What Is Relationship Risk And How Can It Be Managed?

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Contract Management Knowledge Center

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Companies have traditionally implemented credit risk management systems in order to gain an understanding of their loss exposure associated with any given customer. While assessing the ability of customers to meet their obligations and pay for individual products and services is certainly essential, credit risk should also be viewed in a much broader context, the context of the entire relationship. A seller must understand relationships and commitments across all subsidiaries, divisions, and product lines in order to measure their exposure and safeguard against losses. Beyond the ability to pay, a seller must also consider the willingness of the buyer to pay, the ability of the buyer to deliver contracted goods and services and how external influences--such as legal actions that may involve a freezing of assets--will impact the relationship.

A relationship-based perspective on credit risk has implications for suppliers as well as buyers. If a vendor is unable to deliver a part to your company on time, for example, you may not be able to complete an order for a customer on schedule. In turn, this may cause the customer to seek an alternative partner and default on the deal, a move which may well impact not just your company's credit rating—and the way you deal with both the supplier and customer in future contracts—but market perceptions about your company's survivability as well.

Assessing Relationship Risk Requires an Enterprise Perspective

In many situations credit risk is only the tip of the proverbial iceberg when it comes to the risks companies face each time they enter into a business relationship with another organization. As a result, companies confronted with controlling risks should take a more holistic approach and consider the entirety of their relationship when assessing risk.

In the energy industry, for example, a single trading company may have partners in gas production, crude oil refining, and power production, and at any given time may be buying or selling one of several commodities to one or several of these partners. Now, let's say that a pipeline break at a gas production facility prevents gas from being delivered to the power producer. This causes the power producer to turn to one of their partner power companies to step in with extra capacity. But, in order to generate this extra capacity, the producer needs increased delivery of refined oil products. Unfortunately, the refiner has no extra capacity available.

In this scenario credit risk is influenced not only by their trading partner's ability to pay, but also their ability to deliver.--to each other and to all subsidiary customers.

Mitigating Relationship Risk

The relationships that bind one provider to another and to all shared customers are often multidimensional and complex, and companies need to work assiduously to ensure that the risks associated with these relationships are always controlled. While identifying risks is certainly the first step, mitigation requires much more than simple definition, it requires active controls, ongoing monitoring against a referential point of truth that defines the relationship, and the ability to modify relationships as conditions change. In short, the key to mitigating relationship risks is a contract.

Historically, contracts have been used to simply codify relationships, basically to provide a definition of what was expected from all parties signing the contract. And then the contract was filed away, and often was never seen again.

But contracts can do much more. They can actually drive transactions, minimize relationship risks, and even self-correct--if they are well-constructed, if contract information is readily accessible for review and analysis, and if tools are present for extracting, evaluating, and interpreting the data that, in the past, has been locked inside legalese-heavy language.

To achieve these objectives with manual, labor-intensive, error-prone paper-based filing systems is impractical. But with contract management software solutions, the full power of a contract to control relationship risk can be realized.

These solutions provide electronic repositories to store contracts, sophisticated analytics software to pinpoint the exact data needed for any type of risk evaluation, and workflow engines that can kick off chains of actions that ensure responsiveness to changing conditions. Some solutions will even allow contract clauses and terms to be automatically changed when certain pre-set conditions are either met, or not met.

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Relationship Risks Change; Solutions Must be Adaptable

Relationship risk is not a static parameter; it changes with changes in partner management, regulatory climate, partners' costs, credit ratings, and, of course, how well a partner meets the terms of a contract over time. Furthermore, companies often establish multiple contracts for multiple deals with the same partner, and each new contract can impact the overall relationship risk of doing business with that single partner. As a result, all risks associated with all relationships with each single partner must be tracked and reflected in new contracts. These new contracts are then used as reference points to ensure compliance and to drive subsequent risk mitigation actions over the lifecycle of the relationship.

To do this requires a contract management solution that is as adaptable as relationship risk is changeable. This means the system must be able to support a wide variety of contract types that may need to be tailored to meet the specific requirements of each relationship as it changes over time. Risk exposures across multiple contracts with a single partner, for example, may be controlled through the use of new bridge agreements that are cemented with contracts, or annex agreements may be added to existing contracts that require renegotiation of contract terms through the original contract. In short, contract management solutions need to enable fast creation, approval, and information tracking for the full gamut of contracts present in an enterprise.

While virtually any contract management software solution can meet this requirement, most require extensive, expensive, and time-consuming programming to modify established relationships defined by the data architecture of the solution. Only a few enable end-users to modify contract types, structures, terms and clauses on the fly, with no input from, or impact on, IT operations.

To ensure that companies can establish, monitor, and mitigate relationship risks demands a contract management solution that can be quickly and easily adapted to meet the rapidly changing demands of the relationships that define today's enterprises. But even more than that, the solutions need to be adaptable enough to do the same long into the future.