

COUNTERPARTY RISK MANAGEMENT IN AN INDUSTRIAL ENTERPRISE

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Abstract

Counterparty risk as a distinct type of risk generates a number of difficulties, some of which to one degree or another strongly influence the functioning, development, survival of the industrial unit. It creates a chain reaction that inevitably leads to lack of working capital for sustaining the current production activity and the timely coverage of costs related to production and its realisation. To a great extent all this reflects on the production activity of the enterprise and on the impossibility to provide enough funds to pay its obligations. The purpose of this paper is the counterparty risk and to justify the possibility of its management, thus limiting and reducing the unfavourable consequences and risk exposure of the industrial enterprise.

Keywords: counterparty risk management, risk counterparties, risk circumstances, risk exposure, industrial enterprise.

Presentation of the Main Material.

The consequences for the industrial enterprise from the counterparty risk can be direct as well as indirect, which indicates exceptional importance of the constant search for opportunities and methods for its management which includes purposeful activities for identification, analysis, estimation, restriction, monitoring and controlling the risk. At the same time, this is a risk that has a bidirectional impact on the interests of both the enterprise and its counterparties, which practically requires the development and application of a thorough, specific and adequate program for counterparty risk management that determines the approach, elements of the management and the resources that have to be provided by the economic unit.

Actually despite the established counterparty risk management

models (classic, integral, holistic, total), every industrial enterprise has to apply the individual approach principle taking into account its potential abilities and available resources (material, labour, financial, informative) as well as the specific peculiarities and parameters of the counterparty risk.

The proper and rational management of the counterparty risk is a key factor for the industrial enterprise because it strongly influences the increase in the level of manageability of the negative conditions and the improvement of quality of the managerial decisions made. At the same time creating a clear idea for management enables the early establishment of the potential reasons for non-performance of the contractual obligations of the company's counterparties, an accurate identification of their risk profile, a fast realisation of successful preventive actions and insurance of maximum security of the enterprise.

The modern industrial enterprise very carefully formulates the *strategic goals* related to counterparty risk management. It mainly gravitates towards timely discovering the weaknesses of the company's counterparties and the correct determination of their risk profile, as well as towards precise performing of scientifically grounded analyses and preparing an objective and real evaluation on the basis of which specific mechanisms are developed for prevention and effective counteraction to the risk circumstances and their consequences. This way the economic unit outlines the guidelines more clearly, focuses its efforts and determines the priorities and vision on reduction, restriction and removal (elimination) of the counterparty risk.

It should be taken into consideration that the establishment of the *counterparties' risk profile* is a difficult and prolonged process. Precisely via it the separate individuals and/or organisations that are directly or indirectly in certain relationships with the industrial enterprise are identified, diagnosed and evaluated.

On the basis of *identification* the possible sources of the counterparty risk and its varied influence on the enterprise's activity are determined. This is a process by which the existing or potential risk situations

linked with the company's counterparties are discovered and described. The modern industrial enterprise uses separately or in combination different traditional and specific techniques and methods which increase the possibility of performing an accurate and objective identification of the risk counterparties (see Table 1).

Table 1

Techniques and methods for identifying the counterparty risk of the industrial enterprise

Tech ni- ques	Key chara- cteristics	Tradi- tional me- thods	Key chara- cteristics	Spe- cific me- thods	Key characteristics
<i>Brainstorming</i>	This is a group technique for determination of the specific problems as well as acquaintance with and description of the counterparty risk.	<i>Method of analogy</i>	On the basis of this method the causal links for the emergence of two similar (identical) counterparty risks but in different time periods are sought.	<i>"Check-list" method</i>	This is a list in which the more essential and typical risk situations in the counterparty's behaviour are registered and mistakes made in previous periods are considered and judged.
<i>Questionnaires</i>	Questionnaires are one of the most common tools for collecting primary information on the counterparty risk. They are a flexible tool that allows some of the cardinal dangers and problems as well as the reasons for their emergence to be pinpointed.	<i>Comparison method</i>	This method allows for the changes in the parameters of the counterparty risk to be evaluated and for the trend and perspective for its development to be outlined. It also allows a certain risk situation to be compared with a similar one.	<i>"What if...?" method</i>	With this method the specification of the dangers is more detailed and the nature and the level of damage are stated.
<i>Case Studies</i>	With the help of different business analyses the influence of different factors that cause the counterparty risk is identified.	<i>"Delphi" method</i>	This method is based on the choice of a certain circle of specialists that have to express their opinion independently and to make a prognosis for the counterparty risk.	<i>"FTA – Fault Tree Analysis" method</i>	With this method the causal links between accidental events with different frequency and different stages are estimated. These links help identify the counterparty risk.

Benchmarking	This is a process that identifies the problem areas through comparing with the leading enterprises in the specific sector.	Scenario method	This is a method for identifying the counterparty risk by creating and using different scenarios for the future. Different scenarios which pinpoint the possibilities for change in the counterparty's behaviour under the influence of different (external and internal) factors are developed.	"ETA – Event Tree Analysis" method	It contributes to the making of a hierarchical structure of different levels of danger in the company's counterparty's behaviour which are systemised and registered in a way that allows their easy identification, qualitative characterisation and correct estimation.
Seminars (trainings)	Through the organization of and participation in discussions, practical trainings and seminars new possibilities for identifying the counterparty risk are disclosed.				

Mainly with the help of this method the enterprise collects, processes, systematises, analyses and evaluates information about the risk, resulting from the actions and behaviour of the company's counterparties which the enterprise works and has certain relationships with. In particular the factors that form the risk situation, its scope, the rate of amendment, specific sources and dangers, the reasons for their emergence and the possible consequences are tracked.

The degree of identification of the risk counterparties is fundamental for the correct and precise *diagnosis* that is linked with logical consistent procedures and actions for studying and analysing the risk circumstances. Normally it aims to analyse the company's counterparties' behaviour and then to establish the "narrow places" that lead to the increase of risk situations.

One of the frequently used methods for diagnosis of the company's counterparties in the industrial enterprise's practice is the *method for analysing the sensitivity* (see Fig. 1)¹. It helps the research of the risk profile of a specific counterparty, as it thoroughly analyses the key risks from its activity or inactivity and based on this the corresponding mitigation measures are indicated while being documented and coordinated with the main interested parties in the enterprise.

At the same time this method allows for a hierarchical structure to

¹ A risk that is connected to the providers of the enterprise is shown in this example.

be created, in which the company's counterparties can be conditionally separated into:

☑ *First level counterparties* – these are low risk counterparties, whose behaviour and actions are fairly predictable on the basis of thorough and exact analysis and evaluations or previous experience; they can lead to damage and losses which need reasonably moderate prevention measures or are minimal for the enterprise;

☑ *Second level counterparties* – they are characterised by risk behaviour and actions, the results of which are unacceptable or unexpected for the enterprise and which can directly or indirectly lead to bigger financial losses or large expenses in order to overcome them;

☑ *Third level counterparties* – they are high risk counterparties; their behaviour and activity can hardly be predicted and can lead to fatal consequences for the enterprise or inflict serious financial losses.

Risk description	Probability score	Impact description	Impact score	Risk rating	Mitigating action(s)	Action owner (s)	Target completion date
Capacity issues due to fewer suppliers	2	Failure to supply if capacity estimates are inaccurate	4	8	Supplier audits in advance of switching suppliers Improved forecast accuracy		
Term			Description				
Risk description			Details the nature of the risk and why it might occur				
Probability score			1-2 (Green), 3 (Amber), 4-5 (Red)				
Impact description			Details the nature of the impact, if the risk occurs (e.g. Failure to supply product)				
Impact score			1-2 (Green), 3 (Amber), 4-5 (Red)				
Risk score			Probability score x Impact score				
Mitigating action(s)			List of actions to help mitigate the risk, either through				
Action owner(s)			Who is responsible to complete the mitigating actions				
Target completion date			When the mitigation action(s) will be completed by				

Fig. 1. Model of the method for sensitivity analysis. (N.V.)

This way the enterprise can determine the company's counterparties of a higher risk class and implement pre-emptive measures and restrictions that lead to the removal or reduction of their negative influence. After accurately identifying the company's counterparties' risk profile, the enterprise should develop a *security strategy (program)* via which the enterprise will ensure its maximum protection. Timely making and realizing specific decisions linked to the performing of immediate actions for restriction of the unfavourable consequences from the occurrence of the counterparty risk is also necessary. When making a decision for impacting on the counterparty risk the following *alternative options* are possible:

- using funds for counteraction against the risk in conditions of uncertainty but in a known risk situation;
- using funds for an unknown risk situation but in the presence of sufficient information for an accurate evaluation of its consequences;
- taking measures in an unknown risk situation but with the possibility of evaluating the results from the possible countermeasures that were used;
- taking measures whose value does not allow the enterprise to risk their own capital;
- spending funds when there is a possibility for receiving positive results.

Despite the different alternatives, the enterprise's choice should mostly be based on the possibilities provided for predicting the threats and reduction (restriction) of the company's losses (damage). In particular the modern industrial enterprise strives to apply a certain system of specific mechanisms for prevention and effective counteraction against the counterparty risk, namely:

consulting specific experts and specialists (i.e. lawyers) – the involvement of experts and specialists that will provide all the possible preventative measures for avoidance of the emergence of the counterparty risk is mandatory. They will be able to ensure maximum protection of the enterprise, clear communication and policy in negotiations for the

conclusion of new transactions and preparation of reliable contracts, containing specific terms, steps and actions;

☑ *developing and concluding secure and quality contracts* – mainly they have to be consistent with the respective counterparty's status and prepared by means of appropriate impact tools according to its capabilities, containing clauses which ensure maximum protection, and using every opportunity given by the Bulgarian legislation to protect the enterprise from future complications;

☑ *conducting research on the potential counterparties in advance* – the implementation of detailed research on the potential counterparties' activity, financial position, image and reputation, the gathering of complete and accurate information about persons connected to the specific counterparty and to its possibility for future collateral in certain risk circumstances is mandatory;

☑ *development and enforcement of collateral in case of violation of the contractual relations* – in modern conditions the provision of collateral for defined amounts/goods is more than mandatory, as well as the prediction of certain terms for its timely redemption;

☑ *creation of a workgroup for effective management of the counterparty risk* – the creation of a workgroup of professionals which will observe the company's counterparties' condition and the probability of obtaining the respective receivables from them is necessary. They must carry out checks on the overall financial position of the respective counterparty, prepare an analysis on its indebtedness, presence of overdue receivables and conclude on the degree of risk of making a specific deal with it;

☑ *termination of the contracts with high risk counterparties* – this is an extreme measure but it is mandatory in the presence of counterparties' actions, which lead to negative and unsolvable risks or to avoid ones for which it is known in advance that cause risks of an unacceptable level or are not a subject of treatment.

Conclusion

The implementation of adequate and effective counterparty risk management gives the industrial enterprise the chance to cope with the great number of challenges and dangers related to non-performance of the contractual obligations by its counterparty. Actually, the enterprise will be able to limit the difficulties more accurately and swiftly, eliminate the weaknesses in its activities and implement policies ensuring that the company will achieve better results and demonstrate a more flexible and competitive business behavioural model.

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