▶ INTERVIEW ● P UMESH, vice-president & head-south zone, Howden India

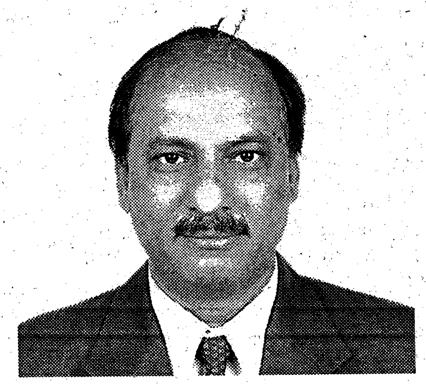
'Bad credit is the most serious and immediate risk'

With the breakdown of major financial institutions in the recent past, the importance one must lay on on bad debts, and more importantly, bad credit, has only been highlighted. ***P Umesh****, vice-president & head-south zone, Howden India advocates the cause of credit insurance in these tough times. Excerpts:*

How can receivables be realised in case of bad credit?

The melt down of the likes of Lehman Brothers and AIG was hard to believe. The myth that things could never go wrong in such Wall Street companies exploded, reminding everyone about the fragile environment we live in. Coming on the heels of the sub prime lending crisis, the failure of iconic companies is adding to the woes of the global credit crisis. All those who have rendered services or supplied products to the failed companies are encountering huge problems in realising their receivables.

When the buyers of products or services default in payment, the provider is left with nothing except earned and unreceived funds. This not only causes a financial loss to the provider, but also disrupts the operating cycle and leads to confusion in the prediction of cash flows. According to a recent survey, bad credit has unseated terrorism as the most serious and immediate risk, and this in turn, threatens the economy. It is time business organisations seriously looked at this risk. Due diligence and being choosy about customers can lessen the risk of bad debts, not eliminate the risk totally. While factoring, receivables securitisation, bank financing through irrevocable L/C and credit default swaps are some answers to this problem, credit insurance is clearly the simplest and the most well accepted solution.



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What is credit insurance?

A credit insurance policy provides indemnity to a seller of products or a provider of services, in case of non-payment by his client, who maybe in the same country (domestic risk) as the supplier or in a different country (export risk). The insurance covers non-payment as a result of insolvency of the buyer or non-payment after an agreed number of months after the due date (protracted default). Typically, non-payment problems may arise due to commercial risks like insolvency of the client, protracted default or a, wrong repudiation of the contract by the client, after the seller has incurred the expenses for the services.

Another important aspect of this is that it is possible cover political risks with credit insurance. These are primarily outside the country, as no insurance firm offers cover against the government of its domicile. Generally, political risks may arise out of the operation of a law or regulation restricting or controlling the transfer of payment from the buyer's country to India, or war, hostilities, civil war, rebellion, revolution, insurrection or other disturbances in the buyer's country. They could also emerge from the imposition of any law or regulation that prevents the performance of the contract and finally, a general moratorium on outward remittances decreed by the government of the buyer's country or by any third country covered under the contract, through which the payment must be made. Like any other insurance cover, credit insurance is not a panacea for all credit-related problems. It also comes with certain exclusions, of which, the most prominent ones are non-payment arising due to genuine trade disputes, sales to a private individual who intends to use the goods or service for non-professional purposes, intra group sales and sales to an associate/subsidiary company, loss due to foreign currency fluctuations and also in case of sales in other countries.

What additional security does credit insurance provide?

First, it protects against the risk of non-payment. To expand, or even to retain the existing business, companies need to buy credit insurance. Exporters can safely offer credit lines and thus enhance sales volumes by building safeguards against the credit risks involved. Most firms lose more money from delayed payments than from bad debts. Credit insurers also offer collection services. The accumulation of claims with an insurer, through the insurer's global standing and contacts, places it in a commanding position to collect overdue debts, than any individual creditor separately. Credit insurance companies also play an important role in developing the exporter's buyer portfolio. The creditworthiness of a potential client can at any time, be checked by the credit insurer. Thus, the exporter will be in a position to be more proactive towards new clients. Also, because the credit insurance company constantly monitors the risks in its portfolio, the exporter is likely to get the information immediately if the financial situation of any of his buyers deteriorates.

Till recently, only ECGC enjoyed certain privileges in credit insurance. But, RBI, vide its circular no. RBI/2007-08/353 AP (DIR Series) Circular No 49, dated June 3, 2008, has stated that credit insurance claims settled by private insurers would also qualify for compliance with foreign exchange obligations.

Companies normally take care in insuring all the assets appearing in their balance sheet like plant and machinery, furniture and fixtures, cash and stock etc. Given the emerging trends in India and the world at large, it is now becoming increasingly necessary to provide a cover against the exposure in debts and arrange appropriate insurance for the debtors. Credit is the lifeline of trade, commerce and business, and an integral part of business activity in the contemporary world. But one has to also reckon the fact that customer insolvency; bad debts and overdue accounts etc are a part of operations when trading is on credit terms.

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