TRADE CREDIT INSURANCE

WHAT IS IT?

In its simplest form, Trade Credit Insurance is a tool that allows a company to extend unsecured payment terms to their clients, and shift the commercial and, if applicable, the political risks of non - payment to a third party insurance company.

IS THIS SOMETHING NEW?

Trade credit insurance is a proven product whose history as a product to support trade dates back over 100 years. Many of the most active insurers that cover the market today, however, were established between 1925 and 1946. Trade credit insurance has had wide market acceptance in the U.S. for more than 25 years and in Western Europe for more than 60 years, with the most rapid growth occurring here over the past 20 years.

The three largest and oldest private insurers are European based companies. This makes sense in that the trade credit insurance market developed much earlier and much more rapidly in Europe. That earlier development was due to geography as much as competition. There are many small countries with their own political and legal systems and in many cases, until a few years ago, their own currencies. In order to expand their business European companies where forced into developing their export business much sooner than their U.S. counterparts, and to accomplish this they had to offer more competitive payment terms.

U.S. based companies have the luxury of a much larger local market and, in many cases the availability of better technologies and more products. This slowed their expansion into international markets, and it meant that the eventual expansion was more deliberate and reliant on traditional bank trade products such as letters of credit. In addition, until about 20 years ago many U.S. based companies had limited access to workable trade credit insurance products.

In today's truly global marketplace companies are comfortable selling to buyers most anywhere and they are facing competition from other suppliers from around the world. The ability to offer competitive terms is a requirement for any company to effectively compete in this global marketplace. The trade credit insurance market has evolved and expanded to meet that demand, and today companies have many cost effective alternatives to best meet their needs.

WHY IS IT IMPORTANT?

There are a variety of reasons why trade credit insurance is an important tool for a company including:

- ability to use credit as a marketing tool without adding risk to your balance sheet
- providing low cost alternative to letters of credit
- protecting company assets against spurious actions by a foreign government
- ability to quantify maximum potential credit loss exposure
- providing catastrophic loss protection against unforeseen events
- protecting cash flow and increasing borrowing capacity
- combining with financing programs to improve cash flows and ratios

There are other reasons to consider this important tool that may not be as obvious. For most companies accounts receivable represent a substantial component of their liquidity and a significant percentage of their assets. It is somewhat of an anomaly that while most assets on a company's balance sheet from cash to fixed assets are insured, management often does not consider insuring one of their largest and most important working assets: their accounts receivable.

Management has a fiduciary responsibility to the company's stakeholders. In today's world company management is being held more accountable for their actions as well as their inactions. The ever evolving world of financial reporting is placing increasing emphasis on identifying impaired assets, recognizing contingencies and disclosing potential risks. An adequate provision for bad debts is not the same as adequate protection of a significant company asset. The time will come, and in the not too distant future, when there will be a derivative shareholder lawsuit against management for failure to protect the company against a material unforeseen default.

WHO PROVIDES THIS INSURANCE?

A. The Government:

1. Export-Import Bank of the U.S. (Ex-Im Bank)

Ex-Im Bank was established as a District of Columbia banking corporation by President Franklin Roosevelt in 1934 and was reincorporated as a U.S. government corporation under the Export-Import Bank Act of 1945. It operates as a sunset organization that must be re-chartered by Congress every four years, with its current reauthorization expiring on September 30, 2014.

Ex-Im Bank is the official Export Credit Agency (ECA) of the United States, and its insurance policies carry the full faith and credit of the U.S. government. Most developed countries have an ECA whose charter is to support export sales from their host country. This means providing officially supported financing where the private market is unwilling or unable to do so, or where foreign competition is offering officially supported financing to create a market advantage. To level the playing field and insure one particular country does not have a competitive advantage simply because of its' ECA practices, the

Organization of Economic Cooperation and Development (OECD) establishes ground rules that are to be followed.

Ex-Im Bank's insurance programs require that the transaction(s) meet certain criteria in order to be eligible for cover. Transactions meeting those criteria can be covered with a variety of policies depending on the nature of the product, the type of buyer, and the location of the buyer. Those criteria include:

1. more than 50% of the product's total cost must be U.S. content
2. the export product can not be sold to a military or quasi military buyer
3. shipment must be to a buyer located outside the U.S. and its possessions
4. the payment obligation must be with a foreign based buyer

With an Ex-Im Bank policy the insured is responsible for gathering the credit and financial information that is necessary for the approval of the buyer. They offer a wider variety of policies, coverage in the more difficult markets, and are often preferred by the exporter's bank. Although Ex-Im Bank can not require it, they strongly encourage exporters to work with a specialty broker.

B. Private Sector Insurance Companies:

1. **AIG**
2. **Atradius (formerly Gerling NCM)**
3. **Coface America (formerly CNA)**
4. **Euler Hermes**
5. **FCIA (Foreign Credit Insurance Association)**
6. **HCC (Houston Casualty Company)**
7. **QBE**
8. **Latin American Underwriters**
9. **Zurich**

Private insurers provide a wider variety of short-term credit insurance options. Their policies have no content requirements, application restrictions or export requirements. They are available to cover domestic sales, export sales, or global sales. Coverage can include all accounts or select accounts provided the insurers feel they are receiving a reasonable spread of risk.

Policy parameters can be designed to fit the situation as well as the insured's particular concerns including amount of premium, timing of payment of premium, and policy administration. The insured has the ability to trade off coverage for premium by assuming higher coinsurance, a higher deductible, or some combination of the two.

Timing of payment of premium is frequently a trade off between cash flow and administration. Most policies require at least payment of a minimum premium in advance of issuing the policy. If the total amount of premium is significant the insured may request payment in installments, and some policies can be set up as reporting policies with premium payable monthly or quarterly in arrears following an initial advance premium.

Policy administration is often times an issue for the insured. Those who wish to be more actively involved with their policy and in their own credit due diligence may prefer a reporting policy with discretionary credit authority. Those who wish to be less involved may have the opportunity to outsource a good portion of their credit underwriting by having the insurer do the buyer approvals. Typically the insured is not asked to supply credit and financial information on the buyer for credit approval. The insurer will use their own resources, but if they do not have current information on the buyer or are unable to obtain current information they will ask the insured to do so.

Private insurance means choices. The lack of restrictions on coverage, the variety of coverage options, the flexibility in policy administration requirements, and the ability to trade off coverage requirements for costs mean private insurers can be an excellent choice. The requirement that the lender evaluate the insurer and the need to be able to determine the best available options, however, means this is not an area for the uninitiated. The insured is well advised to work with a good specialty broker; coverage is only available through a broker or an employee agent.

WHAT DOES IT COVER AND HOW MUCH DOES IT COST?

Trade credit insurance covers commercial risks of non-payment by a buyer to whom you have sold products on unsecured payment terms. If the transaction involves the sale to a client in a foreign country the insurance also covers the political risks of non-payment. The coverage is typically not 100%, the insurers wants you to have a stake in the transaction as well so that they know you are performing in good faith. That stake is in the form of coinsurance where you may have to carry 5% to 15% of the risk of non-payment. Depending on the policy, you may also have to satisfy a first loss deductible before the policy pays on an insured loss. Unlike your auto or homeowners insurance; the deductible is per policy year not per incidence of loss.

The cost is normally based on the risk the insurer is being asked to cover. This varies by the number of accounts you wish to insure, the nature of the buyers, the payment terms you wish to offer, the countries of the buyers, and the amount of risk you are willing to assume. It can range from a low of perhaps $.10 per $100 of insured sales for a large portfolio of strong accounts with payment terms of 60 days or less, to over $10 per $100 to a single buyer in a developing market with 5 year payment terms. As a practical matter, the cost of insuring a portfolio of accounts with insured sales volume of $3 to $5 million, and terms to 60 days with a reasonable spread of risk, should be in the range of $.25 to $.50 per $100 of insured sales volume. Some policies do have minimum premium requirements that can range from $500 to $50,000.

DO I NEED A BROKER?

As previously mentioned, private insurers require you to work with an independent specialty broker or one of their employee agents, and Ex-Im Bank encourages you to work with an independent specialty broker, although they cannot require it.

When selecting a broker it is best to use a specialty broker who does only trade credit and political risk insurance and can represent the entire market. Specialty brokers are trained in these policies and their

financing aspects, which are often more important to the insured than the risk mitigation features of the policy.

At times companies make the mistake of having their property casualty broker, who handles their general business insurance, represent them for trade credit insurance. Those brokers do not know this product or the market, so they will have one of the three private insurers that have employee agents handle the policy. This is normally not in the best interest of the insured, as their broker does not understand the product, is not showing them the entire market, and cannot represent them as their advocate before the insurance company.

A specialty broker plays a vital role in the process as your independent advocate helping you to identify coverage and policy options. They provide all of the application forms, training, and assistance with policy administration including claim filing. They work with your bank to make sure you receive the maximum benefits of having the policy in place, including the ability to borrow against foreign receivables. They work for you as the insured, not for the insurance company.

Best of all, a broker's services are always provided at no cost to you as the insured. If a broker is successful in securing the required coverage and you are issued a policy, the broker receives a commission on the premium directly from the insurer.

POLICY CONSIDERATIONS

A. Nature of Products

1. Consumables
2. Perishables
3. Agricultural
4. Capital Equipment

B. Origin of Product

1. Eligible versus Ineligible Foreign Content
2. Offshore Manufacturing or Assembly
3. Value Added After Export

C. Nature of Buyer

1. Private versus Government
2. Rep./Distributor versus End User
3. Military versus Non-military
4. Related Party

D. Location of Buyer(s)

1. Export versus Domestic Payment Risk
2. Off Cover Markets
3. Ship to versus Bill to Address
4. Developed versus Developing Market

E. Nature of Transaction

1. Single versus Repetitive Sale
2. Requested Terms
3. Delivery Method and Timing
4. Competition

F. Company Concerns and Constraints

1. Costs
    a. Direct- premium and receivable carry
    b. Indirect- policy administration
2. Financing
3. Timing for Application and Buyer Approvals
4. Coverage
    a. coinsurance and deductible
    b. established clients

POLICY TYPES

A. **Short-term Single Buyer –** insures non-payment risk of a single transaction or multiple transactions with a single buyer over a period of up to one year. This can be either a prepaid or a pay as you ship policy that requires co-insurance, but no deductible. It can cover payment terms of up to 180 days and exceptionally up to 360 days.

B. **Medium-term Single Buyer –** insures non-payment risk of a single shipment or multiple shipments of capital equipment to a single buyer over a period of typically up to one year. This is a prepaid policy for single shipments, and pay as you ship for multiple shipment transactions. The buyer is required to make a down payment equal to 15% of the contract amount prior to shipment and sign a promissory note for the balance of the contract price. There is typically a small or no coinsurance requirement, and no deductible. Terms typically range from 2 to 5 years depending on the type of buyer, their needs, and the invoice amount. The policy can cover shipments from a single or multiple suppliers to a single buyer, and the insured can be either the exporter or the funding bank. This policy is typically limited to coverage for buyers in developing markets.

C. **Short-term Multi-buyer** – insures non-payment risk for a portfolio of accounts receivable representing multiple shipments to multiple buyers. This is the most common type of trade credit insurance policy with many options for policy structure and coverage parameters. Depending on the insurer, the premium can be prepaid, paid in installments, or paid monthly as transactions occur. The policy always includes coinsurance, but there may or may not be a deductible. Payment terms are limited to 180 days and exceptionally can be up to 360 days.

D. **Supplier Credit** – this is a bank policy where a financial institution is the insured. It allows the bank to insure and finance receivables of multiple bank clients, for shipments to multiple buyers, and have control over policy administration. This policy can allow a company to insure only select buyers or select transactions. The company is responsible for the coinsurance on their insured transactions.

E. **Buyer Credit** – this is a bank policy where a financial institution is again the insured, but all of the shipments are to a specific buyer. The policy typically involves shipments by multiple suppliers to the single buyer. The suppliers are paid by the insured financial institution at time of shipment. The bank must carry any coinsurance and is not allowed to pass it back to the supplier.

F. **Bank Letter of Credit** – this is a bank policy that provides a bank that is confirming a letter of credit the ability to insure the risk of payment default by the issuing bank.

G. **Bank to Bank Medium-term Repetitive Sale** – this is a bank policy that allows the bank to insure capital equipment export sales from one or more exporters to one or more foreign buyers under a single policy. The insured payment risk is a foreign bank and the buyers must be clients of that bank.

COMMON INSURANCE TERMINOLOGY

Insured – the entity in whose favor a policy is written; the applicant for insurance coverage.

Commercial Risk – non-payments issues related directly to the insured's buyer including protracted default/slow pay, currency devaluation, and insolvency.

Political Risk – action by the host government, in the buyer's country, that prevents the buyer from being able to take possession of or pay for the product. This includes war or insurrection, confiscation, expropriation or nationalization of the product, diversion of voyage, embargo, cancellation of import license, and currency inconvertibility.

Select Risk – insuring either a single transaction or multiple transactions with one buyer.

Spread of Risk – insuring the credit risk of multiple transactions with multiple buyers domestically or in multiple countries.

Coinsurance – the percentage of each insured risk that must be absorbed by the insured on any claim of loss.

Deductible – the per policy year dollar amount of losses that must be absorbed by the insured before the insurance company is responsible for making payment on any claim of loss. The deductible is applied to the claimed loss after application of the coinsurance.

Aggregate Limit – the maximum amount the policy will pay in valid claims during the term of the policy.

Discretionary Credit Limit – the per buyer credit limit that the insured may approve based on their own due diligence or ledger experience without involving the insurance company.

Assignment – assigning the rights to the proceeds of claim payments, by the insured, to a third party lender. Claims typically must be filed by the insured and claim payments are made payable to the insured and the lender jointly.

Loss Payee – endorsement to the policy of a named payee to the proceeds of any claim payments made under the policy. A loss payee may have the ability to file a claim independently of the insured.

ROLE OF THE BROKER

Standards of Service

1. Remain up-to-date on Ex-Im Bank's and private insurers' programs.
2. Educate clients on policy parameters, benefits, proper usage and alternatives.
3. Serve as client's primary contact and advocate for all policy issues and servicing.
4. Work with clients to find the most comprehensive and economic coverage for the client's business, goals and objectives, and situation.
5. Review all applications for new policies, policy issuances, renewals, amendments, credit limits and claims.
6. Review and explain policy quotes, premiums, administration, and client responsibilities under the policy to maximize benefits of the policy to the client.
7. Assist in client's compliance with the policy, shipment reports, premium calculation and payments, reporting of past dues, and potential claim situations.
8. Report policy cancellations and submit a premium reconciliation to the insurer.

Additional Services

1. Serve as single source for obtaining risk mitigation and non- and limited recourse financing.
2. Prepare application packages: spread financial statements, fill out applications, contact suppliers and banks for references.
3. Provide Credit Agency reports.
4. Provide policy administration services.
5. Arrange pre- and post-export financing; coordinate credit insurance for post export receivable financing with pre-export working capital guarantee to ensure access to exporter's line of credit.
6. Provide documentation for financing.

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