Managing the commercial credit risk

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All business activity involves a large element of risk, to the extent that it is often claimed that starting up a business is synonymous with taking risk.

The entrepreneur not only has to be able to manage those risks inherent to the actual activity undertaken (legal liability, operational risks, reputation, strategic risks …), but must also be able to anticipate and manage risks associated with its environment (risks arising from nature or risks associated with the country, amongst others).

The traditional classification normally carried out when analyzing the nature of an entrepreneurial risk differentiates between pure risks, being those where there is only the possibility of suffering a loss, and speculative risks, where there is a probability of making a loss or profit.

In this amalgamation of types of risk faced by the entrepreneur, I would like to concentrate on one in particular: the so-called commercial credit risk which is sometimes also referred to as inter-entrepreneurial credit.

Commercial credit is the payment deferral that companies grant their clients in a business transaction involving the buying and selling goods or services. From the client (buyer) perspective, it is the securing of automatic finance for the company´s activity, via suppliers, with deferred payment formulae. This is the simplest, quickest and simplest method of obtaining finance for a company, and is essential also for economic development; to the extent that the commercial credit received by Spanish non-financial businesses in 2014 amounted to the equivalent of 33 % of GNP, according to the Bank of Spain´s Economic Journal in January, 2015.

I alluded earlier to the singularity of the commercial credit risk, since this cannot be categorically classified within the definition of pure risks or speculative risks but, rather, seems to be of a more hybrid nature since it is fundamentally dependant on two factors: firstly, the commercial credit assignment for clients by the company and, secondly, the ultimate payment behaviour of the client portfolio. In this sense, the granting of commercial credit does not solely represent the possibility of loss, since, with the right policies, it can produce a definite increase in sales. In the same way, the provision of commercial credit does not necessarily produce instant profit or loss for the company, since there are very dynamic diverse prevention and protection mechanisms that enable the entrepreneur to control and correct the situation.

Despite its hybrid nature, the commercial credit risk has a clear accounting reflection within the company, as shown under the "account receivables" entry. This accounting entry can represent more than 25 % of the overall value of the company assets (varying enormously on the nature of its activities, size, etc.), and, therefore, must be subject to constant attention and management, especially bearing in mind that one of the main causes for company disappearances is directly related to client payment default. In Spain, payment defaults account for a third of the 500,000 companies that have disappeared since the beginning of the crisis, according to the 2014 Report on Defaults by the Multi-sector Platform against Default (MsPD).

All of the above justifies the need to manage the commercial credit risk in a professional manner. Within this management, and with a view to defining an appropriate commercial risk policy for clients, it is absolutely necessary to cover a whole series of management stages applicable to any type of risk.

Así, en primer lugar, es preciso proceder a la correcta identificación del riesgo de crédito comercial. En esta etapa, cobran especial importancia aspectos tales como el conocimiento del mercado, país o sector en que se desenvuelve el cliente al que queremos suministrar a crédito, así como aspectos relacionados con información propia del cliente (pertenencia a un grupo empresarial, accionistas, antigüedad, información económico-financiera…). En esta etapa las preguntas clave son: ¿dónde y a quién pretendo vender a crédito?

So, first of all, it is necessary to identify the commercial credit risk correctly. At this stage, aspects such as knowledge of the market, country or sector in which the client to whom we wish to give credit operates, and aspects relating to the actual client (belonging to a corporate group, shareholders, age, economic-financial information, etc …) are especially important. The key questions to be asked are: where and to whom do I intend to sell on credit?

Once the risks have been identified correctly or, in other words, our clients and their environment, it is necessary carry out an evaluation process which will be determined by the correct quantification of the probabilities of customer payment default and the degree in the event of insolvency. Other aspects, such as the probabilities of debt recovery in cases of non-payment, are also very important. Here, the basic questions are: what are the probabilities of non-payment if I sell on credit or what should be the maximum credit limit to be granted?

Only then, once the risks have been identified and evaluated, will we be in a position to look into the third stage, which consists in controlling them or, what is the same and based on prior analysis, to take the appropriate decisions that will lead us to eliminate, mitigate, accept or transfer these risks. There are multiple and very different solutions available that can help the entrepreneur to control the commercial credit risk; these range from demanding advanced payment or cash payment, retaining the risk (a self-insurance fund), transferring the risk completely or partially (non-recourse factoring, letters of credit) or resorting to solutions from the insurance world.

There is not one single solution for carrying out an effective control of the commercial credit risk since this will depend very much on the company´s aversion to risk. Moreover, the previous solutions do not necessarily exclude one another and can be combined. Nevertheless, the business has to take into consideration the cost associated with each of the measures to be implemented, i.e. it must be conscious of the cost of not taking any measures as well as those associated with each of the solutions designed to mitigate or transfer the risk.

Credit insurance is an essential tool for companies in the protection of their business transactions since it guarantees them profitable growth, thanks to the constant work in the field of risk prevention and risk selection, the handling of recoveries and indemnities for losses. It is a credit management instrument that protects companies in respect of their national and international operations and, in summary, supports commercial development by providing the means required to protect them against the risks to which they are exposed when carrying out their activities.

The advantages of credit insurance are many fold. According to a study carried out by the Credit Management Research Centre (CMRC) of the University of Leeds (United Kingdom) for Euler Hermes, a shareholder of SOLUNION together with MAPFRE, the companies that contract this type of cover have better relationships with their suppliers, banks and clients. In addition, they benefit from access to commercial and credit information of a higher quality and at a lower cost. This enables them to save money on researching markets and credit information.

In an interview for SOLUNION, Martín Navaz, President of ADECOSE, recently referred to the work carried out by credit insurance which, in his words "helps companies to face the challenges of commercial expansion with a greater probability of success". This opinion is shared by large corporations some of which have also made declarations to this effect. Ferrán Baraza, the Customer Service Back Office Manager of Coca-Cola Iberian Partners, stated also in an interview that credit insurance "enables the commercial department to sell the maximum with the minimum risk for the company".

Lastly, credit insurance helps companies to protect its cash flow and net profit, since it allows them to concentrate their efforts on developing activities that are essential for the actual business.

SUPPORTING TABLE:

The cost of managing commercial risk of clients, with and without credit insurance.

The cost of managing the commercial risk	Without Insurance	With Insurance	Potential Impact
Payment defaults as % of sales	0.74	0.38	0.36%
Operating costs related to credit as % of sales	1.94	0.56	1.38%
Salary expenses as % of sales	0.65	0.49	0.16%
Average expenses for adquiring information	0.49	0.25	0.24%
Amounts related to fraud as % on sales	0.20	0.18	0.02%

Source: Study carried out by Credit Management Research Centre (CMRC), University of Leeds (United Kingdom), for Euler Hermes