Crisis management vs risk management

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As a treasury services trade risk manager, I share an understanding with our sales staff that JPMorgan’s risk management requirements are designed to accommodate accurately measured and fully understood risks, and are necessary to protect our business against any scenario – including the worst possible case.

As crisis events in our industry continually demonstrate, a good risk management process at origination of any trade finance deal is the best way to minimise loss when problems arise. Good crisis management is essential, but never a substitute for daily risk management processes. Moreover, risk management processes should apply to all customers, although depth and detail may depend on the transaction and customer. Transactions involving credit or other types of financial risk should incorporate a risk management process. A transaction’s risk management process should focus on five areas:

- Knowledge of your client company and product.
- Knowledge of your customer/underwriting.
- Structure and documentation.
- External risk mitigation/portfolio management.
- Crisis management.

Know your product

Before considering any individual transaction, it’s important to know your company’s risk philosophy. What is the risk appetite for this product, geography, customer? Does the company’s success depend on this single transaction? Companies and financial institutions usually know their products very well because they’ve developed them. However, selling a product in a new or changing market may create new product dynamics or risks, and these must always be addressed. Legal and regulatory differences may even affect the ability to offer the product, or to take action when a problem occurs. Unfortunately, the entrance into a new market is often in response to a sales opportunity within a limited time frame. The cost of an appropriate market review may not be supported by the profitability on one transaction. Your company should carefully consider whether the potential for additional business supports the upfront cost to understand the market, or whether a single opportunity can truly be structured appropriately on a cost-effective basis.

Another product risk: the seemingly minor ‘tweaks’ that have been requested by certain customers, or that have been made in response to the requirements of certain markets. Over time, minor adjustments in individual offerings may substantially change the nature of the product’s risk. Additionally, minor changes to a product or transaction in one market may also significantly increase risk with another customer, or in another market. Good risk management processes ensure that one-off modifications never become a permanent part of standard documentation. Companies financing trade deals should be able to identify, evaluate, understand and mitigate the risks associated with every transaction. Excluding derived financing structures, measuring pure financing risk is relatively easy – it is usually the notional amount of the transaction. But measuring other risks, such as regulatory, legal, tax, country/political and reputation, is much more difficult. Proper assessment and mitigation require the participation of internal risk specialists – legal, compliance, accounting, credit or senior management – in the transaction process at the earliest opportunity.

Early risk identification and mitigation don’t just facilitate the deal structuring process; they also help provide timely feedback to a customer when the deal is not viable as proposed. Customers deserve candor and should never be promised what ultimately cannot be delivered.

Know your customer/underwriting

For financial institutions, underwriting and understanding their customers is a highly visible and widely understood requirement. Every company should have a KYC (know your customer) and/or underwriting process for assuming financial risk.

Financial risk is not just providing financing to a customer; the potential for fines, duties or legal action or dependency on one customer for a substantial portion of sales are additional examples. Operational and reputational risks can also have financial impacts. Clearly, greater financial risk requires better risk management and higher compensation. The underwriting process should focus on a customer’s capacity and willingness to meet financial obligations. What are the customer’s financial characteristics relating to cashflow (quality, sustainability and predictability), leverage, asset/collateral coverage, alternative sources of repayment, size, and competitiveness/flexibility?
And what are the customer's qualitative characteristics relating to management, ownership, industry, strategy and reliability of information? Accurate evaluation of the appropriateness of a specific service or product for any customer must be founded on a thorough understanding of each transaction's purpose and structure. In addition, financial institutions in the trade business often provide support by financing or protecting their customers' purchase of product through direct loans, confirmations of letters of credit, etc.

In such cases, it is important to know the answers to these questions: is the customer's customer an existing relationship, and will the business relationship continue?; is there anything unusual about this sale for the customer?; does the purpose of the transaction make sense?; most important, is the customer prepared to be engaged in a crisis event? Hopefully, the willingness to engage will also have some influence with the purchaser. Your customer's involvement will not eliminate the need for due diligence, but may help to focus it.

**Structure and documentation**

There is no single formula for determining an appropriate deal structure. The goal is to achieve a reasonable balance between positive and negative factors. Some factors can be negotiated and/or influenced by each party (amount, tenor, collateral, covenants, etc.), but others, such as industry, geography or purpose, represent the context for the structure. Elements of a good structure include: key risk identification and mitigants; proper identification of the legal entities involved; appropriate ties between cashflows and purpose; early warning signals; level of monitoring appropriate to the level of risk; remedies to act when mutual expectations are not met; and proper risk/reward balance and clear communication of expectations between all parties. Recourse to additional parties should always be clearly documented. Regardless of everyone's good intentions and the low probability and expectation of a crisis event, documentation should always be drafted with the worst case scenario in mind. This drafting can be the most challenging phase of a transaction — with expected potential contention between risk management and sales staff, or between the bank and its customers. Sometimes the sensitivity is due to parties feeling that their integrity is being challenged; more often, it is due to the desire for rapid completion of documentation, lack of comprehension of trade transactions, rules and customs for non-lawyers (and too often in the case of lawyers without trade expertise), and limit on costs. For banks certainly, omitting protective provisions can be disastrous. Legal counsel should be able to explain why a clause is necessary and provide illustrative examples of why a party would require such a clause.

Drafting an agreement without lawyers never saves time — even with 20 years of working closely with legal documentation, I am continually reminded that drafting requires more specific skills than an ability to read and understand trade finance-related legal documents.

**External risk mitigation/portfolio management**

External risk mitigation is an important risk management tool which can also support additional business generation through freeing capacity by distribution of risk. Risk mitigation techniques deserve a separate detailed discussion; in summary, they include funded and unfunded risk participations (where one party sells a portion of a transaction’s risk to one or more third parties); insurance (a third party insures the transaction for certain events); credit default swaps (one party purchases credit protection from another party, similar to insurance in many ways); and collateral. When considering external risk mitigation options, each should be carefully assessed to determine the degree to which it provides needed protection. An aggregate number of these instruments only provide protection against very specific — and relatively narrowly defined — crisis events. It is therefore essential to evaluate whether the protection eliminates, alters or reduces the transaction’s risk. If risk participation or purchase insurance is being sold, the risk of that participant’s or insurer's capacity and willingness to pay at the time of the crisis event has been assumed by the seller. Is the benefit of the risk mitigation measurable? Not surprisingly, cost is closely linked to the value of the protection. Despite difficulties of execution, the benefit of identifying and protecting against individual transaction risks is widely understood. Good trade finance risk managers also need to understand the risk of their entire portfolio or business and then determine whether to seek risk mitigation on a portfolio basis. For example, individual transactions may be acceptable risk; but the aggregate risk of transactions with a customer, industry or country may be too high. In such cases, it will be necessary to determine the acceptable level of aggregate risk, as well as the appropriate risk mitigation techniques needed to stay within those aggregate parameters. Finally, the risk manager must identify and monitor the aggregate exposure arising from risk mitigation (for example, aggregate exposure to an insurer or risk participant).

**Crisis management**

Despite a solid risk management process, there will be problems because we cannot predict all crisis events and protect against them. Be prepared to deal with a crisis event and take action immediately — identifying and assessing issues and options and obtaining expert advice as needed. Ensure that all exposures/transactions with the problem party, industry or geography have been identified — whether as a direct or indirect counterparty, or as risk mitigation provider. In most cases, the best chance for minimising loss is in the early stages of a crisis — or even before the crisis itself. Get a legal opinion on the validity and enforceability of your documentation. Identify and contact parties, such as customers, government contacts or lobbyists, who may be able to provide assistance. Again, know your own company’s priorities and limits — for example, is it more important to avoid a financial loss, lengthy recovery battle or possible reputation impact? Does your company have the financial resources to pursue recovery over a long period and to employ whatever expert assistance is needed?

Good deal structure and documentation, as well as early identification of problems maximises your ability to take action and potentially minimise financial loss. Ensuring that the right risk management processes are in place on a day-to-day basis is essential to managing through any crisis to the best possible outcome for you and your customer.