Trade Credit Insurance: Operational Value and Contract Choice

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Published Online: 1 Jul 2020 | https://doi.org/10.1287/mnsc.2019.3571

Abstract

Trade credit insurance (TCI) is a risk management tool commonly used by suppliers to guarantee against payment default by credit buyers. TCI contracts can be either *cancelable* (the insurer has the discretion to cancel this guarantee during the insured period) or *noncancelable* (the terms cannot be renegotiated within the insured period). This paper identifies two roles of TCI: the (cash flow) *smoothing* role (smoothing the supplier's cash flows) and the *monitoring* role (tracking the buyer's *continued* creditworthiness after contracting, which enables the supplier to make efficient operational decisions regarding whether to ship goods to the credit buyer). We further explore which contracts better facilitate these two roles of TCI by modeling the strategic interaction between the insurer and the supplier. Noncancelable contracts rely on the deductible to implement both roles, which may result in a conflict: a high deductible inhibits the smoothing role, whereas a low deductible weakens the monitoring role. Under cancelable contracts, the insurer's cancelation action ensures that the information acquired is reflected in the supplier's shipping decision. Thus, the insurer has adequate incentives to perform its monitoring function without resorting to a high deductible. Despite this advantage, we find that the insurer may exercise the cancelation option too aggressively; this thereby restores a preference for noncancelable contracts, especially when the supplier's outside option is unattractive and the insurer's monitoring cost is low. Noncancelable contracts are also relatively more attractive when the acquired information is verifiable than when it is unverifiable.

This paper was accepted by Vishal Gaur, operations management.

Volume 67, Issue 2

February 2021

Pages 661-1328, iii-iv

Article Information

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Information

Received: March 21, 2019
Accepted: December 13, 2019
Published Online: July 01, 2020

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Cite as

S. Alex Yang, Nitin Bakshi, Christopher J. Chen (2020) Trade Credit Insurance: Operational Value and Contract Choice. Management Science 67(2):875-891.

https://doi.org/10.1287/mnsc.2019.3571

Keywords

insurance | risk management | trade credit | moral hazard | operations–finance interface

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