SECTION 4

SHORT TERM TRADE INSURANCE

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CHAPTER I

WHAT IS TRADE INSURANCE?

Before we look at what types of policies are suitable for an exporter, or seller let us discuss the general concept of trade insurance.

In a nutshell, the concept of trade insurance is the "the insurance of non-payment of trade debts where such non-payment arises from commercial or non-commercial risks".

Trade insurance is quite different from marine cargo insurance or fire insurance policy, which covers the risk of damage or loss of the physical goods. Trade insurance covers against external causes which prevent you, as the exporter, from collecting payment for goods supplied. In international trade, as long as you are selling on credit you are exposed to the risks of your buyer going bankrupt or defaulting on payment because of poor commercial morality, tight cash flow or refusing to take delivery of the goods for no valid reasons. Further, when you sell overseas you are exposed to even more risks i.e. the country-related risks. These can be a blockage or delay in the transfer of payment, imposition of import restrictions or cancellation of a valid import licence. These actions are usually taken by a government to halt a deteriorating balance of payment situation if the country's foreign reserves are running low. Another country risk is war or political disturbance in the buyer's country.

With credit insurance, should any of the above events occur after the goods have been shipped and you can not collect payment, you can claim indemnity under the policy.

WHY DO WE NEED TRADE INSURANCE?

An exporter can benefit from trade insurance in three ways which can be categorised under the tenets of promotion, protection and profitability.

Promotion

You have an advantage over your competitors when competing for overseas orders if you are able to give credit instead of insisting on a Letter of Credit (L/C). Firstly your buyer may not have access to any L/C facility. Or, if he has access to such a facility, the cost of opening an L/C may too high. In certain countries, it is a regulation that an importer deposits 150% of the value of the LC to be opened.

Secondly, export promotion must be broad-based. New markets must be tapped to expand sales. If you are a manufacturer, there must be viable outlets for your products so as to keep your production lines active. You should not limit your export sales to one or two markets. Your markets should be well spread so that you will not be vulnerable even if there is a change in the country conditions of one or two of your markets. Credit insurance therefore not only helps you to develop new markets but also to be more competitive in giving credit.

Protection

While it is every businessman's dream to make more sales and profits, the sale is not complete if payment is not received. In other words, there is no benefit in making the sales unless your buyer pays you promptly. Trade debts usually form one the main items of the current assets of a trading or manufacturing company. Trade insurance therefore protects you from the loss of a valuable asset, which can affect your cashflow. If your business is concentrated on a handful of key buyers, the failure of just one of them can in turn ruin your business. This is what is called the "domino effect".

Profitability

Let's assume that your cashfiow is able to withstand a bad debt loss, profitability would be affected as you would need to recoup the loss from future sales. Assuming that the business makes a gross profit margin of 20% of each sale, you have a bad debt of $100,000 you would have to chalk up additional sales of $200,000 to recoup the loss. In other words, there is no profit from these sales.

An alternative to buying trade insurance is to self-insure. But this is only feasible for very large organizations where total cashflow is substantial and who can form a fund to be invested. For the average business, the resources would be better used as working capital rather than to be set aside as a reserve against losses. Also the amount of assets, which can be set aside as reserves is usually not sufficient to cushion a bad debt loss on a key buyer.

TYPES OF POLICIES AVAILABLE

There are different types of policies which are available to an exporter, the most usual is the Comprehensive Short Term Policy for credit terms of up to 180 days.

The Comprehensive Short Term Policy

This policy is suitable for a trader or manufacturer who exports goods which are repetitive in nature and the credit period involved does not exceed 180 days. In certain circumstances, trade credits of up to 720 days could be considered.

The Short term policy can be issued either on a "Shipment" or "Contract" basis. The main difference is that the former cover begins from date of shipment and the latter from the contract date.

A manufacturer of customised goods (i.e. non-standard goods) is usually advised to take up a Contracts Policy to give him the additional protection during the manufacturing or pre-shipment period to protect him against the buyer's insolvency. The pre-shipment loss would have been the material and other manufacturing costs incurred based on the buyer's orders. The loss would be even greater if it is difficult to find another willing buyer for the customised or partly produced goods.

The Short Term policy covers all the commercial and non-commercial risks described in the first section and the insured indemnity is usually 85% of the loss except where the loss is due to the buyer rejecting the goods which have been shipped. In the latter case, the exporter is required to bear the first 20% of the gross invoice value. Thereafter, the balance of the loss shall be indemnified at 85%.

Besides the Shipments or Contracts Policy, domestic sales may, by some Trade Credit Insurers, also be insured under the Domestic Trade Policy. The insured risks would be buyer's insolvency and default. Insured indemnity usually remains at 85%.

Policy Structure

Under the Comprehensive Short Term Policy, the basic Policy structure generally covers the following articles:

1. Risks insured, contracts covered
2. Risks excluded, limitation of liability
3. Insured's obligations
4. Loss ascertainment
5. Action after claims payments
6. General Conditions and Definitions

However, there may also be occasions where some terms under the Policy may need to be changed to take cognisance of the nature of the insured business and trade practices. These changes can be varied by special endorsements to the policy. An example would be the exclusion of the non-acceptance risk if the insured goods are perishable items.

Premium Rating and Calculation

There are many variations of premium rating and calculation adopted by different export credit agencies. Premium rating can be based on a matrix rate or a single rate. Short Term policy premium rating may be done in both ways depending on the insured portfolio.

A matrix premium rate is usually given when the insured portfolio consists of the following:

- Well spread markets ranging from good to higher risk markets;
- The payment terms offered to buyers vary.

A single premium rate is given when the payment term offered to buyers is constant and markets are confined to one category.

The premium for each policy will be rated on many factors based on information provided by the exporter / insured in the Proposal Form and interviews / discussions with the exporter / seller. The exporter / seller will have to complete and supply information in respect of the proposed business to be insured - such as markets, type of goods, loss experience, credit control and spread of buyers to be insured in the Proposal Form. The Proposal Form is an integral part of the Policy.

In determining the premium rate, these factors are taken into consideration:

a) Type of Company and nature of business of the exporter / seller;
b) Business experience and turnover offered (sales volume and market spread);
c) Payment terms offered to buyers;
d) Credit control and loss experience

Payment of premium is charged on insured turnover.

RENEWING THE POLICY

The policy is usually valid for a year and annual review of the policy will be made at the end of the expiry date. In renewing the policy, the insured's performance such as difficulty in servicing, slow payment of premium and claims experience will be taken into account. During the review for the renewal of a policy, it is also essential for the insurer to obtain information from the insured on his new business strategy and /or changes. In the event that there are changes, new terms and conditions will be added or deleted in the policy.