STRATEGY OF CREDIT RISK MANAGEMENT IN INTERNATIONAL BUSINESSES

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Abstract:
Risk is an essential part of the activity of any organization and is endemic in all trade forms or trading activity. This is an inevitable factor in the competing, growing, trading and investing activity in a market economy. The main problem with the risk is whether it can be adequately identified, measured and managed.
Risk has many forms - of which credit risk is just one – and cannot be started by most of the predictable threats or dangers than an organization faces, but rather by the failure to maximize the opportunity or possibility to get the results, it is actually something that can prevent an organization from achieving its strategic objectives. It is therefore extremely important that any risk which is not adequate for increasing the activity's economic efficiency or which cannot support the achievement of its reasonable strategic objectives, reduced to the minimum in order to increase profitability and financial stability in a company.

Key words: *credit risk, payment tools and techniques, international business, credit risk determinants.*

JEL classification: *F23 - Multinational Firms; International Business.*

Introduction

Besides the advantage generated by a company's business internationalization there is also a group of risks which, in order to minimize and fight against them, they have to be identified and known through a management strategy and use of adapted tools.

Risk is an intrinsic part of all business operations – there are no business operations where decisions do not involve a risk element. Risk can be seen as a *chance of something to happen and which may have an impact on business objectives.* To say it differently, we think that risk management is an integrating part of business activities. Any management of an exporting company should consider the following aspects regarding risk credit:

To draw a credit risk policy, as well as a strategy which is in accordance with trade policy, company's objectives, financial status, risk appetite and company's level of performance.

To provide efficient management for the risks that may occur, including to apply strategies for reducing them. Risk management is a key performance indicator in all business fields and a fundamental component of strategic planning.

To make an identification of the risks that may occur considering the inventory of risky positions that may affect the results of the business and company's performance.

To quantify risks in order to express in numbers the possible effects of a risk situation on the company's profit.

To assess performances, an action which supposes measuring performances achieved after covering risk exposure. The need to assess the performances of risks coverage completes the management process. Coverage performance measurement shows the quality of risk management, its strong and weak points.

1.1.CREDIT RISK DETERMINANTS

Credit risk is the possibility for the occurrence of a loss for an exporter (creditor) within international trade transactions, as a result of an unpredictable situation for the debtor (importer). It often appears during the deliveries that the exporter makes if the commitment it takes on its enterprise is not too important in case of payment incident. This problem occurs at this time, supposing that the company has not previously developed a method to choose the coverage. In order to define credit risk management policy for an establishment (trade institute) it is necessary to know risk generating facts and their coverage methods.

Prospecting

The cases in which a company sells on a market without having previously prospected are rare. This prospecting requires financial and human resources. The result of this investment cannot be guaranteed before. A company which invests large amounts of money in searching new debouches takes the risk of not recovering the funds it has invested. It has the possibility to choose the services of an insurances house that would propose various policies to cover these risks.

Thrusting abroad

Prospecting can be followed by thrusting abroad, costs that will have to be written off. Some insurance companies conclude policies in order to cover the risk of thrusting.

Establishing stocks abroad – before receiving an order, the exporting company can establish stocks in the target country in order to propose clients shorter delivery terms or to take advantage of a favourable customs regime, which involves not only financial costs, but rather taking storage and products handling related risks.

Offer presentation

Before being appointed as winning company of an auction, it has to submit its offer, a catalogue of prices which are actually commitments for the selling company: commitment on the selling price, on the work execution etc. In case of international adjudication, the company has to, provide a good execution guarantee along with the offer guaranteeing the buyer that the winning company will comply with the contract exactly, according to the conditions established in the offer. Submitting this guarantee by the exporter means taking a risk which can be covered through policies concluded with insurance companies.

Order

Between the order and the delivery, the exporting company may face several risks:

- either the growth of recovery costs (due to the growth of raw materials costs or production costs), being an economic risk;
- either market loss: from the execution of the contract to exporter's compliance with its obligations, it may experience losses resulting from political events, natural catastrophes in the importing country, client insolvability. It is therefore an economic, commercial, country risk.

Packing, shipment

Commodities which are the subject of international trades go through international transport, which supposes the existence of the risk for them to depreciate, to quantitatively and qualitatively suffer due to transport conditions. The international legislation limits transports liability in such cases, the exporter being in the position to lose without being compensated. This is why it is necessary to conclude an insurance policy of the exported commodities during the transport.

Payment

Payment is the last stage of the commercial chain. If it is not made, it may bring the company's perenniality back in discussion. Therefore, after credit insurers, about a quarter of a company's liquidities are necessary for the lack of payment means for one or several clients. In order to deal with this risk, the exporter identifies various components. Among them, special attention is paid to the analysis of turnover and buyers' features as well as to payment conditions granted to them.

The exporting company often sets the payment terms for the importer, the risk for non-payment increases in time. This risk may result from:

-importer's insolvability – commercial risk;

-from the enforcement of governmental decisions issued by the importing country's public authority – political risk;

-from natural catastrophes.

The non-payment risk is assumed either by the exporter (if he sets a payment term), either by a financial institution (in the case of buyer credit). They can cover this risk through various insurance policies at insurance companies.

1.2. CREDIT RISK MANAGEMENT

Managing risks means acting in two fields: prevention and transfer. Companies are interested, every time it is possible, to prevent credit risk. This prevention is made with the help of two means: *commercial:* clients' monitoring and *contracting:* property reserves and payment terms.

Clients' monitoring is made in two stages:

At the order reception time through significant information; the information is provided by:

- *banks*: during the first stage, as far as financial risk is concerned, banks provide a free service of commercial information for their correspondents networks. In order to be reliable, this information has to refer to every analyzed client, on a large number of transactions and on a centralization of payment incidents;

- *commercial information experts*: specialized companies provide remarkable information and services quality. Data is collected from suppliers, banks, clients and local chamber of commerce and incorporated in the files which can be accessed through a terminal.

Autonomous research which is carried by questioning agents networks, exporters clubs, exterior trade advisers.

The use of this channel is easy, but it is very weak because of source heterogeneity and the absence of information control and reliability. *Example.* Trade agents may tend to accept questionable businesses in order to achieve the turnover. The risk for them is actually limited to the size of the lost commission.

Non-payment risk management in international transactions: components of a coverage policy for the non-payment risk

After the acceptance of an order and before the delivery of the commodities, the exporter fears the manufacture risk (which is greater the less the advances given by the importer were). Once the delivery is made, the main concern of the exporter is to be paid. It is the non-payment risk or the credit risk. If it has not developed of coverage policy for the non-payment risk, the exporter wonders on the financial consequences that a possible bankruptcy of the importer may have.

Risk level and turnover distribution

One of the non-payment risk sources is focusing sales on a small number of clients or on a limited geographic area. International commercial transactions practice proves that it is very likely that about 80% of the turnover be achieved with only 20% of the clients and therefore the number of clients will be smaller, the higher the risk will

be. The same reasoning applies for the number of countries in order to determine the intensity of the risk caused by economic recession, conflict or by a lack of estimates.

The search for various markets refers to economic and financial risks distribution. The exporter wants to compensate the unfavourable circumstance of a foreign market through important sales in economically developing countries (this is the current case of the French motor vehicles industry which compensates the sales decreases from the European Union with a growth in South-East Asia, Latin America and Eastern Europe). The non-payment risk level is even higher if the turnover distribution is made in few countries or few clients. For a better analysis of this type of risk, country risk analysis has to be integrated with the analysis of the client's quality.

Risk level and client's quality

The importer can be a private or a public company. The reasons for non-payment could be on one hand, bankruptcy (commercial risk), political events in its country, catastrophes, problems in the transfer of estimates (for private importing companies), and on the other hand, political risk (for the public company). Developing trade relations with a public client could be considered less risky, taking into consideration its financial reliability and order financing (financial protocols, loans from a development bank, funds from European Union bodies). Nonetheless, practical experience proves that in the case of these transactions there can be non-payment rather related to the political client between the two states. As far as the private importer is concerned, its risk can be estimated starting from its financial solvability that can be calculated thanks to banks risk assessment companies, exterior trade centres, insurances houses.

The geographic localization of a client should not be neglected. An importer located in areas with frequent devastating natural phenomena has a higher non-payment risk than usual, company and banks' activities being disturbed. If the non-payment risk is not due to a crisis of the reimbursement system between the countries, payment delay risk is even higher.

The duration of a relation with a client is another non-payment risk analysis criterion in relation to client's quality. Trust is earned in time, and past experiences influence the current analysis of this type of risk.

Risk level and deadline granted to the importer

Insurance companies consider time an enemy in matter of debts coverage. For an exporter who gives a payment term to the importer, non-payment risk increases the further in time is the deadline, importer's bankruptcy or political events being able to occur and delay or prevent the payment.

1.3. THE CHOICE IN MATTER OF PAYMENT INSTRUMENTS AND METHODS

In order to get its debt regulated, the exporter has several instruments, and depending on its related guarantees, instruments and methods used could decrease or cancel non-payment risk. If the seller does not choose simple payment, it has 3 methods to make the payment:

-*documentary credit,* which allows it to receive the payment for its exported commodities during the shipment, if it has met the conditions listed in credit opening. By using it, the exporter is certain of payment reception at the settled time, as well as of the existence of a financing source.

-*letter of credit* is based on the commitment of an issuing bank – coordinating – which acts at the request and in compliance with the instructions issued by the client or by the coordinator of the letter of credit – the buyer – to undertake to perform a payment to third person – the seller, as the beneficiary of the letter of credit – or to pay or accept, as a result of the order given by the beneficiary of the letter of credit, bills

made by the beneficiary or authorize a bank to make a payment to the beneficiary, accept or authorize bills.

-*documentary remittance* for which the banker or the transporter transfer the buyer their representative documents in exchange for payment. Payment methods chosen have an influence over the nature of the risk that the company will have to take.

Payment instruments and methods have significant influence over the credit risk, and the intensity of the commercial risk depends on them. This concerns both the private and the public importer.

Private importer: it can be declared under bankruptcy. Its financial situation related risks can be many *commercial risks,* with two non-payment cases: *insolvability and default.*

Insolvability is the debtor's incapacity to fulfil its commitments, and this incapacity may result from: a juridical act (judicial liquidation); an amicable agreement with all claimers; an actual situation: the insurance company considers that payment is less likely.

Default is the debtor's impossibility or bad faith to make the payment.

Both cases can be covered by policies. Some insurance houses cover only insolvability. An exporter cannot accept that its client's bankruptcy procedure is completed, being able to extend it for several years.

Public importer: state, territorial collectivity, autonomous authorities. Whatever the non-payment risk may be, in the transaction with a public importer, this risk is considered a political risk.

Intensity of the commercial risk depending on payment instruments can be represented as follows:

<table>
<tr><th colspan="4">Instruments</th></tr>
<tr><td colspan="3">Transfer
International money order
Enterprise check (it also includes the certified check).
Bill
Promissory note</td><td>Certified check (within the legal period)
Cashier's check
Bill and promissory note with guarantees</td></tr>
<tr><td colspan="3">Powerful</td><td>Null or very weak</td></tr>
<tr><td>Methods
- Documentary remission against acceptance –
Simple cashing</td><td>- Documentary remission against payment
- Against reimbursement</td><td>- Irrevocable documentary credit
- Irrevocable letter of credit</td><td>- Irrevocable and confirmed documentary credit
- Confirmed irrevocable letter of credit …</td></tr>
<tr><th colspan="4">Risk level</th></tr>
<tr><td>Risk of:
Non-payment after commodities acceptance,
Client's refusal of the commodities</td><td colspan="2">Non-payment as a result of a political event</td><td>No risk for non-payment</td></tr>
</table>

Intensity of the commercial risk depending on payment instruments

Payment terms	Before shipment	During shipment
Instruments	All instruments are possible	Instruments related to documentary credit
Methods	Simple cashing	Irrevocable documentary credit per safe countries Irrevocable and confirmed documentary credit per risk countries

Payment terms chosen by the exporter

At the same time, payment between commercial negotiation and the aforementioned terms may determine the client ask for compensations for the safety of the payment, without interrupting commercial discussions, taking into consideration the trust it is credited by the seller with.

In order to allow order execution, the exporting company has to often accept the credit risk in accordance with its commercial activity. It also has the possibility to transfer it.

Transferring risks means covering them by an entity exterior to the company. This coverage can be made by an insurance company or by a financial body.

1.4. CHOICE CRITERIA IN MATTER OF CREDIT RISK

The main criteria which allow to choose the necessary means to deal with credit risk depend on the market and on the export operation.

Market features

The features of the market which influence decision in choosing the necessary means for dealing with credit risk are the following:

Market type: buyer or seller

The ratio of forces used on buyer's market (meaning when buyers are not numerous in relation with the number of sellers) does not allow the seller to choose or even negotiate the regulating conditions. They are established at command. This constraint exists even on the seller's market while the buyer is public. At the same time, a negotiation may be employed in this case. The more the client needs the products, the more tempted will the market be to make concessions.

Extent of the political risk

It is understood that the higher the political risk is, the more vigilant the buyer should be regarding payment terms and coverage possibilities.

Professional habits

Business practice in a given field can consider habits it may want to know in order to adapt its payment terms. Example. In the German textile industry it is usually provided that the buyer be granted a 4% discount for the payment within 10 days after reception instead of 60 days as it was usually stipulated.

We should note that buying (purchasing) centres of large distribution have buying terms which are difficult to change. In order to know these different practices information should be achieved from an economic expansion centre or be implanted in the buyer's country.

Local legislation has a major influence on choosing the payment instrument. The possibilities of appeal for unpaid debts will actually be different from one country to another. Example. A German debtor may refuse a check submitted for cashing after more than 8 days after its issuance (if it is payable in Germany). This is why, in order to

understand the legislation of the client's country, it is necessary and possible to take advice from banks, which, through their correspondences in the buyer's country, could have privileged information.

Operation features – type of client and order size

Type of client: new or known

It is understood that the company, after having analyzed the order of a new client, will tend to surround itself with precautions. In order not to disturb the buyer, it is important to insist on the fact that precautions are applied to the new clients. The most neutral way of formalization is to indicate the general sale terms for this payment constraint.

The size of the order will pay special attention to very large orders. The actually considered risk for this type of order can unbalance the company.

The following table presents a summary of the choices to be made regarding credit risk coverage means. The constraint related to the buyer's market is not indicated, but it does not allow the company to choose a coverage means other than insurance.

Operation/Market		**Weak political risks (small)**	**High political risks**
New client	Small order	In exchange for reimbursement, simple cashing after the option or guaranteeing application of the insurance company	Advance payment by transfer (SWIFT). simple cashing after the option or guaranteeing application of the insurance company
	Large order	Irrevocable documentary credit or letter of credit or guarantee letter	Irrevocable and confirmed documentary credit or letter of credit
		Option or guarantee application at the insurance company. Order confirmation	Invoicing
Known client	Small order	Simple cashing. Documentary remission against reimbursement. Guarantee application at the insurance company	Advance payment by transfer (SWIFT). Guarantee application at the insurance company.
	Large order	Usual method with client's analysis and insurance option increase.	Irrevocable and confirmed documentary credit or letter of credit. Invoicing. Guarantee application at the insurance company

Choices to be made regarding credit risks coverage means

CONCLUSIONS

After defining the parameters that influence the level of exporter's risk, it can adapt several positions: self-insurance, risk transfer to a specialized or prevention institution.

Self-insurance means choosing a payment method where other guarantee financial institutions do not interfere. Risk transfer to a specialized operator (insurance company, factoring company or order confirmation company) means giving the non-payment risk to these institutions in exchange for a commission paid to them, with an increased safety.

Risk prevention can be made by collecting information on the foreign client from specialized companies, thanks to their specialized year books (exterior trade centres, insurance houses, banks etc.). Clients' evolution monitoring is made in their books and charts, kept by the export service, with solvability, payment punctuality parameters.

The coverage policy of non-payment risks may have several forms (risk transfer associated to a self-insurance policy, depending on the country and client); still, some insurance products involve a global approach, the export turnover whole being insured by the insurance company.

The exporter adopts a clear and simple conduct in order to be insured against non-payment risk, depending on each client's specificity.

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