Allianz
Trade

Options for mitigating credit risk

There are several options and tools to mitigate credit risks. You should weigh the costs and benefits of these options and investigate carefully to determine the best fit for your company. Here are some of the most common tools:

Self-insurance

Many companies choose to self-insure in the form of bad debt reserves. This fund, set aside, is available to offset the deficit should any of your customers become unable to pay.

The cost considerations are as follows:

- You will need to invest in credit management resources, systems and data to consistently analyse and monitor your credit risks;
- it may impact your sales, depending on your given risk tolerance: you will not want one customer to eat up all of your reserves should they go insolvent;
- it will impact your working capital; and,
- you may struggle to build reserves fit for large and unexpected catastrophic losses.

Invoice finance (factoring/invoice discounting)

Invoice finance gives you access to money from your outstanding invoices before your customers pay you. An invoice finance company will purchase your invoices at a reduced amount of their face value plus a fee. You may choose to get funding against a single/handful of debtors or all of your outstanding invoices.

Factoring companies will also control the sales ledger and collect the debts.

It is important to take into account that not all invoice finance companies will assume the risk of non-payment of the invoices they purchase (this is known as non-recourse finance). If they don't, you will need to reimburse the funding if your customer does not pay.

Other impacts include:

- It will affect your margin;
- you may lose control of customer relationships; and,
- factors will have a maximum amount they are prepared to purchase.

Not all invoice finance companies will assume the risk of nonpayment of the invoices they purchase.

Letters of credit

Letters of credit (sometimes knows as documentary credits) allow you to trade by providing certainty that you'll be paid for the goods you export. A letter of credit is a promise by a bank that the payment will be made as long as the right goods are shipped at the right time with the right paperwork. It protects both you and your customer by mitigating potential risks. For you, the risk of non-payment is transferred to the bank who issued the letter of credit.

In developing markets, it may need to be cash secured by the buyer.

Impacts include:

- Only covers a single transaction for a single customer – regularly relying on this form of protection can be tedious and time consuming for you;
- it's expensive for you and your customer, both in terms of absolute cost, time (administration) and in terms of credit line usage with the additional need for security; and,
- the claims process can be lengthy and laborious and can be derailed by minor discrepancies in paperwork.

Trade credit insurance

Credit insurance is a business insurance product that protects you against unpaid trade debts. Credit insurers provide a 3-tiered service: financial information on your customers (credit checks and monitoring), collection of unpaid debts and, if all else fails, you are protected by insurance.

The insurance premium cost is linked to the level of covered transactions, and additional service fees may be charged.

The benefits are:

- It secures trade with new and existing customers;
- it helps you select the most stable prospects to go after;
- it enables you to offer competitive credit terms; and,
- can save on credit information costs, third-party collection costs and protect your cash flow.

Credit insurance provides a 3-tiered service:

1. Your customers' financial info (credit checks & monitoring)
2. Collection of unpaid debts
3. Insurance coverage

Click here to find out more

Can credit insurance and invoice finance work together?

Yes, when you need funding but want non-payment security, you may work with your bank or factor and use credit insurance as well.

The bank or factor will provide the funding and the credit insurance policy will protect the invoices. In this case, when a funded invoice goes unpaid, the claim payment will go to the funder.

Feature	Credit Insurance	Letter of credit	Factoring	Self-Insurance
Cover/protection against credit risk	• Insolvency • Protracted default • Political risks Yes	• Buyer default Yes	• Insolvency • Protracted default if non-recourse finance Yes	No
Additional services	• Credit risk information • Risk assessment • Market intelligence • Debt collection Yes	No	• Debt collection Yes	No
Financing	• But can facilitate financing No	• But can facilitate financing No	• Converts invoices into cash for a fee Yes	No
Customer relationships	• Your customer is unaware of credit insurance contract • Better terms of payment enhance relationship	• Both are aware of the set up	• Collection by factor of trade receivable may affect client relations	• Maintains direct relationship with customer
Costs	+	+++	++	+ • Cost of opportunity and bad debt

+ **Affordable** ++ **Moderate** +++ **Expensive**

Contact us:

If you'd like to find out more about how trade credit insurance can help you, contact us today at **+44(0)800 056 5452** or email **info.uk@allianz-trade.com**