

## CREDIT INSURANCE\*

A large percentage of mercantile business transacted is on credit for terms which vary from ten days to six months, or more, according to the class of trade. The amount of credit extended to individual debtors is generally based upon the estimated capital and credit rating of the corporation, firm or individual, indicated by a Mercantile Agency in its published books or reports. The outstanding accounts receivable range in value from 10% to 25% of a merchant's annual business. For such accounts he usually has nothing more than the acknowledged obligation of the debtor for the open account, or his promise to pay in the form of a note, always subject to the honesty and ability of the debtor to pay.

It frequently occurs, however, that the debtor defaults in payment, or becomes insolvent. This may be because of incompetency, inexperience, speculation, neglect of business, personal extravagance, lack of capital, fraud or other cause. The result in any case is a bad debt, or "loss". Merchants rarely escape a certain amount of such losses and so include with overhead cost charges an estimated percentage of their annual sales for bad debts but they often find that this method is neither practical nor profitable; it being impossible to estimate the amount of bad debts likely to occur in the ensuing year with the same degree of accuracy as cost items and therefore they suffer from time to time unexpected and unprovided for losses in excess of their estimates.

From this it will be seen that it is important to be able to estimate the amount of loss that may occur on outstanding accounts during the year, since any excess over estimates dissipates profit and may seriously affect the merchant's financial condition. It would have been difficult, for instance, at the beginning of the year 1920 to estimate the amount of loss caused by insolvencies during that year because of the unusual and unprecedented conditions which created these insolvencies. The same may be said of 1921. It is well known that a great number

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of business enterprises suffered loss on this account far in excess of their estimates, and of what they considered a normal expectancy in their business. Those who carried credit insurance, however, were to a great extent relieved because of having been indemnified by insurance for the excess over the fixed amount of initial loss which they bear under such policies.

The drain on the commercial interests of the country through bad debts and insolvencies will be more fully appreciated if we compare the amount with the amount of fire loss. For instance, in 1921 the amount of insolvent accounts reported was in excess of \$750,000,000 as compared with \$485,000,000 loss by fire. During the past ten years such losses exceeded fire losses by \$400,000,000.

Credit insurance is provided to protect the wholesale merchant or manufacturer against loss in excess of the normal expectancy—"initial loss"—sustained on their accounts. It does not undertake to insure the normal or expected amount which is regarded as inherent in business and which occurs continuously. This is practically a certainty and therefore may be carried without undue burden. For this reason the normal or expected amount of loss is borne by the insured and in the policy is called the INITIAL LOSS, which is a percentage of annual shipments. Thus is determined at the beginning of the year the extent of normal loss and the reserve provision which should be made for bad debts.

The percentage of initial loss is determined by the loss experience of the Applicant as shown by a statement of his annual shipments and losses over a period of years during which he has been in business, his terms of sale, the amount of insurance required on the Mercantile Agency ratings of his various debtors, the line of business and the territory in which principally the Applicant trades as well as the moral hazard of the Applicant which has a bearing on the rates quoted. If, however, the Applicant is new in business, then the Company determines from the experience of new concerns in a similar business an initial or "normal" loss applicable to his business.

The estimated capital and credit rating of the debtor as indicated by the Mercantile Agency to which he subscribes being the basis for credit, it follows that coverage is limited to the amount of insurance obtained on each rating. A schedule of

the Mercantile Agency ratings which the Applicant decides shall govern is provided in the policy, and the limit insured is specific opposite each rating. The policyholder is not limited as to the number of customers to whom he may sell, nor in the amount for which he wishes to extend credit, but he is limited in the amount insured on each debtor at the date of insolvency.

The limits insured on each rating may be determined by the Applicant, provided they do not exceed the maximum limits fixed by the Companies. These limits are sufficiently high to provide a reasonably safe line of credit averaging from 25% to 40% of the debtor's estimated capital where first or highest credit rating is given, and 20% to 30% where the second credit rating is given. Debtors whose ratings indicate an estimated amount of capital and first or second credit are considered preferred over those with other credit ratings, and are covered on a parity of 100%.\* Debtors with credit ratings lower than first or second are graded at 66 2/3%. The total amount covered on this class of accounts under a policy insuring all ratings is limited to a nominal amount.

Recovery under the policy on a debtor's account is dependent upon an act of insolvency (as defined in the policy) having been committed by the debtor after the payment of premium for the policy, and prior to its expiration. The policyholder must be a bona fide creditor for the amount of the indebtedness, and the limit of coverage is determined as of the date when insolvency occurs.

The limit of coverage is named in the schedule for the specific rating of the debtor, at the date of shipment, for shipments made during the period covered by the policy.

Under a policy covering the accounts of insolvent debtors, such insolvency is limited and defined in the policy as deemed to occur at the date when,

- (a) A petition in bankruptcy or insolvency is filed by or against a debtor.
- (b) A debtor makes an assignment or deed of trust for the benefit of creditors, either general or with preferences.
- (c) A receiver is appointed for a debtor.

\*It is the practice of the Mercantile Agencies to rate each firm noted in their index on the basis of capital in certain classes, including one "uncertain" or "unknown" and of credit standing in its capital class.

(d) A compromise is made by a debtor for less than the amount of his indebtedness, with a majority (in number and amount involved) of his creditors.

(e) An attachment or execution is levied on a debtor's stock in trade.

(f) A debtor's stock in trade is sold under a writ of attachment or execution.

(g) A writ of execution against a debtor is returned unsatisfied.

(h) A sole debtor dies or becomes insane.

(j) Possession of a debtor's stock in trade is taken under a chattel mortgage given to a creditor or creditors, or said chattel mortgage is recorded.

(k) A debtor absconds.

(l) A debtor confesses judgment.

(m) A debtor transfers or sells out his stock in trade in bulk.

(n) A debtor's business is assigned to or taken over by a committee appointed by a majority in number and amount of his creditors.

There is issued also a form of policy called the "Collection Form." It is for the purpose of serving the policyholder in respect to his past due accounts, and under it the definition of insolvency is extended to include "A debtor's account that has become due under original terms of sale and is filed with the Company within forty-five (45) days thereafter."

In presenting claim thereunder the policyholder files his past due accounts with the company for collection, the company accepting them as insolvencies and charging the policyholder the usual fees based on collections for this service. Very often however it is able to render this service for less, and sometimes without any expense, in which case it can make collection for less than the stipulated legal rates. It often serves materially to reduce the normal loss of the policyholder because of prompt action which is not always taken when the assured attends to the collection of his own accounts.

The policyholder is required to file, on blanks supplied by the company, prompt notice on acquiring knowledge of the debtor's insolvency. Under the Collection Form notice is required after an account is forty-five (45) days past due. Also, in the event of

a claim, a statement of loss, blanks for which are mailed by the company on request, must be filed with the company not later than thirty (30) days after the expiration of the policy, or as often as there may be a claim during the term of the policy, if the policy provides for "interim adjustments."

The premium for each policy is based upon the limits insured on the Mercantile Agency ratings, and the amount of shipments. It averages between \$40 and \$50 per thousand of the total amount insured, which is limited to twenty-five times the amount of the ascertained premium. This amount, however, may be increased if the applicant so desires to as much as \$200,000 at a reduced rate per thousand for the excess.

The loss adjustment is made by first ascertaining the amount covered on each insured debtor's account owing at the date of insolvency, from which is deducted the amount of all dividends or payments and the amount of merchandise returned or replevined, the amount of discount on the covered amount of the accounts to which the debtors would have been entitled had the accounts been paid at the date insolvency occurred, also the amount mutually agreed upon as thereafter obtainable on any account. If no amount is mutually agreed upon the account is included for the full amount covered and the amount remaining after making these deductions is the net covered insured loss. From this is deducted the amount provided in the policy—usually ten per cent (10%), as an offset for profits—and the amount of initial loss which is to be borne by the policyholder, the remainder being the amount due and payable to the policyholder upon the assignment to the company of all accounts of debtors included in the adjustment, together with securities, guarantees, etc., held for or by the policyholder on such accounts to the extent of the amount covered on same at the date the debtor's insolvency occurred.

Assignment of the account or securities, etc., is not required, however, if an amount is mutually agreed upon and deducted from the account in the adjustment. The company in the event of realizing on assigned accounts, securities, etc., an amount equivalent to, or in excess of, the total amount paid to the policyholder must re-assign such to the policyholder to the extent not realized on and must refund to the policyholder any excess of the amount paid. In the case of "interim adjustments" having

been made, inasmuch as the agreed amount to be borne by the policyholder—INITIAL LOSS—cannot be calculated until the expiration of the policy, the policyholder agrees to refund to the company the amount thereof deductible, but not deducted in prior adjustments. In no event, however, can the amount to be refunded by the policyholder exceed the amount paid by the company under all adjustments.

There is no cancellation clause in the policy. If, however, the policyholder, during its term, becomes insolvent, or ceases to continue business, or goes into liquidation, or dissolves partnership, then the policy immediately terminate sand a statement of claim, (if there should be a claim at that date) may be filed and an adjustment made as if the policy had expired at the original date of termination. Temporary interruption by fire or strike, or the death or withdrawal or admission of a member of a partnership composed of more than two members, is not deemed discontinuing business, nor dissolution of partnership.

The policies provide that the premium shall be remitted by check with the application therefor. The application requires statements showing how long the applicant has been doing business as manufacturer or jobber, and what portion of his sales are made to manufacturers, jobbers, and dealers; the territory in which sales are principally made and the terms of sale; also whether he has any information detrimental to the credit or financial standing of any customer, or prospective customer and whether he contemplates making any material change in the manner of conducting business, either as to terms of sale or territory; the name of the Mercantile Agency which they have used for checking credits and the one selected to govern if a policy is issued. It also provides as a basis for the terms of the policy a warranty as to the amount of gross sales and shipments for given years, the net amount of insolvent debtor's accounts after deducting actual cash received and the amounts collected from insurance companies on such accounts.

The company is permitted by the policyholder to examine and take extracts from the books, securities and papers bearing upon any matter involved in any adjustment, or bearing upon any representation or warranty made in the application for a policy, or upon any claim made either by the policyholder or the company.

As is usual with insurance policies the policy constitutes the entire agreement between the company and the policyholder, and no change or waiver of any of its terms, conditions or limitations, or no assignment or transfer is valid unless endorsed thereon and signed by the company's manager and countersigned by the authorized executive. The form of policy is not a matter of statutory regulation nor is approval thereof by any state official required.

The policy may be, and often is, upon request from the policyholder, assigned to banks as collateral for credit obtained by the policyholder. It is found under such circumstances, to be a valuable collateral, as in the event of excess loss the interest of the policyholder is a guarantee to the bank and to that extent does not injure the policyholder's credit standing.