Risk Reward

riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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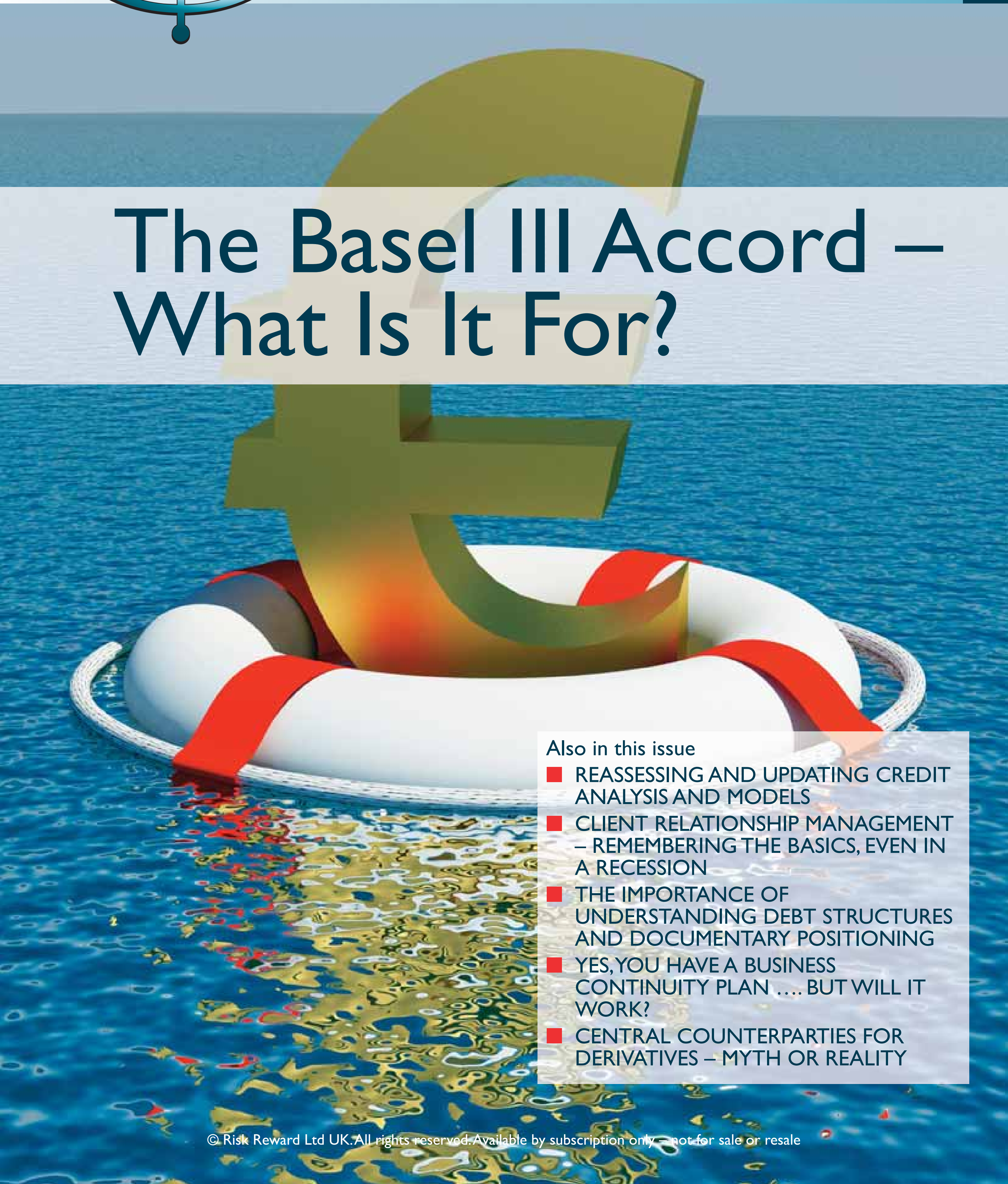

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REASSESSING AND UPDATING CREDIT ANALYSIS AND MODELS

After a financial crisis, there is always room for improvement in corporate credit-risk analysis. This is the first of three articles examining why and how corporate risk models should be reassessed on an ongoing basis. Tracy E. Williams, Former Managing Director at JPMorgan, makes recommendations for model updates and shows how analysis can be forward-looking and anticipate unforeseen risks. The first article questions old habits, suggests new principles for analysis, and highlights the importance of detailed disclosure from borrowers and counterparties.

It's no secret corporate credit-risk managers rely on models and tools to help them make credit-risk decisions. They may be any combination of the following: credit or financial models, financial analysis, risk analysis, statistics, spreadsheets, financial ratios, market signals, market models, credit data, and credit research.

Those tools, if used properly, assist in making decisions about clients, counterparties, exposures, portfolios, industry risks, deals, transactions, or new relationships. Sometimes, however, if they are outdated, the tools are a hindrance to making rational, proper decisions. Or if they are unreliable, inflexible, or too mired in the past.

Models, analysis and tools themselves shouldn't make decisions; risk managers do. They help rationalize or support decisions. Ineffective use or even exploitation will lead to bad decisions or portfolio disasters that could take years to clean up. A risk manager doesn't approve a deal, transaction, exposure or risk because a ratio or market indicator says so. But the ratio or market indicator should be a contributing factor in the final decision.

With the financial crisis waning, now is the right time to step back, reassess and rethink many of those credit models and financial-analysis methods or approaches. In fact, risk managers should reassess and rethink on an ongoing basis. Credit models and financial analysis should be dynamic, evolving, and flexible. After a crisis and after a period of portfolio restructuring, decision-makers should examine what worked and what should be tweaked and ensure that revised models can anticipate risks and downturns much better.

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Questioning Old Habits and Old Ways

To start, risk managers should have a "state of the union" assessment of how they analyze borrowers and counterparties and assess the risk of doing business with them. They should ask:

1. What models and methods worked and didn't work? What approaches, analytical techniques, financial ratios, or market indicators contributed to good decisions, risk aversion, risk reduction, sound portfolios, or proper risk management?

2. Which ones were best at anticipating unforeseen risks, hidden risks, and deteriorating or declining performance from clients and counterparties?

3. How should models and analysis be changed or transformed to be more predictive and useful? How should they be changed to be more forward-looking? When should unreliable methods be scrapped in favor of something new and different?

4. How do risk managers avoid inertia—resorting to old, familiar habits in making risk decisions; using familiar models and methods because they might have been helpful in past crises or situations? How do they avoid relying entirely older cash-flow, "Ebitda" or debt-equity models because that's what they know or because that was convention?

How do risk managers encourage flexibility in financial models without making them too complicated, too unwieldy or too hard to interpret and use? How do they encourage analysts or other decision-makers to use insight or creativity to employ new ratios or novel approaches—those that can capture hidden risks or project credit deterioration?

5. How frequently should models and methods be overhauled to incorporate new risks, pending financial regulation, new businesses models, and complex global corporate structures?

6. After the lessons of the crises, what aspects of credit analysis warrant more attention than they did before: Balance-sheet strength? Leverage? Liquidity? Corporate structures? Capital adequacy and cushion? And if they deserve more attention, how should models change to measure their importance or measure trends and deteriorating signals?

7. Do existing models and methods capture new risks, factors or variables that might have been overlooked or taken for granted before, e.g., complex corporate organization structures, intercompany capital and funds flows, or cash flow trapped in far-flung subsidiaries?

8. Do existing models and analysis sufficiently address how a client, borrower or counterparty withstands stress—from a sudden collapse in its business, in unexpected turns in financial markets, or in emergencies and unforeseen events and risks? Do they address vulnerability from flaws or unexpected weaknesses in cash flows, balance sheets, capital, and funding? Do they show or prove that the borrower is prepared for contingencies or unexpected risks?

9. What market-based models and indicators (those based on prices, trend or signals from trading markets, including bonds, equities and derivatives) should be used (a) to anticipate risks or sudden declines, (b) to measure the impact or weight of an oncoming crisis, (c) to determine if trends have reached a pivotal point? Which ones should be avoided? And what do they really tell us?

The Anchor: Ongoing Principles

If there are benefits to dynamic reassessments of credit models, then underlying principles should guide the process. Models and analysis shouldn't be tweaked or overhauled just for the sake of it. There should be purpose and rationale.

1. Credit models, financial analysis and credit methodology should be tools for making risk decisions. They should guide and support the judgment that goes with decision-making.

2. They should be polished, detailed, and precise. They should encompass a variety of scenarios. While they should acknowledge and study the past, they should be forward-looking.

3. Credit models and analysis should be flexible and evolving to adapt to changing business conditions and new business models and industries.

4. They should provide benchmarks and standards to guide in decision-making, but are not substitutes for the synthesis and judgment necessary to make final decisions.

5. They should adapt immediately to changing clients, businesses, industries, and business and financial scenarios.

6. They should be rigorously assessed, regularly reviewed and updated for relevance, usefulness, and their ability to anticipate risks and declining scenarios.

Financial Analysis: How to Adapt?

To improve models and analysis, it's not enough to introduce new ratios and dare to design and project cash flows from now until the next crisis. Analysts should thoroughly examine how models "behaved" or "performed" in the recent crisis.

Did they predict the decline of companies within an industry? Did ratios, trend analysis, profit-margin assessment or

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balance-sheet reviews suggest how a company would perform during a downturn? Did analysts allow themselves to get lost behind a barrage of ratios, numbers, spreadsheets, and data, stifling their efforts to see risks? Did models suggest a downturn, but analysts, for various other reasons, ignored the signals? Or worst, did analysts merely shuffle the presentation of data to reach the decisions they wanted or substantiate previously made decisions?

For risk managers: Did they understand the kind, type and amount of credit exposure, and did they use the correct analytical approach to assess the counterparty/client? For example, should they have taken a long-term analytical view, if credit risk could potentially extend farther than initially thought? If a short-term loan could extend beyond one year, did they use the method or analysis that assesses long-term risk?

Over the past decade, because of new products and innovative extensions of credit, credit risks and credit exposures have become complicated. Credit risks may start as short-term exposures, but morph into something long-term. They can be contingent, quasi-guaranteed, and structurally subordinated. Or they may appear to be senior liabilities, but in a liquidation scenario, they get bogged down in a legal process that makes them appear subordinated or equity-like.

In one way, this past crisis was similar to other crises, when bank risk managers presumed they had approved short-term, collateralized, senior risks, but realized later, the exposures oddly transformed into long-term, unsecured risk.

Before Analysis: Understanding Exposures

Long before the risk decision and before the analysis or model examines the risk, risk managers are reminded to understand the risks, exposures, and products they oversee:

1. Lending risks, including loans, bonds, receivables, letters of credit
2. Counterparty-trading risks, including securities, currency and derivatives trading
3. Operating risks, including intraday processing, funds transfer and securities settlement

Within these categories, they must measure and classify these risks in their various forms:

1. Secured/unsecured exposures
2. Intraday/short-term/long-term exposures
3. Direct/indirect exposures
4. Contingent and conditional exposures
5. Committed and uncommitted exposures
6. Senior and subordinated exposures.

After classifying, understanding and measuring these risks and their forms, risk managers should prioritize them based on magnitude and risk tolerance before deciding what credit model, analysis or risk methodology is the right one to determine client/counterparty creditworthiness. They should ask, for example: If the exposure is contingent (probable), but long-term and unsecured, what is the right model to assess the exposure? If the exposure is short-term, collateralized, but substantial, what is the right credit methodology?

Risk managers must have well-understood guidelines to determine when it is appropriate to perform a thorough, in-depth analysis, and when it is appropriate to use market indicators or external ratings. They should be clear and consistent about what kind of analysis or model applies to one-, three- or five-year risk; or secured or unsecured exposure.

Risk Ratings: Message Updates

Internal ratings or grades of clients and borrowers have been an important risk tool for banks for a long time. They are usually derived from credit and financial analysis and from other factors (assessments of management, operations, and industry risks) and used to set standards or limits for risk categories, exposures, forms, and tenors.

In boom times, when business is brisk and there is a flurry of deals, transactions, and exposures, bank risk units sometimes fall behind in their efforts to rate borrowers and counterparties properly or sufficiently. They may rely on rapid, insufficient analysis or skip analysis altogether and rely on external sources (from ratings agencies or market indicators). Or they may use computer algorithms based on a borrower's financial statistics, ratios and trends to determine a rating.

Risk grades and risk ratings continue to be useful tools to set risk parameters, limits, and guidelines. Ratings are communicators that send precise

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messages bankwide about risk managers' view of a company.

Problems with corporate borrowers or trading counterparties the last few years taught a few lessons. Ratings are useful when they are dynamic, reviewed constantly, react quickly to changing markets, and permit judgment and insight to set the final rating. Judgment and insight permit risk managers to be forward-looking, to examine worst-case scenarios, to assess the quality of quantitative analysis, and to determine whether a borrower can endure a downturn. External ratings or programmed ratings are useful guidelines to start the decision-making process, but not to end it.

Banks with hundreds or thousands of corporate counterparties scramble to keep up with ratings and collect new information to keep ratings current. Risk managers can handle this burden better if they pose the following questions regularly in a reflective, candid risk-rating review:

1. Will changing market conditions have impact on any counterparties, clients, industries, or industry segments? Is any client or industry subset vulnerable to changing conditions?

2. Are current risk-ratings appropriate for affected clients? Do we adjust the ratings now to reflect new risks? Is there any reason why a rating for a specific counterparty shouldn't be changed now?

3. Are the criteria that apply to ratings up to date and encompass new factors and risks? Do the criteria evaluate how well a company is prepared for downturns?

Financial Information: More, More and More

Securing ample financial information and statements is the starting point for most credit analysis. The events over the past few years proved that more information is better, and more explanation and description of the information is best. Analysts should go beyond a simple transfer of statements in a data dump into financial models. From lessons of the past few years, they should:

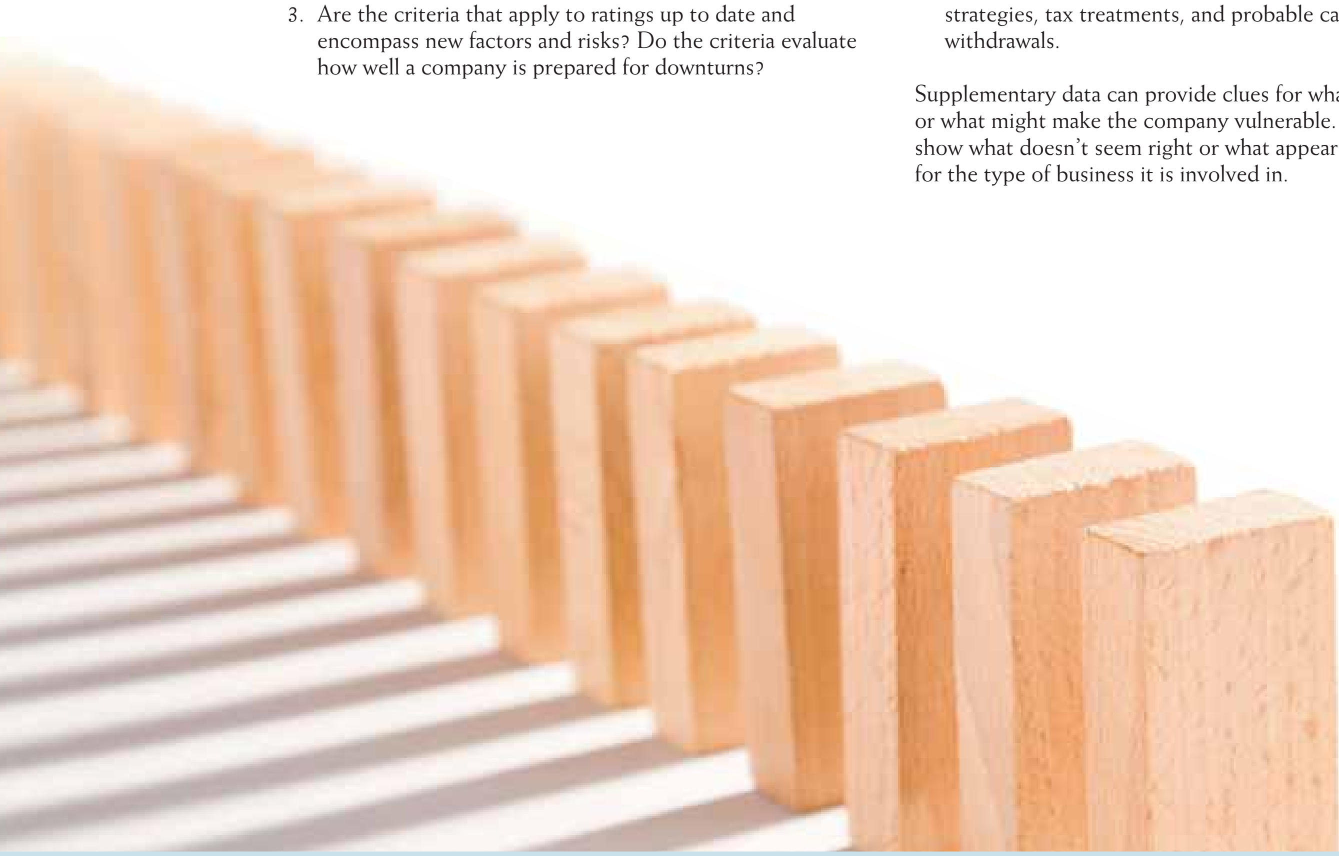
1. Be wary of discrepancies, inconsistencies, and incomplete disclosures.

2. Ask questions and request detail and explanations to look for hidden risks—in, for example, foreign subsidiaries, special-purpose entities, shell affiliates, or non-strategic activities.

3. Appreciate the importance of footnotes, where often a truer, more complete story of the company's business is told. In footnotes, an analyst can detect hidden risks in the form of contingent liabilities, accounting oddities, off-balance-sheet data, cumbersome subsidiary structures, and regulatory requirements.

4. Request more information. Audited statements may not include other invaluable information that is prepared and available, if requested. Supplementary information will show under-the-surface risks: inter-subsidiary transactions and funds flows, management's long-term investments and strategies, tax treatments, and probable capital withdrawals.

Supplementary data can provide clues for what can go wrong or what might make the company vulnerable. Or they might show what doesn't seem right or what appears inappropriate for the type of business it is involved in.



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