Is your risk over once you have sold your logs?

Jo McIntosh

After harvesting and getting your logs to market you may be forgiven in thinking that the risk is all behind you – but is it? What happens if you sell your timber and you do not get paid? Whether you are trading with sawmillers, manufacturers, timber merchants, distributors, or exporting logs overseas you may be subject to credit risk.

How can you manage the risk? One of the options is with credit insurance. In basic terms, credit insurance protects you against the financial consequences of bad debts. If your customer fails to pay you, this insurance helps to ensure that you are not left high and dry.

Insolvency

A trade credit insurance policy is generally triggered by one of four main events that lead to the non-payment by your customer. The first and probably the most high-profile is insolvency, for example if your customer is put into voluntary administration, liquidation, bankruptcy or receivership.

There have been plenty of recent high profile examples recently including Southern Cross Forest Products, Ahead Lumber Ltd and Tachikawa Forest. In respect of Southern Cross Forest Products secured creditors such as banks, the Inland Revenue and employees were first in line for payment. Unsecured creditors were owed approximately $3.9 million but there were no available funds to pay these suppliers.

One of the things which is worrying about your risk around insolvency is there may be problems even if you have managed your trade risk well. For example, you may have ensured prompt payment when you have seen a slow-down in payment and have done the right thing and changed your terms to cash on delivery. However, you are still exposed to voidable transactions already made to you up to two years before the insolvency beginning. This is known as preferential payments and can apply if your customer has traded with you while insolvent.

The second policy that comes into play is default, which is when your customer simply fails to pay. There is a range of reasons why that might occur including cash flow problems. However, as you will be aware, it is not unusual for buyers to use excuses such as disputes or invoicing errors to hide an underlying problem. The third policy concern is contract repudiation when your customer fails to accept goods that you have exported to them.

Finally, the fourth policy concern is a topical one which is political risk. These are instances where you have export losses due to foreign exchange blockage, import bans, war, civil riots, contract frustration or public buyer default. It is a fast-changing world out there and for clients exporting, especially to developing and emerging markets, there are many unknowns.

Customer profiles

Credit insurance is not just about buying an insurance policy to transfer your risk. There is more to this than meets the eye. An important additional benefit to a credit policy is that, as part of your risk analysis process, insurers help by giving you more detailed profiles of your customers.

Credit insurers are able to provide you with assessments on proposed customers. Because they constantly monitor these customers they will also keep you informed if that company's financial status changes. If the customer's financial stability drops too low, the credit insurer may stop offering continued cover for this particular customer. What good is that to you? The big advantage is that you know about this in advance and can elect to change your trading or terms before it is too late.

While good credit management and careful selection of your customer and payment terms will reduce your risk exposure, there is always the possibility that you or your forest manager selling on your behalf could be faced with a customer default or insolvency. For exporters the situation is aggravated by the distance of the customer, longer payment terms and any jurisdictional issues around legal action and recovery of goods.

Some of the questions I have received are answered below.

How are policies structured?

Usually there are three ways that insurers will look to structure policies. The first is a portfolio cover or whole of turnover cover. With this approach all your customers

above a pre-arranged loss level are included in the coverage. As I highlighted earlier, as part of the benefit of the policy these customers are constantly monitored so that any changes in the status of a customer is highlighted to you.

Another is a single transaction policy. This is useful for a business which deals with only one buyer or has a significant financial concentration with one buyer.

The final option is selected risks. In this case you may not wish to insure all your customers but want or need cover for certain selected risks. Two of the most common reasons for choosing this type of cover are the need to protect key concentration exposures or income that will be assigned to a bank.

While on the topic of banks, trade credit policies are often used by a business to give banks confidence and as a result can be important to advancing funding. As mentioned above, banks can be noted as interested parties on these policies, useful for exporters needing trade finance.

How does an insurer calculate the premium?

There are a few factors that the insurers will consider when determining their premium rates for a trade credit policy. These include a review of your turnover levels, the industry you work in and how volatile it is, your customer base, your bad debt history and your internal credit control procedures. From this information a premium rate is set to each policy.

This rate is agreed at the beginning of the policy and adjusted against your actual insurable sales at the end of the policy period. It is a bit like paying a deposit on a marine cargo premium and then the final payment on your actual shipments.

Here is an example of how this might look. You estimate your sales to be covered over the next 12 months at $5 million. If the agreed premium rate is 0.3 per cent the estimated annual premium would be $15,000 calculated as 0.3 per cent of $5 million.

Is trade credit for everyone?

The simple answer is no, trade credit is not for everyone. This type of insurance has minimum premiums and most insurers have a minimum of $8,000 a year. Therefore, as a rule of thumb, we suggest that it only makes financial sense for business with an annual turnover of $3 million. That might sound a lot, but with many forest owners planning to harvest within the next few years, perhaps combining their harvest with other owners, we suggest you consider your options.

I would also like to highlight that trade credit insurance is a specialised area. When deciding on this insurance you need to make sure the placement is correct and get expert help to establish the best structure for you.

Aon trade credit has a lot of experience putting together credit insurance programmes for the forestry sector. They have been involved in offering solutions for various forestry services including log sales both domestic and export, pruning contracts, sales to sawmills and more. Over the years, our trade credit team have identified clients' main reasons for purchasing credit insurance and these include –

- Risk protection and business continuity
- Credit management and information
- Secure access to additional funding lines
- Encouraging open account trade over secure terms to offer a competing edge
- Sales growth especially into new markets
- Corporate governance

By focusing on these main areas, you will build a credit insurance programme that best suits your needs.

I also take this time to remind members that we have a scheme for tailored standing timber cover and also for forest owners' liability. Aon makes a contribution to the NZFFA for every policy taken out by members.

NZFFA 2017 conference

Feilding from 6 to 9 April

Now is a good time to make sure your diary is free for the 2017 NZFFA conference. It is being hosted by Middle Districts and is based in Feilding from Thursday 6 April to Sunday 9 April.

There is an additional field day on Monday 10 April as an optional extra for those able to stay a little longer.