By Diana Klemme

Counterparty Credit Risk: Managing Your Risk-Basket

VeraSun Energy's Chapter 11 bankruptcy filing on October 31 sent shockwaves across the grain industry. Farmers and elevators with high-priced sales suddenly were unsure whether those contracts would be honored. Sellers wondered whether it's safe to trade with VeraSun after the filing date. The Pilgrim's Pride Chapter 11 filing a month later only added to the uncertainty, leaving most managers unsure how lessen counterparty credit risk on any sale contract.

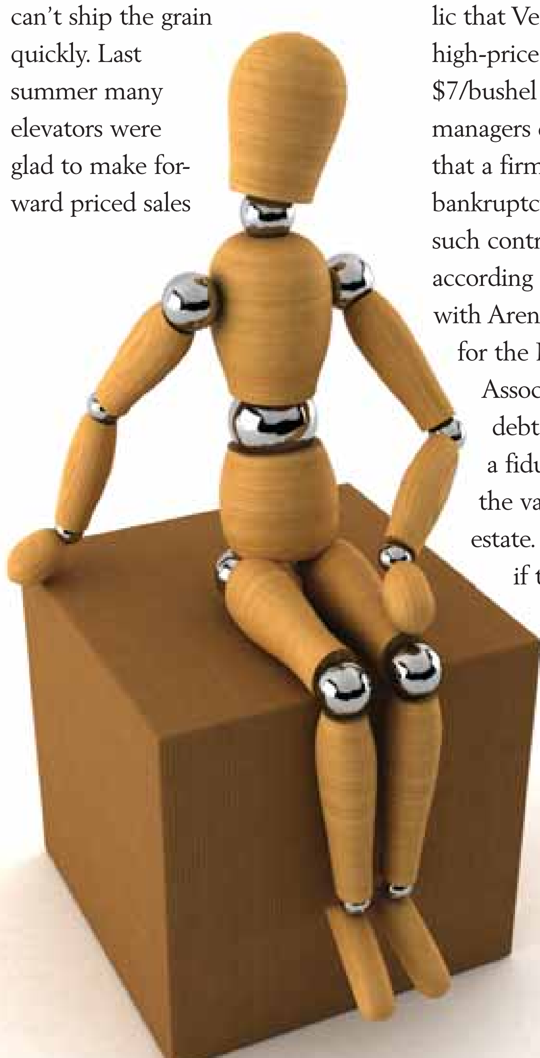
Carrying a basket of risks

Counterparty credit risk on sales was a new addition to a basket that was already overflowing: freight, financing, quality, default risk, basis, spreads, producer origination alternatives, and everything in between. Smart managers know every business has a limit to how much risk it can tolerate. Imagine a basket with a fixed capacity; put too much in the basket and it can tip over or split apart. Even if the basket holds together, keeping track of the contents is difficult if the basket is overflowing. The manager's challenge is to find the best blend of risks to carry: enough risks to create sufficient profit opportunities, diverse enough to ensure no single risk can tip the basket, balanced so different sectors of the business can operate, and with sufficient working capital and credit to accommodate the basket's financing needs. But even that approach is not enough. Management has to sort through the contents and search out less obvious risks.

Consider both probability and the loss potential of risks. One outcome may have a very low probability but with dire consequences if it occurs. Another problem may occur more frequently but cause only minor loss. Watch them all, but focus on the high-cost risks. Be realistic — just about anything is possible given the volatility of prices this year and turmoil in the global financial markets. Inflation could return, interest rates could rise, and commodity futures could

move sharply in either direction.

Time affects decisions. Strategies and decisions that seemed reasonable, even prudent, at first, can turn into a disaster when conditions change. A general manager knows, for example, that carrying a large inventory of high-priced fertilizer ownership bought last summer became a major risk within months. As an offset, this manager could decide to reduce basis ownership of grains, and to diversify grain sales among buyers to lessen counterparty exposure. He might opt to liquidate soybean ownership to reduce credit demands and help balance the firm's risk basket. Another manager might also lock in futures carries on grain hedges as another safety net if the elevator can't ship the grain quickly. Last summer many elevators were glad to make forward priced sales where possible to reduce the margin calls from short futures, only to discover the cost of that solution is even greater — counterparty credit risk. There's no single "right" way to balance a firm's risks; what's important is to quantify the maximum potential loss, reduce exposure when necessary, and check your basket regularly.



Counterparty credit and performance risk

Most elevator managers carefully documented and monitored open purchases as futures soared earlier in 2008, then sighed with relief as prices retreated before harvest. But that relief was short-lived when VeraSun failed and Pilgrim's Pride followed. Suddenly it became public that VeraSun had sizable forward high-price corn purchases, near $7/bushel in some cases. Elevator managers discovered to their horror that a firm in Chapter 11 and the bankruptcy judge can legally void such contracts. That is permissible according to Christopher Giaimo with Arent Fox, outside counsel for the National Grain & Feed Association in Washington. A debtor such as VeraSun has a fiduciary duty to maximize the value of its bankruptcy estate. He further clarified that if the debtor determines a contract is a liability it can reject and terminate the contract(s), but must do so in its entirety, subject to approval of the court. The non-debtors — sellers in this case — cannot terminate such contracts on grounds the debtor is in default. The bright news is that a firm in Chapter 11 may actually become a better counterparty during the reorganization.

In 2008-09 with the credit markets nearly frozen, firms that had been healthy are facing unprecedented challenges to secure sufficient operating funds. And falling commodity prices left some end users holding "above market" purchase contracts, further adding to their basket of risk. Elevators and farmers wonder how to quantify these risks and how to know who are safe trading partners in this environment.

No single approach to managing counterparty credit/contract risk is foolproof, but there are steps that collectively can help.

- Work with competent knowledgeable legal counsel — a firm that understands grain contracting and our industry. Have them review all your contract language and forms.
- Send written trade confirmations to buyers as well as producer/sellers.
- Always send a written sales cofirmation/contract even if the buyers send their confirm to you. National Grain & Feed members can specify that dispute will be subject to NGFA Trade Rules, and also subject to resolution by NGFA arbitration.
- You can include language that says your contracts will be subject to reciprocal performance margins. This means if prices decline (on sales) you may be able to ask your buyer to send you the cash equivalent to at least part of the equity of the contract as a performance assurance. (The same as asking farmers to send money to you when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prices rise against their contract.) Coordinate with legal counsel on correct legal steps, however.

- Consider using Master Contract Agreements — documents which outline standard trading terms that apply to all future transactions with the counterparty.
- Know your trading partners! Assess all potential buyers and rate each one and each potential transaction on a scale. (see chart below right) This is subjective, of course, but it forces you to recognize risks.
- Owners and boards should quantify acceptable maximum accounts-receivable exposure with any single buyer (or farm seller) and limit bushel volume per counterparty where justified.
- Decide what basis premium you want to deal with a given firm. You might sell only limited quantities to a firm that's low on your scale, and demand a higher basis value. But even a nice basis premium on a sale to a low-rated buyer can turn into a costly loss if the buyer fails to perform. Sometimes a cheaper basis is the more prudent sale!
- Keep forward sales unpriced where possible to reduce price exposure until shipment. This is negotiable on a contract, but if not agreed otherwise, a cash buyer has the right to determine time of pricing. While reducing counterparty risk it does raise your potential financing requirements (margin call risk).
- Don't be afraid to insist on daily payment by buyers, or in some cases prepayment. Consider selling in-store with warehouse receipts to the buyer upon payment. These acts don't mean you distrust someone; it's about protecting your business.
- In some cases owning a small percentage of exchange-traded put options against priced sales can lessen the financial cost of a counterparty failure. But this protection has a cost; use it with restraint.

One of Warren Buffet's favorite sayings is "You don't know who's swimming naked 'til the tide goes out."

There are various factors that can help you set your subjecting rating of a counterparty.

1. Business structure: You might rate a farmer-owned ethanol plant higher-risk than an integrated publicly traded processor/exporter, for example. LLCs are an effective shield; identify the real assets behind the LLC as members are not individually liable!
2. Consider buyers' payment history. Has anything changed? Is payment history more important for certain business structures?
3. Review public information on firms where possible; stock trend, earnings, SEC reports (available on firms' websites), analysts' reports. Check Secretary of State records on LLCs, LLPs.
4. Public companies: Check their Credit Default Swap price (insurance against default). This signals the broader market's assessment of the cost to guarantee credit default risk on a given quantity for a fixed time period. You don't have to buy a CDS but check the cost. Bloomberg Service subscribers can access most CDS values.
5. Pay attention to local "chatter" – sometimes it's unfounded but not always.
6. Spread sales among multiple buyers when risk rating(s) are acceptable. Concentration raises your financial exposure.
7. Your subjective ratings might look something like this:

High	Firm A (highest confidence they're sound and will perform on contracts)
	Firm B (you want additional basis premium versus selling to Firm A, and perhaps sell smaller quantities to this tier.)
Low	Firm C (sell limited quantities, unpriced until shipment, demand prepayment)
"No way"	Firms on your temporary 'do not sell to' list

Being in business involves risk; without risk there's no opportunity for gain. The challenge is to avoid the risks that can bankrupt your firm. ■

Diana Klemme is a longtime contributor to *FEED & GRAIN*. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at diana@grainservice.com.


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