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Managing Credit Risk in volatile Global Markets

Success Strategies for Today's Workplace

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Managing Credit Risk in volatile Global Markets

International business has never been boring, but recent events throughout the world have definitely ratcheted up the stress levels. Let's face it. There are times where you can do execute your strategy perfectly and yet factors completely out of your control make a mess of your plans.

The No. 1 mandate of a credit professional is to maximize sales while also safeguarding the company's assets.

"If you want to make God laugh, tell him about your plans."
-Woody Allen

Regime change in Egypt. Unrest in Syria. Violent uprisings in Libya. The thriving BRIC economies of China, India, Russia and Brazil. The sovereign debt crisis of Greece, Portugal and other countries in the European Union. Not to mention the ever-present possibility of runaway inflation and natural disasters. It's enough to keep a credit manager up at night.

Opportunities in the global market are immense. According to the US Census Bureau exports from the United States in 2008 totaled $1.287 trillion in products to the rest of the world.

When doing business abroad, credit professionals are compelled to perform a two-part analysis. The first part is to become familiar with the country (sovereign risk) within whose boundaries you will be doing business. The second part focuses on researching the individual company (counterparty-risk) you want to do business with.

There are at least four elements of risk to consider: Political and Social, Economic and Financial, Growth trends, Long-Term potential and Volatility (Chacon).

Political Risk – These risks can manifest themselves in a number of ways: strikes, terrorism, coups, civil war and government stability. Complications businesses and governments can face as a result of any political change that alters an expected economic outcome.

Economic Risk – Hyperinflation, short-term / long-term growth prospects, interest rate outlook, currency values relative to the dollar. Companies must consider the possibility of a downturn in the economy having a negative impact on its' investment. Will the project's output generate enough revenues to cover operating costs and debt obligations?

Commercial Risk – Risk assumed by extending unsecured credit without any collateral. Does the country's business environment facilitate the conduct of commercial transactions? This is the risk of loss arising from a debtor that does not make payments as agreed.

Macroeconomic Risk – A view of an economy as a whole. What is the likelihood that an economic downturn could torpedo your investment? Is the country capable of delivering sustainable economic growth? The country's business environment must include stable inflation, unemployment and interest rates. (Cord)

Knowing your customer is super critical when they are located in another country. Take the time to build strong relationships in foreign countries. Visit your customer (if possible). The hard work will pay off in a big way down the road.

Be cautious when establishing credit lines. Start small and extend lines of credit as justified. Being able to put a face to a name means a lot. By taking the necessary steps to investigate the new customer, a credit professional can determine an appropriate risk level and what terms to extend.

The use of credit reporting agencies (Graydon, Dun & Bradstreet, Coface, etc.) can be especially helpful when making quick decisions on well-established clients.

Not all customers are created equal and a diligent credit team should continue to re-evaluate the risk profile of the customer and adjust the terms of the transactions, if possible. (Tawil)

The 5 C's of credit:
Character (integrity): What type of borrower is the applicant? Payment history, public records, references. Is the company public or private? Personal credit of top executives. What have they done in their previous business activities? Timeliness in fulfilling obligations.

Capacity (sufficient cash flow to service the obligation): The ability of an organization to stay afloat during rough times. Business disruptions are a fact of life but are usually unexpected. An interruption can be short term, long term or in some cases permanent. Borrowing history and record of repayment. How much "stress" can your company handle?

Capital (net worth): How well capitalized is your prospective client? Creditors want to know that you have a financial stake in your enterprise. Have you put your neck on the line?

Collateral (assets to secure the debt): Property or large assets to help secure the loan. Real estate and office or manufacturing equipment. In some instances collateral is required in addition to cash flow. Especially when your creditor has no history with your business.

Conditions: (of the borrower and the overall economy): Interest rate and principal amount. How are you going to maneuver your company during economic downturns? How is your company positioned to prosper in the current economic climate?

Risk-Free Transactions. The best way to completely avoid collection problems in foreign countries is to require cash in advance (CIA) or cash on delivery (COD).

Cash in Advance. By receiving payment before shipment the seller avoids all risk. Most commonly payment is made by credit cards, wire transfer and less frequently international ACH (automated clearinghouse). Of course, a U.S. company using this method will most likely lose business to competitors who offer more favorable terms.

Best option where the following conditions exist:

- Customer's country has a high political risk or unstable economic environment.
- The seller has a unique or high demand product.
- The customer is unknown to the seller or has a negative history.

Cash installment payments. Buyer and seller agree that the buyer will make periodic payments of an agreed upon amount for an agreed upon period until the sale price is reached. An example would be the sale of an item at an agreed upon price $45,000 where the buyer could not afford to pay the total price all at once. The seller could agree to accept an immediate payment of $15,000 (upon receipt of invoice), a second payment of $15,000 30 days later and a final payment of $15,000 30 days after that.

Best option where the following conditions exist:

- The seller is confident that the buyer has cash flow issues but will pay.
- The seller needs to have a solid, positive history with the buyer.
- Seller's product is not a particularly high demand item.

Documentary collection. Also referred to as "Cash Against Documents". The bank of the seller (exporter) and the bank of the buyer (importer) basically facilitate the transaction. Goods are shipped first and the seller receives payment through the document exchange between both banks. These same documents allow the buyer to take possession of the goods. This transaction is slightly more favorable to the buyer as the bank offers no guarantee of payment. They are liable only for correctly executing the exporter's collection instructions.

Best option where the following conditions exist:

- Buyer's country has a low political risk and/or stable economic environment.
- The banks of both the buyer and seller are familiar in international trade.
- The buyer and seller have a positive, well-established history.

Letters of Credit. A letter of credit is a document issued by a financial institution on behalf of the applicant and used as payment for a transaction. The financial institution guarantees payment to the seller (beneficiary) once certain terms have been met. The seller receives payment by redeeming the letter of credit.

Best option where the following conditions exist:

- Political risk and/or economic stability of the buyer's country should be at least minimally acceptable.
- The banks of both the buyer and seller are familiar with international trade.
- The foreign customer is unknown to the seller or has limited or negative history.

Open Account. Most risky to the seller, least risky (or expensive) to the buyer. Should be reserved for well-established companies with strong payment histories. The seller ships the goods and waits for remittance from the buyer per terms of the transaction. In competitive environments, this method may be the only option for securing the sale.

Best option where the following conditions exist:

- Customer's country has a low level of political risk and/or has a very stable economic environment.
- The seller is operating in a highly competitive market.
- The foreign customer is financially strong, has a very positive history and/or has a well-established relationship with the seller.

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