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APPLICATION OF ASSET MANAGEMENT SERVICES FOR ISSUING FINANCIAL GUARANTEES BY INSURANCE COMPANIES

1. Introduction

One of the main characteristic features of financial guarantees market in emerging economies is constant, high demand for such products. On the one hand, at the time of slowing economy growth, high demand for financial guarantees is a result of increased liquidity problems of many companies, due to lower sales volumes and liquidity problems of their own clients, or even due to delays in state agencies payments. On the other hand, at the time of accelerating economy growth, the demand for financial guarantees increases due to higher sales volumes. The demand is also fuelled by law requirements, e.g. the law of public tenders [9].

In either case, the need for financial guarantees comes from investor requirements, which need to be fulfilled by prospective contractors. Unfortunately for the latter, it is not easy to buy and use such guarantees instead of cash, in order to meet the requirements of the investors, who in this case are the beneficiaries of the guarantees.

One of the most common obstacles in obtaining a financial guarantee is the financial and legal situation of the applicant, which may be below the requirements of the issuers. Very often there are also problems in fulfilling the needs of the investor concerning the provisions of the guarantee. Also the key element of the guarantee issuer's subsequent claims to the obligor cannot be ignored. Even companies with a high level of their own assets, due to large number of pending contracts come to a point when they can no longer submit additional assets which could be used as a collateral for subsequent guarantees.

A question arises then: do contractors, facing such requirements of the creditor, unable to give an additional asset as a collateral, have to put cash as a collateral?

The cash which will be stored on the creditor's current account, paying only about 1% interest rate per year, with the risk to the contractor that he may not get it back, e.g. due to bankruptcy of the investor? Or is there any other alternative, which will give the contractor proper profitability above its cost, eliminate the risk of not getting the collateral back, and at the same time will be accepted by the insurance company as a collateral?

Before we try to answer these questions, let us analyze at least some basic issues concerning the issuance of the guarantees and asset management services.

2. Basic issues concerning the issuance of guarantees

It is obvious that the requirement of giving a guarantee of contract realization, e.g. financial guarantees, comes from the lack of certainty on the part of the creditor if the counterparty are going to fulfill the provisions of the underlying contract. In every contract the creditor is subject to a risk of a financial loss if the contractor does not fulfill or fulfills improperly the statutes of the contract. In order to lower this risk, the investor requires from the counterparty a sufficient guarantee. In this case the best collateral for the creditor is of course the most liquid one, which is cash, i.e. cash bail or blocked deposit account. But for the contractor this is obviously the worst possible collateral he can give, because this money should be used in a more profitable activity, e.g. in its own enterprise.

However, there are financial services and products which make it possible to solve this conflict of interest: these are financial guarantees issued by insurance companies and banks. They bring to the contract a third party, a guarantor, which must be a reliable and trustworthy public institution. Another important issue is that the issuer of the guarantee does not make a bill guarantee, but actually takes over the contractor's full obligation. Such construction of the guarantee improves the guarantee beneficiary's safety, because it creates an additional commitment from a reliable institution. Insurance companies enjoy high credibility, which comes from the fact that they are strictly controlled by the state.

Another important characteristic of the financial guarantee is that from the contractor perspective the guarantee itself does not give him any protection in case of any demand from the beneficiary. This is because a financial guarantee, unlike an ordinary insurance, does not transfer the underlying risk from the contractor to the insurer, as e.g. a civil liability insurance does.

The aim of issuing a financial guarantee, apart from the protection given to the beneficiary, is to give an additional assurance of the contractor's credibility. This comes from the fact that its legal and financial situation has been positively verified by professional institution – an insurance company. It is the most important purpose of the advance payment guarantee, which makes it possible for the contractor to raise necessary capital for executing the contract. Therefore financial guarantees help to improve the contractor's liquidity and its profitability by lowering the capital needs of the company.

Figure 1 shows basic mutual relationships of entities involved in a financial guarantee contract.

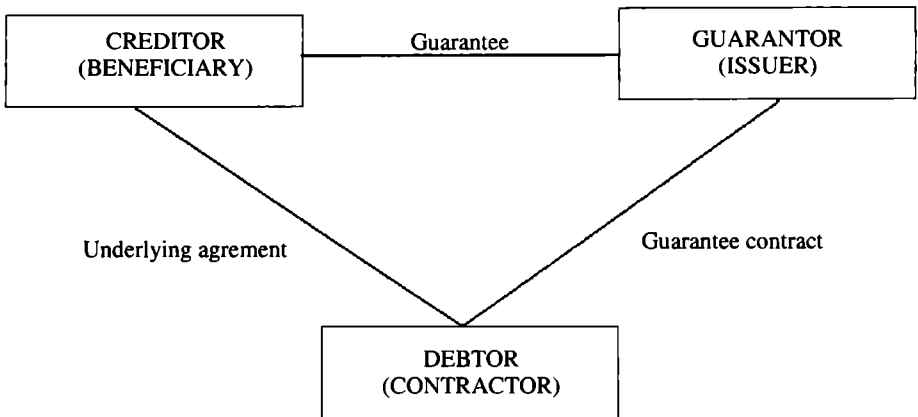


Fig. 1. Basic mutual relationships of entities involved in a financial guarantee contract
Source: own study.

The creditor signs with the debtor an agreement, e.g. a construction contract. It is the contract which the requirement of submitting a performance guarantee stems from. Then the debtor and an insurance company sign a guarantee contract, which is the basis for issuing a guarantee for the creditor. It should be noticed that the guarantee itself is rather abstract in nature, i.e. it is separated from the basic agreement which it guarantees.

In theory everything seems simple. But in practice it is not always so, because many contractors, executing many contracts at the same time, have problems with fulfilling those requirements. In practice it boils down to the problem of having sufficient collateral for the insurance company. The contractor, for the price of the guarantee, does not buy any protection from the beneficiary's claims, but receives an instrument that confirms his credibility and improves his own liquidity and profitability, as more cash stays in the company. The contractor still bears the responsibility to the beneficiary and, additionally, to the issuer of the guarantee. The former comes from the provisions of the underlying contract, the latter from the guarantee contract, which specifies the obligation to return the amount that the issuer of the guarantee had to pay for the obligation of the contractor. That is why insurance companies, before issuing a guarantee, require sufficient collateral for its possible subsequent claims, such as a third party guarantee, mortgage, deposits, contingent transfer of ownership, and any other collateral permitted by the law.

It is the lack of sufficient collateral, along with poor results of insurance company scoring of the legal and financial situation of the contractor, that is usually the main source of difficulty with obtaining guarantees. Recently, another problem has

appeared - a discrepancy between beneficiary's constantly increasing requirements regarding guarantee provisions (guarantee specimen) and the standard guarantee provisions offered by insurance companies. In practice, however, it can all be reduced to the question of a proper and sufficient collateral for the insurance company.

Now, we have to reconsider the following: if the insurance company receives safe and liquid collateral of the guarantee, which will cover its possible future claims, will it be able, for a certain price, to modify the provisions of the guarantee, so as to fulfill the beneficiary's requirements? And will it be able to issue the guarantee for a contractor whose credibility is slightly worse than the issuer's requirements, especially in case of a well known company with a reliable track record?

3. Overview of asset management service

In the asset management service, also called managing investment portfolios, clients entrust their funds to a dedicated company, which professionally invests their money on capital market and aims to increase the funds value.

Asset management companies operate as brokerage houses under the Polish law. Polish Securities and Exchange Commission grants the licenses and conducts strict supervision of brokerage houses. The clients' funds are managed by the company specialists, possessing necessary knowledge and experience in the field of investment management. These are usually licensed investment advisors and CFA charterholders. Investment decisions are made collectively by the Investment Committee.

Asset management service is a prestigious product, designed only for companies and wealthy private investors. Generally, clients should have funds exceeding 100 000 PLN.

Asset management companies offer wide spectrum of investment strategies, with diverse level of expected rate of return and risk. To match the investment strategy with the investor's profile, the questionnaire research is carried out, in which the client informs the asset management company about the ratio of the funds dedicated to the portfolio to his/her overall property, their future plans concerning the use of funds, their knowledge about the field of investments, education, experience in investments, expected investment horizon and liquidity needs. The asset management company analyses the client's investment objectives and constraints, in order to choose the most suitable strategy.

The majority of clients choose one standard investment strategy, which allows for investments in most popular asset classes, such as Polish equities, bonds or bills. The most popular standard investment strategies are:

- Equity portfolio (up to 100% equities in portfolio).
- Balanced portfolio (on the average, 50% equities in portfolio).
- Stable growth portfolio (on the average, 30% equities in portfolio).

- Bond/Money Market portfolio (0% equities in portfolio).

Some asset management companies, including Wroclawski Dom Maklerski SA, also offer active allocation portfolios (e.g. equity dynamic allocation portfolio), which adjust the share of equities in a portfolio to the current situation on the capital market. Asset managers increase the exposure to the equities in anticipation of rising equity prices and decrease it in anticipation of falling equity prices. For clients interested in global investing (including investments in emerging markets, such as Turkey, Russia, Brazil, China or India) some asset management companies prepare investment portfolios denominated in EUR or USD.

To clients with funds exceeding 1 000 000 PLN asset management companies offer the possibility of preparing an individual investment strategy. In such case the spectrum of investment vehicles is broadened, e.g. there are strategies available with exposure to currency market, commodities or hedge funds.

The client signs a portfolio management contract and gives the asset management company the power of an attorney to conduct portfolio management activities. The client can open a brokerage account by himself or have it done by the asset management company. Through the whole life of the contract, the account belongs to the client. This insures the safety of the funds, because all the time they are located on the client's account. This is feature becomes especially important when the asset management service is used for creating an insurance guarantee collateral.

Within the limits of the power of the attorney, the asset management company acts on behalf of and on the account of the client and can e.g. buy and sell financial instruments. The client receives periodical reports on portfolio management, which include the list of instruments held in the portfolio and all transactions made during the last reporting period. The client also has the right to directly contact the investment advisors team that manages his portfolio.

4. The role of the asset management company in the process of issuing a financial guarantee

In what follows we will analyze the possibility of using an asset management company in the process of issuing a financial guarantee by an insurance company, on the example of Wroclawski Dom Maklerski SA.

The main idea is for an insurance company to issue financial guarantees using asset portfolio held on brokerage account as a collateral. The portfolio consists of securities with the value at least equal to the amount guaranteed, which otherwise would have to be submitted in cash. In this way a financial guarantee is made available to the contractor who would not be able to purchase it due to his own insufficient credibility or special provisions of the guarantee required by the beneficiary. The cash used here as a collateral is not blocked on a current account but

rather on a brokerage account managed by a professional asset management company.

This gives the contractor two very important advantages. First, his financial resources are not inefficiently blocked for e.g. five years on the beneficiary's current account, which is the general practice in the case of long term maintenance guarantees, but they are efficiently managed, yielding higher return, owing to the asset management services. Second, the contractor avoids the risk of not getting the collateral back, which can happen in case of the beneficiary's bankruptcy, because the collateral is held on an account that belongs to the contractor.

Here we can also see an additional positive effect of the proposed solution, which concerns the contractor's balance sheet. This effect is very important for the contractor when he and his financial statements are scored by e.g. a bank making decision on a credit or an insurance company considering the issuance of a financial guarantee to the contractor. In the process of the analysis of financial situation of any company conducted by a bank or an insurance company, a debtor with a portfolio of securities on his own brokerage account managed by an asset management company, will look much better than the one who is not going to use the proposed solution, showing on the balance sheet only the receivables from the creditor, which is often a risky private company.

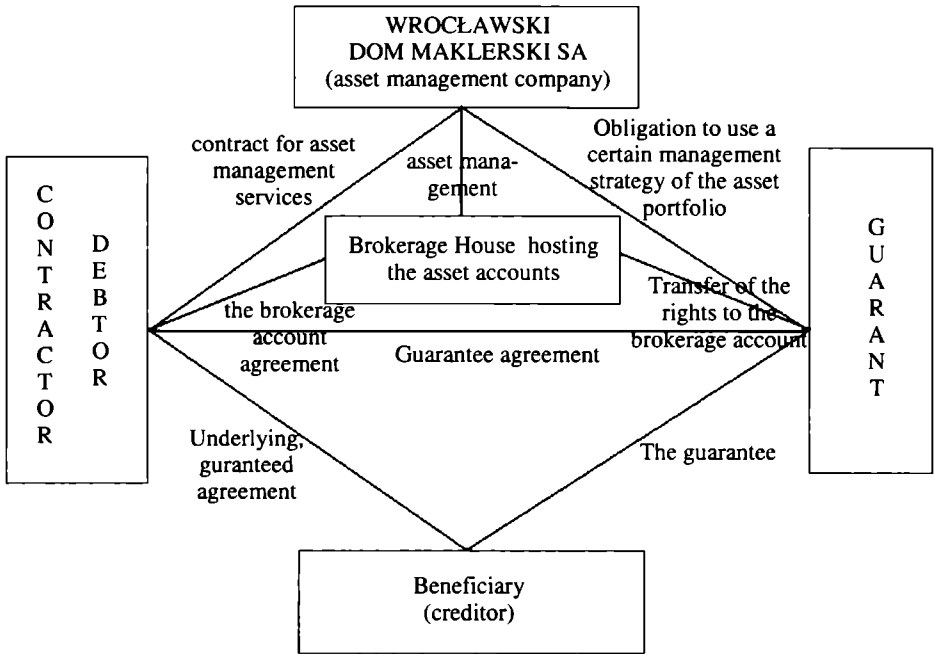


Fig. 2. The role of the asset management company in the process of issuing a financial guarantee
Source: own study.

In the latter case, there is a high risk of not getting back the provided cash collateral. The risk is much more serious than the risk of the debtor's asset portfolio

falling below the initial value, e.g. due to mistakes in the portfolio management process, because of the professional character of the asset management company and because of all safety features concerning such activity.

Our own practice in the field shows such odd cases as the payment of 5 units made by the contractor for a guarantee which amounted to 4 units. This was justified on the one hand by the contractor's knowledge of serious problems of the beneficiary, and his conviction that the beneficiary will go bankrupt before the expiration of the guarantee, and on the other by the positive tax effect (30% tax at that time) of 0,5 unit. It is obvious that the insurance company issued the guarantee on spec.

A question arises here, which asset management strategy is optimal form the point of view of the issuer of the guarantee. It seems that the key elements that should be considered when choosing a portfolio strategy are the investment horizon and the expected risk of the strategy.

The investment horizon depends on the type and nature of the guarantee. For **short term guarantees** (tender, advance payment and short term performance guarantees), the investment horizon is generally short (up to one year). In this case the investment strategy should focus on safe and liquid securities (T-bills, short term bonds). The aim of this strategy is to increase the value of the portfolio achieving higher rate of return than short term bank deposits. It ensures higher liquidity as well as profitability, at the same time minimizing the investment risk.

For **long term guarantees** (long term performance guarantees and maintenance guarantees), a longer investment horizon (above one year) allows for a more risky strategy, e.g. investments in publicly traded common shares.

The insurance company is interested in low or medium (moderate) investment risk, so the probability of the portfolio falling below initial value is very low. Some degree of risk is however desirable, because the expected rate of return depends on the risk taken. The higher the risk taken, the higher the expected rate of return of the portfolio. A higher rate of return increases the value of the portfolio thus increasing the value of the collateral of the guarantee, which benefits the issuer of the guarantee.

That is why it makes sense to include in the portfolio (in case of long term guarantees) also more risky assets, such as publicly traded common shares of Polish companies. To keep the level of risk at a reasonable level, the share of the investment in equities should not significantly exceed 30% of the portfolio. Such structure of the portfolio resembles the structure of pension funds portfolios, which invest money for retirement of all Poles, so they are obliged to keep the level of risk at reasonable level. Figure 3 shows the portfolio value of four biggest Polish pension funds: CU, ING NN, PZU, AIG, starting from time they were established, in the period between 1999 and 2006. In fact, a 30% share of common stock in the portfolio ensures its stable growth. Medium growth of those four portfolios in the specified period amounted to 140%, which gives the average yearly rate of return of 16%.

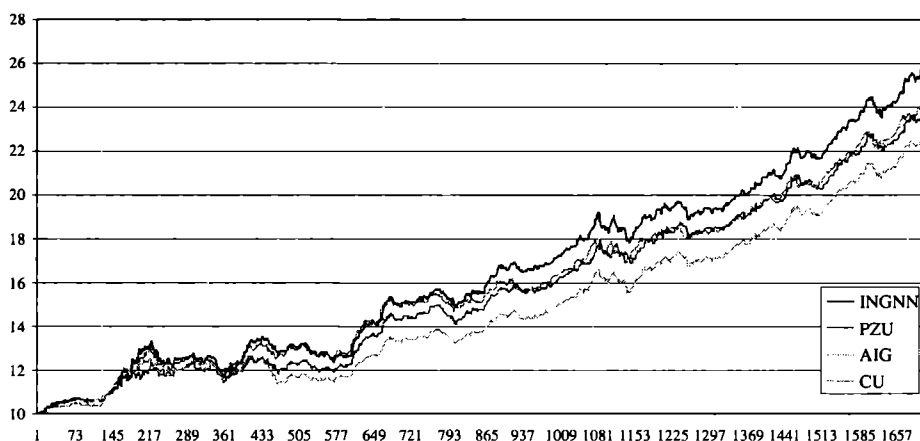


Fig. 3. The portfolio value of four biggest Polish pension funds: CU, ING NN, PZU, AIG, starting from time they were established, in the period between 1999 and 2006
Source: own study.

If we compare the above with the price of a financial guarantee, which for the period of above one year amounts to about 2% per year, the advantages for the contractor using asset management portfolio as a collateral are obvious. From the perspective of the contractor it is important that all necessary contracts and documents in the process of issuing the guarantee are not too problematic in nature and the cost of the process, apart from the cost of the guarantee and asset management services, stays at a reasonable level. This is where the idea of creating the WDM Financial Group came from. The group, which consists of a securities brokerage house and an insurance brokerage company, gives comprehensive services for such transactions, which is to the benefit of both the client and the insurance company.

5. Economic conclusion

The analysis presented above shows that asset management companies can be very useful in the process of issuing financial guarantees by insurance companies, helping both the companies required to submit guarantees and the insurance companies. The asset management services bring a new quality into the relationships between the insurance companies, debtors and creditors.

The creditors are given sufficient guarantee of their contract in the form of financial guarantee of the insurance company, which gives them desired security.

The debtors avoid inefficient long term blocking of their cash on the creditor's current account and, owing to asset management services, obtain an additional profit which exceeds the cost of the guarantee. They also eliminate the risk of not getting the submitted collateral back, which might happen in case of the creditor's bankruptcy.

The insurance companies are also beneficiaries of the proposed service, because they can issue the guarantees to companies that they would otherwise reject, collecting more premiums and gaining clients for their other products. In practice, an insurance company issuing a guarantee to a client usually also sells him other services. It is up to the insurance company how to secure their rights to the money placed as collateral on the brokerage account, e.g. by blocking the account with a proper proxy, transferring the right to the account to the insurance company, or some other means.

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WYKORZYSTANIE FIRM ZARZĄDZAJĄCYCH AKTYWAMI W URUCHAMIANIU GWARANCJI UBEZPIECZENIOWYCH

Streszczenie

Przedstawiona analiza zagadnienia wykazuje, że firmy zarządzające aktywami mogą być bardzo pomocne w uruchamianiu gwarancji ubezpieczeniowych, czyli wprost w ułatwianiu funkcjonowania firm zobowiązanych do przedkładania gwarancji oraz zakładów ubezpieczeń. Działalność firm *asset management* wprowadza więc nową jakość w relacjach zakłady ubezpieczeń – dłużnicy – wierzyciele. Wierzyciele otrzymują wymagane zabezpieczenia w formie gwarancji ubezpieczeniowych wydawanych przez instytucje zaufania publicznego, co dobrze zabezpiecza ich interesy. Dłużnicy unikają bezproduktywnego zamrażania na rachunkach bieżących wierzycieli sporych kwot na długie okresy (nawet 5 lat), osiągając nadwyż-

żących wierzycieli sporych kwot na długie okresy (nawet 5 lat), osiągając nadwyżkę finansową dzięki usłudze firmy *asset management*, której efekty kilkukrotnie przewyższają koszty związane z uruchomieniem gwarancji ubezpieczeniowej. Pozbywają się również istotnego ryzyka upadłości wierzyciela i braku zwrotu zatrzymanych kwot. Z kolei zakłady ubezpieczeń mogą uruchamiać gwarancje w sytuacjach, w których byłoby to dotychczas niemożliwe, zarabiając w ten sposób na tej działalności oraz powiększając swój portfel klientów, bowiem pewną praktyką rynkową jest to, że niejako obok gwarancji realizuje się inne ubezpieczenia majątkowe. Kwestia zaś wyboru jakości zabezpieczenia w tym przypadku zależy w zasadzie tylko od zakładu ubezpieczeń, np. blokada rachunku maklerskiego ze stosownym pełnomocnictwem do niego, przywłaszczenie tegoż rachunku czy jeszcze inne rozwiązanie.