Key Principals for Credit Risk Management

Author: Fu Junsheng, Consulting Director, Sinotrust Credit Risk Consulting Services

Nowadays when even a mention of risk stirs fears, we can still maintain poise with some golden rules in store. To name a few, pinning on effective sales and proactive control, adopting a more reasonable policy as regards accounts receivable, designing a proper size of credit sales, and giving more big-picture thinking on risks.

The core of credit sales lies with risk management, which calls for a thorough understanding on risks. The breadth and depth of our understanding vary with the perspective taken. Risk management, although a complicated process, is manifested in a number of guiding principles, which can help to smooth out the confusions arising from or in connection with credit management and then promote business growth in a real and healthy way.

Aiming at effective sales

Marketing is the key to materialize the value of a company. A survival or a failure, the answer for a company usually hinges on the effectiveness of sales, which naturally puts the sales department in a vital place. Owing to their seemingly contradicting positions, sales department and risk management department are inevitably in dispute on the pattern of sales to be adopted.

Lowering thresholds for credit applicants indiscreetly can speed up the distribution of products and relieve pressure on sales department remarkably, but this does not necessarily mean that effective sales have been accomplished since no actual income is generated yet. As dishonest clients are revealed upon credit expiry, the biggest crisis ever might be impending.

The benefit of risk management is to dig out clients and orders at the cost of controllable risks. Now almost all companies, whatever their type, resort to credit sales more or less. Risk management cannot only detect the potential threats but also find means and countermeasures to ensure effective sales by undertaking a reasonable level of risks.

Focusing on proactive control

Beijing: 7-8/F, C&W Mansion, 14 Jiuxianqiao Road, Chaoyang District 100015 Tel: 010-59267688 Fax: 010-58671800
Shanghai: 7/F, Guoxin Plaza, 29 Middle Jianguo Road, Shanghai 200025 Tel: 021-61331788 Fax: 021-61331766
Guangzhou: 7/F, Taiheng Building, No.18, Siyouyimalu, Wuyangxincheng 510600 Tel: 020-22373266 Fax: 020-22373299
Website: www.sinotrust.cn

Every kind of risk evolves in three stages when different priorities are addressed before, in the process and after the credit decision is made. Based on previous experiences, Sinotrust perceives that around 80% of the doubtful accounts actually result from negligence and inadequacy in proactive measures, and the rest 20%, even being collected through legal action, cost much more than the accounts paid in. Forestalling is required in credit management to control the risk before and in the process of decision forming.

Accounts receivable: the less, the better?

Accounts receivable should be regarded and treated dynamically as their balances always change with sales curve. The sales of any product fluctuate seasonally and shipment may vary noticeably in different periods. Therefore, more flexible considerations are necessary as far as receivables control is concerned. Firstly, accounts receivable is a variable depending on sales. Secondly, quantity is not commensurate with quality of accounts receivable. Thirdly, quality should be used to measure the effectiveness of receivable control, or in other words, holding risk to the safe level, rather than controlling the balance of accounts receivable, should be the goal of effective receivables control.

Determining the size of credit sales in line with risk tolerance

The activities of a company can be divided into such three segments as sourcing, manufacturing and marketing, while accounts receivable and accounts payable are always two sources of pressure. For any company, the faster accounts receivable is moving, the better it is, and it is to the contrary when referring to accounts payable. However, risk tolerance and capital chain should be considered as well. Any company which utilizes credit sales should take a credit stress test and there are some keywords, i.e. risk factors, significant conditions, loss estimates and countermeasures to design the procedures of such test.

The final result of a stress test can predict the maximum level of risks tolerated by the company under test and diagnose major risk factors. To minus the maximum affordable loss from working capital can set down risk tolerance and risk budgeting.

The first step of stress test is to identify risk factors and how the risks spread. The second step is to find out significant conditions that may influence the aforesaid factors, and when and how these conditions change. The third step is to build models and measure the probability of loss, based on which an estimate of loss can be calculated. The fourth is to design countermeasures and pertinent policies in the light of influencing factors.

A transcendental perspective to view risks

An effective risk management system and solution usually encompasses both risk management and non-risk management, and sometimes the management over non-risk factors is even more important than that over risk factors. However, few companies have fully researched and probed into the key

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principals governing credit risk management and they have never given credit management some thoughts from a strategic perspective or established any countermeasure strategies owing to weak big-picture thinking, which can explain the absence of sound methodology and management system.

A company should always practice the systematic approach in risk management and rethink relevant cases from different aspects. The historical review can lead to effective execution, avoid oft-repeated mistakes and find feasible strategies and measures for successful implementation.

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