The Association of Corporate Treasurers

Briefing note:

Bank counterparty credit assessment for companies

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

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The Association of Corporate Treasurers

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The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including The Treasurer magazine.

Our 3,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

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The ACT's approach to policy issues is set out in our Manifesto (www.treasurers.org/technical/manifesto)

This briefing note was drafted by The ACT's Policy and Technical Department (e-mail: technical@treasurers.org) and commented on by members of the Policy and Technical Committee, to whom thanks are due.

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Bank counterparty credit assessment for companies

1) **Background**

1.1 One of the text-book roles of banks is as delegated monitors of credit – relieving depositors and investors with the bank of the need to assess the credit of all the individual borrowing clients of the bank. However, there remains for depositing and investing clients of the bank and potential beneficiaries of contingent liabilities of the bank the need to assess the credit standing of the bank as part of establishing credit limits and conditions for their dealing with the bank.

1.2 It is also necessary for companies to consider the credit standing of banks which might be lenders to the company. This is both in terms of the bank's ongoing ability to maintain lending and, perhaps, agency roles in relation to lending and where costs of borrowing will be linked or potentially linked to the bank's own cost of funds.

2) **First steps**

2.1 Assessing bank credit risk from scratch is difficult and time consuming.

An important first step is to ensure that you know which legal entity or entities within a bank group you are dealing with. If you deal with more than one, separate limits should be set for each entity as well as an overall limit for the group as a whole. Consider seeking guarantees or other explicit support from a strong member of the group if you are dealing with a weaker one or one for which information is difficult to obtain or dealing with overseas branches (see below).

Ensure you are aware of how the legal entity and the relevant branch are regulated and by which regulator(s).

2.2 Ensure that you understand the parent bank's attitude towards its foreign branches and subsidiaries with which you deal. In certain cases parents may not be required to support foreign branches under regulations in the parent country or under the terms of applicable contracts such as ISDA agreements. On the other hand, reputational risk or long-term business plans may cause parents to support overseas subsidiaries where there is no obligation. The same bank may react differently in different cases[1].

2.3 If you are dealing with more than one entity in a banking group, set an overall bank group credit limit as well as limits for individual legal entities/overseas branches.

2.4 In the environment current at the time of writing it is particularly important to understand the extent and reliability of support for the type of bank obligation you are considering which may have been undertaken by relevant governments ("home" or "host") or other authorities. (See also 3.5, below.)

3) **Using credit ratings: analyst-driven ratings**

3.1 Credit rating agencies are available as useful monitors of credit when looking at banks. Of course you need to be sure that the credit rating you are

[1] E. Cerutti et al., How banks go abroad: Branches or subsidiaries? Journal of Banking & Finance 31 (2007) 1669–1692 is useful background on this topic. Now available on the World Bank's website at http://siteresources.worldbank.org/DEC/Resources/How_banks_go_abroad_Branches_or_subsidiaries.pdf).

considering applies to the particular entity/branch you are dealing with (see above) and to the type of obligation you are considering.

3.2 Starting with the conventional, analyst-driven credit rating of the bank[2] is a great help. But it is important to look well beyond the published simple character ratings.

Such ratings are forward looking opinions in a limited sense. They take account of the discussion by the credit analysts with the management of the bank about its plans and forecasts. The credit analysts will have stress-tested the forecasts against likely developments and the effects of the normal business cycle so, conceptually, investment grade ratings and particularly stronger ratings are normally relatively stable.

3.3 Look at the historical default rate and ratings transitions (changes in ratings, for better or worse) published by the rating agencies and the ratings you will be using paying attention to performance during downturns.

3.4 Subscribing (rather than relying on the freely available abbreviated ratings) gives access to the ratings reports written by the analysts that provide more nuanced information and the opportunity to talk to the analysts about the report. It also, if you set appropriate alerts, helps you to follow changes in ratings as they are posted. Relying on rating opinions relayed through third parties or looking at ratings when you remember or have time can cause delays.

3.5 In the case of banks, rating agencies may provide a “stand alone” rating as well as a rating which takes account of possible government support.

Rating agencies may also publish an overall assessment of the willingness and ability of governments to support “their” banks[3]. Together with the “home country’s” sovereign credit rating (for which “own currency” and “foreign currency” ratings are usually available[4]), this can help in establishing limits for overall exposure to a country’s banks as well as the limit for any single bank.

3.6 It is very important to have attention to the “outlook” indicated by the rating agency for the obligor, and for the government (domestic and foreign currency).

3.7 Rating agencies may publish a “loss given default” rating for weaker credits but are unlikely to be available for the type of counterparty envisaged.

3.8 Careful attention to credit rating details can be most helpful. Ratings reflect the agency’s view of fundamental credit standing after review and importance is attached to ratings stability. Accordingly users need to note

[2] It is important, when discussing ratings, to distinguish between sovereign, municipal, corporate, bank, structured finance and any other ratings, and between issue specific ratings for obligations of the same issuer. While ratings agencies protest otherwise, a particular rating will have different implications when relating, for example, to a sovereign than when relating to a corporate issuer as they respond differently to events, the economic cycle, etc..

[3] For example, Standard and Poors’ Banking Industry Country Risk Assessments which allocate countries to groups numbered 1 (highest) to 10 (lowest). Fitch similarly publishes systemic risk indicators in its Bank Systemic Risk report. Moody’s publishes a separate banking system outlook for each country which it takes into account in the overall rating of the bank.

[4] Governments may be able to satisfy obligations in their own currency (if need be by printing it) more easily than they might satisfy obligations in another currency where they are not the issuer.

the outlook status of a credit to see if the rating is being reviewed and if that is likely to be favourable or unfavourable. But, particularly in times of systemic perturbance, banks can fail quickly if confidence is lost.

4) Using other information

Credit analyst driven ratings can be supplemented by other information – but risk averse investors would not use this to *raise* the credit limits you set.

4.1 **Using market implied and other credit ratings:**

i) "Model driven" ratings or "market implied ratings" or a combination of them are commercially available. Market implied ratings may be updated much more frequently than analyst driven ratings.

ii) Model driven ratings are based on a statistical analysis of published data. Market implied ratings use observed market prices for, for example, credit default swap pricing for the obligor, movements in its equity price and the prices of its bonds and CDSs, all of which are related in some way to credit standing. These pricing signals, like the underlying price movements can be very volatile with false signals but they can provide a wake-up call for investors.

iii) The indicators monitored in model driven ratings can themselves be used as an input to the credit decision. But the volatility and false signal issues discussed apply even more strongly.

4.2 **Other information**

As well as the ratings based information discussed above, use other sources for information about counterparties. At the lowest level, you can read the financial newspapers and set "Google alerts", and Reuters and Bloomberg feeds to pick up news stories and comments from all over the world about your counterparties.

5) **Credit limits**

5.1 Credit limits will be set based on the credit assessment, the maturity of the intended investment, the risk appetite of the company and so on.

5.2 Credit limits should be regularly reviewed but also be subject to prompt reconsideration whenever it is felt desirable. No authority should need to be sought to *reduce* a credit limit (and report the decision).

5.3 At times of uncertainty, credit limits will tend to be reduced, portfolio diversification increased and attention will be given to credit support for material exposures (including collateralisation etc. for contingent exposures).

5.4 It is important to consider the effects of any netting or set-off agreements with the counter-party and, where there is such an agreement or agreements their applicability and enforceability and the need for gross and net limits.

5.5 There is some further discussion of credit limits in the companion guidance note, "Corporate investment of liquid funds" [available from http://www.treasurers.org/investingcash].

6) **Governance**

6.1 Policy and practices in credit assessing bank counterparties, setting credit limits and monitoring of compliance and regular reporting will normally be part of the Board approved policies, possibly through a Treasury Committee if the Board has established one.

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