CREDIT & COLLECTIONS

Shelter Your Dollars

How to protect against losses with credit insurance

By Roy W. Urrico

A wholesale receiver/jobber account you have been dealing with for the past six months is looking to significantly increase its available credit with your organization well beyond its current limit. You are aware that the company has picked up a significant account in its own right; however, upon doing an updated credit check on the company, you realize that they have reported a negative working capital position (i.e., current assets, less current liabilities) coupled with a loss for the most recent fiscal year end, which has adversely affected the equity standing of the company. While you do have the opportunity to go through the Perishable Agricultural Commodities Act (PACA) in the event of problems, you are concerned that the account's overall net worth would make collecting a substantial percentage of the funds in a liquidation unlikely. Under this scenario, what other means do you have to protect your receivables?

Credit risk insurance is designed to protect companies from unexpected losses due to the insolvency or past-due default on the part of insured customers. It protects businesses against non-payment or significantly late payments.

Despite the numerous advantages, the major share of U.S. businesses disregard the protection credit insurance provides even when 40 percent of a typical company's assets are normally held in the form of trade debts, according to Euler Hermes ACI, North America's largest trade credit insurer based in Owings Mills, MD. Furthermore, most companies choose to ignore the possible impact on cash flow and financing if debtors do not pay on time. Without cash flow, an unanticipated debt can turn an operating profit into a loss or even devastate a company. This is where trade credit insurance comes in.

As American companies begin to realize what is at stake, they are starting to protect their accounts receivable. During the last several years, spending on credit insurance by U.S.-based companies has increased 10 to 15 percent per year, and the market has grown to approximately $550 million in annual premium revenue, according to Atradius Trade Credit Insurance, a trade credit insurer headquartered in Baltimore, MD.

Types of Credit Insurance

Among the main product groups offered by credit insurers are the following.

Domestic credit insurance. This type of insurance offers coverage for sellers of goods and services within the United States. For the typical domestic credit insurance application, carriers can provide full quotes with account underwriting decisions in approximately two weeks. This varies depending on the number of accounts and underwriting backlogs. Your broker should follow-up on your behalf to make sure that the quotes are returned in a reasonable timeframe.

Export credit insurance. This insurance covers against foreign commercial and political risks such as government takeovers, confiscation, war, and civil strife. Export credit insurance allows you to extend credit to qualified international buyers, reduce risk of nonpayment, and increase access to working capital. Applications for export coverages can take longer due to the longer lead times in underwriting overseas accounts.

Key Elements

Trade credit insurance protects businesses against non-payment or late payments. There are many benefits to using credit insurance.

- Trade credit insurance guards businesses from unanticipated losses due to the insolvency or past-due default.
- Numerous companies use credit insurance to expand existing credit limits for long-standing clients or new clients seeking significant credit.
- Insurance protects a line of business that has small profit margins and cannot afford to take large losses.

To learn more about each key element, look for the throughout the article.

With more companies sourcing customers outside their own borders, the risk of granting credit terms has to be balanced against maintaining competitive terms against other sellers. Export credit risk insurance is one tool used to offer competitive open credit terms without additional risk.

Multiple buyer policies. These policies protect a range of export or domestic sales, or key accounts. Exporters of U.S. goods and services can reduce their risk of selling on credit terms by insuring their export accounts receivable. The policy can help increase international sales by extending competitive credit terms while minimizing risks.

There are also variations and combinations of coverage that can insure sellers of goods against select credit, financial, and political risks. "While most trade credit insurance policies have traditionally been issued [to cover their entire credit portfolio], many trade credit insurers allow customers to tailor coverage more specifically to key account or even single-buyer transactions," explains Brett Halsey, manager at Atradius. Single-buyer policies cover single or multiple shipments to one buyer and protect the seller from the date of the contract until the date of payment.

Benefits of Credit Insurance

Credit risk insurance can be an extremely valuable tool for your company, and one that more than pays for itself in any number of ways. Some key benefits of a trade credit policy include the following.

Catastrophic loss protection. Just one sudden, unexpected loss could have a devastating impact on a company. Receivables are a concentration of both cost and profit; in many cases, businesses create receivables based on nothing more than a customer's promise to pay, which creates a tremendous amount of risk.

"It is generally true that the top 20 percent of accounts represent approximately 80 percent of a company's revenue," says Victor Sandy, executive vice president of Global Commercial Credit Bingham Farms, MI, a specialty broker representing multiple carriers and one of the fastest growing credit insurance operations in the United States. Credit insurance removes this disastrous risk from the balance sheet and caps a company's exposure. Sandy adds, "You do not have to worry about a big default taking down the business."

Safe sales expansion. Many companies use credit insurance to be able to expand on existing credit limits without having to put themselves at additional risk. It is also helpful in covering open credit sales to new accounts that might have limited information and sales history. "Using your credit insurance policy to support additional sales…will not only allow you to recapture the premium," says Sandy. "It will help you drop additional profit to your bottom line."

Credit decision support. Most companies operate on the general rule that as long as the customer is paying timely credit management, efforts can be focused elsewhere. Unfortunately, payment history is not a valid predictor of default. Many companies are current on their bills at the time they file for bankruptcy protection or are forced into default. Having the carrier watching your covered accounts and helping you evaluate credit limits on new risks is a great advantage to the program.

Credit insurers also provide credit decision support since underwriters will vigorously investigate, endorse, and observe the accounts you hope to cover. They also continue to monitor their customers' buyers for sustained credit worthiness through public-record monitoring systems and analysis of common customers with other policyholders.

Borrowing enhancement. If the company borrows against its receivables, credit risk insurance can provide additional protection to the lender so they may be able to enhance the borrowing arrangements. They do this by increasing the percentage they will advance against insured accounts and/or roping more accounts into the borrowing base (e.g., large concentrations, slow payers, export customers, etc.). This allows a business to maximize the amount of working capital available from the same pool of receivables. If the company is in a high growth mode and needs more working capital, credit insurance is a great way to resolve the problem.

While having credit insurance does not replace the need for a credit management department, it does enhance the credit decision-making process. "It is an enhancement to the credit process, not a replacement," says John Pontin, national sales director for Euler Hermes ACI, America's largest trade credit insurer based in Owings Mills, MD. "Companies still have to make the right business decisions; they still need a sound credit department."

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Credit Limitations

As a custom-tailored program, there is no standard "off the shelf" policy to buy that will automatically be the right fit, since companies have specific needs and circumstances. As important as it is to know what trade credit insurance is, it is equally important to know what it is not. Credit insurance should not be an instrument for granting credit to unworthy companies. It is extremely difficult to predict which client will default on payment. Indeed, almost half of all payment defaults, according to Euler Hermes, occur from long-term customers considered stable.

Similarly, credit insurance should not be viewed as a shelter against imminent loss. That, says Sandy, would be like "trying to get fire coverage on a burning home." In addition, coverage typically does not cover receivables that go unpaid because of business disputes over defective products or late deliveries, nor does it cover fraud. However, the coverage does attach to disputed invoices, but only if the dispute is resolved in favor of the insured. Below lists other parameters to consider.

Premium. There are numerous factors that affect the premium. The ultimate premium that the carrier charges will be priced based on a number of factors, including default rates in the industry, loss history, customer credit quality, the spread of risk, and the deductible and coinsurance levels in the policy.

Premiums seem a small price to pay for credit protection for produce sellers. "The biggest benefit is obvious," suggests Pontin. Trade credit insurance protects a line of business that has small profit margins and cannot afford to take large losses. "In the produce industry, there is no salvage—you cannot take it back," Pontin says. "Plus, there are a lot of purchasers, and you should make sound decisions of who you sell to."

Risk retention. These come most commonly, in the form of deductibles and coinsurance. Carriers use either or both to allow for risk sharing. Deductibles are typically a one-time per annum first loss position satisfied before claim payments start. Coinsurance is a percentage of the loss retained on each account, typically ranging between 10 percent and 20 percent, according to Global Commercial Credit.

One general rule in designing a policy is to use a coinsurance level less than or equal to the gross margin. This ensures a company is covering the cost, avoiding paying additional premium, and ensuring profit. A deductible can be used to lever down the premium to a certain point. A small reserve can cover the deductible, or the deductible can be taken out of the cash flow at the time of the first loss.

Coverage limits. An underwriter will review and approve specific coverage limits on the customers wanting to be insured. It is often the accounts that appear "good as gold" that carry the largest balances and can hurt the most if an unexpected default occurs.

Extending Credit

Credit insurance is not widely used in the United States across the board. However, it does seem to carry benefit for the produce industry. "If you are in the segment of the industry where margins are thin, its takes a lot of sales to bring in a profit. Credit brings an extra risk, and it is a risk that goes right to your profit," explains Sandy of Global Credit Insurance.

PACA provides special protection for sellers of perishable agricultural commodities. PACA ensures that licensed creditors receive payment paid ahead of any other claims and offers dispute resolution in the case of a payment disagreement. It requires prompt payment terms of ten days subsequent to acceptance for produce purchased and provides a method that allows the seller and buyer to agree to different payment terms.

While a PACA license offers protection, suppliers still should provide their own due diligence when issuing credit. The credit insurance carriers hold disputed amounts aside until a judgment is rendered, showing that the money is actually owed by the debtor. At that point, they will pay the claim and then pursue recoveries for everyone. However, if a customer disputes that they owe the money, the carrier will not pay until it is clear that the courts find the money is owed.

Credit insurance offers an extra safety net against a big unexpected loss, such as in the event of liquidation, where the debtor has insufficient assets to compensate the seller fully. "The proactive decision support from the underwriters can help clients avoid stepping into the wrong relationships in the first place," says Victor Sandy, executive director for Global Commercial Credit, a broker of all trade credit insurance. Credit insurers also provide risk assessment, which is becoming more difficult for small to medium-sized companies as cross-border transactions increase.

Being able to assess the risks correctly affects the bottom line. Companies also can raise capital more easily. "A lot of companies borrow against their receivables on a specific formula-driven advance rate," explains Sandy. "Using credit insurance to make it a safer deal for the lender can allow them to enhance the deal and squeeze more liquidity out of the existing base of receivables." BP

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Credit Insurance in Europe

In Europe, approximately 40–45 percent of businesses carry some form of credit insurance, a type of protection that dates back to the late 19th century. However, in the United States, credit insurance is practically non-existent, with estimates placing coverage at approximately 5 percent or less for American companies. In a progressively more international marketplace, the time may be right for U.S. companies, including those in the produce industry, to turn to trade credit insurance as a risk-mitigation device and a capital-raising tool.

Historically, credit insurance has been more popular in Europe than elsewhere, with more than 80 percent of worldwide premiums underwritten in Europe, according to the Centre for European Policy Studies, an independent policy research institute located in Brussels. However, like in the small and medium-sized enterprises in the United States, neglected credit management often exists and typically lacks the administrative resources to assess buyers' risks, adapt credit terms, and monitor payments in order to reduce cash collection periods and minimize payment defaults.

As compared to 15 percent of all large enterprises, less than 10 percent of European small enterprises use credit insurance. For those that do have credit insurance coverage, they are similar to policies issued in the United States. They provide policyholder protection on outstanding receivables, the risk of protracted default, or insolvency. In the early days of credit insurance, insurers were mono-liners (i.e., they carried a single line of insurance) and domestic and export credit insurance were seen as distinct product lines. Nowadays, this distinction has blurred, and many companies offer domestic and export coverage within the same policy and under the same conditions.

European companies have adopted credit insurance more readily—not because they are more adverse to risk, but because they have extensive familiarity in managing intricate cross-border transactions. That is something becoming progressively significant to companies in the United States.