Lessons for Businesses to Learn from Today's Credit Crisis

"The time is now to place an emphasis on managing credit"

The Credit Research Foundation

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- Most businesses that sell to other businesses and to consumers are also in the business of lending money. This is done in the form of trade credit (products and services being sold on open account terms).

- In an economy characterized by tight cash and declining margins the concept of "let's make a deal" should take a back seat to "cash is king". Your organization's mission at this point should be to abandon the thrust to increase revenues and garner market share in favor of increasing cash flows and profitability.

- The majority of businesses within a company's customer base are going to survive the financial crisis. Some will be better for it. Other businesses however are going to succumb to the economic pressures and fail. Trying to segregate the winners from the losers represents a daunting task.

- Trade Creditors should be prepared to accept the challenges brought about by the current credit crisis. A strategy of prudence in lending with an eye on receivable turn, cash management and customer satisfaction should be pursued.

If it walks like a duck and it quacks like a duck, damn it, it's a duck. It's not a peacock. Why is it that despite getting whacked across the head with a two by four repeatedly, management in the financial services community keeps trying to make it look like a peacock when it quacks? When engaged in lending there is only one set of credit standards that work. The standards are based on common business sense. Why do folks within the financial services industry feel compelled to reinvent these standards? The tendency to do so has inevitably taken them down the same path. Let's look for example, to the S & L crisis of the 80's, the LBO craze of the late 80's and early 90's, the dot.com debacle, Enron, and now today's credit crisis, all brought on by a failure to follow a tried and true set of values that should govern the way we behave when lending or investing money. Maybe it is greed, probably ego, and sheer ignorance for sure, but for some reason the banking and financial services community just doesn't get the fact that if you are going to lend money there is a certain set of principles that should be adopted when doing so….By the way, as they line up to get their bailout money from the federal government, the banks still don't seem to get it…. The next festering crisis on the horizon can be labeled the "Credit Card Crisis," brought on once again by sheer greed, ego and ignorance.

So, what should American businesses outside of the banking and financial services sector construe from the current credit crisis? Most businesses that sell to other businesses and to consumers are also in the business of lending money. This is done in the form of trade credit (products and services being sold on open account terms). These businesses, while they aren't holding worthless paper labeled sub-prime mortgage, are also confronted with a major issue which is a subset of the current credit crisis. Banks are running out of capital to lend. Accordingly, the banks are put in a position of having to curtail working capital loans to their business customers. Businesses in need of working capital lines of credit to see them through extended periods where inventory is being converted into cash are turning to their suppliers (the trade creditor) for this funding. They are compelled to stretch out payments for goods purchased on open account terms. The supplier of goods and services is suddenly being thrust into the position of becoming the banker for its customers. For the supplier it's double jeopardy, as frequently the supplier, now banker, is also being impacted by a tightening of working capital lines from its own bank.

It is not likely that a multi billion dollar bailout of the financial services industry is going to end this country's economic woe. While almost out of necessity the government has to come to the rescue of the financial services industry, they don't have the appetite or the capital to bailout all businesses in America. Businesses throughout the U.S. are going to have to stand on their own and weather the coming economic storm. While the bailout will certainly provide relief, it is not going to bring an abrupt end to this country's economic tailspin. We are confronted with deeper seated economic issues. While the credit crisis as we know it currently represents a major threat to the well-being of our economy, there are a number of other issues that are undermining our economic health. The price of energy, rising food costs, the declining value of the dollar, unprecedented debt being incurred by government, businesses, and consumers, rising unemployment, a housing slump, a sagging automobile industry, foreign wars, government bailouts and jobs being lost to countries abroad are but a few factors contributing to the possibility of an extended economic downturn.

Recognizing this and the fact that the government is not likely to come to its aid, business in America needs to adapt to the potential of a prolonged economic slump. In an economy characterized by tight cash and declining margins the concept of "let's make a deal" should take a back seat to "cash is king". Your organization's mission at this point should be to abandon the thrust to increase revenues and garner market share in favor of increasing cash flows and profitability. Risk standards in credit granting should become more stringent and the collection effort more aggressive. This is a time for senior management to understand that the future of their respective organization lies heavily upon the shoulders of those managing the companies' receivable portfolio. The investment in A/R is typically the largest of the liquid assets on an organization's books. Mismanagement of this key asset is certain to lend to the unraveling of the organizations fabric and has the potential of bringing the business to its knees. One only needs to look at Fannie Mae, Freddie Mac, Lehman Brothers and Washington Mutual to understand this fact. As pointed out previously, given today's economic situation, management must realize that cash is, in fact, king. The ability to accelerate the turn of non-cash liquid assets into cash is imperative if a business wishes to gain or maintain a competitive edge. For most businesses the primary cash producing liquid asset is accounts receivable.

Receivables are created through lending. There are rules to follow when engaging in the practice of lending money. These rules are based on a simple concept - "Only lend money to folks that you are reasonably sure can pay you back in a relatively timely fashion". Just about every credit manager engaged in trade credit knows and ascribes to these rules. But, they also know and respect the fact that they can't set out on the mission of accelerating receivable turn at the expense of jeopardizing relationships with valued customers. A strategic approach has to be developed to guarantee a free flow of cash from receivable turn while maintaining good customer relationships. It is important that senior financial management as well as credit management understand that the role of the credit function is to manage a key and integral asset; the receivable portfolio. The credit function should not just be viewed as a back office operation spending its days dialing for dollars. It needs to be empowered to do what is necessary to efficiently manage this key corporate asset.

The majority of businesses within a company's customer base are going to survive the financial crisis. Some will be better for it. Other businesses however are going to succumb to the economic pressures and fail. Trying to segregate the winners from the losers represents a daunting task. This is where credit management has to rise to the challenge. A misguided decision has the potential of costing the business thousands if not hundreds of thousands of dollars in either bad debt loss, if the customer fails, or lost future revenues, if the customer is turned away and ultimately survives.

How should a business react to this issue? Typically in a slumping economy businesses tend to hunker down. Spending is sharply curtailed to preserve resources. This is certainly an appropriate reaction. However, it should be understood that when confronted with an economic crisis, sufficient resources need to be allocated to the credit function to allow it to effectively handle its responsibilities. To handicap the credit department by trimming resources at a time when its performance is critical can be viewed as penny wise and pound foolish.

Gaining a thorough understanding of the business's key customers is imperative. A concerted effort to recognize the customer's position within its respective industry, and to know and understand their operations, financial situation and bank relationships is essential. This endeavor should not be the strict realm of the credit department, but information should be gathered collectively by all who deal with the customer. Those engaged in this effort would not only include credit but other areas within the organization like, the sales function, customer service, etc., all of whom should be vigilant and on watch for any changes in the behavior of the way a customer conducts its business.

In today's business environment credit and sales need to bond and reach out to the customer base with assurances that the organization is willing to work with its customer as a business trading partner. The customer should be assured that his best interest is in your best interest. A business relationship should be nurtured to get the customer to buy in to the philosophy that in a true business partnership each partner should be looking out for the other. Once a spirit of cooperation is established it becomes far easier for the credit function to get the essential information and cooperation necessary to make informed decisions. It is important to understand, however, that in this spirit and given today's credit constraints, at times one should be prepared to make concessions in the form of allowing the customer extended periods to pay back outstanding debts if there is confidence that the customer has the means to repay and the decision makes common business sense. Remember that with bank restrictions on working capital lines one would be establishing a lasting customer relationship if they can assist the customer with working capital issues while at the same time avoiding putting themselves in a working capital bind.

The decision to sell to customers on open account terms and relax payments if necessary is certainly not without risk, but the risk can be significantly mitigated if the credit analyst has a thorough understanding of the customer and its business. Shipping to a key customer that represents a significant dollar loss exposure on the premise that the customer has always met their obligations satisfactorily is like driving down the highway at 60 miles per hour blindfolded. If the highway is straight you will likely succeed, but if there is a curve in that highway you will crash and burn. The point is, in an economy where available cash is restricted you should not blindly put large dollars at risk by making uninformed credit decisions. If you have nurtured a true partnering arrangement with the customer then there should be no reluctance on the part of your trading partner to share the necessary business detail and financial information required for you to make an informed decision. Reluctance on the part of the customer to share this information should send up red flags.

Trade credit exposure is generally short term. Payback is typically anticipated in 30, 60, or 90 days. When assessing a customers financial situation the focus should be on short term liquidity. Is there sufficient cash flow in the short term to meet maturing obligations? The cash position should be assessed as well as receivables and inventory. The analyst should ascertain how long it takes for the customer to convert its receivables and inventory into cash and factor that into the liquidity equation. If there is insufficient liquidity to meet maturing obligations then the customer's banking situation should be examined. Are working capital lines in place? Is availability on these lines coupled with available internal cash flows sufficient to meet maturing obligations? Is there a clean up provision tied to the line that might occur during the period of exposure? When are these lines of credit up for renewal? Are there covenants tied to the line that the customer is in jeopardy of breaching that would nullify its ability to draw on the line? In most cases the information to answer these questions appears in the financial statements. However, if it is necessary for you to contact your customer's bank for additional information it should be done with the customer's consent and the customer should contact its banking officer and encourage him or her to share the requested information. Once again a customer's reluctance to do so should be viewed as a red flag.

American businesses should appreciate the fact that the primary source of working capital for business is from business in the form of trade credit. Trade credit represents the largest source of capital for the majority of businesses in the United States, far exceeding working capital provisions extended to American business from banks. With banks reeling from their misguided ventures, creating restrictions on available bank funding, the impetus to keep commerce in the U. S. moving forward is falling on trade creditors. Business management should gain an appreciation for the value the credit function brings to the organization. Credit management should be prepared to accept the challenges brought about by the current credit crisis. A strategy of prudence in lending with an eye on receivable turn, cash management and customer satisfaction should be pursued.

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