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Designing a Corporate Credit Policy

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The correct design of a credit policy for a corporate entity requires both an analysis of the company's own business and place in the market, as well as an understanding of its customers' business and their place in the markets.

While most companies have some sort of a credit policy, very few apply rational criteria to its design or link to wider corporate objectives. In my view, a basic understanding is needed as to why a company grants credit to its customers, as historically granting credit was considered the main business driver. In the modern day, from a banking perspective, credit has become an enabler to sell other fee generating services (such as investment banking, fee generating trade finance products, etc), while the corporate view has always been that granting credit is just a sale enabler.

Effect of Granting Credit

The first question to answer is what role does granting credit (that involves both taking risk on the buyer and using capital) play in selling the product?

Relationships between terms and sales are unproven for most companies. Conventional wisdom in the company needs to match 'standard' terms offered by the market. The reality is that in a large corporate or government sector getting out of the terms specified in the procurement policy of the buyer increases the chances of disqualification (while offering longer terms than required may not be seen as an advantage). With other customers, buyer perception of the terms differs as some pay very little attention mainly considering price, some would have a view of what terms 'ought to be' included and would only buy if these are offered, and some would have a 'value' they put on terms readily exchanging it for price (both as a discount with early payment discount and for a premium by offering longer terms). It is essential for a business to go through a learning curve to understand their customer segmentation.

Originating Credit

The next question centres on how the company originates credit. Extending credit has two components.

1. Capital usage.
2. Risk - credit and operational.

A company may wish to outsource the risk but keep the funding (credit insurance, bank guarantee, etc), outsource the funding but keep the risk (factoring with resource, asset-based lending (ABL), trade receivable conduits), or outsource both (invoice discounting, factoring without resource, traditional instruments such as letters of credit (L/Cs) with discounting of draft or deferred payment).

The last option (where both risk and funding are outsourced) is an interesting case where the credit just becomes a normal product to sell at a margin (sometimes very healthy particularly in the small to medium-sized enterprise (SME) space where large buyer have access to wholesale funding and risk at a fraction of the rates individual customer may have), providing the company is able to identify the customer segment and arrange an effective sales process. Interestingly, while most of the companies take such view on leasing and consumer finance products (through branded financial services arms), still very few take this approach to short-term receivables where the arbitrage opportunity is much higher.

Risk Management

On a risk side, the company needs to answer two questions:

1. How do they measure the risk?
2. What is the acceptable threshold (that may vary depending on a number of factors)?

It is important not to confuse prudence (i.e. low risk threshold against effective measurement of the risk) and incompetence (i.e. not taking decisions because people have no idea about the risks involved).

While receivables risk is a very important issue, the level of sophistication and effort put in its analysis is fairly limited, as most of the effort (by banks, rating agencies and regulators) was historically put into longer-term financial assets, such as loans and bonds.

From the viewpoint of credit risk, trade receivables may actually represent a relatively low-risk asset compared with other obligations of a given buyer. This is due to their short duration, structural issues and the mechanics of consensual restructuring.

In my opinion the rating agencies tend to apply an almost mechanical approach to short-term ratings, in that they are pre-determined by the long-term rating. However, the nature of the risks is very different. Long-term risk is very much a function of the perceived long-term sustainability of a business model and a 'through the cycle' view of the firm's ability to service debt, considering many strategic factors that can affect the company in years before the debt coming due.

Short-term risk - where payments fall due within, for example, 60 days - is simply a question of what might trigger non-payment within this time frame. In many cases, fundamentally weak companies have strong cash reserves (although one has to be mindful that some recent Chapter 11 cases had large, although significantly depleted cash balances at the time of announcement. In most such cases, however, the company was publicly discussing such opportunity well before the announcement). Even in some highly leveraged companies with covenant-lite loans and deferred amortisations, short-term risk is very limited, due to the absence of trigger events. Technical default is unlikely if there are virtually no covenants, while without amortisations there are no large payments to default on. So, after the 'credit crunch' years, we see companies that have avoided default (including to trade creditors) even though there may be serious concerns voiced about their eventual fate. Of course, as stated by the economist John Maynard Keynes: "In the long term, we are all dead." But the short-term view could be surprisingly different. And, interestingly, the Merton-based credit risk model, mainly calibrated on longer-term assets, produces a very low default probability (even on an annualised basis) for such a short duration.

Moving on to the topic of structural subordination, receivables normally occur at the operating company level, making them senior debt compared to obligations at the holding company level. (The latter are effectively an equity position in the subsidiary's bankruptcy.) In cases where exposure to the operating subsidiary is also supported by a parent guarantee, one can have best of both worlds - i.e. the debt of the subsidiary and an unsecured claim against the parent. Some additional support may be obtained from retention of title and other contractual clauses, although the efficacy of these tools in some jurisdictions may be questionable.

Lastly, let's consider the mechanics of a consensual restructuring. When trying to keep a company or its operating subsidiary as a going concern, financial creditors often exclude trade creditors from the restructuring negotiations, in order to maximise future enterprise value. This is important because, once core suppliers stop dealing with the company, either of their own accord or triggered by the credit insurers' cancellation of limits, the recovery prospects might well cease to exist. So this is clearly a critical issue for those subsidiaries that a liquidator or administrator hopes to sell as a going concern. In fact, I have been involved in several situations where relatively healthy subsidiaries in a high-profile restructuring were eventually sold off successfully. That would not have been possible if their trade creditors had not been paid on time, even though the parent company was going through very serious debt restructuring.

Additionally, if the supplier is essential to provide on-going support (service, spare parts, consumables, etc) without which significant assets would be worthless, but is freely able to withdraw such support (i.e. is not legally or contractually prevented from doing so), they may in fact have extra leverage because the value of the assets could collapse if the supplier were to walk away.

This means that the real level of credit risk (determined in this case more by market or product circumstances rather than by financial constraints) may differ significantly between suppliers, with core or essential suppliers (i.e. involving a high supplier switching cost for the buyer) having substantially lower credit risk than commodity suppliers (that is a unique differentiator comparing with financial creditors were the same class of creditors needs to be treated equally). At the same time, if the supplier has a high degree of dependency on the particular buyer, the administrator/other creditors can take a bet that supplier will have to accept a large write off in exchange for ability to continue trading with the buyer. This means that a careful analysis of a supplier's position in the market is as important as analysing the buyer's generic credit risk.

Effect of Dilution and Late Payments

At the same time, receivables have a number of unique risks and are different from loans, commercial paper and other asset classes. One is 'dilution risk', caused by the possibility that a receivable might not be paid because of a real or alleged contractual dispute. (In some cases the buyer may be using this purely as an excuse). A second risk arises because the timing of payment can be quite uncertain, particularly in some markets. This in turn can represent an increase in risk because of the longer duration. The risk of delay and dilution is normally positively correlated to overall credit risk, as a company in financial difficulty could well use all possible means to increase the number of days payable outstanding (DPO), particularly if that represents their only way of obtaining financing.

The impact of trade receivables is largely determined by three factors:

1. Portfolio concentration.
2. Duration.
3. Trade margins.

First, let's look at the duration and margin effects. For example, if the expected loss is 5% per annum and the average payment duration is 40 days, the profit and loss (P&L) impact would be 5% x (40/365) = 0.55%. With a 10% overall profit margin, this accounts by only 5.5% reduction in net profit margin or a return on capital measure. (Furthermore, an expected loss rate of 5% would in fact be very high, given that most developed countries have an annual expected default frequency rate of between 0.3% and 1% and only got to 1-5% at the worst time of current crisis, according to a recent Moodys KMV). We should also note that, in assessing the credit impact on the margin, we only need to take into account the marginal (variable) cost, so that in many cases (where the variable cost is merely that of producing an extra unit) the risk-taking proposition looks even more attractive. This highlights that, from a P&L point of view, a highly conservative credit policy is not necessarily the most profitable strategy for some businesses.

Effect of Concentration

Such an approach works well if the portfolio is well diversified. Admittedly, the current crisis has not so far reflected a rapid increase in general default levels over our short-term perspective. (Nor was there any sharp increase, for example, in the number of claims on credit insurers, although they have experienced a gradual rise during the crisis.) On the other hand, with a concentrated portfolio of customers, a single default (say, of a customer accounting for 50% of the business receivables) could have a devastating effect. Similarly, some client portfolios could well be highly correlated because of the industry or region.

One example of this might be a distribution channel where a supplier could easily convert inventory risk to accounts receivable (A/R) risk by overstocking, but as a result could well face the risk of sizeable channel bankruptcies, as channel partners might not have sufficient capital to absorb the loss from significant inventory write-offs. (There were some suggestions that one of the major network equipment providers was facing this issue back in 2001, when the dotcom crash led to a significant drop in demand, costing them a massive loss when they eventually have to face the situation.) The level of market concentration for both the buyer and the supplier is often ignored in analysing companies. Interestingly, these are sometimes rated significantly better than the risk of their respective channels and suppliers.

Capital Effects

Finally, a purely P&L driven view of credit risk often overlooks the capital consumed by granting credit to a buyer. In the absence of access to relatively cheap borrowing and/or specific ways to finance receivables (e.g. invoice discounting, factoring, securitisation, discounting drafts, etc), the marginal cost of such a credit extension approaches the cost of equity. In this case, one needs to consider the extension of credit in the same way as one would assess an investment decision involving a similar amount, expected duration and risk (the latter including both default risk and the risk of late payment), and compare this with the risk/reward equation arising from alternative uses of the capital. In the previous example, just 10 days average delay (against 40 days payment terms) will cause 20% increase of capital being consumed by receivables book and would cause 20% reduction in return on capital. This would have massively higher impact on return on capital basis than credit loss scenario we considered above.

Conclusion

The correct design of a credit policy for a corporate entity requires both an analysis of the company's own business and place in the market as well as an understanding of its customers' business and their place in the markets. It shall not be done just reliance on some 'objective' risk metric for individual customer companies, and shall consider the actual sales/margin effect of granting terms, credit risk (adjusted to specific supplier/transaction), as well as capital usage, particularly affected by late payment risk. This is a critical part of company strategy and requires close co-operation between different functions in the company and shall be one of the core issues for boards to consider.

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