

Outlook

How Macroeconomics Impact Credit Risk

It is September 22nd as this article is being written. The stock markets around the world are tumbling. The TSX is down 460 points in the first half hour of trading. Rio Tinto yesterday advised of slower growth due to falling commodity prices. The Fed announced the “twist”. Unemployment remains high in North America and Europe. Greece is in danger of defaulting. Italy, as a country, and 7 banks have been downgraded plus 3 banks in the USA have also been downgraded, Bank of America, Citibank NA and Wells Fargo.

In an interview with Amanda Lang on the *Lang and O’Leary Exchange* show this week, Gordon Nixon, President and CEO of the Royal Bank of Canada, indicated the bank regularly carries out internal stress testing to identify and quantify risks to its capital, but now they are going further and expanding the scenarios being addressed. Stress Testing is considering the impact of risks, which are possible, but not probable, on the capital of an entity.

All companies should be regularly stress testing the balance sheet to determine the likelihood of an impairment of the assets and the consequences on the capital of the company. Publicly traded companies, their directors and their auditors should be most concerned because of the new reporting requirements under the International Financial Reporting Standards, IFRS, but all companies should be doing it.

There is a tremendous degree of connection between the macro economic situations in Greece, Italy and the average company. The first connection is between the government debt and European banks which hold most of the debt. The next connection is between the European banks and other banks around the world that have exposure to them. The net pulling all this together is Basel III which will require banks to increase their capital by 2014. Also higher risk assets on the balance sheet will require even higher levels of capital to support them. In the *Report on Business* today, HSBC indicated after selling its wealth management unit, it was putting its personal finance unit on the market. One of the reasons given was to avoid the need for higher capital to support the higher retail credit risk.

As banks seek to increase the quality of the assets on the balance sheet, they will become more selective in the financing they are providing and they may not be prepared to offer new financing to marginal clients or even renew financing of existing lines of credit. They will also be much less benevolent with waivers of breaches of the covenant conditions and may be more aggressive in calling the lines of credit. A good example that recently occurred was Hart Stores filing for protection. From the Creditors’ List it is apparent most suppliers were caught off guard. Hart Stores was a fairly large publicly traded retailer in Eastern Canada and as such, its financial statements were readily available.

What most credit analysts failed to take into account was its financing was with Wells Fargo and after 2 losing quarters, it was coming up for renewal in October. From the documents filed with the court, when Wells Fargo advised it wouldn’t be renewing the line of credit, Hart Stores couldn’t find new financing and it had no choice other than filing for protection. Wells Fargo has always been more aggressive as an asset lender, but now it has to be concerned with the stress on its own balance sheet and the recent down grading.

The first thing a company should do is analyze the major assets on its balance sheet. Accounts Receivable will probably be one of largest assets. In stress testing it, the company should look at the large exposures and up-date the information it has on hand. Given the current economic situation, the review should look at: the industry the buyer is in, if the buyer is growing and leading the industry or is it a weaker player, has its purchasing and payment patterns changed and who is providing the financing and when does it come up for renewal. Even if it is improbable the buyer would fail, it is possible and if it were to fail, what would be the consequences on the capital of the company?

Boards of Directors must ensure they are proactive in managing balance sheet risk and they have evaluated and chosen the most practical ways of mitigating the consequences of possible risks.

Investments, physical assets and cash flow streams related to overseas projects should also be subjected to stress testing for the consequences of political events completely outside of the company’s control.

The Benefits Division of our sister company, Cowan Insurance Group, is conducting their annual Pension/Benefits Update on October 26th at the Cowan Building in Cambridge Ontario. This session will include information about Pooled Retirement Pension Plans; Catastrophic Drug Claims and Biologic Drugs; and a Pension and Benefit Case Law Update [Click here to find out more or register](#)

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Preferential Payments, Demands from USA Trustees

Recently, Millennium clients have had demands from Trustees in USA bankruptcy cases for return of payments made 90 days before the buyer filed for bankruptcy protection. After reading an article entitled, "Handbook on US Bankruptcy Code's Chapter 11" in the August Edition of Coface's Trade Line Magazine, I took the opportunity of contacting the author, Mr. Jean Francois Rondest, through Coface, to ask him to clarify how the demand for return of preferential payments applied.

He kindly explained that demands for return of preferential payments are more common under Chapter 7, Liquidation, than they are under Chapter 11, Protection from Creditors. A trustee can deem a payment made 90 days before the bankruptcy as preferential. The Bankruptcy Code presumes a buyer is bankrupt 90 days before the filing. The exposure to demands for return of deemed preferential payments increases if the supplier changes the normal terms of payment in recognition of the buyer's financial conditional and possible filing.

The consensus of the legal opinion in Canada would appear to recommend acknowledging the demand immediately and advising the trustee that the demand will be contested. Trustees are apparently going after low hanging fruit and it may be possible to reach a quick compromise with them.

Preferential payments are covered under some policy conditions. Euler's policy covers it in the boilerplate wording, but with most other underwriters, it must be requested and added by endorsement, although Export Development Canada has covered the exposure to preferential payments without the need for a specific endorsement. All of the underwriters would expect the insured to contest the demand and would limit their claim payment to the agreed amount of the refund.

Something that must be considered is any claim payment, including the amount of the preferential payment demand, is limited to the amount of the Approved Credit Limit in effect at the time of the claim. When selling to buyers in the USA, it may be necessary to build some additional capacity into the credit limit request to allow for a possible demand for a return of a preferential payment. Whereas a company may have based its credit exposure on 2 month's shipments, it maybe should consider a 50% gross-up of the limit to allow for possible demands for returns of preferential payments.

Millennium is working with the underwriters to see how this problem can be addressed more easily.

Smoke From Burning Cash = Danger

Based on the assumption that it is going to be harder for higher risk companies to increase or refinance their working capital lines of credit, cash becomes an important indicator of the health of a company.

The first thing to look at on analyzing the financial strength of a buyer is the cash on hand to meet the operating needs, also is the company generating cash from operations to meet its needs, or is the company burning cash faster than it is generating it?

To determine if a company is generating sufficient cash to meet its upcoming requirements, one needs to look at what its capital commitments are for debt repayment or capital leases. If the company is generating enough free cash from continuing operations to meet these capital commitments, it shows a reasonably stable short term outlook. However, in analyzing the information, it is important to attempt to identify any risks which may impair the critical cash flows, for example labour problems.

Even if a Balance Sheet shows material amounts of cash, the source of the cash is important. Was it generated from operations or was it obtained from financing or investing activities. The distinction between cash from continuing operations and cash from other sources is important. If a company is not generating free cash flow from operations, but rather it is in a deficit position, cash wise. It is burning cash. Do you smell the smoke?

If a company is burning cash, it is important to determine the burn rate and how long it can go before it either has to raise more capital or increase its borrowings. The question today is, if a company is not generating a profit and free cash, how likely is it will be able to attract new capital or increased financing?

This is where it is critical to answer the following questions:

- If the company has room under its existing facilities?
- When do the financing agreements expire and have to be renewed ?
- Is the company complying with the covenants of its financing agreements?
- Does the buyer have a commitment to renew the financing?

These are very basic points, Credit Analysis 101, but when we look at claims filed by some of our clients, they have been overlooked by both the policyholder and the underwriters. It appears that if it is a large account, the amount of rigorous analysis is often reduced because of pressure to maintain sales, particularly in a slow economy.

Remember, Financial Statements are historical documents. By the time an analysis is completed, the next quarter will have passed and it is impossible to know if the trend has been reversed or continued. You will have to read the legal notices to find out.

Worldwide Commercial and Economic Intelligence Sources

In the preparation of this issue of the Millennium Outlook, the information supplied by Coface S.A has already been referenced. It was also intended to include the summary of an article drafted by Atradius, "Trade successfully with Russia", outlining 10 important principles to consider when dealing with Russia. Upon review it was impossible to précis the article without overly diluting its important points. With permission of Atradius, the article by Atradius is on the Millennium website at www.mcm.ca and it can also be obtained directly from Atradius at www.atradiusamericas.com/canada.

When researching information for the Millennium Outlook, it became apparent that Canadian exporters are very fortunate to be able to avail themselves of several excellent sources of global intelligence on commercial and economic matters from the international credit insurers that actually have operations in many different countries and understand the various cultures with which they work on a regular basis.

Atradius, Euler Hermes and Coface all have excellent publications on their websites that provide up to date information on the commercial and political risks around the world. These sources complement the information that Canadian exporters receive from Export Development Canada and the services of the Department of Foreign Affairs and International Trade.

In today's uncertain world economy, where it seems none of the old rules apply, all exporters, foreign investors and contractors need the most current information available to assess the risks facing them in doing business in foreign markets. Further, once they understand the risk, they need to consider how much risk they can retain and how much risk they need to transfer. As Millennium represents all of the international credit insurers licensed in Canada and Export Development Canada, its experts are the perfect partners to allow you to take advantage of export opportunities while limiting the risk.

Please visit our website at www.mcm.ca for information on Country Risk Rating reports, as provided by our insurers. You can also find previous newsletters, links to blogs written by Ron Doyle and complete information on Millennium and our services.