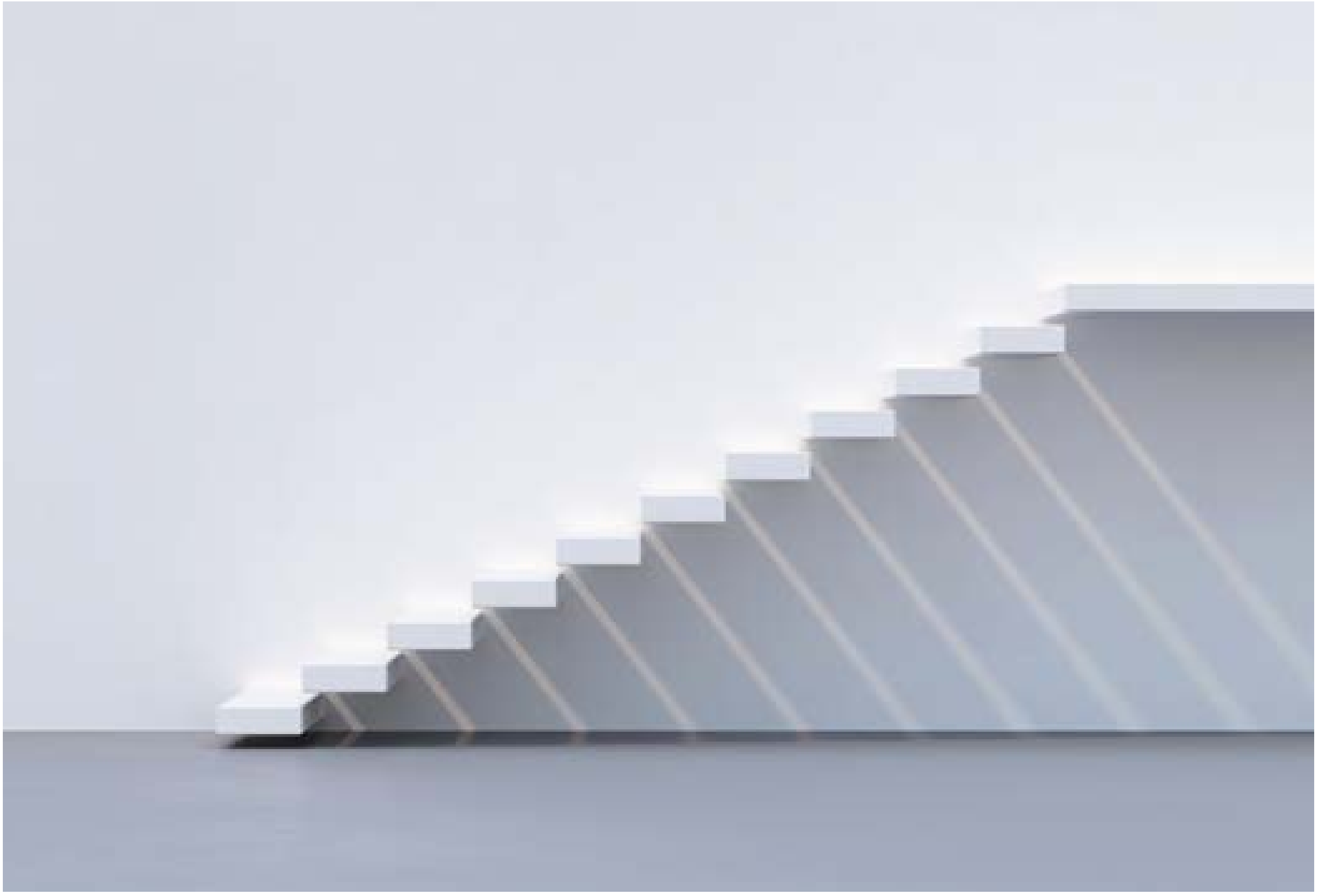
Five Steps to Avoid Unwanted Exposure

A Guide to Minimizing Counterparty Risk



S&P Global
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Introduction

We have entered a new era for counterparty risk. In 2020, global corporate defaults in S&P Global Ratings' universe of rated issuers totaled 226, up 91% from the previous year.[1] Much of this was due to defaults in the U.S. and Europe, regions that account for the largest number of rated issuers and that had been heavily affected by the COVID-19 pandemic.[2]

Continued COVID-19 related pressures are expected to lead to additional defaults around the world, especially for small- and medium-sized enterprises (SMEs) that have felt the burden more than larger companies that have better access to credit.[3] The magnitude will also vary by sector and sub-sector.[4] Adding to this, the pandemic has brought environmental, social, and governance (ESG) risks to the forefront, as well as the deep linkages that exist between businesses and their stakeholders across value chains.[5]

The growing complexity posed by these intersecting risks calls for a sharp focus on counterparty assessments, underscoring the need for deep and timely data and robust analytical tools. This Guide describes the five steps that credit risk professionals typically take to protect their organizations from counterparty losses, some of the challenges they face, and several ways to address these challenges.

Steps to Protect Your Organization from Counterparty Losses

1 **Profile counterparties**

2 **Perform peer group analysis**

3 **Dig deep on creditworthiness**

4 **Establish credit limits and terms**

5 **Monitor exposures**

[1]Credit ratings are prepared by S&P Global Ratings, which is analytically and editorially independent from any other analytical group at S&P Global.

[2]"How can one identify the early-warning signs of credit deterioration?", S&P Global Market Intelligence, March 9, 2021, www.spglobal.com/marketintelligence/en/news-insights/blog/how-can-one-identify-the-early-warning-signs-of-credit-deterioration.

[3]"COVID-19: Assessing The Credit Risk Impact On Small- And Medium-Enterprises (SMEs)", S&P Global Market Intelligence, July 24, 2020, www.spglobal.com/marketintelligence/en/news-insights/blog/covid-19-assessing-the-credit-risk-impact-on-small-and-medium-enterprises.

[4]"The Outlook For Corporate Credit Risk; COVID-19 Pandemic And Macroeconomic", S&P Global Market Intelligence, May 11, 2020, www.spglobal.com/marketintelligence/en/news-insights/research/the-outlook-for-corporate-credit-risk-covid-19-pandemic-and-macroeconomic.

[5]"Pandemic Pandemonium, The ESG lens on COVID-19, Part 1", S&P Global Market Intelligence, April 20, 2020, www.spglobal.com/ratings/en/research/articles/200420-the-esg-lens-on-covid-19-part-1-11444298?utm_campaign=corporatepro&utm_medium=contentdigest&utm_source=covid_esg.

Step 1
Profile counterparties

The first step is to gather information on the counterparty to create a profile of the business, including details on date established, industry, location, number of employees, and ultimate parent.

This can then be embellished with financials. Although financials can be accessed in multiple ways, the challenge is to find a timely source that has broad coverage with data that is standardized to easily facilitate cross-company comparisons. In addition, since companies may reclassify or restate their historical results for various reasons (e.g., divestitures, mergers, and accounting changes), point-in-time data is also helpful. Finally, having a source with robust search capabilities can save time when looking to zero in on companies of interest.

Not surprisingly, it is more difficult to obtain financial data for private companies, many of which are SMEs. Gathering details from suppliers, customers, or banking relationships can yield ad hoc results that are not easy to assess. Again, there are many benefits to identifying a timely source that offers standardized data for comparisons with both private and public entities.

As ESG issues continue to take center stage, it will become more important to add these factors to your counterparty profiles, as well. For example, there can be physical risks if a counterparty's assets are located in areas known for severe weather conditions, such as hurricanes, droughts, and wildfires.

How it works

Get details on company firmographics
Profiles of public and private firms worldwide, including contact information, competitors, financial auditors, and summary or detailed descriptions can be found in the Company Intelligence dataset. Selected firmographics are also available via RiskGauge.

Dig deep on public company financials
Standardized data for over 5,000 financial, supplemental, and industry-specific data items for over 150,000 companies globally, including over 95,000 active and inactive companies across multiple industries is offered via S&P Capital IQ Financials. Data is available at numerous frequencies and point-in-time representations of a financial period include press releases, original filings, and restatements.

Tap into a large source of private company data
Data on 16 million private companies around the globe, 11 million private with financial statements, and 500,000+ early stage companies supported by data from Crunchbase is available from the Private Company Dataset.

Look at geographic risks from climate change
Company exposure to physical risk at the asset-level can be assessed with a database of over 500,000 assets mapped to 15,000 listed companies with S&P Global Trucost's Physical Risk. The dataset includes seven climate change physical risk indicators, including heatwaves, cold waves, water stress, hurricanes, wildfires, flood and sea level rise.

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[2]"How can one identify the early-warning signs of credit deterioration?", S&P Global Market Intelligence, March 9, 2021, www.spglobal.com/marketintelligence/en/news-insights/blog/how-can-one-identify-the-early-warning-signs-of-credit-deterioration.

[3]"COVID-19: Assessing The Credit Risk Impact On Small- And Medium-Enterprises (SMEs)", S&P Global Market Intelligence, July 24, 2020, www.spglobal.com/marketintelligence/en/news-insights/blog/covid-19-assessing-the-credit-risk-impact-on-small-and-medium-enterprises.

[4]"The Outlook For Corporate Credit Risk; COVID-19 Pandemic And Macroeconomic", S&P Global Market Intelligence, May 11, 2020, www.spglobal.com/marketintelligence/en/news-insights/research/the-outlook-for-corporate-credit-risk-covid-19-pandemic-and-macroeconomic.

[5]"Pandemic Pandemonium, The ESG lens on COVID-19, Part 1", S&P Global Market Intelligence, April 20, 2020, www.spglobal.com/ratings/en/research/articles/200420-the-esg-lens-on-covid-19-part-1-11444298?utm_campaign=corporatepro&utm_medium=contentdigest&utm_source=covid_esg.

Step 2

Perform peer group analysis

Peer group analysis is a vital part of credit risk assessments, enabling comparisons between groups of companies to evaluate relative performance and identify anomalies. This can help quickly flag areas that need to be investigated further. Since peer group analysis uses financial ratios and other risk measures, gaining access to timely, comprehensive, and standardized data is especially key here to make sure comparisons are done on a consistent basis. Having adjustments for nonrecurring charges in financials will be important, plus the ability to identify items that have been restated or reclassified. In today's environment, comparing relative performance on sustainability factors should also be included, where possible.

How can we help?

Access standardized financials for public companies

Industry-leading financials with over 5,000 individual data items, including industry-specific metrics on 17 industries can be found in S&P Capital IQ Fundamentals. The data is adjusted for nonrecurring charges to enhance comparability and are auditable down to the source documents. In addition, the GICS methodology assigns each public company to a sub-industry and corresponding industry, industry group, and sector according to the definition of its principle business activity.

View a large source of private company data

Data on 16 million private companies around the globe, 11 million private with financial statements, and 500,000+ early stage companies supported by data from Crunchbase is available from the Private Company Dataset.

Compare credit ratings across companies

As the official source for S&P Global Ratings' credit ratings and research, RatingsDirect® combines this essential intelligence with comprehensive market data, credit risk indicators, and dynamic visualization tools, all on a single platform. Corporate scores and modifiers are available on approximately 3,900 rated corporates globally, and bank factors on approximately 600 rated banks globally.

Look at credit scores when ratings are unavailable

Point-in-time factors combine with forward-looking qualitative factors, converging trends, and relationships between key drivers to provide a full picture of credit risk with our Credit Assessment Scorecards, which are especially helpful for low-default portfolios. ESG factors are considered too, as part of a holistic approach to assessing credit risk.

Add a lens on ESG performance

Company-level, dimension-level, and criteria-level scores from S&P Global ESG Scores draw upon 20 years of experience analyzing sustainability's impact on a company's long-term value creation.

Gain insights on import and export activitiy

Company trade activities available from Panjiva Supply Chain Intelligence provide insights into market shares by seeing where businesses source their goods and which entities are involved in the shipment of goods. This provides visibility into the import and export activity of competitors, partners, and prospects — all in one place.

Step 3

Dig deep on creditworthiness

Credit ratings, when available, provide useful forward-looking opinions about the ability and willingness of debt issuers to meet their financial obligations on time and in full. More challenging, is understanding unrated counterparties, given the lack of widely available credit opinions. In addition, it is not uncommon for private firms to comprise more than half of one's risk exposures, with financials being typically hard to obtain. Probability of default (PD) models can provide the insight needed to stay one step ahead of credit risk in these situations.

Having exposure to a distressed firm, and a potential default, is a real possibility. Equally important, however, is what may be recovered if a default occurs. Ignoring loss given default (LGD), or assuming a fixed average LGD, may be misleading and potentially result in a misallocation of economic and regulatory capital, inefficient pricing, incorrect provisioning, and inappropriate limits. This underscores the importance of looking at PD and LGD together.

Climate risks can no longer be ignored, as well. This include physical risks from assets being impacted by severe weather, as well as transition risks that may result as policies (such as a carbon tax) are implemented to encourage companies to move to a green economy.

In addition, the impact of COVID-19 has shown that disruption to supply chains is another critical factor that will weigh on the creditworthiness of some sectors, making shipping data and supply chain intelligence important elements to consider.

How can we help?

View a company's credit rating

As the official source for S&P Global Ratings' credit ratings and research, RatingsDirect combines this essential intelligence with comprehensive market data, credit risk indicators, and dynamic visualization tools, all on a single platform.

Generate credit scores

Sophisticated models are used to generate quantitative credit scores on counterparties around the world, which can be scored individually or in a batch with the Credit Analytics suite of analytical models.

Determine the size of a loss

LGD estimates the portion of an exposure (bond or loan equivalent) that will likely not be recovered in the event of default and can be determined using our LGD Scorecards.

Evaluate risks from climate exposure

As the effects of climate change and the importance of mitigating activities becomes more widely known, credit professionals can assess the climate exposure of their portfolios with Climate Credit Analytics.

Zero in on supply chain risks

Global import and export transaction details for over 1 billion shipment records with information on buyers and sellers, product descriptions, values, and more is available with Panjiva Supply Chain Intelligence.

Step 4
Establish credit limits and terms

Defining the appropriate credit limits for customers plays an important role in helping a supplier maintain short-term liquidity, optimize growth opportunities, and manage the risk of non-payment. There are no generally accepted approaches for setting business credit limits that capture the risk factors on both sides of the exposure, i.e., supplier and customer. Approaches based on a customer's financial information are often unfeasible for small and private companies due to the limited availability of information. These approaches also typically lack responsiveness in terms of the macro environment and, in most cases, do not explicitly consider the supplier's risk appetite. A framework is needed to assess the total maximum exposure based on both the customer's and supplier's information, even when financials are missing. The analysis should consider a customer's creditworthiness, the dynamic assessment of their industry payment behavior, and additional size adjustments.

Both trade payment risk and default risk are types of credit risk that focus on the same question: Will a debtor make a repayment on time and in full? However, trade payment risk originates from trade credit, which is fundamentally different from the underlying exposure of default risk (e.g., on a loan or bond). The distinctive objective, size, duration, and collection cost of a trade credit leads to a special set of assessment criteria that are different from the typical criteria for a loan or bond. Consequentially, the traditional default risk measures, such as credit ratings and PDs, are not applicable for trade payment risk. An approach is needed that enables a quick and forward-looking estimate of trade payment likelihood and related expected delinquency (i.e., payment delay).

How can we help?

Set exposure limits
Maximum exposure limits can be determined based on an analysis of a customer's PD, liquidity risk, recovery, and risk appetite with MaxLimit, contained within RiskGauge Reports, available via Credit Analytics.

Evaluate late payments
Trade payment risks of SMEs can be uncovered with the PaySense model that uses historical payment data and macroeconomic factors to estimate a company's potential delinquency (i.e., payment delay), captured in a PaySense Score that ranges from 1 to 100.

Understand potential defaults
Point-in-time factors combine with forward-looking qualitative factors, converging trends, and relationships between key drivers to provide a full picture of credit risk with our Credit Assessment Scorecards, which are especially helpful for low-default portfolios. ESG factors are considered too, as part of a holistic approach to assessing credit risk.

Step 5
Monitor exposure

Monitoring emerging credit risk before it hits the financial statement can be a challenge, especially when looking at hundreds of counterparties. Early-warning signals are important and can be captured by evaluating the market's sentiment about credit quality in-between financial statement dates. Equity market-driven models can provide timely indications of changing default risk — either positive or negative. This can be embellished with news and research to better understand the drivers of risk, as well as third-party research from buy and sell side analysts.

Scenario analysis is also a useful tool to help anticipate the impact of unexpected changes in the business environment on a counterparty's performance. This approach can also be used to assess credit risks under different future climate outlooks.

How can we help?

Gain fresh insights on potential risks
Assessing and monitoring the credit risk of counterparties and investments globally is supported by RiskGauge Reports that are updated daily, providing fresh information to stay on top of developments that may impact a firm's creditworthiness.

Stay on top of important developments
Information on more than one million key developments, with topics such as earnings announcements, dividends, board meetings, customer announcements, organization structural changes, and more can be accessed in the Key Developments datasets.

See what the buy- and sell-side has to say
The Aftermarket Research features more than 30 million reports from 1,800+ global investment research providers, plus small- to middle-market brokers, to help users gain essential perspectives on the companies, sectors, and industries they track.

Perform climate scenario analysis
The impact of different climate-related scenarios on counterparties can be evaluated with Climate Credit Analytics, a climate scenario analysis and credit analytics model suite.

Protecting Your Organization from Counterparty Losses

Credit risk professionals play an important role in organizations throughout the capital market ecosystem. As COVID-19 continues to put a heavy strain on global credit conditions in 2021, it is critical to have rigorous methodologies in place to better understand potential credit deterioration with key counterparties. Many of the solutions mentioned in this Guide are available via multiple delivery options — from desktop platforms to flexible data feed, cloud, and API delivery options.

Contact us to learn more about our global counterparty risk solutions

About S&P Global Market Intelligence

S&P Global Market Intelligence integrates financial and industry data, research, and news into tools that help track performance, generate alpha, identify investment ideas, understand competitive and industry dynamics, perform valuation, and assess risk.

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