Challenges for credit risk managers

Globalisation is forcing businesses to reassess the way in which they manage credit risk. Terry Bridgman formerly of NCM examines the issues.

As businesses have become more multi-national, so best practices from the countries within which the groups operate have become more visible to chief financial officers and their credit risk teams. The US, in particular, in addition to contributing to the world's best practices in risk management, has developed singular expertise in asset-backed financing mechanisms.

Its financial guarantee monoline insurance companies, steeped in public sector bond issuance experience, have provided the intellectual seed-corn for the triple A rated reinsurance community – particularly in Europe – to flex its capacity muscles in entirely new ways.

Contributing factors

So revolutionary are some of the new practices, and the 'sciences' that engineer them, that we are now seeing an extraordinary broad range of knowledge among corporations.

Their approaches to managing credit risk range from the old tried-and-trusted reactions of shaping micro solutions to compartmentalised issues, to the new sophisticated, strategic and macro approach to shareholder value and balance sheet cosmetics.

Historically, for most companies, the dynamics of day-to-day trading risks, the complexities of export contracts, foreign exchange and currency volatility and overseas political risks (at least until recently) have left these issues separately compartmentalised within finance departments.

Credit was all too often seen as a financial risk, monitored by credit control departments, which, supported by information from status agencies such as Dun & Bradstreet, vetted the accounts of prospective new suppliers or buyers, transactions in turn were financed through banking or factoring arrangements, and foreign exchange problems were handled by corporate treasurers.

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Buyer and supplier terms of payment were subject to detailed negotiation and dictated – at least in part – by the corporate liquidity position. Risk transfer was available through credit insurance and occasionally through without-recourse financing arrangements (for example, ECA-guaranteed project finance; forfait contracts; and invoice purchasing).

Risk handlers

It has been usual to leave financial risks to be handled on a case-by-case basis, perhaps by the CFO himself, and/or his treasury management team and/or his credit control department, while the more tangible risks (and compulsory classes of insurance) have been handled in the risk management area.

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In the area of financial risks, the corporate risk manager has experienced minimal involvement, and many of the vehicles and techniques used by him (such as captive insurance vehicles), have not been considered to be relevant to credit risks. Specialist brokers (invariably, not the same one as that appointed on general insurances) have advised the CFO and/or his credit risk managers on the structures best used to insure credit risks and on the prices at which such insurance could be obtained.

Generally, self-insurance has been a policy used to justify saving the cost of insurance, rather than reflecting any clear policy towards the management of this risk retention. But it was not only the risk components that were compartmentalised within finance departments. The different forms of financing the business were separated too, both by the desire of the CFO not to be dependent on a single bank or financing source and by the different specialty offerings from within the banks.

The division between these centres of expertise is now being severely tested, not only by the competition emanating from the more sophisticated groups (as best practices impact to create major efficiencies) but also by the rapidly changing face of the way business is being carried out globally. These developments all present enormous challenges to the CFO.

Going global

Globalisation of markets and trade and the explosion of e-commerce are the principal background contexts against which new best practice techniques are being applied. Globalisation of capital has meant the near complete

breakdown of artificial exchange rates and protectionism in many parts of the world. The first dramatic impact of this was seen in South East Asia when interest rate differentials, between currencies that theoretically were linked to the dollar, revealed the true reality.

Perceptions of investment and trading risks, previously seen as political or sovereign risks for insurance purposes, turned out to be a cavalcade of commercial insolvency risks, as governments were unable to stem the currency tide and the private sector took the full force of the collapse.

The reactions of the insurance and ratings agencies to this sea change could be said to have been somewhat perverse. Neither has recognised that this inability of governments to block the transfer of funds should actually improve assessments of the pure political risk of non-payment. Rather, against downgraded ratings, the insurance companies continue to charge high rates for political risks, while at the same time allowing competition to continue diluting rates in the area of commercial (buyer) risks – which is where, in reality, the underlying systemic risks relating to the country, have soared.

Globalisation

Increased communications have led to increasing levels of international trade. While even smaller companies now trade internationally, global and multinational businesses generally dominate our world. Their growth, however, has rarely been by building from green-field sites; rather, it has been by acquisition. All too often, the immediate knock-on consequence is the rationalisation of product lines, distribution routes and supply chains.

Suppliers and sub-contractors are squeezed to provide the required efficiencies, and casualties are frequent among those who cannot maintain adequate margins and liquidity. As to the global and multi-national companies themselves, the old distinctions between export and domestic trading have suddenly disappeared.

Is there any real difference in the risks when the same buyer orders from a group subsidiary overseas and at the same time orders from another in the same country? One will be an export, the other a domestic transaction. The practice whereby suppliers (certainly from Europe) insure their exports, while often leaving domestic receivables uninsured, lacks logic in these circumstances. At the same time, the very act of rationalising distribution and supply chains, in the sense of reducing the number of companies to be dealt with, increases the depths to which the group is exposed by way of debt and/or damage through non or faulty supply.

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As competition increases from low-cost suppliers and countries worldwide, so more companies are forced to trade internationally for new markets – with the consequent risks that emerge from stepping into unfamiliar territory.

The events described earlier in South-East Asia meant the loss of markets there for many European and North American companies. The search for replacement markets has obviously led to higher competition elsewhere and a decline in the risk standards applicable to buyer assessments.

However, increasingly, officers of public companies worldwide are under pressure to comply with standards of corporate governance, which *inter alia*, highlight their duty to safeguard the value of their companies' assets (for example, the Turnbull Report in the UK).

Receivables generally represent one of the largest single assets of any company. It is a rare company, however, that can point to the make-up of its receivables asset as being entirely of investment grade rated debtors. Rather, in the total scheme of things, such quality will attach only to a small minority.

In multi-national groups, the CFO has the problem multiplied because of the aggregations that occur upon consolidation of the line companies' figures.

Transparent value

Globalisation has also produced a demand from worldwide shareholders for transparent value. The progressive CFO therefore is now seeking innovative ways to maximize returns by using his corporate capital in the most efficient way. It was inevitable therefore that corporate credit policy, particularly credit risk, would be reviewed in this context. The cost of capital depends substantially upon the efficiency with which it can be allocated to risk and upon the quality of the reflected assets:

- what is the group priority in regard to the receivables item;
- does it represent the most dynamic use of the group's resource to achieve the sale of its products;
- are the credit terms reflected by the receivables item sufficient to optimise sales;
- is it an asset that can be sold into a securitised pool? If so, how can the capital markets be persuaded that an acceptable level of investment grade security is attached to it;
- alternatively, is it an asset to be retained in the group balance sheet and against which more straightforward trade finance is to be raised;
- what is the corporate appetite for risk retention;
- what could a captive achieve with such risk retention; and
- what can be done to enhance the receivables 'pot' to meet investment grade criteria?

Unsurprisingly, both the suppliers of money (banks) and the suppliers of risk protection (insurance and reinsurance companies) have seen this as a fertile market for themselves. The capital markets have shown an increased appetite to finance risk. The resultant bringing together (principally by the investment banks and the reinsurance firms), of their respective skills has produced a whole range of alternative risk transfer solutions, for example, insurance risk securities, derivatives and securitisations.

Central to all issues are the ratings, such as Standard & Poor's, Moody's, that attach to their offerings. The better the rating, the better the investment grade security, so the keener the cost of money.

The debate continues over whether there is a level playing field in this area. Reinsurance companies have been able to allocate far less capital to the guarantees they provide, than banks have been able to do against their lending (because of their more prescriptive risk capital ratio restrictions). Therefore, their risk capacity has been cheaper. Inevitably the banks (under the auspices

of the Bank of International Settlements) are now in the middle of reviewing their criteria because they perceive themselves to be at an unfair disadvantage.

In the meantime, the credit insurance companies have begun to develop their own financial solutions units, enhancing their core knowledge of credit trading risks, with techniques and capabilities fine-tuned from the financial guarantee monolines.

Here, credit insurance is not so much an end unto itself, but rather a vehicle that underpins the provision of increased shareholder value.

A new virtual

The CFO therefore has been given far more strategic options with which to manage his balance sheet. But if these developments were not large enough challenges for him, the dramatic explosion in e-commerce activity certainly is. Increased communication capabilities and immediate access to sources of supply mean there is less need for traditional shops and markets.

Whole new marketplaces are developing in a new virtual world that represent vastly different challenges for identifying the status of buyers and assessing their creditworthiness. Speed of response is essential, while pricing has suddenly become very transparent. Commoditisation is forced upon even sophisticated products, as price becomes the main objective of the buying customer.

Payment mechanisms and ensuring security of payment are practices that are having to be re-learned, so fundamental are the changes to traditional trading. The re-appearance of trading houses, which bulk buy and sell on the back of their e-commerce marketplace expertise, is the new millennium's version of the old export merchant and confirming houses. Sellers must recognise here that they are dealing with middlemen, where the risks rise exponentially.

As business-to-consumer (B2C) techniques rapidly extend to business-to-business (B2B) trading, the risks multiply almost as exponentially as the opportunities. Again, the more innovative credit insurers, such as Coface with @Rating and NCM with eCredible, have stepped up already to the challenge of providing new technology-based tools and online payment guarantee services for B2B transactions.

The challenges for credit risk managers are probably more complex than at any time in recent history. But the opportunities to really make a difference to the corporate success, either by using the receivables item more efficiently to the benefit of corporate capital and shareholders, or by becoming more aware of the risks of e-commerce trading and the tools that are available to help, are the motivations to rise to those challenges. ■

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