

## Credit Insight: The Backbone of Counterparty Risk Management

By Lance Pan  
CFA, Director of Investment Research  
[LPan@capitaladvisors.com](mailto:LPan@capitaladvisors.com)

### Abstract

*Changing credit landscapes, more complex financial products, multiple touchpoints with large financial intermediaries, and high profile bank failures are just some of the challenges treasury management professionals and cash managers face in counterparty risk management. An effective counterparty strategy should provide clarity on the counterparties' credit strength individually and collectively and have a desired "benchmark" level of risk. This requires transitioning from a reactive risk management practice of identifying sources of risk to a proactive approach of managing risk against a "benchmark" with quantifiable risk scores. Separately managed accounts' flexibility may help mitigate risk.*

### Introduction

On March 8, 2023, a small California bank with \$11 billion in assets failed due to cryptocurrency exposures. Two days later, Silicon Valley Bank (SVB), the 16<sup>th</sup> largest bank in the US with \$209 billion in assets, failed after news of large unrealized losses in low-yielding government securities caused a run on uninsured deposits. In another two days, bank runs felled New York-based Signature Bank of \$110 billion. The banking crisis of 2023 would not end until May 1, 2023, when First Republic Bank, a \$212 billion bank for high-net-worth clients, was taken over by JPMorgan Chase in an FDIC-assisted transaction. Across the Atlantic Ocean, the Swiss banking giant Credit Suisse became collateral damage of lost confidence in bank funding and was swiftly sold off by Swiss banking authorities to its cross-town rival UBS.

While deposit outflows largely stabilized by the end of 2023, profit challenges continued for some banks in 2024 due to higher funding costs and rising credit losses in commercial real estate (CRE) and personal loan sectors. In March 2024, New York Community Bank, the acquirer of the failed Signature Bank a year earlier, nearly failed itself due to larger-than-expected losses from high CRE exposure in the last quarter of 2023 before a private equity-led bailout. In April, Philadelphia-based Republic First Bank with \$7 billion in assets became the first bank to fail in 2024 largely due to operating losses driven by higher funding costs.

In the aftermath of the Great Financial Crisis (GFC), financial regulators and central banks introduced rules and policies to make global systemically important banks (GSIbS) safer by discouraging higher risk activities, imposing higher capital and liquidity buffers, and implementing contingent resolutions. The regional banking crisis of 2023-2024 came as a surprise to some corporate treasury professionals and cash managers and showed that credit concerns with financial intermediaries continue to demand attention.

However, the community continues to struggle in finding an effective means to help identify and manage counterparty risk.

As managers of institutional liquidity investments, we saw firsthand our clients' need to understand and measure this risk not only in their investment portfolios, but also from their deposits, line of credit providers, swaps, forwards counterparties, and so on. Over the years, services have become available geared towards identifying

and consolidating these exposures, but important questions remain: “How can I build confidence in managing these exposures and evaluating new ones? What do I do with the myriad of information provided to me? Is my counterparty risk appropriate for my investment objectives and constraints? And how do I separate real credit issues from the noises generated by headlines?”

In more than three decades of managing institutional liquidity portfolios, we analyze and evaluate the creditworthiness of large financial institutions and corporate borrowers in the commercial paper and debt markets as part of our daily routine. In response to frequent inquiries on effective approaches to counterparty risk management, we developed the CounterpartyIQ® web-based credit monitoring service in 2013. It allowed corporate treasury professionals and cash managers to aggregate and evaluate risk exposures in liquidity portfolios as well as in banking relationships such as deposits, commercial borrowing, investment banking and derivatives underwriting. While the service evolved to serve the needs of different users, we believe that credit insights derived from our investment research methodology remain a valuable and differentiating feature not seen in other commercially available transparency products. This paper provides a primer on the key components of the credit research that forms the backbone of counterparty risk management.

## **Counterparty Risk Management – The Corporate Perspective**

Counterparty risk refers to the risk that a party in a contractual relationship fails to fulfill its obligations. In essence, counterparty risk is a form of credit risk. In recent decades, businesses became more global, multifaceted, interconnected, and resource dependent. These new dynamics resulted in increased interactions of trade finance, support agreements and hedging activities with multiple financial intermediaries.

On the other hand, as financial instruments became more sophisticated, resource-constrained treasury and cash management organizations found it more difficult to identify, track, manage and mitigate more complex counterparty risk. Large organizations may also face concentration risk due to the need to do business with the same large financial firms across business lines and national boundaries. The so-called universal banking model resulted in multiple touch points with the same large banks, such that the failure of a counterparty may have impact on multiple areas within a corporation.

Lastly, as demonstrated by the domino effect from the SVB failure, counterparty risk remains difficult to anticipate and much harder to eliminate despite improved bank regulations. Counterparty risk management will likely remain a top priority in most corporate treasury and cash management functions.

## **Credit Insight – The Backbone of Counterparty Risk Management**

Because counterparty risk essentially represents credit risk of the financial intermediary, one should be more concerned with their creditworthiness than simply knowing their identity. Thus, the process of capturing, identifying, attributing and aggregating risk only accomplishes half, and perhaps the less important part, of the task. Credit insight into whether a counterparty meets one’s minimum credit requirement is the more meaningful and difficult half. This step, unfortunately, is the most lacking among commercially available transparency and aggregation services.

Additionally, without the anchor of “current” versus “desired” levels of counterparty risk, one may find it difficult to understand the appropriate level of exposures. One may be swayed by headlines and follow others into actions they regret afterwards. One may pick counterparties indiscriminately or pull back from all of them without analytical backing.

For this consideration, we introduced a credit risk scoring system based on our earlier FundIQ® credit scoring model. In addition to properly attributing and aggregating exposures to the ultimate counterparty, we developed a hybrid credit research tool that combines fundamental credit research, macro influences, and market implied signals into a single scoring system.

## Fundamental Credit Analysis

Fundamental analysis takes a bottom-up approach to credit risk assessment. A firm's operating conditions and profitability, liquidity, capital and leverage, asset quality of loans and trading portfolios, growth strategies and risk culture are some of the major categories of input variables to the risk scoring system. This process is similar to what goes on at rating agencies and large asset managers. Financial ratios analysis is combined with analysts' subjective assessments to arrive at a final credit score for each counterparty.

## Macro Analysis & Sovereign Support

Addressing the impact of macro conditions on counterparties, macro analysis focuses on the macro economy, industry and sector trends, and interest rate and credit cycles. For each category, a few key variables are identified and assigned as either positive or negative adjustments to the fundamental scores. In addition, each credit is assigned a probability and level of sovereign support based on its systemic status and the sovereign entity's credit strength and receives an appropriate "uplift" score adjustment. The end product is an adjusted fundamental credit score for each counterparty.

## Market Signals

A counterparty's credit risk is often not adequately reflected in its fundamental credit profile. Signals from trading activities of its stock or bonds may supplement it. Since financial intermediaries are confidence sensitive businesses that rely on deposits and/or wholesale funding, market signals can serve as an early warning system to alert users of weaker players in a deteriorating market. These signals may include share price volatility, changes in bond yield spreads and credit default swaps relative to some relevant benchmarks. A composite market signals score is then combined with the fundamental score to represent an overall credit score for each counterparty.

With the component credit scores the analytical system can compute a weighted average credit score for a specific counterparty. Individual counterparty scores can then be summarized into a weighted average score for an organization's overall credit exposure. This final score forms the basis for further risk analysis and credit decisions, such as what-if analysis on the impact from adjusting counterparty positions. We believe this systematic approach simplifies the decision-making process as both qualitative assessments and quantitative ratios analysis went into score construction.

## The Capture-Analyze-Manage Framework

We introduced a Capture-Analyze-Manage (CAM) framework for treasury organizations and cash managers with limited internal resources. This framework, when combined with a credit scoring system, may simplify and standardize counterparty risk management.

**Capture:** This refers to the process of cataloging and updating risk exposures throughout the organization. Through a combination of automated and manual input methods, the organization may capture risk positions

from various parts of the firm, such as deposits, money market funds, direct purchases, repurchase agreements, letters of credits, and notional values of derivative contracts and credit lines. The positions can either be at stated values or assigned dynamic values based on expected use of contingent instruments. Account aggregation products and services may be commercially available to simplify this process.

**Analyze:** With relevant data collected and standardized, the next step is to analyze and attribute risk. An important part of this step is to resolve the transparency issue in many financial instruments and attribute exposures back to the ultimate parent or support entity. Some common types of risk reporting, such as credit/industry concentration, types of exposures/instruments, countries of domicile may be inaccurate if risk attribution does not identify the parent or support entity. Duration of risk is another concept that is often overlooked when attention is solely on the amount of exposure at risk.

**Manage:** With sound understanding of the sources and magnitude of counterparty risk, the next step is to manage it. A treasury organization or cash manager may optimize and monitor its risk exposures across the enterprise with standardized risk scores. The weighted average score at the enterprise level can be compared to a credit ratings-comparable “benchmark” score (for example, to a level above the equivalent of A/A2). Score changes from credit developments and market conditions may prompt readjustments in risk positions to return the enterprise level score to the desired level.

## **Separately Managed Accounts – The Keys to Proactive Counterparty Management**

In our Capture-Analyze-Manage framework, the goal is not to identify and understand risk, but to manage it. A proactive risk management practice may be a portfolio approach that rebalances exposures to a desired level of risk tolerance. Designating a portion of one’s liquidity portfolio to direct purchases or separately managed accounts (SMAs) may provide the flexibility to achieve this goal.

In the normal context of cash investment strategies, SMAs are frequently thought of as yield enhancing strategies with higher interest rate or credit risk potential. In a counterparty risk management context, however, SMAs may help reduce risk by adding higher quality, non-financial, and non-correlated credits, or credits with more desirable risk characteristics. This allocation of assets may counterbalance concentrated positions in deposits and commercial banking relationships to diversify the overall exposure. The transparency and credit discretion aspects of the SMA may enable the risk re-calibration and optimization process as discussed in the “Manage” part of the C-A-M framework.

## **Conclusions**

This paper recaps some of our earlier research on counterparty risk management for corporate treasury and cash manager functions by stressing credit insight as its backbone. We discussed the unique corporate perspectives to this risk, especially in the context of recent bank failures. We believe that the more important aspect of an effective counterparty strategy is not about identifying the sources of risk, but understanding and proactively managing them. We briefly discussed the Capture-Analyze-Manage framework. We went into some depth on how one gains credit insight through a credit scoring system based on fundamental and macro research, as well as from market signals. We ended with our view that separately managed accounts may be an effective counterparty risk reduction tool.

As corporations continue to assign high priority to counterparty management, the marketplace may try to satisfy the demand with more transparency and aggregation products. At the end of the day, an effective product must provide clarity on the credit strength of the counterparties individually and collectively and allow a way to assess and compare current levels to a desired "benchmark" level of exposures. Short of this, treasury practitioners and cash managers may be inundated with the flood of new data while stuck with indecision.

## About Us

Capital Advisors Group, Inc. is an independent SEC-registered investment advisor specializing in institutional cash investments, risk management, and debt finance consulting. Our clients range from venture capital-funded startups and emerging growth companies to Fortune 100 companies.

Drawing upon more than a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separately managed accounts (SMAs) that seek to protect principal and maximize risk-adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research; CounterpartyIQ® aggregation and credit analysis of counterparty exposures; risk assessment on short-term fixed income securities and portfolios; and independent debt finance consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

### Disclosure Information

Any projections, forecasts and estimates, including without limitation any statement using "expect" or "believe" or any variation of either term or a similar term, contained herein are forward-looking statements and are based upon certain current assumptions, beliefs and expectations that Capital Advisors Group, Inc. ("CAG", "we" or "us") considers reasonable. Forward-looking statements are necessarily speculative in nature, and it can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes. Some important factors that could cause actual results or outcomes to differ materially from those in any forward-looking statements include, among others, changes in interest rates and general economic conditions in the U.S. and globally, changes in the liquidity available in the market, change and volatility in the value of the U.S. dollar, market volatility and distressed credit markets, and other market, financial or legal uncertainties. Consequently, the inclusion of forward-looking statements herein should not be regarded as a representation by CAG or any other person or entity of the outcomes or results that will be achieved by following any recommendations contained herein. While the forward-looking statements in this report reflect estimates, expectations and beliefs, they are not guarantees of future performance or outcomes. CAG has no obligation to update or otherwise revise any forward-looking statements, including any revisions to reflect changes in economic conditions or other circumstances arising after the date hereof or to reflect the occurrence of events (whether anticipated or unanticipated), even if the underlying assumptions do not come to fruition. Opinions expressed herein are subject to change without notice and do not necessarily take into account the particular investment objectives, financial situations, or particular needs of all investors. This report is intended for informational purposes only and should not be construed as a solicitation or offer with respect to the purchase or sale of any security. Further, certain information set forth above may be based upon one or more third-party sources. No assurance can be given as to the accuracy of such third-party information. CAG assumes no responsibility for investigating, verifying or updating any information reported from any source.

Please note: This report is for personal, non-commercial use only. You may not copy, distribute or modify this report without prior written authorization from Capital Advisors Group.

All contents © copyright 2024 Capital Advisors Group, Inc. All rights reserved.



Capital Advisors Group, Inc.  
One Federal Street, Suite 2200  
Boston, MA 02110  
Tel: 617.630.8100 ~ Fax: 617.630.0023  
[www.capitaladvisors.com](http://www.capitaladvisors.com)  
[info@capitaladvisors.com](mailto:info@capitaladvisors.com)