Credit Basics: Setting Credit Limits

It seems that no two companies are alike when it comes to actually setting a customer's credit limit, but doing so is often more art than science. Here are some factors and strategies companies consider when they tell their buyers just how much in the way of goods or services they can borrow.

-**Payment Record**: This works when the customer in question actually has a payment history with your company. Pay on time or early and the credit limit goes up. Pay late, or not at all, and a credit review process is triggered. This is a sales department's favorite method for setting credit limits because it incentivizes buyers that pay better to buy more.
-**Competition**: If your competitors are offering *x* amount of dollars then it behooves your company to offer something similar, lest a lower limit box your company out of potential sales. This is a difficult factor to evaluate if your company is much smaller or larger than your competitors, or if it plays a different role than other suppliers.
-**Security**: The presence of lien rights in certain transactions makes it a lot easier to set higher credit limits.
-**Payment Performance**: Often effective when the company has a conservative risk appetite but is looking to take on new customers, this basically starts new buyers with little in the way of payment history off with a lower credit limit, but rewards them as they pay. Sales is less of a fan of this philosophy, because it slows sales growth.
-**Period of Time**: A method wherein the amount a customer can purchase over a designated period of time, be it a week or a month or otherwise, cannot exceed the established credit limit. This can speed up the order approval process since anything that fits within the given credit threshold can be approved.
-**Agency Rating**: Companies can create a matrix wherein a certain agency rating on a credit report garners a specific credit limit.
-**By Formula**: When setting a credit limit companies can take into account a number of different calculations that suit their specific needs and then establish a way to combine them, divide them and then average them to set a credit limit. This depends on data availability though, as some of the more important figures on a new customer might not be available. Companies that use a formula also tend to rely on it as a preliminary tool that's then extrapolated using other methods into an actual appropriate credit limit.
-**Expectation of Use**: This method takes the expected dollar volume of credit sales over a period of time and then divides it by the number of expected orders over the course of the same period, and the result is used as a basis for a preliminary credit limit estimate.
-**Collection**: Like a secured investment with slightly less security, the more confident a company is that any receivable is able to be collected, the easier it is to set higher limits since whatever sales are made are expected to be collected.

Source: NACM-National