

Credit Insurance is for Short-term Trade Accounts Receivable

08/07/06

Andi, I love your article and feedback, very informative. I wanted to comment on a recent article from a reader who asked about letters of credit. There is an alternative, especially for someone who is shipping overseas.

"My company (and others) provide credit insurance. A policy holder can ask for coverage for their exposure on a particular buyer and get credit. The buyer never is involved. We simply insure the receivable against default in payment, be it an insolvency or past due. It's a guarantee on their receivable. Policy terms are one year and they may add and delete customers as needed. The policy has very little administration, much shorter wait time and the backing of a company that specializes in protecting the receivable. If you would like some more information, give me a call or send an e-mail. Also note we insure domestic receivables as well." Ryan M. O'Leary, Agent, Coface North America Insurance Company, 1350 Broadway, Suite 2001, New York, NY 10018, 212-560-0402.

Ryan, since you were good enough to write in, I did some homework on credit insurance, and here's what I found out. There is a governing organization, called the International Credit Insurance and Surety Association (ICISA), found at www.icisa.org. Founded

in 1928, ICISA, through its member organizations, accounts for about 95% of all global credit insurance business. Additionally, starting in the 1950's ICISA built a base of trade credit and surety bond insurance membership. In 2005, ICISA members insured over \$1.5 trillion dollars of trade. The ICISA management committee members work for companies that include Coface, Euler Hermes, CESCE, QBE, Mapfre, Danks Dauton, Swiss Re and Atradius.

Who buys credit risk insurance? The exporter, or seller buys the insurance, to protect that the buyer will pay for the goods on time. If you are a buyer, involved in import transactions, you may want to introduce your trading partner, the seller, to the concept of credit risk insurance, as an alternative to letters of credit. Keep in mind that for credit risk insurance to be appropriate, there must be some other assurance, relationship or trust, that the goods will be delivered in order, and there will be no disputes about what was delivered vs. what was ordered.

Here is what ICISA has to say about credit risk insurance. It's different from a letter of credit. This type of insurance deals with the risk that the buyer does not pay, or pays late, for goods received. It can be limited to just a few vendors, or a blanket for all transactions. And if the buyer does not pay, the credit insurance

policy will pay out a percentage of the outstanding debt, typically from 75% - 95% of the invoice amount, depending on coverage purchased. Credit insurance is for short-term trade accounts receivable, due in less than one year. According to one provider, you usually need annual sales of \$1,000,000 to make the program cost-effective.

Trade credit insurance can be domestic or international, and is insurance against non-payment of a buyer in this country (domestic risk), or another (export risk) country. Non-payment must be due to insolvency of the buyer, non-payment past a specified due date, or following a (political) event outside of the buyer or seller's control. Bear in mind that trade credit insurance is not insurance from disputes between the buyer and seller. And it does not insure that the delivery takes place. The advantage of credit risk insurance is that you are not tying up cash or lines of credit, the way you do if you deal with letters of credit.

Trade credit insurance can help to protect a seller from cash flow shortfalls. It can also be used when delivery is certain, but the credit worthiness, or payment assurance of the buyer, may be in question. It can also help to improve your working capital position with your lenders. Lenders want to know that your write-off of aged accounts receivables is minimal, and this

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type of insurance can help you provide that assurance.

A credit insurer does not issue credit, but simply issues a conditional insurance policy. The credit insurer guarantees payment in case of specific conditions of non-payment on the part of the buyer. In the case of the buyer's bankruptcy, the loss triggers the start of a claims and collection process. If the policy includes civil unrest, the policy holder will be able to recover losses from not getting paid as a result of strikes and protests. For example, the buyer may not be able to transfer money from one country to another.

If you as the buyer or seller are concerned that there may be a dispute regarding the goods being transferred, then credit insurance will probably not solve the problem. Buyer and seller are expected to work out any disputes about goods received, prior to approaching the insurance company with a claim.

On the other hand, you may have good experience, and a trust relationship built up with a trading partner. If you are the buyer, you simply want to assure your seller that payment will be made on time, once goods are received. If you are the seller, you want to know that the buyer will pay you once they receive what you ship. One or both of you may have shipping insurance, covering the value of the goods while in

transit. There is no question about delivering in good order, according to specifications. In such a case, credit insurance may be what you're looking for.

Credit insurance policies can be set up to cover a limited number of trading partners. Alternately, you can have a blanket policy, covering all transactions. Or, you can insure only very large transactions. If there is coverage for all transactions, expect a limit on the total insurance amount. This limit is called the discretionary amount; under this amount you can trade without notifying the insurer about individual transactions. Exposure over the discretionary amount requires that the underwriter be informed of more specifics, such as the company being insured, the amount and purpose. Keep in mind that policy limits mean that any actual loss over the policy limit will not be covered.

Specific companies offer credit insurance in specific countries. The role of the credit insurance company includes assistance with collections, monitoring of credit worthiness of buyers, and management of losses due to political risks. Not every credit insurance company operates in every country. You can find out which companies operate in which countries by going to the ICISA website. The four most common players globally seem to be Atradius, Coface – the

company Ryan represents – Euler Hermes and QBE.

Typical cost of credit risk insurance is cited by one insurance company as generally less than 1%, based on trading history, historical debt lost, trade sector and customer base. Political risk may push the premium higher.

If you want more information, you can contact the person who brought up this article, Ryan M. O'Leary, Agent, Coface North America Insurance Company, 1350 Broadway, Suite 2001, New York, NY 10018, 212-560-0402. While I have not met Ryan personally, and cannot vouch for him, he was kind enough to bring the issue forward, and does work for one of the four organizations recognized by the ICISA, as providers in the US and other countries worldwide.

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