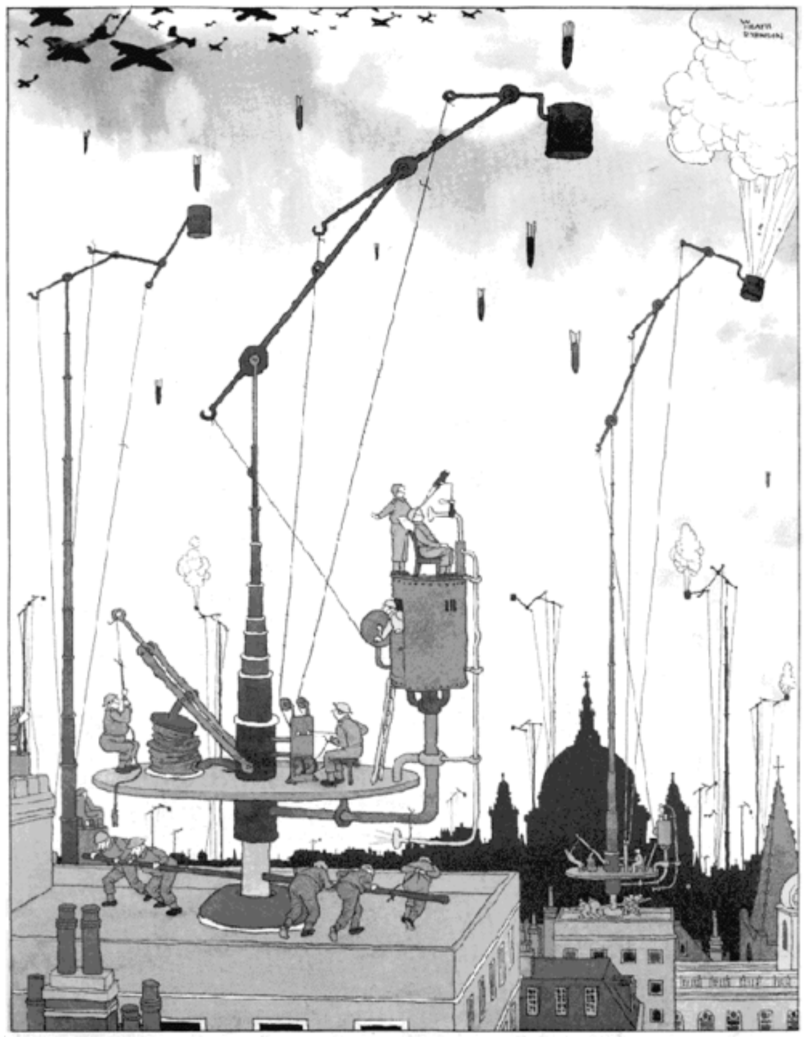
Improving The Cost and Availability Of Corporate Credit



The multi-movement bomb-catcher

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Catching bombs: Risk Management the banking way

Policymakers are keen for banks to lend. However, the banking model is broken. Many of the methodologies developed to intermediate credit are no longer cost effective or trusted by investors. Banks have responded by tightening credit issuance and de-leveraging. Alongside tougher Basel and domestic regulation, fee-earning has been hit. Banks are using general de-leveraging to cleanse their exposure to individuals, companies, other banks/ Financial Institutions and sovereigns who they believe will not only be unable or unwilling to repay debt but also unable to afford the cost of re-priced risk.

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With bank shareholders and creditors nervous, governments dare not push banks too hard. This has left banks free to quote higher borrowing costs in the belief borrowers have limited options. However, banks continued focus on performance metrics such as Return on Equity misses a broader institutional shift towards risk-adjusted measures of financial performance. This offers clear opportunities to 'move the goalposts' some banks believe they own.

As a result of credit constraints and economic uncertainty, companies are preserving cash, delaying investment decisions and becoming more demanding creditors of banks. Protecting themselves and their cash from systemic shocks has become critical. However, whilst banks may say otherwise, improving the cost and availability of external credit whilst also improving Return on Capital Employed are not mutually exclusive.

Capital formation solutions are increasingly sought beyond established bank players. Insurance regulation such as Solvency II & European Reinsurance directive 2005/68/EC and a move to risk-based capital financial regulation globally offer alternative progressive methods of cross sector risk transfer (hardly a new idea) found in Catastrophe and Longevity bonds, that arbitrage price differences between reinsurance and capital markets. As the UK 'NewBuy' mortgage program suggests,[Note the creation of a 9% credit reserve] if bank-sponsored solutions are unavailable/uncompetitive, alternative structures are available. Additionally these solutions may help eliminate a key fault-line of the financial crisis; Information asymmetry which has undermined trust & confidence.

Counterparty credit risk is central to resolving the crisis. Lehman Brothers had more than one million counterparties when it fell. There is no doubt these counterparties were not accurately aggregated across ultimate holding companies or with other group members. Legal Entity Identifcation issues persist and are being addressed by the FSB. As the crisis developed, transaction parties had little timely and high quality daily credit risk data to rely on. Their inability to track granular risk within 24 hours of an observable event being triggered (observable events may include a payment, delinquency, credit note, default or

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protracted default) caused confidence in the financial system to drain. Uncertainty delayed timely decision-making. It was impossible to trust and rely on the risk maps that the banks 'black-box' models used to assess, price, monitor and navigate risk.

High quality credit analysis is therefore critical if a company's credit profile is to reduce all-in funding costs particularly given that creditors and credit insurers currently rely on multiple sources of credit analysis to make decisions. Before the financial crisis, banks & credit rating agencies often relied on 30-90 day old credit information for due diligence and transaction risk monitoring purposes (see P.6). When economic cycles turn, companies rarely receive the benefit of the doubt. High quality and timely trading information is simply unavailable to support informed judgement. In these circumstances, creditor decisions fall back on often self-fulfilling economic forecasts, rather than actual trading performance. Funders and insurers rush to the exits, letting clients reputations get savaged. Umbrellas removed as stormclouds gather; an old story.

Companies must therefore manage two explicit challenges exposed by the receding credit tide:-

1. Growing concern about exposure to corporate counter-party credit risk particularly when growth through export is sought.
2. A company's "Going Concern" status. Whilst the Balance Sheet "Solvency test" (Assets > Liabilities) is easier for an auditor to affirm, there is growing uncertainty a company (e.g. a prescient UK sporting example) will be able to 'meet its obligations as they fall due' if a customer defaults as relationship bank are less likely to "make good" any cash shortfall.

Existing credit risk management processes must address these fundamental challenges. By doing so, they can begin to solve the following problems:-

1. Reduce the total cost of internal and external funding and increase Return on Capital Employed (ROCE).
2. Enable a cash-funded allowance for doubtful debt to be built within a captive insurance structure.

3. Reduce Treasury administration whilst improving Management Information for Risk Dashboards used as part of the Enterprise-Wide Risk Management program.
4. Create a cost-effective and sustainable method of working capital funding.

When it comes to protecting against the cost of buyer/customer default, companies either self-insure or buy trade credit insurance, often a bank funding condition. Most companies do not buy insurance; they self-insure or if the company exports, the bank may seek protection from an Export Credit Agency. It is no surprise insurance isn't popular. Many companies were let down by trade credit insurers pulling cover without notice in 2008. Companies were suddenly self-insuring more and banks, aware insurance cover was disappearing, withdrew contingent liquidity. Either way, credit default risk is priced by banks within the funding margin they charge. For many companies in 2008, their bank-sponsored funding collapsed in '08. Companies want robust alternatives.

Progressive Credit Risk Management (CRM) transparently presents "own credit risk" to improve Asset-Backed transaction terms. When the CRM output is combined with insurance and funding methodologies, the financial benefits are striking. This is because banks rarely offer funding terms based on a due diligence process as thorough as the company themselves can execute daily. Advance rates and terms suffer. In bank-sponsored funding transactions, each €1 of the total trade receivables portfolio receives 65-75¢ of cash once ineligible invoices (concentration risks, geographical limitations and credit dilutions) are excluded. Progressive CRM drives insurance and funding eligibility criteria and monitors covenant compliance, creating a virtuous, sustainable funding circle. For example, a €25m trade receivables portfolio currently supporting a €17m facility could be increased to €22m. Over a 3 year term, €15m of extra liquidity can bring growth forward.

Also, given banks require companies to retain the "first loss" for a funding transaction, these assets can be far better utilised within a captive insurance structure, helping address the "going concern" issue. Building an 'allowance for doubtful debt' cash reserve offers an effective risk barrier for funding programs and a formalised way of managing self-insured credit risk.

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Another critical point for treasurers is value-for-money. Expenditure on traditional trade credit insurance has little if any impact on the company's cost of capital. This is because few insurance policies qualify as eligible credit risk mitigants as defined by Basel banking rules. This highlights a weakness among many banks and insurance companies who - as the global financial crisis shows - have tended to tailor their products and services more to meet their own and other financial market participants commercial needs rather than those of their corporate clients. It also highlights how effective 'insurance' can reduce a bank funders RWA significantly.

So, progressive CRM and the better presentation of a company's own credit risk profile create clear benefits:-

1. Risk information required to manage compliance with a company's explicitly agreed corporate risk appetite and external funding programs.
2. Support transparent pricing of external credit using funding structures that reward companies who manage -and therefore influence the outcome of- credit risk effectively. Advance rates increase to 85-95% of the total trade receivable portfolio and all-in funding costs reduce by 10-20%, increasing ROCE.
3. Address risks a company faces from a sudden cash shortfalls when a customer defaults. Introducing captive insurance vehicles into funding structures enables companies to build cash reserves covering credit default. This is now achievable operationally thanks to technology, supporting the auditors assessment of company's going concern status.

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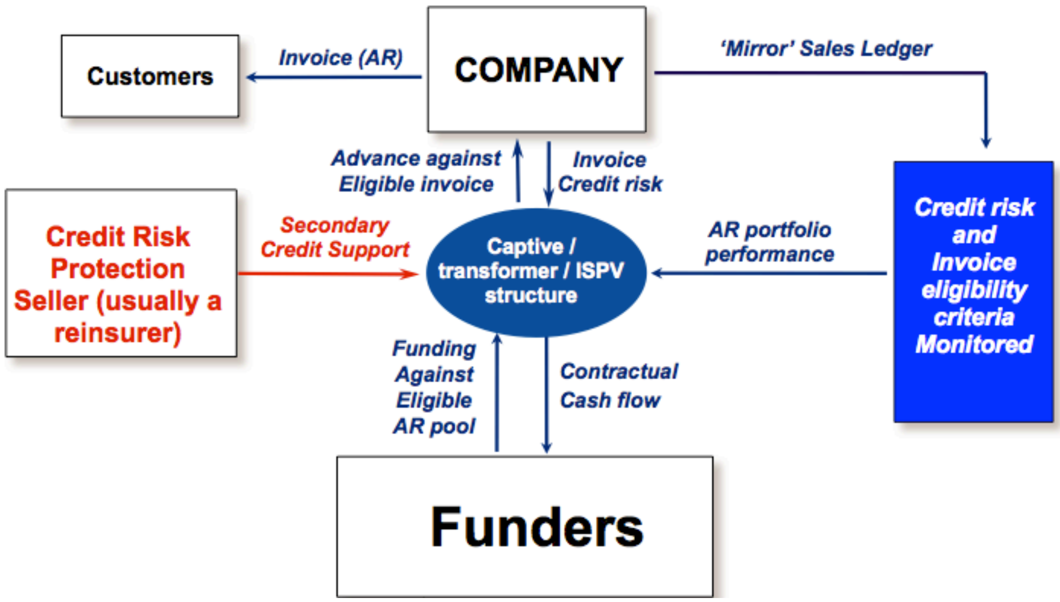

Progressive CRM holistically reduces credit risk and therefore funding costs. It opens the door to investors seeking high quality disclosure and timely risk monitoring which eliminates a fundamental cause of the financial crisis, information asymmetry.

Dissatisfaction amongst companies expecting innovation from their relationship banks is growing. L & G CEO Tim Breedon's report to the UK government released Friday should call time on opacity-generating banks control of credit creation in favour of investors keen to reward effective risk management and good corporate governance.

Main benefits of progressive credit risk management

1. Reduce "all-in" funding costs and Improve Return on Equity/Capital.
2. Improve access to credit by reducing regulatory capital costs for bank funders.
3. Reduce reputation, liquidity & systemic risk.
4. Improve cash-flow forecasting.
5. Create a more formal "self-insurance" process, building bad debt reserves.
6. Enhance Enterprise-wide Risk Management.
7. Limits call on scarce Senior Risk Management time.
8. Expands funding capacity for clients exporting to overseas customers.
9. A holistic approach to customer, funding, self-insurance & insurance credit risk.
10. Use accumulated reserves for Supply Chain Finance purposes.

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