Association of British Insurers

TRADE CREDIT
INSURANCE GUIDE

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Introduction

Credit insurance provides the key to successful trade and at ABI we are proud to include all of the leading providers within our membership. To deliver the very best solutions to the market, the credit insurance industry champions' innovation whilst maintaining the highest standards of performance that only many decades of supporting businesses around the globe can bring.

Credit insurance is more than a simple protection against loss; policyholders benefit from access to detailed information on all aspects of trade and receive guidance from industry experts. Trade credit insurance is an enabler for businesses with almost 12,000 policies taken out by British companies in 2015; not only to protect their business, but also to see it grow. In 2015 ABI members insured almost £300 billion of turnover and enabled numerous trading partnerships to flourish.

This guide explains what credit insurance is, how it works and the benefits it can bring to businesses of all sizes who trade in the UK or who may be looking to export. It provides details of the types of different policies available and how a business can go about taking out suitable credit insurance cover.

What is credit insurance

Credit insurance is a Business to Business type of insurance providing cover against the risk of not being paid for goods or services that businesses sell. If their customers (also known as buyers) do not pay, the loss is covered by the insurance policy. The protection gives businesses the confidence to extend credit to new customers and also improves access to funding, from banks and financial institutions often at more competitive rates.

With credit insurance, businesses can choose a policy that protects against commercial and/or political risks that are beyond their control, knowing that invoices will be paid. This helps firms to grow profitably, supporting them at all stages of the business cycle and minimising the risk to them of unexpected customer *insolvency* or *protracted default (non-payment of a debt within the agreed credit period).*

Credit insurers will generally cover two main types of risk that a business can chose to include in their cover:

- **Commercial risk** – the risk that the business' customers are unable to pay the outstanding invoices because of financial reasons, for example, declared insolvency or protracted default.
- **Political risk** - non-payment as a result of events outside the business' or customer's control, due to political events (wars, revolutions); disasters, (earthquakes, hurricanes); or economic difficulties, such as a currency shortage that causes problems transferring money owed from one country to another.

Credit insurance cover is available to businesses of all sizes, from SMEs, to large corporates and international businesses across any sector that supplies goods or services on credit terms.

Different types of product are available to suit each type of business, with cover available for both domestic and export trade. Having credit insurance gives suppliers the option to sell on *open account terms* where they may have previously been restricted or only sold on a secured basis, giving suppliers a competitive advantage.

How credit insurance works

A credit insurance policy is designed to meet the needs of the policyholder's business and is actively managed throughout the lifetime of the policy. A key feature of credit insurance is the assessment of creditworthiness and monitoring of the policyholder's customers, assigning them each a *credit limit* - the amount the insurer will protect them if the customer fails to pay, less any agreed pre-determined excess.

Insurers will monitor the business' customers using a variety of sources, for example:

- Analysis of financial statements including management accounts.
- Information supplied by other policyholders that sell to the same customer.
- Public records.
- Past due reports.
- Visits to the customer.

Buying a credit insurance policy gives the policyholder access to an extensive information network which acts as an effective early warning mechanism for adverse customer trends. Unlike many other types of business insurance, once a credit insurance policy is taken out, the relationship between the insurer and the business/policyholder does not remain static until a claim is made as the credit provider will be there to support a company when trading domestically or when exporting. Throughout the lifetime of the policy, the credit insurer will inform the business of any changes that might impact the financial health of their customers and their ability to pay them for goods or services delivered. They will then establish a plan with their customer to mitigate the risk.

The terms of cover may change over the lifetime of the policy to reflect the financial strength of any customer and it is the responsibility of the insurer to proactively monitor its policyholder's customers, to ensure their continued creditworthiness, using the sources mentioned above.

During the policy period, a business may request additional coverage for trade with any of its customers. The credit insurer will then evaluate the risk of increasing cover and either approve or decline the additional credit limit request, with a clear and timely explanation. A business can also request a credit limit for a new customer under an existing policy.

What is not covered?

1. **Currency Devaluation** – a deliberate downward adjustment to the value of a country's currency relative to another currency, group of currencies or standard.
2. **Bond defaults** – failure of the debt holder or buyer to settle their debts.
3. **Any derivatives** –a security (such as stocks and commodities) with a price that is dependent on fluctuations in the market.
4. **Sanctioned countries** – countries where there are political trade restrictions put in place against target countries with the aim of maintaining or restoring international peace and security.
5. **Non-enforceable debt** – when the statute of limitation for debt collection has passed, a creditor is no longer allowed by law to keep chasing a debt that's statute barred.
6. **Bribery** – giving or receiving a financial or other advantage in connection with a function that is expected to be performed impartially, or improper performance of a position of trust or in good faith.

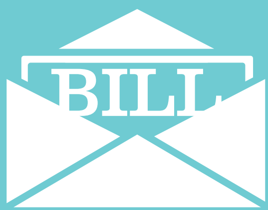
Credit insurance at work

Manufacturer A (The policyholder) supplies goods to company B (the customer) on credit, with 30 day payment terms.

Unfortunately, company B begins to get into financial difficulty with increasing bad debts and cash flow problems.

With its ongoing monitoring of their policholder's customers, the credit insurer is aware of company B's growing problems and as a last resort alerts manufacturer A that cover will be withdrawn for company B.

Company B becomes insolvent and is unable to pay its debts to those who have supplied goods on credit.



Manufacturer A is able to claim on its credit insurance policy for goods supplied prior to cover being withdrawn in accordance with the policy terms and any excess that is deductible.

In doing so, manufacturer A is able to continue trading, preventing the business from having significant bad debts that could have hits its ability to continue trading and pay its own suppliers.

Types of credit insurance

Credit insurance providers offer flexible products to meet the needs of individual businesses. Policies are designed to cater for the cover requirements of the policyholder's business and provide a range of options:

1. A business can typically cover their entire portfolio under one comprehensive policy insuring a wide range of risks across both domestic and export transactions.
2. Options that provide cover for key buyers only: either on an individual basis or as part of a smaller portfolio of key risks.
3. There is an increasing market for supplying businesses that have very specific requirements that trade credit insurers can provide tailored solutions for.

There are many different types of credit insurance policies to suit the needs of all businesses:

- **Single Risk/Buyer** – A policy that covers an isolated single risk. This policy is relevant if the policyholder is exposed to a particular market risk, such as an exceptional transaction in relation to the value of the customer's overall book of business, or a delivery of capital goods, or when cover is demanded by the bank financing the transaction.
- **Export** – A policy that is specifically designed for exporting companies, and provides additional cover for a range of risks such as new import restrictions, war, *inconvertibility of exchange*, that may arise as a result of the actions of the buyer or a third party government.
- **Multinational** – A policy that provides multinational group-wide or worldwide cover under the same conditions, irrespective of the location of the business units.
- **Political Risk** – A policy that covers inconvertibility of exchange, *contract frustration* (for example, by civil war), contract cancellation, import and export restrictions, etc.
- **Excess of Loss** – A policy that covers for exceptional losses over and above the normal level of bad debt by setting an aggregate first loss for the whole policy period. It is sometimes referred to as a "Catastrophe policy" aiming to secure the Policyholder against the failure to pay of major buyers.

Cancellable vs Non-cancellable:

- **Cancellable** – credit limits are established for a specific time period, but the limits may be withdrawn or amended if the credit insurer determines there has been a significant change in the credit risk.
- **Non-cancellable** – credit limits are agreed for a fixed period (typically 12 months) and allows a business to manage its own risk profile and make decisions if market conditions or buyer risks change.

Benefits of credit insurance

Credit insurance policies are suitable for all types of businesses, whether they are trading nationally or internationally, and for a variety of sectors from manufacturing to services. In terms of size, the benefits can apply to micro SMEs, right through to the largest multinationals.

While protection against non-payment is often perceived as the main reason to purchase credit insurance, there are also a number of other benefits to businesses taking out credit insurance.

These include:

- **Expanding sales**
  Credit insurance helps businesses to securely sell more to existing customers or expand to new customers that may otherwise have been deemed too risky, knowing they are insured should the customer not pay their debts.
- **Helping expansion into new international markets**
  Credit insurance helps protect businesses against the risks of exporting overseas, reducing uncertainty for firms. Credit Insurers not only have a wealth of experience in all aspects of trade, but also have access to real time business intelligence on millions of businesses worldwide and access to information is a key advantage to any firm trying to expand into new territories.
- **Obtaining better finance terms**
  Banks will typically lend more capital to businesses who have trade credit insurance in place or actually require it in order to qualify for an *asset-based loan*.
- **Gaining in-depth knowledge of the marketplace**
  Credit insurers provide businesses with extensive knowledge of companies, sectors and economic trends to help them grow safely.
- **Reducing bad-debt reserves**
  Credit insurance helps free up capital for the business to use elsewhere. In addition, credit insurance premiums are tax deductible, unlike *bad-debt reserves* where a company simply sets aside money in case a debt is not recoverable.
- **Protecting against non-payment**
  Should a customer be unable to pay its debts due to insolvency or protracted default, trade credit insurance will pay out a percentage of the outstanding amount owed (typically around 90%). This gives business access to cash in the event of a default, which means that cash continues to flow and significantly reduces a risk to the business.

Case Study: 'The construction firm'

When the customer of a construction company unexpectedly went into insolvency, their cash flow was secured by the quick payment of their claim for £600,000 under their credit insurance policy.

For this medium-sized company, the sudden failure of a major customer owing this significant amount had the potential to place the viability of the company in doubt. Unlike many business failures, poor financial performance was not to blame, so the insolvency was unexpected and caught the whole sector by surprise, meaning there was no time for the company to reduce their credit exposure.

However, the company had insured their trade receivables with a credit insurer, who as soon as they were aware of the situation had their claims team work with the policyholder companies credit manager and broker to ensure swift payment of the claim. Less than 4 weeks after submitting the claim, the construction company received payment in full, helping prevent the potentially damaging impact on their cash flow and balance sheet.

Case Study: 'The multinational'

As a multinational company that operates around the clock, is present in almost 100 countries with a direct presence in over 30, this international manufacturer not only appreciates the cover provided by their credit insurance policy, but also really values the information their insurer can provide them with about the companies in different parts of the world they want to do business with.

The relationship with their credit insurer allows them to apply for a credit limit for a new customer, and if the insurer is happy with the request, then the limit can be agreed quickly. If they do not agree, then the firm knows more work may need to be done and more information required to have that credit limit accepted.

Having a credit insurance policy allows this multinational firm to ensure they are not taking on any unnecessary risks, and work with their insurer who have taken the time to visit their larger subsidiaries and really understand how the business operates. While they work directly through their broker most of the time, they can have direct access to the credit insurer if they wish, when they need them.

Case Study: 'The SME'

This SME makes bespoke metal products for specific construction projects that can take over a year from first design to an order being placed with them. Having experienced a few cases of non-payment, this SME took out a credit insurance policy to help mitigate these scenarios in the future and ensure they can continue to meet their obligations to pay factories, suppliers and distributors on time, if they experienced non-payment again.

Buying direct from the credit insurer, the SME was able to obtain a comprehensive credit insurance policy, with credit limits based on the latest information about their customer's financial health; indemnity for unpaid customer debts; and the collection of overdue payments.

The SME also had access to the insurer's online policy management tool that allows them to request policy limits almost instantly, which helps them to decide quickly if a new/ potential customer is a suitable risk, and reduces the administrative burden on them.

Credit insurance and exporting

Choosing to export comes with regulatory, commercial and financial challenges that businesses would not otherwise face if they focus only on growing revenues in the UK.

Exporting means a business may face greater risks overseas than when it sells within the UK. They may because they have no previous experience of dealing with customers overseas or because of political or economic uncertainties – or disasters – in the country they are exporting to.

Case Study: 'The exporter'

In the 1990s, the fashion retail sector was going through a period of significant change, where some large brands were experiencing growth and others were struggling, with some falling by the wayside. As a result a leading clothing manufacturer decided to purchase credit insurance as a way of managing their risk.

The firm had just embarked upon a major export drive and so taking out a credit insurance policy enabled them to manage the risk on a real time basis rather than relying on past trading history and historical accounts.

They chose a credit insurer with offices and affiliates around the world that had sector and customer specific market intelligence that they could rely on before deciding to trade with anyone.

In addition, the credit insurance policy also gave their banks more confidence they were taking a prudent approach to running their business, which in turn, helped the manufacturer to seek increases in the trade finance they required to run their import-export business.

How to apply for credit insurance

When taking out a credit insurance policy, the insurer or broker will typically require a business to provide them with the following important information to ensure you get the right product:

1. Insurable turnover - You will need to indicate your business' credit sales per annum, usually your insurer will ask you to confirm credit sales for the previous period and year to date. You may also be asked for the previous year's turnover.

2. Your sector and the sectors of your customers into which you sell.

3. Any past loss history you may have - you will be asked to provide details of any bad debts incurred by your business for the previous trading period (s) and also confirm any overdue accounts currently on your books.

4. Credit control details - You will already have indicated your payment terms and you will also be asked to indicate the steps usually taken to collect receivables – how many days after invoice/ past due you follow up, when you put a stop on the account, when you normally engage a debt collector, whether *retention of title clauses* are enforceable etc.

Taking out credit insurance

If you are interested in taking out a credit insurance you can purchase a policy through a number of specialist credit insurance brokers. Their knowledge can help businesses take out the most appropriate cover for a business' needs for the best price. The British Insurance Brokers Association (BIBA) can assist you in being put in touch with a suitable broker through their 'find a broker service. This can be accessed online at **www.biba.org.uk** or by calling **0370 950 1790**.

Alternatively, you can also buy credit insurance directly through a trade credit insurer. These include the following ABI members:

Atradius
3 Harbour Drive
Capital Waterside
Cardiff
CF10 4WZ

Tel: + 44 (0)29 2082 4000

AIG
The AIG Building
58 Fenchurch Street
London
EC3M 4AB

Tel: +44(0)20 7954 7000

Coface
80 St Albans Road
Watford
Hertfordshire
WD17 1RP

Tel: +44 (0)1923 478100

Chubb
100 Leadenhall Street
London
EC3A 3BP

Tel: +44 (0)20 7173 7000

Euler Hermes
Euler Hermes UK
1 Canada Square
London
E14 5DX

Tel: +44 (0)20 7512 9333

Tokio Marine HCC – International Group
The Grange
Rearsby
Leicester
LE7 4FY

Tel: +44 (0)1664 424896

Markel International Ltd
20 Fenchurch Street
London
EC3M 3AZ

Tel: +44 (0)20 7953 6600

QBE
Plantation Place
30 Fenchurch Street
London
EC3M 3BD

Tel: +44 (0)20 7105 5411

Zurich
Zurich Insurance
70 Mark Lane
London
EC3R 7NQ

Tel: +44 (0)20 7648 3200

Glossary of terms

Asset-based loan – A business loan secured by collateral (assets). The loan, or line of credit, is secured by inventory, accounts receivable and/or other balance-sheet assets.

Bad-debt reserves - An amount set aside as reserve for bad debts.

Commercial risk - The risk that the business' customers are unable to pay the outstanding invoices because of financial reasons, for example, declared insolvency or protracted default.

Contract Frustration – Legal termination of a contract due to unforeseen circumstances such as war or civil war, that prevents the contract from being executed or achieved.

Credit insurance - If the customer of a policyholder becomes insolvent or when they fail to pay within the terms of a contract, credit insurance will reimburse the money owed protecting the business.

Credit limit – The amount granted to each customer up to which the insured business can trade and be able to claim should something go wrong. This limit can be revised upward or downward as new information on the customer becomes available.

Inconvertibility of Exchange – Where one currency cannot be exchanged for another currency because of various factors such as foreign exchange regulations, physical barriers, extreme high volatility or political sanctions.

Indemnify - To provide security for financial reimbursement to an individual in case of a specified loss incurred by the person or business.

Insolvency - When a business is unable to raise enough cash to meet its obligations, or to pay outstanding debts as they become due for payment.

Open account terms - A sale where the goods are shipped and delivered before payment is due.

Political risk – The risk of non-payment as a result of events outside the policyholder or customer's control, for example due to political events (wars, revolutions); disasters, (earthquakes, hurricanes); or economic difficulties, such as a currency shortage so are unable to transfer money owed from one country to another.

Protracted default - The failure by a customer to pay the contractual debt within a pre-defined period calculated from the due date or extended due date of the debt.

Retention of Title Clauses – These clauses can allow you to transfer possession of goods which have not yet been paid for whilst, at the same time, retaining the essential legal ownership of the goods until your customer has settled their debts.

About the ABI

The Association of British Insurers is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.8trillion.

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