Managing credit risk in scrap recycling

by Jason Dworin

Considering today's challenging global economic environment it is vital to understand the financial and credit risk your company faces. Businesses cannot afford the uncertainty and financial risk of excessive payment delays, cash-draining delinquencies, or worse, bad debt write-offs.

Many scrap recycling businesses have traditionally relied on "The Relationship Approach" to manage their credit risk. But the days of a handshake being good enough are long gone. Businesses can't afford to think they know a company, based upon what a buyer or executive has told them. Many credit decisions are often wrongly influenced by long-standing relationships with a strong personal connection, but without sound, objective analysis. This is a very ineffective way to manage credit risk. Credit decisions based solely on intuition or a gut feeling are a recipe for poor financial results. Emotion needs to be taken out of the credit decision process. Decisions need to be made based upon objective data that delivers a clear, accurate view of a customer's credit profile.

Too many businesses rely on a customer's historical payment record as a way to manage credit risk. This method is widely used and deeply flawed. Unfortunately, in many insolvency cases, customers are paying suppliers in a timely fashion right up until the filing date. A warning sign is not always provided via payment deterioration, and many will see timely payments up until the one time the payment doesn't come at all.

It should also be noted that a customer's payment information does not provide good insight into how that customer is paying other suppliers. A business could be getting paid on time while one of its customers stretches its other suppliers well beyond terms. If this business is a critical supplier they have no idea others are not getting paid. Again, this is hardly a prudent way to manage credit risk. The customer only needs to default one time on a payment for a business to be caught with a big exposure.

Depending on mass market credit reporting services is another common and rather marginal credit risk management approach. To be truly effective, credit reporting should be industry-specific and handled by analysts who specialize in that sector. The broad market credit reporting products that many in the industry rely on today are based on publicly available and self-reported information that is often dated and can be inaccurate. Non-industry-specific providers can be spread too thin across every business category to provide real insight and decision support that is of measurable value to a recycling company.

Effective ways to manage credit risk

It's a simple fact of business that every sale puts capital, profit and net worth at risk. Companies need to find effective ways to manage such risk, especially given today's uncertain environment.

So what can owners and managers do to protect a company? To start, a paradigm shift needs to take place. That means acknowledging that credit risk is a serious – even potentially fatal – threat to any business. It means setting up procedures to aggressively address credit risk on an on-going basis. Ideally, it also means putting someone in charge of managing credit risk, and most importantly, giving them the resources and time to do the job. In reality, most scrap companies can't afford to employ a full-time credit manager, so this role should at least be filled by an existing staffer with some financial experience.

A good credit policy is an essential component and a fundamental part of a successful business strategy. It is critical to design and implement a policy to mitigate future credit loss potential and to capitalize on new revenue opportunities. Policy must account for all phases of the credit life cycle – from account acquisition through collection. Businesses need to evaluate historical performance data, focus on goals and determine a company's appetite and tolerance for risk. Establishing a sound credit policy aligned with your overall business strategy, following it, and having a clear understanding of how the policy affects revenues and profits are key drivers of success. A well written policy and its implementation will ensure that revenue converts into cash while avoiding potential loss situations.

Consider partnering with an industry specific credit reporting service with core expertise in the recycling industry. These niche companies understand the industry better because they are following it closer, including the markets of customers and the related supply chain. They have the ability to obtain information from market derived relationships with access to multiple industry participants selling the same accounts. Acting as a third party, these specialized reporting services are able to leverage their unique relationships to secure industry specific payment and financial information. This often also helps avoid competitive threats.

A recycling business should also consider implementing an accounts receivable insurance program. Credit insurance can provide substantial benefit to a company in a number of different areas, including protection from catastrophic credit losses, the ability to extend open credit terms and capture additional sales above a company's internal risk appetite, enhancing receivables based borrowing arrangements, and providing some level of credit decision support. A properly structured credit insurance program can more than pay for itself while removing the risk of a large, unexpected credit loss.

Extending credit is a necessary element of doing business. So the decision companies must make isn't whether to grant credit, but rather how to mitigate and manage the risks when doing so. The bottom line is that extending credit without meaningful insight can put any business at great risk, or conversely, not extending credit when perceived risks are not real can stunt growth potential.

ProfitGuard (PG) was founded in 2000 to meet a growing need for credit information in the U.S. and Canada and is the only credit reporting firm in the metals industry today. Currently, PG serves 18 of the top 20 scrap processors among many others, and is active in ISRI, CISA, CARI, NACM and many other trade organizations in the metals segment.

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