Insurance can Help Mitigate Credit Risks

Credit insurance protects unexpected losses a lender may face due to wilful default or insolvency on the part of the insured buyer

ET 13/04/12

Guest Column

UMANG RATHOD

The quality and availability of credit to global buyers have taken a hit due to the European crisis and US slowdown.

Credit insurance can help protect unexpected losses due to any wilful default and insolvency on the part of the insured buyer or due to the political risks faced by them. Here's how one should go about the process of getting a credit insurance.

DETERMINE THE NEED

Before deciding to go for the options available, identify if there is a need for credit insurance and how it will benefit the company. The risk of unexpected default persists even with customers believed to be "as strong as a bank". Credit insurance is a great tool to remove this probable uncertainty and cap a company's unsecured exposure by mitigating it.

It is not uncommon for customers to request for more credit than one is comfortable giving them, or to have new customers one isn't familiar with. Or it could just be that one is venturing into an unchartered territory, having no good knowledge about the political environment. Unfortunately, payment history is not a valid predictor of default. Credit insurance is a means to offer competitive open credit terms without taking incremental risk. It supports additional sales that would not have been made otherwise to safely expand the global reach of an organisation.

STRUCTURING THE PROGRAMME

Policy premium is a primary and logical parameter to examine. The final premium that the insurer charges will be priced based on a number of factors, including insurable turnover, industry performance, past bad debts, customer quality, and risk participation levels in the policy. Risk participation or retention assures insurance companies that the insured has a vested interest in continuing to manage its exposure in a prudent manner, while also allowing it to minimise the premium payable.

Deductibles will generally be either in the form of each and every loss or aggregate loss, which needs to be accounted for before claim payments start.

One broad rule while designing a policy is to use a self insurance level less than or equal to gross margin. This allows the policy to at least cover the cost while avoiding paying additional premium to insure the profit.

THE APPLICATION PROCESS

Care should be taken in terms of what information, which has to be technically correct, is being provided in the proposal form, which is the most important aspect of credit insurance policy. The policy will be quoted based on the information submitted in the proposal form, and this will become a part of the contract as an underlying representation in the agreement between the insured and the insurer.

EVALUATING OFFERS

Each reinsurer has its own risk appetite, underwriting philosophies and contract wording. While the coverage is fundamentally similar, reinsurers widely differ in how they structure and administrate their policies. One should take time to understand how each of them differs on key parameters where the policy needs to be customised taking into account special terms of sale, industry practice, seasonality, etc.

From the perspective of a buyer, it is essential to evaluate the reinsurers and their offers based on three key categories — the reinsurer's reputation, contract wording and the policy terms

and proposed coverage. Among other things, it is important to understand what the claim filing deadlines and obligations or reporting requirements of the programme are, since they could be different for each reinsurer. Comparing premiums and deductibles and/or coinsurance has to be done in light of what the carriers are offering on coverage limits and policy conditions.

Credit insurance is not a commodity product that can be shopped on price alone. The goal is to find the programme that best matches the needs on how the policy should work under the given business constraints.

IMPLEMENTING, MANAGING PROGRAMME

One should monitor, on an ongoing basis, buyer exposures in the event where there is a need to add new accounts or increase the coverage limits on existing buyers. As a healthy practice, it is advisable to maintain a summary of the obligations and the key policy requirements like claim filing time frames or overdue reporting and periodical declarations.

Credit insurance is a tremendous financial and risk management tool. With the right partner, the insured can enjoy protection on one of company's largest assets, safely expand sales, improve borrowing arrangements and take advantage of expert credit guidance. Credit management offers businesses a competitive advantage in today's global uncertain times. It is much more than just an off-the-shelf product and can do wonders if used in the correct manner. Corporates that recognise the potential will be the ones that will win in the long run.

(The author is promoter of Origin Insurance Brokers India, a specialised Credit Insurance broker. He and be reached at umang.rathod@originindia.in)