

# An Overview of Trade Credit Insurance

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## Introduction

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, the hundreds of billions of dollars in losses associated with bad debt charge-offs in 2002 brought new attention to managing trade receivables.

Accounts receivable, which typically represent more than 40% of a company's assets, are naturally a vital component of a healthy business. If a major customer is unable to pay its invoices, or if several customers are unable to pay their invoices, there will be a negative impact to cashflow, earnings, and capital. In a worst-case scenario, this could literally put a company out of business. These risks require thorough analysis.

In the face of today's changing domestic and global economic climate, recognizing and managing future risks has become a priority for our 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 from trade credit risk. This is evidenced by the data found in the Euler Hermes Global Index of Business Failures, which predicts an 8% increase in U.S. business insolvencies in 2007.

Financial executives should weigh the cost-benefit of several options in an effort to mitigate 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:

### 1) 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. But it also impacts other areas of cost:

- Investments in credit management resources
- Investments in systems
- Investments in information acquisitions, analysis and management
- Impact on sales given risk tolerance
- Impact on capital allocation of the balance sheet

### 2) Factoring

A factor is a company that typically purchases companies' accounts receivable at a reduced amount of the face value of the invoices. These discounts may range from 1% to 10%, based upon a variety of factors. 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
- Line availability

### 3) Trade Credit Insurance

Trade credit insurance is a business insurance product that indemnifies a seller against losses from non-payment 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.

### More about Trade Credit Insurance

Trade credit insurance is a financial tool to hedge against both commercial and political risks that are beyond a company's control. Balance sheet strength is ensured, cash flows are protected, and loan servicing and repayments are enhanced.

A trade 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 be restrictive today or only sell 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 too risky without insurance.
- Expansion into new international markets
- Better financing terms – in many cases, a bank will lend more capital against insured receivables, and may also reduce the cost of funds.
- Reduce bad-debt reserves – This frees up cash for the company. Also, trade credit insurance premiums are tax deductible, but bad debt reserves are not.
- Indemnification from customer non-payment

While indemnification is what most companies recognize as the main reason to purchase trade credit insurance, the most common reason to invest in a policy is because it helps them increase their sales and profits.

As an example, a wholesale company's credit department had granted a credit line of \$100,000 to a customer. 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 DSO 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 some cases the bank actually requires trade credit insurance to qualify for an asset-based loan. For example, a \$25 million scrap metal dealer 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 scrap metal dealer purchased a trade credit insurance policy that specifically named all 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 scrap metal dealer 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 scrap dealer was able to use the additional cash to continue to fund the growth of the company.

As important as it is to know what trade credit insurance is, it is equally important to know what it is not. Trade credit insurance is not a substitute for prudent, thoughtful credit management, and sound credit management practices must be in place before a trade credit insurance policy is bound.

Additionally, trade credit insurance does not cover fraud. However, the coverage does attach to disputed invoices, but only if the dispute is resolved in favor of the insured.

## **The Philosophy of Trade Credit Insurance**

The process of insuring accounts receivable involves understanding a company's trade sector, risk philosophy, business strategy, financial health, funding requirements, and internal credit management expertise.

The ultimate goal is not simply to indemnify losses incurred from a trade debt default, but to help the insured avoid catastrophic losses and grow their business profitably. The key is having the right information to make informed credit decisions and therefore avoid or minimize losses.

A trade credit insurance policy does not replace a company's credit practices, but rather supplements and enhances the job of a credit professional. 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. The better credit insurers will also analyze payment information about its policyholders' buyers to identify early signs of financial trouble.

These risk analysts research and evaluate information about individual buyers and use that information to extend, deny, or hold down credit limit requests to the policyholders. Having access to this private information allows companies to make more informed decisions about how much credit to extend to which buyers. More importantly, it enables companies to avoid losses through the close monitoring of their customers.

## **How Does A Policy Work?**

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, but rather 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.

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.

Throughout the life of the policy, the policyholder may request additional coverage on a specific buyer should that need arises. The insurer will investigate the risk of increasing the coverage and will either approve the additional coverage, or decline with a written explanation.

Similarly, policyholders may request coverage on a new buyer with which they'd like to do business.

It is the credit insurer's responsibility to proactively monitor its customers' buyers throughout the year to ensure their continued credit-worthiness.

They do this by gathering information about buyers from a variety of sources, including: visits to the buyer, public records, information supplied by other policyholders that sell to the same buyer, receipt of financial statements, etc.

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 ultimate goal of a trade credit insurance policy is not to simply pay claims as they arise, but rather 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.

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."

The insurer does not individually underwrite all buyers that fall under the discretionary credit limit, but rather it is the policyholder's responsibility to establish minimal acceptable credit criteria and be aware of any warning signs that these buyers' credit-worthiness 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.

### **Is Trade Credit Insurance for Everyone?**

Trade credit insurance can be a smart investment for many companies, but it may not be applicable to the following types of commercial companies:

- Retailers – Trade credit insurance only covers business-to-business accounts receivable
- Companies that sell exclusively to governments

For the most part, however, any business that conducts business-to-business trade transactions is essentially investing in a trade credit insurance program. It is the sum of the costs associated with their risk philosophy, sales avoided, 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 outsourcing many of these functions to a competent credit insurer and the benefits it would derive.

In the face of the Federal Reserve's repeated raising of interest rates in 2005-2006, soaring energy prices, geo-political events, natural disasters, and challenges in key industry sectors (automotive, airline, etc.), the global economic climate is changing, requiring more vigilance from our business leaders. 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. And, ultimately, should an unexpected loss occur, the trade credit insurance policy provides indemnification, thus protecting the policyholder's revenue and bottom line. 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.

**About Joe Ketzner**

Joe Ketzner is executive vice president of Commercial for Euler Hermes ACI. Following a brief period as a trust accountant with Mercantile Safe Deposit & Trust Co., Joe has spent virtually his entire professional career with Euler Hermes ACI.

In his formative years, he started in the Credit department as an information gatherer and a financial analyst. This led to several years as an underwriter handling both policy structuring and limits underwriting. During 1975-76, he was on special assignment with the Finance department to evaluate cost controls, process flow, and work measurement for all departments in the organization with the exception of Sales.

In 1977, he returned as manager of Rate and Premium Computation, and in 1980 he took over management of the Credit Processing, Rate, Policy Writing, and Information departments. By 1985, he was elected vice president and once again assumed the role of senior underwriter.

In 1991, Joe assumed the position of regional vice president of the Northeast Region. He aggressively repositioned the retail-oriented portfolio to better match the market, returning the region to profitability. In 1994, he assumed a similar position managing the southeast region, and by the end of 1996 the region had become the top-producing region in the country.

Following his tenure as a regional vice president, he returned to Euler Hermes ACI's corporate office in 1997 to serve as senior vice president of Commercial Underwriting. In 1999, he assumed his current position as executive vice president of Commercial. During this most recent period, he has brought the Commercial Underwriting, Sales, Marketing, and Service departments under one umbrella. In addition, he has been responsible for the introduction of a new generation of products, market and servicing segmentation, and the joint development of a direct sales force and broker relations.