

Risk Alert

A report for clients and colleagues of Marsh on risk-related topics

Trade-Credit Insurance—A Solution for Growth



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Marsh publishes *Risk Alert* to keep its clients and colleagues informed on critical issues related to risk. For additional copies, please contact questions@marsh.com. This report is also available for download at <http://www.marsh.com>.

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Five Common Myths About Trade-Credit Insurance

Myth No. 1: Trade-credit insurance is expensive.

- In fact, the cost of trade-credit insurance is generally a fraction of 1 percent of sales. It is far more expensive to write off a bad debt than it is to pay for trade-credit insurance.

Myth No. 2: Trade-credit insurers will only cover entire portfolios of debtors.

- Trade-credit insurers generally like a spread of risk, but will consider protecting insureds against loss from a key customer or smaller numbers of critical customers, rather than insist on the whole-portfolio approach.

Myth No. 3: If the country is not in recession, bad debt will be low.

- Levels of bad debt fluctuate whether or not the country is in recession. The risk to a company of insolvency or payment default may vary widely by industry and by customer type.

Myth No. 4: Trade-credit insurance is difficult to administer.

- In fact, reporting can be set to mirror your current procedures for monitoring accounts receivable. Many insurers offer online systems that enable real-time and simplified policy administration.

Myth No. 5: Trade-credit insurance diminishes the importance of the credit function within organizations.

- The insured can retain a discretionary credit limit appropriate to its business, risk management strategy, and credit-management function. Thus, the insured can make its own credit decisions, within specified parameters, without first acquiring insurer approval.

Introduction

In simpler times, business bankruptcy filings in all sectors of the economy would closely reflect our overall economic health. But recent history teaches us that problems in whole industry sectors, allegations of corporate fraud, and mass-tort litigation can produce sizable bankruptcy actions and generate their own independent and chilling effects on the economy. Risk managers, credit managers, CFOs, and others who handle credit risk for their companies may be well-served by trade-credit insurance—one solution they can use to help protect their companies against the bankruptcies of their customers and clients.

A sampling of recent statistics helps illustrate the scope of bankruptcy today:

- WorldCom and Enron, with total combined assets estimated at \$167 billion, represent the first and second largest bankruptcies in U.S. history.
- There were 35,739 business bankruptcy filings for the 12 months ending June 2004. Although this represents a decline from prior years, the number is still very close to the historical six-year average of 37,684.

Business and Nonbusiness Filings

Years Ended June 30, 1999, through June 30, 2004

Year Ending	Total	Nonbusiness	Business
June 30, 2004	1,635,725	1,599,986	35,739
June 30, 2003	1,650,279	1,613,097	37,182
June 30, 2002	1,505,306	1,466,105	39,201
June 30, 2001	1,386,606	1,349,471	37,135
June 30, 2000	1,276,922	1,240,012	36,910
June 30, 1999	1,391,976	1,352,042	39,934
Six-Year Total	8,846,814	8,620,713	226,101
Six-Year Average	1,474,469	1,436,786	37,684

Source: U.S. Courts, Bankruptcy Statistics, <http://www.uscourts.gov/bnkrpctstats/statistics.htm>

Bankruptcies leave buyers and customers “holding the bag” on uncollected receivables—uncollected credit.

- Of the 16 largest business bankruptcy filings in the United States since 1980, 10 were filed between March 2001 and July 2002. Eight of the 10 largest Chapter 11 cases (filings for reorganization under U.S. Bankruptcy Court protection) in history were filed after December 2001.

These statistics are just the tip of the iceberg. They do not reveal how bankruptcies weaken the financial health of many suppliers and customers. Single huge bankruptcies, such as WorldCom and Enron, have an enormous ripple effect throughout the economy, but the aggregation of smaller bankruptcies has similar systemic consequences.

Bankruptcies leave buyers and customers “holding the bag” on uncollected receivables—uncollected credit. And because most organizations sell on credit, bankruptcies and payment defaults weaken their own financial stability.

Companies know that insurance is an important component of their efforts to protect themselves against losses to people and property, but many companies do not seem to view their trade-credit risk in the same light—even though accounts receivable may represent 40 percent or more of their assets.

Beyond protecting your company against the financial ravages of clients’ and customers’ bankruptcies and payment defaults, trade-credit insurance can help a company grow. The services trade-credit insurers offer can enable entry into new markets, helping you choose the right region and the right clients and customers for expanding your business.

In this issue of *Risk Alert*, we explore and demystify trade-credit insurance—its role, scope, and limitations. We look at the main types of trade-credit insurance and discuss how this coverage can help companies grow. We then briefly address three other methods of managing the risk.

Note: This issue of *Risk Alert* is an update of “Credit Risk Insurance—Overlooked Solution?” (*Risk Alert*, September 2002).

Key Terms in Credit Risk

Most managers of credit risk define “credit risk” as the probability of a nonpayment default due to insolvency, protracted payment default, or political risk.

- **Insolvency** includes the formal filing for protection under the U.S. Bankruptcy Code—either Chapter 11, the reorganization of a company under the protection of the U.S. Bankruptcy Court, or Chapter 7, the dissolution of a company’s business—or under equivalent procedures in a foreign country.

- **Protracted payment default** is defined as nonpayment by a customer that, for all intents and purposes, is insolvent, but that has not taken any legal steps to declare the insolvency.

- **Political risk** involves nonpayment due to such causes as the inconvertibility of a local currency to hard currency or the inability to transfer hard currency out of a debtor’s country.

Other key terms in credit risk—and in trade-credit insurance—include the following.

- **Accounts receivable** is a record of sums owed to a company or organization.

- **Credit** (or trade credit) is the time allowed for the payment of something sold on trust. This definition brings together three critical elements—time, sale (transaction), and nature of the transaction.

- **Credit history** is the record of each business’s historical usage and payment of credit. Typically, these records go back five or more years.

- **Credit terms** are the conditions, including time periods and amounts, under which a seller will extend credit to a buyer. A seller bases its decision to extend credit on the belief that the buyer will pay.

The Basics of Trade-Credit Insurance

Trade-credit risk insurance indemnifies your company if a customer either becomes insolvent or does not pay in a timely fashion, leaving your company without the anticipated funds. The default may be caused by conditions within the control of the defaulting party, such as insolvency, or by conditions outside the buyer’s control, such as bank accounts in the buyer’s country being frozen, preventing the buyer from releasing funds for payment.

Trade-credit insurance comes in many forms. Some types of policies work better for smaller companies, some are geared to larger companies, and some are more relevant to specific transactions. In all cases, coverage applies to nonpayment and protracted payment default (see sidebar on this page)—subject to policy terms, conditions, and exclusions.

Four Main Types of Coverage

The following are the four main types of trade-credit insurance programs:

- **Whole-turnover trade-credit insurance** is suited to businesses with less than \$100 million in total revenue. Coverage typically applies to all customers and debtors of the business, but it can be tailored to certain key debtors. A key benefit of this coverage is the credit-analysis service of the insurer—in effect, a credit-management service for the insured.

- **Catastrophic/excess-of-loss trade-credit insurance** is more suited to large or global organizations with more than \$100 million in revenue that have their own sophisticated credit departments. Coverage is similar to whole-turnover trade-credit insurance, but it applies in excess of a significant retention.

- **Export trade-credit insurance** is intended for businesses of any size. Coverage is designed for companies doing business with organizations located in other countries. It can apply to nonpayment or insolvency due to “political risk,” which includes the arbitrary actions of foreign governments or government agencies. Global trade-credit insurance is similar to, but broader than export trade-credit insurance (see sidebar on page 4).

- **Single-debtor trade-credit insurance** is best suited to large transactions with lengthy payment terms.

We discuss all four of these policy types in more detail later in this issue of *Risk Alert*.

Trade-Credit Insurance Terminology

Trade-credit insurance can be defined from several angles, including where coverage applies and to what range of credit terms:

- **Domestic trade-credit insurance** provides protection for a company's domestic accounts receivable against insolvency and protracted payment default.
- **Global trade-credit insurance** is used for companies that seek to protect all their sales—export and domestic—as well as the sales of their foreign subsidiaries.
- **Short-term trade-credit insurance** is usually written for domestic, export, and global programs. Only sales with payment terms of fewer than 360 days are insured. In the vast majority of programs, this involves underwriting of the seller's/insured's whole customer base. The seller/insured may be permitted to insure only certain accounts, as long as the selection of customers is made on a divisional, geographic, or credit-limit-size basis (for example, only the 10 or 20 largest of its exposures).
- **Medium-term trade-credit insurance** is typically used when repayment terms are between three and five years. More often than not, these policies are written on a transaction-by-transaction or single-debtor basis. Coverage provided under these policies protects the insured against nonpayment due to insolvency, protracted payment default, and political risk.

The Benefits of Trade-Credit Insurance

In addition to covering loss arising from nonpayment or late payment and providing credit-analysis services, trade-credit insurance, in its various forms, can offer a number of other benefits.

- **Marketing assistance:** If your company wants to liberalize its payment terms to a particular customer and you're in a competitive situation, arranging trade-credit insurance may help your company gain a competitive edge. You may be able, for example, to liberalize payment terms from 30 to 90 days and still have an insured transaction. This additional flexibility will give you an advantage over a competitor that may only be able to provide 30-day payment terms.
- **Finance applications:** Accounts receivable are an important asset and quite often used as collateral for borrowing purposes. Lenders will typically provide a credit for accounts receivable; however, lenders may not grant your company the maximum potential credit for foreign accounts receivable and/or accounts receivable that represent a high concentration of the company's sales. Trade-credit insurance will help lenders mitigate the issues they have in these areas, enabling them to include a broader pool of your company's accounts receivable when using them as collateral (see sidebar on page 7).
- **More certainty for bad-debt reserves:** Trade-credit insurance can help to set a stable bad-debt reserve that protects your company against unforeseen increases in bad debts. You can establish a known maximum loss that your company will suffer before insurance “kicks in” to reimburse your company for any further losses.
- **International trade:** Export and global trade-credit insurance policies are designed to cover both insolvency and protracted payment default even if they are caused by political risks in the buyer's country—risks of arbitrary or capricious actions by governments or government agencies.

Who Should Consider Whole-Turnover Trade-Credit Insurance?

Businesses with sales ranging from \$25 million to \$100 million are good candidates for whole-turnover trade-credit insurance. It may also be appropriate for larger companies that need additional credit-management services, such as buyer analysis and collections. Sales can be within national boundaries or a combination of domestic and international sales.

Small to mid-size businesses can benefit not only from coverage to protect against potentially significant losses, but also from the credit-research services available from insurers.

Whole-Turnover Trade-Credit Insurance

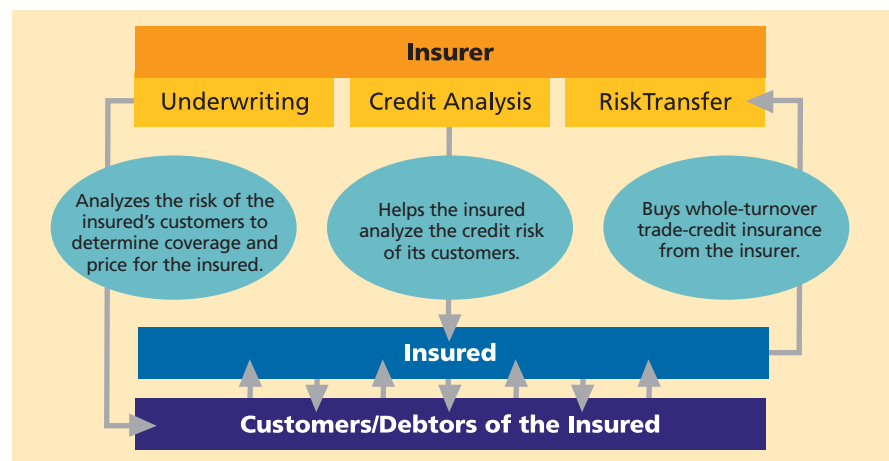
It is difficult for any organization to pay its own bills if its debtors do not pay their bills and pay them on time. Many organizations recognize this fact and arrange whole-turnover trade-credit insurance, also known as multi-debtor trade-credit insurance. Like some other insurance policies, the whole-turnover trade-credit insurance policy is a contract of indemnification—your company must incur a loss before your insurer pays it for the loss. This is the most common form of trade-credit insurance.

Insurers, for their part, will normally underwrite nonpayment and protracted payment default risk for insureds with a portfolio of buyers or customers. This portfolio approach gives the insurer more premium and greater diversification. It avoids the problem of adverse selection, where the insurer is asked to provide coverage only for bad credit risks. When adverse selection is involved, insurers tend either to charge much higher rates or to refuse to provide any insurance.

In whole-turnover trade-credit insurance policies, the insurer will initially review the payment records of every one of your company's customers before agreeing to provide coverage. Because the insurer typically has extensive databases at its disposal, it has the ability to understand the payment records and financial strength of all your customers.

Some global trade-credit insurers maintain databases that give them access to the payment records of millions of private and public companies worldwide.

Whole-Turnover Trade-Credit Insurance



The Berne Union

Almost every trade-credit insurer is a member of the Berne Union, a worldwide association of government and private insurance organizations. It was formed in 1934 to facilitate exchange of information, promote sound underwriting principles, and assist in enforcing foreign buyers' payment obligations. Members of the union are informed rapidly of any deterioration of the credit behavior of any one of millions of companies.

The Berne Union's value statement is: "We are committed to operate in a professional manner that is financially responsible, respectful of the environment and which demonstrates high ethical values—all in the best interest of the long-term success of our industry."

For more about the Berne Union, go to <http://www.berneunion.org.uk>.

An insolvency loss in whole-turnover trade-credit insurance is likely to be a total loss—the insured's customer/debtor will probably never pay. There may be times, however, when an insured's customer/debtor is still solvent, but is unable to pay in a reasonable period of time. This still causes loss to the insured because it loses a predictable income stream. In such cases, the insured company seeks to collect the payment throughout the waiting period (see page 8) in the trade-credit insurance policy, then submits the claim to the insurer. The insurer will adjust the loss and pay the claim.

What happens next depends on the insurer. Some will allow the insured to continue to collect the overdue payment, but will direct the insured's efforts; others will take over the collection effort from the insured. In either case, the insurer would share in the recoveries as its interest appears in the whole-turnover trade-credit insurance policy. In many cases, the psychological influence wielded by a large insurance organization that takes over the collection process can be considerable, making it more effective in collecting than the insured.

Services Provided by the Insurer

Providing financial intelligence to insureds is one of the most important services whole-turnover trade-credit insurers give their clients. Most insurers' databases contain information on the insured's customers—their balance-sheet strengths, sales histories, payment records, and financial ratios. In addition, some insurers hold mercantile information from several of the credit-reporting agencies, such as Dun & Bradstreet.

The insurer's analysis of your company's buyers or customers can become a valuable tool. You can use this information when identifying new customers and deciding what credit terms to offer. If, for example, the insurer is unwilling to underwrite a transaction for a \$10 million sale on 90-day terms, it will normally be willing to discuss with you why it is uncomfortable with that level of risk. This information may prove critical to your company's growth plans—or even to its ongoing viability.

Other services a trade-credit insurer can offer include:

- **Buyer-limit management:** The trade-credit insurer makes the decision about what limit is permissible for each debtor, based on information in its database. Anything above that limit is self-insured. This is a particularly valuable service if your

A Credit Risk Case Study

A manufacturer uses its accounts receivable as collateral for a revolving credit line with a bank. The bank allows use of a credit line up to 75 percent of the value of the manufacturer's month-end accounts receivable balance. This is subject to an agreed-upon maximum amount. The interest cost is the prime rate plus 1.5 percent.

The manufacturer decides to purchase whole-turnover trade-credit insurance to enhance the collateral provided by its accounts receivable. As a result, the bank increases the credit line from 75 percent to 90 percent of the manufacturer's accounts receivable balance and reduces the interest cost from prime plus 1.5 percent to prime plus 1 percent.

The cost of the whole-turnover trade-credit insurance policy is offset by the greater availability of the company's credit line, by the interest savings from the reduced borrowing rate, and by the profits generated by the new sales.

company is exporting goods to foreign companies where you may not have access to information. This service is available not only as part of purchasing a trade-credit insurance policy, but also as an unbundled service. You can purchase just the credit-approval process without transferring the risk to the insurer. Of course, if your company only buys this service, any losses—even within the approved limit—would be out of its own pocket.

- **Country-risk information:** Companies that want to expand into new markets can use the insurer's expertise on countries and regions. Your company can ask the trade-credit insurer for information regarding a particular country where you would like to begin selling your products. Another approach is to ask for information on specific prospective clients/customers in a new region. You can get a "limit opinion" to determine which prospects are viable, then tell your sales staff to go after those prospects—with the foreknowledge that your insurer is willing to add them to your trade-credit insurance policy. This makes the country-risk information a powerful tool for growth.
- **Collection services:** Collection services are another extension of trade-credit services. If your company has a slow-paying customer, you would normally pursue some in-house collection activities, but at some point, you would likely outsource it to a collection agency. Insurers are as interested in your collecting from slow-paying customers as you are. They want to prevent the slow payers from becoming claims. To help avoid the claim, the insurer will help you collect—and generally charge less than an outside collection agency. Like buyer-limit management, this is a service some insurers will provide independent of an insurance policy—again, often charging less than a collection agency would, but more than would be charged to an insured.

Typical Coverage

The insuring agreement of a typical whole-turnover trade-credit insurance policy is fairly broad. Generally, the insurer agrees to indemnify the insured for all losses arising out of insolvencies or protracted payment defaults. The following policy terms are common to whole-turnover trade-credit insurance, as well as to catastrophic/excess-of-loss trade-credit insurance (discussed later in this Risk Alert):

Cancelable and Noncancelable Debtor Coverage

Certain terms and conditions vary from one trade-credit insurer to the next. Cancellation and reduction of coverage is one example of this variability.

■ **Cancelable debtor coverage:**

Some insurers reserve the right to cancel or reduce the approved coverage for a specific debtor by giving a certain number of days' written notice to the insured. The notice period required varies from one insurer to the next. The right to cancel allows the insurer to cancel coverage on a specific date stated in the notice. This means that all shipments made up to the cancellation date are insured and any shipments made after this date are not insured or are subject to the new approved limit in the case of a reduction in limit.

Shipments made after the notice date may still be eligible for coverage if they are covered by the insurer's "construed cover" clause. This clause states that in the event of a debtor-limit cancellation or reduction, all orders in-house on the date of the cancellation may be covered even if they are shipped after the notification period. This coverage can vary slightly from one insurer to the next.

■ **Noncancelable debtor coverage:**

This coverage states that the insurer does not have the right to cancel or reduce debtor coverage approved in the policy, provided either for a named debtor or under a discretionary credit limit. The insured must abide by a set of warranties and covenants set out in the policy that requires the insured to manage future exposure if it becomes aware of a known loss situation.

Most trade-credit insurers offer either cancelable or noncancelable coverage; a few offer both.

- **Loss triggers:** Insolvency or protracted payment default triggers loss across most types of trade-credit insurance policies.
- **Waiting periods:** Before a loss is paid, a period of time must elapse, during which your company must make every attempt to recover the outstanding payments. This period of time is called the "waiting period." At the end of this period, the insurer pays the loss retroactive from the inception date of the loss forward. Waiting periods are determined by insurers and depend, in part, on the countries of the debtors/buyers. They usually run anywhere from 90 days to 360 days. The waiting period is always clearly stated on the trade-credit insurance policy at inception.
- **Coinsurance:** The insured must participate in each and every loss at a level designated in the policy. By having the insured participate in every loss, the insurer lessens the likelihood that the insured will seek to "grow sales" solely at the insurer's expense. Bad decision making in terms of credit extension will result in loss experience for both parties.
- **Discretionary credit limits:** In many, but not all cases, the insured has "discretion" to offer credit terms to designated customers without prior approval from the insurer. In these situations, buyers meet the requirements of having a certain financial strength or an established track record with the insured/seller. This allows the insured to preapprove any transactions with its designated customers, up to the discretionary credit limit and within the stated guidelines.

The scope of coverage in whole-turnover trade-credit insurance and catastrophic/excess-of-loss trade-credit insurance policies is narrowed by the exclusion of:

- intercompany sales;
- sales to governments or entities owned or controlled by governments; and
- goods sold through more secure payment instruments, such as letters of credit, irrevocable letters of credit, and conditional irrevocable letters of credit.

Naturally, cash-on-delivery sales would be excluded, as there is no credit element involved.

Trade-Credit Risk for Low-Margin Companies

The level of profit margin can be an important factor in considering which organizations will benefit most from purchasing trade-credit insurance. Obviously, high-margin businesses will need fewer additional sales to offset a credit loss as compared with low-margin businesses.

Companies with thin profit margins may have a greater need for trade-credit insurance. The question becomes, "Can they afford it?" Since their profit margins are lower, does this additional cost make sense?

The best analysis may be to compare the cost of trade-credit insurance to bad-debt provisions that most companies charge to their overhead on a monthly basis. For many companies, this would fall somewhere between 0.25 percent and 1 percent. Since most trade-credit insurance costs a fraction of 1 percent, the insurance is generally competitive with the company's bad-debt provisions.

Insurance Markets

In the case of whole-turnover trade-credit insurance, market leadership is concentrated in a small number of insurers worldwide that dominate the business. Because trade-credit insurance is much more prevalent in other parts of the world than it is in the United States, many of the major insurers are not U.S.-based. In addition, there has been considerable consolidation among trade-credit insurers in the past several years. These two developments tend to make trade-credit insurance more "mysterious" to the U.S. buyer.

Studies have shown that in Europe, the credit information provided by the insurer is one of the main reasons so many European companies purchase whole-turnover trade-credit insurance. In fact, European companies buy almost 10 times the amount of trade-credit insurance as U.S. companies. This dependence on trade-credit insurance originated because of Europe's many nation states, with their differing financial conditions, currencies, and legal systems. Sellers needed trade-credit insurance as they sought to deal with numerous variables that could affect the sale. A number of European insurers have created operations in the United States, but their headquarters are still in Europe.

Most whole-turnover trade-credit insurers retain the right to cancel coverage for a specific debtor of the insured at any time. Although some insurers have fewer restrictions on cancellation, others may restrict credit terms or lower a credit threshold for a specific debtor of the insured that has a deteriorating financial statement.

A key point is that you may be able to use the insurer's threat to cancel or restrict credit terms to your company's advantage. For example, when the insurer tells you that a debtor's credit history or payment record warrants cancellation or restriction, you might be able to use that information in persuading that debtor to abide by more prompt payment terms or to provide more financial information to confirm its ability to pay.

Who Should Consider Catastrophic/Excess-of-Loss Trade-Credit Insurance?

The best candidates for catastrophic/excess-of-loss trade-credit insurance are corporations with the following characteristics:

- They have been in business for at least five years.
- Their sales are more than \$100 million per year.
- They offer credit terms of 180 days or fewer.
- They have an internal credit staff.
- They have excellent credit control and analysis procedures.

A Sample Case: Powering Up

In order to grow its business more rapidly and transfer the increasing credit exposure on its balance sheet, a subsidiary of one of the world's largest power-generation companies relies on whole-turnover trade-credit insurance. The policy has multiple ways for the credit department to obtain insurance coverage under just one policy. This helps to meet the unique needs of the different industry segments with which this subsidiary does business. The policy contains:

- blanket coverage for small-business credit exposures less than \$50,000;
- a discretionary credit-limit authority up to \$250,000 per existing customer; and
- online access to the insurer's buyer-underwriting database to approve coverage for individual buyer limits as required.

All exposures—buyer limits—above \$250,000 are reviewed once annually by the insurer prior to renewal. This company has experienced year-over-year sales growth of more than 50 percent by actively using its trade-credit insurance.

Catastrophic/Excess-of-Loss Trade-Credit Insurance

For more than 15 years, a second type of trade-credit insurance—catastrophic/excess-of-loss trade-credit insurance—has been popular with large, mainly global corporations.

Large corporations typically do not need to insure every credit risk, nor do they want to obtain approval for individual credit decisions. They have the resources to assess the credit risk of their customers by themselves. They also have a much deeper knowledge of the dynamics of their businesses than would an insurer.

The threats for a large corporation are the potential for aggregate credit losses above expected levels or the possibility of several very large losses in a short period of time. Either scenario could affect the balance sheet in a significant way. Catastrophic/excess-of-loss trade-credit insurance is designed to respond to these threats. Coverage applies on an indemnifi-



cation basis above a high retention for single and aggregate losses. Higher retentions keep premiums affordable for larger insureds, and insurers are able to earn a profit because they are providing fewer services and because their coverage applies above the level of day-to-day losses.

A catastrophic/excess-of-loss trade-credit insurance policy also can work quite well with a company's captive insurance program. The factors that make a captive an attractive option for other lines of insurance also apply to trade-credit insurance. And trade-credit insurers can also offer some additional benefits to the captive management, such as policy management, claims handling, and reinsurance.

Because the credit risks of larger or global corporations are complex and diverse and many larger corporations have departments to manage their credit risk, the underwriting process for catastrophic/excess-of-loss trade-credit coverage is very different from whole-turnover trade-credit insurance. Insurers focus, instead, on the credit procedures and controls of large corporations. They typically do not provide the credit data and research services marketed to smaller insureds. However, your company can generally purchase other services from the insurer—such as buyer-limit management and country-risk information—as part of this coverage.

The very large single transactions that exceed the discretionary credit limit require prior approval from insurers to be covered under the policy. In individual cases, the extensive databases of the insurer can help turn around a decision on a large single credit risk.

Some large corporations decide not to insure their entire portfolios of credit risk, but rather ask the insurer to focus on their 10 or 20 largest debtors. The application for this type of approach requires the insurer's review of each of the corporation's debtors in the program. The insurer, thus, restricts the autonomy of the large insured in these cases.

A Sample Case: Concentrated Risk

A \$350 million publicly traded video-game manufacturer uses excess-of-loss trade-credit insurance to insure against a catastrophic loss that could have a significant impact on the bottom line and earnings per share. Consolidation in the retail sector has created

Who Should Consider Export Trade-Credit Insurance?

Export trade-credit insurance is appropriate for any company seeking to:

- expand sales to include foreign customers;
- expand foreign sales to other foreign markets;
- have access to local-market and buyer-related intelligence in other countries;
- move sales on letters of credit to open-account trade terms of sale; and/or
- finance its foreign receivables.

In all these situations, export trade-credit insurance will upgrade a company's position when its bank reviews its foreign risk issues or its buyer concentration.

greater concentration of credit risk in this company's portfolio, and the competitive threat from the big-box retailers has weakened specialty retailers.

Although the insured's credit-management team is experienced and competent, the team understood that the rapidly changing retail environment was adding risk to the portfolio. The excess-of-loss trade-credit insurance allowed the company the flexibility of continuing to qualify most customers under the discretionary limit, while protecting the bottom line by mitigating the potential impact of a large loss or aggregation of losses.

Export Trade-Credit Insurance

Many corporations in the developed world find that their greatest opportunities for growth and trade come from less developed countries. These countries are rapidly growing in a number of areas—particularly in infrastructure projects, technology transfer, and the import of raw materials unobtainable within the country itself.

The higher growth rates of developing countries present not only an opportunity, but also a challenge to sellers because the buyers in those countries are not as well-known and generally present higher risk. Some of the major risk areas found in developing countries include the following:

- **Currency risk:** The currency of the buyer in a less developed country could decline in relation to the currency of the seller from a developed country. Further, the importer's government or central bank might be able to block the conversion of the foreign currency into the "home currency" of the exporter, making payment impossible.
- **Political risk:** A foreign government or a public governmental authority can arbitrarily interfere with a transaction, making late payment inevitable or even making any payment impossible. Causes of loss include:
 - currency blockage, obstruction of payment;
 - embargo by the customer's government of all shipments from the seller's country;
 - war between the buyer's and seller's countries; or

Who Should Consider Single-Debtor Trade-Credit Insurance?

Single-debtor trade-credit insurance is typically used for companies' making larger sales of capital or quasi-capital goods to overseas markets.

Single-debtor trade-credit insurance assists the bank in overcoming some of its hurdles in providing financing for the transaction.

– cancellation of the buyer's operating license to sell in a particular country.

Exporters must overcome these barriers to be able to sell to certain parts of the world. Export trade-credit insurance helps overcome many of these barriers. It is particularly popular with global distribution companies.

The exclusions contained in export trade-credit insurance policies are the same as those in ordinary trade-credit insurance policies, with the addition of the following:

- trade disputes (see sidebar on page 14); and
- sales to sovereign obligors—entities owned by the government of the country in which they reside.

In all types of trade-credit insurance policies, sales of damaged goods or disputes on the quality of the goods are excluded.

A Sample Case: Growing New Business

A produce cooperative saw that future growth in its business would be driven by sales into Asia. But with limited experience with credit management in this area of the world, the company was searching for a mechanism to be able to increase sales on extended terms without taking on a commensurate level of risk.

As the trade-credit insurance markets had a significant history of experience in this sector, the cooperative was able to use an insurer's expertise to increase sales by selling on open-account terms with the comfort of export trade-credit insurance. This proved to be more cost-effective than using letters of credit or other secured terms.

Single-Debtor Trade-Credit Insurance

Single-debtor trade-credit insurance covers one specific debtor. Usually, these policies are written for companies selling capital goods overseas. More often than not, these policies are written on a transaction-by-transaction basis. The policy provides coverage for nonpayment due to insolvency, protracted default, and political risk. The transactions generally involve financing with repayment terms that extend beyond one year.

Understanding Trade Disputes

In order to have a legitimate claim, an insured must be able assign a valid and legally enforceable debt to the insurer. If the insured cannot establish such an obligation, the debt is deemed a trade dispute under the terms of the trade-credit insurance policy. It is not insured unless and until such time as the dispute is resolved and the insured is able to establish the debt as legally enforceable.

Sometimes, single-debtor trade-credit insurance policies are written to cover domestic transactions that involve substantial sums—again, generally with payment terms that go beyond one year. More often than not, the seller purchases the policy, at least in part, to facilitate the sale.

Single-debtor trade-credit insurance helps the bank manage the issues of country risk and/or the concentration of exposure to a single debtor.

Insurers generally require one or more of the following conditions to be met to offer a single-debtor trade-credit insurance policy:

- The debtor is investment-grade or better.
- The transaction is for export sales.
- The bank's financing requirements drive the need for coverage.
- The terms of payment are between three and five years.
- There is some form of down payment.

A Sample Case: Easing a Two-Year Risk

A multinational manufacturer of large generators that sells to power companies worldwide sought to mitigate a two-year credit risk of over \$50 million from a new contract with a global utility that has operations in Latin America. The project generated credit risk both from pre-shipment construction of the generators and from post-shipment quarterly payment risk.

Single-debtor trade-credit insurance enabled the company to execute the contract, knowing that a significant portion of the risk was transferred to the insurer for protection against nonpayment due to insolvency, protracted payment default, and political risk.



Trade-Credit Risk Assessment

To help determine whether your company has a trade-credit risk issue and should, therefore, consider trade-credit insurance, you should ask yourself the following questions:

- Are my company's sales concentrated with a few large customers?
- Are the industries to which my company sells consolidating, resulting in fewer, larger customers?
- Do my company's bad debts fluctuate from year to year?
- Is the bank providing sufficient credit toward my company's finance package for both its domestic and its export accounts receivable?
- Are my company's sales terms competitive when it is selling overseas?
- Can my company withstand an insolvency of one of its key customers?
- Does my company have an opportunity to sell more to its customers if it can come up with greater trade-credit capacity?

If you answer "yes" to any of these questions, trade-credit insurance may be appropriate. The following is the basic information trade-credit insurers will need:

- a list of your top 10 to 20 customers;
- a list of the countries in which your company is selling;
- a three-year history of bad-debt losses;
- a description of your credit-management procedures; and
- an aged list of accounts receivable.

Trade-credit insurance is not the only way to handle credit risk. There are alternatives.

Other Methods for Managing the Risk

Trade-credit insurance is not the only way to handle credit risk. There are alternatives. Three of the more prevalent methods are factoring, credit default swaps, and receivables securitization. Each has its pros and cons, and each can be used independently or in conjunction with trade-credit insurance to manage the risk.

Factoring

Factoring is the sale of your accounts receivable to a financial institution, known as a factor. The factor, then, assumes the credit risk and collects from the debtors—your customers/clients. Factoring is particularly popular in start-up industries that need the cash from sales to purchase the raw materials they need to continue manufacturing their goods.

■ **The pros:** Factoring provides immediate infusion of funds into your company upon the sale of its invoices. This allows you to use the proceeds to manufacture or purchase more products right away. You do not have to wait for the buyer/debtor to pay the bill, and you do not need to borrow money to continue manufacturing or purchasing.

Another benefit is eliminating the need for a credit department. The factor is responsible for all credit monitoring, collection activity, and other activities that a credit department would handle.

■ **The cons:** One drawback to factoring is the price. Rates normally range from 0.75 percent to 2 percent on international transactions.

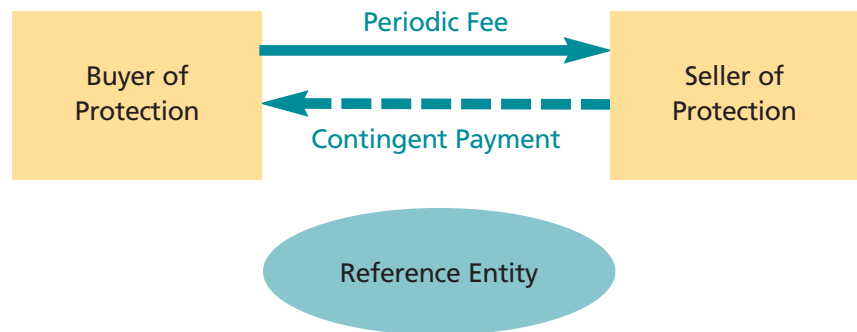
A further problem is that most factors have limited capabilities for handling international transactions, as they lack the databases to evaluate privately held foreign companies.

Another drawback is the potential strain on your company's relationships with its customers/clients that may result from inserting a third party—the factor—into the “equation” as the “middleman” for collecting accounts receivable.

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Credit Default Swaps

A credit default swap (CDS) is a bilateral financial contract in which the buyer of protection pays a periodic fee in return for a contingent payment by the seller of protection, following a credit event of a reference entity:



A credit event is usually defined as bankruptcy, cross default, repudiation, failure to pay, and/or restructuring—although increasingly, restructuring is no longer covered. If one of the specified credit events occurs, the swap is terminated, and the seller of protection pays the buyer. The payment is commonly effected by a cash-settlement mechanism designed to mirror the loss incurred by creditors of the reference entity following a credit event. The payment is typically calculated as the fall in price of the reference obligation below par (100), measured in a dealer poll at a specified point in time after the credit event.

- **The pros:** Credit default swaps are straightforward, using standard documentation.

There is a liquid market for credit default swaps with numerous well-rated counterparties.

Maturities are typically five years, but they are available up to ten years.

The credit event—the occurrence of default—is contractually well-defined, and the pricing is relatively transparent.

- **The cons:** Capacity may be limited for privately held companies.

The amount of protection may need to be adjusted for bankruptcy recovery in the final settlement.

Securitization is a financing technique whereby a portfolio of assets is pooled and repackaged as securities.

Receivables Securitization

Securitization is a financing technique whereby a portfolio of assets is pooled and repackaged as securities. Typical assets may be mortgages, student loans, credit card receivables, and so forth—including trade-credit receivables.

Securitized assets typically involve the creation of a bankruptcy-remote special purpose vehicle (SPV). The assets and the credit risk are transferred from the issuer to the SPV. In turn, the assets are used to back the securities issued by the SPV to investors. The advance rate is adjusted to reflect the credit risk of the underlying assets.

Through the use of an SPV, the assets are separated from the bankruptcy risk of the issuer. Therefore, funding may be obtained at a cost lower than that of traditional financing, due to the lower credit risk.

- **The pros:** Receivables securitization typically provides cheaper funding—rating the SPV enables a sub-investment-grade issuer to sell investment-grade securities at investment-grade rates.

Securitization converts the receivables into liquid securities, producing a more favorable advance rate than factoring.

This is a deep market with a sophisticated investor base.

Credit risk is transferred from the issuer to the SPV.

- **The cons:** This is a more complex form of financing—due, in part, to its legal, tax, and accounting issues—in which costs must be carefully weighed against the benefits.

The costs include legal, professional, rating-agency, and administrative fees.

Additional costs may be incurred if credit enhancement is required to achieve a minimum rating.



Conclusion

There are a number of myths about trade-credit insurance. Three of the more prevalent myths are that it is expensive, that it diminishes control, and that it is difficult to administer. In fact, the opposite is true: Trade-credit insurance is generally reasonably priced and easy to administer, and it strengthens a company's control over its accounts receivable position.

Although it may not be the right solution in all instances, trade-credit insurance can also assist companies in other ways beyond protection against insolvency or nonpayment by providing benefits long before a claim is paid:

- It can help upgrade the value of a company's accounts receivable by improving its quality as collateral for financing.
- It can help reduce a company's exposure to a concentrated customer base.
- It can enable a company's offering more competitive credit terms to customers in new markets.
- It can help a company to be more competitive in its existing markets.
- It can help protect a company's cash flow against unforeseen bad-debt losses from one or more debtors.
- It can help protect a company against foreign bankruptcy laws, the potential inconvertibility of foreign currency, and other transfer issues that could result in nonpayment.

Trade-credit insurance can help protect a company's credit, enabling it to grow, unfettered by fear of customers' insolvencies, protracted defaults, and/or political risk.



Web Sites in This Issue

- The Berne Union
<http://www.berneunion.org.uk>
Page 6
- U.S. Courts, Bankruptcy Statistics
<http://www.uscourts.gov/bnkrpctystats/statistics.htm>
Page 1

Abbreviations and Acronyms in This Issue

- CDS: credit default swap
- CIC: Certified Insurance Counselor
- CPCU: Chartered Property Casualty Underwriter
- MMCSC: MMC Securities Corp.
- NASD: National Association of Securities Dealers
- SIPC: Securities Investor Protection Corporation
- SPV: special purpose vehicle



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Notes

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- Mercer Delta Consulting works with CEOs and senior teams of major companies on the design and leadership of large-scale transformation.
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[Risk Alert: Trade-Credit Insurance](#)

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