



Charterparty Credit Risk and Charterers' Default Insurance

In late 2006, market commentators described the bulk sector as 'unprecedented' and 'highly volatile' and yet the charter market continued to increase exponentially. The meteoric increase in hire rates encouraged a number of owners to charter in tonnage solely for the purpose of chartering the same vessel out at a higher rate in order to make a profit. Yet too few owners bought protection against counterparty default believing that they would be able to charter the vessel for an even higher amount if the counterparty failed to pay.

At the time it was recognised by too few that the principle of supply and demand of basic commodities was not sufficient explanation for the rise in charter rates and that there had not been a significant enough change in economic fundamentals to warrant the increase. Yet the market continued to rise for almost two more years until the third quarter of 2008. The reason for the crash is understood now, but at the time was unexpected as it occurred somewhat earlier than anticipated. The drop off in Chinese demand for iron ore after the Beijing Olympics couldn't compete with the bursting of the credit bubble, symbolised by the spectacular failure of a 150 year old financial institution in the US. A shock wave went through the western banking system and the resultant lack of liquidity had a dramatic impact throughout the world; confidence evaporated, international trade suffered, companies faltered and shipping companies were forced to renegotiate charter rates, some as a result of imminent insolvency. Perhaps the most shocking of these corporate failures in the shipping industry was Korea Line earlier this year.



Not surprisingly there has been a significant increase in interest from the shipping industry in the availability of Charterers' Default Insurance ever since the end of 2008. Appetite within the credit insurance market however was non-existent until the end of 2010. The credit insurance market as a whole will no doubt suffer criticism for failing to offer cover when it is most desired. However, the shipping industry must recognise that credit risk management is something that must be considered when markets are stable and insurance capacity is available. Although it would be foolhardy to suggest that the markets are stable currently, there is capacity within the insurance markets to provide protection on a range of counterparties, including Cosco Bulk.

Charterer default insurance is a bespoke insurance product that offers shipowners cover if their charterer defaults. Navios Maritime is the most well-known recent beneficiary of this product. The company inherited the policy when it acquired Belgian dry bulk operator Kleimar in 2007. The insurance cover, backed by Belgium's export credit agency Office National du Ducroire (ONDD), is typically only available to Belgian insureds; Navios benefited more significantly than perhaps they imagined, from the purchase of Kleimar. There are however other well rated European insurance carriers that will underwrite the risk, including one major one that is rated AA by Standard and Poors.

The insurance provides an indemnity against loss of hire resulting from a default by the vessel's charterer; it protects the owner against unpaid invoices, the cost of laying up the vessel between charters and most importantly any shortfall in hire realised at re-fixing.

So what is a typical loss scenario? Let's assume that the vessel has undertaken a six-week voyage and after one week the charterer fails to make a hire payment. Further investigation reveals that the charterer is unable to honour their financial obligations. The insurer accepts that the charterer is essentially insolvent and as such, any settlement of the outstanding charter hire is unlikely. The insurer indemnifies the insured for eighty percent of the unpaid hire invoices while the vessel completes the voyage and claim payment is made within 30 days. Once the vessel reaches destination, the owner takes redelivery of the vessel and if necessary repositions the vessel to facilitate a refixture. Whilst the vessel is laid up awaiting new employment, the insurer reimburses the insured for eighty percent of an amount equal to the loss of hire less any expenses the shipowner is saving by not operating the vessel e.g. bunkers. Once refixed, the insurer will typically indemnify one hundred percent of any shortfall in the charter hire for the balance of the indemnification period.

It is possible to structure protection that will extend beyond the point of uncertainty and then 'roll' the cover forward. The value of having bought cover in 2007 has never been more apparent than now. The financial landscape has changed for the foreseeable future; without doubt, regulators will be taking a much closer look at banks' activities. Investors too, will be ever more wary of the shipping sector and the impact that highly leveraged balance sheets can have on the industry as a whole.



An illustrative example of what default insurance could cost would be as follows: assuming the shipowner gets \$20m annual revenue from the charterer, the premium on a two-year policy indemnifying two years' worth of revenue would be around 2.5% of \$40m. For a two-year policy indemnifying seven years' worth of revenue, the premium would be higher, at around 6% plus of \$140m.

Charterer default insurance can prove attractive to those companies that want to keep counterparty risk to an absolute minimum, and are prepared to pay for it.

Baltic Dry Index (BDI) Source: Baltic Exchange

