Credit Insurance: Practical Applications in Receivables-Based Borrowing Arrangements

By Victor Sandy

After weathering one of the most difficult economic downturns in at least the past 50 years, and in anticipation of a weak recovery and tight credit markets, more companies are now looking for ways to maximize working capital availability to help sustain their businesses.

As you look for new ways to maximize working capital availability, there has never been a better time to get up to speed on credit insurance and how it can benefit both you and your clients. Any risk-management program that helps your client protect the assets they pledge to you is prudent. However, there is more to credit insurance than just the coverage the policy provides.

In particular, using credit insurance to support a receivables-based borrowing arrangement is an excellent way to help clients expand their working capital by better leveraging the same base of assets. There are several ways to do this.

First, because credit insurance programs can be written around advance rates and, typically, indemnify a client or its lender beneficiary up to 90 cents on the dollar, you may find that you can increase your advance rates without increasing your exposure. For example, if you currently lend at 80 cents on the dollar and implement a credit insurance program with 90% indemnity, you could in theory raise your advance rate to 90 cents on the dollar and still be fully insured in the event of a credit loss. Even going to 85 cents would free up an additional 5% for the client to put to work.

A majority of the credit insurance policies issued today include past-due default coverage in addition to protection against insolvency losses. Carriers typically provide clients with time to work with a customer before they file a claim. Because the carriers provide this protracted default protection, you may find it possible to extend the eligible receivables window. This can benefit clients with good-quality credit risks that just have a history of paying slow and where the dollar amounts are of sufficient size.

In some cases, clients have significant exposure to one or a few key customers. Concentration caps limit the lender's exposure to such accounts. By insuring the accounts for the proper credit limits, you can eliminate these issues. This will allow the client to access the full potential availability on the total account exposure.

Company
Emission Testing Equipment Manufacturer

Situation
Medium-size company experiencing tremendous growth opportunities, especially in international markets. Growth was internally funded and was beginning to limit opportunities.

Operating Facts
Annual Sales: $20 million (50% from export sales)
Average Accounts Receivable: $3 million
Gross Margin: 40%
Account Turns Per Year: 7
Credit Function Handled By Corporate Controller

Objective
Credit risk was not an issue. The prospect was interested in leveraging assets within a borrowing arrangement, thereby freeing up capital so it could maximize selling opportunities, both domestic and international.

Solution
Implement a domestic and export credit-insurance program that eliminated all credit risk for both the prospect and lender.

Results
Credit insurance transformed pledged accounts receivable into "riskless" assets for the lender, allowing an increase in advance rates, inclusion of formerly excluded receivables and the ability to borrow against export open-credit invoices. In total, both programs freed up approximately $1 million in additional capital for the client.

Additional Capital	
Average Receivables	$3 million
Allowed Receivables	$1.2 million
Prior Advance Rate	80% *(domestic sales only)*
Formerly Available Capital	$960,000
New Allowed Receivables	$2.5 Million
New Domestic Advance Rate	90%
New Export Advance Rate	70%
New Available Capital	$2 million

Cost Benefit Analysis	
Additional Capital Provided	$1,040,000
Funds Employed Back Into Business at	40% Gross Margin
Additional Opportunity	$416,000
Account Turns Per Year	7
Potential Incremental Return	$2.9 million
TOTAL COST OF CREDIT INSURANCE PROGRAMS :	**$50,000***

* Credit insurance policy premium

More and more companies are also expanding overseas. Because lenders typically exclude export receivables from the borrowing base, export credit and political risk insurance can help pull those accounts back into the borrowing base. This could free up significant additional working capital for the client.

The box above contains a typical borrowing-enhancement scenario in which credit insurance is used to increase the client's working capital position with less risk and with a program that more than pays for itself on the first advance.

Credit insurance is a great financial tool with significant value for both clients and their lenders. As a custom-tailored risk-management program, it can accommodate specific coverage needs and address any or all of the issues noted above. The coverage also provides clients with expert credit-decision support, discounted collections support and additional risk-management expertise to help strengthen the credit practice.

When exploring this unique type of protection, it is prudent to rely on a specialty broker that knows the markets and policy contracts and can help find the ideal solution for each situation. Every case is unique and there are no standardized, one-size-fits-all approaches. With the proper expertise, a client and its lender can realize the benefits of credit insurance and enhance the relationship, creating long-term value for everyone. TSL

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