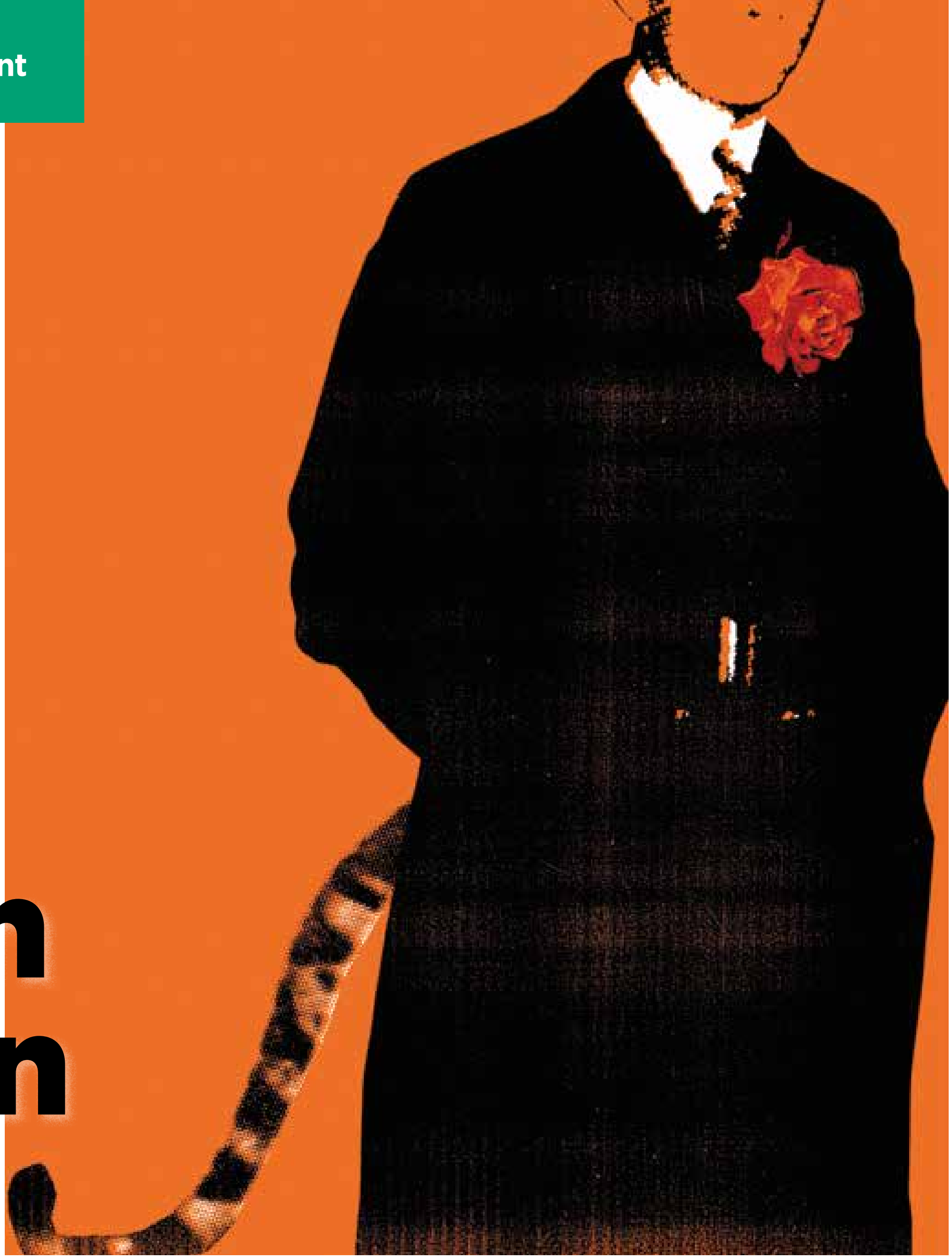

IMAGE SOURCE

Risk hidden in plain sight

MOST OF US THINK COUNTERPARTY RISK BEGINS AND ENDS WITH BANKS. BUT THIS VIEW OVERLOOKS THE RISK TO CORPORATES' CASH POSITION FROM CUSTOMERS AND SUPPLIERS, ARGUES MICHAEL STEFANSKY

Counterparty risk occurs where one party in a contract is not able to fulfil its obligation to the other. This is a large topic in the corporate and banking worlds, but when we talk about counterparty risk management, the parties that tend to come to mind first are banks, where we as treasurers hold cash and face currency and interest-rate fluctuations. But what about the customers that owe us money or the down payments we extend to suppliers? Do we always think to include these parties in our discussions on risk management? And how should we tackle this area?

There are several options that can protect a company from the default of a customer or a supplier. The first reaction could be not to sell anything to a particular customer or to make it a policy not to make advance payments to suppliers. However, this approach could lead to a default of the client or supplier, which, in turn, could harm our company. There are several other possibilities in the market – the most appropriate ones are outlined here.

Bank guarantees

A guarantee or letter of credit (LC) is a promise by the bank to assume responsibility for the debt obligation of the customer or supplier in the event of a default. This arrangement is tied to certain criteria and to bilateral agreements between the customer or supplier and the bank. There are a lot of different guarantees available, and not all of them are useful in this context, however. (Below you will find a short explanation of advance payment guarantees and payment guarantees or standby letters of credit (SLOC)).

Both can be structured for short-term coverage or for as long as a contract runs. The bank usually covers risks that they can evaluate. The pricing of a guarantee is a matter of credit risk and negotiation with the bank as well, as it necessitates a credit line or pledged cash at the bank. The bank usually covers 100% of the amount stated in the guarantee. The default trigger is as per contract specification and as soon as the counterparty is in breach the company may request funds from the bank. The credit rating of the issuing bank is very important and has to be looked at when requesting a guarantee.

- **Advance payment guarantee** – the advance payment guarantee serves as a security for the reimbursement of an advance payment made by the company in the event that the supplier fails to supply the ordered goods or as per the agreed contract. In order to make a claim, the company is generally required to declare in writing that the supplier did not fulfil its contractual obligations properly.
- **Payment guarantee or SLOC** – the purpose of the payment guarantee is to ensure that the customer will pay their payment obligation on the agreed date. The documents required when drawing the guarantee are checked against the details given at the initial agreement when the guarantee was negotiated. To make a claim, the company is required to declare in writing via post or email that the company has fulfilled all of its contractual obligations, but has not received any payment as of the due date. There is no material difference between a payment guarantee and a SLOC. The latter is primarily used by US banks, which are not able to use bank guarantees and which therefore created the term 'standby letter of credit'.

Types of guarantees

Guarantees can be direct or indirect. A direct guarantee is where the bank issues a guarantee directly in favour of the company. An indirect guarantee is where a correspondent bank is involved and is used in cases where the company doubts the creditworthiness and financial stability of the house bank of the customer or supplier, due to legal requirements or domestic laws. A corporate may also use the house bank as an advising bank. However, its only role is to pass the SWIFT message on to the company. This is often done once the company trusts the client's bank.

Factoring

Factoring is a type of debtor finance in which the company sells its receivables to a bank or a third-party provider at a discount, which covers the cost and a risk premium. Invoice finance providers offer factoring on a recourse or non-recourse basis. Factoring on a non-recourse basis is a real protection against a default of a customer. Non-recourse factoring is much more costly than factoring with recourse.

The maturity of this type of product is usually six months. The downside of this product is that it is often unavailable for high-yield and distressed companies. It is a lengthy process to establish a factoring relationship, as due diligence into the invoices needs to be carried out. Factoring is a good instrument for working capital improvement, as the company generally receives funds earlier than it would otherwise and the receivables are taken off balance sheet, but only in case of non-recourse factoring.

Trade insurance

Credit insurance is usually offered to companies wishing to protect receivables from loss due to protracted default, insolvency or bankruptcy. The usual maturity of such insurance is a minimum one year, but as for factoring, this form of protection is often unavailable for high-yield or distressed companies.

> Each company should have a counterparty risk policy in place, especially for customers and suppliers

It may also involve a substantial underwriting process, which is another factor to consider. The benefit of all this, is that it can be inexpensive for available non-high-yield and non-distressed companies. Usually it is not a full protection due to the deductible on the insurance policy. Claims made against trade insurance policies can be cumbersome, however, and may include a waiting period of up to 180 days.

Credit default swap

A credit default swap (CDS) is a financial swap agreement where the seller of the CDS has to compensate the buyer in the event of a credit event. This is to say that the seller of the CDS insures the buyer against some reference loan. The buyer of the CDS makes a series of payments to the seller and receives a pay-off if the loan defaults. The CDS is a standardised product, tradeable on a lot of stocklisted names and therefore only useful if trading with big names. The most common maturity is the five-year CDS. A committee decides whether or not a default has occurred, and the recovery in case of a loss is par minus a specific recovery rate, as per the ISDA Agreement.

Receivable put

The receivable put allows the company to purchase the right to deliver receivables to the bank in the event of a default of a client. After a customer defaults and in case the receivable put has been triggered, the company delivers its outstanding receivables to the bank. After the bank has validated the claims, the company is paid the par value of the receivable or a predetermined purchase price. This can be set at 100% of the coverage amount or at a discount. The receivable put is a custom-made product to address the unique needs of a company.

Conclusion

To tackle the problem correctly, each company should have a counterparty risk policy in place, especially for customers and suppliers, with the definition of the approval process for a request for credit lines. Any amount above this line should trigger a request for protection.

There are many possibilities available, but each company has to evaluate its needs. To protect large amounts, a CDS or a receivable put is available. Factoring is feasible to protect receivables of a company and to increase working capital at the same time. A bank guarantee or trade insurance would make sense for single customers or suppliers.

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