

Arm yourself by improving credit risk management practices



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The past few years have seen financial institutions experience major losses as a result of the credit crisis. Improving the practice of credit risk management by banks has thus become a top priority and is becoming increasingly critical in protecting the interests of both lenders and consumers.

The Credit Risk Framework

Based on our experience both locally and globally we have defined a list of Credit risk areas that form a framework which adds meaningful value to measuring, monitoring and managing credit risk on a counterparty and portfolio basis.



Credit Risk Portfolio Strategy

The three drivers of a credit risk portfolio strategy are policies, risk appetite and risk adjusted pricing. If these drivers are not practically implemented, it becomes an administrative exercise. It is far more valuable to equip both credit and sales-focused staff in making targeted marketing decisions, and hedging their current exposures appropriately by:

- Articulating executives' expectations in the policies by making it practical, easily understood and complimented by quantitative risk indicators;
- Identifying unused risk capacity (profit opportunities); and
- Pricing according to risk while still remaining competitive in the market.



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Portfolio Management

The focus of portfolio management should be on creating and maintaining a balanced book, allowing risk to be offset by reward and optimizing the ratio of risk to reward. The factors reported on should empower management to make quick decisions in changing markets. Examples include:

- Limits versus exposures
- Excesses and breaches,
- Large and risky exposures
- Non-performing loans
- High concentrations – e.g. locations, cyclical, default grades, etc
- Correlations between different risk factors in the current book – e.g. impact of a share price declines on credit spreads

Counterparty Relationship Management

Whereas portfolio management provides a balanced view, counterparty management provides a means of maximising the potential of individual client relations. It is important to understand a specific client's business and use them as a single point of contact to be able to identify additional opportunities with similar clients.

Exposure on risky clients can be managed by ensuring systems, policies and processes enable proactive decisions, rather than reactive crisis management. Clear policies should be in place to equip staff to proactively manage both collateral management collections and restructuring.

Risk Metrics

Risk metrics should be real time and incorporated into both risk adjusted pricing of new deals and in ongoing monitoring and decision making. Some examples:

- Probability of Default
- Loss Given Default
- Exposure at Default
- Risk-weighted assets
- Economic Capital
- Expected and Unexpected Loss
- Risk Adjusted Return on Capital
- Credit VaR
- PV01
- Potential Future Exposure

Stress and scenario testing should give an indication on whether the risk metrics mentioned above are reliable and relevant in different economic conditions.



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Capital Management

The cost of capital is usually incorporated into the pricing of the lender's products. Risky clients will be prompted to change behaviour and offer more collateral while the lender will retain the less risky clients by offering better pricing. This will safeguard shareholders and depositors against potential losses.

Credit Operations

This function ensures that all systems, policies, processes and metrics identified above are sound and governed appropriately. Lastly, ensure that the right people are fulfilling the required roles, all processes in the credit lifecycle are covered and the full credit risk framework as listed above is reported on.

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