

A photograph of a computer monitor on a desk. The monitor displays a scene of a port at dusk with a large cargo ship and cranes. The text "Using Trade Credit Insurance" is overlaid on the left side of the monitor in a red circle.

**Using Trade
Credit Insurance**





Effective Uses of
Trade Credit Insurance to Mitigate Risk,
Maximize Liquidity And Increase Sales

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Risks Faced by Exporters in Trade

Risks Faced by Exporters in International Trade



Slow payment/default	Financing risk	Commercial risk
Bankruptcy		
Contract repudiation	Contract risk	
Contract dispute		
Abusive bond drawing		
Foreign exchange control legislation	Political risk	Country risk
Discharge of debt legislation		
Government repudiation of debt		
Payment moratorium		
Insurrection/overthrow/domestic turmoil		
Non-payment due to war		
Non-payment due to natural disasters		
Currency inconvertibility	Transfer/economic risk	
Currency fluctuation/devaluation	FX risk	

Credit/Payment Terms Trends in Trade

- Though still very prevalent in some regions, the percentage of total NA trade flows backed by L/Cs is decreasing
- Open account terms with the buyer as repayment source are increasing and at much longer tenors
- Being able to provide extended terms is increasingly critical for U.S. exporters to win sales
- These trends have financial impacts that are being felt by exporters
 - Many banks limit to amount of international A/R eligible or allow lower advance rates in their credit facilities so there is an increasing need to exporters to maximize their borrowing capacity to grow sales
 - Balance sheet impacts such as increasing DSO, increased risk on balance sheet, higher cost of capital

***Credit Insurance: Solution That Can Mitigate
Many of These Issues***

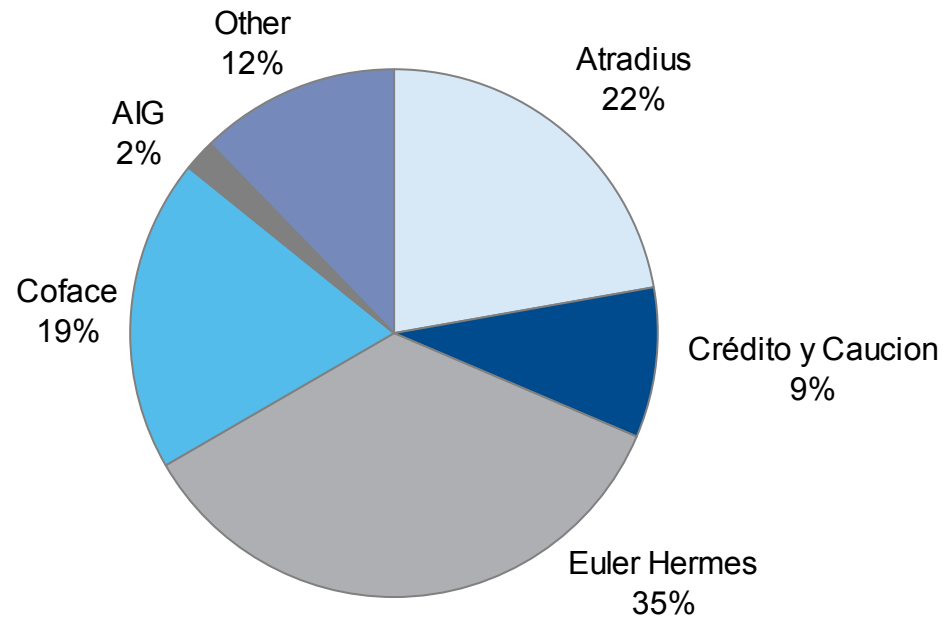
What Is Trade Credit Insurance?



Trade credit insurance protects a company's commercial accounts receivable from unexpected and catastrophic losses resulting from insolvency or "non/slow-payment" by its buyers and from political events that obstruct payment.

Like all insurance, credit insurance involves some aspect of risk sharing rather than 100% risk lay-off (like an exporter gets with a letter of credit or avalized draft).

Credit Insurance Market Shares Worldwide



Source: Berne Union Yearbook 2005.

Two Basic Types of Coverage Offered

■ Commercial Risks

- Insolvency (Chapter 7, 11)
- Protracted default (non-payment within six months of due-date)
- **DISPUTES are not covered!**

■ Country Risks

- Transfer Risk—political/economic events preventing or delaying transfer of payments
- Government Moratorium/Exchange Controls/Discharge of Debt—government legislation preventing release of funds or absolving buyer's payment obligations
- Contract Frustration—government action preventing performance of the contract
- Civil Turmoil—insurrection, war, natural disaster



Typically 80%–90% of invoice value is covered by trade credit insurance.

Principles of Credit Insurance

Credit Limits

- The insurer approves credit limits on the insured's (largest) buyers based on the maximum outstanding amount anticipated during the life of the policy

Named-Buyer Coverage

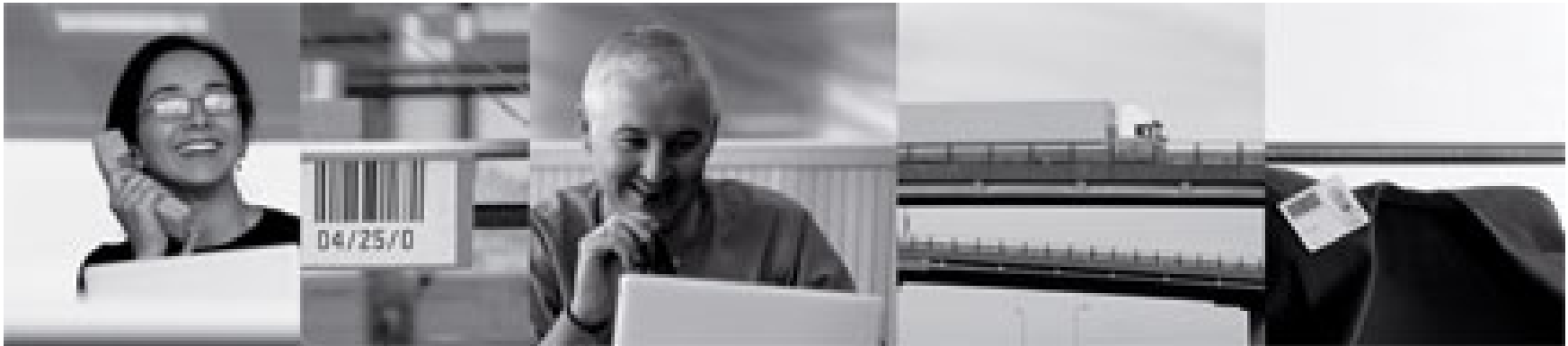
- “European-style” insurance involves the insurer individually underwriting and accepting the risks of each buyer
- Named-buyer coverage normally allows the insurer to reduce or cancel credit limits upon notifying the insured of deteriorating credit conditions (“cancelable coverage”)
- Non-cancelable coverage carries additional conditions to make certain the insured continues to make prudent credit decisions

Discretionary Credit Limits (DCLs)

- “American-style” insurance provides the insured with a DCL so the insured can automatically offer credit terms up to a pre-set maximum limit amount for smaller buyers
- A DCL will be accompanied by an annual deductible and other conditions on its use

The designations are historical: Nowadays, European insurers offer “American-style” insurance and American companies offer “European-style” insurance.

Common Types of Credit Insurance Policies



- Whole Sales Policy (a.k.a. “whole turnover,” “ground-up”)
 - All domestic and/or export buyers
 - No selectivity
- Key Account Policy
 - Sufficient spread (e.g., > \$100k)
- Single-Buyer Policy
 - Investment grade quality buyers
 - Premium > \$50k

Policy Variables: Impacts Coverage & Cost

- Cancelable or non-cancelable limits
- “Risk attaching” or “Loss occurring”
- Insured percentage
- Annual deductible
- Non-qualifying loss amount
- Individual buyer limits
- Discretionary limit
- Insurer’s maximum policy liability
- Covered terms of sale

Benefits of Trade Credit Insurance

- Protect your company against catastrophic events
- Enhance credit management
- Improve financing
- Increase sales

Protect Your Balance Sheet

- If you are like most companies, 80% of your business comes from 20% of your customers. Imagine the impact on your company if one of your best customers were to stop paying you.
- Manage your bad debt reserve and write-offs with greater certainty.
- Take excess bad debt reserves back into income.
- Improve your cash-flow; no big surprises!
- Improve Sarbanes-Oxley compliance!

Credit insurance can give you peace of mind!

Enhance Your Credit Management



- Receive unbiased, third-party credit opinions on your customers.
- Reduce your credit investigation costs and ensure sound Credit Management procedures.
- Accurately budget and forecast your premium costs and bad debt write-offs.

... and premiums are tax deductible!

Increase Your Sales

- Credit insurance enables you to sell more goods/services on longer credit terms while substantially reducing the overall risk of exposure to non-payment from your buyers.
- Credit insurance allows you to offer open account terms; a more competitive alternative to requiring customers to obtain letters of credit.
- Credit insurance assists you with entry into new markets.

As sales increase, you are better able to finance your increasing receivables.

Improve Your Financing

- If you have a few large customers or do a lot of exporting, trade credit insurance could increase seller's sales & borrowing capacity
 - **Reduce** concentration risk
 - **Increase** the pool of "eligible" receivables to include foreign receivables
 - **Increase** advance rates
 - **Reduce** interest rates
 - **Strengthen** client relationships—you can offer better financing terms backed by the knowledge you can obtain funding
- Some banks will *purchase* insured receivables, enabling programs where you can offer customers financing that will actually be carried by your Bank.
 - **True Sale Treatment** can neutralize potential negative impact on DSO
- If you are securitizing your receivables, credit insurance can be used to overcome concentration limits and to make foreign receivables "eligible."

Financing Insured Receivables

When financing insured receivables, it is important to remember these key points:

- The policy will specify retention in the form of coinsurance, deductibles or both for each transaction to be insured. The Bank will take this retention into account when calculating the borrowing base of eligible receivables.
 - For example, if the Insured has coinsurance of 15% on a covered receivable in the amount of \$100,000, our maximum claim for this buyer is \$85,000 (85% of \$100,000). The Bank will count 85% of the invoice value as eligible in this case in order to assure themselves of a full recovery of the principal amount if a valid claim against the policy arises.
 - The Bank will subtract the full amount of any deductible from the borrowing base.
- Although they may be used as loan collateral, it is not feasible to sell receivables covered by a policy with a deductible.
- Lenders are often concerned about the additional conditions that accompany discretionary limits.

Policies can be written with no deductibles and no discretionary limits.

This tends to comfort lenders and facilitate financing.

Loss Payee vs. Joint Insured

- When a Bank uses insured receivables as collateral, the Bank can be named as a *Loss Payee* under the policy.
 - Insurance carrier issues an endorsement naming the Bank as **Loss Payee** for all proceeds paid under the policy. The Bank may be the sole payee or joint with the Insured.
 - This endorsement gives the Bank an assignment of all rights under the policy in the event the Insured defaults on their loan and the Bank forecloses on the receivables.
 - This endorsement cannot be changed without written consent from the named Bank.

- When a Bank *purchases* insured receivables, the Bank can be named as a *Loss Payee* or as a *Joint Insured* under the policy.
 - Insurance carrier attaches a **Trade Finance Endorsement** that recognizes the Bank as owner of the receivables and a **Joint Insured**.
 - This endorsement gives the Bank the right to take over management the policy at any time.
 - The Bank shares the obligations of the Insured such as payment of premiums, reporting of sales and past dues, etc.
 - No terms of the policy except buyer credit limits may be changed without consent of the Bank.

Key Policy Points

When using credit insurance, it is important to remember these key points:

- Insurance does not cover disputed invoices
 - Disputes between the Insured and Buyer must be settled in the Insured's favor to maintain coverage under the policy
- Policy reporting
 - Sales reporting must be completed within the time specified in the policy (usually 15 days after the end of each quarter).
 - All accounts that reach 60 days past due must be reported to Insurer within 20 days from the expiration of the Maximum Extension Period.
- Claims must be filed with Insurer no later than 180 days from the expiration of the Maximum Extension Period. If filed after that date, no payment will be made under the policy.
- If a covered buyer on the policy is more than 60 days past due, new shipments will not be covered by the policy unless the past due invoices are cleared.

Key Policy Points

When using credit insurance, it is important to remember these key points:

- All insurance policies have an “Exclusions” section. These exclusions are fairly consistent between insurers but should be reviewed.
 - Disputes and illegal contracts
 - Import and export licenses
 - Third-country shipment (can be covered by endorsement)
 - Radioactive contamination
 - War between the major powers
- Certain limitations for risky countries are incorporated into the policy. For example, carrier may have a maximum allowable term or may impose an additional claims waiting period.
- Coverage is contingent upon payment of the policy premium.
- Coverage is contingent upon meeting all other terms and conditions under the policy.

Bank's Due Diligence on Credit Insurance as Mitigant & Financing Tool



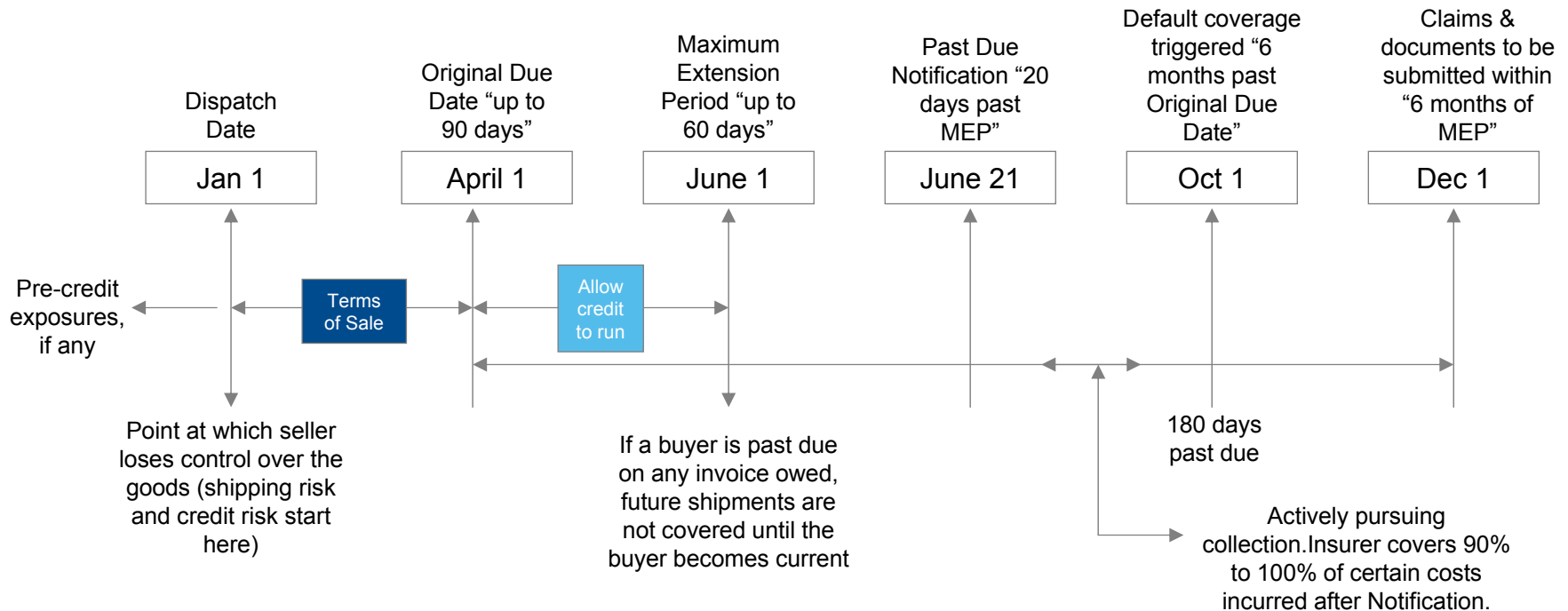
- Evaluation Credit Insurance Policy/Ratings of Insurance Carrier
 - Credit Worthiness of Insurer. Rating agency \geq A-, A3
 - Bank as Loss Payee or Joint Insured
- Performance History of Receivables/Supplier's Ledger Experience
 - Past due and DSO levels
 - Dilution levels and category of dilution
 - e.g., cash discounts, sales reversals, write-offs, product dispute
 - Payment terms
 - Range of receivable account balance levels
 - Supplier Credit Policy and cash collection practices
 - Supplier bad debt experience
- Supplier's Know Your Customer Process (KYC)
 - Awareness of AML issues/restrictions
 - Procedure/process for choosing Buyers

Bank's Due Diligence on Credit Insurance as Mitigant & Financing Tool



- Supplier's ability to meet insurers conditions of coverage is extremely important to Banks
 - Can supplier comply with terms and conditions under the insurance contract?
 - Is there confidence in the insured's ability to maintain records and administrative procedures about it's A/R and deliver to Bank when requested?
 - Is insured able to provide timely data to the Bank with respect to the non-payment/delayed payment of A/Rs by Buyers?
 - Annual certifications from Seller and insurer that premium payments have been made timely. Semi-annual audits of Seller's accounts receivables processing areas, payment of policy premiums, policy reporting will be undertaken.

Claims Process / Timeline for Payment?



Claims Waiting Periods:

- **Insolvency:** None--immediate ascertainment of loss upon occurrence of insolvency
- **Default:** Six months after original due date
- **Transfer & Discharge of Debt:** Four months from later of completed formalities to transfer payment or original due date
- **Government Moratorium, Contract Frustration, War & Public Buyer Default:** Four months after occurrence or immediately after date of suffering loss, whichever is later.

Case Studies

Credit Management Case



Company	Manufacturer
Situation	The growing company was experiencing tremendous sales opportunities, domestically and abroad. However, they needed assistance in determining whom to sell to and whom to avoid. The company could not afford to risk valuable working capital selling to financially unstable accounts.
Operating Facts	Annual Sales: \$140 million Average Accounts Receivable: \$20 million Gross Margin: 8% Account Turns Per Year: 7 Credit Management handled by the management team
Objective	Outsource credit analysis function to provide expert advice, allowing the company the ability to safely grow their business.
Solution	Implemented a credit insurance program that provided credit risk assessment on their medium and large accounts. The policy was customized to provide immediate credit decisions for new medium sized accounts.
Results	The program produced immediate results. Sales were made to new and existing accounts on open credit terms that our client would have never entertained prior to the adoption of the credit insurance program. Our client successfully grew their business by 200% during the initial policy period and is projecting to generate approximately \$350 million in revenue over the next year.

Enhance Borrowing Case



Company	Consumer products manufacturer
Situation	Medium-sized company experiencing good growth opportunities, especially from international markets. Foreign receivables were being internally funded, which was beginning to limit their opportunities.
Operating Facts	Annual Sales: \$200 million (50% from export sales) Average Accounts Receivable: \$30 million Gross Margin: 20% Account Turns Per Year: 7 Credit Management handled by Corporate Controller
Objective	Company was interested in increasing its capacity under its borrowing arrangement with its Bank to get higher advance rates on its foreign A/R and concentrated domestic A/R, so they could maximize on its international selling opportunities.

Average Receivables	\$30 million
“Eligible” Receivables (Borrowing Base)	\$15 million
Advance Rate	80% (domestic sales only)
Available Working Capital	\$12 million
Internal Funding Required	\$18 million

Enhance Borrowing Case



Solution	Implement a domestic and export credit insurance program that eliminated buyer credit risk for the lender.
Results	Credit insurance transformed pledged accounts receivable into “credit wrapped” assets for the lender, allowing an increase in advance rates, inclusion of foreign receivables in the borrowing base, and elimination of concentration limits. In total, the program was projected to make available approximately \$12 million in additional working capital for the company.

Additional Working Capital/Profit

Average Receivables	\$30 million
“Eligible” Receivables (Borrowing Base)	\$15 million
Prior Advance Rate	80% (domestic sales only)
Prior Available Working Capital	\$12 million
Internal Funding Requirement	\$18 million (capped out)
New Eligible Receivables	\$30 million
New Domestic Advance Rate	90%
New Export Advance Rate	70%
New Available Working Capital	\$24 million
Total Cost of Credit Insurance Program	\$500,000
Incremental Sales Necessary to Break Even	\$2,500,000 (1.25%)

Increase Sales Case



Company	Steel scrap processor servicing manufacturers and brokers
Situation	Well capitalized, established company, experiencing good growth opportunities within an industry that has witnessed increased demand in addition to several consecutive raw-material price increases. This caused average account exposures to double in some cases, increasing the financial risk of a potential catastrophic credit loss.
Operating Facts	Annual Sales: \$120 million Average Accounts Receivable: \$15 million Gross Margin: 10% Account Turns Per Year: 8 Credit Management handled by Corporate Controller
Objective	Prospect had a few large accounts that offered additional selling opportunities but had reached their "comfort" credit limits. They were interested in a credit risk protection program that would allow them the ability to safely increase sales without increased risk.

Increase Sales Case

Solution	Cover total customer portfolio, offering a better spread of risk to underwriting, allowing increased coverage on tougher risks.
Results	Coverage approved on just one account generated additional gross profit that covered the total cost of the protection program—sales increases projected to return over 200% of the program's total annual cost.

Profit/Payout	
"Comfort" Limit	\$750,000
Approved Coverage	\$1 million
Sales Opportunity	\$250,000
x Account Turns	8
= Incremental Annual Sales	\$2 million
x Gross Margin	10%
= Incremental Gross Profit	\$200,000
Program's Annual Cost	\$75,000

Extend Terms/Balance Sheet Management Case



Company	Telecom equipment manufacturer
Situation	Company evolving to a direct sales model for EMEA, Asia, and Latin America retailers. Change of sales term net 45 days to 120 days will be required, and the finance team would like to have neutral impact on existing DSO of 45 days. Foreign buyers do not want to use their local bank lines.
Objective	Company was interested in helping its key buyers purchase more product by offering extended terms, obtaining the most cost effective source of capital, no negative distortion of DSO need to keep levels in alignment with peers. Increase cost effective capital into the financial supply chain.
Solution	Insurance carrier able to provide cover for the select group of buyers for sales terms up to 180 days. Telecom seller was able to upload most, if not all of the insurance premium and financing costs into the invoice price. Bank was able to provide \$75 million credit insured accounts receivable purchase facility to exporter.
Results	New sales tool, ability to provide extended terms, no adverse impact on DSO-maintained at 45 days, Bank mitigated its account debtor/concentration risk through the trade credit insurance. Investment grade credit wrap enhanced the A/R pool and exporter/buyer were able to obtain attractive financing cost.

Questions

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