CREDIT INSURANCE GUIDE

RODNEY MATHERS CONSULTANCY LIMITED

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LIKE FOR LIKE COMPARISON BEST PRACTICE BROKERS VERSUS OTHER BROKERS

BEST PRACTICE		OTHER BROKERS	
On line applications with real time commentaries	YES	On line capability with real time commentaries?	NO
On line buyer records	YES	On line records?	NO
Read only bank access	YES	Bankers read only access?	NO
On line over due reports	YES	On line over due reports?	NO
Sales declarations online	YES	Sales declarations online?	NO
Dedicated credit risk management team	YES	Full time credit risk management team?	NO
Specialist broker with 0800 number with full back up	YES	Specialist credit insurance skills 0800?	NO
Data base of buyers on line	YES	On line data base of buyers?	NO
Specialist full time credit insurance claims team	YES	Dedicated full time credit insurance claims team?	NO

TRADE CREDIT INSURANCE

Credit insurance ensures that a sale is a sale. It is a tool that allows sales departments to sell product on open account - without letters of credit.

The below chart illustrates the degree of safety inherent with the four main methods of sales, with one being the safest and four being the most hazardous.

TERMS	SECURITY	TOTAL COST OF GOODS*	RISK TO SELLER
(1) Cash in advance	Cash	High	Nil
(2) Letter of Credit	Letter of Credit	High	Low
(3) Open Account	Credit Insurance	Low	Low
(4) Open Account	None	Lowest	Highest

*Including the time value of money and all transaction costs

The competitive advantage of using credit insurance is that it typically costs 50% to 70% less than the cost of Letter of Credit. This allows a sales department to compete more favourably with other local sources of similar products who might sell on open account terms.

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Credit insurance covers the intangible risk of non-payment for goods or services by a buyer, or the inability to receive payment due to some political action.

Unless able to obtain payment in advance of shipment, the seller will have an exposure to the possibility of default in payment, and while good credit management and careful selection of the payment terms will reduce the risk exposure, there will always be some liability in an export or domestic transaction. It is always difficult to monitor the financial performance especially with an overseas buyer. The buyer may pay on a regular basis with the seller unaware of factors that might impact on the buyer's ability to pay.

The buyer may have an exposure to a third party who is unknown to the seller, and the exposure could be of such a magnitude that a slow payment from this party will be enough to cause the buyer to default. This is a very common situation that credit insurers see in their claim files.

Potential cost of bad debts

Bad debts have a snowballing effect out of proportion to their size, as extra sales are required to offset a loss. Even a small bad debt can have a significant impact on your business.

Bad debt	Extra sales required if profit margin is 5%	Extra sales required if profit margin is 20 %
$ 5,000	$ 100,000	$ 25,000
$ 10,000	$ 200,000	$ 50,000
$ 50,000	$1,000,000	$250,000

Market Considerations

All businesses selling on open credit are exposed to the problem of bad debts, and while good credit management can reduce the risk exposure it can never be totally removed. For exporters, the situation is aggravated by the distance between them and the buyer and longer payment terms. The physical distance provides delays in communication of problems, limits the information available on the buyer, and dilutes market intelligence. Language difficulties often compound any of the previous problems.

Add to this the possibility of political actions that might delay or stop payment from the buyer's country, and the risk profile increases yet again.

A common retort to the above 'fear' scenario is that the exporter knows the buyer and has no concerns. However, buyers will not usually forewarn a supplier of financial difficulties as continued supply (and continued cash flow) is required in the hope that default can be avoided. The nature of the relationship with the buyer makes no difference with insurers' claim files full of situations where the buyer/seller relationship was seen to be intimate from both business and personal levels, but with the same sad result when default occurred.

Surprisingly, it is usually when an economy is recovering from a recession that most insolvency’s occur. Businesses are often caught out with growing sales and stretched resources, and lenders tend to be less forgiving in these situations.

Commercial Risks

These are the risks of payment default by buyers. Specific causes of loss not caused by any action of an exporter are:

- ❖ Buyer insolvency;
- ❖ Protracted default by a solvent buyer; and
- ❖ Contract repudiation (buyer's refusal to uplift goods on arrival provided that this is not caused by any action of the exporter).

Similar risks are faced with domestic sales with the possible exception of contract repudiation.

Political Risks

These risks are country related rather than buyer related and can be divided into three broad categories.

- ❒ Inconvertibility. The failure of a buyer's country to transfer foreign exchange as a result of economic, financial, or political difficulties. This is the most common cause of political risk loss.
  This is a red alert area as the financial commentators are now warning about with likely much larger losses possible in the future than was experienced in 2008 – Leading country financial collapses !

- ❒ Contract Frustration/Cancellation. The failure to pay, due to war or any action taken by the buyer's country which directly prevents performance of the contract and the cancellation or non-renewal of valid export/import licences.

- ❒ Public Buyer Default. The contractual default of a public buyer which can be the government, a government agency, a regional or local authority, a nationalised undertaking, or a state trading organisation.

Applying for Cover

Information Required

Before providing cover, credit insurers assess risk based on their own investigations into the buyers and the country risk involved. They may require certain basic information:

- ❖ Company details and often a set of the latest accounts.
- ❖ Nature of the business, eg manufacturer / agent / merchant.
- ❖ Type of goods exported.

- Countries for which cover is required.
- Current/proposed turnover to those countries.
- Methods of payment used.
- Debtors' analysis and details of overdue accounts.
- Details of the credit management policy.
- Details of the buyers for whom cover is required, including the credit limit required, and the proposed turnover to them.
- Details of any policies, guarantees, and/or securities applied for or held.

When considering a proposal for cover, in addition to the particular overseas market conditions and the individual buyer's situation, insurers also take account of the proposers own circumstances by:

- Credit management systems;
- Trading experience;
- Current and predicted needs.

Level of Cover Provided

After the policy terms have been agreed, the Insured is notified of the credit limits approved for the various buyers. It is usual for credit insurance policies (for both export and domestic trade) to cover an agreed percentage of any loss that might occur. The level of cover provided is usually 90 percent for commercial risks.

In some instances, a first loss, or deductible or excess may be applied to remove what are considered to be small nuisance claims. Likewise claims under a certain agreed figure may not be claimable. These are known as ‘Non qualifying Losses’ or ‘Threshold’ , however if the loss exceeds this sum the claim is payable in full.

When an Insured receives their policy, they should ensure that:

- The agreed credit limits have been issued;
- All countries of trade are endorsed on to the policy;
- The terms and conditions are understood and any restrictions are explained.

Calculation of Premium

A premium rate (percentage of invoice value) is agreed with the insurer at the commencement of the policy, and in some cases a schedule of rates may be agreed, giving differing rates for different payment terms and differing political risk exposures. However, it is more common for one rate to be applied that reflects the spread of business offered. This rate is normally expressed as a percentage of insured turnovers and is applied to the estimated annual value of all insured transactions.

The insured may be called on to declare sales on a monthly, quarterly, half yearly or annual basis to the insurer, and depending on the system utilised, will be invoiced for those sales at the agreed premium rate. At the end of the policy year this turnover figure will be compared to the estimated figure given at policy inception and an adjustment to the prepaid premium made.

Premium rating example

An insured estimates that sales for the next 12 months will be $3 million.

If the agreed premium rate struck is $0.3% so the estimated annual premium would be sales of $3,000,000 times the $0.3% = an annual premium of $9,000 and would be paid either annually or quarterly in advance.

At the year end if the actual declared sales were $3.6 million, then an additional premium would be charged on the $600,000 of additional sales.

Therefore the $600,000 would be charged at the rate of $0.3% = $1,800, as a year end adjustment. Conversely credits are issued through overstated sales.

In most instances a buyer approval fee or charge is levied at the beginning of a policy period, this amount being dependant on the number of buyers, the buyers country and the like. With the policies being reviewed annually the premium rate is then adjusted at this time.

It is also possible in certain cases to apply a ‘No Claims Bonus’ which varies in percentage but is commonly set at 5%. This refund of premium is deducted from the subsequent year’s premium charge after the insured waives their right to claim.

Payment of Claims

The time taken to pay a claim depends on the terms of the insurance and the cause of loss. To aid prompt settlement the insured is obliged to:

- Commence recovery action as early as possible and, if the policy requires them to do so, keep the insurer advised of progress.

- Warn the insurer as soon as possible if loss is suspected.

- Present the claim as early as possible.

  They will also need to ensure that supporting documentation is accurate and complete. Documentation should always provide evidence of:

  - Existence of the order / contract;
  - Dispatch / delivery of goods;
  - Recovery action taken; and
  - Proof of insolvency / exchange transfer delays (if appropriate).

The insured **should not** (unless instructed to the contrary by the insurer):

- Claim monies from the insurer which are not normally covered under the policy, eg penalty interest or commission unearned by an agent, unless specifically agreed in advance, and

- Overlook responsibility to try and recover a loss after a claim has been paid by the insurer.

Rejection of Claims

Claims are most often rejected by insurers for one or more of the following reasons:

❖ The exporter failed to declare the shipment to the underwriter;

❖ The exporter did not perform as per the contract of sale (Dispute);

❖ Premium was not paid;

❖ Incomplete or inaccurate documentation;

❖ The buyer credit limit was exceeded (in which case liability is limited)

❖ The insured took no recovery action on the current or a previous claim;

- ❖ The insured withheld relevant facts about the buyer from the insurer;
- ❖ Payment terms were amended in favour of the buyer without the consent of the underwriter;
- ❖ Goods were released to the buyer while previous sales remained unpaid or released against payment in local currency without the consent of the insurer.
- ❖ The exporter did not obtain an export licence before shipment where required.

Tax Considerations

If there is a bad debt general provision in the businesses budget, it is arguably the most inefficient means of dealing with bad debt losses as general bad debt provisions reduce profit but give no corresponding tax relief being non- deductible. A write back of the provision has the reverse effect on profit, and can free funds for shareholder distribution.

Summary of Key Points

- ❒ **Debtors are a class of asset, susceptible to loss or reduced realisable value, like other assets. Manufacturing companies debtors, are substantial assets and in some cases, the major asset.**
- ❒ **The commercial and political risks can be minimised by credit insurance.**
- ❒ **Do not assume that known buyers are necessarily safe. Big collapses are increasingly unpredictable.**
- ❒ **Credit insurance policies can be used to support financing arrangements, in some cases up to 100% of the debtors ledger and if the companies accounts are strong, on a 'Non Recourse' basis.**
  (Are the working capital needs of the business well looked after? Are debtors valued fairly? Does your bank take excess security? When sales increase, does your access to working capital increase?)
- ❒ **Be aware of policy limitations and restrictions.**
- ❒ **Ensure that proper documentation is supplied when making claims.**

COMMONLY ASKED QUESTIONS

Q *Why do we need credit insurance?*
A Most of your assets are in debtors – all your risk is in debtors

Q *What is the alternative to credit insurance?*
A Use the bank documentary credit system, or obtaining security from buyers (letters of credit).

Q *Why do I need a broker?*
A To negotiate a fair contract – there are a number of underwriters all with varying terms also to supply claims advice, to act as the client's confidante and to secure broker clout. Broker fees are included in all quoted premiums.

Q *The premium is quite expensive surely we could put funds aside to establish our own contingency fund?*
A One moderate debtor collapse could blow the premium in one go, the fund is not tax deductible and would have to be made out of after tax profits.

Q *What are the legal considerations of not carrying credit insurance as directors of the company?*
A Under the Companies Act, solvency is a key statutory demand on directors and officers. In the case of a major loss rendering you incapable of meeting a solvency test each director could be personally liable.

Q *Can premiums be paid progressively?*
A Premium payment frequency is negotiable, monthly, quarterly or annually.

Q *When does cover attach?*
A Cover operates on all invoicing done on or after the inception date of the policy and applies to all invoices issued up to the expiry date notwithstanding that claims may come to light after that date.

Q *Can the cover be backdated?*
A Yes but overdue buyers are excluded (Overdue meaning outstanding past or beyond agreed payment terms)

Q *Are there any additional charges ?*
A There are annual buyer charges (called limit administration charges) which are made by the insurer for their credit reporting and assessment costs. These are charged for each buyer for whom cover is requested or who has a limit in excess of the '***Discretionary limit'***. (see page 9)

Q *What is a "**The Discretionary Limit**"?*

A This is the maximum limit to which you may grant credit to buyers without specific reference or approval of the insurer, provided you meet the criteria outlined in the policy for assessing credit worthiness.

Q *Is it desirable to contain certain provisions relative to insurance and payment security in the buyer's contracts?*

A Rodney Mathers Consultancy may be able to assist you provide draft clauses depending on your terms of trade and specific contracts.

Q *What happens if the buyer credit limit is exceeded?*

A The insured should ask for an increase prior to this happening otherwise cover is limited to the approved amount. Trading over the approved limit can have serious implications in the event salvage is recovered as the underwriter has rights in this regard.

Q *At what point does the underwriter take over the debt?*

A If recovery prospects are real but complicated it may take an assignment of the debt.

Q *When does the underwriter actually pay out?*

A Within 3-4 weeks but with protracted default no sooner than 4 -6 months after due date or extended due date. Political risk claims have a longer waiting period.

Q *Why does the insurer usually only pay an "Insured percentage" of each claim?*

A To create the proper incentives for good credit management.

Q *How are buyers assessed?*

A Through references from credit agencies, the insured and direct contact between the insurer and the buyer.

Q *Are buyers comfortable to release information to insurers?*

A No, but they usually co-operate when they are provided with the underwriters confidentiality undertakings and find it enhances their credit facility.

Q *How can we trust the insurer with regard to buyers confidentiality?*

A They are acutely aware they must enhance the insured's sales potential upon which their premium income depends. Often a Non Disclosure agreement Is completed prior to financials are released.

Q *Does the insured have access to confidential information?*
A No only the underwriter is privy to buyer financial data unless the buyer provides specific approval for their release.

Q *If the buyer knows credit insurance is in place isn't there a danger they will pay other buyers ahead of me?*
A On the contrary if the buyer knows that credit insurance is in place they will also know that credit management and collection will be disciplined and rigorous. (The insurer of course does not assume direct responsibility for the debt).

Q *Do I have to provide on going debtors ledgers information?*
A With some underwriters monthly overdue reports are required on an ongoing basis however this requirement varies from underwriter to underwriter. We recommend they be provided irrespective of the policy requirements.

Q *Can just the 10 or 20 largest debtors accounts be insured ?*
A Yes, any number from a minimum of the three largest buyers although single buyer cover is also available.

Q *What is Pre- shipment or Pre – credit risk?*
A Pre-shipment risk is where a contract has been entered into with a buyer, usually a deposit is paid, and the goods or products are in the process of manufacture when the buyer falls over leaving the insured with the balance unpaid, holding low value or worthless goods. It is also known as Work in Progress cover.

Q *Can I insure against pre-shipment insolvency of buyer risk?*
A Yes you can but only for insolvency risk and not for contract repudiation risk.

Q *Why should I insure for shipments covered by letters of credit?*
A If the buyer fails to pick up the goods the letter of credit can't assist, or there may be a country (political) risk or the bank issuing the letter of credit may be unable to honour the letter of credit.
Insisting on letters of credit may cause a possible sale to fall over due to the extra costs involved for the buyer. Trade credit insurance could provide the same cover at a fraction of the cost.

Q *Can I insure an associated or sister company?*
A If the ownership is identical – no. If the shareholding is say less than 20% - yes it is possible.

Q *Does the policy cover disputes?*
A Disputes are not viewed as insolvency issues. Sometimes a debtor will create a dispute to delay or avoid payment and if their argument has substance, then only after arbitration or a court decision will the insurer entertain liability.

RODNEY MATHERS CONSULTANCY LIMITED

You are only ever as good as the professional representing your company; insurance is no different. Many of RMC's clients originated from 'International Brokers' who's so called experts failed to perform their expected duties in this respect.

To obtain the 'Best' it is our duty as specialists to represent the client and to present their risks to underwriters in the most favourable manner possible.

RMC are unique in NZ as we are consultants having particularly strong knowledge about trade credit risk. The principal has been in the insurance industry as a broker for many decades, but more particularly with credit insurance since 1999, born out of a need for specialised treatment in an area that general brokers did not posses. Trade credit insurance is one of the least understood risk subjects and calls for specialist skills as it is more akin to financial risks.

RMC's focus is one of an absolute allegiance to the client. We adopt a strict commercial approach to client relationships, and approach our client's needs as if we were shareholders in their business.

We have a strong loyalty to the client which always takes precedence ahead of the underwriter. We deal with all client divulged information on a strictly confidential basis.

Top class service is our number one objective with our strap line being

New Zealand's Innovative Insurance Architects

Being primarily trade credit and insurance specialists we possess unique skills and know that our personal service will not be bettered in the market place. Whilst our main focus is in credit risk consultancy, we do have wide experience in commercial and industrial areas which holds us in good stead when negotiating on behalf of our clients and understanding the various industry sector risk profiles.

Should you wish to pursue your enquiries regarding the implementation of credit insurance please contact the office of RMC and speak with the principal of the company and director Rodney Mathers in the first instant.

We recommend you also visit our website which provides additional information about our activities.

www.rodneymathers.co.nz