Patterns in Markets and Financial Statements to Be Mindful of When Making Risky Credit Decisions

When working with customers, paying attention to the volatility of the current market can be a deciding factor when extending credit to a new or existing customer. Terms can be impacted by the state of the current economy, and customers may have complications in their industry due to bullish or bear markets.

With any trends in the market, taking note of patterns from past recessions and flourishing markets can aid in making credit decisions, despite how unpredictable a certain market can feel at times. According to a recent webinar by Moody's Analytics titled "Navigating Choppy Markets: Focus on Asia," Asian and American markets are becoming increasingly risky, but this pattern of risk does not deviate from patterns of the past.

When looking at the data, Director of Research Samuel Malone, Ph.D., and Associate Director of Senior Research Analyst Team Yukyung Choi analyzed the economic risk outlooks from the past 10 years, focusing on the 2008 recession and data from 2018.

"During the financial crisis, both measures [of credit risk] spiked significantly [in the U.S.]. The deterioration probability metrics began to rise a little more quickly before the event, but both experienced a significant jump in 2008, then a significant spike in 2009," Malone said during the webinar. "… At the end of 2018, we saw the equity market in the United States experience some significant volatility in October, and a partial recovery following that."

During the Great Recession of 2008, deterioration probability (DP) spiked to about 25%, then saw a major decline by 2010 and 2011 at less than 7%. Before the spike in 2008, risk remained low, with DP in 2004 at around 12%. Looking at the DP from 2016-18, 2016 saw a spike then a sharp dip moving into 2018 from about 12% to about 7%.

With such low DP percentiles in 2018, Malone said, "All good things must come to an end." Like the patterns seen in the U.S.' DPs, several Asian countries saw similar patterns to those in the U.S. in 2008 and in 2018.

"You can see that the deterioration probability is steadily increasing. It actually doubles twice until the downgrade happens," Choi said during the webinar. "Our data clearly shows that there is a warning [before] the company has since downgraded."

Keeping patterns in mind will help a credit manager to mitigate risks in the future, whether doing business in the U.S. or abroad. While much of Moody's analysis stemmed from the U.S. and Asia, a common thread of detective work can be found between the two world markets. If the similar payment patterns that occurred during the 2008 recession are appearing again now, there may be trouble ahead.

Combined with due diligence, keeping an eye on domestic and global markets' trends can help to mitigate serious risk when dealing with a new or returning customer. Suspicious patterns can be best spotted in financial statements as well, which once obtained, can paint a clearer picture for the credit professional on whether a customer can conceivably pay for something.

"If a company really wants to improve their view of how a customer is doing, they should be asking for financial statements, even if it's something they think they won't get," said Larry

O'Brien, CCE, ICCE, senior director of corporate credit at Nutrien, Ltd. "And if you get those, you have to actually look at the statements, translate the currency, etc. Those statements may not be audited all the time, but as long as you're getting statements every year, you can still build a trend of how the company is doing, even with un-audited statements."

Due diligence never hurts when extending credit, but playing the part of a detective and thinking critically about suspicious patterns can make all the difference in a credit decision.

—Christie Citranglo, NACM editorial associate