A CREDIT TO YOUR COMPANY

THE ENRON SCANDAL HAS FORCED THE FINANCIAL COMMUNITY TO LOOK AGAIN AT THE WAYS IN WHICH THEY MANAGE THEIR COUNTERPARTY CREDIT RISK. **TOM ROSS** OF BFINANCE PROVIDES SOME FOOD FOR THOUGHT.

The traditional underpinnings of counterparty credit risk management have come in for unprecedented scrutiny in recent months, as banks, investors and trading partners pick through the post-Enron debris. As well as trying to assess their exposure to the fallen energy giant, stakeholders are trying to ensure that the right lessons are learned – and quickly. Many are asking whether they could have done anything to protect themselves and, given the inaction of the credit rating agencies, whether they can rely on traditional safeguards in the future. In this article, we look at some of the ways in which companies can manage counterparty credit risk.

COMMERCIAL PARTNERS. No business will flourish if it does not ensure that its customers can pay for its services. As well as implementing payments arrangements in keeping with customer profile, it is evidently crucial to ensure that clients have the financial resources to pay. This is easy when payment terms are 30 days or less and your customers are domestic and proven to be creditworthy. But problems arise if your require stage payments over the course of a project or if your customers are located across the globe, often beyond the reach of credit scoring services.

With trading clients, an accurate assessment of counterparty credit risk is a vital element of credit policy as it will help management to decide appropriate credit terms, including limits. As well as profit margins, industry norms and your own firm's financial stability, the creditworthiness of clients should be considered when establishing policy, including procedures following delayed or non-payment. Good information is critical to credit management and, in particular, the assessment of new clients. Potential sources of information that can help assess counterparty creditworthiness include:

- Credit agencies: services vary enormously, covering different industries and regions and offering both factual and reference/opinion-based information. Dun & Bradstreet and Experian are among the better known.
- Trade references: these can be manipulated (one or two satisfied accounts may not be an adequate sample), but can also be helpful, especially if a particular amount is mentioned.
- Bank references: these can be obtained only with the written permission of the client and give an opinion on the financial soundness of the company, rather than the speed at which it pays bills. Expect to pay up to £25.
- Trade sources: these can be the most useful on payment record but depend on informal contacts as well as relationships with trade associations.
- Credit insurers: by the nature of their business, these have very accurate information and may be willing to discuss credit risk informally.
- Companies House: a lot of the information in accounts filed at Companies House is now available online, but, despite penalties, accounts are not always up to date.
- Own records: the sales ledger will tell you whether a client pays on time and whether their payment performance has deteriorated.

CREDIT INSURANCE/EXPORT CREDIT. Credit insurance is not necessarily a cost-effective option for firms with a lot of small debts, but one that relies on large value orders from a small number of firms that may wish to insure against bankruptcy, liquidation and transparency, depending on the credit profile of those customers. Cover to 75%-90% of value is usual and credit insurers are now more flexible than in the past in covering individual debts rather than whole sections of the ledger. Cover may be invalidated if the insurer considers its client to have failed its duty of 'reasonable care'.

For firms with a high number of overseas clients, managing credit counterparty risk can become more complex, even if you are dealing with well-known credit-rated companies. The export finance paper chain is being eroded by new internet-based services, but assessing credit risk for international counterparties continues to be hampered by country differences.

Where there are insufficient grounds for comfort, open account may be eschewed for payment in advance, letters of credit or bills of exchange. Letters of credit guarantee in advance that payment will be made on presentation of the correct documents and inefficiencies are being ironed out by use of electronic platforms. A middle way taken by many UK firms with established US clients in

the wake of the 11 September terrorist attack was to take out export insurance while continuing to trade on open account.

FINANCIAL COUNTERPARTIES. Companies are exposed to credit counterparty risk across a wide range of treasury activities, including borrowing (remember BCCI), investment and risk management. Particularly when dealing in the swaps and derivatives markets, firms have a continuing exposure to bank counterparties and need to implement systems and controls that can monitor risk. Similarly, when investing cash surpluses in bank deposits or money market funds, the company is also exposed to counterparty risk.

CREDIT RISK MANAGEMENT. Companies may become exposed to credit risk in the event of non-performance by their counterparties for foreign exchange, interest rate risk and investment management. Counterparties are not immune to financial turmoil and credit risk is especially important for companies that are most at risk to lesser financial institutions. Companies of any size can be vulnerable to the lure of apparently more competitive services, such as high rates of interest on time deposits.

Staff responsible for investment, foreign exchange and interest rate risk management will be given the opportunity by bank staff to use sophisticated products which involve an element of downside risk for the purchaser. Therefore, it is particularly important that the procedures manual should lay down guidelines for each instrument approved for use.

'A COMPANY'S COUNTERPARTY CREDIT EXPOSURE VARIES NOT ONLY IN ACCORDANCE WITH CHANGES TO THE CREDITWORTHINESS OF THE COUNTERPARTY BUT ALSO IN THE VOLATILITY OF THE FINANCIAL MARKETS'

All companies should establish a policy for the level of counterparty risk that they are prepared to run. For example, a company may decide to enter into derivative contracts only with highly credit-rated counterparties and through credit approvals, limits and monitoring procedures.

Companies should at least attempt to ascertain their counterparty's credit ratings and by simply 'keeping an ear to the ground', a treasurer can detect early warnings about the credibility or reliability of financial institutions.

INVESTMENT RISK. Proposed investment counterparties (that is, other than core banks) and an investment limit for each counterparty should be agreed with the group treasurer and approved by the board. The treasurer will usually cite a minimum acceptable credit rating of the institution taking investment funds. Actual outstanding levels of investment against counterparty limits should be reported quarterly or half-yearly.

When deciding where to invest surplus funds, the treasurer may be restricted by company policy and consideration of future funding needs. Companies may also prefer not to invest in instruments with longer maturities because these represent a higher credit and liquidity risk. Performance measurement benchmarks must ensure that returns are achieved within the investment policy constraints on credit risk, maturity and liquidity.

DERIVATIVES. Overall, there are three core elements to companies' credit risk to financial markets counterparties:

- Capital risk: counterparty default leading to total loss of value of transaction.
- Price risk: counterparty default leading to failure of transaction at agreed price and replacement with a different counterparty at new market price.
- Settlement risk: representing the corporate's exposure to the settlement intermediary on due date.

A company's counterparty credit exposure varies not only in accordance with changes to the creditworthiness of the counterparty but also in the volatility of the financial markets, both of which can change rapidly and must be monitored with appropriate frequency throughout the life of each individual transaction. At the very least, management of credit risk should include:

- Regular reviews of counterparty creditworthiness: rating agency information on financial institutions may be augmented by additional (perhaps internally generated) sources of information.
- Fixed credit limits for each counterparty prior to entering into any transaction: setting credit limits in terms of notional amounts is typically only appropriate for less frequent derivatives users. Credit limits may also need to take into account credit enhancements.
- Reporting of credit limits and exposures in keeping with volume of dealing or depositing activities, preferably by non-dealers – that is, parties economically independent to outcome of transactions. However, only larger firms are likely to need to set up a separate credit function.

When establishing a mandate with a new counterparty, corporates should verify that dealers have the legal authority to enter into transactions.

MEASURING RISK. Credit ratings on banks and other financial counterparties indicate probability of default based on analysis of business and financial risk. But to measure credit risk accurately, particularly for derivative transactions, both current and potential exposures need to be quantified. While current exposure is relatively simple to calculate, as it represents the replacement cost of a transaction at the time the risk is evaluated, measurement of potential exposure typically involves statistical modeling or simulation analyses. 'Monte Carlo' simulation, for example, generates prices on the basis of random price movements against which portfolios are revalued to establish frequency distributions of credit exposure. Credit/loss distributions can then be combined with default probability data to estimate provisions against potential losses. The more complex or frequent the transactions, the greater the level of sophistication required in monitoring risk. Simulation or option valuation models can generate multiple market scenarios and stress scenarios can calculate the maximum potential loss from a transaction in the event of extreme market conditions.

Tom Ross is Managing Director at bfinance.
tross@bfinance.com
www.bfinance.co.uk