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Using Trade Credit Insurance to Improve the Trade Finance mechanism and Export Generation Capacity within a recovering Economy

Souvik Banerjea, Managing Director

8 June 2018 – Harare, Zimbabwe

Good Morning Zimbabwe

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Today we shall examine:

- Why should we deal on Credit Terms
- The risks associated with Credit Transactions
- How to Manage or Mitigate Credit Risks
- The need for Credit Insurance
- How does Credit Insurance work
- The various products in Credit Insurance
- Trade Credit for Export Transactions

Why Deal on Credit Terms?

Types of sales transactions

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Sales come in three flavors:

- **Cash sales:** Cash is collected when the business makes the sale and delivers the product and/or service to the customer.
- **Credit sales:** Cash isn't collected until sometime after the sale is made; the customer is given a period of time before it has to pay the business.
- **Advance payment sales:** The customer pays the business before the sale is consummated, that is, before the business delivers the product and/or service to the customer.

Why deal on credit terms?

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- Affordability issues
- Competitive advantage
- Better relationships with customers
- Access to Finance
- Supporting sales expansion

Risks in Credit Transactions

What are the risks in extending credit to customers?

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The basic risk is non-payment due to:

- Bankruptcy – financial failure caused by not having the money you need to pay your debts
- Payment Default – failure to make a payment
- Refusal to pay – when a client simply refuses to pay, due to some valid reason or not
- Delayed payment – here, although the money comes in, it is delayed, causing you to lose interest income and affecting your cash flows

The risks of credit transactions (1)

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- The vast majority of trade transactions across the world - around 80-85% - are conducted on ‘open account’ terms, relying on the relationship with the purchaser, supported by a purchase order and invoice with mutually agreed payment terms, as the basis for trust. This percentage however is much less in Africa.

The risks of credit transactions (2)

- The remaining 15% of trade transactions use trade finance instruments such as export letters of credit and export collections. These instruments provide more security against the risk of default by the buyer, or non-payment because of other factors, such as concerns about cross-border risks due to changes in local regulations or even country default.

The risks of credit transactions (3)

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- Credit Risk
- Counterparty Risk: also known as a default risk, and even
- Country risk: the risk of a government being unwilling or unable to meet its loan obligations, or reneging on loans it guarantees. This is also called **Political Risk**.

These are the most obvious risks associated with international trade transactions.

Risk Mitigation Considerations

Mitigating the various credit risks (1)

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1. **Risk-based pricing**: Lenders generally charge a higher interest rate to borrowers who are more likely to default, a practice called **risk based pricing**. Lenders consider factors relating to the loan such as loan purpose, credit rating, etc.

Mitigating the various credit risks (2)

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2. **Diversification**: Lenders to a small number of borrowers (or kinds of borrower) face a high degree of unsystematic credit risk, called **concentration risk**. Lenders reduce this risk by diversifying the borrower pool.

Mitigating the various credit risks (3)

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3. **Tightening:** Lenders can reduce credit risk by reducing the amount of credit extended or reducing the period of credit, either in total or to certain borrowers.

   For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by reducing payment terms from 30 day terms to 15 day terms.

Mitigating the various credit risks (4)

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4. **Credit Insurance**

   Credit insurance protects your business from non-payment of commercial debt. It makes sure that your invoices will be paid and allows you to reliably manage the commercial and political risks of trade.

The FACTS on Trade Credit Insurance

The need for credit insurance

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- “Extending credit is a double-edged sword…I give credit terms so more people can afford my services. I also have people who still owe me money-and who will probably never pay.“
- The biggest mistake businesses make in extending credit, say experts, is failing to create-and follow-strict credit policies. That means first figuring out how much you can afford to have tied up in accounts receivable without losing sleep.

Who should use Trade Credit Insurance?

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If you answer yes to any of these questions, then you should consider obtaining trade credit insurance:

- Do you sell regularly on credit terms?
- Have you ever experienced bad-debt losses?
- Have any of your customers ever become insolvent?
- Do you have any unpaid commercial debts that you cannot collect?
- Do you regularly sell to new customers?
- Do you sell in international markets?
- Do you need help in assessing the financial status of your customers?
- Do you need to improve your company’s cash flow?

How does Trade Credit Insurance work?

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- Insurer (Zimnat) monitors the financial performance of the various customers of the client
- These customers are each allocated a grade which reflects the health of their activity and the way they conduct business
- Based on this assessment, each buyer is given a credit limit up to which the client can trade
- This limit can be revised upwards or downwards as more information becomes available

How does Trade Credit Insurance Work?

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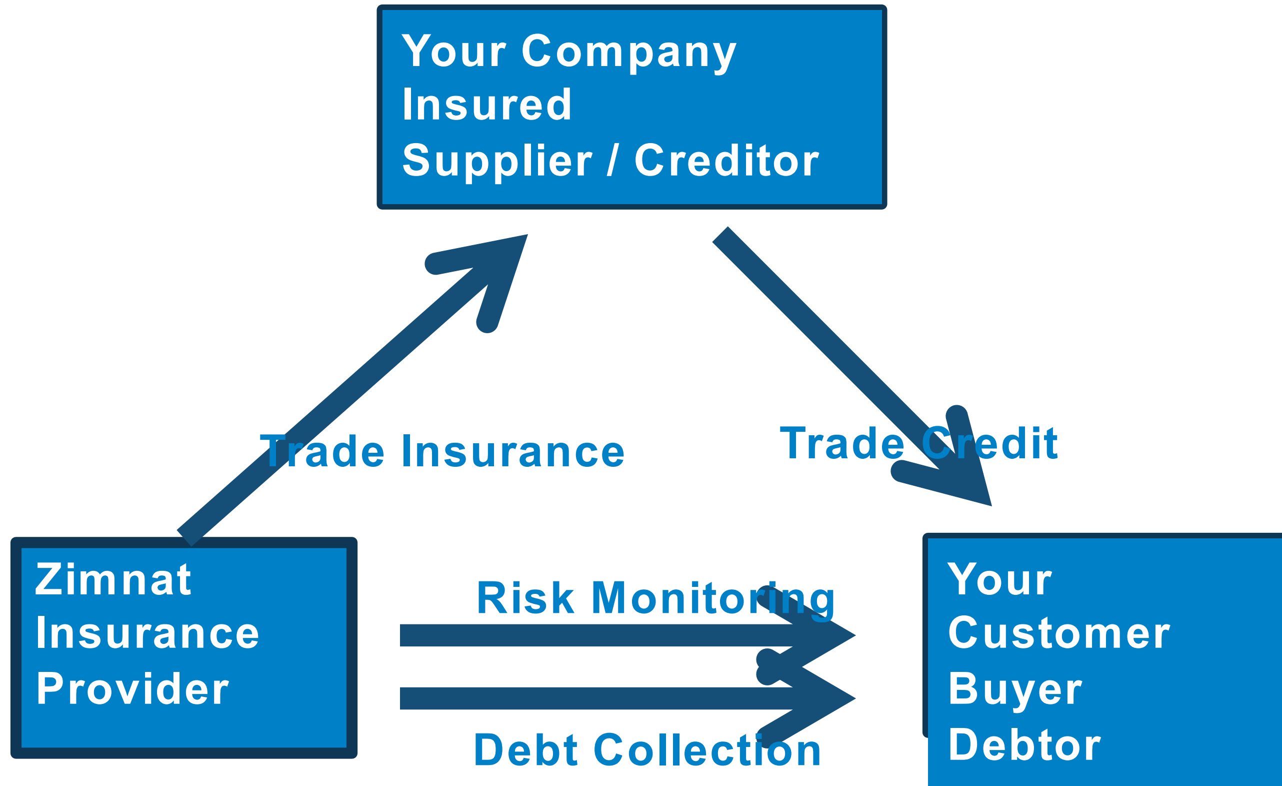

The Products

Various products under Credit Insurance

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- One seller and One buyer Transaction (Single-Obligor CRI)
- One seller and Many buyers Transaction (Whole-Turnover CRI)
- Insurance for Lenders (Lenders All Risk)
- LC Confirmation Lines: Zimnat Policy can be a cheaper alternative (however, need for a bankable rating)
- Receivables Discounting with Banks: Non-payment by a Private Buyer for one or several suppliers whose invoices are being discounted by a Bank

Due Diligence Requirements: What does a Credit Insurer look at

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- 1. Soundness of the Borrower/Contractor/Buyer

- Income Statement – revenue, margins, profitability trends
- Balance Sheet – gearing and liquidity
- Cash Flow – working capital/repayment of long-term obligations

- 2. Prudent Lending Decision:

- Know Your Customer (KYC)
- Understand needs of the customer
- Right products
- Good structure – usage and control

- Security - Backup

Credit Due Diligence (contd..)
What does a Credit Insurer look at

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- 1. Full Financial Statements
  - Independent assessment
  - Risk Rating
- 2. Internal Credit Paper of the Bank, if available
  - Borrower's line of business
  - Ownership and Management
  - Relationship with Bank
  - Repayment Record

Single Obligor Credit Insurance (1)

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- Covering the exposure on one buyer alone
- The key word is exposure – at any given moment of time.
- For example, a road contract of $ 10 million – each certificate valued at maximum $200,000 – client says he will give credit up to 3 certificates maximum – here the sum insured can be $ 600,000, and premium paid on this amount

Single Obligor Credit Insurance (2)

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- The premium rate for SO is high, since there is selection of risk. If the obligor goes bankrupt, loss will be 100%.
- Maximum usage of this insurance is project related, and loan related
- The tenor (duration) depends on the length of the project or loan
- Typically, the indemnity provided will be below 90%, that is, the insured has to bear a portion of the losses. This makes him more careful

Whole Turnover Credit Insurance (1)

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- Under this, the client can cover his whole book of credit sales
- Premium is charged on the turnover with the chosen companies
- Policy is very flexible, new customers can be added as required, and customers whose credit ratings are in doubt can be taken out of cover, during the course of the policy
- The policy works like a declaration policy, a minimum and deposit premium is paid upfront, and premium is adjusted on the basis of declarations

Whole Turnover Credit Insurance (2)

WTO policy can be used in the following sectors:

- Banks, where we can cover a portfolio of their clients
- Exporters, who sell across the globe,
- Manufacturers, who have a big book of customers to protect
- Suppliers / Traders
- WTO policies are generally of one year's duration

Whole Turnover Credit Insurance (3)

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- A typical scenario can involve a customer who uses their receivables as collateral to obtain advance payment or bank financing

- “Blanket protection against payment default risks provides our clients with the freedom to continue expanding their business without worry”

Insurance for lenders (Lenders All Risks)

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- This is an available product to reach out to SMEs
- Product is sold to banks to protect their portfolio of loans to small and medium enterprises
- Individually, these loans would be difficult to cover due to the large volume and administrative work involved

LC Confirmation Lines (1)

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- A Letter of Credit (LC) is a type of guarantee issued by a bank at the request of an importer/buyer, where the bank promises to pay the exporter/seller for the goods or services supplied as per the terms and conditions of the LC.

- LC's have been used in most international trade transactions since the early 1900's

LC Confirmation Lines (2)

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Why do you need to have an LC confirmed?

Scenario 1:

Buyer approaches local bank to finance the purchase of equipment. However, before the gods are shipped, the seller requires confirmation that he will be paid. The seller does not know the local bank of the buyer, so he asks for a confirmation from a reputed international bank or financial organization.

LC Confirmation Lines (3)

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Scenario 2:

A bank may set up a Letter of Credit to enable a local government to import goods. The bank could then approach the insurer to directly insure the LC against non-payment risks in the event the government defaults on its repayment obligations, which is a political risk.

Receivables Discounting with Banks

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A client can, on the basis of receipted invoices, obtain a loan from the bank. The bank uses the receivables as collateral. However, as per bank rules, they have to take much higher levels of collateral, and here a credit insurance policy can be used as additional collateral. The bank transfers the risk of non-payment of the invoices to the Credit Insurance company.

Export Credit Insurance

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- Across the world, export credit and guarantee insurance is one of the major tools for growing the exports of a country
- Type of **insurance** policy that protects an **exporter** against non-payment (default) by an importer.
- Offered generally by a country's **export** promotion agency, it provides the **insurance** cover on an ad valorem fee that takes creditworthiness of the importer and country risk into consideration.
- ECI generally covers commercial risks (such as insolvency of the buyer, bankruptcy, or protracted defaults/slow payment) and certain political risks (such as war, terrorism, riots, and revolution) that could result in non-payment.
- ECI also covers currency inconvertibility, expropriation, and changes in import or export regulations.

Export Credit Insurance…contd.

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- - ECI allows exporters to offer competitive open account terms to foreign buyers while minimizing the risk of non-payment.
  - Even creditworthy buyers could default on payment due to circumstances beyond their control.
  - With reduced non-payment risk, exporters can increase export sales, establish market share in emerging and developing countries, and compete more vigorously in the global market.
  - When foreign accounts receivable are insured, lenders are more willing to increase the exporter's borrowing capacity and offer more attractive financing terms.
  - ECI does not cover physical loss or damage to the goods shipped to the buyer, or any of the risks for which coverage is available through marine, fire, casualty or other forms of insurance.

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