Assessing Foreign Credit Risk:

Five Main Areas for Consideration

By David M. DiPiero

This area of finance requires cautious entrance and extra diligence to navigate the sources of potential risk. Additionally, this area of finance is constantly evolving and changing and demands constant reassessment of procedure—anything less opens the door for unnecessary and undesirable uncertainty. This article discusses five key areas to consider when evaluating foreign credit risk.

When evaluating foreign credit risk, there are five key areas to consider: Political Risk, Commercial Risk, Collateral Risk, Customary Business Practices, and Transactional Risk. Although every deal is unique, and assessing foreign credit risk is a complex and somewhat subjective exercise involving a multitude of factors and concerns, evaluating these 5 key areas will give you a good sense of the big picture, and provide you with clues as to where you need to dig deeper. For the sake of brevity we have decided to exclude Fraud Risk as a primary subject of consideration. While it is certainly an inherent transactional risk, a discussion of this subject would require more text than this article will allow.

Please note that this article is not meant to be interpreted as a "how to guide". Instead, we hope it will be considered as "food-for-thought," and an interesting window into the factors that go into risk evaluations in international transactions.

Political Risk is the risk of loss due to factors caused by the governing body or the general political climate of the country in question. Risk in this area stems from a multitude of sources, including: war; la-

bor strikes; currency inconvertibility or devaluation; government actions preventing entry of goods; expropriation or confiscation; restrictions on repatriation of profits, or any other government action that may negatively affect an investment or financial position.

In order to successfully navigate political risk, it is necessary to avoid two situations in particular. First, avoid non-hedged exposure to foreign currencies. Exposure to the ups-and-downs of the exchange rate can result in disastrous consequences if you are expecting payments from customers in conjunction with currency devaluation. Second, it is best to avoid (whenever possible) dealings in countries where imminent changes in political parties, whether through elections or through potential displacement of political incumbents, may result in unknown shifts in policy that may have a negative impact on trade policies, taxation, tariffs, and the like.

So for example, if you notice delays in receipt of payment from customers in the presence of evidence that customer has indeed made payment, this may indicate currency convertibility issues. And if a sudden devaluation of transaction currency occurs relative to the base currency, and by this we mean a rapid or sudden decline in the value of the buyer's currency versus the local currency in the seller's locale, steps must be taken immediately to limit exposure to the foreign currency.

Commercial Risk is, quite simply, the risk of a customer being unable to pay for merchandise that has been purchased. In order to limit exposure to commercial risk, one must do comprehensive research in four main areas.

First and foremost, credit reports and other published information can give you a basic profile on the customer. These reports should be the starting point for any evaluation of commercial risk. Secondly, one must evaluate the strength of the buyer's financial statements and their ability to service debt obligations to ensure they will be able to pay you back. Third, whenever possible, research the buyer's trade history, especially for deals of similar size and structure. This will provide you with a wealth of knowledge and insight. Fourth, look into what the generally accepted credit limits and terms are within the industry, to make sure that the deal fits within those parameters.

Even when you perform due diligence in the four areas listed above, commercial risk is always present. There are two main red flags that can help identify a problematic situation. First, declining payment trends, (i.e. days sales outstanding extending over time). If payment trends are declining, this certainly has negative implications for the successful completion of the terms. Secondly, if financial statements or credit reports begin to indicate deteriorating financial health, the same issues may be present.

Business Practice Risk refers primarily to the risk associated with the cultural differences of how business is customarily conducted in different countries. Risk is introduced primarily as a result of differing expectations held by parties doing business internationally. In this category of risk there are two important areas to consider: terms-of-sale and disputes resolution.

Different countries, and even individual industries within those countries, may have customary practices with respect to terms of sale that may be quite different from terms of sale as conceived by the seller. For example, a seller may have stated invoice terms of net 30 days, however, if the customary practice in the region of the buyer is 90 days, the customer may choose to observe customary practice and the seller will realize strained cash flow due to consistent delinquent payments. For this reason it is important to define terms concretely before entering into any international agreements—particularly in regions that may have different expectations with regard to terms of sale.

Secondly, expectations regarding dispute resolution frequently differ in different geographical regions. Customer disputes and remediation may differ with respect to product sales, despite contractual obligations from one region to the next. This presents a unique challenge to sellers due to the fact that contracts may be frustrated and payment either delayed or altogether unpaid due to the inability of a buyer and seller to agree on the appropriate course of remedy. It is imperative that terms for dispute resolution be agreed upon before moving forward with structuring a facility.

Collateral Risk is the risk associated with securing appropriate collateral—specifically, one must have the ability to perfect a security interest in the collateral, and be able to ensure you will be able to collect according to the terms agreed upon. To this end, it is important to ensure three things. First, the collateral must be clear of existing liens, mortgages, and charges. Secondly, proper documentation is required, in order to ensure that security interest is in place and on record, as appropriate. Third, supplemental documentation is necessary for customers, or other parties, as required in accordance with local regulations, to ensure that collateral is perfected wherever it resides.

Transactional Risk is the risk associated with the proper (or, frequently, improper) documentation of the actual transaction, as well as the performance under the contract documenting a contemplated transaction. Transactional risk can be avoided with consistent and accurate transactional documents. These can include properly drafted purchase orders, contracts, invoices, and shipping documents, among others, which will all go a long way to reducing this type of risk. In order to ensure that transactional documents are properly drafted, it is crucial to retain counsel who practices law in the region with which you are doing business. Differences in legal systems and practices may preclude the enforceability of commercial contracts, so expert counsel is required to ensure that the proposed transaction documents comply with the local legal system and are therefore enforceable.

The most important thing to remember when assessing any type of risk, is that the validity of any assessment is completely dependent upon, and limited by, the accuracy and timeliness of the information on which it is based. Current and accurate data is essential to a precise evaluation of risk.

Hopefully this article has provided you with valuable insight with regard to assessing foreign credit risk. This area of finance requires cautious entrance and extra diligence to navigate the sources of potential risk. Additionally, this area of finance is constantly evolving and changing and demands constant reassessment of procedure—anything less opens the door for unnecessary and undesirable uncertainty. ◆

ABOUT THE **AUTHOR**

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