

Collaborative Credit Risk Management Counters Impact of Bad Loans

Abstract

Though credit rating agencies provide detailed scores under the Basel II guidelines, banks have the option to develop their credit risk models. It is mandated by some central banks for banks to use their own credit risk assessment framework for lending and investment decisions, instead of relying on ratings assigned by agencies.

Banks may, however, have limited access to the data and analytical models necessary to carry out objective credit risk analysis. Hence a collaborative credit risk management service provided by leading regulatory or financial bodies would prove beneficial to the economy as well as individual institutions.

Benefits of a Centralized Credit Risk Management System

As the interest obtained from long-term loans is a key source of revenue for banks, their non-repayment severely impacts profitability. Large banks typically employ more people and sophisticated management information systems (MIS) to monitor and contain credit risk, whereas smaller institutions rely more on their in-house experience to guide loan decisions.

Different institutions, with varied levels of credit risk management maturity, can threaten the stability of an economy. Governments and regulatory bodies have the power to address, and even prevent this to a large extent.

Although new regulations such as the Basel guidelines act as checkpoints for banks worldwide to follow standard risk management procedures, the implementation of sophisticated credit risk models entails several practical challenges:

- Prohibitive cost of setting up databases and analytical tools needed to publish the MIS reports required for credit risk management
- Technical and analytical skill requirements to run sophisticated credit risk assessment systems
- Regular updates of models and methods are needed to keep pace with new developments in credit risk modeling

These challenges can be addressed by a centralized credit risk management system jointly set up by central and other banks. The system would provide access to enormous historical and current data and current analytical tools.

As banks no longer operate in silos, the failure of one can have devastating ripple effects on other financial institutions, which provides the motivation for banks to cooperate in implementing a centralized system.

The failure of Lehman Brothers in 2008 sent shock waves through the world, highlighting the deleterious impact of bad loans on national and global economies.

In response to the banking crisis of 2008, the US Dodd-Frank Wall Street Reform Act has created an Office of Financial Research (OFR), with the mandate to establish a sound data management infrastructure for systemic risk monitoring.

'European Credit RiskOutlook', a study conducted by the financial services organizations, Efma and FICO, found that more members of the European financial services community are turning to data analytics to enhance their credit risk models, with more than 40% planning to invest in the technology.¹

Components of Credit Risk Management

Risk management is the bedrock of banking operations and a comprehensive credit risk management system should typically cover risk rating and credit portfolio management.

Risk rating incorporates financial analysis, covering projections and other economic factors, including industrial and management risks. Financial analysts need to review reports from the credit risk analysis models and adjust ratings to account for other relevant factors that cannot be modeled.

Credit portfolio management involves diversification to lower the risk of non-repayment of loans with respect to an entire industry. Credit risk models are available to examine credit risk exposures across geographies and product lines in a timely manner.

Collaborative risk management system provides several benefits such as:

- Access to the borrower's complete credit history and the experience of other banks with respect to the potential borrower
- Realistic internal credit risk assessment apart from the rating provided by a professional credit rating agency
- Access to analysis tools, reports, and expertise to enable more informed lending decisions

How Data Affects Risk Monitoring

Systemic risk monitoring is complex, requiring information from diverse sources—including prospectuses, corporate filings, annual reports, and research reports—to be loaded into master files and databases. Raw and derived data is fed into pricing models, calculation engines, and analytical processes. Lack of cohesive data, due to enormous data volumes, and cross-institutional barriers are key issues that prevent timely risk management.

Effective monitoring requires access to all relevant data across institutions, as well as evolving data analytics technology. A collaborative credit risk management system addresses both challenges and delivers strong risk recognition capabilities to the financial system.

Credit Risk Management as a Service

Due to limited resources and high costs, banks may find it difficult to build an information management framework that incorporates the vast amount of data and financial models that are needed for credit risk management. Holistically, the same activities are repeated across multiple banks, leading to inefficiencies across the industry. A central, national body can undertake the responsibility of maintaining an information database and making relevant data, as well as analytical tools available to all banks.

A collaborative credit risk management service can be run in an experimental manner initially, before being deployed on a large scale. The service can be envisaged as a web portal, backed by data processing infrastructure. The central bank and other stakeholders contribute data as well as analysis tools, and the credit departments of subscribing banks access these facilities to empower loan decisions.

To improve the currency and relevance of the service, it is vital to provide real life data sets for a pilot, identify regulatory obstacles and address them in collaboration with the central bank, and invest in trained personnel who can utilize the platform to objectively decide whether to grant or reject loan applications.

Conclusion

Not all banks have access to the data and analytical models necessary to carry out objective credit risk analysis. Central banks and other financial bodies of national importance must take the lead in promoting collaborative credit risk management. They can work with stakeholders using the latest risk assessment data and methodologies, share their expertise, and run pilot schemes followed by wider deployment to alleviate the burden of mounting bad loans.

Summary: Credit risk management is an evolving field, and a collaborative approach holds the key to addressing and improving the financial stability of institutions and global economies.

References

- [1] FICO and Efma, European Credit Risk Outlook: Results of the Seventh European Credit Risk Managers Agency (March 2013), Accessed on 18 February 2016, <http://www.fico.com/en/node/8140?file=5418>

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