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CREDIT RISK MANAGEMENT

What is it and how to manage it?

Making risks manageable

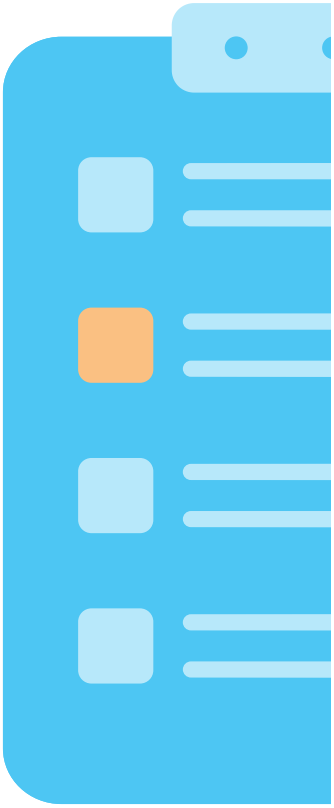
Credit risk management is a tricky part within credit management. You are dealing with opposing interests between maximizing sales and keeping risks as low as possible. But it is sometimes also difficult to determine what the risk is, because in most cases you are talking about a potential risk and that risk is not a fact. In addition, the focus on credit risk management within organizations often slackens when the economy and business is growing. And we're not yet even talking about the practical piece of how to make risk transparent.

In this blog we will provide tools for making risk transparent and how to organize it with "customization" for your organization. The latter is especially important because you are often limited in (human) resources and still you want to give sufficient attention where necessary.

Should you avoid risk?

People tend to avoid risks. That is why people opt for an insurance for their phone, legal aid and more. But how often do you use it and what are the costs? But maybe it is financially more interesting not to have those insurances. You can use that money to pay incident yourself. Chances are you are cheaper off. But there are situations where you do want an insurance because the potential damage is greater than you can afford.

Risk, or rather potential risk, are not necessarily bad. You just shouldn't close your eyes for it. When you consciously make choices, you can calculate risks and that can be very interesting financially. Competitors may not want to serve the same customer or you can ask for a higher price. So it is not a big deal to risk, as long as you do it consciously. And credit risk management can play an important role in this.

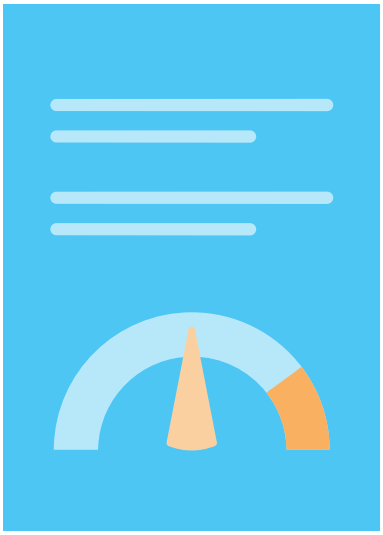


At many companies, credit risk management is a job of the credit management department and for this paper we use the following tasks:

- Making potential risks visible.
- Setting credit limits.
- Monitoring credit limits and risks.
- Managing credit insurance.

How to determine exposure?

Determining the financial risk can be complex and is partly influenced by the industry you operate in as a company. If you deliver capital-intensive goods, you are often confronted with high upfront investments well before delivery to the customer.



The determination of exposure therefore goes beyond the outstanding invoices. In addition to the open invoices, for example, you also look at work in progress, so you know the total exposure to one customer.

What sources do you use?

You want to know what chance of non-payment a customer has. But where do you start? A first step is to identify the customer at the Chamber of Commerce. Is the customer you think he is and do you use the right entity for the contract?

Following the identification you want to know if the customer is creditworthy. An easy way is to use credit information. These are reports provided by organizations like Graydon and Creditsafe. A credit report from these parties summarizes the most important data of a company. These organizations collect data from many companies and combine them in a scoring model. The outcome tells something about a company's creditworthiness, for example a credit limit and the likelihood that a company will go bankrupt.

In special cases, you can also request the customer's figures directly, just like a bank does when you apply for a loan.

How do you calculate a credit limit?

You can determine the height of a credit limit in multiple ways. The most simple way is to use the advice from a credit report. This has the advantage that it takes little time, the disadvantage is that it is quite generic. The latter is sufficient in many cases, but sometimes that is not enough and you should not copy the credit report recommendation without thinking. The standard reports are rarely complete and, moreover, subject to a certain degree of dating.

A custom score model with your own data

It may well be that you don't want to follow a standard credit report and you prefer calculating credit limits yourself. With many recurring customers, you have valuable data that can be used. You can enrich this data with a credit report or with the annual figures deposited at the Chamber of Commerce. You then create a score model that actually matches your organization.

The disadvantage of a custom score model is that you need to have specific knowledge and that it is labor intensive or you will need software that can automate the process. Without software, it's hard to keep the scores up-to-date.

The credit insurance

Just like being able to insure a house for fire incidents, there are also insurances for customers who do not pay their bills or go bankrupt. With a credit insurance, you can make a claim to the insurer. The insurer will reimburse the invoice, which prevents you from being sucked into your customer's bankruptcy.

A credit insurer does impose conditions on insurance and these conditions usually require more attention than standard fire or car insurance such as:

- Not every customer is accepted.
- Only invoices that fall within the credit limit are covered by the insurance. You can sell more, but that's at your own risk.
- As a company, you have to monitor invoices and report them to the insurer when they reach a certain age. From than on, new invoices are not covered.

Monitoring the terms should not be underestimated and can be labor intensive. If a claim does not fulfil the conditions, the invoices of that claim will not be reimbursed. That's one of the reasons why companies should invest in software that supports this process.

A credit insurance is not free and you will have to decide what fits better in your situation: extra costs or more risk.

Customers with the same parent

One more thing needs to be discussed in determining risk and that is the situation in which a customer is part of a larger group. Lets say that you have a customer Alset and Alset has multiple entities like Alset Automotive, Alset Lease and perhaps even more. Each one of them is a separate legal entity and the mother may be liable for the outstanding obligations at the time one of the daughters goes bankrupt. Or maybe the mother herself goes bankrupt. To determine the exposure and risk you should check all obligations (invoices, open orders, work done) that you have with the group to which the customer belongs. The combined value is the your exposure to the group.

In this example checking the credit limit of a single entity, like Alset Automotive, is not sufficient. The customer is part of a larger group and that means you have to assess the credit worthiness of at least the parent company too.

So to determine the exposure and potential risk, you have to create a customer hierarchy that provides an overview the mother with all daughters.

What is a credit risk policy?

We can conclude that credit risk management is comprehensive and that is why companies have a credit risk policy. This is a formal document that a company uses to record credit risk management procedures. The profession includes who can set credit limits, how they are established and what the standard payment conditions are within the company.

One of the benefits of a credit risk policy is that it is clear to everyone what the rules are for delivering on credit. It describes who has decision-making authority and how to deal with exceptions. This is comparable to how a bank operates when providing loans and supplier credit is more or less the same.

Risk is managed with the entire company

Credit risk management can not be carried out just by the credit management department. It is something that must creep into the company's DNA. That is, if you really want to do well. Sales must involve credit management with new customers in a timely manner, so that an estimate of the credit worthiness can be made at an early stage.

Sales can also have a direct impact on exposure (the outstanding risk) at a customer by including shorter payment terms in the negotiation. This has the additional advantage that you can sell more to a customer with the same credit limit, because invoices are paid faster.

The management of a company must support the credit management department in its policy, because not everybody will be happy with the rules that are set. And without the support of management, enforcing the rules becomes difficult. That is one of the reasons why it is important to have a credit risk policy in place.

At CE-iT we have customers where employees who work on site at a customer provide feedback to credit department on how things are going at a company. For example: Are the shelves in a store empty? Then that is passed on, because that is valuable information that you do not get from a credit report.

Credit risk management is more than a one-off activity. It is a process that requires continued attention. On the one hand because you as a company will have new customers and orders, on the other hand because the economy and world changes. If you have set this up properly, you will know beforehand which customers are likely to require more attention.

About CE-iT

We develop software that is flexible. Why? Because our customers want it. Find out more at ce-it.com.

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