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NEWSWATCH

The Case for Credit Insurance

The primary purpose of credit insurance is to allow your company to sell to clients that you may not be financially comfortable with and feel assured that, if there is an insolvency or default, you will be paid. It is a specialized form of insurance whose objective is to reduce risk of loss to the seller.

With the globalization of businesses, and the increased demand of exports, the need for credit insurance has been heightened. In the current state of the economy, both domestic and global, credit risk uncertainty is at an increased level. A customer of your product may have been financially sound a year ago and due to the current economic environment, significant and quick financial deterioration may occur.

There are a total of four companies that offer Trade Credit (Account Receivable) Insurance: Euler Hermes, Atradius, Coface and Chartis. The intent of credit insurance is to respond to the insolvency of a buyer or protect against a protracted default (when a company is not insolvent but has not yet paid the insured on agreed terms and there is no dispute on the amount owed).

All four insurers provide similar coverage. Terms and conditions may differ depending on global region as well as industry. Therefore, it is important to conduct an interview with each insurer prior to requesting a credit commitment.

> ***"The use of credit insurance to lessen a seller's account receivable risk, assuming the buyer qualifies, is an attractive risk mitigation tool.***

For international shipments, if the seller is located in a country where the area politics are not conducive to a stable financial environment, political risk insurance should also be considered. This coverage protects against local instability that can translate into losses for the exporter. Contract repudiation, political violence, and currency inconvertibility are some of the risks that can be insured.

The purpose of this article is not to discuss the intricacies of each individual insurer, but to outline the merits of considering credit insurance as a risk management tool to mitigate the seller's risk. Admittedly, the risks for domestic account receivables should be far less than companies that sell internationally.

Benefits

Trade credit insurance manages commercial account receivable risks which are beyond the company's control. Balance sheet strength, cash flows and asset valuation are better protected from financial instability.

Below is a summary of potential benefits that a seller can derive from considering credit insurance:

- If receivables are insured, a company can safely sell more to existing customers or go after new customers that may have been considered too risky without insurance. It should be noted that each customer must qualify individually.

- Can reduce the risk of high debt concentration. One buyer may represent 30 to 50% of sales or more. This can be devastating to a company's financial health if the customer cannot pay his debt.

Benefits (continued)

- Internationally, if a LOC is not provided and sales are made on an open account, banks will measurably discount the international sales in determining a customer's borrowing base. If credit insurance is purchased for the same customers, these sales should be included in this base.
- In many cases, a bank will provide better financing terms and will lend more against insured receivables. In fact, some banks may require the purchase of credit insurance to qualify for a loan.
- Trade credit insurance premiums are tax deductible.
- Establishes a fundamental strategy to protect the company from an unexpected catastrophic event.

Credit Insurance or Letter of Credit (LOC)?

Traditionally U.S. companies selling internationally secure sales on credit via LOC. Although the LOC approach has been effective in avoiding loss on sales, there are drawbacks.

- LOCs require a significant amount of administration and this process must be repeated with every transaction.
- LOCs while effective in risk reduction can be a deterrent in the acquisition of new and expanding business. The buyer's credit line would be restricted and hence, the use of LOCs may not be as attractive. Clearly, a seller that offers sales on account would be preferred to those that require LOCs.
- Credit insurance can cover one or all transactions in a timely and efficient manner.

When credit insurance is not a viable option, either due to unavailability or affordability, and there is potential for loss, it is reasonable to revert to a LOC. Despite the aforementioned shortcomings, the LOC does provide an irrevocable guarantee of payment.

Bottom Line

The use of credit insurance to lessen a seller's account receivable risk, assuming the buyer qualifies, is an attractive risk mitigation tool. It alleviates the seller's concern for payment in an efficient and cost effective manner without the drawbacks of using a LOC. In today's ever growing global marketplace, this can also translate to a significant increase in sales.

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