Chapter 21 - Contract Credit Risk

Introduction

Contract risk and credit risk are the part of international trade finance and are quite different from each other.

A contract risk is related to the Latin law of "Caveat Emptor", which means "Buyer Beware" and refers directly to the goods being purchase under contract, whether it's a car, house land or whatever.

On the other hand a credit risk may be defined as the risk that a counter party to a transaction will fail to perform according to the terms and conditions of the contract, thus causing the holder of the claim to suffer a loss.

Banks all over the world are very sensitive to credit risk in various financial sectors like loans, trade financing, foreign exchange, swaps, bonds, equities, and inter bank transactions.

Credit Insurance

Credit Insurance is special type of loan which pays back a fraction or whole of the amount to the borrower in case of death, disability, or unemployment. It protects open account sales against nonpayment resulting from a customer's legal insolvency or default. It is usually required by manufacturers and wholesalers selling products on credit terms to domestic and/or foreign customers.

Benefits of Credit Insurance

1. Expand sales to existing customers without increased risk.
2 Offer more competitive credit terms to new customers in new markets.
3. Help protect against potential restatement of earnings.
4. Optimize bank financing by insuring trade receivables.
5. Supplement credit risk management.

Payment Risk

This type of risk arises when a customer charges in an organization or if he does not pay for operational reasons. Payment risk can only be recovered by a well written contract. Recovery can not be made for payment risk using credit insurance.

Bad Debt Protection

A bad debt can effect profitability. So, it is always good to keep options ready for bad debt like Confirmation of LC, debt purchase (factoring without recourse of forfeiting) or credit insurance.

Confirmation of LC

In an international trade, the confirmation of letter of credit is issued to an exporter or seller. This confirmation letter assures payment to an exporter or seller, even if the issuing bank defaults on its payment once the beneficiary meets his terms and conditions.

Factoring and Forfaiting

Where debt purchase is without recourse, the bank will already have advanced the funds in the debt purchase transaction. The bank takes the risk of nonpayment.

Credit Limit

Companies with credit insurance need to have proper credit limits according to the terms and conditions. This includes fulfilling the administrative requirements, including notification of overdoes and also terms set out in the credit limit decision.

Payment of the claim can only be done after a fix period, which is about 6 months for slow pay insurance. In case of economic and political events is six or more than six months, depending on the exporter markets.

Credit insurance covers the risk of non payment of trade debts. Each policy is different, some covering only insolvency risk on goods delivered, and others covering a wide range of risk such as :

- Local sales, export sales, or both.
- Protracted default.
- Political risk, including contract frustration, war transfer.
- Predelivery risks.
- Cover for sales from stock.
- Non honoring of letters of credits.
- Bond unfair calling risks.

Like all other insurance, credit insurance covers the risk of fortuitous loss. Key features of credit insurance are:

- The company is expected to assess that its client exists and is creditworthy . This might be by using a credit limit service provided by the insurer. A Credit limit Will to pay attention to the company's credit management procedures, and require that agreed procedures manuals be followed at all times.
- While the credit insurer underwrites the risk of non payment and contract frustration the nature of the risk is affected by how it is managed. The credit insurer is likely to pay attention to the company's credit managements procedures, and require that agreed procedures manuals be followed at all times.
- The credit insurer will expect the sales contract to be written effectively and invoices to be clear.
- The company will be required to report any overdue or other problems in a timely fashion.
- The credit insurer may have other exposure on the same buyers or in the same markets. A company will therefore benefits if other policyholder report that a particular potential customer is in financial difficulties.
- In the event that the customer does not pay, or cannot pay, the policy reacts. There may be a waiting period to allow the company to start collection procedures, and to resolve nay quality disputes.
- Many credit insurer contribute to legal costs, including where early action produces a full recovery and avoids a claim.

Benefits of Credit Cover

- Protection for the debtor asset or the balance sheet.
- Possible access to information on credit rating of foreign buyer.
- Access to trade finance
- Protection of profit margin
- Advice on customers and levels of credit.
- Disciplined credit management.
- Assistance and /or advice when debts are overdue or there is a risk of loss.
- Provides confidence to suppliers, lenders and investors.
- Good corporate governance.