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# Managing Credit and Collection Processes in Uncertain Credit Markets

By Junhan Wu, October 8, 2008

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Uncertainty in the credit markets has made financial institutions reluctant to lend money between each other, and to businesses. This is evident in the recent increase in LIBOR, as well as the severe contraction within the commercial paper markets. In September, interest rates on three-month dollar loans rose to their highest level since January, short-term borrowing fell by the most ever, and high-yield loans tumbled. The market for commercial paper has shrunk by $94.9 billion, to $1.6 trillion, as the subprime mortgage crisis continues to drive up the cost of borrowing. With banks cautious and unwilling to take on short-term debt, sources of working capital continue to dry up. It will take years before the situation improves.

Prompted by sharp hikes in bank lending rates and their unwillingness to part with liquidity, companies must seek alternative financing to tide them over during this credit crunch. Companies have already begun to stretch their payments for goods and services; this trend will continue to develop and persist across most industries.

**What It Means for Your Company**

With customers seeking alternative financing, companies face an alarming surge in their accounts receivable. Companies' receivable portfolios will begin to age, and risk profiles will likely deteriorate, prompting them to adjust their level of acceptable portfolio risk. Companies will be forced to make tough credit decisions as their customers push for credit extensions.

Companies need to establish the amount of additional credit and risk that they are willing to tolerate. They also need to manage their receivable portfolio within these tolerances. Companies will see their Day Sales Outstanding (DSO) increase, which again calls for them to anticipate the magnitude of the DSO increments, and take a proactive approach toward this precarious situation.

With trade credit emerging as the new growth area of debt, it is important for both buyers and suppliers to review their relationships and maintain credit limits that support their operations. Companies need to evaluate their credit and collection policies, and strategize how they can mitigate the potential adverse implications of their credit risk and DSO, such that their own working capital is not jeopardized.

**Contending with the situation**

Credit and collection solutions are available to help companies turn this bane into a boon. Using these solutions to properly segment the accounts receivable portfolio and implement risk-based collection strategies, companies not only manage their risk exposure, but their DSO as well.

Most companies segment their customer portfolios by industry and geography. Using a credit and collection solution to further segment these accounts by age, credit risk, payment performance over time, customer relationship, account size, loss tolerance etc., and having customized collection strategies to deal with each segment, a company can derive the most value out of their receivable portfolio. This is achieved by focusing the appropriate resources on the individual segments and optimizing overall portfolio risk. For example, a company might want to have liberal credit lines for their best customers, and structure their collection efforts with a focus on sustaining a long-term relationship. Conversely, management will call for more aggressive collection activities on less attractive customers that pose a higher risk, and lower sales potential.

An effective credit and collection solution can also help companies keep their DSO in check by implementing collaboration tools, which bring about portfolio visibility. Visibility essentially means management has the information they need to make the right credit decisions, and collectors have the right information to collect receivables. Managers are provided with the framework and information to ensure the portfolio's risk is kept within acceptable levels. A sound credit and collection solution provides a clear snapshot of the company's portfolio at anytime such that the company's DSO and segment exposure is constantly updated and monitored, and management can establish thresholds to curb unfavorable trends.

For example, instead of just having collectors cover accounts by geographic regions, a company could also further identify customers with deteriorating credit ratings and assign specific strategic steps to collect these accounts. Such measures allow companies to avoid over-exposure of their portfolio to customers of a particular industry, credit rating etc. Clear segmentation of accounts will then allow managers to establish aging parameters in specific collection strategies that will drive collection efforts and keep the receivable portfolio within those tolerances.

The credit markets today are signaling shifts in business trade terms and practices. Customers have a pressing need for trade credit, and companies must find a balance between extending favorable payment terms and the subsequent collections of these customer accounts. As banks further tighten their credit window, discerning companies will need to equip themselves with an adept credit and collection solution to turn the current credit situation to their advantage.

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