

Risky business

Aidan Applegarth, managing director of NoesisRede, takes an in-depth look at risk management in structured trade and commodity finance, and evaluates the market's approach to the processes involved.

"The easiest way to make a small fortune in commodities is to start with a big one!"

— anon

Structured trade and commodity finance (STCF) is a risk business. Handled properly though, it can provide an attractive RAROC (risk adjusted return on capital) to rival most other products, and its application as a support to project finance or export finance, coupled with its potential for bringing in derivatives and capital markets instruments, makes it a valuable tool in a wholesale bank's offering.

We have already seen (*TFR*, April 2005, 'A Veritable Wonderland', page 32) that practitioners hold different views on how best to organise themselves for STCF. This begs the question, do these same practitioners therefore take a different approach to risk management (in terms of required analysis, monitoring and control) or do they share a common ground?

After all, why is it that some institutions seem to consistently avoid the sort of pitfalls that others have a penchant for falling into?

Understandably, those who responded to our survey were reluctant to be disclosed. It's a sensitive topic for many. The feedback reveals, however, that there is indeed a varied approach being taken within the marketplace, but there is also much common ground.

The variety is in the number, frequency and type of processes/systems used – and who uses them. The common ground is the market's perception of risk management.

Risk management of structured trade and commodity finance is a clear

differentiator. Basel II acknowledges this, though we can argue that its underpinning on historic performance provides no guarantee for the future, especially when historic teams leave to be replaced by relative inexperience. That's the case with at least one high-profile institution, which stands to gain from a low-loss legacy even though the current incumbents have little combined experience to draw upon. At the other extreme is an institution relatively new to STCF yet bristling with grey-haired expertise. The nearest asset class it can model against is ship finance, so it's unlikely that the institution will bolster its Basel II standing for STCF commensurate with its more considerable combined experience. Already we see that risk management is not a perfect science.

Perfect or not, the key is to ensure that the risk management systems we use are simple, efficient and relevant. Some banks use customised systems. Others share in those that at best offer a compromise. Being forced to use tools applicable to say, project finance, is like using weighing scales to measure a length of string... they may be a valid tool of measurement, but they're inappropriate for the job. Rubbish in equals rubbish out, and that's a real danger with the statistically driven, compliance dependent, quantitative world in which we operate. It means that all structured trade and commodity finance practitioners should take ownership of the risk management process themselves to fill the gaps left by ill-fitting systems. Only by proving the effectiveness of our own expertise can we then build the credibility essential to driving our businesses forward



Aidan Applegarth, managing director, NoesisRede

and to overcoming the anomalies caused by a faltered legacy.

So, where do we begin?

Our recent survey among a range of STCF practitioners illustrates a few common themes in their perception of the risk management process:

- ❑ That credit management – bar a few cases – does not really understand the risks in STCF deals
- ❑ That quantitative data accounts for no more than 40% of provided risk analysis, yet is used by credit to override and often ignore key non-quantitative data, where credit uses its interpretation of 'tangible' numbers to negate STCF's positive perception of 'future performance intangibles'
- ❑ That monitoring of ongoing risk in deals is frequently outsourced to credit or

operations or audit, where a four-eyes principle may be the norm, but not all four eyes know what they're looking for

- That different institutions rely upon different credit request formats – not all use flow charts or sensitivity analysis, and many rely on quantitative ratings, the input to which is often personal subjectivity.

If there is anything meaningful to extract from the above, it is that the quality and professionalism of the individuals involved in the process is paramount, and that the holders of the purse strings base their approval on apparent numerical tangibility (audited financials, cash flows, quantitative ratings) while STCF practitioners rely upon the intangibility of what may influence performance in the future (strategic importance, network alliances, reputations, political or economic survival). Given this mismatch, is it any wonder that the Credit/STCF relationship is often frictional?

One respondent sums it up for many when he says, "numerical analysis is a good discipline. However, there is perhaps too much reliance placed on its interpretation either to ask endless questions or justify some negative 'feeling' about the transaction".

The ideal, of course, is that credit decisions should be based on both the tangible and the intangible analysis...but that would mean credit having to trust STCF, and STCF having to acknowledge the value of balance sheet analysis.

Building credibility is a two-way street. At the various institutions I've worked, there were quite opposing approaches. I recall presenting my first request to the London Credit Committee of one bank when the financial probing became exhausted and the questioning turned to future performance. To my pleasant surprise, the chairman interrupted to suggest to the committee that since I had been hired for my experience and expertise, unless there was a tangible refute to my intangible claims, he stood by me. We grew the business in that institution to rival any other. Another time, another place, I sat as a new arrival in

front of a credit committee that took delight in informing me that they didn't trust their own STCF staff and that all commodity bankers and traders were crooks. That bank is still failing to fulfil its true potential.

Risk management then is not just about the processes of credit preparation, monitoring and control. It's about the people involved. About their professionalism and open-mindedness. About their relationships internally and externally. Being perceived as the black sheep of the product family means your proposals start on a negative footing. Be perceived as the shining star, and credit will view your proposals through rose-tinted glasses. Somewhere in the middle should come a healthy scepticism promoting constructive challenge and debate.

"People make the difference" is a point emphasised by a number of respondents.

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From the drafting of the credit request to its sanctioning, monitoring and control, it doesn't matter what formal systems are in place, it's the personal appraisals/interpretations/reactions and credibility that are the business makers or breakers. There is a clear frustration at the general quality of credit managers who cannot look beyond a balance sheet, but also annoyance at some STCF credit proposers who fail to address 'the good, the bad and the ugly' in their proposals.

To enhance credibility, many STCF units are now policing their requests through their own formal or informal STCF credit committee. As to addressing the general quality of credit managers, practitioners find themselves embarking on what one veteran describes as "a journey to hold the hand of the sanctioning unit". By building up credibility through relatively

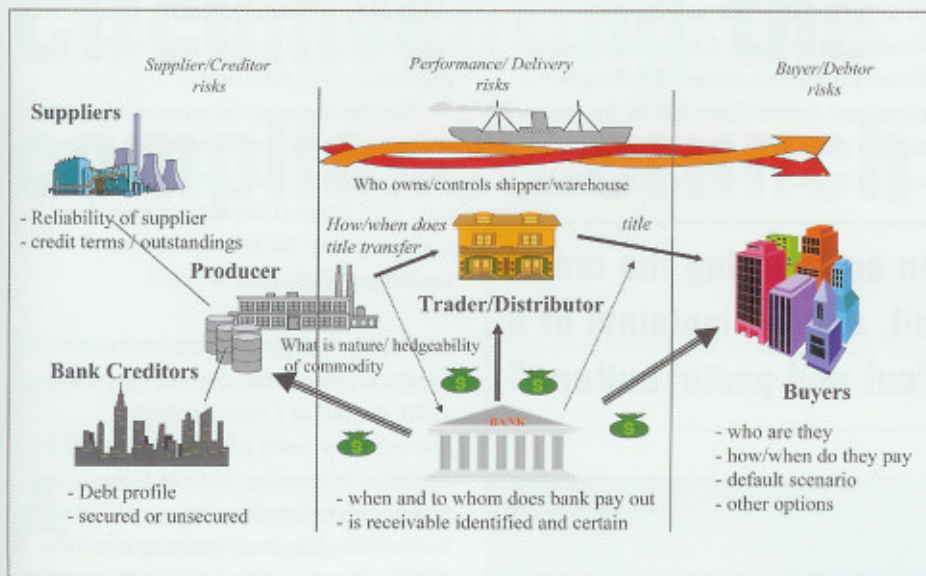
straightforward deals and edging out towards the more structured transactions for credit-challenged borrowers, practitioners are hoping to win over their credit counterparts. Of course, having former STCF practitioners within credit – or former credit managers within STCF – can improve credit quality and ease the approval process, but there's no guarantee.

Ultimately, the presentation of a credit request should be treated as a courtroom drama. The defence (of the request) versus the prosecution. Only by having the better case through anticipating the prosecution's questioning and having answers ready as they arise, can we hope to win. Not being adequately prepared or simply not admitting to the potential failings of a proposal merely arouses suspicion. 'Say what you mean and mean what you say.' I don't claim to have won every case I've fought, but there were occasions when

credit actually felt they owed me one the next time round.

Within the credit preparation process itself, there is a noticeable difference in inputs. One bank has no less than seven software applications for a single request, while three would seem to be the norm. Do seven applications make the process more accurate or reliable? Not according to the users. More than a few respondents felt it was essential for the STCF proposer to prepare and present transactions 'up the line'. Instead, it seems that some banks are even outsourcing the credit write-up to another unit, amid complaints of a 'cut and paste' culture...where inadequate first-hand knowledge and proof-reading puts contradictory or inaccurate information into the proposal.

In terms of our external relationships, a key one is clearly the customer. Know



Visualising transactions encourages thought processes that facilitate seeing risk and finding mitigation

your customer well and you may see problems before they arise. Hardly know the customer at all, and you'll never know what hit you. It would be an easier life to only work with AAA clients, but the income would be minimal and activity probably dull.

Compliance with 'The Money Laundering Regulations 1993' has gone some way to improving our customer knowledge. The downside is that it appears to take banks several weeks longer to acquire new accounts, one bank informing that the backlog of compliance is so great that the data provided will likely be obsolete by the time the forms are processed. In the meantime, the bank risks losing potential clients altogether as more nimble institutions intervene. Has protective compliance gone too far? Probably not. The fault appears more due to understaffed resources than to the compliance requirements themselves.

Knowing our customer is one mitigant, but what about his customers...and their customers, and the suppliers and logistics firms they use? Where do we stop? The simple answer is, we don't. We continue wherever possible to build a holistic picture of the whole transaction chain, because that's where our risk lies.

A surprising finding of our survey is that not all banks insist on a transaction flow chart as part of the credit approval

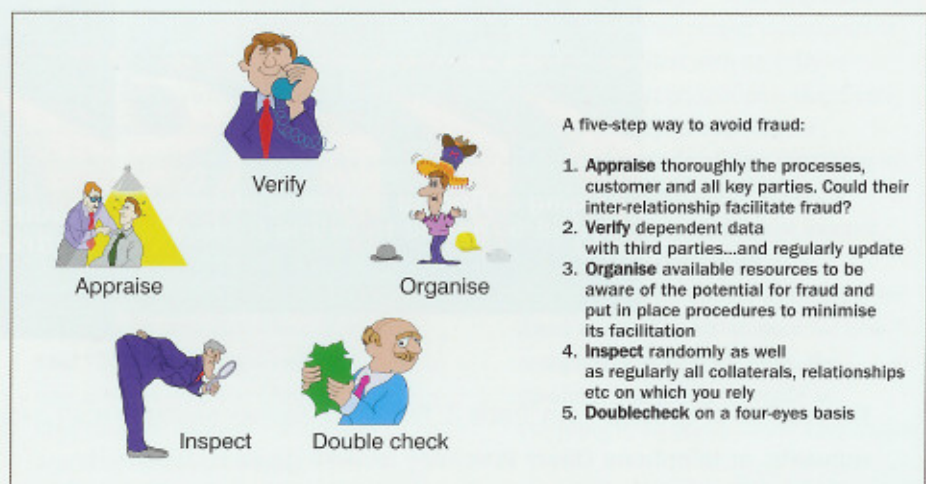
process. I find it indispensable. A picture really does paint a thousand words. On several occasions when asked to support transactions I have insisted on a flow chart, whereupon the proposing account officer has withdrawn the request having seen weaknesses on visualising the detail. If we can't justify a deal to ourselves, how can we sell it to anyone else?

Getting approval though is only part of the risk management process. The real work begins in monitoring and controlling resultant exposure and this, one could argue, is where banks often get it wrong.

Structured trade and commodity finance is not a 'fire and forget' business. The expertise that has gone into

originating and executing deals should be employed in their monitoring and control. To do otherwise is to leave the institution open to operational risk. Yes, there may be a conflict of interest in making the poacher the gamekeeper, but 'two eyes that know what to look for are better than four that don't'. The trend to outsource operational processing and monitoring to centralised in-house units only works when adequate expertise is also migrated – something which in practice is usually frustrated by the comparative cost of specialised staff versus the general pool. We can minimise the impact by education, but there's no substitute for hardened experience.

During the deal negotiation and due diligence process, we are likely to have several meetings with our customers and to make a number of site-trips. Post-disbursement, the frequency of such visits falls away...just as the need to make them increases. Arranged meetings are usual, but random visits add more value. To illustrate this, I once took the opportunity of a holiday in the UAE to make a same-day appointment to meet with the local subsidiary of a well-established trading group. I wanted to see the sugar held in the local port, which my previous bank had just financed. After being duly taken to inspect the warehouse, I called the bank to tell them to move the sugar elsewhere. Why? Because on entering the port, my contact's face was his passport and we had access to wherever we wanted, no formal documents required. Within a month the



A five-step way to avoid fraud:

1. **Appraise** thoroughly the processes, customer and all key parties. Could their inter-relationship facilitate fraud?
2. **Verify** dependent data with third parties...and regularly update
3. **Organise** available resources to be aware of the potential for fraud and put in place procedures to minimise its facilitation
4. **Inspect** randomly as well as regularly all collaterals, relationships etc on which you rely
5. **Doublecheck** on a four-eyes basis

trading group was collapsing and, sure enough, the sugar went missing. One thing in STCF is certain, 'when the going gets tough, fraud happens'.

Fraud is STCF's biggest enemy...but we can avoid it.

led to the failings that saw the likes of Woodhouse Drake & Carey, Goodmans, Drexel Burnham Lambert, Hofflinghouse, Julian, and ArrowChem fall by the wayside taking a number of market participants with them. Not every STCF bank got caught,

already see a dearth of quality practitioners out there, and filling the gaps with experience will take time.

For the moment, no amount of systems and processes will eliminate risk altogether. On the contrary, they may create additional risk. Will Basel II implementation then really improve the risk management landscape? Only time will tell.

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Sometimes the hardest task of any account manager is to say 'no' to their client. Sadly, the remuneration system only rewards us for the profits we make, not for the losses we avoid. Little wonder then that margins are being hammered down, tenors are getting stretched and, quite possibly, sound lending criteria are being waived. This pattern occurred in the late 1980s to fuel a market crisis at the start of the 90s. The clamber for banks to lend to a limited supply of quality counterparts eventually

though some achieved the ignominy of a full house. Going by the previous year's audited financials, one might have been forgiven for not seeing the writing on the wall. But our risk is never in last year's figures...it's in the operationalisation of current and future performance.

Basel II is just around the corner. But not every STCF institution is ready for it. There are concerns that in an attempt to appear compliant, institutions will actually be more open to risk than ever before. We

Aidan Applegarth has been active in the trade and commodity markets since 1980. A spell at Credit Lyonnais preceded ten years of developing UBS's activities in London, Zurich, Geneva and Singapore, before heading up ABN Amro's business in Asia and returning briefly to ABN in London. A former contributor to UNCTAD, Applegarth wrote a chapter on Trade Financing Mechanisms for the WTO's inaugural book. He holds an MBA with distinction from Warwick Business School (2002) and is currently managing director of NoesisRede, providing troubleshooting and strategic leveraging to international businesses. □

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