International Journal of Business and Applied Social Science

E-ISSN: 2469-6501
VOL: 8, ISSUE: 6
June/2022
DOI: http://dx.doi.org/10.33642/ijbass.v8n6p7

Credit Risk Management in International Trade Based On the Research of China

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ABSTRACT

International trade is always accompanied by high risks due to its characteristics: complex, involving many counterparties, and time-delay. Among those risks, credit risk is the issue that Chinese foreign trade firms should take into grave account, under the influence of RCEP and Covid-19. This paper will point out the limitations of some foreign trade enterprises through a case study and provides relevant suggestions: building a credit rating system; gaining more information about the counterpart; establishing a comprehensive risk management system. This paper is expected to help foreign trade enterprises manage their credit risks and make preparations for the new period after RCEP comes into effect.

KEYWORDS: Risk Management, Globalization, Goods transaction.

1. INTRODUCTION

1.1 Background

1.1.1 International trade is risky

International trade has a high degree of complexity, its risk permeates each link of the transaction (Qu, 2010). First of all, in international trade, the transaction parties are far away from each other, which usually leads to obvious time and space barriers in communication. Therefore, information asymmetry may occur. The unfamiliarity between the transaction counterparties and the difference in their information mastery may fail the transaction or even fraud cases. Secondly, the contract performance cycle of international trade is long and involves many subjects. In the performance of the contract, not only the parties to the transaction should abide by their contractual obligations, but also the cooperation of the carrier, the freight forwarder, the bank, and the relevant government management departments, from the transfer of goods to the payment and settlement. Changes in any of these factors may induce potential risks. In addition, due to the influence of national regions, the binding force of laws on international trade is ultimately limited, and there are differences between laws of different countries, so risks will inevitably occur in legal loopholes. In the face of ubiquitous risks, risk management is an indispensable means to ensure the smooth progress of trade.

1.1.2 Credit risk is needed to be alleviated with RCEP signed

The policy of opening to the outside world is a strategic decision that China will not waver in. In particular, the RCEP entered into force on January 1, 2022, and China's foreign trade has reached a new historical level. However, on account of the economic ties and interdependence of the whole world deepened by economic globalization, the economic and financial crisis which breaks out in any country or region in the world would quickly spread to the whole world and aggravate the global economic turmoil. For example, in the 2008 US subprime mortgage crisis, due to the deep economic relationship among global nations, China's export growth rate declined significantly, and the default rate of overseas enterprises of China's counterparties increased significantly. In addition, ASEAN, China's largest trading partner, the RCEP important member of the association of Southeast Asian nations, its sovereign credit risk is also noteworthy. From the research report provided by Dagong Global (2021), it is easy to find that under the impact of faulty economic structure and epidemic situation, in Thailand, Vietnam, the Philippines, and other Southeast Asian nations, the atmosphere of debt-paying ability is not strong, lower than the international average level. The report also shows that the non-performing loan ratio of the ASEAN banking system in 2020 has overall increased compared with 2019, especially in the Philippines, which has increased from 2% to 3.5%, indicating an increase in credit risk. Therefore, it is not difficult to foresee that with the further expansion of the foreign trade scale, new trade disputes will approach. To expand foreign trade more comprehensively, realize trade liberalization, and safeguard the interests of domestic enterprises, it is significant to distinguish and manage the risks in international trade, promote the standardization and safety of trade, and protect China's foreign trade enterprises from the impact of trade risks.

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1.1.3 Covid-19 exacerbates credit risk

In 2020, the COVID-19 pandemic disrupted much international trade and hindered production. On the whole, the spread of the epidemic overseas has lowered the expectation of global economic growth. The downturn of the global economy, the decline of disposable income of residents, and the failure of weak production to stimulate enough consumption have led to a sharp contraction of external demand. Owing to the significant decline in the expectation of consumption, importers may directly abandon original orders and exporters will probably face the risk of default. Furthermore, Hao et. al (2022) illustrate that the contraction of consumption demands in Covid-19 will exacerbate the sovereign credit risk. Additionally, the epidemic situation is gradually identified as force majeure in the law of China. In many cases, the breaching party can exempt itself from liability for breach of contract by the epidemic situation as force majeure. For Chinese exporters, such credit risk losses cannot even be compensated.

1.2 Issue Description

1.2.1 Definition

Traditional credit risk can be an issue of whether a loan should be granted and, after a loan has been granted, evaluating the risk and the possibility of default (Lando 2009). In terms of international trade, credit risk can refer to the uncertainty that the export enterprise cannot fulfill the payment for goods on time or in enough quantity or import enterprise cannot receive the goods on time or in good quality due to some factors including counterparty itself, the commercial environment or a third party involved in the transaction process.

1.2.2 Purpose

Risk management is an issue that foreign trade enterprises must face. Credit risk, as a chronic sore point of Chinese foreign trade enterprises, has troubled the development of enterprises. This paper will discuss cases and put forward corresponding suggestions to help enterprises manage credit risk, and provide certain reference significance for future foreign trade.

2. METHODS

2.1 Case analysis

As a method that analyzes and studies typical problems in practical work, case analysis is relatively less abstract. In this paper, two cases were selected as the object of analysis and research and corresponding suggestions will also be provided. It is expected that through analyzing typical cases, the limitations of foreign trade enterprises can be exposed.

2.2 Literature review

In this paper, through literature analysis, collation, and collection of literature related to international trade and credit risk, learning operational problems of real enterprises, practical credit risk management suggestions have been put forward.

3. LITERATURE REVIEW

In the field of international trade, many studies have been issued to manage the risks. This paper mainly focuses on the credit risk in international trade. Qu (2010) argues that international trade is a complex and risky procedure, containing transport risk, exchange rate risk, and credit risk. Hao et. al (2022) also indicate that the Covid-19 pandemic which leads to economic recession and the contraction of consumption may cause more defaults, making credit risks more serious. To help foreign trade firms alleviate those credit risks, Enterprise Risk Management which provides a more comprehensive risk management structure (Hoyt & Liebenberg 2011) may be an effective strategy.

4. DISCUSSION

In this part, two typical cases will first be analyzed and corresponding suggestions will also be given.

4.1 Changhong company and APEX Digital

4.1.1 case introduction

In 2001, Sichuan Changhong company in China began to engage in business with APEX Digital. In that year, APEX did not collect the payment. APEX owed $41.84 million. In 2002, Sichuan Changhong company offered goods to APEX Digital worth $610 million, while it only received $190 million back, forming the account receivable of $462 million. In 2003, Sichuan Changhong company continued to sell goods for $424 million to APEX Digital. Although Changhong company received $349 million, the balance of accounts receivable has been increased to $537 million. In 2004, Sichuan Changhong ended its business with APEX Digital, with transactions of $35.59 million, and increased the intensity of the receivables, reclaiming $109 million. However, after four-year business, $463 million in receivables have been accumulated. Sichuan Changhong sold goods for $1.113 billion to APEX Digital, while only getting $649 million returned.

4.1.2 analysis

Regulatory omission by factoring companies is a crucial cause. In this case, the two parties reached an agreement on the account. APEX transferred the sales account to a third-party factoring company, which then transferred 90% of the account to Sichuan Changhong and 10% to APEX. However, the biggest risk and loophole, in this case, is that part of the accounts has not entered the factoring company. To facilitate the circulation of goods, APEX did not import part of the accounts to factoring companies due to the efficiency of factoring companies in the processing of accounts underwriting and premium. In international trade, due to the problem of regional all payments involve a third party, and in this case, there is a dereliction of duty of the factoring company in supervision. It should examine the payment of APEX Digital in time and the factoring company ought to have the information on how much APEX Digital should deposit in the factoring company, find the missing payment in time, and urge APEX to make payment in time.

Sichuan Changhong company failed to cut the loss in time. It took four years for Sichuan Changhong to realize the

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seriousness of the problem with APEX Digital. In this case, Sichuan Changhong's risk exposure was often several hundred million dollars, which was not a small deal around the 2000s. Changhong should have stopped the transaction timely when it found that the payment return rate of the previous two years was low, and asked APEX to repay in time. Moreover, it should have found a professional auditing institution to supervise the payment flow of APEX, instead of allowing the receivables to grow.

4.2 H Company in China and Indian customer

4.2.1 case introduction

This order is the first order of H Company in the Indian market. The settlement was "15% advance payment +85% DP AT SIGHT". However, the customer in India has not paid the advance payment in time, claiming that he would accomplish the payment 100% after the goods arrive at the port. The salesman of H company thought that under DP payment, even without advance payment, H Company could still control the ownership of goods, and the buyer could not pick up the goods without payment. Meanwhile, the goods in this order are not customized products and are highly convenient to resell. As a consequence, the salesman, without the approval of his superior, agreed to the buyer's request without advance payment. However, after the goods arrived at the port, the buyer suddenly lost touch and failed to pay for the goods. Furthermore, according to the regulations of Indian ports, even if the exporter has the right to the goods, the exporter needs to provide the "certificate of no objection" issued by the original buyer to return the goods. The buyer has already lost touch, let alone the certificate of no objection. The result is that as the costs of demurrage and demurrage increase day by day, the goods of H Company also face the risk of being confiscated by the customs.

4.2.2 analysis

The biggest problem, in this case, is the excessive confidence of the salesman in the operation. It is an operational mistake. It can be seen that the salesman has a certain awareness of risk control and has considered reselling the goods in advance to make up for the loss if the buyer breaches the contract. However, he did not inform the superior of the buyer's requirements and doubts, and he was not familiar with the trade rules of India, so the backup plan in advance was invalid without the buyer's "certificate of no objection". This case directly reflects the company's risk management loophole: 1. in the face of the actual changes to the contract payment by the buyer, the salesman didn't realize the risk at a deeper level, not report it promptly. More seriously, all other departments in the company did not find the wrong operation of the salesman. If the risk mechanism of the company is advanced and the information is transparent enough, the financial department should quickly find out the non-compliance that the goods are sent without any advance payment and promptly hold the salesman accountable and stop the loss. 2. Risk management department and business department have not the timely performed evaluation of the Indian market. In this case, the Indian market is a new market for H company. For the new market carefully understanding related trade rules to avoid trade disputes is extremely important. Because of the lack of understanding of Indian goods return rules, H Company even failed to reclaim the goods. To sum up, the importance of establishing a complete integrated risk management mechanism within the company is seen in this case.

4.3 Suggestions

4.3.1Credit rating system

Enterprises can conduct credit rating management for customers, establish their internal credit rating system, and divide the number of transactions, corresponding payment methods, and transaction duration according to customers' credit ratings. For example, as an exporter, if the customers are with good credit ratings, export enterprises can sign larger orders, deliver goods in advance, and choose to implement the preferential settlement method of cash on delivery for importers. Customers with poor credit ratings, choose to conduct smaller transactions, require the other side to make an advance payment, and supervise the capital flow of the importer promptly. If it is a new counterparty, the company does not have the corresponding internal rating data, consult a professional rating agency, to be cautious about the credit of the counterparty.

4.3.2 To gain more information about the counterparty

The nature of international trade determines that both parties to a transaction have limited information about each other. To ensure the transaction smoothly, and maintain the interests of the enterprise itself, especially when faced with a huge value order, the enterprise must strive to carefully investigate the current operating conditions of counterparties. whether the short-term cash flow circulates well, whether the counterparties of the company is legal compliance, and whether counterparties have enough ability to perform the contract. A detailed understanding of the current situation of the counterparty is always needed before large orders are made.

4.3.3 To establish a comprehensive risk management system

On the one hand, enterprises should attach importance to risk management, implement comprehensive export risk management measures, set up risk management departments to assess and manage export risks, and make corresponding risk management plans when signing contracts with different counterparties. Meanwhile, firms are supposed to reasonably control risk exposure, take the risk-bearing capacity of the enterprise as the benchmark, and control business and capital investment on a rational scale. On the other hand, the company should introduce Enterprise Risk Management (ERM) to carry out comprehensive risk management. The board of directors decides the clear risk appetite, forming a holistic risk management atmosphere in the whole company, and every

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employee should have a risk management awareness. At the same time, information data flow barriers within the enterprise should be broken, and data of the whole enterprise should be integrated and presented. Since risks are often correlated, the optimal solution can only be found by realizing the free flow of information between various departments and taking into account the risks of the whole company through ERM mode (Hoyt & Liebenberg 2011).

5. CONCLUSION

The above has discussed the necessity of credit risk management from multiple perspectives: the high risk of international trade itself, the expansion of opening-up will increase trade risks, and the aggravation of the epidemic to credit risks. This paper also points out the defects of current enterprises on credit risks, inclusive of low reliability of certain third parties, lack of risk awareness, and improper operations of employees. Finally, three corresponding suggestions for foreign trade companies to prevent credit risks are presented.

6. ACKNOWLEDGEMENT

Much appreciated the guidance of my tutor who offered us some constructive suggestions and informed us of this platform to upload the paper.

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