Trade Credit Insurance

Peter M. Jones

PRIMER SERIES ON INSURANCE
ISSUE 15, FEBRUARY 2010

NON-BANK FINANCIAL
INSTITUTIONS GROUP

GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
DEVELOPMENT VICE PRESIDENCY

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THIS ISSUE

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The Primer Series on Insurance provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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Introduction

The sales of goods and services are exposed to a significant number of risks, many of which are not within the control of the supplier. The highest of these risks and one that can have a catastrophic impact on the viability of a supplier, is the failure of a buyer to pay for the goods or services it has purchased.

In today's challenged domestic and global economic climate, recognizing and managing future risks has become a priority for businesses. 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.

Trade credit risk insurance is an insurance policy and a risk management product offered by private insurance companies and governmental export credit agencies to business entities wishing to protect their accounts receivable from loss due to credit risks, such as protracted default, insolvency, bankruptcy, etc. This insurance product, commonly referred to as trade credit insurance, is a type of property and casualty insurance and should not be confused with such products as credit life or credit disability insurance, which the insured obtains to protect against the risk of loss of income needed to pay debts. Trade credit insurance can also include a component of political risk insurance, which is offered by the same insurers to insure the risk of non-payment by foreign buyers due to the actions or inactions of the buyer's government.

This leads to the major role that trade credit insurance plays in facilitating domestic and international trade. Trade credit is offered by

suppliers to their customers as an alternative to pre-payment or cash on delivery terms, or the need for expensive bank letters of credit, providing time for the customer to generate income from sales before paying for the product or service. This requires the supplier to assume non-payment risk. In a local or domestic situation, as well as in a cross-border or export transaction, the risk increases when laws, customs, communications and customer's reputation are not fully understood by the supplier. In addition to increased risk of non-payment, international trade presents the problem of the time between product shipment and its availability for sale. The account receivable is like a loan and represents capital invested, and often borrowed, by the supplier. But this is not a secure asset until it is has been paid. If the customer's debt is credit insured the large, risky asset becomes more secure, like an insured building. This asset may then be viewed as collateral by lending institutions and a loan based upon it may be used to defray the expenses of the transaction and to fund the production of more goods or supply of more services.

Trade credit insurance thus enables suppliers to significantly increase their overall sales turnover, reduce credit risk related losses and improve the profitability of their business. At the macroeconomic level, trade credit insurance helps to facilitate international trade flows and contributes to the global economic growth, allowing transactions to occur that would otherwise have been too risky. It also enhances economic stability by sharing the risks of trade losses with the trade credit insurers, who are better equipped to absorb them.

In the absence of trade credit insurance, and in order to avoid credit risk related losses, suppliers would have no choice but to rely on either full pre-payment for goods and services by buyers or to seek a third party which is willing to take the credit risk for a price. Hence, traditionally, trade credit insurers have to compete with banking and capital market products. The most common banking product has been the letter of credit, an established substitute for trade credit insurance, and most commonly used in the export sector. Trade credit insurers also compete with factoring, whereby a bank or other financial firm buys a company's receivables for an immediate, but discounted payment. However, factoring companies often buy credit insurance to cover the risk of not collecting on their trade receivables, and so the two products complement one another. Until the recent credit crisis, large suppliers could also sell their receivables at a discount to capital market investors in the form of asset-backed commercial paper.

The essential value of trade credit insurance is that it provides not only peace of mind to the supplier, who can be assured that their trade is protected, but also valuable market intelligence on the finan-

cial viability of the supplier's customers, and, in the case of buyers in foreign countries, on any trading risks peculiar to those countries. As well as providing an insurance policy that matches the client's patterns of business, trade credit insurers will establish the level of cover that can reasonably be provided to the supplier for trade with each individual buyer, by analyzing the buyer's financial status, profitability, liquidity, size, sector, payment behaviour and location. To augment the information that trade credit insurers already hold (for example Atradius already holds information on over 52 million companies worldwide), they also take into account the valuable experience that the supplier may already have through previous trade with the buyer.

Definition

Trade credit insurance (also known as credit insurance, business credit insurance or export credit insurance) is an insurance policy and risk management product that covers the payment risk resulting from the delivery of goods or services. Trade credit insurance usually covers a portfolio of buyers and pays an agreed percentage of an invoice or receivable that remains unpaid as a result of protracted default, insolvency or bankruptcy. Trade credit insurance is purchased by business entities to insure their accounts receivable from loss due to the non-payment of valid debt by their debtors. It can also be expanded to cover losses resulting from political risks such as currency inconvertibility; war and civil disturbance; confiscation, expropriation and nationalization.

The costs (called a "premium") for this are usually charged monthly, and are calculated as a percentage of sales of that month or as a percentage of all outstanding receivables.

Trade credit insurance insures the payment risk of companies, not of private individuals. Policy holders require a credit limit on each of their buyers in order for the sales to that buyer to be insured. The premium rate is usually low and reflects the average credit risk of the insured portfolio of buyers. Additional premium is payable if the cover is expanded to include political risks.

In addition, credit insurance can also cover single transactions with longer payment terms or trade with only one buyer, normally large transactions.

Background

The first trade credit insurance policies were offered by the British Commercial Insurance Company established in 1820 to offer fire and

life coverage. However, trade credit insurance, as we now know it, was born at the end of nineteenth century, but it was mostly developed in Western Europe between the First and Second World Wars. Several companies were founded in every European country; some of them also managed the political risks associated with exports on behalf of their state.

Since then, trade credit insurance has grown into a multi-billion dollar line of business. In 2008, for instance, an estimated Euro 5.3 billion of global credit insurance premiums covered about Euro 2.6 trillion of sales. International trade (exports) has been the area where international credit insurers have been particularly active. Despite experiencing the period of major growth and profitability, trade credit insurance remains a highly specialized area of non-life insurance, which is distinctly different from the rest of non-life business. To operate profitably, trade credit insurers must have the ability to diversify the risk globally, have very large portfolios of business and possess state-of-the-art credit risk underwriting and information systems.

During the 1990s, a concentration of the trade credit insurance market took place and three groups now account for over 85% of the global credit insurance market (Figure 1). These main players are focused on Western Europe, but have rapidly expanded into Eastern Europe, Asia and the Americas:

- Atradius. A merger between NCM and Gerling Kreditversicherung. Later renamed Atradius after it was demerged from the Gerling insurance group and now majority owned by Grupo Companía Española de Crédito y Caución, S.L., of Spain.
- Coface. Formerly a French government owned institution established in 1946, this company is now part of the Natixis group.
- Euler Hermes. Comprising of a merger of the two credit insurance companies of the Allianz Group.

While trade credit insurance is often mostly known for protecting foreign or export accounts receivable, there has always been a large segment of the market that uses trade credit insurance for domestic accounts receivable protection. Domestic trade credit insurance provides companies with the protection they need as their customer base consolidates, creating larger receivables to fewer customers. This further creates a larger exposure and greater risk if a customer does not pay their accounts. The addition of new insurers in this area has increased the availability of domestic cover for companies.

Many businesses found that their insurers withdrew trade credit insurance during the financial crisis of 2007-2009, as insurers foresaw

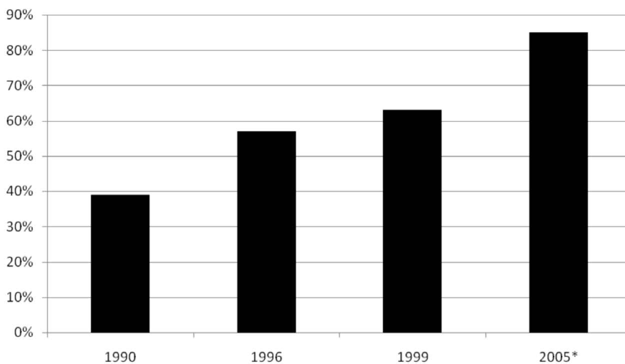
large losses if they continued to underwrite sales to failing businesses. This led to accusations that the insurers were deepening and prolonging the recession as businesses could not afford the risk of making sales without the insurance, and therefore contracted in size or had to close. Insurers countered these criticisms by claiming that they were not the cause of the crisis, but were responding to economic reality and ringing the alarm bells.

However, the trade credit insurance market has bounced back quickly, picking up good business that the banks let fall by the wayside, with an estimated Euro 2.0 trillion of sales covered in 2008.

In addition to the three major trade credit insurers noted above, and the remaining state owned export credit agencies, the other major commercial participants are as follows:

Afianzadora Latinoamericana (Argentina) • Allianz (Germany) • Askrindo (Indonesia) • AXA Assurcredit (France) • AXA-Winterthur (Switzerland) • AXIS Re (Ireland) • CESCE (Spain) • Chartis (USA) —China National Investment & Guaranty Company (China) • Chubb (USA)—CLAL (Israel) • COSEC (Portugal) • CGIC (South Africa) • Ducroire/Delcredere (Belgium) • ECICS (Singapore) • Ethniki (Greece) • Fianzas Atlas (Mexico) • Fianzas Monterrey (Mexico) • Garant (Austria) • Groupama (France) • GCNA (Canada) • Hannover Re (worldwide) • HCC International (UK) • ICIC (Israel) • Lloyd's of London (United Kingdom)—Malayan Insurance (Philippines) • Mapfre (Spain) • Mitsui Sumitomo (Japan) • Munich Re (worldwide)

Figure 1: Global market share of the five largest credit insurance groups, 1990–2005



Note: *Top four groups only. Since 2005 CyC has become the majority shareholder of Atradius, effectively reducing the number to three.

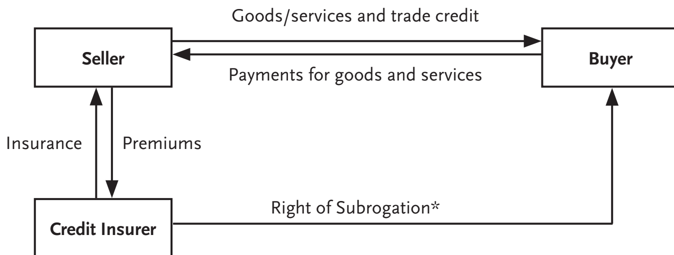
Sources: T. Dowding (1998), "Developments in European credit and political risk insurance". Financial Times Finance; Moody's; Swiss Re.

• Nationale Borg (Netherlands) • Partner Re (worldwide) • PICC (China) • Prisma (Austria) • QBE Insurance (Australia) • SACE BT (Italy) • SCOR Switzerland (worldwide) • SGIC (Korea) • SID First Credit (Slovenia) • Sompo (Japan) • Swiss Re (worldwide) • Tokio Marine & Nichido Fire (Japan) • TrygVesta Garanti (Denmark) • Zurich Surety, Credit & Political Risk (worldwide).

What is Trade Credit Insurance?

For example, a German toy manufacturer sells toys on credit to domestic and international clients. Because of previous bad experience with buyers not paying, and the need to borrow against its international receivables in order to grow its business, it seeks protection against payment delays and non-payment by its buyers. A "whole turnover" trade credit insurance policy, which covers all of the toy manufacturer's buyers, the "good, the bad and the ugly", is the solution. In exchange for a premium, which is based on the annual turnover and credit risk of its buyers, the toy manufacturer receives protection up to an agreed percentage of any losses incurred against late payment or the failure to pay by its buyers. It can then use this trade credit insurance policy to borrow from its commercial bank against the insured receivables, probably on better terms and conditions where the trade credit insurer is a higher rated credit risk than the toy manufacturer.

Figure 2



**Note:* The right of subrogation provides a trade credit insurer that has paid a claim the contractual right to collect directly from the buyer who has failed to pay.

Trade credit insurance protects a supplier from the risk of buyer non-payment, which can occur due to commercial or (in the case of international trade) political risks. The commercial risks normally

covered are the insolvency of the buyer and extended late payment, which is the failure to pay within a set number of days of the due date (normally 60–180 days) and is known as protracted default.

Political risk involves non-payment under an export contract or project due to the actions or inactions of a buyer's government. These risks may include currency inconvertibility; transfer of payment; war and civil disturbance; confiscation, expropriation and nationalization, etc. Trade credit insurers normally only provide cover against political risks in combination with coverage against commercial risk.

Trade credit insurers generally cover short-term commercial and political risks for periods not exceeding 365 days, and normally for periods of between 90 and 180 days. Medium term cover for periods up to 5-years are a small part of the business and are generally provided by the relevant state owned export credit agencies.

Trade credit insurers, as with most indemnity insurance products, maintain the right to recover any losses from the buyer. This is known as the right of subrogation and allows the insurer to "stand in the shoes" of the insured supplier and take legal action against the delinquent buyers, which helps the insurer manage and contain its overall loss position.

Trade credit insurers normally establish credit limits and terms of business (e.g. maximum invoicing period and maximum payment period) on all of a supplier's buyers, using their extensive credit and trading information data base. In addition, a trade credit insurer may grant automatic cover on buyer risks up to a discretionary limit, which may be a percentage of the overall policy limit or the credit limit on a particular buyer. These discretionary limits allow the supplier flexibility to transact business with a new buyer or temporarily increase the level of business transacted with an existing buyer, during peak business periods such as Christmas or St. Valentine's Day. However, in order to exceed these discretionary limits the supplier would be obliged to apply for a new or increased credit limit from the insurer.

The trade credit insurer also retains the right to reduce or cancel credit limits of a specific buyer if it's financial situation, or the overall political situation in the case of exports, deteriorates. These changes will only apply to future business and previously accepted risks remain covered.

Short-term trade credit insurance policies are normally "whole turnover", covering all of a company's trade receivables, either globally or on a country by country basis. While the insurer may exclude or limit cover for specific buyers it may consider high risk or not credit worthy, the supplier (insured) may not select which risks to cover, thus protecting the insurer against adverse selection whereby the insured

would seek to only cover its highest risks. The premium charged by the trade credit insurer will reflect the overall credit worthiness of all the covered buyers, which makes trade credit insurance a very cost effective method of risk management.

The majority of trade credit insurance policies are renewed on an annual basis, with the premiums being calculated on the insured supplier's annual turnover and its historic loss ratio. For new policies the premium rate is calculated at the start of the policy, and a minimum premium charged based upon the forecast turnover for the period of the policy, with the insured declaring its actual turnover on a monthly, quarterly or annual basis. Where the actual annual turnover exceeds the previously forecast turnover, then an additional adjustment premium is charged calculated using the agreed premium rate established as a percentage of insured turnover.

Trade credit insurance policies never cover 100% of the risks assumed, and normally do not exceed 85% to 90% of the losses, thus ensuring that the insured supplier is motivated to manage its buyers prudently, as the supplier will always share in any losses. In addition, limits may be set whereby a loss has to exceed an agreed threshold before a claim can be submitted to the insurer, or a deductible can be established whereby the insured supplier will assume this first level of loss for its own account.

There is also a pre-established waiting period for protracted default of between 60 and 180 days, where the supplier must make every effort to recover the outstanding payments from the buyer before the insurer will pay the loss. In the event of insolvency it is normally required that the receiver or liquidator acknowledges the debt as being due and unpaid.

Although most trade credit insurance is written under whole turnover policies, trade credit insurers also offer a range of products to meet the specific needs of suppliers, for example:

- Specific account policies, covering only certain named accounts;
- Single account policies, covering only a single named buyer; and
- Catastrophic policies, which have a high deductible and therefore only protect the insured supplier against a catastrophic trade credit default in excess of the amount of the deductible.

The scope of coverage will normally exclude inter-company sales; sales to governments or entitles owned or controlled by governments; goods sold benefiting from letters of credit; and cash sales.

In addition, many trade credit insurers, especially the big three, also offer two other products consisting of credit information and receivables collection management.

What are the Benefits of Trade Credit Insurance?

The need for trade credit insurance arises from the common practice of selling on credit and the demand by buyers to trade on open account, where they only pay for the goods and services after having on-sold them and are not willing to provide any form of security, for example by way of full or partial advance payment, bank guarantee or letter of credit. It should be remembered that trade receivables can represent 30% to 40% of a supplier's balance sheet and companies therefore face a substantial risk of suffering financial difficulties due to the impact of late or non-payment. For example, one in four insolvencies of suppliers in the European Union is due to buyer late payments.

Trade credit insurance, an important risk management tool for managing the risks of late payment or a complete failure to pay, offers insured suppliers several important benefits:

- It transfers the payment risk to the trade credit insurers, whose credit expertise, diversification of risk and financial strength enable them to assume these risks;
- It provides insured suppliers with access to professional credit risk expertise and related advice;
- It can help prevent insured suppliers from suffering liquidity shortages or insolvency due to delayed or non-payments;
- It reduces earnings volatility of insured suppliers by protecting a significant portion of their assets against risk of loss;
- It facilitates the access by insured suppliers to receivables financing and improved credit terms from lending institutions, some of which will insist on trade credit insurance before providing financing;
- It enables insured suppliers to extend credit to customers rather than requiring payment in advance or on delivery, or requiring security such as a letter of credit, thus allowing the supplier to effectively compete in a global marketplace where many buyers only buy on credit; and
- Allows insured suppliers to move up the value chain and accept direct buyer risk, thus cutting out the wholesaler or auction house.

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

As an example, a wholesale company's credit department has granted a credit line of Euro 100,000 to a customer. They then

purchased a trade credit insurance policy and the insurer approved a limit of Euro 150,000 for that same customer. With a 15% margin and average turnover of 45 days, the wholesaler was able to increase its sales to realize an incremental annual gross profit of Euro 60,000 on that one account. [(150-100)x0.15x360/45)]

Trade credit insurance can also improve a supplier's relationship with their lender. In some cases a bank will require the supplier to buy trade credit insurance to qualify for accounts receivable financing. For example, a flower grower in East Africa had an extreme concentration in its accounts receivable because it only had eight active accounts. The smallest of these customers had account receivable balances in the low six-figure range, and the largest was into the low seven-figure range. The flower grower's bank was concerned with this concentration and it required trade credit insurance in order to include the flower grower's accounts receivable as collateral. The flower grower purchased a trade credit insurance policy that specifically named all its buyers, providing the bank with the security it needed.

In fact, the trade credit insurance policy allowed the bank to increase the advance rate against the receivables from 75% to 80%. This allowed the flower grower to obtain an additional Euro 400,000 in working capital as a direct result of their trade credit insurance coverage and the flower grower was able to use the additional cash to fund the continued growth of the company.

However, 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 can be bound.

Should a Supplier Purchase Trade Credit Insurance?

In order to help assess whether a trade credit insurance policy would be beneficial, a supplier should ask themselves the following questions:

- Are the supplier's sales concentrated on a small number of large buyers or is the industry in which it operates consolidating into a few large customers?
- Do the supplier's bad debts suffer wide fluctuations from year to year?
- Does the supplier's lending bank provide adequate credit limits against its domestic and export accounts receivable or could the supplier sell more goods or services if it could increase its lending bank's credit lines?

- Are the supplier's terms of sale competitive with those of its mains competitors?
- Can the supplier withstand the insolvency of its top one or two buyers?

How Does a Trade Credit Insurance Policy Work?

The process of insuring accounts receivable must, by definition, involve a thorough understanding of a supplier's trade sector, risk philosophy, business strategy, financial health, funding requirements, and internal credit management processes. It should be expected that the trade credit insurer will, at a minimum, need the following basic information about the supplier's business:

- A listing of the supplier's top 10 to 20 buyers, broken down by country if applicable;
- A list of all the countries to which the supplier is selling goods and services;
- Full details of the supplier's credit management and collection procedures;
- Full details of the aged accounts receivables covering the previous 12 month's trading; and
- Three year's history of buyer delinquencies and credit losses.

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. It is therefore critical that the insurer has the right information to make informed credit decisions and thus avoid or minimize losses. A trade credit insurance policy, therefore, does not replace but supplements a supplier's credit processes.

Unlike other types of business insurance, once a supplier 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 supplier's credit manager plays an active role in that process. The majority of trade credit insurers will individually analyze the supplier's larger buyers and assign each of them a specific credit limit. This is where the type and amount of information the insurer has on a buyer, or is provided by the supplier, plays a very important role in setting and monitoring the credit limits.

Throughout the life of the policy, the supplier may, for example, request additional coverage on an existing buyer. The trade credit insurer will investigate the risk of increasing the credit limit and will either approve the requested higher limit, or decline with a written explanation. Similarly, suppliers may request coverage on a new buyer with whom they would like to do business.

It is also the trade credit insurer's responsibility to proactively monitor its customers' buyers throughout the year to ensure their continued credit-worthiness. This is achieved by gathering information about buyers from a variety of sources, including: visits to the buyer, public records, information provided by other suppliers that sell to the same buyer, receipt of the most recent financial statements, and so on. When it becomes knowledge that a buyer is or may be experiencing financial difficulty, the insurer notifies all suppliers 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 also to help suppliers avoid foreseeable losses. If an unforeseeable loss should occur, the indemnification aspect of the trade credit insurance policy comes into effect.

In these cases, the supplier would file a claim with the trade credit insurer, including the required supporting documentation, and after the expiry of the applicable waiting period, the trade credit insurer would pay the supplier the amount of the indemnified loss.

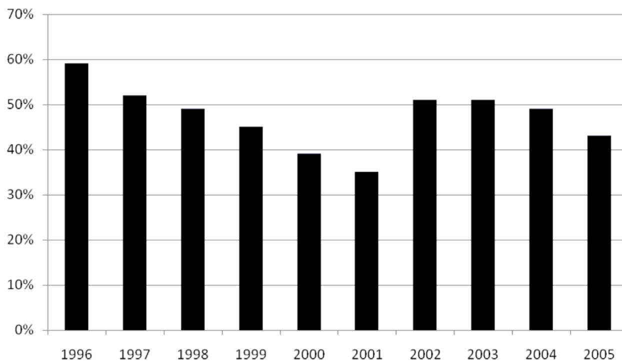
However, it should be understood that trade credit insurers do not cover losses where there is a valid dispute between the supplier and the buyer as to the quality of the goods and services provided, for example, where the goods are found to be damaged on delivery. In order for a supplier to have a valid claim against the insurer, it must have a valid and legally enforceable debt against the buyer that can be assigned to the insurer. Until the dispute has been finally settled in favour of the supplier it will not be considered an insured sale. In the case of insolvency this means that the supplier must obtain a written acknowledgement from the receiver that it has recognised and accepted the debt.

Reinsurance

As with all insurance products, reinsurance plays an important risk management role for the trade credit insurers, with the risks being shares with a group of specialised trade credit reinsurers, who also write direct business in some instances. The major trade credit insurance groups ceded about 50% of their business to reinsurers (Figure 3) under two basic types of reinsurance treaties: proportional and non-propor-

tional. Under a proportional reinsurance treaty, the direct insurer and the reinsurer share premiums and losses on a contractually defined ratio. A non-proportional reinsurance treaty (also known as an excess of loss treaty) sets an amount up to which the direct insurer will pay all losses. The reinsurer then pays all or a pre-determined percentage of all losses above this amount, up to the overall limit of cover.

Figure 3: Global rates of reinsurance cession of trade credit insurers. 1996–2005



Source: Swiss Re.

Alternative Products

As noted earlier, trade credit insurance competes both with bank letters of credit as well as factoring/invoice discounting. Up until the recent global credit crisis, it also had competition from capital market products such as credit default swaps and asset-backed commercial paper. Table 1 below provides an overview of the two main products and their features.

Letters of credit

A documentary letter of credit is a bank's agreement to guarantee the payment of a buyer's obligation up to a stated amount for a specified period of time. Unlike trade credit insurance, the buyer has to approach the bank to request a letter of credit, which has the disadvantage of reducing the buyer's borrowing capacity as it is charged against the overall credit limit set by the bank. In developing markets it may need to be cash secured. A letter of credit will only cover a single transaction for a single buyer whereas trade credit insurance usually covers

all of a supplier's shipments to all of its buyers. As a letter of credit is for a single transaction for a single buyer, it is normally more expensive than trade credit insurance, both in terms of absolute cost and in terms of credit line usage with the additional need for security.

Factoring

Factoring is a traditional product that allows a supplier to pre-finance its receivables whereby the factor pays a percentage of the face value of the receivables based upon its assessment of the credit risk and the underlying payment terms. Consequently, it is more expensive than trade credit insurance. It may be either non-recourse factoring, or full recourse factoring whereby the factor will reclaim the money from the supplier if the buyer does not pay.

Trade credit insurance and factoring both complement and substitute for each other. Where full recourse factoring is used, then it is in the best interests of both the supplier and the factor for the supplier to purchase trade credit insurance, and where it is non-recourse factoring then the factor may itself purchase trade credit insurance to protect themselves against non-payment by the buyer.

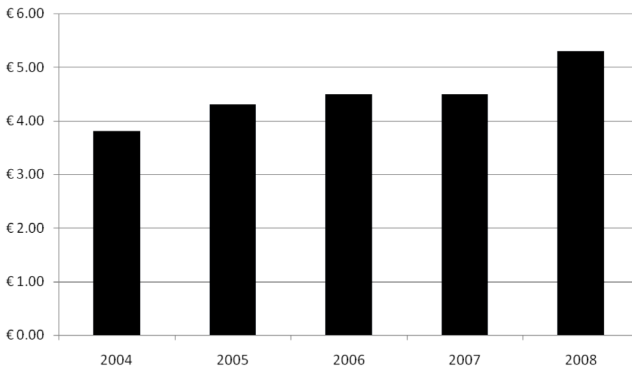
Table 1: Trade credit insurance and its substitutes

Feature	*Credit insurance*	*Letter of Credit*	*Factoring without recourse*
Risk Cover	Insolvency, protracted default and political risks	Buyer default	Insolvency and protracted default
Ancillary Services	Credit information, risk assessment, market intelligence, debt collection	None	Debt collection and credit information
Financing	None, but facilitates financing	None	Converts trade receivables into cash at a discount
Client relations	Buyer is unaware of credit insurance contract	Buyer initiates provision of letter of credit	Collection by factor of trade receivables may affect client relations

The Credit Insurance Market

In 2008, global trade credit insurance premiums increased to Euro 5.3 billion (Figure 4), following three years of relatively flat figures, as a

Figure 4: Global trade credit insurance premiums. Euro billions.

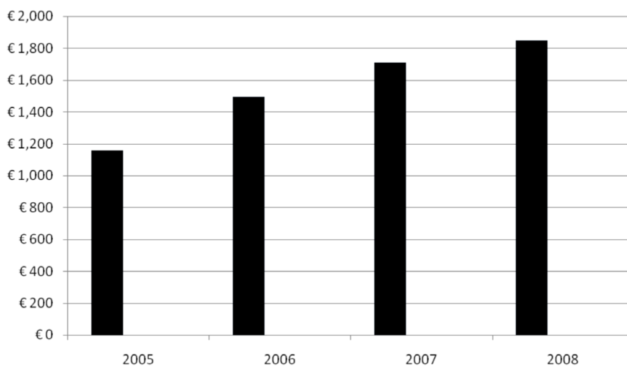


Source: International Credit Insurance & Surety Association (ICISA)

result of the contraction in the availability of banking products and the increase in premiums associated with the higher overall risk of default.

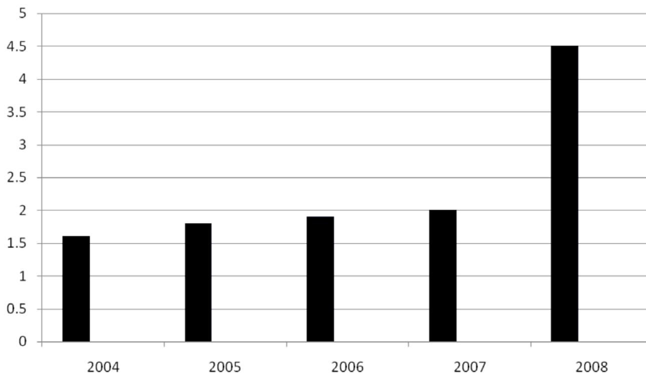
The comparative insured exposure showed a steady growth during this period (Figure 5). This is the risk exposure at the end of the financial year in question and is not the same as the total amount of supplier credit supported during the relevant year. As we have seen earlier, the supply and payment period is normally less than a complete year, which means that the exposure figures can support a higher volume of trade in any one year as goods and services are supplied, paid for and further supplies delivered. For example, and as noted earlier, the 2008 exposure of Euro 1.85 trillion had supported Euro 2.6 trillion in total sales.

Figure 5: Global trade credit insurance exposure. Euro billions.



Note: No figures available for 2004.
Source: International Credit Insurance & Surety Association (ICISA)

Figure 6: Global trade credit insurance claims paid. Euro billions.



Source: International Credit Insurance & Surety Association (ICISA)

The claims during this period have shown an over 100% increase in 2008 to Euro 4.6 billion (Figure 6), as the impact of the global credit crisis started to be felt. It can be seen that losses as a percentage of gross premium written, the so-called loss ratio, increased from an average of 42% in 2004, 2005 and 2006, to 45% in 2007, before doubling to 85% in 2008.

Is Trade Credit Insurance for Everyone?

Trade credit insurance can be an excellent risk management tool for many companies, but it may not be applicable to the following types of suppliers:

- Retailers—Trade credit insurance only covers business-to-business accounts receivable and not retail sales;
- Suppliers that sell exclusively to governments; and
- Suppliers that do not sell on open account terms.

For the most part, however, any supplier that conducts business-to-business trade transactions is essentially already investing in a trade credit insurance program. This investment is the sum of the costs associated with the supplier's risk philosophy, sales avoided, systems, credit/financial information, accounts receivable management, losses incurred, collection and insolvency management. All these are real costs and should be weighed against the cost associated with

outsourcing many of these functions to a competent trade credit insurer and the benefits the supplier would derive from such a relationship.

Conclusion

In the face of the global recessionary climate, increased business failures both domestically and globally, and the tightening of credit across the board, it is clear that business suppliers must be ever more vigilant regarding the management of their accounts receivable. 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 existing exposure can be effectively managed. Not forgetting that should an unexpected loss occur, the trade credit insurance policy provides indemnification, thus protecting the policyholder's revenues, profits, balance sheet and employees from what could otherwise be a financially catastrophic event. 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, capital and employment are protected.

For the convenience of the reader we have provided links to a glossary of the terms used in trade credit insurance in Annex 2 (provided by the International Credit Insurance & Surety Association (ICISA) to its members). Further information can also be found on the web site of the Berne Union http://www.berneunion.org.uk

Annex 1—Some frequently asked questions and answers

Bankruptcy: What happens if bankruptcy occurs?

The most common reason for not getting paid is that a buyer goes bankrupt before payment is due. Through a trade credit insurance policy a supplier can assure payment, either from their buyer or from their insurer. Bankruptcy, or its equivalent depending on the jurisdiction, is a recognised cause of loss in trade credit insurance policies, and triggers the start of the claims and collections process.

Buyer: Can I insure a buyer based in my own country?

A domestic credit insurance policy addresses the payment risks of buyers that are established in the same country as the supplier. Domestic policies usually have lower premium rates and a relatively simple structure.

Buyer: If I am only concerned about a few buyers, can I insure only these?

Companies that are generally not worried about getting paid may have a few large buyers that can cause concern in case they cannot or will not pay. Credit insurance policies can be structured to cover only these exceptional losses without including all the company's receivables, but the premium may be more expensive.

Buyer: Does the trade credit insurer need to know the identity of all the buyers of the insured supplier and the usage of under approved credit limits?

Credit insurers are not always aware of the identity of all the insured buyers or debtors of their clients (specifically the smaller ones). Suppliers are normally given a discretionary amount up to which they may trade under the cover of the policy without notifying the insurer. Any exposure exceeding this discretionary amount has to be made known by the underwriter and accepted by means of a written credit limit.

Credit insurers are not always aware of the exact usage of the granted credit limits, although average usage is known, and high risk exposures are actively monitored.

Civil Unrest: Is this insured?

Payment from a buyer can be obstructed as a result of strikes, protests, or other civil unrest. With a trade credit insurance policy that includes cover for political risks, not getting paid as a result of these occurrences is covered.

Chapter 11: Is this insured?

Buyers sometimes opt for a bankruptcy protection arrangement, also known as Chapter 11 in the USA and under different names in other jurisdictions. Such an arrangement allows the buyer to delay payments for an extended period. This occurrence is considered to be an insolvency/protracted default and is covered under a trade credit insurance policy.

Cover: What kinds of risks are insured?

Trade credit insurance provides cover against the risk that a buyer does not pay in accordance with the agreed terms of business. It can also cover the risk that a buyer pays very late. A buyer will not pay after he has been declared bankrupt, insolvent, or a similar legal status. Similarly buyers sometimes opt for a bankruptcy protection arrangement, which allows them to delay payments for an extended period. Both instances are covered under a trade credit insurance policy. Trade credit insurance policies can include a wider range of cover, depending on the circumstances. If a buyer does not pay, the trade credit insur-

ance policy will pay out a percentage of the outstanding debt. This percentage usually ranges from 75% to 95% of the invoice amount, but may be higher or lower depending on the type of cover that was purchased.

Credit insurance policies are flexible and allow the policyholder to cover the entire portfolio or just the key accounts against corporate insolvency, bankruptcy and bad debts. The most common type of cover is called the Whole Turnover Cover, which covers all buyers of the supplier.

Cover: What kind of risk does a credit insurance policy not cover?

The trade credit risk that is insured has to have a direct link with an underlying trade transaction, i.e. the delivery of goods or services. If no such direct link exists, the outstanding amount is not insurable under a trade credit insurance policy.

To be insured, transactions may not be subject to disputes. Parties are usually requested to resolve any valid dispute, prior to involving the insurer, and the insurer will not pay a claim until the dispute has been finally resolved in favour of the supplier.

Credit Insurance: What is it?

Trade credit insurance insures suppliers against the risk of non-payment of goods or services by their buyers. This may be a buyer situated in the same country as the supplier (domestic risk) or a buyer situated in another country (export risk). The insurance covers non-payment as a result of insolvency of the buyer or non-payment after an agreed number of months after due-date (protracted default). It may also insure the risk of non-payment following an event outside the control of the buyer or the seller (political risk cover), for example the risk that money owed cannot be transferred from the buyer's country to the supplier's country.

Credit Limit: How do these work and what is their value?

The trade credit insurer issues a credit limit for every buyer with whom the supplier trades. The level of the limit is set at the maximum amount that can be owed to the supplier by the buyer at any time. The credit limit is the maximum insured amount for a specific buyer and the poli-

cyholders can trade on an insured basis within the approved credit limit throughout the policy period without further reference to the insurer. If a discretionary limit has been agreed, exposures up to that amount do not have to be agreed by the insurance company but are covered based on the payment experience of the policy holder.

The insurance company has the right to reduce or cancel a credit limit at any time, usually as a result of negative information. This allows the exposure to be brought down in a timely manner, as negative news (such as deterioration in payment behaviour) is known immediately. A new limit will apply to all deliveries that are made by the supplier to the buyer after the date of the credit insurer's decision to reduce or cancel a limit.

Debt Collections: How does this work?

If a buyer is late in paying his bill, an established collection procedure is required of the supplier. Most suppliers have internal guidelines on how to deal with late payers. However, sometimes these efforts do not have the desired effect. In these instances it can be helpful to employ a professional collection agent. Recovery approaches include telephone calls, written demands, and visits to the buyer's premises. Most credit insurance companies offer debt collection services, or have partnered with specialised collections firms who can provide this service.

Financial Guarantee: Is trade credit insurance a type of financial guarantee?

A trade credit insurance policy is a conditional contract of indemnity between two parties that cannot be traded. A financial guarantee is unconditional, usually on-demand, and transferable.

A trade credit insured risk is always directly related to an underlying trade transaction, which is either the delivery of goods or services. The correct fulfilment of this trade transaction is essential for trade credit cover to exist.

A financial guarantee is independent and does not rely on a third party contract.

Financing: How can trade credit insurance ensure my company's liquidity?

Outstanding receivables are usually the largest or second largest item on a trading company's balance sheet. Bad debt losses can affect

liquidity and profits. Even worse, they can cause a company's financial ruin. Late payments or non-payments therefore pose a considerable threat to future liquidity of that company if no measures are taken. By insuring these receivables against non-payment or late payments, the company ensures its cash flow. Companies that have their business financed by a bank can assign their credit insurance policy to their bank as a security and frequently can borrow against the policy on more favourable terms and conditions.

IFRS: How is credit insurance considered in IFRS?

Following an IASB amendment regarding IFRS 4 Insurance Contracts and IAS 39 Financial Instruments, trade credit insurance contracts can be accounted for under the Standard for Insurance Contracts (IFRS 4).This will be reviewed in phase 2 of the IASB project.

Insolvency: When does insolvency occur?

Trade credit insurance covers against the risk of not getting paid following insolvency. Normal payment ceases when a buyer is declared bankrupt, when a receiver is appointed, or when a bankruptcy protection period is announced. These and similar occurrences are regarded as "insolvency".

Maximum Liability: What is the maximum liability?

The maximum liability amount is used to limit the maximum loss that can be sustained under a single policy, irrespective of the number of claims. If the total loss of a policy occurring in one year exceeds the amount of the maximum agreed liability, the actual loss for this policy is limited to this amount. The maximum liability is often defined as a multiple of the premiums paid during a given policy period.

Multinationals: Are there policies designed for Multinationals?

Multinationals want to benefit from their buying power. They look for seamless cover across borders, but with local service in local currency and local language. At the same time group exposures should be constantly monitored. Multinational credit insurance programmes are offered by many trade credit insurers. These often include single

wording with policies issued in different languages and/or currencies to suit the needs of the different subsidiaries.

Policy: Are trade credit insurance policies standard or tailor made?

Trade credit insurance policies are drafted to suit your needs. This makes them unique for each customer. A trade credit insurer will always investigate the supplier's particular circumstances and needs. The result is a custom made policy at a corresponding risk based premium. Most trade credit insurers also offer standard policies, which may be more suitable depending on the trade to be insured. Many trade credit insurers have developed particular policies aimed at small and medium sized enterprises. These policies have low administration, and are competitively priced.

Policy: How do I get a policy?

All credit insurers offer information on their products through their websites. Often policy wording or non-binding quotes can also be obtained on-line. Custom made quotes and policies can be obtained either on-line or directly from the insurer. Brokers, in particular specialised brokers or brokers with a specialised trade credit insurance department, also offer non-binding indications upon request.

Political Risks: Is this included in a trade credit insurance policy?

Trade credit insurers that insure export risks normally also offer a political risk cover endorsement for an additional premium. This is the risk that payment cannot be made due to actions or inactions by a foreign government such as transfer restrictions, nationalisation, war or civil disturbance.

Premium: What does a trade credit insurance policy cost?

Insurers have different ways of insuring receivables. Policy holders can often choose smaller or larger risk sharing options. Policies that are currently offered can cover domestic sales as well as world-wide sales, depending on the wishes of the supplier. Suppliers can often choose

between insuring a single transaction or all their sales. All these factors influence the premium rate charged. Insurers offer a free quote without any obligation, either on-line or from dedicated sales staff.

Premium: How is the premium calculated?

Credit insurance is priced on the basis of standard actuarial techniques. It is sold mostly on a whole turnover basis (whole turnover cover policy) and premium rates are generally given as a percentage of the company's turnover (including financially sound and weak customers). Obviously, the actual annual turnover is not known at inception of the policy and so the final dollar amount of the premium is also not known. Therefore, a minimum premium amount is usually calculated based on the premium rate being applied to the estimated annual turnover as an integral part of the contract. At the end of the year the actual turnover is used to calculate the final premium amount dues, and where it is higher than the minimum premium an additional adjustment premium is paid by the supplier to the insurer.

Protracted Default: What is this?

Policies that include this cover pay out if a buyer is late in paying, and payment is still due after a pre-determined period (usually 60-180 days after due date of the invoice). After this period the buyer is presumed to be insolvent provided the delay in payment is not due to an unresolved valid dispute.

Selected Risks: Can I insure only those risks that are of concern?

Companies that are concerned about only a few of their buyers often opt for a credit insurance policy that covers only those buyers. Alternatively, high thresholds or retentions in a policy aim to fulfil the needs of those companies that are only concerned with very large exposures.

Single Transaction: Can I insure a single transaction only?

This usually applies to large or complex contracts, although single transaction cover also occurs in other circumstances. This type of cover

is particularly useful for companies that deal with only one buyer or that have very few transactions.

SMEs: Are there policies designed specifically for SMEs?

Many credit insurers offer policies aimed at small and medium sized enterprises (SMEs), which contain simple language, are competitively priced, and have low administration requirements. Often these policies are available on-line, directly from the insurer.

Transfer of Currency: Is this insured?

The risk or the inability to transfer money from one country to another, and therefore for not getting paid, can be insured under political risk cover.

War: Does Credit Insurance cover the effects of armed conflict?

War disrupts an entire country and often makes it impossible for buyers to pay their bills. War cover forms part of political risk cover, and provides cover against this risk.

Whole Turnover Cover: How does that work?

A whole turnover credit insurance policy includes all buyers and insures against non-payment. Because of the spread of risk, premium rates are usually very competitive. The entire buyer portfolio is constantly being monitored, and suppliers are advised about the financial status of every buyer.

Source: International Credit Insurance & Surety Association (ICISA)

Annex 2—Glossary of terms used in trade credit insurance

Please visit:
http://www.icisa.org

OR

http://www.worldbank.org/nbfi

Earlier published primers can be downloaded from
http://www.worldbank.org/nbfi and currently include:

1. **Introduction to the Insurance Industry**
by Rodney Lester
2. **Introduction to Reinsurance**
by Rodolfo Wehrhahn
3. **Microinsurance Business Models**
by Taara Chandani
4. **Role of the Actuary in Insurance**
by Michael Hafeman
5. **Asset Structures for Insurers**
by Michael Hafeman (based on a document written by Ray Willing)
6. **Insurance Accrual Accounting**
by Oliver Reichert
7. **Consumer Protection Insurance**
by Rodney Lester
8. **The Role of the Underwriter in Insurance**
by Lionel Macedo
9. **The Role of the Insurance Industry Association**
by Brad Smith and Diana Keegan
10. **Intermediaries**
by Rodney Lester
11. **Insurance Governance and Risk Management**
by Rodney Lester and Oliver Reichert
12. **Agricultural Insurance**
by Ramiro Iturrioz
13. **On- and Off-Site Inspections**
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14. **Risk Based Supervision**
by Tony Randle