A CFO'S GUIDE TO THE STRATEGIC APPLICATIONS OF ACCOUNTS RECEIVABLE INSURANCE

Sponsored by

July 2016

EXECUTIVE SUMMARY

Insurance that pays for itself without having to file a claim. That may sound too good to be true, but it does exist, and more and more Chief Financial Officers (CFOs) are catching on. Accounts receivable insurance is one of the few insurance products that does more than mitigate risk. It is a strategic tool used by CFOs of companies of all sizes to help grow the business and support their role in the execution of corporate strategy.

A BRIEF OVERVIEW OF ACCOUNTS RECEIVABLE INSURANCE

Insuring tangible assets like buildings, vehicles and equipment goes without question for most businesses. In the minds of risk professionals and corporate decision makers, the risk of financial loss is simply too great. Yet there is an asset that is frequently uninsured by North American businesses, and surprisingly it is often one of the largest and most important factors in generating cash flow for a company – accounts receivables.

Insurance coverage for accounts receivables has been around for quite some time. Also known as short-term trade credit insurance, the product dates back to the end of the 19th century and was refined between the first and second world wars. After World War II, it was deeply relied upon throughout Europe to help re-build and facilitate growth throughout the continent. Policies can be structured to insure against commercial risk (e.g. customer insolvency) and/or political risk (e.g. embargo, currency inconvertibility, etc.).

The coverage is not nearly as deep-rooted in North America as in Europe because historically most North American business expansion has occurred domestically. In Europe, a continent of many nations, exporting has long been a necessity. While there is a market for accounts receivable insurance in domestic trade, the heightened risks of foreign laws, cultures, and customs in cross-border transactions drives demand.

But times have changed, and the global economy of today often requires North American businesses to look for growth overseas. In turn, demand for accounts receivable insurance is growing. According to Finnacord, a leading international financial services market research and consulting company, “In terms of forecast growth in premiums, the U.S. and Canadian markets are expected to increase at compound annual growth rates of 4.9% and 5.7%, respectively, between 2013 and 2017.”[1]

Despite its clear benefits, many North American CFOs remain unfamiliar with the product. They frequently view it as an unnecessary expense or do not fully understand the return on investment (ROI).

“Part of the reason for the lower penetration rates in North America is that CFOs are often comfortable taking risk in terms of accounts receivables,” explained Glenn Robins, Vice President, Crisis Management, at Allied World. “They have yet to realize that the insurance is a strategic tool that can help grow their company’s business by securely leveraging this key asset of the business.”

USE OF ACCOUNTS RECEIVABLE INSURANCE IS DIFFERENT IN THE US THAN IN EUROPE

Differences in the banking systems also contribute to the popularity of accounts receivable insurance in Europe. “The real estate loan department of a North American bank will require property insurance before giving out a loan on fixed assets. The asset base department, however, will often lend on the receivable invoices without insurance,” said Robins. “So the banks in the U.S., especially on domestic receivables, are very different.”

---

[1] *Finnacord, Press Release, “Trade Credit Insurance-Worldwide Series,” (June 30, 2014), http://www.finaccord.com/documents/press_releases/2014/press_release_trade_credit_insurance_global.pdf*

Another difference is the way that finance departments are often structured in North America. "The CFO is paying a credit department to not have bad debt and collect money," said Robins. "The credit department is rewarded based on minimizing bad debt write-offs and keeping other credit function stats, such as DSO (Days Sales Outstanding), at a target number for the business. Credit insurance is seen as an expense at this point and not as a tool to assist growth. They don't see the point in spending the extra money for insurance."

Robins frequently sees this when a company hires a new CFO. "When new CFOs are hired, they often receive financial incentives to cut expenses. They drop the accounts receivable policy because they do not fully understand its value," he said. "They have no idea that over the past five years they were able to grow because of it."

This trend, however, appears to be changing. More North American businesses now require CFOs to take on a broader and, more importantly, a more strategic role within their organization. For example, companies are increasingly phasing out the Chief Operating Officer (COO) position, leaving the CFO and CEO responsible for the strategic implementation of day-to-day operations.[2] As a result, CFOs have no choice but to view the business through a different lens where balancing the cutting of costs against effective growth strategies is necessary.

One CFO noted that "becoming a business partner helps ensure his team acts as an objective advisor to the business, injecting logic without letting emotions get in the way." [3]

HOW ACCOUNTS RECEIVABLE INSURANCE CAN BE A STRATEGIC TOOL

Chief financial officers from companies of all sizes increasingly use accounts receivable insurance as a strategic tool. "The sales pitch that it usually pays for itself without having to file a claim in a given year, and that it can help deliver on their responsibilities, is gaining traction," said Robins.

Consider Fortune 500 companies who are using accounts receivable insurance to meet different objectives. For example, "One company had a highly rated customer outside the U.S. with several hundred million dollars of exposure, the board of directors wanted accounts receivable insurance in case an unforeseen geopolitical event caused them not to get paid," explained Robins.

Another common objective in corporate America for very large companies is growing sales to strategic customers without taking additional risks to their balance sheet. "Chief financial officers increasingly utilize accounts receivable insurance to accomplish this," said Robins.

Some Fortune 500 companies buy the coverage because they have accounts receivable exposures in multiple countries, many of which are in developing nations with a high degree of political instability. Their concern is the potential for a political meltdown that could cause losses exceeding their bad debt reserves.

Middle-market companies on the other hand often purchase accounts receivable insurance for the extra liquidity it can provide. Banks will frequently offer a higher advance rate on insured accounts receivables. This is extra working capital that can then be used to grow sales.

"I heard one CFO say he was getting a 70 percent advance rate. He purchased the coverage and the banker redid the loan agreement at a substantially higher rate. This is not uncommon," said Robins. "I've talked to several bankers of asset based lenders and depending on the case, country and obligor, they'll increase the advance rate with the insurance in place."

---

[2] *Thomas G. Canace and Paul Juras, Strategic Finance, "CFO: From Analyst to Catalyst," (February 2014)*
[3] *Thomas G. Canace and Paul Juras, Strategic Finance, "CFO: From Analyst to Catalyst," (February 2014)*

Another example, which also impacts liquidity and illustrates the cost benefits of accounts receivable insurance versus self-insuring, is the ability to limit bad debt reserves. “As companies grow, so do their bad debt reserves, but if they have coverage in place their auditors may allow them to cap their bad debt expense at the policy deductible,” said Robins.

Other examples of cost and benefits of accounts receivable insurance versus self-insuring through bad reserves include the following.

- The ability to reduce or maintain bad debt expense versus maintaining a bad debt reserve to fund write-offs.
- The ability to access an expanded credit team including underwriters and economists versus paying for credit information, analysis and review.
- The ability to access additional credit information from the insurance carrier versus paying for credit systems, credit scoring and matrix review.
- The ability to increase risk tolerance and, therefore, sales to new customers versus restricting sales due to lower risk tolerance.
- The ability to access capital at favorable advance rates versus it having an impact on capital allocation to the balance sheet.

CFOS’ USE OF ACCOUNTS RECEIVABLE INSURANCE

As just mentioned, strategic-minded CFOs use accounts receivable insurance for more than mitigating risk. They use it to grow sales, expand working capital, indemnify unsecured losses, and enhance corporate governance, among other reasons. The following are practical examples of how the coverage benefits CFOs.

GROW SALES

Accounts receivable insurance provides a competitive edge by giving suppliers the ability to extend credit to their customers as opposed to requiring payment in advance or on delivery. It also can be helpful in lengthening payment terms with customers to match or exceed the competition. It allows for these aggressive growth strategies without taking additional balance sheet risk.

For example, accounts receivable insurance enables companies to improve competitiveness overseas by offering buyers longer payment terms and the ability to reduce their interest rates by converting bank debt to supplier debt with longer payment terms.

EXPAND WORKING CAPITAL

Accounts receivable insurance can help to obtain a higher advance rate with lenders that use accounts receivables as collateral. This will provide increased liquidity without having to increase the asset base. It can also help to negotiate lower borrowing rates.

Imagine a company has accounts receivables of $10 million and an advance rate of 80 percent. This results in a borrowing base of $8 million. With accounts receivable insurance, the advance rate can be increased to as much as 90 percent. This would provide the company with an additional $1 million in liquidity.

“If it is a strong name and country, the company will be more likely to receive a 90 percent advance rate whether there is insurance or not,” said Robins.

"If it is a tougher country or name, they will most likely be at 80 percent or lower, but with insurance they could receive an extra five or ten percent," Robins explained. "For a smaller company the accounts receivable premium may be $50,000 but they get additional $350,000 in liquidity. The product will pay for itself."

INDEMNIFICATION FOR LOSSES

Large accounts receivable losses are now more frequent, severe, and difficult to predict. For example, unsecured losses were sustained by creditors in recent high-profile strategic bankruptcies by Chrysler, General Motors, Kodak, and United Steel, to name a few. If the suppliers insured their receivables, they would have been indemnified for a substantial portion of the losses sustained.

Accounts receivable insurance can also be designed to provide protection against losses resulting from political risk, such as currency inconvertibility, contract frustration, and permit restrictions, to name a few. This enables suppliers to expand into emerging economies and take advantage of new growth opportunities.

ENHANCE CORPORATE GOVERNANCE

Many businesses have little experience managing credit risk. Purchasing accounts receivable insurance enables in-house credit teams to tap into insurance company resources to make informed decisions rather than educated guesses. This provides the board of directors and shareholders assurance that a third party (the insurance company) is reviewing their exposures and credit management processes.

GIVING COMFORT TO A COMPANY'S LENDER

With accounts receivable insurance acting as a second source of repayment, a CFO can now assure his lender that his company will not have covenant issues if there is default by a customer. "A CPA told me of a situation where the CFO had a large customer who filed bankruptcy and the first call the CFO made was to his CPA," said Robins. "The CPA recommended the next call be to his lender but the CFO was concerned about making that call because without accounts receivable insurance the lender was not a loss payee, and the loan agreement would have to be amended with less favorable terms to the CFO's company. The CPA said he wished he knew about accounts receivable insurance as it would have saved his client a lot of issues," added Robins.

CONCLUSION

By some estimates, only seven to eight percent of North American companies utilize accounts receivable insurance – a small fraction compared to the approximately 70 percent who purchase the coverage in Europe.[4] The complexity of global commerce is now making the strategic value of accounts receivable management ever clearer. As a result, product familiarity is growing, and more companies realize that if used properly, accounts receivable insurance provides a valuable enhancement to a company's management of accounts receivable for working capital and credit management purposes.

[4] *Green, Paula, Global Finance Magazine, "Risk Management: Insuring Trade Credit," (February 05, 2014), https://www.gfmag.com/magazine/february-2014/risk-management-insuring-trade-credit*