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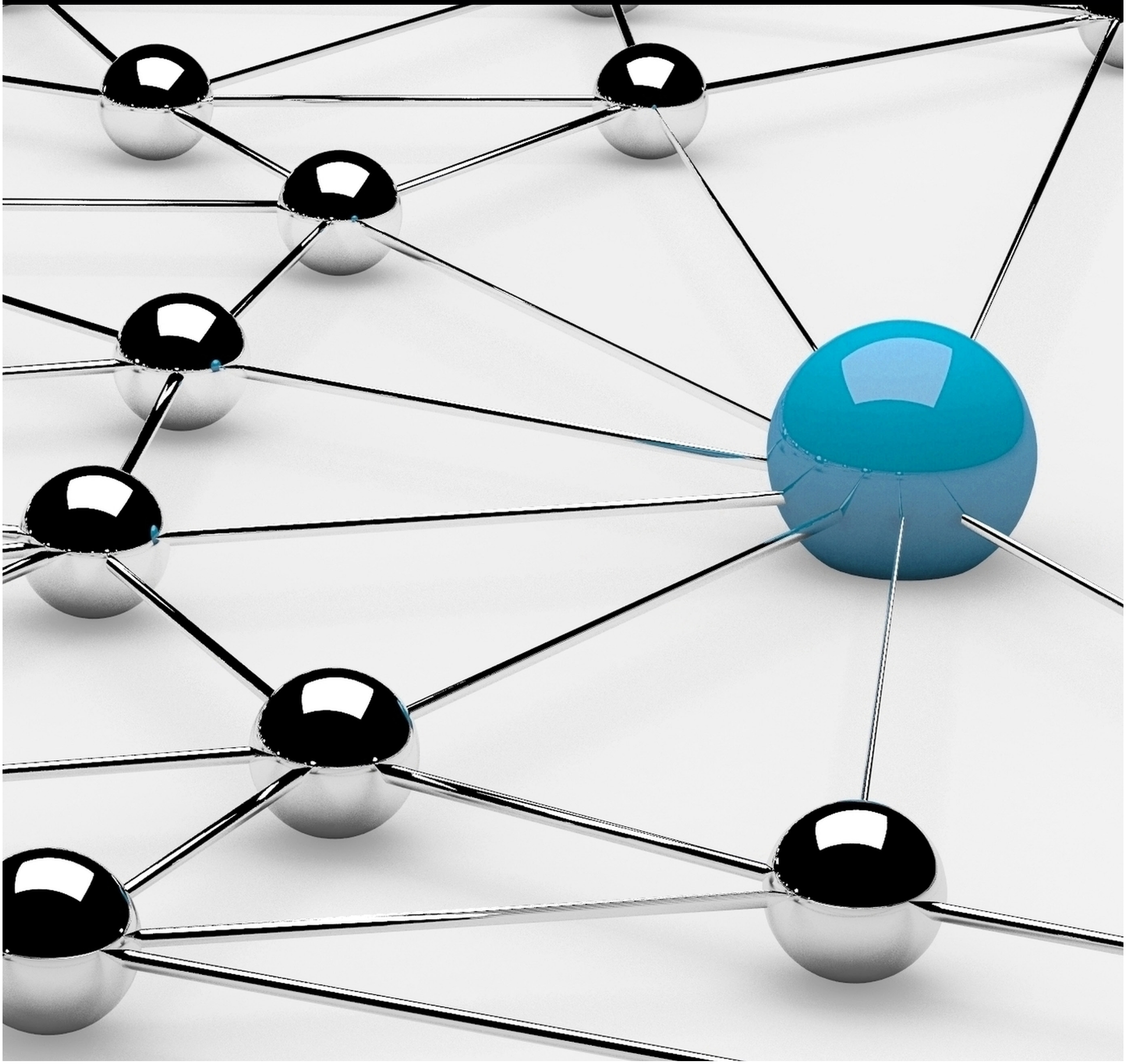

Four Best Practices for Effective Credit Monitoring

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INTRODUCTION: "FAILING TO PREPARE IS PREPARING TO FAIL"

Hockey legend Wayne Gretzky lived by the motto, "Failing to prepare is preparing to fail." Whether one is preparing on the ice or in the corporate arena, the saying holds true. Long-term forward thinking is critical for companies trying to navigate counterparty risk. A robust credit monitoring system is essential to prepare your firm for potential risky situations ahead.

This article discusses four best practices for effective credit monitoring, which can help corporates prepare for today's uncertain business environment, including:

» Ensuring limits are not breached.

» Refreshing credit analysis regularly.

» Conducting detailed quarterly reports on your highest exposures.

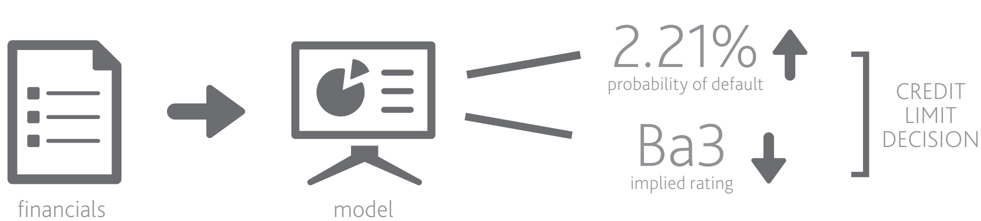
» Tracking public market sentiment.

1. Ensuring Limits Are Not Breached

Integrated scoring systems are put in place to ensure that customers do not exceed their credit limits. As a standard practice, the credit management team analyzes the counterparty before recommending increases to these limits. Important factors in determining if an increase is warranted include the counterparty's financial standing relative to the size of the proposed increase, payment behavior, and your overall history/relationship with the counterparty. An objective third-party model, built on applicable financial statement data and defaults, determines an obligor's probability of default more consistently.

It is also a best practice to run weekly reports that screen for all counterparties that are utilizing 85% or more of their existing credit limit. These reports should also include a composite credit score or probability of default (PD) credit risk measure to gain a snapshot of risk levels in the respective accounts. Share these reports between credit and risk professionals, sales teams, and operation departments to ensure consistency and proper communication across stakeholders in the organization.

For example, after inputting Johnson Energy Partners' most recent financials into a third-party model, the model computes both an increase in probability of default and a degradation in implied rating. This should be a trigger for credit management to examine these adverse changes and decide if Johnson Energy Partners' credit limit should be lowered.



2. Refreshing Credit Analysis on a Regular Basis

A prudent credit risk management practice requires a company's counterparties to provide updated audited financial statements annually. While audited financials are recommended, company-prepared financials and tax return information is still valuable in the credit risk scoring process and have been found to produce strong default predictive power. In instances when a counterparty does not provide updated financials, we recommend projecting pro forma financials by applying industry trends to the most recent financials on hand.

> For example, if you are evaluating Johnson Energy Partners, you can analyze their closest competitors in terms of asset size and geography. If you deduce similar energy companies, on average, are experiencing year-over-year revenue declines of 8% and gross margin declines of 3%, you can apply these trends to your pro forma financials. It is best practice to combine this exercise with a model that incorporates not only information about a firm's own credit risk profile, but also sectoral, geographic, and macro-credit cycle factors to arrive at a composite score or probability of default risk measure.

It is critical to store all counterparty information in one centralized database, which enables you to perform peer and batch analysis easily, and ensure data consistency and accessibility across the organization. Ideally, your database would contain several million financial statements that have been analyzed by data experts and mapped to actual defaults. Counterparty financial statements should be reviewed and entered into an objective third-party model to screen for credit deterioration. It is only with the proper scale of data and precise analysis that a model can provide an accurate forward-looking probability of default measure.

3. Conducting Detailed Quarterly Reports on Highest Exposures

Significant credit losses on the top exposures in a portfolio can have devastating effects on an organization. The best practice in this case is to perform detailed credit reviews of the top 15 exposures on a quarterly basis. Reports should include detailed financial analysis coupled with a qualitative framework. By using a qualitative overlay framework, you are able to incorporate important factors from a more in-depth perspective, including:

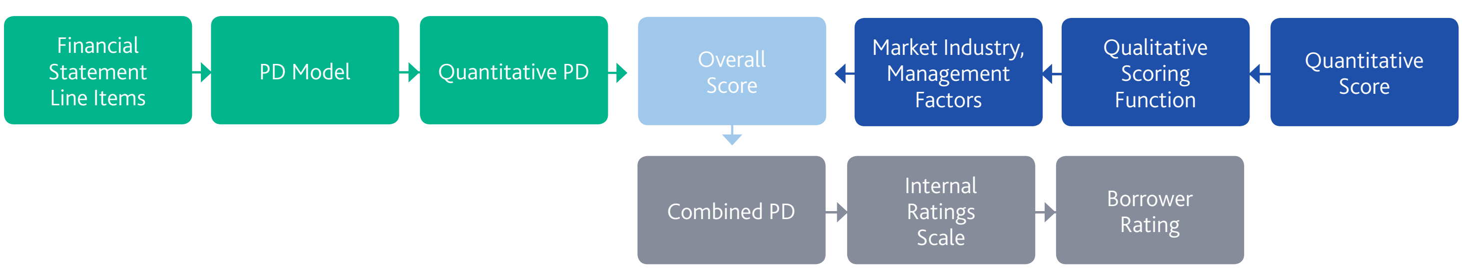
» Sector dynamics: customer power, diversification of products and competition in the market.

» Company specifics: length of relationship with the counterparty, supplier power, and its payment behavior.

» Management analysis: years of experience within the industry, risk appetite, and the strength of its financial reporting.

» Balance sheet factors: audit method, debtor risk or accounts receivable risk, pro-forma interest coverage, and pro-forma liquidity.

By overlaying qualitative factors onto fundamental factors, you can get a better overall assessment of risk. The combination of qualitative and quantitative inputs can provide a more comprehensive view of the creditworthiness of your counterparty and enable you to make recommendations to maintain, raise, or lower counterparty credit limits.



For example, the credit department for Johnson Energy Partners could be carrying the counterparty risk of hundreds of companies, primarily concentrated within the energy industry. Large swings in equity market prices can be a telling signal for credit risk. If oil and gas companies within the equity market have experienced a 35% drop in their stock prices over the past two months, it is imperative that you re-examine both your public and private counterparty risk within the oil and gas industry. A third-party model that proactively adjusts probability of default based on public equity prices can provide forward-looking indicators for an early warning system to detect potential defaults.

4. Tracking Public Market Sentiment

Track the prices of your counterparties' and their competitors' publicly traded securities, as they are forward- looking indicators of financial health for both public and private counterparties. It is best to use a third-party model with this functionality to account for public and industry market shifts. If an industry or market is experiencing a period of distress, there is a high likelihood of impact on both public and private firms.

Conclusion

Not only is it a best practice to use a credit risk model in assessing and monitoring counterparties, it is critical to use the best model available to predict potential losses. Investment in the right modeling framework for your organization can translate into a return on investment that exceeds expectations. Avoiding defaults is the name of the game in a credit function. The cost of a default includes credit losses from bad debts, soaring legal fees if a firm attempts to enforce contracts through either arbitration or litigation, and the time spent addressing a deal gone bad. If a robust modeling solution can help your firm avoid just one material default over the course of a year, the time, resources, and money saved would likely far outweigh the cost of investing in a third-party model.

In today's business environment, as in sports, it is important to have foresight and be prepared. Treasury, finance, and credit professionals must be able to detect impending credit deterioration of their counterparties. Credit models and forward-looking PD credit measures are important tools for companies to establish and develop effective and efficient early warning and monitoring strategies. These tools are relatively easy to calibrate and implement with available data, software, and functionalities, such as email alerts, a monitoring dashboard, and reporting templates. They can produce a strategic advantage by providing advance notice of potential defaults and estimation of future losses, informing proper preparations, and diagnosing the health of a portfolio on an ongoing basis.

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