is quoted in television, radio, and print media on financial and economic issues.



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## UPCOMING INDUSTRY CREDIT GROUP MEETINGS

### APRIL 9, 2021

Electrical Suppliers Industry Credit Group  
Teleconference Call

### APRIL 13, 2021

Fine Paper/Graphic Arts Industry Credit Group  
Book of Reports Only  
Regional Paper & Packaging Industry Credit Group  
Teleconference Call

### APRIL 14, 2021

Plumbing & Heating Industry Credit Group  
Teleconference Call

### APRIL 15, 2021

Construction Industries Credit Group  
Teleconference Call

### APRIL 16, 2021

IL Fine Paper Industry Credit Group  
Teleconference Call

### APRIL 19, 2021

Western Electrical Suppliers Industry Credit Group  
Book of Reports Only

### APRIL 20, 2021

Building & Construction Materials Credit Group  
Teleconference Call

### APRIL 21, 2021

Minnesota Electrical Suppliers Credit Group  
Teleconference Call  
Food Service Supply Hospitality & Food Suppliers  
Industry Credit Groups  
Teleconference Call

### APRIL 28, 2021

Iowa Plumbing Heating Electrical & Construction Industry  
Credit Group  
Teleconference Call

### No Meeting this month

Metals & Industrial Suppliers Credit Group  
Minnesota Fine Paper Credit Group

**BCMA**  
Business Credit  
Management Association

## Education Events

**April 12 & 19, 2021**

[“BANKRUPTCY BASICS” WEBINAR](#)  
[WHAT EVERY CREDIT PRO NEEDS TO KNOW](#)

**April 12 & 19, 2021**

[ICE BREAKER WEBINAR ~ THE PERFECT STORM](#)

[HOW TO MEASURE & IMPROVE CREDIT](#)  
[DEPARTMENT PERFORMANCE](#)

**May 20, 2021 | 9:00 –10:00 AM CT**

**Details are still being ironed out**

“Credit Decision Making” Webinar  
**June 16, 2021 | Time TBD**

“How the Credit Department can Damage Its  
Relationship With Sales” Webinar  
**July 20, 2021 | Time TBD**

CHECK OUT OUR [CALENDAR](#) FOR MORE UPCOMING EVENTS.

YOU CAN TRUST THE ASSOCIATION TO ASSIST IN [COLLECTION RECOVERY](#) FROM YOUR  
DEBTORS ANYWHERE IN THE WORLD.