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Protect against bad debt risk.

What companies need to know about trade credit risk and insurance.

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Introduction: Any sale carries risk.

Any sale carries risk, because with every sale, there is a chance the buyer will not pay. Non-payment can be damaging or even catastrophic to a seller. "One or two bad debts can wipe out our profits for the year" said one chief executive officer. If a business operating on a low margin, e.g. 5%, doesn't get paid they likely won't be in business for long. According to Euler Hermes, the world's largest credit insurer, unpaid invoices of accounts receivables can represent up to 40% or more of a company's balance sheet assets.

The number of North American businesses that failed in 2014: nearly 30,000

The hundreds of billions of dollars in bad debt that were written off during the recent Great Recession brought new attention to managing the risk of receivables. Today, post-recession industry data show that one in 10 invoices become delinquent.[i] Bankruptcies happen more often than one would think. Nearly 30,000 businesses failed in North America in 2014, according to Euler Hermes.[ii] Even "good as gold" customers can default. Many companies are current on their bills with most suppliers when they file for bankruptcy. The company can do everything right. It can ship a high-quality product on time, damage free and provide an accurate invoice — and then still not get paid. Companies are probably not as safe as they think.

Because companies have been burned before with bad debt, they become very conservative and limit their growth severely, especially internationally. Conservatism may be fine until a competitor expands, gains scale, lowers its cost structure and begins to overtake the business. Companies today use trade credit insurance as a means to safely and more confidently expand into new markets, offering their customers more flexible credit terms. These companies are viewed as the gold standard for customer satisfaction.

In summary, trade credit insurance can help protect domestic and international accounts receivables against unexpected bad debt loss due to insolvency or slow-paying customers, and just as importantly, provide a foundation for growth.

How do companies manage bad debt risk?

Clearly with or without trade credit insurance, it's a good practice to avoid bad debt situations and still find a way to grow. But as much as a company tries to avoid them, bad debts will occur. There are four major options to manage the credit risk of bad debt:

1. Self-insurance
This takes the form of bad debt reserves. Self-insurance fails to protect against very large, unexpected losses and negatively impacts cash flow and the balance sheet. Companies that tie up capital with self-insurance hamper their ability to invest in growth opportunities and often become very conservative, limiting their growth, especially in the all-important international markets. These companies have to take on the total responsibility of evaluating the credit worthiness of their customers or potential customers. They often use tools like Dun and Bradstreet (D&B), but that has its limitations. The data can be outdated as people found during the Great Recession.

2. Factoring
Factoring, or selling receivables to a third party, is another option to manage bad debt.[ii]

Factoring has two major drawbacks:

1) there is a significant cost, and more importantly,
2) when companies turn over the collection of debt to an aggressive third party, they risk alienating customers.

3. Letters of credit and payment in advance
These tools apply normally to international sales. Unfortunately, they limit the amount buyers can or will buy; they are expensive (it can cost customers 3% per transaction); and they generally have to be set up on a transaction-by-transaction basis.

4. Trade credit insurance
There is a modest cost, but it comes with many advantages, as described in this white paper.

Self-insurance fails to protect against very large, unexpected losses

Why do companies need trade credit insurance?

Thousands of small and mid-size companies purchase trade credit insurance. And, many larger companies (more and more multi-billion dollar revenue firms) purchase it as well. There are many tactical and strategic reasons why these companies acquire trade credit insurance. And once they buy it, they keep it. According to Euler Hermes, generally, companies renew their policies 90% of the time.

90%
of companies renew their trade credit insurance policies

Tactical reasons:

1. **Bankruptcy of a customer:** As noted above, bankruptcies occur more often than many people realize, making full-collection on an invoice virtually impossible. Banks know this, and often they urge their clients to purchase trade credit insurance. This helps them feel more comfortable lending with accounts receivables used as collateral.

2. **Foreign trade issues:** There are many issues that can arise in international trade that can prevent or seriously delay payment, such as communication and culture issues and unforeseen cancellation of permits. Other disruptive global trade events take the form of serious global political events, government interventions, currency inconvertibility, or even "expropriation," i.e. the act of taking privately owned property by the government for public benefit.

3. **Customer responsiveness:** When a business opportunity for increased sales presents itself, it is important to be able to respond quickly. Firms need the capability to thoroughly and quickly analyze the viability and financial stability of potential customers or they risk missing a narrow window of sales opportunity. A trade credit partner can provide that service by accessing extensive information databases for a quick assessment of a customer's viability, including solvency, risk, payment profile, and trading history, as well as perhaps some intangibles. On an on-going basis, the trade credit insurance provider can monitor critical accounts, which incidentally avoids the cost of attempting to do that in-house.

4. **Competitive advantage:** Trade credit insurance gives a firm the ability to quickly match its competitor's credit limit and pay terms. If a competitor offers a $250,000 line of credit with 90-day terms, and your company can only offer $100,000 with 15-day terms, who gets the business?

5. **Qualitative:** As one business owner said, "Having trade credit insurance allows me to sleep better at night, and that's worth a lot."

In addition to these tactical reasons for purchasing trade credit insurance that arise day-in and day-out, there is a wide range of strategic reasons influencing why companies should buy trade credit insurance. In fact, if employed correctly, trade credit insurance can be a significant strategic advantage.

37%
average growth of companies that export

Strategic reasons:

1. **Business growth with confidence:** All businesses need to be able to grow and grow confidently. In fact, the typical company that buys trade credit insurance is one that wants to build and grow its business. Some examples help illustrate this point. In one case, a $30-million company sold goods to its European customers through distributors, representing 48% of its total sales. Those distributors were initially aggressive and brought many opportunities for expansion. But, the company was not willing to extend credit and payment terms, and eventually the distributors began focusing where there were fewer roadblocks. In another example, a firm wanted to sell $4 million in product to a Russian company that would not share all of its financials. By working with a trade credit insurer, it was able to offer $1 million initially, save the account and then expand later. In a third example, a company lost a critical customer that it had for five years, because it couldn't offer the same terms as its competitor. In a final example, a firm selling globally said that trade credit insurance allowed them to avoid restrictive letters of credit or up-front cash payment requirements. It allowed them to offer competitive, open credit terms in the global market.

   According to Euler Hermes, companies that export grew 37%, and those that did not decreased by 7%. Many, if not most, companies must look globally if they are going to expand. But global trade carries an exponentially larger risk of bad debt. Therefore, many companies require a wire transfer up front or a letter of credit. Their potential customers will resist paying in advance, especially if they can buy from another company without these restrictions.[iii]

2. **Organizational alignment:** Companies need to be organizationally aligned and focused on growing the business. Trade credit insurance can bridge the traditional gap between the sales department and the credit department, two areas often at odds. In addition, with trade credit insurance, a firm can streamline the accounts receivables and collections department. That department can focus on day-to-day issues and leave most of the credit monitoring and credit evaluation to their insurance partner. Trade credit insurance also provides a more stable and confident environment for sales and marketing to penetrate global markets.

3. **Financial stability:** Receivables in the average company represent up to 40% or more of its balance sheet assets, and therefore, have a major impact on cash flow and how investors and banks view the company's financial viability. Banks loan 80% more on insured receivables and can lend an advance against the receivables, according to Euler Hermes, which is especially important for international trade. A company can potentially get better financing terms and a lower interest rate if its receivables are insured. It also can avoid catastrophic bad debt losses and reduce or eliminate the bad debt reserve.

   And, it is interesting to note that receivables are usually the largest item on a balance sheet by far. Most of a firm's assets on a balance sheet, including facilities, equipment and even inventory are insured, but oddly its largest balance sheet asset, receivables, are not often insured.

   Apart from the balance sheet, the loss on a profit and loss statement (P&L) due to a bad debt can be severe. If a business operates on a low margin (say 5%), and is unable to collect a $100,000 debt, it has to generate $2,000,000 more in top-line sales just to break even.

Why do some companies resist buying trade credit insurance?

With all of these tactical and strategic advantages of trade credit insurance, why doesn't everyone purchase it? There seem to be three primary reasons.

1. Lack of knowledge

Perhaps the biggest reason is simply lack of knowledge of the product. It has always been more popular in Western Europe, but it has struggled to gain as much traction in the United States, despite being available in the country for more than a century. Perhaps Europeans are more conservative than Americans. In any event, they buy trade credit insurance at a rate of five times that of U.S. companies. However, the 2008 to 2010 Great Recession made the need for trade credit insurance painfully apparent and caused many companies to look for ways to better protect themselves in the future.

Without sufficient knowledge of the product, some firms mistakenly worry that trade credit insurance is too expensive, and they will have a difficult time actually processing claims and collecting. Or, they hear that customer disputes regarding the wrong product, bad quality, etc. can interfere with coverage, which is not true with a clearly written policy.

Some companies don't know the true risk they face. Ignorance is bliss until the wheels come off. And finally, some feel that the economy is currently in good shape and bad debt is at a minimum. Of course, no one can predict when the next recession will hit, and it could be too late to put the right protection in place.

European companies buy trade credit insurance at a rate of

5x greater

than U.S. companies

2. Self-protection

Some companies assume that they are large enough to self-protect against bad debt. But these firms have to carry and finance a substantial bad debt reserve. In addition, some losses may be totally unexpected and not anticipated in setting up the bad debt reserve.

3. Politics

Internally buying trade credit insurance can pose a political risk to the finance area and the credit department. The chief executive officer may question why trade credit insurance is needed if the credit department is doing its job. Unfortunately, almost no company has the resources to continuously monitor the credit situation of all of their customers, nor do they have the resources to try and collect, especially in the global arena. Moreover, trade credit insurance provides protection against the unforeseen losses that even the best credit departments cannot see coming.

Trade credit insurance can pay for itself.

It may sound too good to be true, but trade credit insurance can provide substantial benefits and not cost the company a dime — essentially paying for itself. Trade credit insurance can help in the following ways:

1. Lower interest rate from banks
Companies that insure their receivables often receive lower interest rates from their bank, and therefore, lower interest costs. Some companies have 15-day terms with their suppliers, and 60-to-90 days with their customers. Clearly they need an on-going credit line with the bank, and they must carry a substantial loan balance. Interest costs are a significant expense for many firms.

2. Credit and collections cost
With trade credit insurance and the credit monitoring services that come with it, companies can save on credit and collections cost. See the example below.

3. Margin on increased business and more aggressive goals for growth
Credit insurance allows for confident expansion of the business; and therefore, the chief executive officer can set more aggressive internal goals for growth. In one company, the chief executive officer heard from his sales department that the credit department was constraining growth by being too conservative. He agreed to ease credit terms as long as sales agreed to set a goal to grow the business 15%. He then used trade credit insurance to protect his firm.

A small company purchases trade credit insurance.

A small company has $10 million in annual sales and receivables of $1,000,000. It decides to purchase trade credit insurance, which for illustrative purposes costs 0.15% of sales or $15,000.

The savings and costs.

$14,000 credit research savings + **$3,000** cost of capital for bad debt reserve + **$4,000** lower borrowing interest cost + **$100,000** margin on increased sales − **$15,000** cost of trade credit insurance

The results.

= **$106,000** net gain from having trade credit insurance

The firm is able to reduce its credit research costs by $14,000. (In this firm, credit research was 40% of a person's job.) The firm no longer has to carry a bad debt reserve of 1% of sales or $100,000, and therefore, it doesn't have to tie up money at a cost equal to its cost of capital of 3% or $3,000. The company uses on average a credit line of $2 million. The bank gives a lower borrowing percentage of two-tenths of 1%, or a savings of $4,000 per year in borrowing cost.

The firm then has the confidence to expand the business by 10% or $1,000,000 at a 10% margin, generating $100,000 in additional profit.

In this example, trade credit insurance more than pays for itself, even without a bad debt loss.

What companies offer trade credit insurance?

The largest firms selling trade credit insurance directly are Euler Hermes, Coface, and Atradius. Then there are the major brokers and third-party distributors, like UPS Capital Insurance Agency Inc.[iv] Third parties have some significant advantages, as they can evaluate all of the industry offerings and recommend the best options customized for your business. They also may have additional capabilities; for example, UPS Capital can see more holistically across the entire supply chain and provide a layered approach to risk.

There are three basic principles a company should consider when buying trade credit insurance.

1. Supply chain expertise
It is important to purchase trade credit insurance from a company that understands supply chains and their inherent risks. Many bad debts have their roots in supply chain risk. The supply chain is responsible for delivering the "perfect order," an order that is on-time, complete and damage free. Any perceived or actual deviation from that can cause the invoice to be disputed by the customer and eventually result in an invoice being uncollectable.

2. A true partner
Buy from a firm that is willing to take the time to learn your business and can make the claim collections process simple and easy. The trade credit insurance provider should partner with the company to develop a strategy and a policy to identify the company's exposure to risk and customize a policy based on the level of risk. The trade credit insurance provider should clearly be interested in a long-term relationship not just a one-off transaction.

Many bad debts have their roots in supply chain risk

Once a firm purchases trade credit insurance, the relationship with the insurer should remain very active. The trade credit insurer should be a partner to assist in managing on-going risk. It should also routinely monitor a firm's customers to ensure their continued credit worthiness and recommend changes in the customer portfolio. A credit partner should be able to monitor changes in corporate solvency on a daily basis. The databases used by the largest credit insurers include a massive 40-million global companies! And finally, the trade credit insurance partner should be proactive in helping complete the claims forms and make sure the paperwork is submitted correctly.

In addition, the trade credit insurance partner may even work with another firm to manage an emergency situation. In one case, a shipment of perishable food to Russia was blocked when nearing port due to a geopolitical dispute. The trade credit insurer helped the company very quickly find another buyer, repackage the product, and deliver it to the new customer.

3. Quick response customer evaluation
The trade credit insurance provider should assist with quick response account research and risk mitigation strategies. Decisions must be made quickly when a company is trying to close a sale with aggressive competitors and needs to expand credit limits. With a massive amount of data and resources, trade credit insurers are in a far better position to do this than a typical firm.

The bottom line is that trade credit insurance should be purchased from a supply chain partner, not just an insurance expert. It should be purchased from a provider that can customize a process to fit the company's needs.

How is the price for trade credit insurance set?

Pricing for trade credit insurance is surprisingly low and based on a number of variables, tempered by judgment of the underwriter. Those variables include:

- The amount of sales being protected (the number one factor).
- The percentage of bad debt the insurance covers. (Generally 90%; but some companies are purchasing it with much higher deductibles.)
- Geopolitical risk in the countries in which the company does business.
- Risk profiles of the company's customers.
- Industry risk, e.g. default rates in the industry.
- Bad debt loss history of the firm.
- How broadly the risk is spread among a range of the company's customers.
- Length of payment terms.
- Credit limits on buyers.

The supply chain expertise and ability of the insurance provider to partner with the firm and offer a customized plan is critically important.

Trade credit insurance generally covers 90% of bad trade debt

What is covered with trade credit insurance?

Trade credit insurers generally cover a wide range of problems that can disrupt payment, such as bankruptcies and defaults, as well as global political risks.

At the onset of the policy, the trade 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.

It is the trade credit insurer's responsibility to proactively monitor its customers' buyers throughout the year to ensure their continued creditworthiness. Throughout the life of the policy, the policyholder may request additional coverage on a specific buyer should that need arise. The insurer will investigate the risk of increasing the coverage and will either approve the additional coverage, or maintain the current coverage with a detailed explanation. 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.

Today, 15,000 North American companies are using trade credit insurance

Future trends and advice.

1. Trade credit insurance will be a growing product of the future for U.S.-based companies, as European companies have been using it for years. The Great Recession and the globalization of trade have made it essential. More and more companies are getting on board, with approximately 15,000 companies in North America using trade credit insurance today.

2. There is also a trend toward simplicity and customization. The knowledge gap regarding this product is significant. Therefore, insurance carriers know that they must provide simple, straightforward, easy-to-understand policies that are flexible enough to accommodate the unique needs of an individual company.

3. The additional risk management services that come with trade credit insurance are becoming more robust and sophisticated. Companies that offer this coverage know that they must provide more than basic credit insurance. They must also provide guidance on developing a holistic plan to mitigate risks in their client's supply chain.

The best advice is to invest time to learn about trade credit insurance. That should be as easy as placing a call to an expert in the field (such as the sponsor of this white paper). Know that when the next big recession hits, it will be too late to buy it. Also, make sure the company thoroughly understands its risk profile; trade credit insurance providers can help evaluate risks that might otherwise be overlooked. Make trade credit insurance part of the company's customer-focused growth strategy to meet and achieve competitive advantage.

[i] Euler Hermes

[ii] CIT

[iii] A letter of credit (LC) is a document from a bank guaranteeing that a seller will receive payment in full as long as certain delivery conditions have been met. In the event that the buyer is unable to make payment on the purchase, the bank will cover the outstanding amount. The use of letters of credit was historically a very important aspect of international trade, but today they are considered cumbersome and expensive.

[iv] UPS Capital Insurance Agency, Inc. and its licensed affiliates are wholly owned subsidiaries of UPS Capital Corporation. Insurance coverage is not available in all jurisdictions.

About the University of Tennessee
The highly ranked supply chain management program at the University of Tennessee is housed in the college of business administration. It provides undergraduate, MBA and doctoral student education, with 30 faculty members. The supply chain management faculty at the University of Tennessee is ranked No. 1 for academic supply chain research productivity.

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