AIG® Global Trade & Political Risk

Implementing Trade Credit Insurance as a Corporate Strategy

What is Trade Credit Insurance ?

Trade Credit Insurance indemnifies the policyholder for unpaid invoices due to a customer's insolvency or default.

When an Insured's customer files for Chapter 11 or Chapter 7 with the United States Bankruptcy Court, it receives protection from the court. The company is not required to pay their suppliers or fulfill outstanding debt obligations unless it emerges from bankruptcy protection. A trade credit insurance policy provides coverage for the unpaid invoices.

When a customer does not pay monies owed due to reasons other than payment disputes, such as financial difficulty and cash flow constraints, the Insured's credit department would typically conduct an internal collection effort by making phone calls, placing the customer on order hold, and then using external resources to get paid. If an Insured is unable to collect unpaid funds after a specific number of days, typically 90 days, the Insured can file a claim under the trade credit insurance policy for the unpaid invoices.

Policies are written on a 12 month renewable basis covering all goods delivered to the Insured's customers during the policy year.

Why do Companies Need it and Buy it ?

Trade Credit Insurance can be used as a strategy to address customer and country risk when a company has receivable exposure in the millions of dollars to these external risks. Some of the reasons companies choose to purchase credit insurance are to:

- **Mitigate Accounts Receivable Concentration.** Credit insurance can mitigate accounts receivable concentration risk whereby the largest customers have substantial exposures owing. This can eliminate concerns about a large loss exceeding the bad debt reserve and having a material impact on a company's bottom line.

- **Reduce Bad Debt Reserve.** By purchasing credit insurance a company may be able to reduce its bad debt reserve by capping catastrophic receivable losses and thereby allowing a company to reduce its Bad Debt Accrual Expense for that year.

- **Protect against Economic Downturn.** Companies are purchasing Credit Insurance due to concerns about a prolonged economic downturn that could give rise to more corporate bankruptcies. Companies desire this additional protection when they feel they could suffer more losses during a weaker economy.

- **Address growth in Emerging Markets.** Companies are purchasing credit insurance as a strategy to address growing exposure to emerging markets as their customers' accounts receivable balances increase to the point where a company feels uncomfortable.

- **Obtain Improved Financing Terms.** Companies in the past have looked at credit insurance as a means to get more attractive bank financing as the banks look at credit insurance as a second source of repayment. Banks are more likely to offer a higher advance rate or provide a lower interest rate on insured receivables.

- **Address overall Accounts Receivable Exposure.** Companies seek to address their overall corporate accounts receivable balances whereby they may have millions of dollars owed to them by their largest customers and thousands of dollars owed to them by their middle market companies. As these numbers grow, companies feel it is necessary for a global approach to address this risk.

Who is Buying Credit Insurance ?

In the past credit insurance has been purchased by the Credit Manager or Treasurer primarily to mitigate risk or to facilitate more attractive bank financing. Today the Risk Manager is more involved as the purchase of credit insurance is more of a strategy to address large credit risk exposures as described above. Typical industries are food, chemical, pharmaceutical, high tech and energy.

How Much Does It Cost ?

A typical premium rate is charged against insurable sales. Each program is priced differently based on overall customer risk, industry risk, and country risk. Coverage level also affects the price and can be designed around the Insured's budget. An Insured can purchase coverage on their whole portfolio or on just their largest customers and exclude their smaller customer exposures. Another consideration affecting the cost is the amount of retention a company is willing to take through a deductible and coinsurance. Through discussions with the underwriter, a policy can be designed with a structure and premium that meets the Insured's budget.