

What is Credit Risk and How to Manage It?

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Published on www.lorman.com - April 2018

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Written by Michelle Dunn

What is credit risk?

Credit risk is the risk of loss due to a default on a contract, or more generally, the risk of loss due to some “credit event”. Traditionally, this only applied to situations where debt holders or business owners were concerned that the debtor or customer to whom they made a loan or extended credit might default on a payment. For that reason, credit risk is sometimes also called default risk.

In business, almost all companies carry some credit risk, because most companies do not demand upfront cash payments for all products delivered and services rendered. Instead, most companies deliver the product or service, and then bill the customer, often specifying their terms of payment. Credit risk is the time in between when the customer leaves with the product or service and when you get paid.

Managing credit risk.

Managing credit risk is important for any business but especially for new or small businesses. For larger companies, there may be a credit risk department whose job it is to assess the financial health of their customers and extend credit (or not) accordingly, much like a credit manager. For example, a new business that is selling its products to a troubled customer may attempt to lessen credit risk by tightening payment terms to “net 15” or by actually selling less product on credit to the retailer, or even cutting off credit entirely and demanding

payment in advance. They might even lower the existing credit limit and re-run the credit application to re-evaluate the credit risk factors. This will probably cause friction in the relationship with the customer but you will end up better off if the customer is late paying their bills, or especially if they default and you have to place the account for collection, take them to court or if they file bankruptcy.

Credit risk is not really manageable for very small companies with only one or two customers. This makes these companies very vulnerable to defaults or even payment delays by their customers. Thus the reason to have a sound credit policy in place.

Some things you can do to limit your risk are:

- Get a personal guarantee
- Offer month-to-month credit
- Offer ship-to-ship credit
- Ask for a security deposit
- Get a 50% deposit on every order

Checking people's credit

Once you have a new customer and they want to apply for credit, you have to check their credit in order to make an educated decision on how much credit you want to extend to them, or how much of a risk you want to take by how much credit you extend to them. If you have signed up with a credit reporting agency to pull credit reports, you want to run a credit report once you have the signed credit application back in your office. You also will want to check all references. Remember, most people put down references that they know are good, but check them all anyway. Make notes right on the credit

application or new account form. Call the business references personal references, and their bank reference. Always get the full name, title, and extension of the person giving the reference. When you are using a credit application to check credit some questions you can ask are:

- How long have you know the customer?
- How long has the customer been doing business with you?
- What payment method does the customer normally use?
- Does the customer pay within terms, late, or early to take a discount?
- What is the customer's average balance and how many days past due?
- What is the average amount of the customers' orders?
- How often does the customer order from you?
- What is the customer's current balance due? Is any of that past due? If yes, how many days past due?
- What are the customer's terms with you?
- Does the customer make a lot of returns?
- Does the customer take any discounts?
- What is the customers' high credit in the last year or 6 months?
- Is the customer's account current today?

When you contact the bank for a reference, you sometimes will have to fax your request on your company letterhead stating that you have authorization from the customer to request the credit reference information. You can easily type this up on your letterhead and fax it; then give them a call right back. Some things to ask the bank include:

- What type of account do they have? Business, personal, savings, checking?
- When did they open the account?
- What is their average daily balance?
- Have they had any NSF or other returned checks?
- Do they have any outstanding loans?
- What types of loans do they have?
- Are the loans secured or unsecured?
- Are they being paid as agreed?

Many new and small business owners or credit managers balk at running a credit report because there is a cost involved. Depending on what you pay, think of this amount in relation to what you could lose by not pulling the report and checking credit. The cost to run a credit report as a member of a credit bureau is an investment that is well worth it.

Creating a Credit Policy

When a new customer or potential customer calls or come in to set up an account, you should set up the account on a pre-paid or cash only basis. The customer should be sent or given a credit application if they wish to become a charge customer. Once the completed application is received, you need to check their credit and make a decision on a credit limit. If the customer is approved you must send them a letter letting them know they have been approved and for how much. If they are denied credit, you must send them a letter letting them know they were denied and what the reasons are. There needs to be a notation on the bottom of the letter telling them where they

can call or write to obtain a free copy of their credit report if they disagree with any of the information.

Specific steps for successful credit management

- Have every new customer fill out a credit application and/or new account form
- Check customers credit
- Deny or approve credit
- Send out denial or approval letter
- Lock all credit forms and credit information in a file cabinet.
- Input credit limits into your computer on customers account

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