

Counterparty Risk- What does it mean to you?

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Farming is a risky business, always has been and quite likely always will be. Risk exposure levels are at an all time high as farms are becoming larger, land values are increasing and debts are greater. As a farmer you work to manage production risks like weather, pricing and crop protection decisions every day. Now there is another risk you may have heard of and it's becoming increasingly more serious- counterparty risk. While counterparty risk has always been around, stable times made it a relatively low risk; however in today's volatile market it is vital that you give it your attention. Many of you have questions about what counterparty risk is and how best to manage it. Through this series of common questions we'll help you understand what it is and how to manage it for your situation.

I've heard a lot about counterparty risk, what is it exactly?

Simply put, counterparty risk is the risk that the party on the other end of your contract will not perform as agreed and default on that contract. This can be broken down further into:

- Risk of payment default or delivery default
- Risk the contract will have no value
- Risk that deferred payments will not get paid

Losses from this risk often come without warning, and can be significant. You don't have to look far to see the impact of counterparty risk. Sun Country Airlines is feeling the dramatic effects of the investigation into Tom Petters and their parent company Petters Group Worldwide.

How does counterparty risk happen?

There are two main reasons for contract default (other than fraud). These include:

- The other party is unable to meet the terms of the agreement (either financially or otherwise).
- The other party's perception or understanding of the agreement terms differs greatly from your perception.

What are examples of counterparty risk?

Examples abound and each individual situation is unique. Common examples include:

- Cash contracting- in cash contracts the producers have faith the buyer will be there to accept the grain and payment will be made. It is important to note there is also the risk to the buyer who is relying on you, the producer, to deliver on the date of the contract. Understand which contracts transfer title immediately. These contracts bring risk if there is insolvency or bankruptcy on the part of the buyer.
- Many fertilizer suppliers are requiring 100% cash prepayment upon ordering the product. Counterparty risk becomes real if the supplier is unable to deliver the product either timely or at all.

I am a livestock producer, should I be concerned with counterparty risk?



The short answer is yes. Examples of counterparty risk for livestock producers include:

- You contract with a farmer to raise your livestock and suddenly that farmer is evicted and sells your stock to pay the rent.
- You contract for silage or other feed from a local farmer who fails to harvest the crops at the appropriate time or isn't able to harvest the crops at all.

What if a party I am dealing with files bankruptcy? What are my risks and responsibilities if I have a contract with them?

Nebraska Farm Bureau is urging producers to be “vigilant and monitor the situation closely when delivering grain on contract to financially struggling grain buyers.” Farm Bureau’s legal counsel, Paul Peter of Lincoln, Nebraska has provided tips to producers on what to do if the buyer of their contract is facing bankruptcy. Specifically, he urges farmers to visit with the grain buyer and determine how payments are handled. (Refer to section 8 of Managing Counter Party Risk for examples of tools to manage payment risk.) “Farmers should also seek advice from their attorney, who can review the contract and help farmers determine their rights and how best to protect their interests,” according to Peter. It is important to realize that (as stated in the section on examples of counter party risk) contracts require performance from both the buyer and seller. Peter goes on to clarify, “If a buyer declares bankruptcy, it does not void the contract. It can, though, change how the contract is fulfilled. Again, it is important farmers visit with their attorney before proceeding.”

Sources for this section: Robert Pore. “Farm Bureau Warns Farmers Need to be Vigilant in Grain Sales.” The Grand Island Independent. <http://www.theindependent.com/news/x1197769805/Farm-Bureau-warns-farmers-need-to-be-vigilant-in-grain-sales>. November 1, 2008. And “Be Vigilant When Delivering Grain to Struggling Producers.” <http://www.nefb.org>. Nebraska Farm Bureau. October 31. 2008.

How do I assess my counterparty risk?

In a marketplace that is experiencing shortages, the risk of the other party defaulting becomes greater. Recognizing and managing counterparty risk is essential to your business. It is important to understand this is a *process* and not a set of check boxes to be crossed off one at a time. Assessing counterparty risk is ongoing and requires you to remain vigilant. According to Richard Gilmore from Ascendant Partners, Inc., a company specializing in risk management consulting, the prevailing question to ask as you assess each party you are in relationship with is, “What is my potential for being “left holding the bag,” and how can I manage this risk?” Considering the risks of what could go wrong and potential implications is no less important than the price or other factors in a contract. Wondering where to start? Here’s a good place:

- Based on the scope of your business, identify the 5-10 largest third party relationships you have. These are your key business partners.
- Put together a plan to review these partners and do your due diligence.

What kind of Due Diligence should I complete?

As a producer you may feel like the shoes have switched feet and you’re now playing an unsecured creditor to most of your suppliers. This is especially true as the need to prepay for the largest discounts is becoming the standard and contract dates are moving further from the actual delivery date. Price volatility, length of time



between contract date and shipment, or time between payment and delivery are factors that can increase the risk to you.

Regardless of the type of party you are dealing with, knowing them may be one of the most important factors in limiting risk. However, even strong relationships will be tested as market volatility increases and financial losses are incurred. At times, a single, unrelated event can severely limit a company's ability to fulfill a contract.

Something as simple as researching a company you are thinking of selling to can save you both headaches and money. Below are some tips for doing due diligence on publicly traded companies and also on private companies/individual. (Richard Gilmore. "Risk Assessment in the Agriculture Industry." PowerPoint presentation. AAPEX Meeting. July 28, 2008.)

- Publicly traded companies
 - Review their annual reports and financial statements (often found on their websites). If you don't have access to the internet, ask the company for them.
 - Use internet search engines to monitor the company.
 - Keep your ears to the ground- What are you hearing in the news and from other information sources?
 - Questions you should ask yourself as you are reviewing information include:
 - What are the public credit ratings?
 - What is the company's performance record- is it consistent?
 - Do they have any joint ventures or off balance sheet activities and what are the risks in those?
 - What are their trends for borrowing, earnings or liabilities?
 - Is the company local, regional or nationally based- what implication does this have?
- Private companies/individuals
 - This can be considerably more challenging and the key is questions, questions and a few more questions.
 - Things to think about or ask until you have a satisfactory answer:
 - Is the management sound?
 - Do things appear to be maintained when you look around the property?
 - Don't be afraid to talk to the owners or management and staff.
 - Ask for financial information and investigate the trends of borrowing, earnings and liabilities.
 - Look into their track record. Have they been timely in delivery (what's the recent trend)? What do their payables and receivables look like?
 - Do they have any joint ventures or off balance sheet activities and what are the risk in those?
 - Consider ethical issues.
 - Does your gut, experience and judgment tell you they are being upfront with you and you have transparency and full disclosure?
 - Again, keep your ear to the ground and monitor information sources.

How do I manage or control counterparty risk?



1. **Pre-plan. Do your due diligence.** Understand your risk and operate within your risk tolerance. One of the most important things you can do according to Mike Fassler, Vice President of Consulting for AgStar Financial Services, is to put thought and analysis into to how much of your net worth is exposed to counterparty risk. Due diligence is not simple; consider working together with other producers in your area to analyze shared vendors. Stay vigilant in monitoring your situation, as it isn't a once and done activity.
2. **Always have written documentation of the transaction.**
 - a. Signed contracts are strongly encouraged. Handshakes cement relationships but are far less enforceable in court if something goes wrong.
 - b. Write up the documentation immediately upon agreement of a deal. Time and changes in market conditions can change the parties' memory and understanding of what the details were.
 - c. Include as many specifics as possible. Possible specifics include:
 - i. Identification of the parties
 - ii. Volume
 - iii. Price
 - iv. Time of delivery
 - v. Specific product (name/description)
 - vi. Alternatives to manage risk (granting you access to harvest crops or remove your animals from the property)
 - d. Make sure everyone understands the agreement. Regardless of who writes it make sure you know what every term means. Know what the remedies for default are. If you don't understand why something is in the contract, ask questions until you do. Do not enter into contracts you don't understand.
 - e. Look for resources to help you. The National Grain and Feed Association offers contract guidelines that many in the industry use effectively. These contracts are structured to protect trade partners on both sides of transactions. A lawyer knowledgeable in agriculture can prove to be a strong asset in preparing or reviewing contracts.
3. **Calculate the true cost of carry.** Consider the interest cost on the early purchase. Purchasing inputs up to a year early add a real cost interest expense to your operation, be sure you know what this is. Is there a net savings to you and is the risk worth the reward?
4. **Look for ways to narrow the time between performance and payment or possibly eliminate deferred income all together.** An increase in the length of time between contract date and shipment, or time between payment and delivery are factors that can increase the risk to you. Consider the risks carefully if you are postponing income recognition for tax reasons. Visit with your tax consultant; is it better to take the income now vs. the risk of recognizing zero if something happens to the other party?
5. **Deal directly with the source when possible.** Wherever possible, remove the middleman. If there is a party in the middle, there is the additional risk of default.
6. **Consider diversification.** Tried and true: Don't have all your eggs in one basket. Look closely at who you are doing business with. Are you selling all your production to one elevator or pre-paying all your inputs with one elevator? What are the risks? If it is the same elevator your risks just went up. Consider spreading your purchases and sales out over different purchasers or suppliers.
7. **Identify other parties who might impact the outcome of the agreement.** These might include business partners, parent companies, suppliers, banks or even landlords. Consider these parties' interests when



you review the agreement. Are their interests covered, if they are not, what impact could that have? Depending on each case, some parties may need to be notified or at least be made aware of your agreement. Do not be afraid to ask a third party to sign an acknowledgement of your agreement. (Ben Yale. "Avoiding a Wreck from Counterparty Risk." Progressive Dairyman. May 27, 2008.)

- 8. Look for additional tools to manage your risk.** According to Fassler, the easiest way to mitigate risk is to take delivery immediately. If that is not possible, look for other ways to protect your interests. Can you obtain a lien or security agreement? In the case of a contract feed grower, you may be able to take a lien or a security interest in the proceeds of any crop insurance claim(s). Without the ability to obtain a perfected lien or with others having a lien ahead of you (think the supplier to your cooperative or the bank who makes the operating loan to the supplier) consider possible alternatives. Can you place a percentage of money down and set a payment schedule based on achievement of targeted milestones? Will they allow you to place money in an escrow account that pays out upon delivery?

In the case where you are delivering on a contract to a financially stressed buyer, Farm Bureau Legal Counsel Paul Peter says, "Perhaps suitable arrangements can be made such as a wire transfer or letter of credit to assure payment." What other guarantees of payment can you get? If you are concerned that checks might not clear, it is ok to ask for cashier or certified checks, or you might consider asking for payment to be placed into an escrow account that pays out when you deliver. Anytime you can get cash on delivery or guaranteed payment you move further from being an unsecured creditor should financial insolvency happen to your buyer between delivery and payment.

Reducing counterparty risk is different for every operation, not every example of counterparty risk has been identified nor has every method of assessing or managing it been discussed. While intended to help you think about and navigate counterparty risk, this document should not be taken as legal or tax advice. Rather it is provided as a framework to help you start planning for, assessing and managing your way through this unpredictable time. As with any risk, the more you assess and manage it, the better chance you have of mitigating it.

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