TRADE CREDIT INSURANCE

WHAT IS IT AND HOW DOES IT BENEFIT MY COMPANY?

MARCH 2018

Trade credit insurance is an insurance product used by businesses, banks, and alternative lenders to insure against the risk of a default by an obligor. In the purest sense, trade credit insurance is used to insure accounts receivable (A/R) against a buyer default. Given that A/R is often the largest asset on a company's balance sheet, insuring the collectability of A/R provides benefits to companies and lenders, as well as factors or alternative lenders who buy these assets, providing liquidity to the selling company.

Trade credit insurance is offered by The Export Import Bank of the United States (Ex-Im Bank) as well as numerous private sector insurers, and the policy types come in many different structures and forms. The two primary underwriting philosophies for trade credit insurance are Ground Up and Excess of Loss coverage. Ground Up coverage is, in effect, a way for companies to outsource most of their credit decisions to the insurance underwriter, and the policies generally have little or no deductible. Excess of Loss coverage allows companies to make a majority of the credit decision themselves, and the policies generally have a deductible as a form of risk sharing.

Below are a few of the different policy options available along with examples of how companies and lenders can leverage trade credit insurance.

TYPES OF TRADE CREDIT INSURANCE POLICIES

Single Buyer coverage is credit insurance in its purest form. With coverage on a single account debtor, the risk of non-payment is shifted from the insured to the insurer, minus any deductible and the co-insured percentage. While this form of coverage is very specific, obtaining this coverage can be difficult due to the lack of ability for the insurance company to spread their risk amongst numerous account debtors or regions. Ex-Im Bank and a select few private insurers provide this type of coverage.

Key Account coverage is an insurance program covering a select number of account debtors, often based on size, location, or related to some form of financing arrangement. These policies tend to be larger and are generally underwritten by the private insurance market. An example of Key Account coverage is a company insuring its top five or ten buyers to ensure financial stability in the event of a default. Some companies will look to only insure the buyers which would cause a material impact to their business if they defaulted.

Multi-Buyer coverage is the most common form of trade credit insurance and is used by companies to insure a majority of their A/R. Many times, these policies will be specific to either domestic or foreign buyers and can at times be structured to include all buyers in a specific region. These policies are offered by Ex-Im Bank and most private insurance companies.

COMPANIES LEVERAGE TRADE CREDIT INSURANCE TO MITIGATE NON-PAYMENT RISK, FINANCE WORKING CAPITAL, AND GROW REVENUE

It is commonly understood that insurance, in general, is used to mitigate risk and for financing purposes; however, it is not commonly understood that trade credit insurance, specifically, is often used to drive revenue growth. Companies today are selling more products and services outside of the United States than ever before. Many of those companies, due to risk aversion or lack of financial ability, do not offer attractive payment terms to their buyers, often leading to a loss of sales. By using trade credit insurance, companies can offer open account payment terms (helping to win new business), borrow against the insured A/R to finance their ongoing working capital needs, and confidently grow the business knowing that a majority of the invoice amount will be collected, even in the event of a buyer's non-payment.

EXAMPLE

A US company, GOOD Co, manufactures and sells large capital equipment, with about 70% of their sales in the US and 30% outside of the US. GOOD Co's payment terms on export sales require the buyer to make a down payment along with progress payments throughout the manufacturing process, with 90% of the money to be paid prior to shipment. One day, GOOD Co lost an order from a large client in Brazil to its European competitor, even though it was well known that GOOD Co had a superior product. When GOOD Co's founder asked why, the Brazilian company explained that while GOOD Co's product was superior, the European competitor offered five-year payment terms based on European interest rates. The local borrowing rate in Brazil at the time was near 20% annually, and the loan terms would have been limited to three years. In short, it was simply less expensive to repair the equipment over time rather than having to borrow the money locally to finance GOOD Co's product.

While this example may be extreme, it is a very common occurrence. Regardless of the product or service being offered, when a company can offer its clients a way to pay for the product or service being delivered that is less expensive than their buyer's alternative, the company is delivering extra value to their clients and distinguishing themselves from their competition.

By leveraging trade credit insurance, companies can offer extended terms, limit their payment risk, finance their working capital needs, and grow their revenue. As for GOOD Co, the next proposal for a foreign contract included an option to finance the purchase for seven years, based on US interest rates. GOOD Co won the contract.

BANKS LEVERAGE TRADE CREDIT INSURANCE TO MITIGATE NON-PAYMENT RISK AND GROW REVENUE

Similar to how companies use insurance, banks leverage trade credit insurance to mitigate non-payment risks and to help grow revenue by being able to make loans or provide letter of credit confirmations that would otherwise be too risky without mitigation. Banks tend to limit or not offer advance rates against foreign A/R; however, by leveraging trade credit insurance, banks are usually able to offer a similar advance rate as they do on domestic A/R. A lesser known use of trade credit insurance is for internal limit management purposes. For example, banks often run into issues with maximum hold levels, limiting their ability to support their client's growth due to internal credit constraints. In cases like this, banks often use insurance, rather than a competing bank, as a partner to risk share some of their exposure, freeing up availability to enable the bank to support their client's growth.

IS TRADE CREDIT INSURANCE THE RIGHT FIT FOR YOUR NEEDS?

Trade credit insurance is a versatile solution that can add a lot of value to your business and can be a critical component of a company's overall strategy. Whether you are considering ways to grow revenue, reduce risk, or finance your company's operations, trade credit insurance is a tool worth consideration.

ABOUT IMPELLO GLOBAL

Impello Global is a trade finance advisory boutique and trade credit and political risk insurance brokerage, headquartered in Seattle, Washington. We specialize in trade credit and political risk insurance and provide advisory services to companies and banks who are looking to expand their global trade capabilities.

Our team partners with senior leaders to develop strategies which address global challenges, risks, and opportunities. We leverage our global network to source, structure and implement the appropriate insurance coverage, proper financing, or a combination of both, to propel our client's business.

If you are a bank or a company trying to better understand trade credit insurance or looking for guidance as to how to grow your trade finance capabilities, our team would be delighted to learn more about your business and discuss options available to you. Please visit our website at www.impelloglobal.com or contact us directly at info@impelloglobal.com.