Managing counterparty CREDIT RISK

Corporates face significant uncertainty in 2021, not least due to the fallout from Brexit and COVID-19. While many risks remain unknown, counterparty credit risk can – and should – be managed on a proactive basis, now more than ever.

On 1 January, the Central Bank advised Irish companies to ensure that all UK institutions they currently deal with have the necessary authorisation to provide financial services to Irish clients post-Brexit.

To ensure regulatory compliance, several institutions established new European entities to conduct their business. Invariably, these new entities are smaller than the original entities and, as with regulatory advice, it is also prudent for corporates to determine the financial standing of any new counterparty to ensure that they are adequately capitalised to support the business being transacted.

This article outlines the potential credit risk corporates absorb in dealing in derivative transactions, including everyday foreign exchange forward transactions.

What is counterparty credit risk?

Counterparty credit risk (CCR) emerges when banks trade in derivatives and transactions where securities are used to borrow or lend cash, such as repurchase agreements.

The CCR in a transaction between two counterparties can be either unilateral or bilateral. A loan from a bank to a corporate is unilateral CCR exposure as if the corporate defaults, only the bank is exposed to the loss. This type of transaction does not expose the corporate to a loss or credit exposure if the bank defaults. A corporate that transacts a derivative instrument with a bank or financial counterparty experiences bilateral CCR, as both counterparties are exposed to each other throughout the life of the derivative. This credit exposure is a variable of the underlying market value of the derivative.

CCR is often spoken about in the context of a financial counterparty giving a loan to a borrower. Today, there are rigorous lending rules in place to protect the lender if the borrower defaults. A corporate entering into a derivative with a financial counterparty will have to undergo a credit assessment before transacting a derivative. Given that the CCR associated with a derivative is typically bilateral, it is imperative that corporates also conduct a credit assessment of the derivative provider. In some circumstances, there may be a two-way collateral agreement in place. However, this is usually for financial counterparties dealing with other financial counterparties.

The 2008 financial crisis demonstrated the systemic effects a major financial counterparty default event can have on the global economy. Lehman Brothers is arguably the most high-profile financial bankruptcy in recent decades and the largest in US history. The collapse was monumental because of its global footprint: the bankruptcy led to an additional 75 bankruptcy proceedings and, at the time of its demise, Lehman Brothers is said to have been party to roughly one million derivative contracts.

Risk assessment

How can corporates assess the credit strength of a financial counterparty? The first thing is to ensure that they are regulated by the Central Bank of Ireland or an equivalent regulatory body. Corporates should know what specific legal entity they are dealing with, and who owns and controls it. If dealing with a publicly listed entity, the annual report, share price and credit rating can allow for a quick assessment of the counterparty's strength.

Certain non-bank providers are not obliged to publicly report their financial accounts and do not have a public share price or credit

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rating. However, you can instead review the institution's filings with the Companies Registration Office (CRO). On foot of Brexit, many financial institutions have been forced to restructure to continue to offer their services in the EU post-transition period. Corporates should, therefore, ensure that they understand any resultant changes to their counterparty's credit strength.

> **"The regulator and other authorised bodies have tried to increase transparency and protections for corporates, which has added to the financial reporting burden."**

Corporates should also ascertain the degree to which their provider can withstand unexpected losses associated with an extreme, unprecedented market event. The impact of COVID-19 on the global economy was certainly unprecedented at the outset of 2020, and we must assume that the months ahead will be far from stable from an economic perspective. Corporates should, therefore, view CCR as a risk to be proactively managed now more than ever.

Conclusion

Corporates will undoubtedly continue to use derivative instruments to manage their foreign currency exposure for many years to come. The market was disrupted in the last decade by new providers and geopolitical events, which impacted the external environment and increased corporates' need to know their counterparty. Meanwhile, the regulator and other authorised bodies have tried to increase transparency and protections for corporates, which has added to the financial reporting burden for finance managers.

Corporates should ensure that they proactively manage these risks to ensure that derivatives remain risk management tools, and do not instead threaten the bottom line.

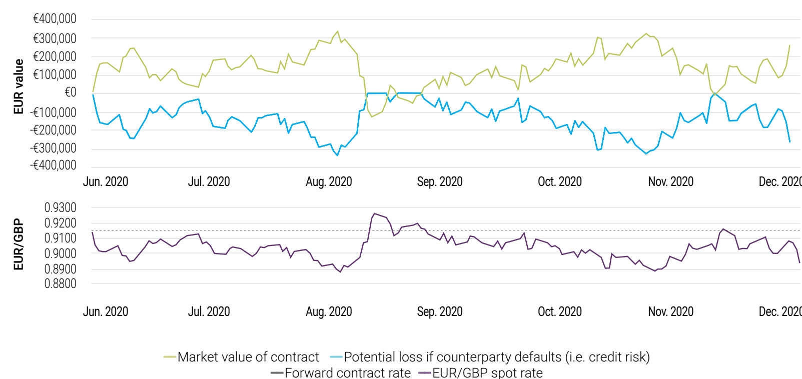
For more information, visit www.investec.ie

A theoretical example

To illustrate the counterparty credit risk concept, let's take the example of a company that entered into a forward contract at the end of June 2020 to purchase £10 million at the end of December 2020 (i.e. six months later) at a EUR/GBP rate of 0.9150.

As currency markets (EUR/GBP) fluctuate over the life of the hedge, the market value of the hedge rises and falls. The green line in Figure 1 shows the market value in euro of the forward contract. This is the difference between the euro cost of £10 million at the contract rate versus the cost at the prevailing market rate at any given time. As the chart shows, for most of the hedging period, this particular contract had a positive value for the company as the contract rate was better than the prevailing market rate. The blue line, which mirrors the green line when the value of the contract is positive, represents the risk to the company of their hedge counterparty defaulting on their contract. Such an event would force the company to book a new contract at the prevailing market rate and, therefore, lose the positive market value on the original contract. This is the mark to market risk or potential loss in the event of a counterparty default.

Figure 1: Credit risk to a corporate's balance sheet



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