

## **CREDIT INSURANCE – GRUDGE PURCHASE OR ESSENTIAL CREDIT MANAGEMENT TOOL?**

### **QUESTIONS & ANSWERS**

#### **Introduction**

In business, there is only one thing that is really important: getting paid. The only 'good' client – so the phrase has it – is a paying client.

There are, however, a whole host of reasons for non-payment, some simple, some more complex. Whatever the reasons, and wherever the fault lies, however, a bad debt could place your business in serious jeopardy. The business world as we know is littered with incidences of spectacular bad debts bringing companies to their knees.

Consider a Balance Sheet. Whilst most firms insure their physical assets (buildings, stock, contents), future income by way of business interruption insurance, and purchase liability insurance to protect against third party claims, far fewer consider protecting their debtors' balance, often a significant asset,

A simple insurance policy can make all the difference. This is where Credit Insurance comes in.

#### **What is credit insurance?**

Credit insurance provides your business with protection against the failure of your customer to pay their trade credit debts – i.e. money that is rightfully yours. Such a debt can arise as a result of your customer becoming insolvent (i.e. going bust) or because your customer simply fails to pay within an agreed credit period.

The protection covers as standard goods sold and delivered but can be tailored to cover many other risks such as pre-despatch work-in-progress and binding contracts.

As well as 'commercial' risk, credit insurance can also protect against 'political' risk for those trading abroad. Examples include war or civil war, cancellation of the contract by the government of your customer's country, or governmental regulations which prevent the export or import of goods.

Credit insurance can indemnify you against a complete spectrum of perils such as inconvertibility, contract frustration, contract cancellation, and export and import restriction problems.

#### **Who uses credit insurance?**

The sensible ones! Credit insurance is suited to all manner of companies, regardless of whether they are trading nationally or internationally, and in all sectors from manufacturing to services. In terms of size they tend to be firms with turnovers from £250,000 through to the turnovers of the largest multinationals.

#### **When and why would you consider using credit insurance?**

On average, companies are estimated to have 40% of their current assets in the form of trade debtors. (For some companies this figure can be much higher). Research has shown consistently that companies are unable to predict the vast majority of failures to which they are exposed.

Indeed it is estimated that up to 50% of all failures concern customers that were previously considered to be both long standing and prompt paying. It is a sobering thought that even the customer you thought you knew best of all could inadvertently end up being your downfall.

The cost of bad debt can be very significant. For example, if a company is operating on a 5% profit margin, a £10,000 bad debt would require £200,000 of additional sales to compensate for the lost ground. Double the

debt and it is easy to see why businesses can be brought to the brink of collapse. Unless of course you are covered by credit insurance.

A further reason why businesses should consider using Credit Insurance is because a bad debt often causes a company to reduce the amount of credit it extends to its customers. Again in simple terms, it is easy to see how this potentially exposes that business to its competitors, leaving it in a potentially much weaker competitive position.

### **How can credit insurance improve my business?**

Many benefits of credit insurance have a positive impact on a business, especially in relation to the wider subject of 'credit management'.

For example, credit insurance provides an early warning that a customer is in financial difficulty, allowing a company time to withdraw from the relationship on a structured basis, reducing exposure gradually.

Another positive aspect of credit insurance is that it assists you with targeting your sales effort, focusing on profitable buyers and markets, and avoiding financially weak customers or politically unstable export territories. It also positively impacts on your balance sheet by reducing a company's bad debt provision, thereby releasing tied-up capital that can be invested elsewhere.

The 'security' which credit insurance provides, gives you the confidence to tackle new markets and take-on new customers, safe in the knowledge that if anything happens beyond your control, then you're covered. It can also be used to provide greater security – in essence a guarantee – to a lender for trade or export finance, and thereby provide greater access to finance.

Furthermore, being credit insured offers you representation at meetings of creditors and free legal and practical advice on enforcing your Retention of Title rights over goods supplied but not paid for; and generally provides access to high quality and more often than not fairly up to date credit opinions on companies both in the UK and internationally. Finally bank lenders may be positively influenced if your debtors are insured.

### **How does it work?**

How it works is this: You ask the credit insurer for a credit limit on each of the customers with whom you trade above an agreed level. Below this level – referred to as your Limit of Discretion or Discretionary Limit – you do not need to ask for a credit limit. Instead, you can use your own sources of financial status information and trading experience to justify the trade credit which you extend. Provided you trade within the set parameters and abide by the terms and conditions of the policy (which we shall come to in a moment), you will be covered (up to the limit of cover agreed) if one of your customers should fail.

As regards the level of cover available through a credit insurance policy, typically 80%-90% indemnity applies, depending on the type of solution you choose. Credit insurers are generally flexible insofar as your choice of which customers to cover. Some companies may wish only to cover their top customers or against 'exceptional' losses. (There are specific policy types available that allow you to do just this).

### **To what extent do I need to be involved?**

Your role is to provide the credit insurer with certain information, such as when a customer's account becomes overdue beyond the contractual due date or any extended due date which may be allowed under the policy. You must also inform your credit insurer if you receive or become otherwise aware of any adverse information about a customer which suggests that the customer may not be able to meet its financial obligations under the sale or service contract covered by the policy.

### **How soon will my claim be paid?**

Typically you will be paid within 30 days of confirmation that an insured debt has been admitted to rank in the insolvent estate of your customer. We say 30 days, but it is true to say that in many cases the claim can be paid considerably quicker than this. In the case of protracted default, claims tend to be paid within three months of the occurrence of such a default, or the receipt of a claim form – whichever is the later.

### **How much does it all cost?**

The cost of a policy, in our case, is calculated as a percentage of a company's turnover, and will depend on its trading history, turnover, business sector and customers on which you need cover. Historically, the range is from less than 0.1% of turnover to more than one percent. Typically however, a company will currently pay between 0.3 and 0.8% although this could be higher for certain political risks.

Premiums are usually paid by interest free instalments over 10 or 12 months. There is often a one-off limits charge made at the start of the insurance period.

### **Summary**

It is important to see credit insurance for what it really is. A business tool which can be used pro-actively as a mechanism for securing further funding for business expansion, something which can help them grow as their customers grow, and enable them to take on new business with confidence and security which they need going forward.

**For more information and to seek a quotation visit [www.rowlands-hames.co.uk/credit-insurance](http://www.rowlands-hames.co.uk/credit-insurance) or contact John Isles on 01253 598953 or email [john@rowlands-hames.co.uk](mailto:john@rowlands-hames.co.uk)**

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