

Experts in the News

Mitigating the Myriad of Risks in Trade

Risk has always been an inevitable component of trade but the significance of managing risk effectively has heightened due to rapidly changing market dynamics and the ongoing impact of the credit crunch. In this challenging environment, how can corporates develop a comprehensive risk management policy and protect themselves from the risk of reputational damage or financial loss?



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With the advent of globalisation in the trade and cash space, supply chains have become longer and more complex as companies increasingly develop trade links cross-border and overseas. In addition, the credit crunch has created a liquidity squeeze, which has restricted the investment and funding capabilities of many corporations with lenders now focusing more closely on the creditworthiness of their trading partners. Add to this the myriad of risks inherent within trade (which are equally significant and often overlap) and we can see that mitigating risk in trade is a complicated task.

Implementing a comprehensive risk management policy is, however, imperative and a good starting point for corporates is identifying the different types of risk prevalent in trade and understanding the salient issues around them.

Credit Risk

Buying and selling goods invariably involves credit risk, i.e. the risk of extending money or goods and not receiving the equivalent consideration in return. Establishing the creditworthiness of a trading partner and their ability to repay is therefore paramount. Parameters such as a company's cash flows, past history, financial stability, quality of management, ethics, reputation and business strategy should all be taken into account when ascertaining creditworthiness. Knowing your counterparty is therefore vital in any trading relationship. One of the time-tested rules for corporates is to take an evolutionary approach to their supply chain relationships and start with non-creditory dealings before slowly and gradually extending credit. (This technique is particularly applicable when dealing with cross-border trade.) This approach will vary obviously across industries and geographies – both in terms of credit being extended, as well as the time it takes to mature from a “cash down payment” basis to advancing trade credit.

Another core principal of lending is to ensure both the amount and the period it is advanced for are need-based. It is important that corporates understand the working capital cycle of their buyers in order to match the credit period to the actual need and no more.

Further down the line, from a creditor's perspective, it is also necessary to have different ways out within the lending structure. For instance, while a corporate might directly extend credit to buyer A, it is likely that buyer A is not the end user and is in turn dependent on end user B for repayment. Unfortunate changes in the financial status of end user B could therefore have a detrimental impact

on the corporate being paid back. Therefore, a safer solution would ensure not only recourse to A for the exposure, but also an alternate, i.e. through an independent third-party agency (such as insurance), in case B fails.

This common scenario also highlights the significance of the underlying documentation associated with each trade. In the unlikely event of a default, it is this documentation and the legal jurisdiction that will dictate recourse options including loss given default. A related aspect is that of criticality of the goods to the particular industry and country. For example, given the salience of crude oil products to the functioning of the economy, corporates and countries are less likely to renege on their obligations. If this were to happen, it could have a disastrous impact on their image and jeopardise any further ability to buy oil in the international markets.

Counterparty Risk

Counterparty risk refers to the obligor's risk and, as mentioned above, it is vital to understand on whom the risk is predicated. Is it the actual buyer, the buyer's parent, a financial institution or an intermediary? In most cases, corporates might directly extend credit to one party while basing their decision on support from a third party so the ramifications can be very different under each of these options. For example, a financial institution's letter of credit (LC) or guarantee as support is a good way to transfer the direct risk on the buyer to the financial institution. In addition to the primary way out (i.e. the buyer being able to pay), it adds another layer of comfort in the form of the financial institution's creditworthiness. Additional security comes at a cost, though, and companies could consider eliminating this guarantee for counterparties in countries where they have an established track record, while opting to seek additional security where they feel less comfortable.

The risk of fraud is also closely connected to counterparty risk. Without conducting in-depth due diligence on their counterparties, corporates run the risk of getting duped by fraudsters on the lookout for gullible victims. These fraudsters can be extremely sophisticated and well-versed with international practice so corporates need to be careful that they do not fall prey to them. In this regard, corporates need to embed and operate a robust customer selection criteria when it comes to any new business relationship. Companies should seek guidance from their banking partners, as well as other market sources, before establishing any new relationships.

Foreign Exchange Risk

International trade is predominantly US-dollar denominated. While it makes it easier for various counterparties to deal in, it also creates various complications for its participants.

First, in the emerging markets there are a number of countries where the US dollar is still not readily accessible. Given the limited availability of the US dollar, corporates need to go through the central bank while waiting for weeks, if not months, to consummate their payments. For a corporate expecting to be paid in 30 days, for example, it is important to know whether the obligor will be able to access the funds in time. More often than not, there are frequent delays in obtaining sufficient US dollars to make the payment, and it would be advisable for corporates to build in these delays into their pricing models.

Second, the fluctuating strength of the US dollar vis-à-vis other currencies has had far-reaching consequences, particularly over the last year. A buyer's receivable may be in the local currency and when the US dollar appreciates, the buyer might be exposed financially to receiving less than what was due to them. Foreign exchange (FX) covers can be taken by the buyer to mitigate this risk but, depending on the financial standing of the buyer, it is not always

possible to get this cover. To mitigate this risk, corporates could adopt a strategy to collateralise their flow, i.e. extend credit for a percentage of the underlying flow (75-80%) as opposed to the entire invoice value.

On a more strategic level, as a currency depreciates vis-à-vis the US dollar, it puts a strain on the country's overall imports and balance of payments. Over time, it can lead to substantial changes in the direction of trade flows. Corporates need to keep a close tab on these changes to both re-align their product suite to best suit the marketplace and re-price their products to keep in line with the effect the FX fluctuations might have on the longer-term demand for their products.

Finally, different strategies might be needed for countries that are pegged to the US dollar as opposed to those that aren't. For example, while trading with some countries in the Middle East where the local currency is pegged to the US dollar, an import in euros can suddenly become costlier as the US dollar depreciates against the euro. In this case, for a European exporter selling in the Middle East with an in-built "collateral" structure, it could mean mark-to-market of the underlying security to ensure that, at all times, they are hedged against these fluctuations.

Price Risk

For corporates operating in the international trade space, there is a close relationship between FX risk and price risk, i.e. the risk of not having priced their output correctly, thereby leading to a loss. As a result, there is a tight balance between being competitive in the market place, while ensuring one makes a profit from the sale. Given the sheer pace of change in the global markets, however, particularly over the last year, one could be caught off guard. For example, one could suddenly see an increase in the cost of goods due to either the cost of raw materials going up or the cost of logistics spiralling. A rise in oil prices could lead to the former and unexpected closure of ports due to political instability or strikes could result in the latter. If a corporate is relatively unhedged on its sales contracts, i.e. it does not have price flexibility with its buyer on longer-term off take contracts, it could find itself suddenly making losses.

Sovereign Risk

One of the most important risks in international trade is related to the overall solvency and political stability of the importing country. Trade obligations usually get a preference over longer-term sovereign debt and it has been empirically observed that countries facing an FX crisis continue to meet their trade obligations while attempting to re-schedule their longer-term borrowings. That said, corporates would be wise not to depend solely on this preference, especially for countries in the emerging markets, which have volatile economic or political backgrounds. Banks can be effective partners in mitigating this risk through relatively simple risk defeasance products such as LC confirmations.

Closely tied in with sovereign risk is event risk, which is the risk of an event suddenly changing the economic landscape of the country and catchment region. Armed conflict between nations is one example of an event risk that can radically transform commercial flows, and this type of event is one that corporates would do well to foresee and specially safeguard against.

Compliance and Regulatory Risk

Since the 1950s, the US dollar value of international trade flows has grown almost 200-fold. It is increasingly becoming cross-border and governments and central banks continue to regulate these flows around the world. For a corporate participating in international trade, it is vital to keep up to date with

the laws and regulations that govern trade. While the various rules published by the International Chamber of Commerce (ICC) are relatively easy to understand and adopt, it is the local nuances in regulatory framework that need greater attention and effort. For example, in some countries goods need to be inspected locally by customs before import payments can be effected; while in others, there is extensive regulatory paperwork that needs to accompany each and every payment. There are also some countries where a corporate needs a government license to conduct trade.

What makes the situation even more complicated is the frequent changes to these regulations. Fortunately, global banks can help to alleviate some of this pain, especially with regard to the documentation needed to make import payments. Corporates can outsource this document preparation and consolidation to a banking partner who will be able to manage this on a larger scale. To assist their clients, some global banks also conduct regular training sessions so that corporate customers are updated promptly about any significant regulatory changes.

Operations Risk

In international trade, operations risk can take two forms: logistics risk where goods do not reach their destination on time, thus rendering the sale useless; or documentation risk where the underlying documents that support the trade are not prepared in time or contain discrepancies leading to increased costs or not being able to secure payment.

The former risk, i.e. transportation risk, is usually handled well by corporates. For instance, in-house logistics departments with the help of freight forwarders employ professional carriers who ensure timely deliveries. It is the latter risk – discrepancies in documents – that is often overlooked. Fortunately, global banks can again be of great help as either partners to outsource document preparation to or as advisers who can regularly provide training on the subject. Employing simple practices, such as a two-step maker-checker transaction approval process, could also ensure errors are spotted early on. In addition, some corporates have taken the extra step of implementing document-checking software to ensure errors are avoided.

Conclusion

As the international trade arena continues to expand, opportunities continue to grow too but the global marketplace is far from perfect. Inefficiencies in demand and supply, dislocations due to political and economic developments and unforeseen events all continue to create a dynamic international trade environment. But with opportunity also come risk, as outlined in this article. Corporates that keep both the opportunities and risks in international trade in close focus will be best armed to expand and succeed.

**Key Points:
Mitigating Risks in Trade**

Credit risk	<ul style="list-style-type: none"> • Establish the creditworthiness of trading partners. • Take an evolutionary approach to supply chain relationships. • When it comes to lending, ensure both the amount and period are need-based. • Establish different ways out of the structure. • Understand the importance of underlying documentation associated with each trade.
Counterparty risk	<ul style="list-style-type: none"> • Establish where the risk is predicated within your relationships. • Conduct due diligence on all counterparties. • Seek guidance from bank partners before establishing new relationships.
FX risk	<ul style="list-style-type: none"> • Factor in potential delays in obtaining sufficient US dollars to make a payment in pricing models in countries where the dollar is not readily accessible. • Understand the fluctuating strength of the US dollar compared to other local currencies and its impact on trade flows. • Employ different strategies for countries that are pegged to the US dollar compared to those that aren't.
Price risk	<ul style="list-style-type: none"> • Stay abreast of changes in the global market. • Maintain some price flexibility with buyers on longer-term offtake contracts.
Sovereign risk	<ul style="list-style-type: none"> • Keep up to date with the solvency and political stability of importing countries. • Take into consideration event risk, such as armed conflict, that could transform trade flows.
Compliance and regulatory risk	<ul style="list-style-type: none"> • Stay abreast of the laws and regulations that govern international trade. • Pay closer attention to nuances in local regulatory frameworks. • Use bank partners to outsource document preparation.
Operations risk	<ul style="list-style-type: none"> • Use bank partners to outsource document preparation and as advisers on this task. • Employ document-checking software and practices within trade workflows.

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