Modern
Credit Risk Management

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Framework for Credit Risk Management

It is now over 10 years since the onset of the credit crisis. There are now increasing signs of a weakening economic environment, heightened political risks and rapid and disruptive changes are affecting many industry sectors. Given the combination of a potential cyclical downturn and rapid and disruptive change there is a need to re-evaluate the traditional tools of corporate financial analysis. Additionally, because of the stage of the economic cycle, investors may be seeking to increase their exposures to debt, rather than equity, related investments. This eBook will focus on key operational risks facing companies, Common ways to manipulate presentation of financial performance and on Corporate Credit Portfolio management.

3 Key Pain Points of Credit Risk Management

1 Key Operational Risks Facing Companies

2 Common Ways to Manipulate Presentation of Financial Performance

3 Corporate Credit Portfolio Management

1. Key Operational Risks Facing Companies

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. Key risk indicators (KRIs) are an important tool within risk management and are used to enhance the monitoring and mitigation of risks and facilitate risk reporting. Operational KRIs are measures that enable risk managers to identify potential losses before they happen.

Effective KRIs

1.	2.	3.	4.
Measurable Metrics Should be Quantifiable (e.g., Number, Count, Percentage, Dollar Volume, Etc.).	Predictable Provide Early Warning Signals	Comparable Track Over A Period of Time (Trends)	Informational Measure The Status of The Risk and Control

Establish KRI Framework

Provide Training on KRIs

Workshops / Interviews with Business / Functional Units

Identify The “Key” Risk Indicators for The Firm

Set Tolerance Levels (Green, Yellow, Red) for KRIs

Track and Report KRIs

Establsh Risk Mitigation Plans to Address of KRI Limits

Ensure That Controls are Added / Improved to Address The Issues

Reassess KRI Inventory on A Regular Basis

Let’s understand the KRI roadmap above in detail.

KRI Identification

- Identify existing metrics.
- Assess gaps and improve metrics.
- Identify KRIs via risk control self-assessment (RCSA) - interview business units.
- Don’t over rely on them; focus on indicators which track changes in the risk profile or the effectiveness of the control environment.
- Concentrate on the significant risks and their causes and consider forward looking and historical indicators.
- Consider absolute values and numbers, ratios, percentages, ageing, etc.
- Data on KRIs should be collated on a systematic and consistent basis in order to be meaningful, e.g., on a monthly basis.

KRI Selection

- Select the KRIs that are measurable, meaningful and predictive (leading indicators).
- Gather a good mix of leading and lagging indicators for effective risk management.
- Don’t select too many KRIs that:
  - Are too difficult to manage (track).
  - Might become unmanageable.
  - Select only the ones that provide useful information.

Setting Thresholds

- Determine and validate trigger levels or thresholds.
- Based on industry tolerance or internal acceptance.
- Board of directors should approve thresholds.
- Should coincide with risk appetite statement.

KRI Tracking & Reporting

- Periodic tracking of KRIs (monthly, weekly, depends on what the KRI represents).
- KRIs should be reported regularly and escalation procedures should be in place (as part of the KRI framework) to ensure timely reporting to management and board.
- Various KRIs will have different levels of escalation. When in doubt, escalate higher but don't dump too much information on management/board because they will get overwhelmed.
- Reporting of KRIs to head of business units by KRI owners. Head of business units then reports into risk management. Risk management reports to risk board and when applicable, the full board.
- This can help improve corporate governance structure.

Risk Mitigation Plans

- Risk mitigation plans (RMPs) should be set for High risk items.
- Items with high severity or high frequency of occurrence need to have RMPs to mitigate risk and enhance controls.
- Determine what is high risk by assessing control levels.
- Track RMPs to ensure that controls are enhanced and risk is mitigated. Report on RMPs to management/board, and set target completion dates.

Roles & Responsibilities

- Risk management
  - o Create Framework and provide training.
  - o Guidance and challenge KRI selection process.
  - o Reporting/Escalation of breaches.
  - o Identify Trends.
- Business units
  - o Identify KRIs.
  - o Set thresholds.
  - o Monitor positions.
  - o Escalate breaches of limits to management..
- Internal audit
  - o Validation and assurance around KRI process.
  - o Incorporate output into audit plan.
  - o Assess control effectiveness for KRIs that were breached or yellow.

Challenges (Table)

The potential challenges of establishing an effective KRI framework include:

- Getting business units to buy-in into the need for KRIs.
- Demonstrating the effect (positive) that it can have on the firm overall and for each business unit.
- Might result in setting aside more capital.
- Identification of KRIs can prove to be difficult.
- Lack of resources to track KRIs.

2. Key Financial Indicators Used by Rating Agencies for Evaluating Corporate Credit Risks

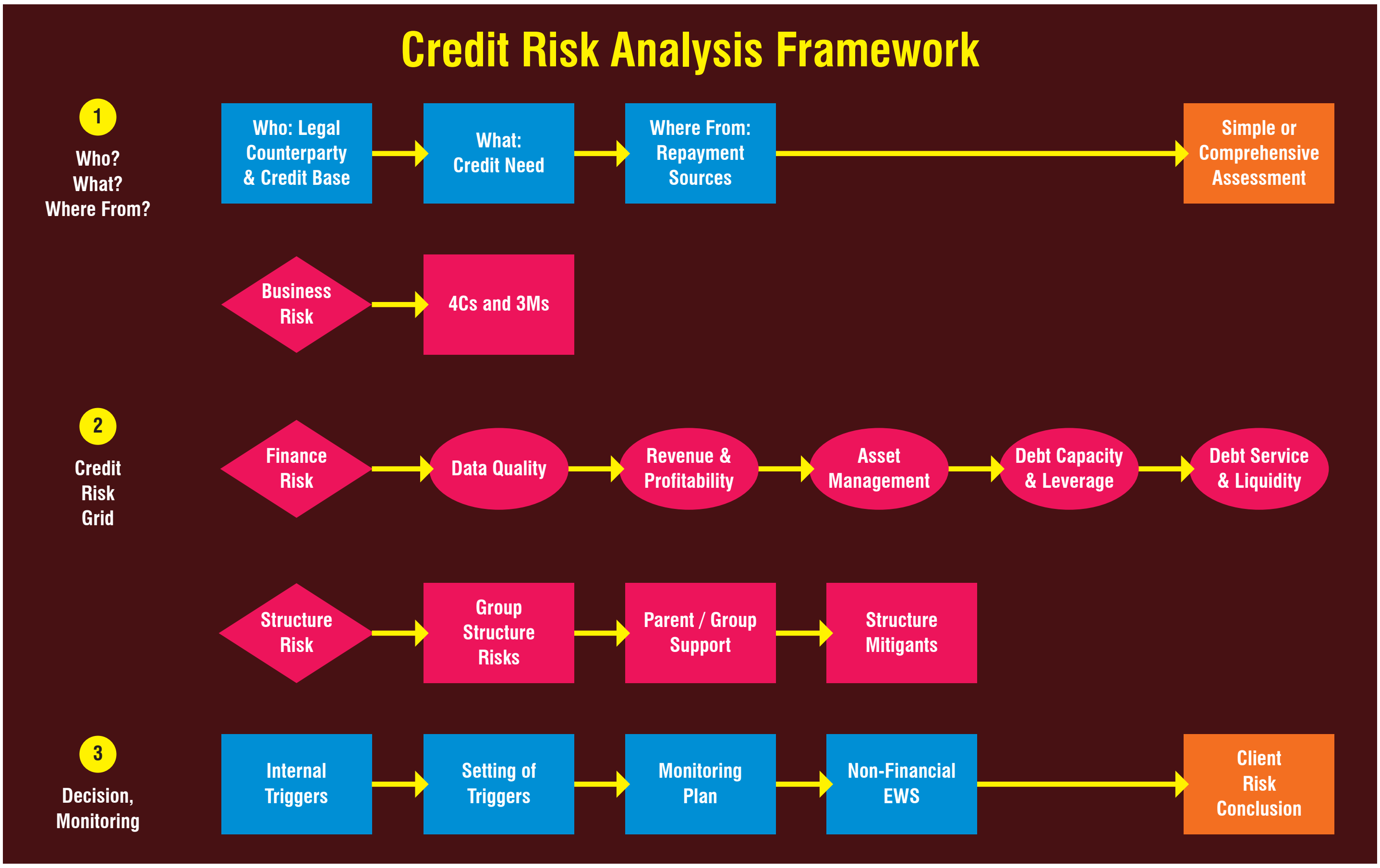
Talking about rating agencies, let's take a look how one of the most renowned rating agencies in the world, Moody's Analytics, evaluates corporate credit risks.

Moody's Analytics provides financial intelligence and analytical tools supported by risk expertise, expansive information resources, and the application of new technology. Its solutions, made up of research, data, software and professional services, are assembled with the aim of delivering a seamless customer experience.

The Moody's Analytics solution for credit risk management includes:

1. **Economic forecasts and scenarios via Scenario Studio, a collaborative forecasting platform.**
2. **Expected Consumer Credit Loss (ECCL) service.**
3. **CreditForecast.com – a joint offering from Equifax and Moody's Analytics that combines consumer credit and economic data.**
4. **CECL Solver for Moody's CreditCycle – a lifetime loss forecasting module.**
5. **CreditLens – an integrated, cloud-based credit lifecycle management solution that automates the collection and analysis of credit data and allows lenders to easily access all portfolio and historical data from one platform.**
6. **Collaborative Analytics Platform (CAP) – a cloud-based solution that aims to promote collaboration and efficiency across the orgnaization, encompassing the end-to-end lifecycle of risk and finance modeling.**
7. **RiskCalc Models and Scorecards – private firm default and recovery risk models and scorecards for commercial and industrial loans.**
8. **Commercial Mortgage Metrics (CMM) – default and recovery credit risk model for commercial income producing real-estate properties.**
9. **RiskBench – a global online credit risk data community and app platform that provides analytics and peer insight across asset classes.**

The diagram below shows the credit risk analysis framework of Moody's Analytics.



3. Corporate Credit Portfolio Management

The figure below shows the techniques adopted for corporate restructuring and reorganization.

1. Joint Ventures

All joint ventures are typically characterized by two or more ventures being bound by a contractual arrangement which establishes joint control. The contractual arrangements establish joint control over the joint venturers. Such an arrangement ensures that no single venturer is in a position to unilaterally control the activity. Joint venture may give protective or participating rights to the parties to the venture.

2. Divestitures

Divestitures does not deal with acquisition or combination but it examines the various recently acquired assets and divisions to determine whether the assets or divisions are fit into overall corporate strategy in value maximization and its future plans. If it does not serve the purpose, such assets or divisions are hived-off.

3. Slump Sale

When a company sells or disposes the whole or substantially the whole of the undertaking for a predetermined lumpsum amount as sale consideration is called ‘slump sale’. The acquirer may be interested in purchase of an undertaking or part of it as a going concern and the acquirer is not interested in taking the whole company as part of the transaction. While fixing the selling price, the value of assets are not individually counted and the liabilities are not separately considered while fixing the slump price.

4. Strategic Alliances

An ‘alliance’ is defined as associations to further the common interests of the members. Strategic alliance is an arrangement or agreement under which two or more firms cooperate in order to achieve certain commercial objectives. The motives behind strategic alliances is to reduce cost, technology sharing, product development, market access, availability of capital, risk sharing etc. The strategic alliances are in the forms like joint venture, franchising, supply agreement, purchase agreement, distribution agreement, marketing agreement, management contract, technical service agreement, licensing of technology/patent/trade mark/design etc.

5. Equity Carveout

It is a situation where a parent company sells portion of its equity in a wholly owned subsidiary to the general public or to a strategic investor. An equity carveout enable the parent to generate cash inflow which can be used for further investments. In a spin-off, the shares received from the acquirer of undertaking is distributed among the existing shareholders of the parent company. But in equity carveout the shares of the parent company are sold out to outside investors.

6. Franchising

Franchising provides an immediate access to business operations and technology in profitable fields of operations. It is an important means of doing business in several countries and represents an effective combination of the advantages of large business with the motivation and adaptation capabilities of small or medium scale enterprises. It also enables linkages of large and small businesses within a framework of vertical division of labor. Franchises are becoming a key mechanism for technological, marketing and service linkages between enterprises within a country as well as globally.

7. Intellectual Property Rights

The worth of a company lies more in its intangible assets (patents, trademarks, brands, copyrights etc.) than tangible assets (land, building, plant & machinery). Patents, trademarks and strong brands lead to higher sales, economies of scale and profits. Some business gains, however, instead of investing efforts, time and money in research and development for new patents, trademarks and brands, prefer to buy these from companies or go to the extent of acquiring the companies themselves.

8. Holding Companies

A holding company enjoys controlling interest in the subsidiary by acquiring substantial voting power in the form of acquisition of equity shares carrying voting rights. When the holding company acquires 100% voting power in subsidiary, it is called 'wholly owned subsidiary'. Acquisition of controlling interest in subsidiary by holding company is form of combination and can also be used as a technique of restructuring.

The holding company is also called as 'parent' enterprise.

9. Sell-Off:

In a strategic planning process, a company can take decision to concentrate on core business activities by selling off the non-core business divisions.

A sell-off is a sale of part of the organization to a third party in the following circumstances:

(i) To come out of shortage of cash and severe liquidity problems.

(ii) To concentrate on core business activities.

(iii) To protect the firm from takeover activities by selling-off the desirable division to the bidder.

(iv) To improve the profitability of the firm by selling-off loss-making divisions.

(v) To increase the efficiency of men, machines and money.

(vi) To facilitate the promising activities with enough funds by sell-off non-performing assets.

(vii) To reduce the business risk by selling-off the high risk activities.

10. Going Private

In a restructure program, the management of the widely held company may decide to go private by purchase of stocks from the outside public and delisting the shares in the stock exchanges where the shares are traded. By going private, a company can avoid the predators from bidding the company. It can avoid the listing fees of the stock exchanges and when the company is in financial difficulties this will avoid the fall in share prices. It facilitates to avoid the declaration of periodical results for general public. By keeping-off from the public, trade secrecy can be maintained.

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