Allianz Trade

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A Guide to Trade Credit Insurance

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Financial executives must continuously balance the cost of doing business with the risk of doing business.

In the face of today's changing domestic and global economic climate, recognizing and managing future risks has become a priority for business leaders. Losses attributed to nonpayment 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 to trade credit risk.

This is evidenced by the data tracked in the Allianz Trade Global Index of Business Failures. The risk of buyers defaulting on trade debt continues to loom.

Options for Mitigating Credit Risk

Financial executives should weigh the costs and benefits of several options for mitigating 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:

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.

However, it also impacts other areas of cost:

- Investments in credit management resources, systems and information acquisitions, analysis and monitoring;
- Impact on sales, given risk tolerance;
- Impact on capital allocation of the balance sheet;
- Typically does not account for large and unexpected catastrophic loss.

Euler Hermes does not issue direct policies in the Middle East. It operates in partnership with and provides reinsurance support to a number of selected locally licensed insurance companies, which issue Trade Credit Insurance Policies designed and approved by Euler Hermes in its capacity as a Reinsurer.
Allianz Trade is the trademark used to designate a range of services provided by Euler Hermes.

Factoring

A factor is a company that typically purchases companies' accounts receivable at a reduced amount of the face value of the invoices.

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;
- Capacity constraints associated with line availability.

Letters of Credit

A documentary letter of credit is a bank's agreement to guarantee the payment of a buyer's obligation will be received on time and in the correct amount.
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 counted against the company's overall credit limit set by the bank.

In developing markets it may need to be cash secured.

Impacts on cost include:

- Only covers a single transaction for a single buyer - regularly relying on this form of protection can be tedious and time consuming for a buyer;
- Expensive, both in terms of absolute cost and in terms of credit line usage with the additional need for security;
- Ties up working capital for buyers, thus potentially restricting opportunities;
- The claims process can be lengthy and laborious and can be derailed by minor discrepancies in paperwork.

Options for Mitigating Credit Risk

Credit Insurance

Credit insurance is a business insurance product that protects a seller against losses from nonpayment 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.

What is Credit Insurance?

Credit insurance protects businesses from non-payment of commercial debt.

It makes sure invoices will be paid and allows companies to reliably manage the commercial and political risks of trade that are beyond their control.

Capital is protected, cash flows are maintained, loan servicing and repayments are enhanced, and earnings are secure from these events of default.

A 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 have previously been restrictive or only sold 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 perceived as too risky.
- **Expansion into new international markets:** Protection against unique export risks and market knowledge to make accurate growth decisions.
- **Better financing terms:** Banks will typically lend more capital against insured receivables, and may also reduce the cost of funds.

- **Reduction in bad-debt reserves:** Insuring receivables frees up capital for the company. Also, credit insurance premiums are tax deductible, but bad debt reserves are not.

- **Protection against non-payment and catastrophic loss:** Should an unforeseeable event catch a company and its insurance carrier without warning, the bill gets paid via the claims process.

While protection is often perceived as the primary reason to purchase credit insurance, the most common benefit companies receive by investing in a policy is that it helps them increase their sales and profits without additional risk.
It is in this way that a credit insurance policy can typically offset its own cost many times over, even if the policyholder never makes a claim.

What Credit Insurance is Not

As important as it is to know what trade credit insurance is, it is equally important to know what it is not.

Credit insurance is not a substitute for prudent thoughtful credit management.

Sound credit management practices should be the foundation of any credit insurance policy and partnership. Credit insurance goes beyond indemnification and does not replace a company's credit practices, but rather supplements and enhances the job of a credit professional.

How Does a Credit Insurance Policy Work?

At the onset of the policy the credit insurance carrier will analyze the creditworthiness and financial stability of the policyholder's insurable customers and assign them a specific credit limit, which is the amount they will indemnify if that insured customer fails to pay.

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

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

By implementing credit insurance, the policyholder's credit management team has been enhanced by the thousands of professionals associated with these carriers; your credit insurer essentially becomes an extension of your team. Throughout the life of the policy, the policyholder may request additional coverage on a specific buyer should that need arise.

How Does it Work?

Similarly, policyholders may request coverage on a new buyer with which they'd like to do business. This information is constantly updated and cross referenced. 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 Goal of a Trade Credit Insurance Policy

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

Conclusion

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.

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.

To schedule a meeting with our experts, please contact advisory.team.uae@allianz-trade.com

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Allianz Trade
United Arab Emirates-DUBAI
c/o Alliance Insurance PSC
501, al Warba Center
P.O. Box 183957
Phone: +971 04-2660019

Kingdom of Saudi Arabia-Riyadh
c/o Allianz Saudi Fransi Cooperative Insurance
2nd Floor, Alliance Building -
Khorais Rd, Malaz
P.O. Box 3540 Riyadh 11481
Phone: +966 11 473 6917

Kingdom of Saudi Arabia-Jeddah
c/o Allianz Saudi Fransi Cooperative Insurance
Allianz Branch - Ibrahim Aljafali Rd,
Al Andalouse
P.O. Box 122901 Jeddah 21332
Phone: +966 2 283 0229

Website: www.allianz-trade.ae

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