What is credit insurance and how does it work?

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With trade customers holding the potential to both make and break a business, financial protection is top of the agenda for most business owners – and this is precisely the role of credit insurance.

Transferring risk away from the business and over to an insurer, credit insurance protects the policyholder in the event of a customer becoming insolvent or failing to pay its trade credit debts. Not only this, but insurers can actually help to reduce the risk of financial loss through credit management support.

What types of cover are included in a credit insurance policy? And in which circumstances might you need one?

The lowdown on credit insurance

Laurence Hill

Laurence Hill, Director of S-Tech Insurance Services Ltd in Cambridge, has worked in the finance sector for more than 30 years and is a specialist in the field of credit insurance. He explains: “Insolvency, where a business cannot pay its debts, is a common scenario. If you receive a note from an insolvency practitioner saying that one of your customers has been put into insolvency, that’s the point at which a claim would be triggered.

“Credit insurance policies also cover defaults,” he continues. “Any business owner will know it’s fairly common for customers to pay after the due date of an invoice. However, there comes a point where the payment becomes so late – it might be 60 or 90 days past the due date, depending on the policy – that the insurer should be notified. A certain number of days after the notification, they will consider a claim.

“By that point you could be taking some sort of legal action against the customer to recover your money. However, the insurer may still consider and pay a claim while your litigation continues. This is usually only if the debt isn’t under dispute, unless you have dispute cover. In that case, the insurer will pay out regardless and recover the funds once the dispute is resolved.”

Protection against international risks

“The other key situation where a credit insurer would step in is a political event,” Laurence explains. “For example, a company might have exported goods to another country. The government of that country subsequently imposed sanctions on the UK, preventing the customer from paying for those goods. If the company had political risk cover added onto their credit insurance policy, a claim would be triggered by this event.”

Political intervention isn’t the only potential problem facing exporters. “They are also particularly vulnerable to loss due to the lack of information available on customers abroad. This can be coupled with language barriers, which can become more apparent when discussing overdue debts!”

The impact of Brexit is another key consideration for businesses in the UK – especially if they are importing or exporting. “We’re heading into some economically turbulent times, which could affect businesses detrimentally and increase credit risks," warns Laurence. "If the UK doesn't manage to negotiate a decent trade deal, I think we'll see the UK downgraded in terms of its own credit standing. That will affect currency prices and the supply chain. Importing may become more expensive and exporting more attractive. It could also make the banks nervous, which would likely make business funding more difficult to come by."

Credit insurance: added value

Credit insurance providers can offer expert assistance as well as cash-flow protection – particularly when setting credit limits. Relying on credit reports and trading history as a form of risk assessment often proves to be inadequate and time consuming for businesses. However, a credit insurer can manage trade credit risk effectively and efficiently on behalf of policyholders.

"Credit insurers have huge databases of information, which they can use to quickly set credit limits (i.e. the maximum amounts that can be owed to a policyholder). The insurer can then monitor the situation in case of any positive or negative changes in the customers' risk profiles, and alert the policyholder accordingly," Laurence explains.

"As a policyholder, you could request a credit check (a.k.a. limit application) on a customer. Your insurer would assess the risk and send back a decision on the levels of credit you should extend. It may or may not be what you hoped for, but at least you'd know it had been properly risk assessed and that you're insured."

Most insurers require policyholders to carry out this process for each of their customers, but some offer 'discretionary limits'. These allow policyholders to set their own credit limits based on certain criteria. Others offer 'non-cancellable limits'. That means they'll write a limit – either at the outset of the policy or during the policy period – and then hold it there regardless of any problems that might arise with a customer's risk profile, such as late-filed accounts (providing, of course, that the customer continues to pay their debts to the policyholder in a timely manner!).

In addition, some insurers offer a free worldwide debt collection service. They will step in to collect a debt on the policyholder's behalf if it remains unpaid after a certain amount of time. They may even sue the buyer and pay the policyholder's claim if the debt cannot be collected.

Business growth risks

"Business owners also need to consider the risks associated with growth," adds Laurence. "New customers, new markets and requests for higher credit limits from existing customers all bring additional risk to a business. Growth can stretch a business' cash flow and leave it less able to sustain a loss."

Speaking of growth, credit insurance can be looked upon favourably by lenders when a business seeks funding. "Any funder holding a charge over book debts will take comfort in the knowledge that this part of their security is backed by insurance. It may also be formally assigned to them. So, in the event of a loss, the claim funds are routed directly from the insurer to the funder," Laurence explains.

Navigating the market

Credit insurance premiums are now widely considered to be on the increase. This is down to several factors, but most of these can all be traced back to a combination of Brexit and online trading. Insolvency rates continue to rise across most trade sectors, but we are seeing a concentration of losses within Retail, Construction and Food.

> Insurers have now set their stalls out, bracing themselves for a hard Brexit. They're stepping up financial monitoring and closer risk management practises, particularly for businesses in the UK who are struggling with increased import prices – they're notoriously difficult to pass through the supply chain.

As with any insurance product, it's important to choose the right policy and level of cover to ensure you have adequate protection. And with such a wide and competitive marketplace, specialist credit insurance brokers are well-placed to ensure their clients receive the most affordable and appropriate deals.

"A specialist broker will not only provide its clients with a wider view of the whole market, but should also be able to drive the best deal. They will also remain on hand to support clients through the policy period and assist with the renewal process when the time comes," Laurence affirms.

As ever, it's important to keep a paper trail, should the need to make a claim arise. "Claims are submitted to the underwriter via a claim form, along with evidence of the cover and loss, as well as any related documents. That means invoices, statements of accounts, evidence of insolvency and proof of delivery, etc.," says Laurence.

A case in point

During his career, Laurence has seen countless examples of the value of credit insurance. "I recently encountered a business that had only decided to purchase a credit insurance policy after a year of trading. It previously used local knowledge and trading history to set credit limits for its customers. Almost immediately after taking out the policy, the business suffered a loss against a customer with an insured credit limit of £20,000. Unfortunately, the loss amounted to around £80,000. Because most of the debt was accrued before the policy – and a carefully researched credit limit – put in place, £60,000 of the loss wasn't covered by the insurance.

"This demonstrates the need for using an expert to manage your credit exposures and set appropriate levels of credit for customers – preferably from the very start."

If your business is trading with customers under open credit terms (as opposed to pro forma or with letters of credit), then credit insurance could prove to be a life-support machine. After all, your trade debtors are likely to be among your most valuable assets – and that makes them well worth protecting.