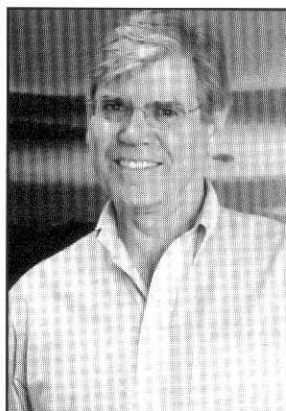


Customers Will Fail To Pay, But Which Will Fail And When?

Scenario Planning would benefit Credit Risk Management

By Ron Wells,
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As amounts of unsecured credit grow ever larger with the relentless increases in input costs – based on commodity and logistic shortages – but consumer prices are suppressed by excess supply, credit managers are increasingly concerned to judge which of their customers will fail, and when.

The question is: should we suffer “the slings and arrows of outrageous fortune, or ... take arms against a sea of troubles, and by opposing end them?”

The answer is obvious: we cannot sit on our hands while our employer companies slide toward the waiting abyss of bad debt. It is incumbent on professional credit managers to find a way to identify the unfortunate, the badly managed, the naively managed, the fraudulently managed, and the carelessly managed companies that are unlikely to survive.

While your CFO diligently watches DSO statistics - useless and misleading as they are – and traditional credit managers rely on the hopelessly outdated Z-score, or the questionable value of “through the cycle” S&P or Moody’s credit ratings, to foretell the future demise of this or that counterparty; there is something useful you can do to prepare the best possible defence for your company.

We have all been trained in the traditional art of credit management, with its emphasis on financial analysis and the scrutiny of umpteen ratios. All our training and processes are based on the belief that the future can be extrapolated or “foretold” by looking back at the past; all are useless in the present environment. All are built on the erroneous and often disproved assumption that next year will see progress from the base of last year. Those rear-view mirror gazers who run so many companies need to know that “*change has changed.*”

No longer is it additive. No longer does it move in a straight line. In the twenty-first century, change is discontinuous, abrupt, (and) seditious. The age of progress is dead. We now stand on the threshold of a new age – the age of revolution. In our minds we know the new age has already arrived; in our bellies, we’re not sure we like it. For we know it is going to be an age of upheaval, of tumult, of fortunes made and unmade at head-snapping speed. (*Leading the Revolution* - Gary Hamel)

The future is where we will be paid or not paid by our customers. Hence as credit managers we need to understand what the future may hold so we can prepare a range of plans that best fits what materializes in the fullness of time.

An understanding of what the future may hold can be gained through the use of the Scenario Planning technique.

Scenario planning derives from the observation that, given the impossibility of knowing precisely how the future will play out, a good decision or strategy to adopt is one that plays out well across several possible futures.

These sets of scenarios are, essentially, specially constructed stories about the future, each one modelling a distinct, plausible world in which (*Continued on page 26*)

About the Author

Ron Wells is a Credit Manager for Chevron Corporation’s office in London. Ron is an active member of the International Energy Credit Association (IECA) European Division and the Association for executives working in Finance, Credit and International Business (FCIB). He is the author of *Global Credit Management* - an Executive Summary, published by John Wiley & Sons Limited. This is a concise but authoritative work that exposes the power of credit (see www.barrettwells.com/gcm.html for details). The Chinese version of this book has now been published and is an ideal credit tool for Chinese business executives, see www.l3plimited.com for details. His free access international credit management web site www.barrettwells.co.uk is highly regarded as a valuable resource for those interested in trade finance and business-to-business credit management. Ron’s email address is: ron.wells@barrettwells.com.

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“The way forward ...is to create stories of the future ...then look back from the vantage point of those futures to identify which customers are most likely to have failed along the way”

we might someday have to live and work. (*How to Build Scenarios* – Lawrence Wilkinson)

The way forward for credit managers then (not being bean-counters of the 19th century but rather each one being the remarkable synthesis of economist, commercial lawyer, negotiator, management accountant, business manager, detective and master strategist) is to create scenarios of the future for the market or industry in which their customers will be operating. Then to look back from the vantage point of those futures to identify which customers are most likely to have failed along the way.

A scenario is not a plan, it is not a projection of current trends; yes the future begins from where we find ourselves today, yes the future is shaped by forces we see existent today - if we open our eyes wide enough and shake off assumptions - but it is also shaped by the future actions of men and women of vision, it is shaped by disruptive technology, and it is shaped by unexpected pivotal events, like the fall of the Berlin Wall.

Scenario planning does not offer the security blanket of a single forecast.

What it does do is create plausible “stories of the future”. These enable one to pick up the signals and search out the clues to the future. Scenarios are learning stories ... the process of working through them (and) experiencing them, is as important as the conclusions. (*Russia 2010 and what it means for the World* - Daniel Yergin and Thane Gustafson)

It is ironic that many of the companies that suffer a sudden reversal of fortunes are those that up until the onset of their demise are the most successful in their field. Unfortunately

too many such companies cling on to the formula that created their success, and institutionalize it when they should be changing as the competitive environment changes. According to Robert Heller, writing in *The Fusion Manager*, “Five Fatal Flaws interplay and interrelate to produce incompetence and inertia” within companies that have been successful. These take root well before trouble becomes apparent through reported financial results. Heller lists these flaws as:

Denial: Management has such a high opinion of itself that it cannot accept criticism of its operations.

Systemic failure: The organisation is geared to continuity, not to systematic, radical improvement and reform.

Bureaucracy: The layers of command and control slow down reactions.

Complacency: A rich cash flow cushions any sense of urgency.

Conservatism: Dissenting voices are ignored or suppressed by senior managers who are sure that they know better.

Scenario planning cannot provide the sort of precise answers that are available to those analysts who are looking back into the past, with ratio calculators in hand. However as we consider how poorly such precise backward-looking answers have served analysts in the past we must conclude that a new approach is required. How many of the Rating Agencies and traditional credit managers predicted the spectacular failures of recent history, before it was too late for hapless creditor companies and banks? None

In good conscience we cannot cling on to precision in the same way as an insecure child clings to a tatted piece of rag, we must explore new methods to enable the support and promotion of our companies’ sales, while protecting their future survival.

It is not good enough after a bankruptcy occurs to say: “the ratios were good, and they always paid on time”. Rather be the credit manager to say, “their strategies didn’t make sense in terms of any reasonable future scenario, and their business model was inflexible, so we withdrew open credit months ago”. ■