Recession or Economic Slowdown on the Horizon? Strategies to Reduce Credit Risk and Preserve the Customer Relationship

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Abstract

This article will prepare credit teams to consider economic factors when reevaluating A/R portfolio risk, and offer strategies to reduce risk, whether at the new account stage or account maintenance, while preserving the trade relationship, especially during a recession or economic slowdown.

Introduction

Credit teams in most industries have enjoyed a remarkable 10-year run of modest bad debt loss and consistent DSO as customers have flourished with record earnings. The U.S. economy is healthy as unemployment is at the lowest level in decades, employers have continuously added jobs for eight years, and the economy has grown at its fastest pace since 2005. Even though many conditions remain strong, the risk of a recession or economic slowdown is increasing as a handful of signs reveal weakness in major markets.

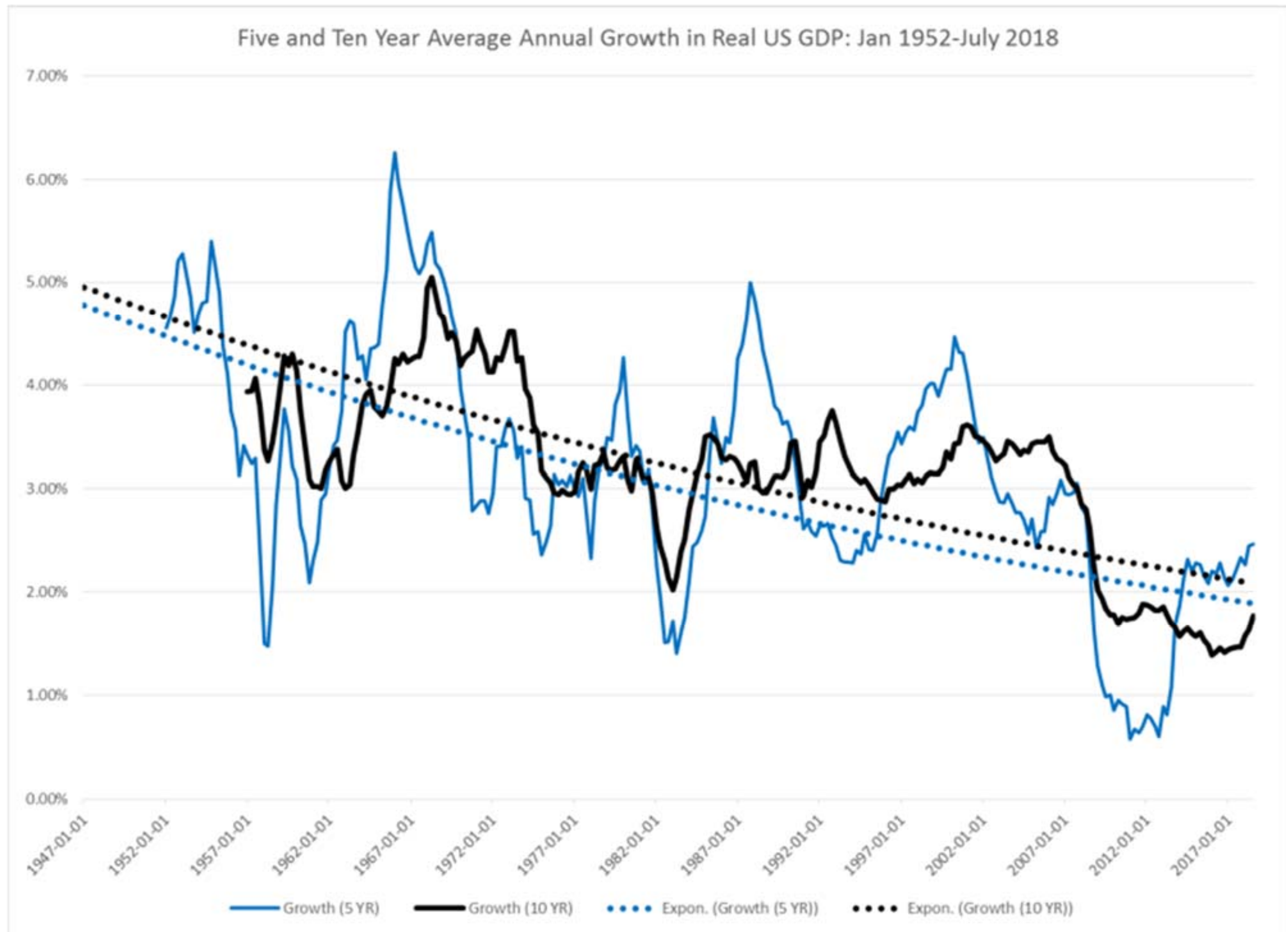
Fueling this fear is growing trade tensions that are creating economic worries among many U.S. and foreign companies. In a recent study conducted by Duke University/CFO Global Business Outlook, more than 80% of U.S. CFOs believe a recession will strike in 2020. The study refers to several precautionary factors that signal a recession: a warning expansion that began in 2009, heightened market volatility, corporate earnings, and the flattening of the yield curve which has accurately predicted recessions over the past 50 years.

This paper considers economic factors the credit team may consider when reevaluating A/R portfolio risk, and strategies to reduce risk, whether at the new account stage or account maintenance, while preserving the trade relationship.

Economic Factors that May Impact A/R Portfolio Risk

Slowing Growth in the U.S.

The U.S.'s long term real economic growth has been significantly slowing and the new normal seems to be low growth, which could lead to a recession. Wall Street has begun to predict an economic slowdown by the patterns in selling and extreme volatility plaguing the stock market. Many key commodities are on track to experience declines, while the strong U.S. dollar has weighed on prices for raw materials. This will produce winners and losers for companies, as lower prices will deplete investment spending and the loss of income for major oil-producing nations will outweigh any consumer gain. Driving declines in raw materials is the fear that trade tension between the U.S. and China will affect growth at a time when international expansion is low.



Long term real economic growth has been slowing

Reduced Corporate Earnings and Increased Corporate Debt

Corporate earnings are reporting a 4.5% growth over the next 12 months, down nearly 13%. The Trump administration's international trade disputes, particularly with China, have led many U.S. companies to put investments on hold until tensions clear up. According to data from the Federal Reserve and Commerce Department, U.S. corporate debt has climbed to roughly 46% of gross domestic product. Interest rates have been raised 8 times since December 2015.

This softening is visible in the bond markets, which dictate the cost of borrowing money, and can determine actual economic activity. When company payments skyrocket and corporate earnings slow, the economy will follow suit. In 2018 alone, the U.S. has reduced its stockpile of bonds by nearly $370 billion.

Due to low interest rates, U.S. companies have taken on significant debt over the past decade, and regardless of a recession, will have to address the enormous debt problem. Hedge funds are also feeling the effects, as major hedge funds are racking up negative returns amid bad bets in a saturated market. Hedge funds are having their worst year since the 2008 crisis and nervous investors have pulled $10.1 billion from funds since October.

In 2018 there was 3% growth; it is predicted that 2019 will bring 2% growth and 2020 1% growth, significantly increasing the risk of recession. The financial markets are likely to be the culprit of the next downturn as corporate debt continues to be a potential trigger. Excessive debt can drag on an economy, which impedes the ability of governments to respond to downturns and prolong recessions.

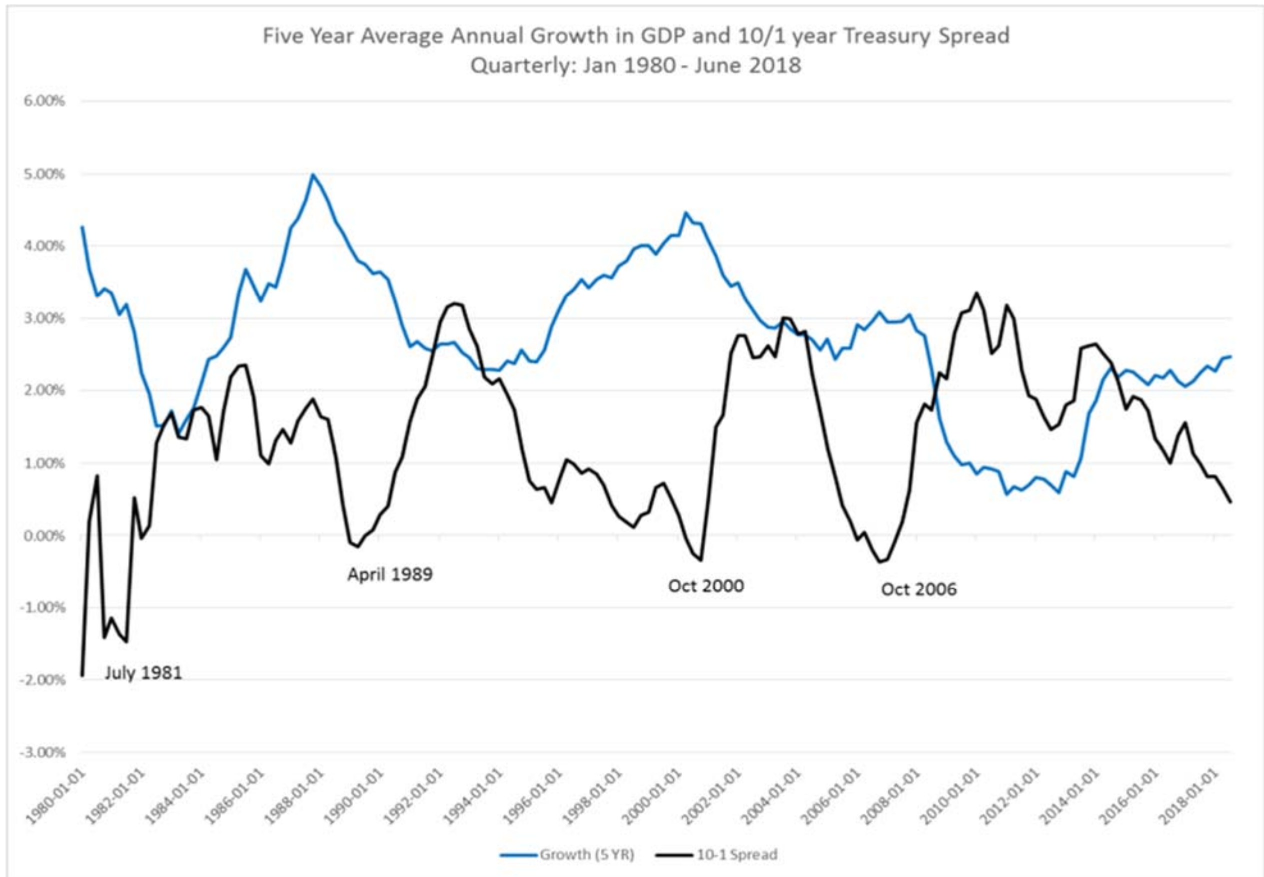
Among the concerns for investors is that the debt incurred since the 2008 crisis hasn't been put to optimal use, and that debt has been curtailed in ways that could hurt the economy. These large amounts of debt have stemmed from merger and acquisition activity. Additionally, a large majority of the debt has been used to buy back corporate shares. This has created a fear for corporations about their credit rating, and if share buy-backs drop, this could have a negative effect on the stock market.

Slowing Global Growth

Firsthand economic figures from Europe and China have added to growing concerns of slowness. China reported weak industrial production and retail data, while a key business index in Europe dropped to its lowest level in more than four years. In Europe, France had the first decline in economic growth in two and a half years, while Italy hovers on the brink of recession and nervous bank executives make sure Brexit doesn't turn into a financial meltdown.

Yield Curve

The most reliable tool used for recession prediction is the yield curve, which is the gap between the two-year and 10-year Treasury yields. This yield is close to inverting; a sign for a coming recession. Inversion occurs when short-term rates are higher than long-term ones and has occurred every prior U.S. recession for the past 50 years.



The yield curve is in a flattening cycle: prior flattening has preceded recessions.

The Nomura Analysis

In the life of a decade-long credit cycle, the global economy's current condition shows it's firmly heading toward a downturn, according to a new analysis from Nomura. The chief Japan rates strategist, Naka Matsuzawa, explains that a single credit cycle is historically a decade long. The beginning is marked by the end of a crisis/a cyclical bottom and ends when credit contracts and the economy enter into a recession. The global economy today is within what Nomura calls the credit expansion/last stage, heading toward a plateau and then a downturn. Matsuzawa predicts that the immediate cause could be a global credit crunch caused by a sharp drop in the credit market, including the US corporate bond market.[1]

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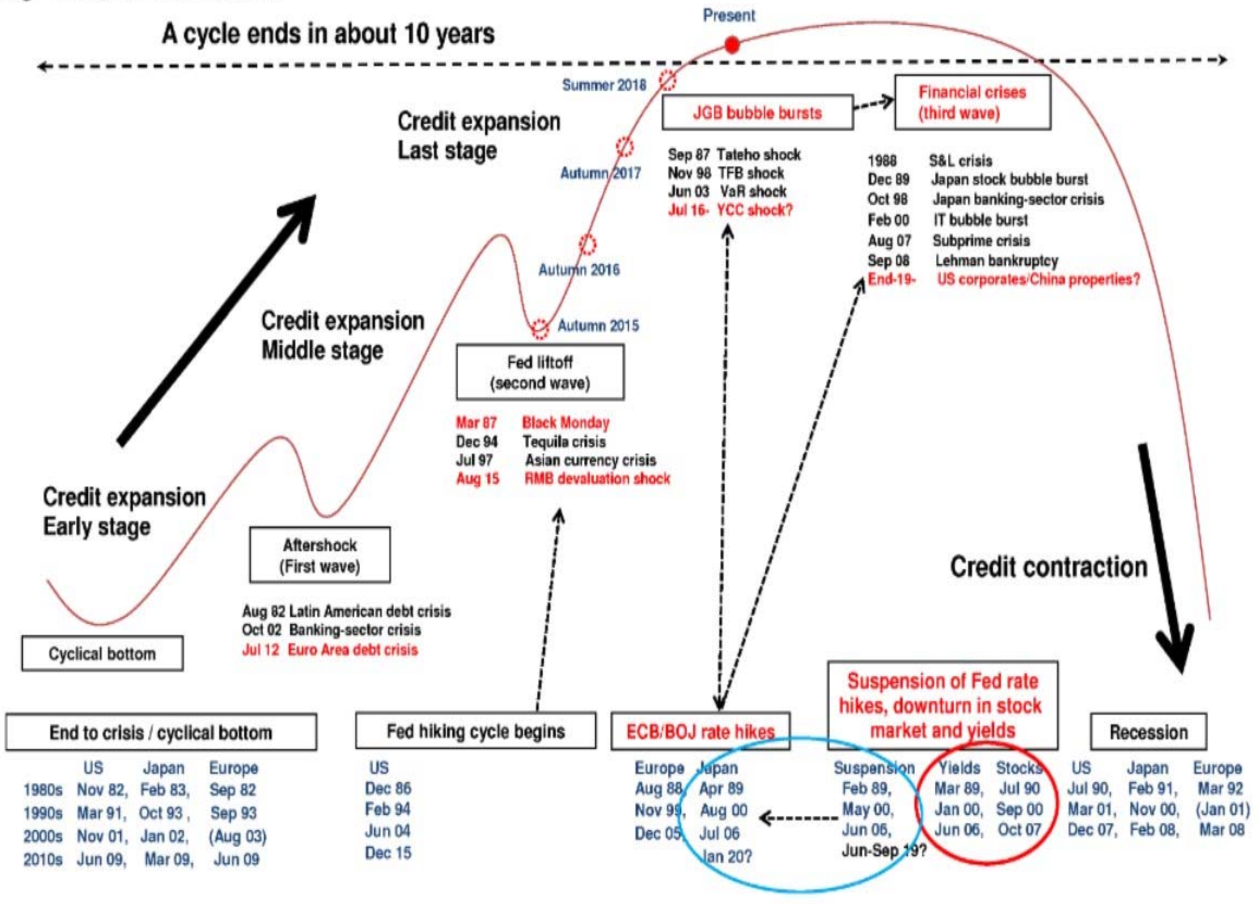
[1] Ungarino, Rebecca. "The Global Economy Is 'Already on an Irreversible Path' to a Downturn, Nomura Says | Markets Insider." Business Insider, Business Insider, 30 Dec. 2018.

Fig. 1: Diagram of credit cycle



Note: The S&P 500 and 10yr USTs are used to denote equities and yields in the downward shift beginning when the Fed stops raising rates.
Source:Nomura

Government Shutdown

The 2019 government shutdown stretched into historic territory, a full 34 days, leaving economists worried about the potential to take a significant bite out of the U.S. economy. Analysts warn that the effects could start to compound and result in a worse economic hit than expected.

Credit Team Strategies to Reconsider Credit Risk in the Face of Recession Risk or Economic Slowdown

Given the various reporting of an economic slowdown, what steps should the credit team consider in order to evaluate whether a heightened credit risk exists and, if so, to mitigate the credit risk?

Reconsidering Credit and Collection Policy

With an economic downturn, many credit teams reconsider their standard credit terms, including discounts. Credit teams also reconsider the risk profile of their A/R portfolio, including redefining the collection strategy and policy on bad debt.

Relationship with Credit and Sales

Any reconsideration of a credit and collection policy requires input from the sales team. The shared goals of credit and sales in an economic downturn means the credit team understands the company's competitive position, and the impact of tightening a credit policy may impact this position. The credit team must keep the sales team updated on their credit decisions and the impact that poor collections has on the credit department and the company. This also means the credit team must hear from the sales team about potential sales and how the credit team can facilitate new sales with a more flexible credit approach, such as with backstopping the added risk in an uncertain economic environment with credit enhancements.

The sales team is also another source of early visibility into a customer's risks that allows the credit team to reconsider its terms and credit line. In this economic environment, the credit team should provide weekly collection history reporting on accounts, including alerting the sales team of planned credit holds.

Rescoring the Customer

Does the credit scoring model parameters need updating in light of an economic slowdown, especially if Sarbanes-Oxley compliant? Should the model be more heavily weighted to payment collectability and solvency? Should an internal score be more weighted to EBITDA, leverage and interest coverage? Should more flexibility in the model be imposed to allow for the credit professional's judgment?

New Account Set Up

In an economic downturn, the credit team should reemphasize that terms and conditions contained in the credit application are required to open the account. Key T&Cs can assist the credit team in identifying credit risk earlier, and provide for a legally defensible strategy to protect the A/R and holding orders.

Due Diligence and Sources of Information

In an economic downturn, the credit team needs to consider a variety of traditional and modern sources of information to create better transparency and identify and validate the risk flags. Whether at the on-boarding stage or account maintenance, the credit team may need to update customer account information more frequently, which includes greater reliance on industry group reporting for small- to mid-sized customers.

Customer Visit

Credit and sales team members should attempt an in-person meeting with the customer to end the silence, assuming a large balance and orders are being held, to share the risk flags the credit team has gathered and offer steps to resolve the credit team's insecurity, such as through credit enhancements discussed below.

Terms Pushback in an Economic Slowdown

In a slowing economy, customers have greater pressure to manage their cash, including building a cash cushion, as orders may fall. Where a TPS is rolled out by a small- to mid-sized customer in a slowing economy, the credit team should re-score the customer to determine whether the TPS is motivated because of the customer's deteriorating financial condition. If the re-scored customer shows significant credit risk, should the supplier move to extended terms and evaluate risk mitigation alternatives?

Validating the Credit Risk Flags

In an economic downturn, the credit team should have a protocol for confirming the risk flags embodied in the revised credit and collections policy. When risk flags are identified, the credit team should have procedures for promptly validating the risk identified, whether provided by suppliers, customers or third parties.

Credit Enhancements to Preserve the Trade Relationship in a Slowing Economy

In the face of a slowing economy, the supplier may consider credit enhancements to backstop credit risk. The following may be negotiated by the credit team.

Letter of Credit

L/Cs are independent from the supplier. The bank honoring the L/C is concerned that the documents conform to the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the customer. The L/C's independence of contracts allows the supplier to avoid the customer's credit risk.

Credit Insurance

CI covers credit risk that may result from an economic downturn. The CI generally covers up to 90% of the insured account. The insurance policy, however, may allow for the insurer to pull coverage of a high risk account.

Guaranty

A guaranty, whether personal or corporate, may be used to offset a customer’s increased credit risk as a result of an economic downturn.

Certificate of Deposit

A CD may be issued by the customer's bank in the name of the supplier. The CD is unconditionally payable to the supplier upon demand, is funded by the customer, and automatically renews for the length of the credit line. The limits of a CD for supplier credit risk is the ratio of deposit to credit line, commonly not greater than 30%, leaving the supplier at risk with a customer default.

Purchase Money Security Interest

Under Article 9 of the UCC, the supplier may take a security interest in the goods it sells, as well as the proceeds from the sale of the goods. The supplier must get a signed security agreement from the customer describing the goods covered in favor of the supplier and file a financing statement with the Secretary of State. The PMSI primes the customer's lender blanket lien provided the supplier also gives written notice to secured creditors. The PMSI allows the supplier to preserve credit terms yet mitigate credit risk as a result of an economic downturn.

Consignment

Unlike PMSI, with consignment, title to the supplier's goods is not transferred until the goods are sold. A consignment agreement is signed by the customer, a financing statement is filed and the supplier must give written notice to secured creditors. As with a PMSI, a consignment agreement is a negotiation with the customer. In the face of an economic slowdown, the credit team, with the support of the sales team, may condition credit terms with this enhancement.

Responding to Economic and Customer Credit Risk Flags

The credit team’s options, once economic and customer risk flags have been confirmed, range from holding orders and meeting with the customer (credit and sales in-person call), to converting credit sales to cash, stopping goods in transit, and reclaiming goods to terminate the trade relationship.

Demand for Assurance of Payment

Where the credit team has an open order and has grounds to believe the customer may not pay, the credit team may demand written assurance of performance. If the customer does not provide such assurance within a reasonable time, the credit team may suspend deliveries.

Turning a Credit Sale into a Cash Sale

Where the credit team accepts a PO requesting terms, but determines the customer may not be able to honor the credit sale, the credit team may insist on COD before releasing the order.

Stopping Goods in Transit

Under Article 2 of the UCC, the credit team may stop goods in transit where it is discovered the customer is insolvent. Once the goods have been received by the customer, or controlled by a third party, the right of stoppage is lost.

Reclamation

Reclamation is the right of the supplier to recover possession of goods delivered to the insolvent customer. The credit team must make written demand for the return of the goods within ten days (or in certain cases twenty days) after being delivered to the customer, which is governed by Article 2 of the UCC.

Repayment Agreement

A repayment agreement can be used to cure the delinquent account, as opposed to resorting to litigation or a collection agency. The repayment agreement can be based on time, as well as charging a premium for new POs placed by the customer. The credit team should include as many terms and conditions necessary to provide them with the greatest leverage.

Credit Team Takeaways

Given the predictions of heightened recession risk, or economic slowdown, seasoned credit team members will lead the reevaluation of account risk, while educating junior team members (who may have only experienced expansionary times and low bad debt) about reducing their A/R portfolio credit risk during a recession or economic slowdown.

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