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MANAGING COUNTERPARTY RISK

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Economic uncertainty and escalating geopolitical tensions has the potential to materially impact your supply and customer value chains and threaten survival. Smart businesses are proactively managing this risk. We explain how to protect your business by applying the Three Golden Rules of counterparty risk management - Diversify, Quantify, Engage early and act.

Leading into 2020, the main priorities of a typical CFO and Treasurer were the usual combination of financial management, funding, liquidity management, risk management and treasury operations. COVID had other plans however, and refocussed priorities now mean that risk management and financial resource optimisation has been thrust to the forefront of the finance manager's consciousness. A recent Bloomberg article puts it succinctly –

"[A] company can do everything right, secure its own funding, and put itself in the best position possible, but if its customers, suppliers and hedging counterparties have not been able to do the same, then its survival is still at risk.[1]"

This article looks specifically at counterparty risk – the risk that your client fails to deliver, or more seriously, enters administration or insolvency leaving you as an unsecured creditor with uncertain prospects for a full (or any) recovery of receivables owed.

Risk Management Framework

For a finance manager today, a healthy regard for risk along with application of the tools and knowledge needed to analyse and address it is, of course, critical. Life has changed and while it may eventually return to a semblance of pre-COVID-19 normality, the emphasis now is on managing through the crisis to ensure survival. Secondary aspects of extending support to counterparties and finally, availing of opportunities for future strength through market repositioning or selective acquisitions.

Using a standard risk management framework (e.g. ISO 31000:2018) is a reasonable basis to start from, where it specifies the following core actions: Identification, Analysis, Evaluation, Treatment and Reporting.

For this article, we can presume the risk has been identified, so will focus on analysis, evaluation and treatment components.

Example Risk Management Process (ISO 31000:2018)

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1. Risk analysis and evaluation

Traditional accounting tools such as Aged Receivables balances provide an overarching snapshot of the effectiveness of receivables collection for the business. The challenge however, lies in forming a client-level (bottom-up) analysis to feed into a Value at Risk (VaR) model to accurately reflect the potential bad and doubtful debt provision that should be captured. It is not uncommon for the sales team to be unreceptive to the idea their clients are facing credit deterioration, which can mean getting accurate data is a challenge.

However, your sales team are an invaluable source of 'informal' data that should be leveraged. Indeed we know that early engagement with problematic counterparties can often lead to mutually acceptable outcomes and risk mitigation.

Enterprise Resource Planning (ERP) systems typically report on the status of collections and any overdue amounts. Combining that data along with other knowledge of the credit profile of counterparties (either from credit bureaus or a bank's credit risk pricing), a model can be built that provides an expected loss position from all accounts, even those that are not currently under signs of stress.

Taking these probabilities of default, multiplied by exposure provides a financial loss expectation, the aggregate of which is a quantification of the counterparty risk in each year. This work can then form the basis of a cost-benefit analysis to assess the risk management vehicles at a finance manager's disposal.

2. Risk treatment

Within a typical Corporate's credit policy, there will be acceptable risk positions outlined, along with directives around management of positions and the accepted approaches (or instruments) for treatment. Some approaches to treatment can include:

(1) Diversification of client base

- This acts to limit the effect of concentration, namely the risk of a single counterparty defaulting.
- In today's environment, this traditional approach may not be enough as multiple industries and jurisdictions simultaneously experience demand (and/or supply) shocks.

(2) Commercial credit insurance

- Akin to Credit Default Swaps, a credit insurance policy can be arranged to underwrite the risk of several counterparties defaulting on receivables balances owed. This can be extended to whole of turnover cover, though the fine print is important to understand. A large-scale default by a considerable proportion of a debtor book may breach maximum limit of liability thresholds resulting in an uninsured exposure above those levels.
- In the current market, anecdotal evidence suggests credit insurance is currently being rationalised so a new policy (if available) may be on relatively unfavourable terms compared with having entered a policy pre-crisis. For existing policies, a tick up in premium might be expected considering the globally heightened credit risk.

2. Risk treatment (continued)

(3) Transactional support from banks underwriting the counterparty's credit risk

- Traditional payment and transactional approaches are regaining their fashionable status after a brief time in the spotlight following the GFC. The International Chamber of Commerce 2020 Global Survey on Trade Finance finds that "Products like letters of credit and bank guarantees [...] will likely grow in popularity given their reputation for risk mitigation. As such, we expect a temporary shift [towards these instruments].[2]"
- Letters of Credit transfer the counterparty credit exposure to the buyer's bank (uplifted from the buyer itself) which can provide a credit enhancement. Letters of Credit can also be a useful tool in managing supplier performance risk, in that your payment obligation is only triggered on a supplier's apparent conformance with the LC documentary requirements.
- Limited recourse receivable discounting and factoring allow for various degrees of credit underwrite by the seller's bank, providing risk management and working capital. The increased digitisation of international trade will act to further streamline this paper-intensive process.

(4) Collections Management Processes – Review and uplift

- Corporates should ensure the collections channels are best aligned to meet the expectations of their customer base, whilst also ensuring efficiency of processing.
- Consumers and businesses have an increasingly diverse range of options to choose from, to maximise speed, accuracy, identity, and increasing, the quality of the data with payments. The shifting landscape is driving systemic change in payments even faster, and is an important factor to consider when deciding on the most appropriate collections management solution mix.
- Escrow accounts are a means of managing counterparty risk and involve a third party's independent assessment of performance. The involvement of a trusted third party (typically a professional services firm) then enables release of payment.
- Documentary collections secure the transmission of title documents through the banking system. This means that in the event of a buyer's insolvency prior to receipt of goods, retrieval of the title documents (if still held in the banking system) is possible and a new buyer can be found.
- Other treatments can include – reviewing timing of invoicing, bespoke processes for larger invoices, or considering prepayment for some customers. Increasingly card payments are being used as working capital management tools for business payments, and may be favoured by your customers. Considering some alignment to your customers preferred form of payment can somewhat mitigate risk of non-payment.

"Diversifying exposures, quantifying the risk downside potential regularly and engaging your counterparties early at the sign of trouble, are the Three Golden Rules to successfully managing counterparty risk. Failure on any one of these areas can lead to a extinction event."

Shane Conway
Executive
Transaction Banking & Enterprise Payments

2. Risk treatment (continued)

(5) Pricing for risk

- Sometimes the company will just have to accept the risk as part of doing business. Where risk is retained, what framework does the company have for pricing for any residual risk? If the team has identified an estimate provision or probability of loss (see Section 1 above), has this cost been incorporated into pricing models downstream?
- Analysis of risk pricing is a complex issue that requires its own deeper paper, but ensuring you are pricing suitable for any residual risk from the counterparty / within the transaction is a method to preserve value for taking that risk.

A combination of the above approaches will potentially yield an improvement in the VaR assessment and the associated cost or risk management techniques employed should be considered in the cost-benefit analysis undertaken.

3. Reporting

Reporting is a key step in the Risk Management Framework and is achieved in this case through use of existing systems such as ERP aged debtor analysis and a summary report showing the enhanced VaR for each significant exposure. Communication of the improvement in the counterparty risk profile contributes to effective Board or CEO oversight and in all likelihood, increases organisational support for actions taken.

Counterparty Risk Comparison – Treatment Options

Instrument	Supplier Risk Exposure	Buyer Risk Exposure	Cost	Considerations
Payment in Advance	Minimum	Maximum	$	Negotiated commercial outcome – Supplier usually has commanding position in relationship
Open Account	Maximum	Minimum	$	Negotiated commercial outcome – Buyer usually has commanding position in relationship. Credit enhancement possible through credit insurance or limited recourse receivables discounting at additional cost ($->$$$$).
Documentary Collection	Low-Medium	Medium	$$	Transaction is supplier-initiated leading to potential supplier performance risk from buyer's perspective. Supplier only receives payment if buyer honours arrangement to receive title documents in exchange for payment.
Documentary Letter of Credit	Low-Medium	Low	$$$	Buyer's credit risk substituted with risk of issuing bank (usually an enhancement from perspective of supplier.)
B2B Credit Card Payments	Medium	Medium	$$	Seller becomes card merchant for purposes of sales process, and debits card number provided by buyer.
Escrow Account	Low	Low	$$$$	Requires involvement of third party to determine if funds release trigger has been met

Summary

The ramifications of the current economic and health crisis are not yet fully understood and the crisis continues to impact the global economy. A Corporate's obligations to their stakeholders (as always) is to effectively navigate through uncertainty and deliver value. The delicate balance of remaining competitive with healthy client relationships, whilst protecting against the known and quantifiable risk of those clients failing is a key challenge of recent and necessary focus.

Corporate finance teams should ensure that risk management strategies and mechanisms are appropriately established and are covering counterparty risk effectively. Focussing on the 3 Golden Rules of counterparty risk management will help your business navigate these uncertain times:

1. Diversify your risk
2. Quantify your exposure
3. Engage early and act

The key to successful counterparty risk management lies in understanding and diversifying your risk, regularly quantifying the actual and potential impact of any failure and engaging counterparties early at the first sign of trouble – and then acting quickly if necessary to avoid an 'extinction event'.

For existing Corporate & institutional clients, NAB is available to support your business in analysing the best options for their business. To explore options for your organisation, please contact your local NAB Transaction Solutions, Trade & Working Capital Specialist or Relationship Manager

For new clients interested to hear more about how NAB can assist, please contact:

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