Credit Limit: How to manage the credit you extend to your clients?

Minimise credit risk for your business by setting the right credit limits for your clients. Here is what you need to know about credit limits.

What Is a Credit Limit?

To encourage larger orders, build customer loyalty, and offer a competitive advantage, it is common practice to extend credit to other businesses you work with. This method of financing between two companies – also known as trade credit – facilitates the purchase of goods and services without the need to resort to traditional loans. Based on your clients' credit history and on the financial soundness of their organisations, you will have to determine a reasonable credit limit. Here is what you need to know.

What is a Credit Limit?

The term "credit limit" refers to the maximum amount of credit your company can extend to a client. This means that you will agree to provide the goods or services your client wishes to purchase without receiving immediate payment for the corresponding invoice. Instead, the client company will proceed with the payment after a certain period of time, which will have been decided in advance.

The credit limit is there to minimise risk on your end, as the consequences of a late payment could otherwise be damaging to your own balance sheet. The amount of the credit limit should never be based on a rough estimate of how much you could bear to lose. Instead, it should depend on how much you can allow your customer to borrow from you without increasing default risk on their part. As a supplier or service provider, it is up to you to learn enough about your clients to be able to calculate their credit limits.

Taking the right precautions is essential if you wish to manage the risks associated with extending credit.

Credit Limit: Running Business Credit Checks

Extending credit is not without risk, which is why you need to do your due diligence on setting the right credit limit and, most of all, on selecting the right partners in the first place. Using a reliable database to find new business partners allows you to be proactive and to access key insights into their creditworthiness. Running a credit check on every potential customer gives you the edge when negotiating the terms of your business relationship. This is common practice across industries, and they should be willing to submit to this assessment and eager to prove their ability to pay on time. Any refusal should be interpreted as a red flag.

As for your existing clients, you can check their credit scores and ratings at any time. Using automated tools, it is possible to examine the context in which they evolve, including the political, environmental, and operational risks they face. An even sounder strategy would be to monitor the situation and to increase or decrease the credit limit you extend to your clients based on their current performance, in addition to their credit history.

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The Right Credit Management Strategy?

Some companies are reluctant to set strict credit limits because they fear this precaution may be interpreted as a lack of trust. On the contrary, knowing exactly how much available credit should be granted to each client can create opportunities for both parties.

Credit Monitoring

To be able to update your credit policies as necessary, you need to not only generate a credit report to assess the reliability of every new partner, but to keep an eye on the credit rating of every business you work with. Focusing all your attention on the credit score of new borrowers may leave you blind to developing issues within your existing client base.

Using a credit risk management solution that can monitor your customers' creditworthiness is the best way to be alerted whenever a partner shows any sign of financial struggles. This allows you to be proactive and to make the right business decision to minimise risks. You can choose to change the credit limit you extend to them so that it matches their credit score.

While credit monitoring is not there to help you predict the future, it can be used to track highly relevant financial data reliably and will call your attention to any significant changes in your clients' behaviour.

Setting your Own Limits

Basing the credit limits that you extend to your customers solely on their ability to honour their commitments may be insufficient to ensure your own stability. Having too much money out in the form of debt owed to you – even if you are certain that the payments will eventually arrive – could jeopardise your business's financial health. If a credit limit increases because a client is able to afford it, it doesn't mean that it won't impact you negatively.

Remaining flexible in how you set credit limits and taking your own performance into account is key if you wish to increase your growth and reduce your risk. This is not to say that there isn't any room to take measured risks if you have determined that it would ultimately benefit you.

A good way to establish a sound risk policy is to broaden your understanding of the environment you are operating in. For example, Coface Cross Border Network gives you access to a wealth of information about connections between companies and directors in the CEE region. Thanks to this functionality, you can explore other organisations through the relationships they have with others.

Building Trust

In an ideal world, every client would pay their invoices on time, and you wouldn't dream of parting from any of these precious partners. In reality, it's more complicated than that, which makes it all the more important to nurture the good business relationships you do have.

As a supplier, you can choose to offer discounts to clients who repay their debts early, thus encouraging them to make larger purchases. You could also submit your positive payment experiences with them to credit bureaus to help strengthen their credit scores and ratings.

Establishing the appropriate credit limit with every customer is the best way for organisations to both cultivate good business relationships and to look after their own growth and success. With the right credit risk management solution, you can reassess your need to increase credit limits or lower them based on real-time information.

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