crédito y caución
Atradius Group

The future of trade credit

A summary of the Atradius white paper
June 2010

What does the white paper aim to achieve?

Through our research for the white paper, we've sought to establish how the economic downturn of 2008/9 affected credit sales during that period, to examine attitudes towards credit and forecasts for its future use, from a range of viewpoints, to establish if the economic downturn has altered the way and extent to which trade credit will be used in the future, and to make recommendations based on those findings with a view to ensuring that national and international trade can continue to thrive, whatever changes occur in the use of trade credit.

Why trade credit has historically oiled the wheels of trade

As long ago as 1923, W.C. Schluter defined credit as:

'A trust, faith or confidence that reposes in a man or "house" which gives him or it a business reputation of willingness and ability to pay obligations, and, therefore, confers the power or ability to acquire goods or funds upon the promise of future payment or repayment'.

(Factors determining terms of sale, by W.C Schluter 1923)

Schluter's definition describes the essence of credit, as it includes the elements of trust, faith and confidence that are central to the sale of goods and services on credit terms – because that is what creates the business relationship that is vital to successful trade.

The advantages and drawbacks of trading on credit terms

Trading on credit terms has many advantages for both buyer and seller. For the buyer, it relieves pressure on cash flow and allows time to raise funds for payment, while for the supplier, offering credit terms can give a real competitive advantage.

But, of course, those advantages rely on everything going smoothly. If a buyer finds, as many throughout the economic downturn, that payment cannot be made on time – perhaps because bank finance is harder to come by, or demand for his own services is depressed, he can incur penalty charges and find his credit rating downgraded. And the supplier's own cash flow and profits will be hit.

Our white paper seeks to address these and more issues, to reach conclusions and recommendations that will enable credit to continue to drive successful trade.

When we questioned businesses – through interviews and by means of a questionnaire published across the industrialised nations, we found most definitely that the economic downturn has placed exceptional stresses on the supplier/buyer relationship, adding pressure on cash flow, investment and research and development. The balance of the business relationship has in many cases moved in favour of powerful buyers who can demand extended credit terms, while at the same time suppliers who at one time would have offered credit terms are now demanding – and in some instances simply taking – cash up front.

Even so, most of those surveyed believe that trade credit will remain the medium of successful trade, with its main purpose, in the next 12 months at least, being to allow buyers more time to pay and to maintain long term good business relationships. That said, our respondents were mindful of the heightened need to ensure that every implement in the credit management tool box, including third party guarantees and frequent credit checks, is employed to monitor their buyers' performance and take the appropriate action – not to put undue pressure on buyers, but to help them to pay.

Best practice in credit management is essential

Philip King, chief executive of the UK's Insitute of Credit Management, believes that trade credit is essential for businesses to operate, and that the economic crisis has led businesses to take a positive stance of targeting the better risks for future trade. Businesses that failed to react quickly to the downturn have suffered most, and credit insurers' withdrawal of cover may have accelerated the demise of businesses that were due to fail anyway.

Jan Schneider-Maessen, chairman of Gemany's Verein für Credit Management e.V., observes that smaller suppliers have suffered at the hands of powerful buyers, and that the shift in power to such buyers is a global phenomenon and a trend that began before the downturn with a lack of ethics in businesses reflecting a wider societal problem. He warns that suppliers are, if anything, now taking more risks in their sales contracts, because of the pressure to sell, and adds that, alongside best practice in credit management, businesses need to anticipate future market demand if they are to stay ahead of their competitors.

Did credit insurers take the right actions during the downturn?

Credit insurers took what appeared to be harsh decisions during the downturn as they reassessed the cover they provide. They argue that this was necessary because the nature of risks had changed to such a degree that many were no longer insurable, and to continue to provide cover in such circumstances would have ill-served their clients.

Credit insurers have also argued that the criticism they have received has been unwarranted, and recent figures on the credit insurance industry produced by ICISA (the International Credit Insurance & Surety Association) show record levels of claims payments throughout the downturn.

In the white paper, credit insurer Atradius points to the elements vital for successful trade on credit terms: trust, honesty and openness between supplier and buyer; confidence that due dates of payment will be met; a sensible credit management policy on the part of the supplier so that they can monitor and control events that may affect their cash flow; a spread of risk, so that a supplier is not wholly dependent on a single buyer; and the flexibility to adapt to changing trading circumstances – on the part of trading partners, banks and credit insurers.

Atradius believes that the businesses that have kept to those principles have emerged stronger from the downturn, while those who refused to recognise escalating risks have suffered most.

How has the economic crisis affected the credit insurance industry?

Two organisations with a bird's eye view of the credit insurance industry are the Berne Union and ICISA. Both organisations have seen an upsurge in applications for credit insurance, with Berne Union members combining high levels of insurance capacity and claims payment with a resilience to the adverse financial environment.

However, ICISA believe that those businesses that already have credit insurance need clear explanations from their insurers if the level or terms of cover are adjusted, and that insurers must therefore improve their transparency.

The role of governments

At the height of the economic crisis, as credit insurers re-evaluated the insured risks and in many cases reduced or withdrew cover, and banks tightened their lending criteria, the issue of trade finance and trade credit was escalated to the G20 agenda. Subsequently, a number of government initiatives, mainly in European countries, were introduced to top up or stand in place of reduced or withdrawn private credit insurance.

Overall, the schemes have had limited impact, leaving room for improvement.

The Atradius survey of international businesses

A central pillar of the white paper was a survey of businesses across the world, seeking views on the future of trade credit, the results of which are shown in the appendix to this summary report. Responses were received from business people in Australia, New Zealand, Belgium, France, Germany, Italy, the Netherlands, Switzerland, the UK and the USA.

One of the main findings was that a majority of businesses see trade credit extending in the future to allow customers more time to pay, perhaps because of less access to bank finance, and to maintain relationships with valued customers. Suppliers continue to monitor buyers' financial stability and buyers are prepared to trade off credit terms in return for a better price. SME suppliers are particularly sensitive to changes in their own cash flow as a reason to adjust credit terms.

The conclusions of the white paper

It was clear from our research that the dynamics of trade credit have changed as a result of the economic crisis, with more aggressiveness by both suppliers and buyers in the way they behave towards each other, and a lack of what Atradius, for one, perceived to be the essence of successful trade credit – trust, faith and confidence. At its extreme, such behaviour is also perceived to be unethical. Unless this trend is redressed, one conclusion is that this will damage not just long term business relationships but also cash flow, and hamper investment in research and development, to the eventual detriment of consumers.

There is a firmly held belief among many that the use of trade credit will increase in the coming 12 months to maintain trust with loyal customers, regenerate flagging markets and afford customers time to pay. While this may not accord wholly with experience of recent times, it suggests a recognition on the part of business of the value of trade credit and an aspiration for such trade to return to equilibrium.

While not all the criticism aimed at credit insurers over their withdrawal of cover is merited, an improvement in their advance communication, wherever possible, of the reasons for changes in cover could increase their clients' ability to adjust to the changing circumstances.

In obtaining both credit insurance and bank finance, businesses would be well advised to ensure that they adopt a practice of absolute transparency about their financial status.

Our recommendations

As a supplier, view credit as an aid to continuing successful trade with – not as a concession to - the buyer. Our research has shown that credit, when combined with best practice in credit management, but also in a spirit of trust, is an important factor in building and maintaining strong business relationships.

Don't go into panic mode if the economy dips. Instead, use credit creatively. Remember the view of Rob Sherman (page 15 of the white paper): "… accounts receivable efforts are ineffective if your customer simply does not have the financial means to repay… rather than fight a fruitless war, progressive finance departments are instead offering innovative solutions to their customers."

As a buyer, seek credit terms that allow you to be confident of your ability to meet the due date of payment, but not such that would place the supplier at a disadvantage, or deprive them of the wherewithal to invest in research and development of their products and services, because in the long term, that will benefit you and your own customers. A strangle hold will eventually 'kill the golden goose'.

Be absolutely open about your financial status, with suppliers and their credit insurers. Credit insurers can assess trading opportunities accurately only if they are in possession of the most up to date financial information, while out of date - or no - information is likely to result in their refusing cover.

Throughout the downturn, credit insurers continued to insure trade, and will no doubt continue to do so. This has meant both paying more claims than in less volatile times while at the same time reducing exposure on some high risk companies. But that statement of the obvious doesn't help the business who either has credit insurance or is contemplating it. When communicating the withdrawal of cover, credit insurers can help their clients by, whenever practical, giving them as much time as possible to reassess their trading patterns and seek solutions with their buyers that will enable them to continue trading safely: for instance, with the security of a third party guarantee, increased down payment or letter of credit.

Credit insurers have always provided businesses with protection for their credit sales, while at the same time having the right to make changes to the insurance cover if the risks change. But, if they are to provide a valuable service to their clients, even during sharp economic downturns, our recommendations to credit insurers are:

- that their right to withdraw cover is made clear to all clients at the outset of entering the contract of insurance;
- that the circumstances in which this may happen are also made clear;
- that, whenever feasible, as much notice as possible is given to the client before such withdrawal occurs to enable them to seek alternative methods of safeguarding their cash flow; and
- that, in general, credit insurers review the quality of their communication with their clients to reduce the kind of accusations, many unfounded, that they received in the media throughout the downturn.

The recession has had a significant impact on bank lending practices. However, as we emerge from the recession, it is anticipated that prospects for profitable growth will overshadow the poor credit risks of the last two years. There should therefore be increasing opportunities for banks to again focus on corporate lending as an opportunity for generating profit rather than as a risk, and this in turn should help stimulate growth in trade.

Our white paper includes an excerpt from the Confederation of British Industry's paper 'The shape of business – the next 10 years (November 2009) which bears repeating here

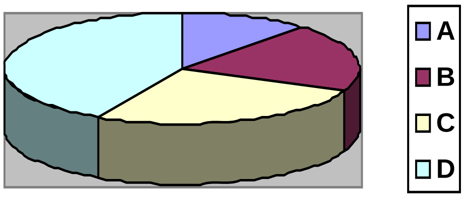
"Businesses do not see credit terms falling back to pre-crunch levels and, having become wary of higher debt levels, firms will look to alternatives to debt-driven growth to protect investment and innovation, More financing options will be deployed.…supply chain finance is expected to develop as a much more important part of future strategies. Larger companies will be prepared to finance their suppliers and smaller firms will look upstream for funds. In particular, this will become commonplace where businesses have built up mutual trust and developed collaborative relationships. …Finance agreements in the supply chain are now perceived by many businesses as less risky than bank lending – as customers, large businesses will; have a good understanding of suppliers' peaks and troughs in demand and they will also be willing to work with them to ensure their survival"

Appendix

The results of the Atradius survey on how trade credit will differ in the foreseeable future as a result of the economic downturn?

Chart 1

Over the next year, what do you consider will be the *prime* purpose of trade credit?



A - To ensure continued competitiveness between businesses

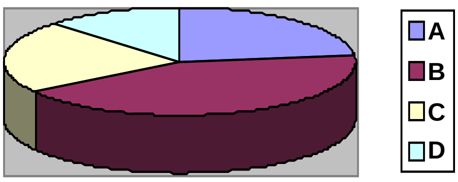
B -To regenerate demand in the market, which may have dropped during the downturn

C - To allow customers time to pay if, for instance, they need to sell goods on or to obtain bank finance

D - To develop and maintain trust in business relationships between suppliers and their customers

Chart 2

In the next year, what effect(s) do you expect the economic downturn to have on credit sales in your industry?



A - Sales on credit terms will increase to regenerate demand

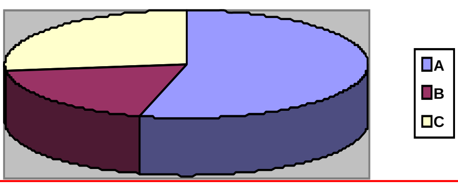
B - Sales on credit terms will increase because customers will need more time to pay

C - Sales on credit terms will diminish because of the risks of non-payment

D - Sales on credit terms will diminish because of pressures on the suppliers' cash flow

Chart 3

In your role as a seller, what would cause you to change the way and extent (*up or down*) to which you offer credit terms to your customers?



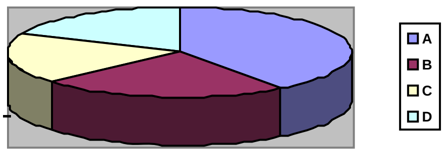
A - Indications that their financial stability was changing

B - Competition from other suppliers

C - Changes in my own cash flow

Chart 4

In your role as a buyer, what would cause you to change your requirement for trade credit from your suppliers?



A - If I could negotiate better prices in return for more secure terms

B - If a vital supplier demanded different payment terms

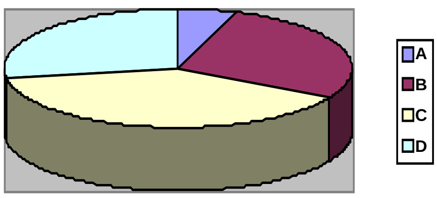
C - If I could foresee changes in demand for my own services

D – If I needed to build trust with a supplier in uncertain financial times

The SME perspective

Small to medium size enterprises (SMEs) were hit particularly hard by the economic downturn. They had less access to trade finance, were often at the mercy of powerful customers when it came to payment terms, and overall had less capital than large companies to cushion them against the downturn. To get a picture of the particular concerns and opinions of SMEs, we looked at the responses from a group of SME consultants, based in Germany, and compared them with the overall results of our survey.

On the question '**Over the next year, what do you consider will be the *prime* purpose of trade credit?'** the SME consultants put more emphasis on allowing customers time to pay, rather than to develop and maintain relationships. This may reflect smaller firms' concerns with cash flow, and difficulty that they may have experienced in obtaining trade finance.



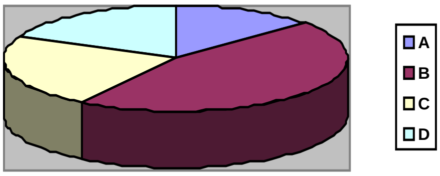
A - To ensure continued competitiveness

B -To regenerate demand in the market, which may have dropped during the downturn

C - To allow customers time to pay if, for instance, they need to sell goods on or to obtain bank finance

D - To develop and maintain trust in business relationships between suppliers and their customers

On the question '**In the next year, what effect(s) do you expect the economic downturn to have on credit sales in your industry?'** There was again a difference, with the SME consultants putting even more emphasis on credit sales expanding to allow customers more time to pay.



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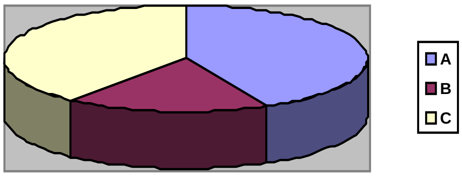
On the question '**In your role as a seller, what would cause you to change the way and extent (*up or down*) to which you offer credit terms to your customers?'** this group of respondents put much more emphasis on changes in their own cash flow as a reason to change: again, a recognition of the particular concerns of SMEs.

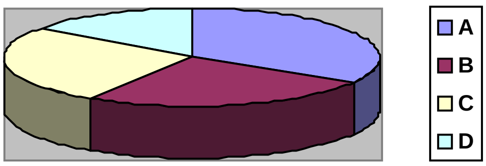


A - Indications that their financial stability was changing

B - Competition from other suppliers

C - Changes in my own cash flow

On the question **'In your role as a buyer, what would cause you to change your requirement for trade credit from your suppliers?'** the SME consultants put less emphasis on negotiating a better price from suppliers – perhaps a sign that they value the breathing space afforded by credit more than this – and more emphasis on demand for their own services: indicating their sensitivity to market demand and the effect that small changes may have on their cash flow.



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B - If a vital supplier demanded different payment terms

C - If I could foresee changes in demand for my own services

About Atradius

Atradius is one of the world's leading credit insurers, with a 31% share of the world credit insurance market and total revenues of more than EUR 1.7 billion. Atradius insures trade receivables against non-payment and offers a wide range of credit management products and services, varying from tailor made credit insurance and global solutions, to international debt collection and on-line services.

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