



NON-CANCELLABLE SINGLE BUYER CREDIT PROTECTION - PRIMER

By the Smyyth Trade Credit Insurance Team
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Credit Default Swaps Vs. Accounts Receivable Puts

Obtaining trade credit protection coverage to protect against a single large customer's insolvency or bankruptcy requires the protection seeker to look beyond traditional credit insurance as that form of coverage tends to be a "whole-turnover" policy; that is, you must insure 100% of your sales, not just the customer at risk.

The two available solutions for Single Buyer are Accounts Receivable Puts and Credit Default Swaps (CDS), both of which are investment bank products, but there are significant differences between them. A CDS is complex and more suitable for financial institutions, while the Accounts Receivable Put is more like traditional single debtor credit insurance and designed specifically for credit risk mitigation needs of a commercial business.

Accounts Receivable Puts and Non-Cancellable Credit Protection

Stated simply, Accounts Receivable Puts are single buyer credit insurance protection in a different form than a credit insurance policy. There are advantages and differences, which are summarized below:

- Unlike traditional "credit insurance" your counterparty for an Accounts Receivable Put is a large investment bank rather than an insurance company.
- Traditional credit insurance is a "risk attaching" instrument, but a the Put contract is "loss-occurring". This means that the loss event must occur during the Put contract term, otherwise the put expires worthlessly.
- In a Receivable Put contract, there are no deductibles or coinsurance, and the coverage is 100%.
- Receivable Puts are usually written with terms from 6-60 months, and from \$500,000 to \$100,000,000 in value
- Receivable Puts, while routinely used today by large and mid sized companies for credit protection, are somewhat complex, so you should consider using an expert intermediary - broker.

Credit Default Swaps (CDS)

A **Credit Default Swap** is much more complex, but accomplished the same goal. It obliges the seller of the CDS (usually an investment bank) to pay the buyer of the CDS in the event of the target's loan or bond default. Generally, this means that in case your obligor defaults, you - the protection buyer - must turn over (or "swap") the loan or bond instrument with the protection seller for immediate payment, which is usually the face value of the loan or bond.

Swaps are an invaluable tool used to cover the multi-million dollar credit exposures at large financial institutions or sophisticated corporations, but they are generally NOT an appropriate way to mitigate credit exposures at the vast majority of businesses. Some reasons that swaps may not be a fitting instrument for the typical corporate credit manager are:

- Under most contracts, the CDS buyer will be obligated to deliver either bonds or bank debt to the CDS seller in the event that the obligor defaults. A buyer of an Accounts Receivable Put, on the other hand, need be concerned only with turning over a valid accounts receivable balance in case of default.
- With a CDS contract, the buyer is required to capitalize the instrument (i.e., show it on their balance sheet) and then use mark to market accounting based upon market value, requiring periodic valuations.
- Mark to market valuation puts the corporate credit manager in a "trading" role, forcing periodic decisions as to if or when to sell the CDS, either at a profit or loss, before the default event occurs.

The global CDS market plays a vital role in managing credit for investment banks and other financial institutions and though it is not suitable for a typical U.S. trade creditor, it is important to the worldwide economy as a risk management tool.

In Conclusion

We believe the best choice for large single buyer credit risks for most corporate creditors is the Accounts receivable Put. For Smyyth's corporate clients, we have had very good results covering their major trading partner risks using Accounts Receivable Puts, a type of non-cancellable protection that lets them sleep at night. For more information, call Marc Wagman, Managing Director at 201-714-4561 or email him at mwagman@smyyth.com.

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