



# EVALUATING COUNTERPARTY RISK: WHOM CAN YOU TRUST?

## THE CREDIT CRISIS

The credit crisis that has engulfed the world's financial markets for the past year has entered an historic phase. Financial institutions that have stood as symbols of strength for decades have disappeared overnight. Governments and central banks throughout the world have scrambled hastily to adopt emergency measures in an attempt to calm the financial markets and facilitate even a minimal level of lending activity. One of the most confounding problems facing those who are trying to resolve the credit crisis is that today's complex global financial markets have dispersed risk across the globe in so many different entities that it is almost impossible to identify all of them, let alone tailor assistance effectively to assist them. Credit risk is no longer limited to simple lending arrangements between banks and borrowers. Risk now appears in myriad financial products ranging from traditional lending facilities to swaps, repurchase agreements, securities lending agreements, derivatives, and similar

financial instruments. Banks, other financial institutions, hedge funds, and businesses that enter into financial contracts are reluctant to extend credit to or enter into financial arrangements with another party because it is difficult to properly assess the true financial health and risk associated with that entity, and the particular products and arrangements they have. Properly assessing and responding to counterparty risk is essential in the current credit environment. This *Commentary* provides a brief summary of ways that entities can identify, analyze, and address the wide range of legal risks that arise when entities enter into a financial relationship.

## STEP-BY-STEP GUIDE TO ANALYZING EXPOSURE

**Step 1: Prepare.** Assemble a legal team with experience in structured finance, litigation, creditors' rights, and regulatory matters.

**Step 2: Analyze Overall Financial Exposure.** As an initial matter, you need to be able to immediately identify your overall financial exposure to each counterparty and its affiliates. You may already have extensive financial reporting and accounting systems in place that gather this information on a real-time basis and provide real-time monitoring and reporting to risk managers and decision-makers. It is important that these financial reporting systems collect and report this information on both an aggregated enterprise-wide basis, as well as on an operating, trading entity, or line-of-business basis. Overall exposure should be analyzed on both an enterprise-wide and global basis, and on a contract-by-contract basis, because setoff or “netting” may not always be permissible under the relevant legal documentation or applicable statutory or regulatory scheme. Enterprises also may have subsidiaries that are subject to different regulatory and insolvency regimes. It is important to identify and understand a potentially significant exposure.

**Step 3: Identify Significant Counterparty Relationships.** The analysis in Step 2 should result in a list of significant counterparties to which you have material exposure. Such analysis should also, in broad terms, identify the nature of the relationship and the likely type of financial or other contracts between you and each such counterparty. A subjective analysis should be made of each of these significant counterparties based on the historical relationship of the parties, the magnitude of transactions, and other factors. Every significant relationship does not necessarily carry with it significant risk. These reviews should be approached with a “risk/benefit” analysis. For example, a significant counterparty may have provided collateral or other credit support to honor its commitments, or it may have never exceeded a specified agreed-upon amount or level of risk acceptable to you.

**Step 4: Identify Counterparties At Risk.** The reports identifying significant counterparty relationships need to be cross-referenced with credit analysis—payment delays, credit rating changes, liquidity positions, regulatory changes, and other objective and subjective “red flags” of credit risk—and other business risk information. Recent events demonstrate there may be little or no advance warning before a counterparty faces a dramatic acceleration of its financial distress. Therefore, it is important to be proactive about analyzing

credit risk of significant counterparties and having all relevant information and documentation readily available. You should have a game plan in place to best protect your interest.

**Step 5: Identify All Legal and Contractual Relationships with Significant Counterparties.** Once you have identified the significant counterparties that are “at risk,” you must identify the specific contractual relationships with such counterparties and the corporate structure and regulation of these counterparties. You should first identify and collect all legal contracts between your company and each of your affiliates that has an existing relationship with each of these counterparties or any affiliate of these counterparties. This includes commitments and arrangements where there is no current exposure, but where features such as trading lines or revolving lines of credit would permit exposures to rapidly increase.

Simultaneously with identifying and collecting documents, an analysis of the corporate structure of each of these counterparties is needed to understand the ownership, states of incorporation, places where the parties do business, and regulatory oversight, if any, of them and their subsidiaries.

**Step 6: Review and Analyze Documents and Implement Plan.** After “at risk” significant counterparties have been identified and you have collected all appropriate documentation and assessed the counterparties’ corporate structure, you, along with your counsel, need to conduct a specific analysis of each contract. This analysis should result in a summary identifying the key provisions, each of the parties’ respective rights under the contract, timelines for required notices, collateral calls and consequences of failure to post collateral, and actions to be taken in the event of default and termination. In addition, a setoff and netting analysis should be performed to determine the extent to which you can net or set off exposure to and from counterparties.

Once this analysis is complete, you can begin to formulate a more strategic solution to the situation based on the specifics of the particular counterparties. This might entail reviewing and undertaking litigation to protect your position or to thwart adverse actions by the counterparties. Strategic steps may include revising and updating existing documentation with the counterparty to increase your protection and minimize

your exposure to the counterparty. For example, if your various agreements with the counterparty and its subsidiaries do not provide for cross-default, cross-netting, or collateral being held by highly rated custodians, you should consider adding these provisions via amendments to the underlying documents, to the extent possible. If the counterparty is in distress and wishes to continue its relationship with you, it may well be amenable to entering into such an amendment that leaves it no worse off. Any such amendment will appreciably improve your ability to manage your exposure to the counterparty. Preparing for possible litigation, bankruptcy, receivership, or conservatorship is useful.

## CONCLUSION

To navigate your way through the current distressed financial markets, you should ensure that you have fully analyzed your exposure in connection with the financial arrangements you have entered into with other parties and are prepared to defend or protect your rights, whether by way of litigation or otherwise. The foregoing step-by-step guide will help you to analyze these risks, be prepared to respond to changes in the financial condition of the counterparties with whom you transact business, and begin to develop a plan with respect to those significant counterparties that are at risk.

## LAWYER CONTACTS

For further information on the above, please contact your principal Firm representative or one of the lawyers listed below and they will be happy to discuss approaches with you in more detail and how these issues can be resolved in light of your specific situation. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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