Integrated credit risk management – are you ready?

Consolidating data across fragmented systems is crucial for integrated credit risk management – but it is not the whole story. In the first of four columns on the subject, David Rowe argues that organisational readiness is a more amorphous but equally important requirement

Geographic and product-based 'silos' – the divisions in an organisation within which there are local stand-alone systems and information – are typical of most financial institutions. They present a major obstacle to integrated credit risk management. Overcoming the resulting fragmentation of information is the most daunting technical challenge to effective portfolio management. Even prior to this, however, it is necessary to ensure that an organisation is prepared for the behavioural changes necessary for integrated credit risk management.[1]

Traditional credit analysis has focused on the obligor's ability to generate the cashflow needed to repay contracted obligations. It also analyses credit enhancement provisions designed to offer second and even third means of repayment. Examples include special seniority rights, collateral (both liquid and illiquid) and guarantees. Consideration is also given to external economic and competitive conditions affecting the obligor, and softer qualitative factors such as the experience and ability of senior management. But the overriding characteristic of such analysis is its micro focus on the specific credit under review.

Portfolio concentration risk has long been recognised as an issue for most banks, but until the advent of credit derivatives there were limited means of achieving greater diversification.[2] In the past 10 years, however, there has been a steady increase in the role of portfolio analysis in managing credit risk. The change has not always been easy. Many traditional credit professionals felt threatened by this development and tended to denigrate the macro focus of portfolio management as hopelessly uninformed about the details. This uneasiness was accentuated by the market-value focus of most portfolio analysis, while traditional credit professionals were, and often still are, far more comfortable in the context of historical cost accounting.

The reality, of course, is that both careful underwriting and effective portfolio analysis are essential to best-practice credit risk management. Recognition, mutual respect and some degree of mutual understanding are essential for integrated credit risk management to be successful. This applies not just to traditional credit underwriters and portfolio analysts but also to line managers with profit and loss responsibility. Since traditional credit underwriting had a micro focus, it imposed limited requirements for integrated information across products. As a result, business unit decisions, especially technology decisions, tended to be made on a parochial basis. The competitive needs of each unit would drive the decision, with little or no regard to how the resulting activity could be incorporated into a broader portfolio view. Obviously, local considerations must continue to be dominant if each business segment is to maintain the required competitive functionality. But effective portfolio management requires unit managers to recognise the importance of portfolio management and to accommodate the associated need for consolidated information.

David Rowe is group executive vice-president for risk management at SunGard Trading and Risk Systems
e-mail: david.rowe@risk.sungard.com

Credit portfolio managers sometimes find it difficult to identify a bank's obligors. Different business units often have their own customer identification schemes with names and acronyms that bear no relationship to those of other units. This problem has been significantly aggravated by the rapid pace of mergers and acquisitions.

Needless to say, consolidated exposure across all products and business units by obligor is the essential starting point for effective credit portfolio analysis. This can be achieved either by imposing central obligor identifiers on all business unit systems or by maintaining correspondence tables between each unit's local scheme and a central database. While the first approach is probably more reliable, it is harder to implement initially since it requires modification of all local systems. If the correspondence table approach is used, a crucial problem is assuring that these tables are accurately maintained. The path of least resistance is to impose this task on the portfolio management group. Unfortunately, this is unlikely to yield satisfactory results – by placing no corresponding obligation on the individual business units, this approach leads to little or no local co-operation. Despite the best efforts of a central maintenance team, the correspondence tables are likely to be out of date and prone to persistent errors.

A better, long-term approach is to place responsibility for accuracy of the correspondence tables on the local business units. To be successful, however, senior management must impose both incentives and sanctions to assure that this responsibility is fulfilled. Among other things, the salaries of local managers must reflect their performance in fulfilling this kind of corporate obligation in addition to the profitability of their individual units. If top management is not willing to follow through on such incentives, and if local managers are not prepared to take their corporate responsibilities seriously, it is unlikely that the institution is organisationally ready for integrated credit risk management. ■

[1] The author is indebted to David Forster of ABN Amro for his persistent emphasis on the importance of organisational readiness

[2] For a more detailed discussion of this issue, see Risk *June 2001, page 72*