

Trade Credit Insurance

Coverage for Accounts Receivable Debts



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In 2008, there was a 40% increase in business failures over the year before, and the number is expected to rise as high as 50% in 2009, according to the *Euler Hermes Global Index of Business Failures*. Needless to say, surviving in these economic times is a challenge for many businesses. Many are looking for alternatives to protect revenue streams and to mitigate the risks associated with entering new markets and/or bringing on new customers, particularly overseas. Trade Credit Insurance is a tool that can protect your accounts receivable while providing support for business expansion. It provides potential benefits for companies that are faced with working capital constraints, and protects companies with high concentrations of customer risk.

William Gallagher Associates is a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks and dynamic needs, within industries that include high technology, life sciences, healthcare, financial risks, aviation, energy, and environmental services, with offices in Boston, MA; New York, NY; Hartford, CT; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

Business credit insurance, trade accounts receivables coverage, or what we'll refer to here simply as *Credit Insurance*, is a financial product designed to protect companies against bad debt. A business owner can insure their accounts receivable from loss if a customer is unable to satisfy their obligation due to insolvency; and there is even a provision for slow payment.

Credit Insurance involves services and a policy that allows the transfer of non-payment of a commercial trade debt by the seller/policyholder to a third party, in this case, an insurer. Some of the benefits of Credit Insurance are:

1. Protection from a bankruptcy or insolvency of a customer and thus a loss on Accounts Receivable (A/R).
2. Favorable financing from your lender, either via favorable eligibility of your A/R's or the inclusion of accounts in the borrowing formula that are not eligible without credit insurance.
3. Sales expansion, which can be into a new risky industry i.e. construction or for international business development.
4. Reduction of bad-debt reserves and A/R's risk concentration.

Issues to consider in determining the need for this coverage are:

- Do you have a serious concentration of A/R's in a few key accounts? If so, are any of them in volatile industries or weak financially?
- Extension of credit to companies in foreign jurisdictions
- Are there markets or countries you are not selling to due to credit concerns or doubts?
- Is bank financing limited or unavailable to you due to the A/R's concerns of your bank?

If the answer to any of these questions is affirmative, it would make sense to look at your options for Credit Insurance.

The Process

The first step in obtaining credit insurance is to complete an application. Each insurer has their own application. Naturally, all applications have a great deal in common. The application is a *warranty* to the policy and must be signed by an authorized person in the company. It is critical all answers be true and accurate as a misrepresentation can be cause for the insurance company to disregard a claim or rescind all coverage.

In addition to accuracy, each insurer wants details on your company's credit history, a current and detailed A/R's aging, any negative collection history, and a clear understanding of your credit terms. Key qualitative aspects are:

- Quality and consistency of your credit and collection people.
- Your company's history of bad debts, the market or markets you sell to and the credit quality of your accounts, particularly ones with large balances.
- Consider how you would like your program structured; what size deductible would you be comfortable with?
- On your smaller exposures, the blanket limit is optimal; credit insurers call it the "discretionary credit limit" or *DCL*. The DCL is the limit the insurer will offer on a blanket limit basis on a number of small exposures that do not require specific limits of coverage.
- What accounts will you want specific limits of insurance on (and the maximum amount of credit will you need).
- It is also an appropriate time to look at policies and procedures that you need to improve or to institute within your credit and collections group.

Once a company receives a complete application they will review it, expect a few additional questions before they offer a proposal. Ideally the first time through this process you should get more than one company to offer a proposal. This will give you a better sense of the marketplace and help with competitive pricing.

A few items to look for in a policy besides pricing are: *how insolvency is defined, the precise rules and timing on filing a claim, how they treat collections on past due customers, how are recoveries shared, what are the terms of cancellation.*

How is a Credit Insurance Program Structured?

Policies can be structured to be based on the total of a company's top line revenue or it can be done on a customer-specific basis. Typical protection covers customer insolvencies and protracted defaults. However, credit insurance may incorporate political risk coverage for clients exporting product. This can include, for example, coverage for cancellation of licenses, foreign government intervention, embargos, war or civil violence, and other foreign related risks. Policies will have a waiting period for filing claims after a default, loss deductible, insured percentage of cover, and other terms and conditions.

How does the Policy Work?

Unlike some other forms of insurance, trade credit policies and the relationship with the insurer are very dynamic. The insured is required to continue their normal credit policies. They also must keep the insurer well informed of any issues or deterioration with any of their existing credit relationships. The policy is not a substitute for sound credit policies and management; rather it augments the resources of the credit department at the insured's company. Policyholders may ask at anytime for additional limits on a customer or to add a new customer to the policy. Simultaneously, the credit insurance companies proactively monitor all of the policyholder's buyers from a wide variety of sources. When there are signs that a company is experiencing financial deterioration, the insurer notifies all policyholders that sell to that company of the increased risk and may establish an action plan to mitigate exposure to avoid losses. In short, there is frequent conversation between the credit issuer and the insured to manage the exposure and the changing credit landscape.

Pricing

The premium for Credit Insurance is based the following of factors: industry default rates, customer credit quality, spread of risk of A/R's, and the effectiveness of credit policies and procedures, the deductible and coinsurance. On a rule of thumb basis credit insurance will cost somewhere between .05% and 2% of total insured values.

With a global recession, a dramatic increase in both domestic and international business failures and the widespread banking financing difficulties, now is an opportune time to review credit and collection procedures and explore the potential of supporting these by purchasing Credit Insurance. A trade credit policy, when used properly, is an excellent investment to protect and expand your credit position and ultimately revenues. For more information, contact your WGA Account Executive.

One important note: Credit insurance is not available to retailers to their customers, companies selling exclusively to governments and companies not selling on open terms.

