



Time To Protect Your Corporation From Counterparty Loss

# Introduction

Traditionally, credit risk management has not been a core activity at companies outside of the banking and financial services sector. The implications of not regularly managing and measuring credit risk can be substantial and potentially lead to bad debt exposure, supply chain disruptions, reputational risk, and hefty legal fees incurred enforcing customer contracts. The good news is that there are several practices that credit managers, CFOs, and treasurers can adopt to avoid such costly mistakes and make more conscious business decisions.

The objective of this article is to:

- » Outline best practices in credit and counterparty risk management for corporate CFOs, treasurers, and credit managers
- » Highlight the principles of effective credit and counterparty risk management
- » Explain the benefits of rigorous credit and counterparty risk management

## Why is credit and counterparty risk management important?

Historically, credit management at corporations has focused largely on customer risk from new and existing customers.

*Traditionally, analysis done in credit departments has centered on the question: "If we extend credit (or lease terms) to this customer, will they pay us back?"* After all, depending on the industry and type of exposure, if one of the largest customers goes bankrupt, their supplier could easily follow suit. However, a prudent corporation should consider risks coming from a wider range of counterparties beyond their customers.

## Types of counterparties in the credit and counterparty risk analysis



## How to Protect Your Corporation From Counterparty Loss

	EVALUATE POTENTIAL COUNTERPARTY	<ul style="list-style-type: none"><li>» Access to private/public financial data</li><li>» Data in a standardized format and centralized location</li><li>» Automate and define calculations of financial ratios</li></ul>
	PERFORM PEER ANALYSIS	<ul style="list-style-type: none"><li>» Industry and peer insight</li><li>» Determine peer group</li></ul>
	DETERMINE CREDIT SCORE	<ul style="list-style-type: none"><li>» Standardized credit scoring system</li><li>» Validate Internal models</li></ul>
	SET CREDIT LIMITS AND TERMS	<ul style="list-style-type: none"><li>» Establish framework for translating credit scores into credit terms</li></ul>
	MONITOR EXPOSURES	<ul style="list-style-type: none"><li>» Identify early warning signals</li><li>» Establish an effective risk monitoring system</li><li>» Conduct scenario analysis for adverse circumstances</li></ul>

# How to Protect Your Corporation From Counterparty Loss

## 1. EVALUATE POTENTIAL COUNTERPARTY



Generally speaking, it is good practice to evaluate the financial strength of a new counterparty before entering into a business relationship. However, financial data from suppliers, customers, distributors, or banking counterparties is often not captured, or captured in different formats by analysts across the company, which makes comprehensive analyses and credit risk reporting difficult. This information should be captured, documented, and archived in accordance with a company's credit policies across geographies and departments, using standardized data entry templates that can be easily accessed and implemented across the company. To address any gaps in data on counterparties, a third-party vendor can be employed to provide financial statements on firms where the company is missing data.

Storing and gathering financial data is critical when evaluating financial statements of a given counterparty. A wide range of ratios can be calculated for a given business, but liquidity and solvency measures are the most important from the perspective of managing credit risk. Liquidity analysis aims to determine whether the company has enough liquidity to meet its short-term obligations. For example, the current ratio (current assets / current liabilities) measures a company's ability to cover its short-term obligations with current assets on hand. Solvency analysis aims to establish whether the company is financed correctly so that it can recover from a loss or a period of losses. A typical technique to analyze insolvency risk is to focus on ratios such as the leverage ratio, which compares a company's total debt to its total equity amount.

## 2. PERFORM PEER ANALYSIS



Peer analysis allows corporations to make more informed decisions by comparing credit risk information and financial ratios for a specific customer, distributor, or supplier against a group of their peers. Peer groups should be defined by industry, region, or company size. After a peer is selected and financial information is provided, an analysis should outline credit risk trends for the company and its peers. Since accumulating peer credit risk data can take years and tremendous effort, using a third-party database with financial information already available can save valuable time.

## 3. DETERMINE CREDIT SCORE



To derive a score or other metric to measure credit worthiness, implementing quantitative probability of default (PD) credit measures result in the most accurate credit risk assessments. This metric should then be mapped to an internal credit score. We recommend implementing internal credit scorecards that incorporate quantitative and qualitative factors. If corporations choose to develop their own predictive scoring models, it is imperative to use validated third-party models as an input to their own model or as benchmarks to ensure accuracy. Corporations should also go one step further and ensure that the same scoring system and framework are being used across divisions and geographies to ensure consistency across the entire organization.

## 4. SET CREDIT LIMITS AND TERMS



Companies can have hundreds — if not thousands — of exposures in the form of credit extended to customers and distributors. These exposures must be consolidated and monitored, both when the exposure is originated (that is when a new customer signs a financing agreement or a new contract is signed with a supplier), and over time. Like a commercial bank, a corporation must manage its entire portfolio of loans. Each new exposure should be compared against pre-defined limits for counterparties, industry sectors, countries, or product type before a risk decision is made. In addition to diligent financial analysis, a prudent credit manager also examines qualitative factors, such as a company's competitive positioning, its history, and reputation in the market. By implementing a limits monitoring system, alerts are sent when limits are breached — particularly when extending more credit to a watch-list customer or distributor beyond the pre-defined limit.

## 5. MONITOR EXPOSURES



For a comprehensive and more relevant view of risk across an organization, it is best practice to consolidate exposures worldwide, across subsidiaries and business units, using limits management software tied to the credit analysis and origination system. Implementing a company-wide monitoring system enables a company's risk management function to push limits and review policies down to the business unit level. Having such a system in place enables a company to manage credit risk exposures actively. Early identification of potential defaults allows a credit manager to act to avoid disastrous situations. Effective credit management also means being prepared for adverse outcomes. Good credit managers should do regular and rigorous scenario analysis on their credit exposures and include both macro and industry-specific shocks in the exercise. The key to effective stress testing is creating appropriate scenarios and ensuring the underlying analytics are meaningful. By using a third-party tool that adjusts default probabilities based on public equity prices, you gain a forward looking indicator to your analysis.

### Why Must Companies Establish Comprehensive Credit Policies?

Companies must ensure that everyone involved in their credit assessment practice follows the same process. Many corporate credit departments are severely understaffed, and a change in culture within an organization is necessary to be able to make efficient and effective decisions regarding credit risk exposure. An actionable credit policy, determined by top executives, provides decision-makers with tangible guidelines when difficult credit decisions or issues present themselves. Components of a credit policy can include important decisions such as limits and concentration appetite, authorization levels and approval roles, contingency planning, and governance.

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## Benefits and Conclusion

### Benefits of Rigorous Credit and Counterparty Risk Management?

If a company rigorously follows best practices in credit and counterparty risk management, it can achieve certain advantages, including:

- » Unifying the credit assessment practice by implementing repeatable processes and standardizing outputs
- » Qualifying new customers quickly, reducing response time, and improving customer satisfaction
- » Developing a more balanced portfolio of counterparties to withstand any downturns
- » Receiving early warning signals necessary for proactive exposure management
- » Minimizing costs in both bad debt expense & legal expenses incurred to enforce contracts
- » Protecting your company's assets that are on lease or credit terms to customers

### Conclusion

For corporations, the decision to implement robust credit risk frameworks and processes is not an option - it is an imperative to building a strong & sustainable business. Depending on the size of the corporation, the credit and counterparty risk management process can be quite sophisticated. However, all firms must take the basic steps of standardizing the way financial data is collected and analyzed, implementing credit limits, introducing monitoring capabilities, and implementing workflows and corporate credit policies. With sound credit practices, a company receives early warning signals on bad credits, improves customer service and, above all, makes better decisions to keep the business running smoothly. As such, the credit and counterparty risk management process at corporations should be viewed as a high strategic priority.

### Moody's Analytics Counterparty Credit Risk Solutions

Moody's Analytics proprietary research, ratings, and software solutions allow corporate treasurers and risk managers to collect financial data and measure probability of default (PD) for sovereigns, publicly listed entities, and privately held companies around the world. Our models offer a comprehensive approach to assessing a forward-looking PD called EDF™ (Expected Default Frequency) credit measures when making important business decisions around vendor risk, limits management, pricing, and early warning signals for credit deterioration. Moody's Analytics can help corporations assess the creditworthiness of business partners, provide consistency in underwriting processes, detect potential credit deterioration early, and gain unparalleled insight into different industries and regions.



Section	Solution-X	Solution-Y	Solution-L
Section-C	61	87	116
Section-B	75	61	91
Section-A	17	19	75



## About Moody's Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By providing leading-edge software, advisory services, and research, including the proprietary analysis of Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

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