



# A GUIDE TO CREDIT INSURANCE

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# INTRODUCTION



**“In an economy where eighty percent of trade is conducted on open terms, far too little analysis is done with respect to the effect of bad debt write-offs on the bottom line and what can be done to avoid that impact.”**

## BUSINESS ASSETS



# 40%

**Uninsured Accounts Receivable**

## UNPAID INVOICES

# 1 IN 10

**Invoices is delinquent**

## BUSINESS FAILURES

# 23,109

**Businesses failed in North America in 2017**

Financial executives must continuously balance the cost of doing business with the risk of doing business. Each time a dollar of revenue is produced, all costs of generating that dollar have been thoroughly analyzed in an effort to maximize the profit margin. However, in an economy where eighty percent of trade is conducted on open terms, far too little analysis is done with respect to the effect of bad debt write-offs on the bottom line and what can be done to avoid that impact. According to the IRS, certain industries keep average bad debt reserves of up to 2 percent of yearly sales. While this amount is atypical, the U.S. average bad debt loss is about 30bps of annual sales, with unexpected or recessionary losses occasionally doubling that amount to 60-70bps – still a major hit to a company’s profitability and cash flow.

**Accounts receivable, which typically represent more than 40 percent of a company’s assets, are a vital component of a healthy business.**

On average, one in every ten invoices becomes delinquent, with many ultimately becoming an unpaid bad debt. When a major customer — or even multiple customers — defaults on a debt, there are devastating consequences to a company’s cash flow, earnings, and capital. In a worst-case scenario, this could literally put a company out of business. These risks require thorough analysis and ongoing monitoring at the buyer, sector, country, and macroeconomic levels.

In the face of today’s changing domestic and global economic climate, recognizing and managing future risks has become a priority for business leaders. Losses attributed to non-payment of a trade debt or bankruptcy can and do occur regularly. Default rates vary by industry and country from year-to-year, and no industry or company is immune to trade credit risk. This is evidenced by the data tracked in the Euler Hermes Global Index of Business Failures. The risk of buyers defaulting on trade debt continues to loom.

# OPTIONS FOR MITIGATING CREDIT RISK

Financial executives should weigh the costs and benefits of several options for mitigating trade credit risk. Each one should be investigated carefully to determine the best fit for a specific company. Some of the more common methods are:

## SELF-INSURANCE

Many companies choose to self-insure in the form of bad-debt reserves. This fund is available to offset the deficit should any of their customers become unable to pay. However, it also impacts other areas of cost:

- Investments in credit management resources, systems, and information acquisitions, analysis and monitoring
- Impact on sales, given risk tolerance
- Impact on capital allocation of the balance sheet
- Typically does not account for large and unexpected catastrophic loss

## FACTORING

A factor is a company that typically purchases companies' accounts receivable at a reduced amount of the face value of the invoices. These costs may range from 1% to 10%, based upon a variety of components. This gives a company immediate access to cash in exchange for a percent of the receivables' value, plus a fee. Many factors will also offer invoicing, collections, and other bookkeeping activities for companies looking to outsource their entire accounts receivable function. Some factors will assume the risk of non-payment of the invoices they purchase, while others do not. Other impacts on cost include:

- Considerable margin erosion
- Loss of control of customer relationships
- Capacity constraints associated with line availability

## LETTERS OF CREDIT

A documentary letter of credit is a bank's agreement to guarantee the payment of a buyer's obligation will be received on time and in the correct amount. The buyer has to approach the bank to request a letter of credit, which has the disadvantage of reducing the buyer's borrowing capacity as it is counted against the company's overall credit limit set by the bank. In developing markets it may need to be cash secured. Impacts on cost include:

- Only covers a single transaction for a single buyer – regularly relying on this form of protection can be tedious and time consuming for a buyer
- Expensive, both in terms of absolute cost and in terms of credit line usage with the additional need for security
- Ties up working capital for buyers, thus potentially restricting opportunities
- The claims process can be lengthy and laborious and can be derailed by minor discrepancies in paperwork.

## CREDIT INSURANCE

Credit insurance is a business insurance product that protects a seller against losses from nonpayment of a commercial trade debt. With trade credit insurance in place, the seller/policyholder can be assured that non-disputed accounts receivable will be paid by either the debtor or the trade credit insurer within the terms and conditions of their policy.

## MITIGATING TRADE RISK: A COMPARISON OF METHODS

FEATURE	CREDIT INSURANCE	LETTER OF CREDIT	FACTORING	SELF-INSURANCE
<b>Coverage</b>	Insolvency, protracted default and political risks	Buyer default	Insolvency and protracted default	Any loss
<b>Services</b>	Credit information, risk assessment, market intelligence, debt collection	None	Debt collection and credit information	Internal resources
<b>Financing</b>	None, but can facilitate financing	None, but can facilitate financing	Converts trade receivables into cash for a fee	No effect
<b>Customer Relationships</b>	Buyer is unaware of credit insurance contract. Better terms enhance relationship with customer	Buyer initiates provision of letter of credit	Collection by factor of trade receivables may affect client relations	Maintain direct relationship with customer

# WHAT IS CREDIT INSURANCE?

Credit insurance protects businesses from non-payment of commercial debt. It makes sure invoices will be paid and allows companies to reliably manage the commercial and political risks of trade that are beyond their control. Capital is protected, cash flows are maintained, loan servicing and repayments are enhanced, and earnings are secure from these events of default.

Credit insurance can enable a company to increase sales by up to

 **20%<sup>1</sup>**

On average, banks lend up to

**80% more** on insured receivables<sup>2</sup>

A credit insurance policy also allows companies to feel secure in extending more credit to current customers, or to pursue new, larger customers that would have otherwise seemed too risky. The protection it provides allows a company to increase sales to grow their business with existing customers. Insured companies can sell on open account terms where they may have previously been restrictive or only sold on a secured basis. For exporters, this especially can be a major competitive advantage.

## COMPANIES INVEST IN TRADE CREDIT INSURANCE FOR A VARIETY OF REASONS, INCLUDING:



**Sales expansion** – If receivables are insured, a company can safely sell more to existing customers, or go after new customers that may have been perceived as too risky.



**Expansion into new international markets** – Protection against unique export risks and market knowledge to make accurate growth decisions.



**Better financing terms** – Banks will typically lend more capital against insured receivables, and may also reduce the cost of funds.



**Reduction in bad-debt reserves** – Insuring receivables frees up capital for the company. Also, credit insurance premiums are tax deductible, but bad debt reserves are not.



**Actionable economic knowledge** – The trade credit insurer's information database and technology platform help reduce operational and informational cost.



**Protection against non-payment and catastrophic loss** – Should an unforeseeable event catch a company and its insurance carrier without warning, the bill gets paid via the claims process.

While protection is often perceived as the primary reason to purchase credit insurance, the most common benefit companies receive by investing in a policy is that it helps them increase their sales and profits without additional risk. **It is in this way that a credit insurance policy can typically offset its own cost many times over, even if the policyholder never makes a claim.**

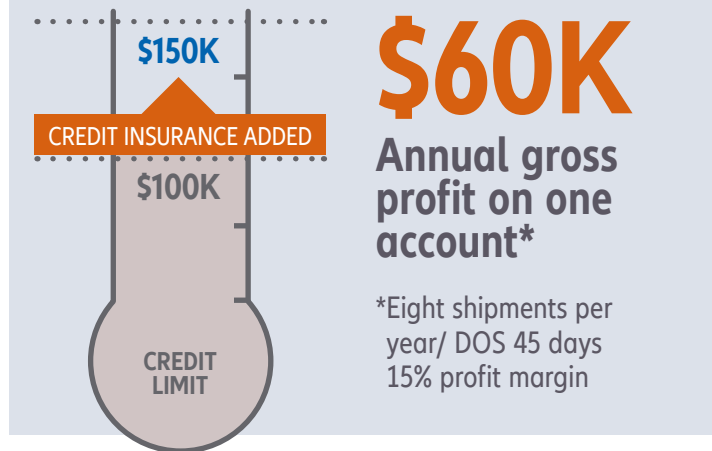
<sup>1</sup> <http://www.eulerhermes.us/en/case-studies/Pages/default.aspx>

<sup>2</sup> <http://www.tradefinancemagazine.com/AboutUs/Stub/WhatIsTradeFinance.html>

# WHAT IS CREDIT INSURANCE? (CONT.)

## EXAMPLE 1: INCREASING SALES AND PROFITS

As an example, a wholesale company's credit department had restricted a credit line to a customer to \$100,000. They then purchased a trade credit insurance policy and the insurer approved a limit of \$150,000 on that same customer. With a 15% margin and an average days sales outstanding of 45 days, the wholesaler was able to increase their sales to realize an incremental annual gross profit of \$60,000 on just that one account.



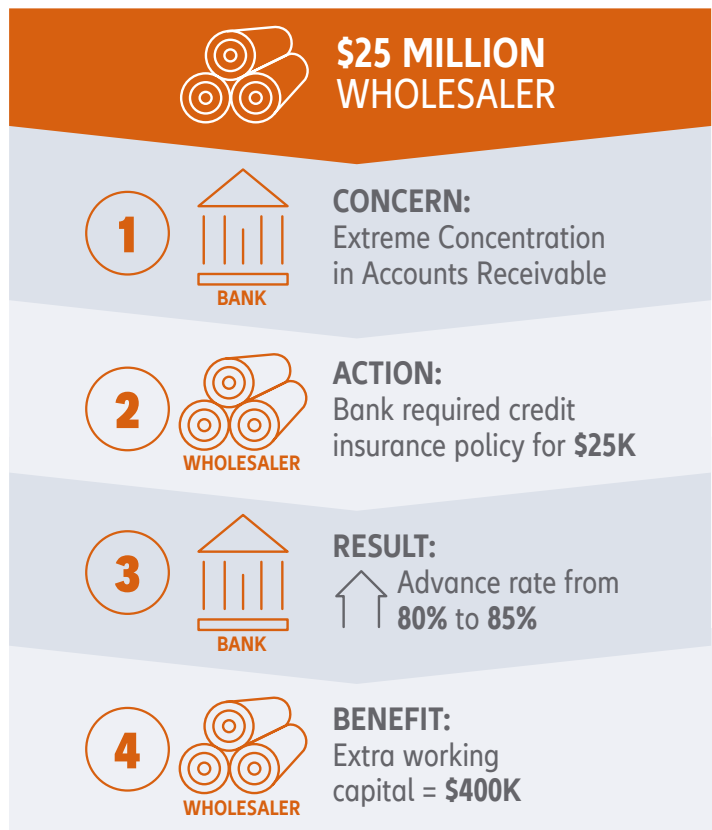
Trade credit insurance can also improve a company's relationship with their lender. In many cases the bank actually requires trade credit insurance to qualify for an asset-based loan.

## EXAMPLE 2: IMPROVING LENDER RELATIONSHIP

For example, a \$25 million lumber wholesaler had extreme concentration in their accounts receivable because they only had eight active accounts. The smallest of these customers had A/R balances in the low six-figure range, and the largest was into the low seven-figure range.

The company's bank was concerned about this concentration and they required trade credit insurance in order to include their accounts receivable as collateral. The lumber company established a trade credit insurance policy that specifically named all of its buyers, providing the bank the comfort level it needed.

In fact, the bank increased the advance rate from 80% to 85%. The net result was that the lumber company was able to obtain an additional \$400,000 in working capital because of their trade credit insurance coverage. The cost of the policy was \$25,000 so the return on this investment was excellent, and the lumber company was able to use the additional cash to continue to fund its growth and expansion strategy.



# WHAT CREDIT INSURANCE IS NOT



**As important as it is to know what trade credit insurance is, it is equally important to know what it is not.**

Credit insurance is not a substitute for prudent, thoughtful credit management. Sound credit management practices should be the foundation of any credit insurance policy and partnership. Credit insurance goes beyond indemnification and does not replace a company's credit practices, but rather supplements and enhances the job of a credit professional.

# THE BASIS OF CREDIT INSURANCE

**The ultimate goal of credit insurance is not simply to indemnify losses incurred from a default, but provide businesses with the support and knowledge they need to avoid them from the start.**

The key is having the right information to make informed credit decisions and therefore avoid or minimize losses. Using this information, companies also have the confidence to make more strategic decisions to profitably grow their business.

The best credit insurers will invest heavily in the development of proprietary credit and financial information, and also will employ risk analysts, as well as industry- and country-based underwriters, in many geographic locations in order to have a close physical presence to its customers' buyers. Credit insurers will also analyze payment information about its policyholders' buyers to identify early signs of financial trouble to ensure early intervention is initiated.

These risk analysts research and evaluate information about individual buyers and use that information to partially or fully approve or decline credit limit requests to the policyholders. The analysis of this information allows companies to make more informed decisions about how much credit to extend to their customers. More importantly, it enables companies to avoid losses through the close monitoring of their customers.

# HOW DOES A CREDIT INSURANCE POLICY WORK?

At the onset of the policy the credit insurance carrier will analyze the creditworthiness and financial stability of the policyholder's insurable customers and assign them a specific credit limit, which is the amount they will indemnify if that insured customer fails to pay.



Unlike other types of business insurance, once a company purchases trade credit insurance, the policy does not get filed away until next year's renewal – the relationship becomes dynamic. A trade credit insurance policy can change often over the course of the policy period, and the credit manager plays an active role in that process.

It is the credit insurer's responsibility to proactively monitor its customers' buyers throughout the year to ensure their continued creditworthiness. They do this by gathering information about buyers from a variety of sources, including: visits to the buyer, public records, and information supplied by other policyholders that sell to the same buyer, receipt of financial statements, etc. By implementing credit insurance, the policyholder's credit management team has been enhanced by the thousands of professionals associated with these carriers; your credit insurer essentially becomes an extension of your team.

Throughout the life of the policy, the policyholder may request additional coverage on a specific buyer should that need arise. The insurer will investigate the risk of increasing the coverage and will either approve the additional coverage, or maintain with a detailed explanation. Similarly, policyholders may request coverage on a new buyer with which they'd like to do business.

This information is constantly updated and cross referenced. When signs indicate a company is experiencing financial difficulty, the insurer notifies all policyholders that sell to that buyer of the increased risk and establishes an action plan to mitigate and avoid loss.

## THE GOAL OF A TRADE CREDIT INSURANCE POLICY

The ultimate goal of a trade credit insurance policy is not to simply pay claims as they arise, but more importantly to help policyholders avoid foreseeable losses. If an unforeseeable loss should occur, the indemnification aspect of the trade credit insurance policy comes into play. In these cases, policyholders would file a claim with supporting documentation, and the insurer would pay the policyholder the claim benefit, typically within 60 days from the date of loss on domestic claims.

The coverage does attach should a buyer default because they were a victim of fraud associated with another party, including preparing fraudulent or misleading financial or credit statements. Disputes also fall outside of the cover of a trade credit insurance policy, though they will become covered losses once the situation is effectively resolved.



# CHOOSING A CARRIER

Your insurance partner will work with you on a daily basis. There are many carriers to choose from but you want to make sure you are working with a partner who understands your business and brings in industry experts who are specialized.

The better-established credit insurers are “limits underwriters,” meaning that the policyholder’s more significant buyers will be analyzed individually and each assigned a credit limit for coverage. This is where the type and amount of information the insurer collects on a buyer plays a very important role in monitoring, because credit limits are assigned based on the information available about that particular buyer.

For a company’s less significant buyers, a credit insurer will often cover these accounts under a blanket, or self-underwritten type of cover, known as a discretionary credit limit or DCL. The insurer does not individually underwrite the buyers that fall under the discretionary credit limit, but rather it is the policyholder’s responsibility to approve credit and be aware of any warning signs that these buyers’ creditworthiness is deteriorating. If one of these accounts should become

unable to pay, and that event was not foreseeable, the insurer will pay a claim up to the predetermined amount established within the policy parameters and qualified by the credit professional.

Limits underwriters like to name as many accounts to their policies as possible and they are equipped to handle large volumes of credit limits to be reviewed. These include companies like Euler Hermes, Coface and Atradius.

By contrast, “discretionary underwriters” do not have the same level of staffing to look at a high volume of credit limits. Their expertise comes into play underwriting the internal credit management of a company and being selective who they take on as insureds, these companies include AIG, FCIA, HCC, QBE and others. The discretionary underwriters will give larger DCLs, in turn they look for policies with fewer credit limits to underwrite.

## CHOOSING A CREDIT INSURANCE CARRIER

FEATURE	LIMITS UNDERWRITERS (LUWS)	DISCRETIONARY UNDERWRITERS (DUWS)
<b>Full-service</b>	Provides a full suite of services that add value beyond just risk transfer	Pure Risk Transfer
<b>Country Limits</b>	Typically uses aggregates to determine coverage so there is no impact on your ability to gain desired coverage by country	Some DUWs use country limits, which can hamper desired coverage on exports.
<b>Known Coverages</b>	Typically uses discretion on any cancellations	Coverages will typically auto-cancel upon any lapse in a company’s Policy and Procedures Manual. Therefore, coverage eligibility is not known until the claim is processed.
<b>Protection for smaller claims</b>	EH deductibles are typically lower than those of DUWs and more than 50% of policies have no deductible	DUWs often use very large deductibles to keep rates down but this discourages claims on anything but huge losses.
<b>Resources</b>	LUWs have world-class expertise in-house for you to leverage and a physical presence in over 50 countries, allowing us the most accurate, internationally consistent credit intelligence available.	Many, but not all, DUWs are not mono-line carriers and don’t specialize in trade credit insurance as a focus
<b>Size</b>	Some LUWs can provide cover for businesses of all size without syndication. Their size also means they have access to a more extensive knowledge base from our risk experts around the world.	Many, but not all, DUWs are smaller outfits that rely on third party intelligence for underwriting.





# IS CREDIT INSURANCE FOR EVERYONE?

Any company that has receivables on its balance sheet has a potential exposure to loss from the inability or failure of a customer to pay them.

Credit insurance is also widely used in export markets with countries and customers where a business has no previous experience or there is a political environment that makes it more of a challenge to do business. While credit insurance can be a smart investment for many companies, it may not be applicable to companies that sell exclusively to governments or consumers since trade credit insurance only covers business-to-business accounts receivable.

For the most part, companies that conduct business-to-business trade are essentially already investing in a trade

credit insurance program. Trade credit insurance is essentially the sum of the costs associated with a businesses risk philosophy, sales restricted, systems, credit/financial information, accounts receivable management, collection and insolvency management, etc. All are real costs, and should be weighed against the cost associated with the credit insurance policy where these services are included as an added benefit. What many will find is that trade credit insurance provides one of the best and most cost-effective solutions.

## 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	VS.	SELF 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.		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.
Realized profits by extending just one credit limit by \$50K <b>\$60K</b>		How much is in your bad debt reserve? \$ _____ Companies keep up to 2.2% of yearly sales tied up in bad debt reserves
Released majority of bad debt reserve converted to earnings (Year One only) <b>\$160K</b>		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
Tax on remaining bad debt reserve @ 20% <b>\$8K</b>		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?
Credit services – included <b>\$0</b>		<b>TOTAL COST:</b> \$ _____
Cost of credit insurance @ .25% of annual sales <b>\$25K</b>		
Tax savings from deducting policy as business expense <b>\$5K</b>		
<b>ADDITIONAL PROFITS AND SAVINGS: \$192K</b> <i>(Pays for itself and returns value to the company even without a claim and provides a guarantee on the only unsecured asset.)</i>		

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.

## CONCLUSION

**Ultimately, should an unexpected loss occur, the trade credit insurance policy provides indemnification, thus protecting the policyholder's revenue and bottom line.**

A trade credit insurance policy, if used properly, provides a valuable extension to a company's credit management practices – a second pair of objective eyes when approving buyers, as well as an early warning system should things begin to decline so that exposure can be effectively managed.

By maintaining a strong relationship between the insurer and the credit management department, trade credit insurance may be the wisest investment a company can make to ensure its profits, cash flow, and capital are protected.

To schedule a meeting with a Euler Hermes representative, please call **877-509-3224** or visit us at **[www.eulerhermes.ca](http://www.eulerhermes.ca)** for a free, no-obligation quote.

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