PROTECTING AGAINST PAYMENT RISK: SELF-INSURANCE OR CREDIT INSURANCE?

www.eulerhermes.ca

A company of Allianz

EULER HERMES

PROTECTING AGAINST PAYMENT RISK: SELF-INSURANCE OR CREDIT INSURANCE?

The growth of your company requires establishing relationships with new customers, expanding business with existing customers, and possibly exploring new markets as well. But as you do all three, you also expose yourself to risk – there is no assurance that your customers, new and old, will pay their invoices.

To address the challenge, you need to assess your willingness to assume credit risk and then determine whether to protect your company via credit insurance through a strong third-party partner or by taking on the risk internally—using the “self-insurance” approach.

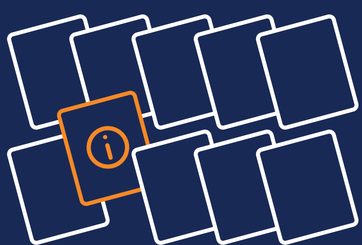
Whether it’s elected by conscious choice or by default, self-insurance offers flexibility but also comes with real risk and opportunity costs for the business owners. In case of late or unpaid invoices, self-insurance can be costly. It may require considerable effort to recover the money – with very uncertain results as to whether or not the money will ever be completely recovered.

DID YOU KNOW?

UNPAID INVOICES

1 IN 10

Invoices is delinquent



WHAT IS SELF-INSURANCE?

A company engages in self-insurance when business owners agree to accept the loss of any invoice amounts that go unpaid plus the full costs required to manage their internal credit granting processes. Businesses typically self-insure by using a bad debt reserve to offset losses and by usining their own means to research customers.

Diligent self-insurers will undertake extensive research to learn about each customer's financial health to make an educated guess as to whether to engage in the commercial relationship. This is a critical decision – if customers do not comply with the terms of their contract, or if there's a long delay in payments, self-insurance requires the business owners to be responsible for any amounts that go uncollected.

To successfully self-insure, companies must first build structured processes for collecting the necessary financial information when acquiring and vetting new customers. If any invoices go unpaid, any recovery efforts must then be funded by the business including third party collections costs.

SELF-INSURANCE DRAWBACKS

Though self-insurance comes without a direct cost, the many indirect costs involved make it far from free for the company even in years with low bad debt losses.

Consider the following potential drawbacks of the self-insurance approach:

Unpaid Invoices Weaken Cash Flow: Self-insurance directly exposes your company to the risk of unpaid customer invoices. This can occur especially during economic downturns when Days Sales Outstanding (DSO) can increase. Many bankruptcy filings occur because of payment delays that lead to an unbalanced cash flow. These companies usually suffer from poor management of customer risk. A default does not necessarily lead to bankruptcy, but if unpaid invoices by major customers accumulate, they greatly weaken cash flow and can permanently paralyze business activity.

Additional Costs Add Up Quickly: The cost of self-insurance is not easily measured. But contrary to conventional wisdom, the cost can quickly exceed the premium of a credit insurance policy when considering the effort to resolve unpaid invoices. Self-insurance requires strict organization and may generate additional expenses such as the cost to purchase customer credit information and collection costs.

More Resources Required: Managing customer risk also demands significant internal resource time and specific skills, which add to the overall cost of the business infrastructure. Additional resources are essential to search and analyze customer information in advance as well as for follow-up recovery procedures. When invoices go unpaid, the company must act quick when its payment reminders do not elicit a response from debtors. The company must then invest time, pay a significant recovery fee to a company that specializes in collections, or even commence court proceedings that require paying lawyers for legal services.

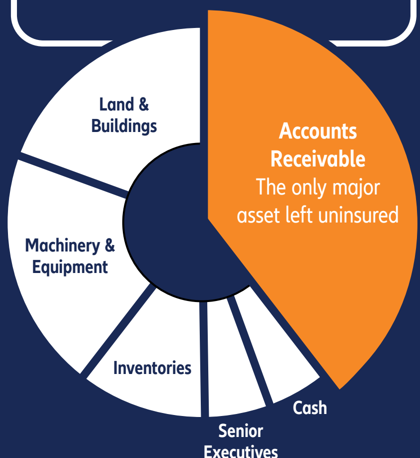
Additionally, choosing to self-insure is sometimes frowned upon by financial lenders. They value the guarantees and the security offered by credit insurance, and customer hedging can reassure bankers so that they feel more comfortable offering loans.

DID YOU KNOW?

COMPANY ASSETS

40%

Unpaid uninsured invoices



THE VALUE OF CREDIT INSURANCE

When compared to the alternative approach for protecting against bad debt risk, credit insurance provides businesses with a predictable safeguard against non-payment of commercial debt.

With a credit insurance policy in place, you can ensure your invoices will be paid, and you can manage the commercial and political risks of trade. This results in safer and more strategic accounts receivable management. Policies can be tailored for small businesses and multinational companies through offerings that take into account the specifics of their vertical industry and their markets.

When you partner with a credit insurance provider, its recovery experts can also be brought to bear on your behalf, implementing fair procedures for collecting on delinquent invoices and/or identifying fair compromises. This is especially helpful in cases involving customers and litigation that take place abroad.

You also benefit from access to credit experts who can quickly respond to your requests for guaranteeing payment on a particular prospect's invoices. With their expertise in your industry, you can receive reliable information about your prospects — a competitive advantage in your customer risk management program. The savings on third party credit reports and extra internal resources required for vetting credit applications can offset the premium of a credit insurance policy even if you never make a claim.

CONSIDER THE COSTS

HAVE YOU CONSIDERED THE HARD AND SOFT COSTS OF SELF-INSURANCE?

Many companies view self-insurance as the lowest cost risk mitigation solution – but is it? Like many credit insurance clients, the example company below actually realized a positive return on its investment in credit insurance. Use the worksheet below to calculate the hard and soft costs associated with self-insurance for your company.

CREDIT INSURANCE

How much more cost effective could it be to outsource this to a credit insurer? Example Company A had $10M in annual sales and decided to use credit insurance instead of self-insurance.

Realized profits by extending just one credit limit by $50K	$60K
Released majority of bad debt reserve converted to earnings (Year One only)	$160K
Tax on remaining bad debt reserve @ 20%	$8K
Credit services – included	$0
Cost of credit insurance @ .25% of annual sales	$25K
Tax savings from deducting policy as business expense	$5K
ADDITIONAL PROFITS AND SAVINGS:	**$192K**

(Pays for itself and returns value to the company even without a claim and provides a guarantee on the only unsecured asset.)

VS.

SELF INSURANCE

How much profit have you lost by holding down credit limits? A company with a 15% profit margin, shipping eight shipments per year to would lose $60K in potential profit by holding a credit limit down by $50K on just one customer.	$________
How much is in your bad debt reserve? Companies keep up to 2.2% of yearly sales tied up in bad debt reserves	$________
How much in tax do you pay on your bad debt reserve? Releasing this reserve in year one as earnings will result in tax savings in future years	$________
What is the cost on your credit function support? Systems, buyer monitoring, staff, third party credit services, collections, etc. are all costing you. Could you realize increased efficiencies by allowing a credit insurer to perform some of these functions as an integral part of a policy?	$________
TOTAL COST:	$________

Company A was able to reduce their bad debt reserve freeing up cash flow, increase sales by extending a limit on a riskier customer and obtain comprehensive support for their credit management. The extra sales revenue, tax savings, and the instant bump in earnings realized by releasing the majority of its bad debt reserve has offset the cost of the policy many times over. Not to mention, they have added coverage in the event of a catastrophic loss and additional credit management resources at their fingertips. Credit insurance was the clear choice for Company A.

WHICH APPROACH MAKES SENSE FOR YOUR COMPANY?

As you determine whether to self-insure your invoices or to rely on the services of a credit insurance partner, here are some general guidelines to facilitate your decision-making process:

- Self-insurance is beneficial for companies that provide products and services to a few well-known, investment-grade customers and operate mainly within local markets.
- Self-insurance makes more sense if you never require financing to grow the company and if you generate sufficient margins to absorb unpaid invoices.
- Credit insurance is preferable if you provide products and services to a large, diversified customer base or if you have large A/R concentrations with only a few large buyers.
- If you operate in or plan to expand into international markets, credit insurance may be critical since vetting customer credit histories and pursuing litigation in foreign countries can be extremely complex and time-consuming.
- If your business is looking to expand its borrowing base, you may also discover that with a credit insurance policy in place your lending partners will consider more of your receivables toward your lending base, increase your margining rate and may extend more favorable rates – in fact, in many lending relationships, credit insurance may be required.

To learn more about credit insurance and to discover the solutions offered by the world's number one credit insurance company, Euler Hermes, visit www.eulerhermes.ca.

Euler Hermes Canada
1155 René-Lévesque West, suite 2810
Montréal, QC H3B 2L2

Phone: +1 877-509-3224

ehcanadacommunications@eulerhermes.com
www.eulerhermes.ca

Euler Hermes Offices

NORTH AMERICA HEADQUARTERS

Baltimore office
800 Red Brook Boulevard
Owings Mills, MD 21117
Phone: +1 877-909-3224

ONTARIO REGION

Toronto office
4 Robert Speck Parkway, Suite 1000
Mississauga, ON L4Z 1S1
Phone: +1 877-511-3224

A company of Allianz

EULER HERMES