RESEARCH ARTICLE

Loan Insurance

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Abstract

The process of granting loans is among the most important activities carried out by commercial banks. As a result of engaging in these activities, they are exposed to many risks, foremost among them credit risks arising from the client's inability to repay their financial obligations or delay in doing so within the agreed period.

These risks can affect the financial position of the bank, and to avoid their effects, banks resort to the mechanism of loan insurance, which is carried out by insurance companies that enjoy financial trust through their commitment under a regulated contractual legal framework to bear and manage most of the risks in return for a certain cost they receive.

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Introduction

The loan process is one of the most important banking operations performed by banks, as it is the means that helps transfer capital from surplus owners to deficit owners. Moreover, the loan itself is considered the main driver of development and economic progress, as it enables individuals to borrow to meet their social needs, which often relate to basic life demands such as housing, and it also enables stakeholders in real estate development activities to finance their projects.

These positive aspects of loans are counterbalanced by negatives in the form of various risks associated with it, most importantly the client's inability to fulfill their financial obligations or delays in repayment, which can cause the bank's financial position to be shaken. This has led banks today to seek sufficient guarantees parallel to the granted loan, whether personal guarantees such as surety and reserve guarantees or real guarantees such as official pledge and possessory pledge, in addition to newly developed guarantees, including loan insurance.
From here, the question arises: How effective is loan insurance in protecting banks from risks resulting from the lending process?

This is what we will attempt to answer according to the following plan:

First topic: The concept of loan insurance.

- **First Section:** Definition of loan insurance and its legal nature.

- **Second Section:** Scope of loan insurance.

Second topic: Bodies responsible for loan insurance and how they manage loan risk.

- **First Section:** Bodies responsible for loan insurance.

- **Second Section:** How loan risk is managed.

Conclusion.

Chapter One: The Concept of Loan Insurance

Loan insurance is among the newly introduced guarantees approved by the Algerian legislator to keep pace with global developments in the banking field and as a goal to join the World Trade Organization. Accordingly, through this topic, we will discuss the definition of loan insurance and its legal nature (first requirement), and then we will address the scope of loan insurance (second requirement).

First Secion: Definition of Loan Insurance and its Legal Nature

Loan insurance is among the guarantees that help strengthen trust between the bank as creditor and the client as debtor. In this requirement, we will first define loan insurance (first branch), then address the legal nature of loan insurance (second branch).

First Branch: Definition of Loan Insurance

In this branch, we will first define insurance (first), then define the loan (second), and then define loan insurance (third).

First: Definition of Insurance

Insurance has a linguistic definition (1), a terminological definition (2), and a legal definition (3).

1- Linguistic definition of insurance:

Insurance[1] linguistically means security, reassurance, and removal of fear.

2- Terminological definition of insurance:

Insurance in financial terminology means providing security. It is a commercial activity aimed at protecting individuals and companies from certain risks in exchange for financial compensation.[2]

3- Legal definition of insurance:

The Algerian legislator defined insurance under Article 619 of the Civil Code as: "A contract whereby the insurer undertakes to pay the insured or the beneficiary, for whom the insurance is stipulated, a sum of money, income, or any other financial compensation upon the occurrence of the accident or risk specified in the contract, in exchange for a premium or any other payment made by the insured to the insurer[3]."

This is nearly the same definition found in Article 2, paragraph 1 of Law 06-04 relating to insurance.[4]

Second: Definition of Loan

The loan has a linguistic definition (1), a terminological definition (2), and a legal definition (3).

1- Linguistic definition of loan:

Linguistically, a loan is money given to another with the obligation to return it after a specified period[5]. The word "loan" has many synonyms in Arabic, including credit and advance[6].

2- Terminological definition of loan:

Some jurisprudence defines the loan as: "A contract whereby a person called the lender places something at the disposal of another person called the borrower, who may use it and undertakes to return it either in kind or an equivalent.[7]"

Another view defines it as: "Lending money for investment in production, based on two elements: trust and duration. The loan or credit corresponds to the word credit, derived from the Latin creditum, taken from credere, meaning to believe or to trust."[8]

3- Legal definition of loan:

Article 450 of the Civil Code defines consumer credit as: "A contract whereby the lender commits to transfer ownership of a sum of money or any fungible thing to the borrower, who must return the equivalent in type, quantity, and quality at the end of the loan."[9]

Article 68 of Order No. 03-11 concerning currency and credit defines the loan as: "Any act for consideration by which a person places or promises to place funds at the disposal of another person or assumes an obligation for the benefit of the other person, such as reserve guarantee, surety, or other guarantees.[10]"

Third: Definition of Loan Insurance

Jurists differ in providing a comprehensive definition of loan insurance. Some define it as: "A means adopted by the institution performing a sales operation, whereby it insures the risk of its client."[11]

Others define it as: "A system that allows creditors, in exchange for a premium paid to the insurer, to be covered against the risk of non-payment of debts due by persons initially known and in a state of payment default."[12]

Another view describes it as: "A contract between a creditor and an insurer, whereby the insurer undertakes, in exchange for premiums it receives, to compensate the creditor for losses that may result from failure to collect debts or insolvency of the debtor."[13]

Based on the above definitions, loan insurance can be said to be a means of guaranteeing the loan, to which the bank or financial institution resorts by contracting with an insurance company that undertakes to guarantee or compensate in the event of the borrower's insolvency or default, in exchange for premiums paid by the bank.

These definitions mainly pertain to domestic loan insurance subject to Order 95-07[14] related to insurance.

Second Branch: Legal Nature of Loan Insurance

The legal nature of loan insurance has sparked various questions and debates among scholars who tried to express their differing opinions. Thus, in this branch, we will discuss the jurisprudential stance on the legal nature of loan insurance (first) and then the position of the Algerian legislator (second).

First: Jurisprudential stance on the legal nature of loan insurance

Jurisprudence is divided into two camps regarding the legal nature of loan insurance, each supporting its view with arguments.[15]

First camp:

They consider loan insurance merely an activity under the jurisdiction of financial institutions, not an insurance contract. Their argument is that in loan insurance, the insurer pays compensation when the debtor stops paying the debt within the agreed term, which contradicts a fundamental principle of insurance function—compensation is paid upon the occurrence of permanent loss of the creditor's right. The debtor's non-payment does not necessarily mean final loss for the creditor; therefore, it is a loan contract under financial institutions, not insurance companies.[16]

Second camp:

They see loan insurance as an insurance contract like other insurance contracts, characterized by the same features. Their argument is that the risk and damage arise from the commercial debtor stopping payment of debts, which harms the lending creditor, as it leads to bankruptcy declaration. This camp adds that if we subject loan insurance to general principles in civil law, it would prevent abuse by insurance companies.[17]

Second: Position of the Algerian legislator

The Algerian legislator classified loan insurance among damage insurances, which relate to the property of the insured. It is thus insurance on things, where the insurance company insures risks threatening the insured's property. This contrasts with personal insurance, which is subject to the compensation principle according to Article 623 of the Civil Code, which states: "The insurer is only obliged to compensate the insured for the damage resulting directly from the occurrence of the insured risk, provided that compensation does not exceed the insurance value."[18] From this article, it can be deduced that the compensatory nature of damage insurance prevents unjust enrichment of the insured at the insurer's expense and avoids intentional risk by the insured. Similarly, Article 30 of Order No. 95-07 on insurance states: "Property insurance grants the insured, in case of an event stipulated in the contract, the right to compensation according to the contract terms, not exceeding the replacement value of the insured movable property or reconstruction value of the insured immovable property at the time of the accident. The contract may stipulate a deductible for the insured, defined in advance."[19]

Second Section: Scope of Loan Insurance

The bank, as the insured party, faces many risks, including the risk of the client's insolvency or inability to pay within the agreed term. In this case, the bank resorts to insurance as a mechanism to avoid these various risks, which are a fundamental element of loan insurance. Therefore, in this requirement, we will discuss the diversity of loan risks (first branch), then the nature of the insured risk (second branch), and then the interest in loan insurance (third branch).

First Branch: Diversity of Loan Risks

Loan risks include the following types: commercial risk (first), non-commercial risks (second), and other risks (third).

First: Commercial risk

Since the insurance contract applies to commercial debts arising from insured clients, except clients subject to public law who cannot be insolvent, commercial risk refers to the event affecting the private debtor leading to insolvency. Political risks are excluded from commercial risk in addition to the public debtor.[20]

Second: Non-commercial risks

These include all risks except those described as commercial. Their scope includes export loans, resulting from the failure of the public debtor or caused by political events or natural disasters, all leading to

all of which lead to the debtor's failure to repay his debts.[21]

Third: Other risks

These are related to loans directed toward export. This category cannot be classified under either the first or second type because this risk is not due to non-payment. Instead, the insured is compensated for expenses he paid without recovering them, whether partially or fully.[22]

Section Two: The Nature of the Insured Risk

According to Article 5 of Ordinance No. 96-06 related to export loan insurance, loan insurance covers commercial risks. These occur when the buyer is unable to fulfill his contractual obligations or refuses to do so without a legitimate reason, whether the debtor is a natural or legal person.[23]

From this, we conclude that there are two types of risks: insolvency (First), and temporary default (Second).

First: Insolvency

This refers to the insufficiency of the debtor's assets to fulfill his due debts. Insolvency differs from suspension of payment, as the latter refers to the debtor's inability or refusal to pay debts at their maturity without necessarily lacking sufficient assets. Insolvency is of two types: legal insolvency (1) and actual insolvency (2).

1. **Legal insolvency**

This relates to proving the debtor's inability to pay debts through judicial or non-judicial procedures.[24]

2. **Actual insolvency**

This allows, based on the period of inability, the assumption that the debt will not be recovered, thus justifying compensation for the insured.[25]

Second: Temporary default

This refers to the debtor's refusal to pay debts, provided that this refusal is not due to any fault on the part of the creditor (the insured).[26]

Section Three: The Insurable Interest in Loan Insurance

The Algerian legislator required the presence of an interest as a component of financial liability insurance. The requirement of interest in loan insurance is dictated by the very concept of insurance. If the insured has no interest in the non-occurrence of the risk (i.e., the complete loss of the loan), the insurance becomes merely a gambling operation.[27]

The insurable interest in loan insurance refers to the insured's benefit from the non-occurrence of the insured risk, which is the loss of the debt. Thus, the insured's interest lies in the continued existence of his debt.[28]

Moreover, the interest constitutes the reason for the obligation and the contract in insurance. Therefore, it must exist and be legitimate, as stated in Article 621 of the Civil Code[29], and it must be the motive for entering into the contract, as confirmed in Article 29 of Ordinance No. 95-07 related to insurance.[30]

Chapter Two: Entities Responsible for Loan Insurance and Their Management of Loan Risk

As a result of the loan operations carried out by banks and the risks arising from them that may affect their financial standing, their primary concern has become how to recover loaned funds upon maturity. To achieve this, banks have turned to loan insurance as a mechanism to ensure repayment, which is carried out by specialized institutions. Accordingly, in this topic, we will address the entities responsible for loan insurance (as the first requirement), and then discuss the management of loan risk (as the second requirement).

First Section: Entities Responsible for Loan Insurance

The loan insurance process is of great importance, playing a major role in securing bank loans and maintaining the continuity of economic projects, preventing their owners from going bankrupt.[31] Therefore, it is necessary to establish specialized companies for loan insurance, such as the Real Estate Loan Guarantee Company. Accordingly, in this requirement, we will examine the Real Estate Loan Guarantee Company (Section One), and then discuss the means available to it to effectively carry out its tasks (Section Two).

The Real Estate Loan Guarantee Company

This company was created to implement the concept of loan insurance. We will discuss its establishment (First), its tasks (Second), its products (Third), and its guarantees (Fourth).

1. **Establishment of the Real Estate Loan Guarantee Company**

The company was established on 05/10/1997 within the framework of the general program for restructuring the financial sector, with a capital of 1,000,000,000 DZD. It was approved by the Minister of Finance through a ministerial decision issued on 08/05/1999, authorizing it as a real estate loan guarantee company to engage in loan insurance operations.[32]

The company derives its financial resources from its founding capital, contributed by shareholders, and from insurance premiums resulting from its guarantee activities, whose value is determined according to legal insurance provisions. It also derives funds from investing its own capital, especially in the real estate sector. The Real Estate Loan Guarantee Company is a public economic institution in the form of a joint-stock company, with participation from various insurance and banking companies.[33]

2. **Tasks of the Real Estate Loan Guarantee Company**

The company performs several tasks, including:

- Providing guarantees for credits or loans granted by lending financial institutions for acquiring real estate property for housing.
- Managing the guarantee fund composed of contributions from financial institutions.
- Monitoring how lending institutions handle litigation, with the possibility of the insurance company stepping in to cover debts.
- Handling all borrowing operations directed toward real estate developers.
- Guaranteeing loans intended for residential real estate[34] on one hand, and promoting real estate on the other.[35]

3. **Products of the Real Estate Loan Guarantee Company**

The company aims to provide confidence to financial institutions engaged in real estate financing by insuring loans in the real estate promotion sector against the risk of permanent or temporary default by the borrower. This guarantee is a form of loan insurance as provided in Executive Decree No. 95-338 concerning the preparation and limitation of insurance operations.[36]

4. **Guarantees Offered by the Real Estate Loan Guarantee Company**

The company provides insurance for loans granted to real estate developers (1), loans granted to individuals (2), and contributes to the development of real estate promotion (3).

5. **Insurance of loans granted to real estate developers**

This guarantee insures the beneficiary against the risk of final default by the borrower up to 90% of the total repayments and interest due. Compensation is provided as follows: 50% of the total original repayments and scheduled interest during the guarantee period after proof of default. The remainder, recovered after selling the mortgaged property, is deducted from the previously paid 50%, within the remaining 40% limit.[37]

6. **Insurance of loans granted to individuals**

This guarantee may be simple, covering only final default, or comprehensive, covering temporary delays in repayment. It includes categories such as: new housing via real estate promotion, ready-to-move-in housing, ownership through off-plan sales, individual purchases, home expansion, and residential renovations. Insurance application is subject to file evaluation and criteria set by the company.[38]

7. **Development of real estate promotion**

The company contributes to developing real estate investment activities. Loans for real estate developers are subject to administrative criteria such as merchant status, real estate ownership, building permits and designs, and a special permit for the developer. Financial criteria include the financial standing of the developer's institution, financial capacity, equity participation, and the bank's or financial institution's shareholding.[39]

Section Two: Means Available to the Real Estate Loan Guarantee Company

Due to the risk and complexity of loan default and the diversity of loan operations and borrowing conditions, the loan insurance company must evaluate each loan individually. To do this and to secure its own profitability, the insurer must have a structure that allows it to manage risk selection.

It must establish a dedicated department for identifying commercial and industrial companies as well as financially capable individuals. The company relies on several means, including economic studies (First) and legal studies (Second).

1. **Economic Studies**

The company uses references and documents to perform its tasks, especially to assess default rates in each insured area for efficient management. It collects necessary data with support from other departments, such as:

- The statistics department, which determines minimum premiums for each economic sector.

- The economic studies department, which conducts thorough analyses of each default case to determine the underlying reasons for the company's failure.[40]

2. **Legal Studies**

The study of laws and regulations related to loan insurance is central to the company's work, focusing on three closely related areas:

3. **General sales terms of the insured**: Legal experts study the risk scope and surrounding guarantees such as retention of title and right of lien.

4. **In case of underwriting a specific risk**: Legal experts advise the creditor (insurance applicant) on how to obtain appropriate coverage for the operation exposed to risk, protecting the creditor's rights.[41]

5. **Regarding disputes**: Legal studies are based on national laws, judicial precedents, and general procedures for debt settlement, including judicial settlement and discharge from payment.[42]

Second Section: How to Manage Loan Risk

The Real Estate Loan Guarantee Company manages loan risk by following a set of precautionary measures, either before the occurrence of the disaster (Section One) or after it [43]

Section One: Managing Loan Risk Before the Occurrence of Disaster

It has been previously mentioned that the Real Estate Loan Guarantee Company is the entity responsible for loan insurance. To ensure the financial solvency of the customer, the company conducts investigations through what is known as information provision. From this, it assesses the customer's situation and makes a decision whether to grant credit or not. If the credit is granted and accepted by the customer, the latter becomes subject to continuous monitoring. Accordingly, the loan insurance contracts for customers with whom the loan insurance company contracts are divided into two categories: named customers and unnamed customers. Thus, in this section, we will address the distinction between two types of insured loans: loans to named customers (First), and loans to unnamed customers (Second).[44]

First: Loans to Named Customers

For this type of loan, the insurance company is obligated to study the customer's situation. The company exercises strict supervision over customers for whom it has provided guarantees. The company may cancel or reduce its guarantee for any customer by simply sending a registered letter to the insured customer informing them of the matter, and the consequences take effect once the customer receives the letter. Compensation in the event of a disaster for named customers ranges between 50% and 70% of the debt amount.[45]

Second: Loans to Unnamed Customers

In this case, the insurance company's approval is not mandatory. It covers the debt against the risk of loss even if it has not granted prior approval to the insured customer. Compensation in this case reaches 50% of the debt amount, which is a lower percentage compared to the compensation for loans to named customers, which may reach up to 70%. The risk resulting from the insured operations is determined at 50,000,000 DZD for institutions regarding loans granted to named customers. In this case, the loan risk assessment is carried out by the lending institution, i.e., the banks.

For unnamed customers, the risk amount is set at 100,000,000 DZD. In this case, the loan insurance company studies each file on a case-by-case basis. For loan insurance concerning domestic trade within the Algerian territory, loan insurance companies propose two types of documents that address the different needs and requirements of the insured: the comprehensive insurance document (1), and the flat-rate insurance document (2).

1. **Comprehensive Insurance Document**

This document is suitable for large individual loans granted by the insured to a small and specific number of customers with whom they deal within the framework of a commercial contract.

2. **Flat-rate Insurance Document**

This document concerns less significant loans granted to a large number of the insured's customers. Both the comprehensive and the flat-rate insurance documents are subject to common rules governing the obligations of the parties to the insurance contract, which sometimes fall on the insurance company and other times on the insured.

Section Two: Loan Risk Management Upon Disaster Occurrence

When a disaster occurs, the loan insurance company follows certain procedures, namely compensation (First), and subrogation (Second).

First: Compensation

Compensation is granted when the debtor's insolvency is proven, which may result from judicial settlement or asset liquidation. To calculate compensation, the loss amount is deducted, knowing that the loss equals the total amount of invoices generating the unpaid debt. Insurance contracts never compensate the insured for 100% of the debt loss, because if that were the case, it would completely exempt the insured from responsibility, potentially encouraging cooperation with dubious customers knowingly. Therefore, the insured directly participates in managing the risks the loan may face. The contract leaves a portion to be borne by the insured, called a "deductible," and it is strictly prohibited for the insured to insure this uncovered portion with another insurance company.

Second: Subrogation

The insurance company is subrogated in place of the insured in the right of recourse against the third party who caused the occurrence of the risk and the loss, but only after paying the compensation to the insured. The insurance company may only apply subrogation under a set of rules: subrogation occurs only after the company pays compensation to the insured; the company substitutes the insured only to the extent of the amount it has paid; additionally, if the compensation paid is less than the actual value of the debt, then the insured retains the right to sue the liable party for the remaining actual debt value. If, due to the subrogation principle, both the insurer and the insured pursue the party responsible for the damage at a later time, the insured is to be compensated first, and the insurer receives the remainder. The insured loses the right to full or partial compensation if they commit actions that make subrogation by the insurer impossible.

Conclusion

In addition to the above, we conclude that loan insurance plays an effective role in protecting banks from the risks resulting from loan operations. It is considered one of the modern guarantees introduced by the Algerian legislator as a mechanism bank can resort to for ensuring the recovery of granted loans. It is both a contract and an insurance operation, similar to other insurance contracts and operations, as it includes the essential elements of an insurance contract and its technical principles. Therefore, it is subject to the provisions of insurance law and is carried out by specialized institutions, including the Real Estate Loan Guarantee Company. To enhance the loan insurance system, we present the following suggestions:

- Bring loan insurance companies closer to economic operators by advertising through various audiovisual media.
- Eliminate the phenomenon of concentration of loan insurance companies in major cities by opening branches across different provinces.
- Encourage loan insurance companies to introduce new products in line with developments in the industrial, agricultural, and service sectors.
- Train staff at loan insurance companies in accordance with the mechanisms of insurance policy in Algeria by establishing specialized schools or centers.
- Enable Algerian loan insurance companies to benefit from the experience of leading foreign companies in this field.

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