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***Professional Risk Managers' International Association***

## Global Event Series

February, March & April 2009

Credit Risk Management in Times of  
Economic Stress

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## **PRMIA Global Event Series**

The PRMIA Global Event Series provides focused examinations of current risk issues, each related to a single key theme. Each series includes events throughout the PRMIA global network as well as a survey of our members on a designated theme.

### **February, March and April 2009**

The February, March and April 2009 series will focus on Credit Risk. The survey, "Credit Risk Management in Times of Economic Stress", will provide a valuable assessment of current credit risk practices.

***The questions in this survey were written as if they were to be answered by a risk practitioner at a user organization; consultants and regulators were instructed that they could either skip a question, or respond from the perspective of their typical/primary company relationships.***

***Please note that participants were asked to select a single answer that best represented their views.***

***In total, over 873 PRMIA members participated in the survey. As noted, not all respondents answered all questions.***



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## **Acknowledgements**

### **Dick Stahl**

PRMIA would like to extend special acknowledgement to Dick Stahl for his assistance in reviewing and structuring the survey questions.

Dick Stahl is President and Chief Manager of Sassafras Consulting, LLC a consulting firm with two areas of emphasis. First, assisting financial service companies in identifying and solving credit risk management issues. Second, helping business firms and organizations in developing, implementing and maintaining international trade and investment relationships.

### **Harland Financial Solutions Worldwide**

PRMIA would like to extend thanks to Harland Financial Solutions Worldwide for underwriting this survey.

### **Global Event Series Advisory Committee**

PRMIA would like to thank the Global Event Series Advisory Committee for their assistance in identifying the questions for this survey.

The biography of special contributor Dick Stahl is provided at the end of the presentation, along with a list of the Advisory Committee members and a profile of Harland Financial Solutions Worldwide.



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## Key Findings

- 84.5% of respondent believe that that the current accounting standards were not designed to handle extreme stress situations and therefore should not be used, to evaluate credit assets.
- The majority of participants (82.3%) believe that the models available today cannot determine potential credit losses under extreme economic stress.
- 81.7% of respondents believe that in an extreme situation the past correlation between assets, which are an essential input into calculations for credit loss across a portfolio, break down completely and therefore cannot be depended upon.
- Two thirds of the respondents do not think that credit risk capital methodologies have proven to be adequate during times of economic stress.
- Nearly two thirds of the respondents think that the current credit crisis IS a result of credit risk and not the irrational fear resulting in a complete choking off of interbank liquidity.



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## Key Findings (cont.)

- 60.6% of participants believe that portfolio risk theory has not proven to be reliable in times of economic stress.
- 48.8% of respondents said hedge funds tended to lack transparency and are more difficult to monitor as counterparties.
- Monitoring of counterparties was the preferred step to be taken to mitigate counterparty credit risk in times of market dislocation with 43.2% of respondents choosing this.

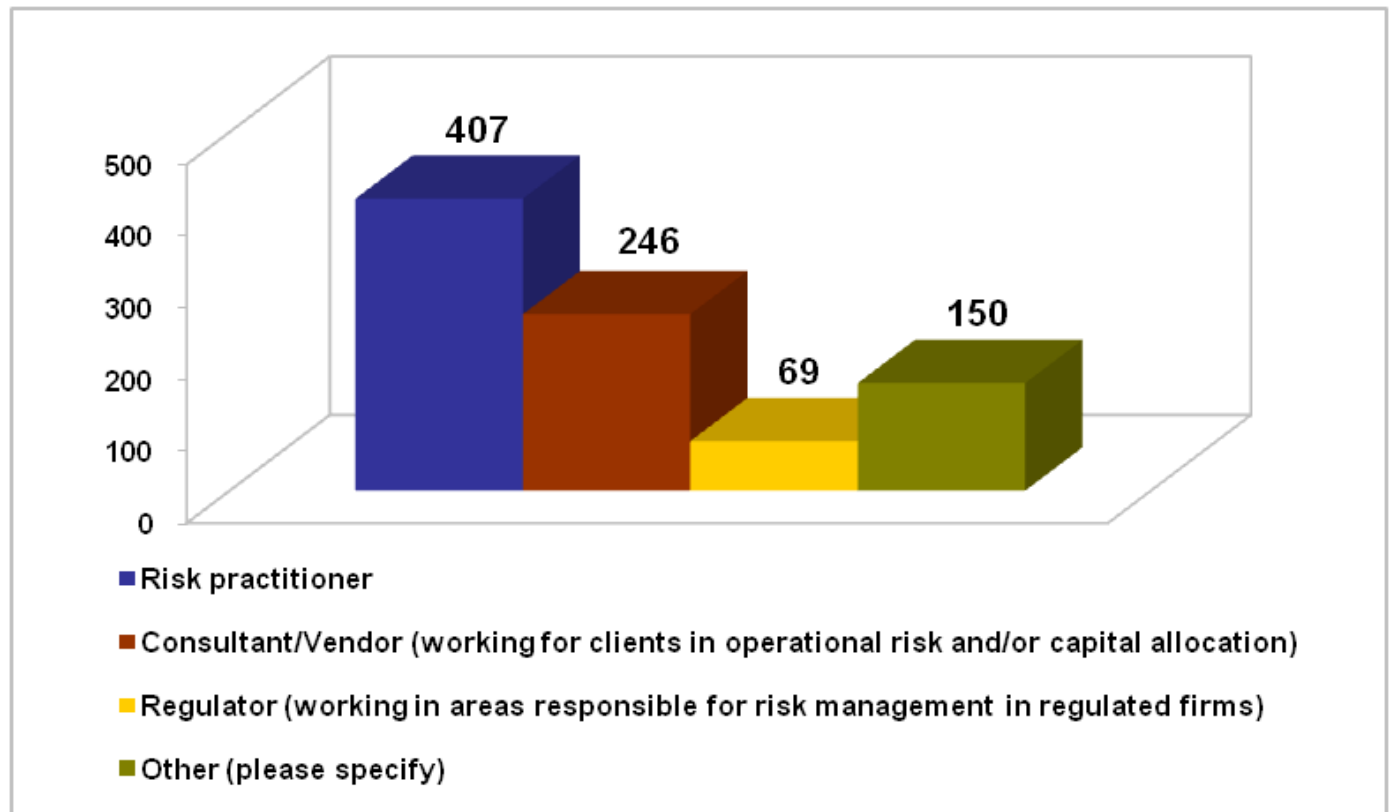


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## My role in the risk profession is:



- In total, over 873 PRMIA members participated in the survey. As noted, not all respondents answered all questions.
- Participants were asked to select a single answer that best represented their views.
- "Other" responses included "Credit Analyst", "Risk Analyst", "Academic" and "Student".

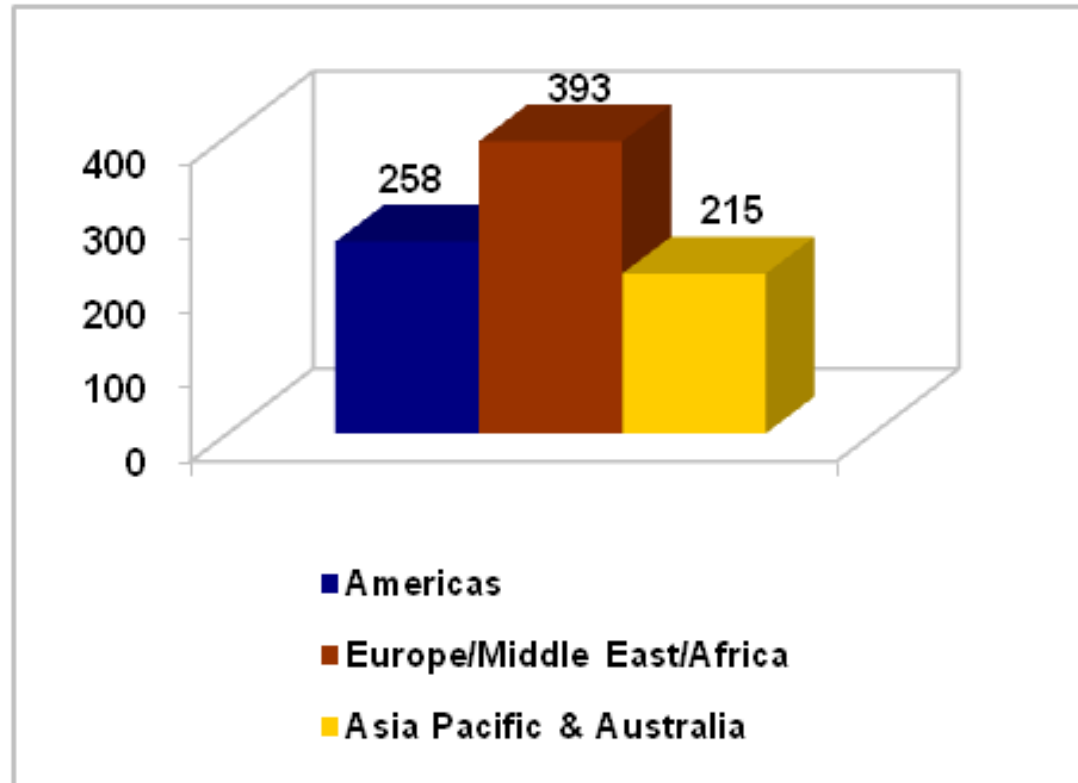


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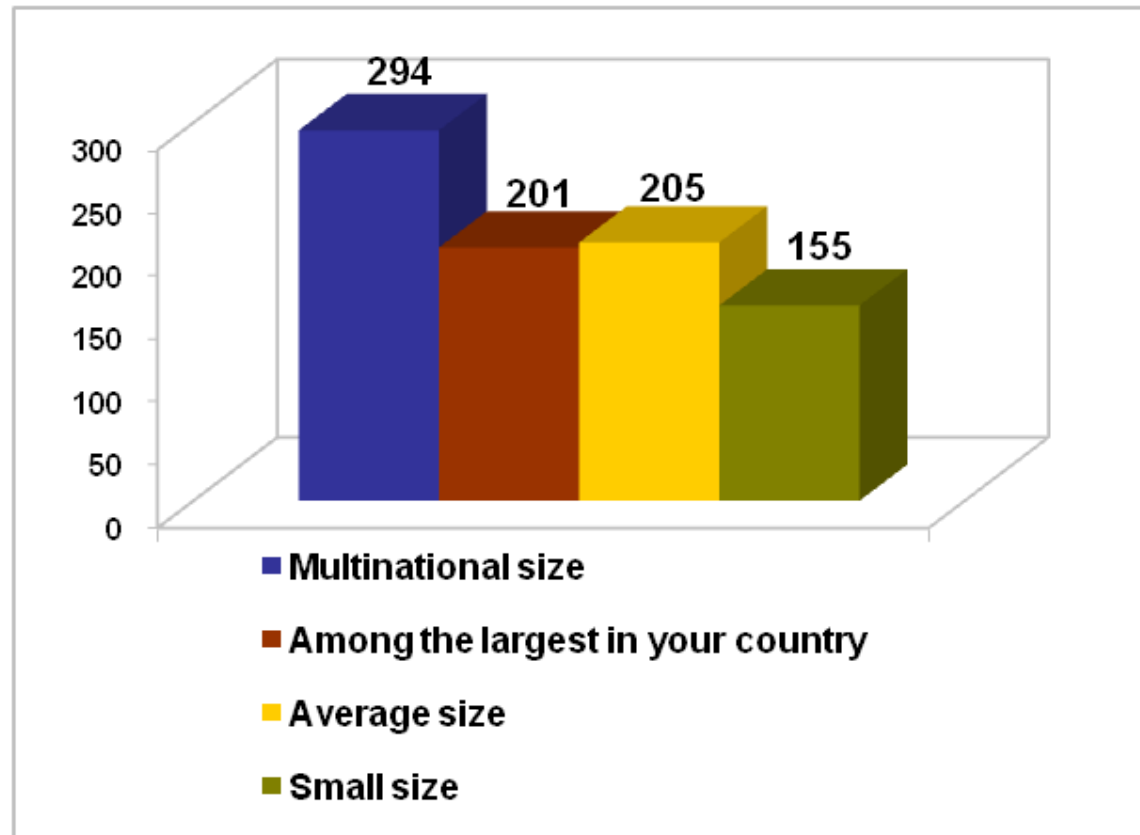
## Regional Breakdown



- Respondents were globally dispersed; 45.4% from EMEA, 29.8% from the Americas and 24.8% from Asia Pacific & Australia.
- 27 of the 69 regulators were from Asia Pacific & Australia.

## Size of Organization

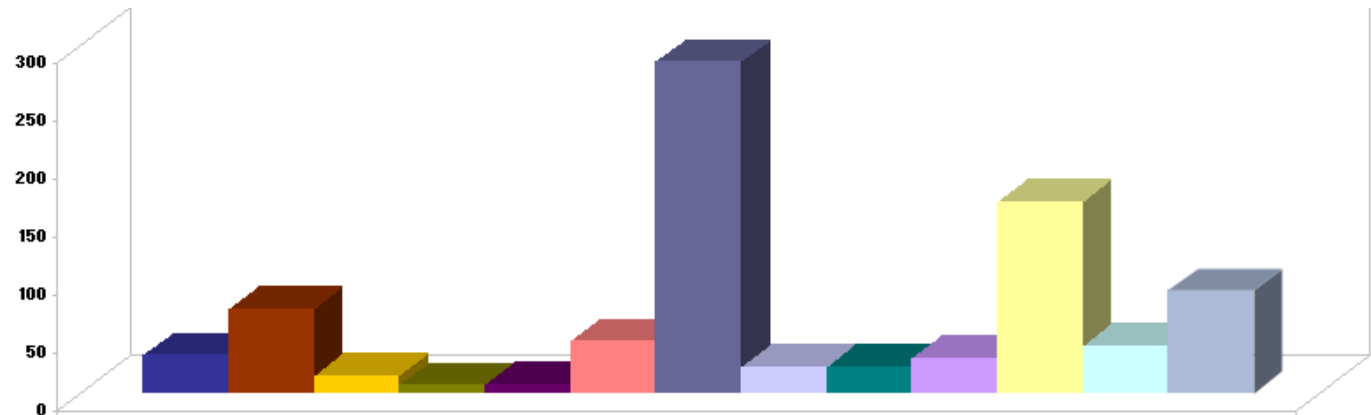
Relative to other companies in your country, how would you describe the size of your organization?



- Survey participants work for a range of companies by size, with 58% reporting that they represent institutions that are multinational or among the largest in their country.
- Respondents from Asia Pacific & Australia were most evenly spread across all size categories.

# Primary Responsibility

What is your primary responsibility in your organization?



- Board or Senior Management (not Chief Risk Officer or Finance Director)
- Chief Risk Officer or equivalent
- Finance Director or equivalent
- Head of Compliance or equivalent
- Head of Audit or equivalent
- Project Manager for Credit Risk
- Risk Management Department (all levels)
- Head of Business
- IT
- Academic
- Consultant
- Regulator
- Other

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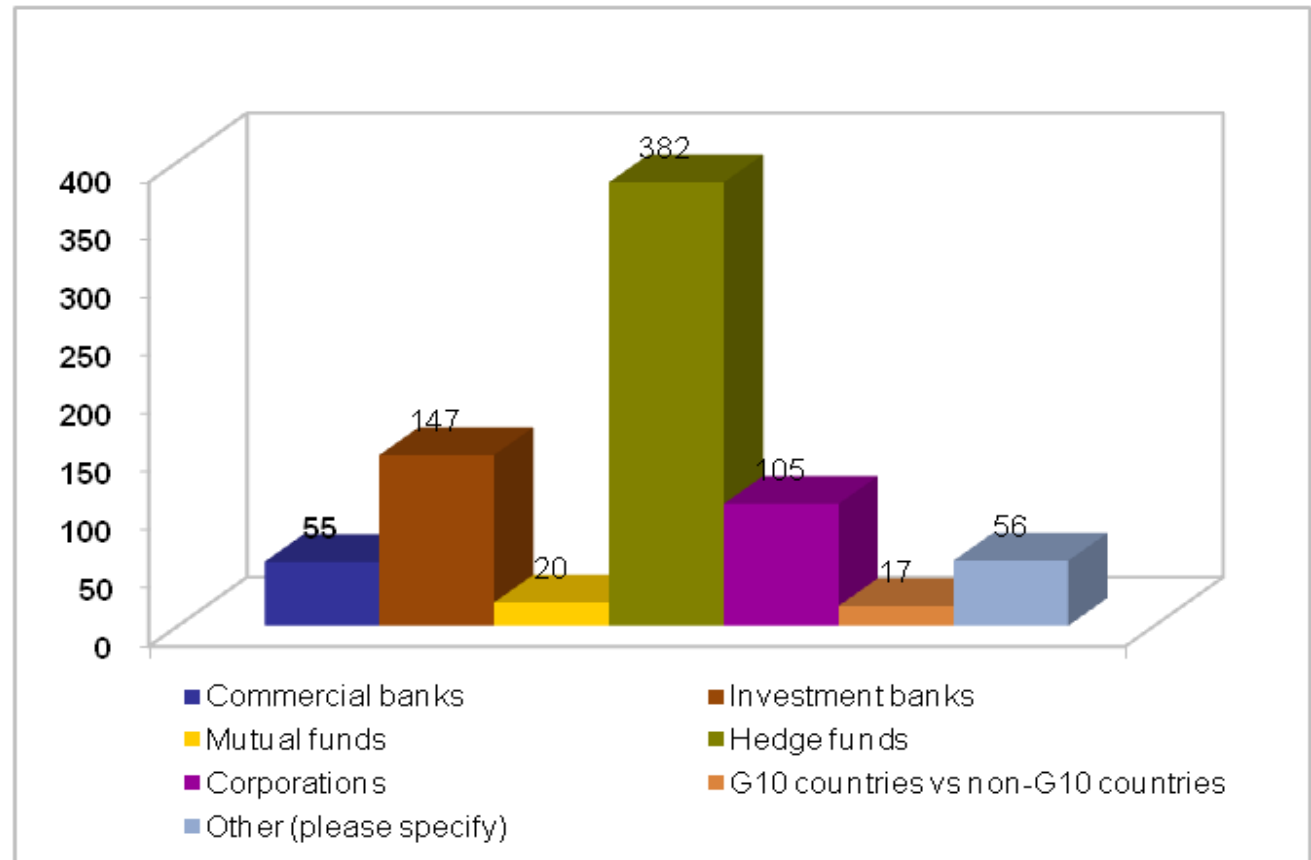
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➤ Survey respondents held a range of job responsibilities, with 34.1% from risk management departments, 19.7% consultants, 8.7% CROs and various other positions as seen above.

# Valuation

**What types of counterparties tend to lack transparency and are more difficult to monitor?**



- **48.8% of respondents said hedge funds tended to lack transparency and are more difficult to monitor.**
- **67% of the responses were from hedge funds and investment banks. These two types of counterparties were significantly impacted by the credit events of 2008.**



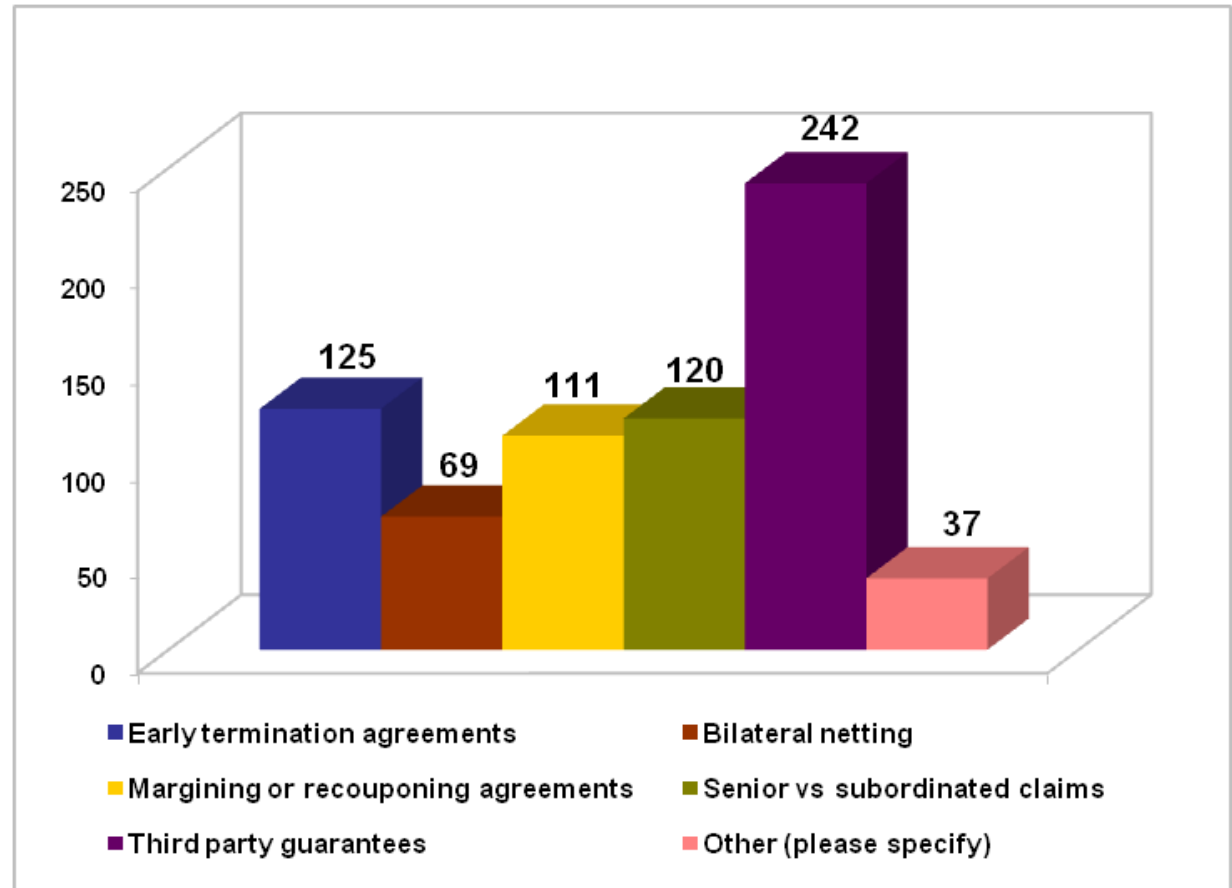
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## Valuation

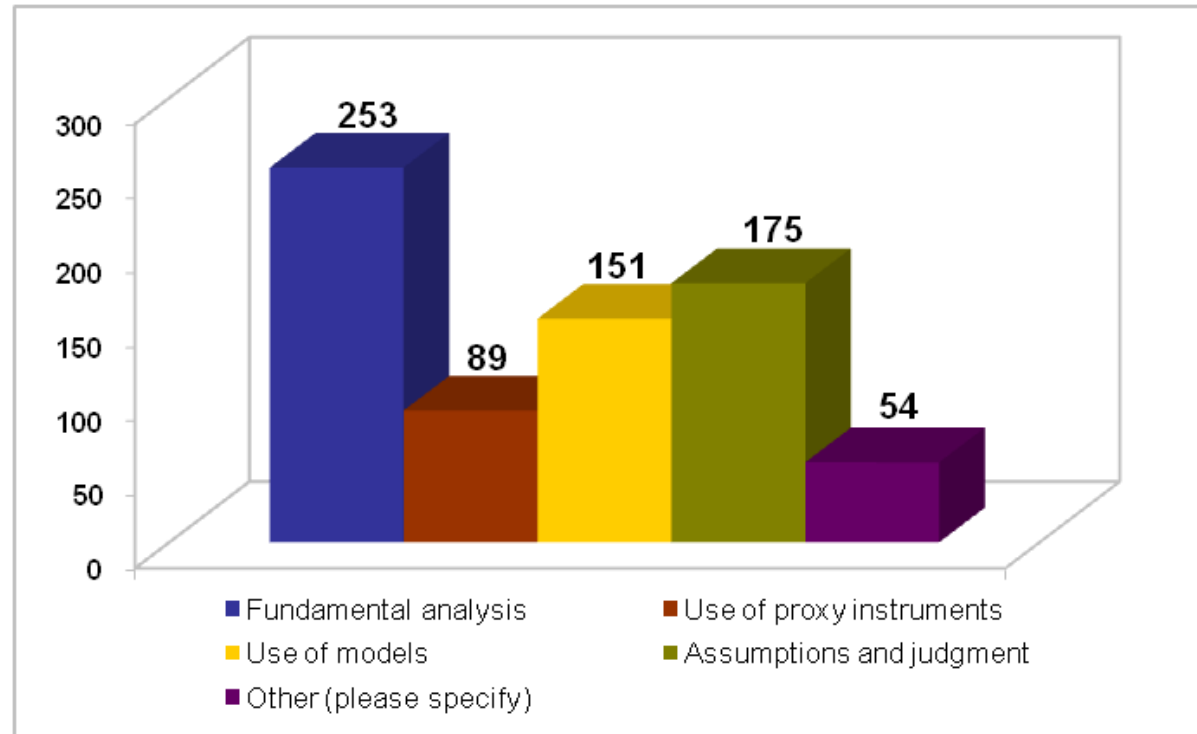
**What elements of structure are difficult to assess in terms of their potential performance under stress?**



- **Third party guarantees came out being the most difficult to assess in terms of their potential performance under stress at 34.4%.**
- **“Other” responses included “All of the above” and “Liquidity”.**

## Valuation

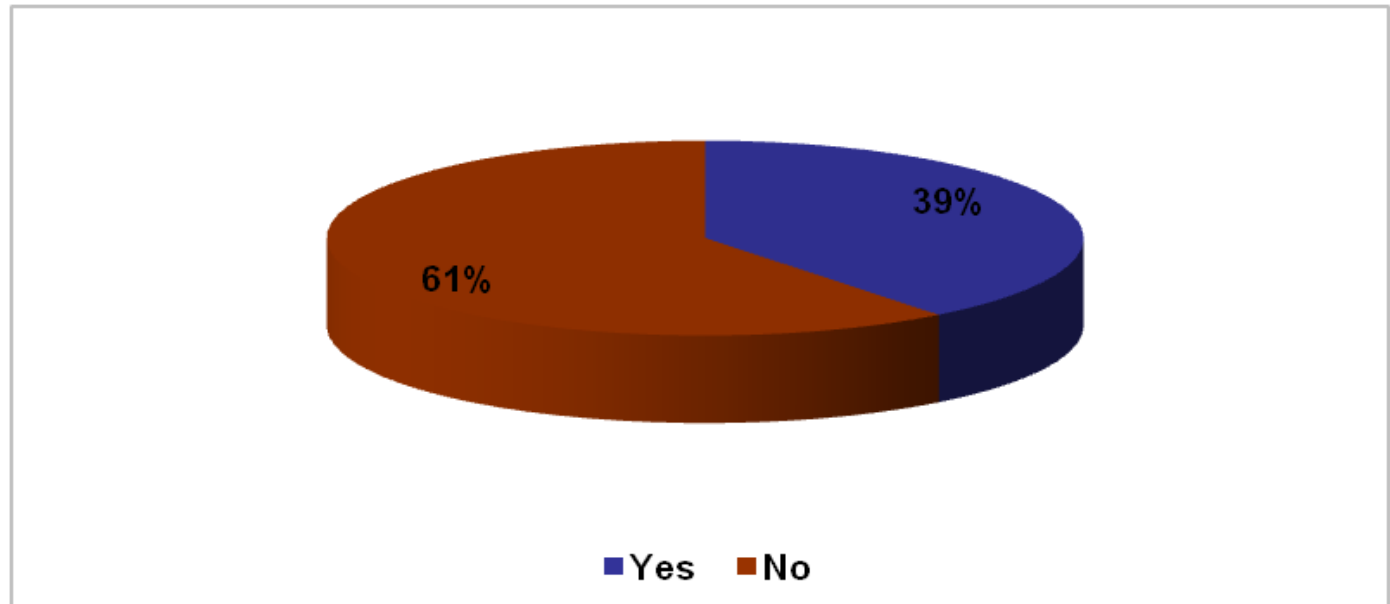
**How should banks, asset managers, hedge funds and investors assess valuation of their positions during illiquid markets?**



- **35% of respondents believe that fundamental analysis should be used to assess valuation during illiquid markets with the use of models and assumptions and judgement following at 20.9% and 24.2% respectively.**
- **“Other” responses included “All of the above” and “A combination of the above”.**

## Valuation

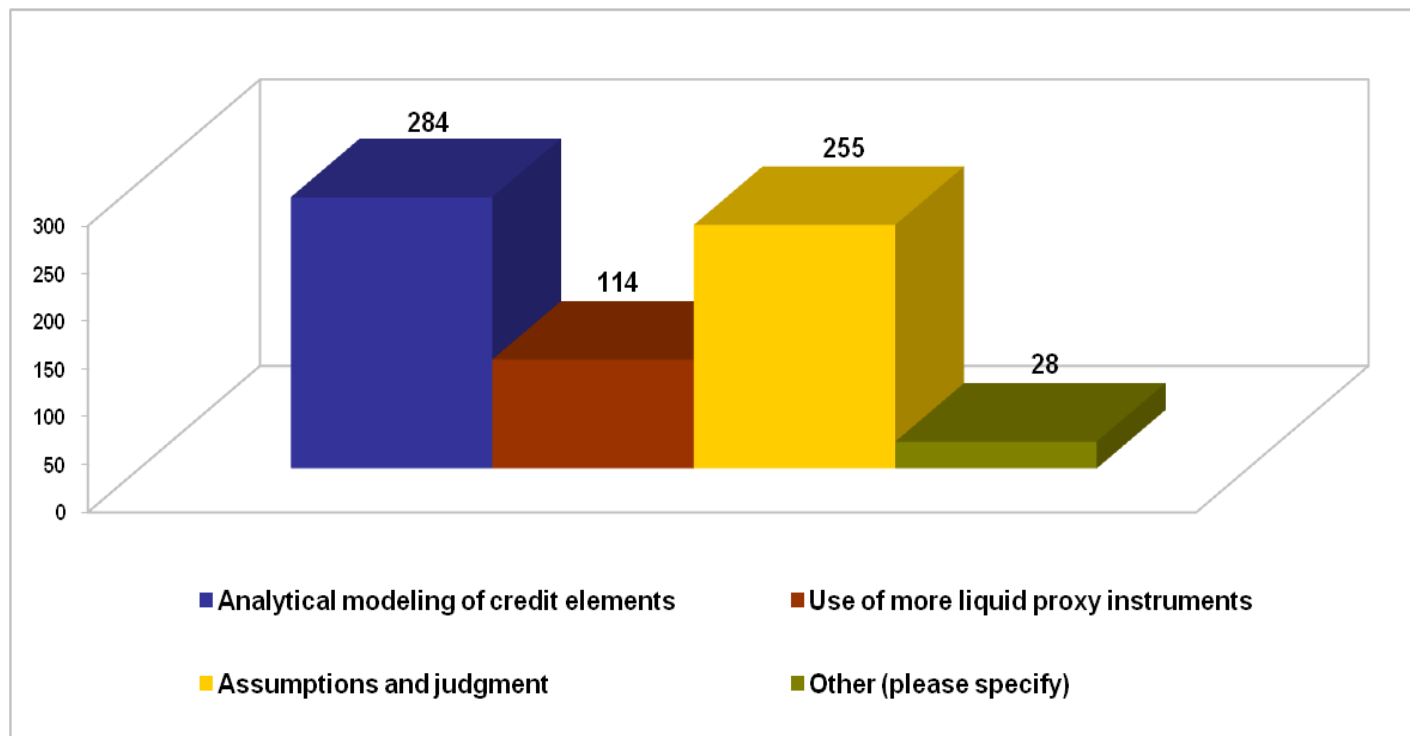
Has portfolio risk theory proven to be reliable in times of economic stress?



- **60.6%** of participants believe that portfolio risk theory has not proven to be reliable in times of economic stress.
- **Significantly**, responses were evenly spread across job function geography and size of business.

## Valuation

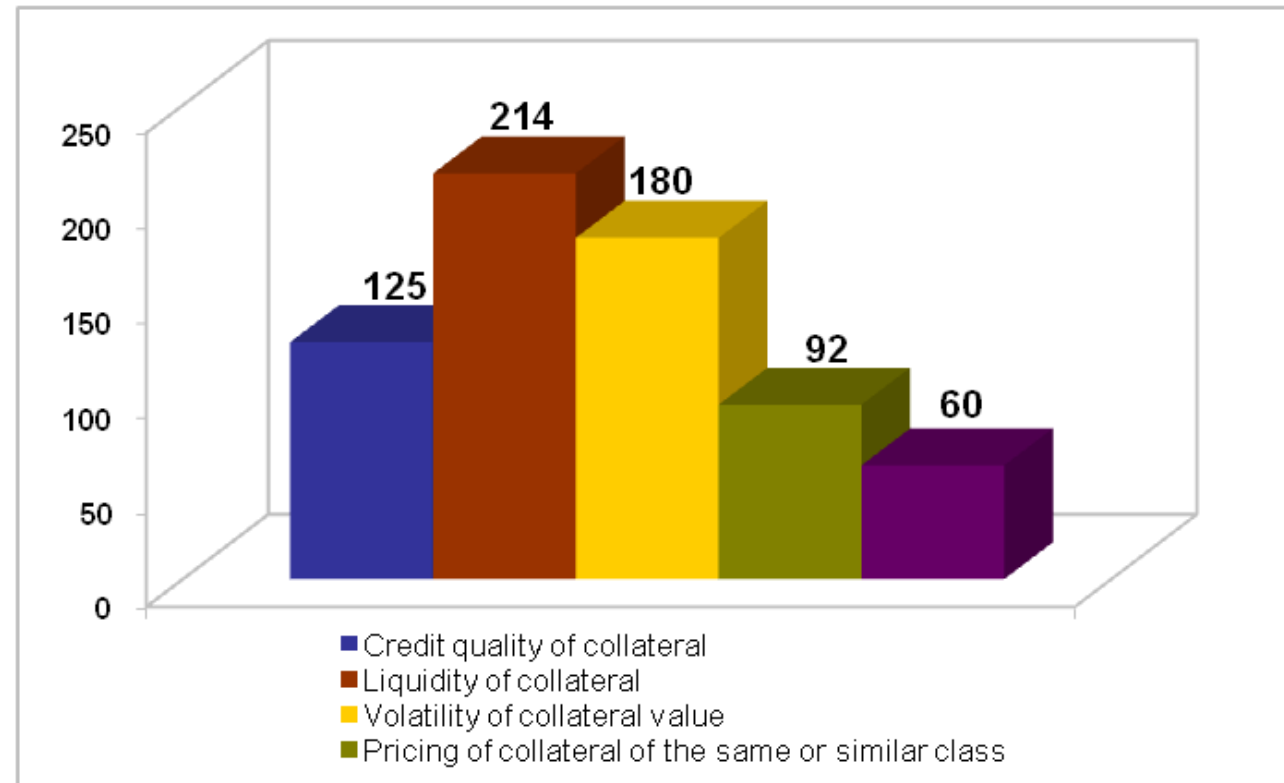
**How do you distinguish between credit deterioration vs. illiquidity effects in assessing appropriate valuations?**



- Analytical modeling of credit elements and assumptions and judgment were almost or nearly equally most used to distinguish between credit deterioration vs. illiquidity effects in assessing appropriate valuations at 41.7% and 37.4% respectively.
- "Other" responses included "All of the above" and "The two are not independent of each other".

# Mitigation

**What should be the basis for determining appropriate collateral hair cuts?**



- The responses were quite evenly spread with liquidity of collateral (31.9%) and volatility of collateral value (26.8%) preferred for determining appropriate collateral hair cuts.
- The majority of respondents who chose "Other" specified "All of the above" and "A combination of the above".
- Respondents from the Americas & APAC were evenly spread on liquidity of collateral and volatility of collateral value.



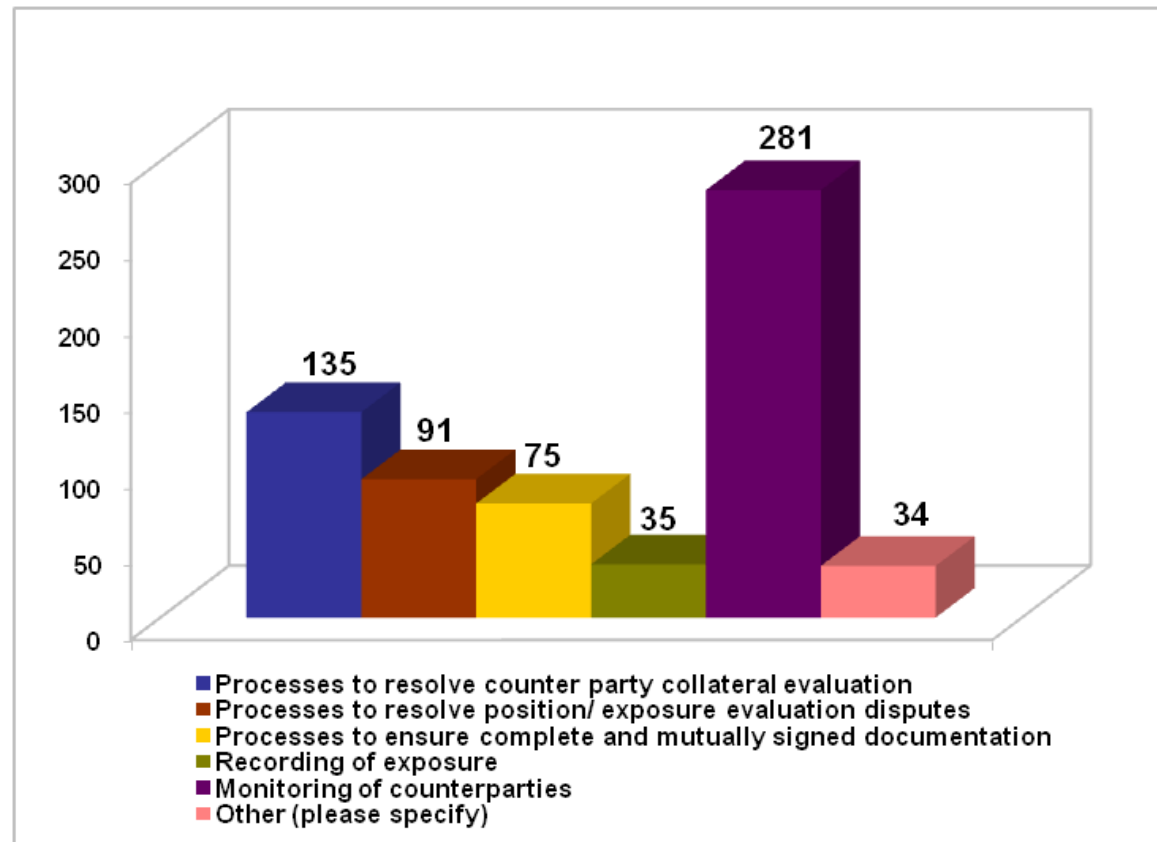
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# Mitigation

What steps can be taken to mitigate counterparty credit risk in times of market dislocation?



- Monitoring of counterparties was the preferred step to be taken to mitigate counterparty credit risk in times of market dislocation with 43.2% of respondents choosing this.
- Many regulators also opted for processes to ensure complete and mutually signed documentation as did respondents from multinational companies.
- Again most of the "Other" responses specified "All of the above"



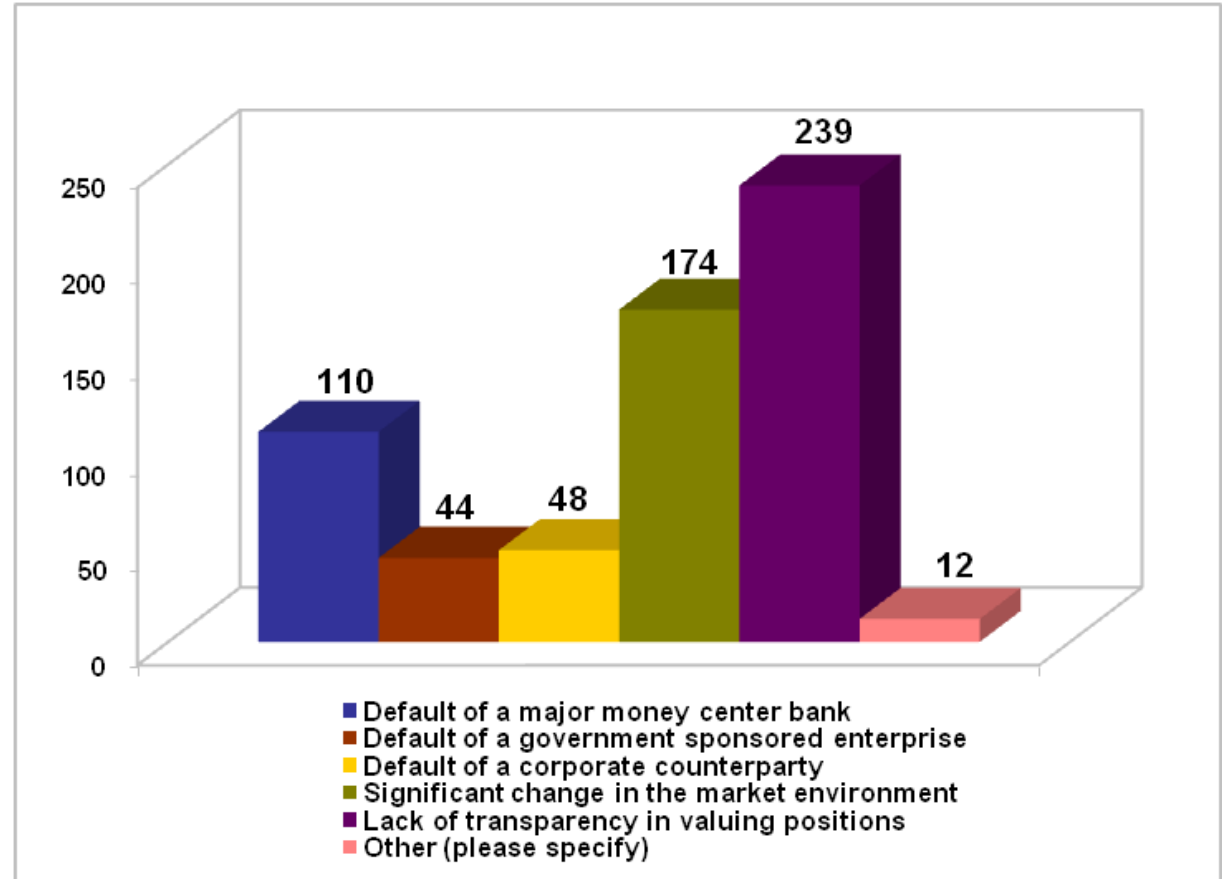
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# Mitigation

**What circumstances are most challenging to effectively evaluate your credit exposures directly or indirectly resulting from the following events?**



- 38.1% of respondents chose lack of transparency in valuing positions as being most challenging to evaluate their credit exposures.
- The majority of consultants and regulators opted for lack of transparency, whereas most risk practitioners chose a significant change in the market environment.



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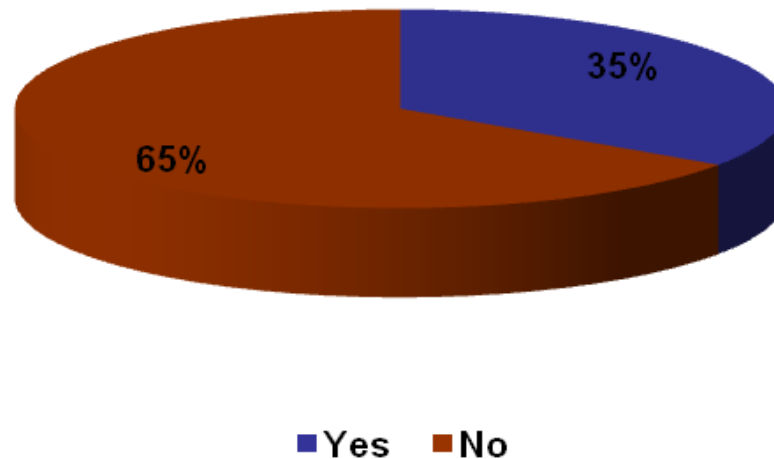
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## Methodologies

Have credit risk capital methodologies proven to be adequate during times of economic stress?



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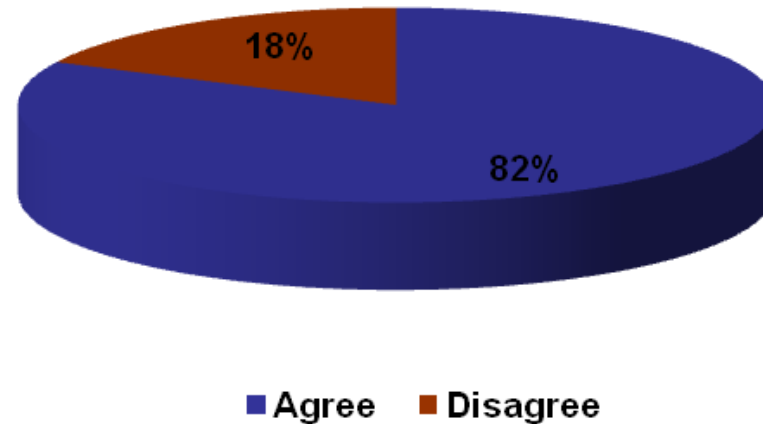


- Nearly two thirds of the respondents do not think that credit risk capital methodologies have proven to be adequate during times of economic stress.
- The response was completely consistent across geographies and size of business.



## Methodologies

**There is a view among practitioners that the models available today cannot determine potential credit losses under extreme economic stress:**



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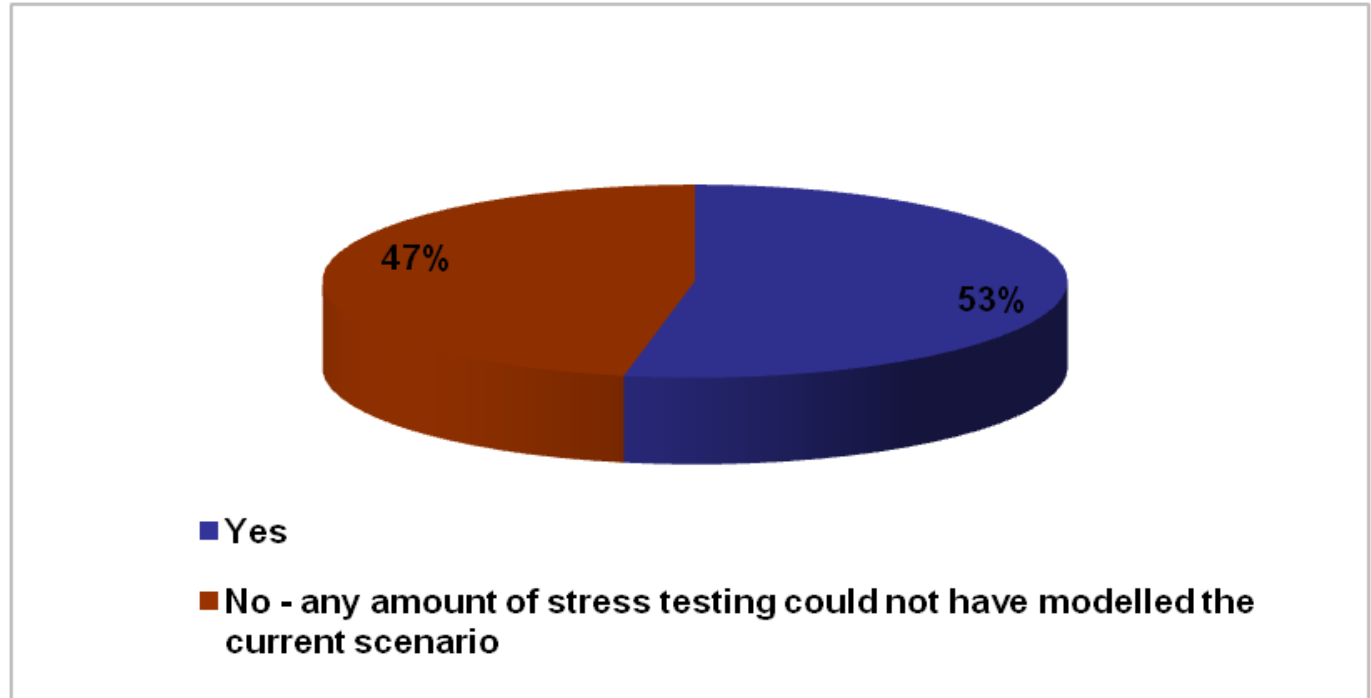
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- **The majority of participants (82.3%) believe that the models available today cannot determine potential credit losses under extreme economic stress.**
- **These answers were consistent amongst job description, geography and size of business.**

# Methodologies

**Today's financial crisis could have been avoided had institutions performed more rigorous extreme stress testing:**



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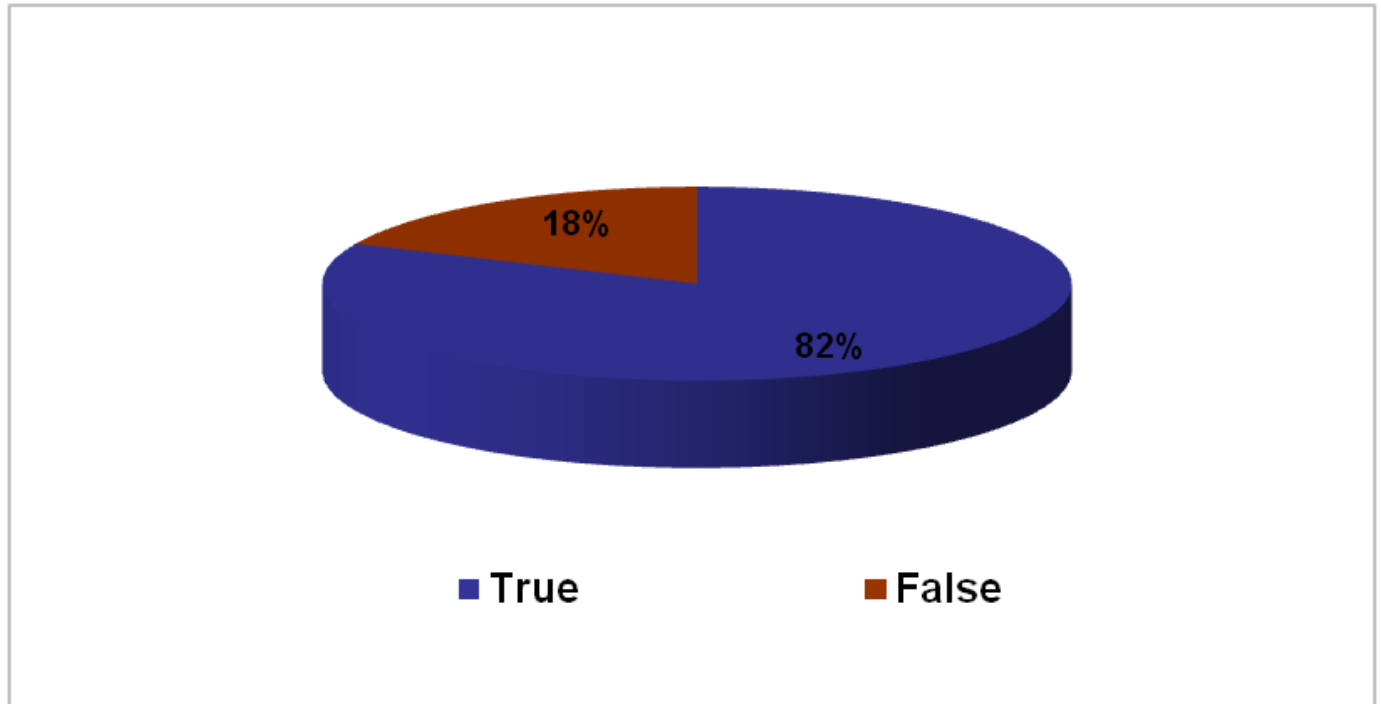
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- Interestingly the responses were almost evenly split here with only a tiny majority believing that today's financial crisis could have been avoided if institutions had performed more rigorous extreme stress testing.
- Consultants and vendors had a larger yes majority compared to the other job descriptions.

# Methodologies

**An essential input into calculations for credit loss across a portfolio is the correlation between assets. In an extreme situation, the past correlations break down completely and therefore cannot be depended upon:**



➤ **81.7% of respondents believe that in an extreme situation the past correlation between assets, which are an essential input into calculations for credit loss across a portfolio, break down completely and therefore cannot be depended upon.**



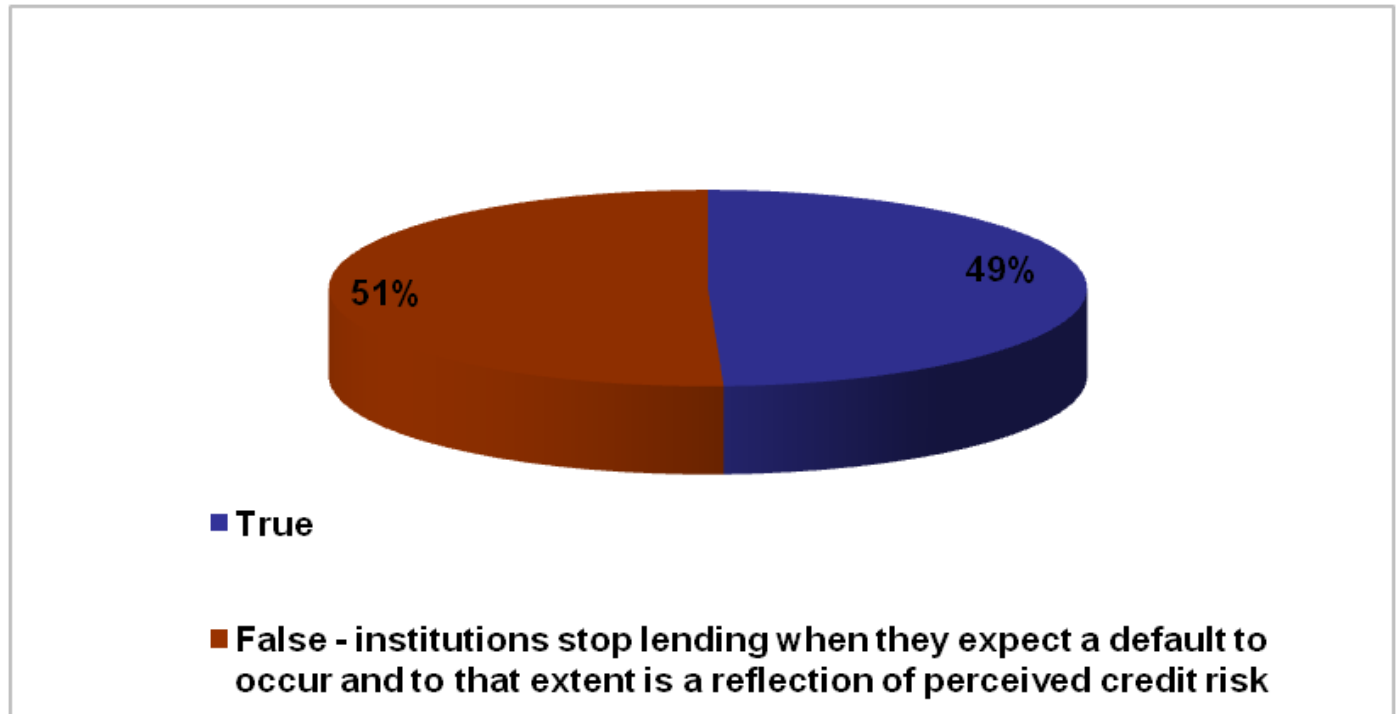
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## Methodologies

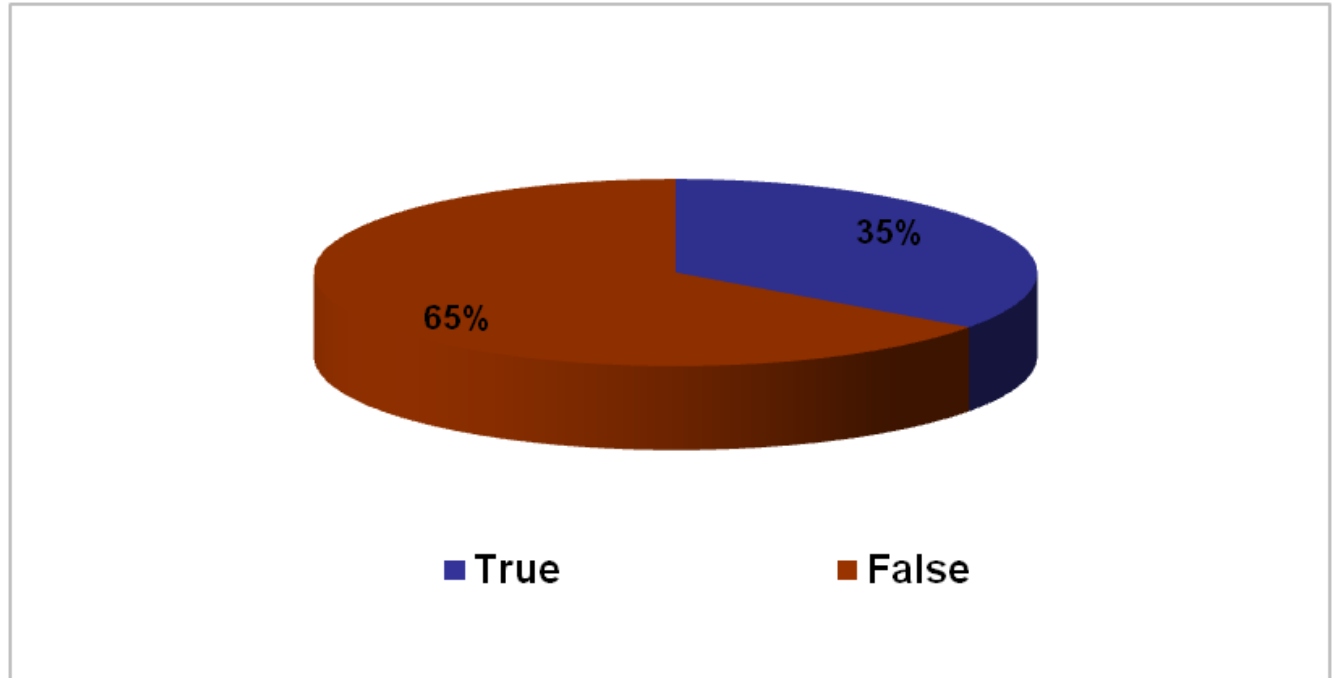
**As a corollary to the previous question, the situation remains the same even with optimally diversified portfolios across industries and countries:**



➤ Compared to the results obtained in the previous question, the responses were almost exactly evenly split here, which confirms the benefit of having an optimally diversified portfolio across industries and countries.

## Methodologies

**The current credit crisis has nothing to do with credit risk and more to do with irrational fear resulting in a complete choking off of interbank liquidity:**



- Nearly two thirds of the respondents think that the current credit crisis **IS** a result of credit risk and not the irrational fear resulting in a complete choking off of interbank liquidity.
- Interestingly most regulators opted for "True"!



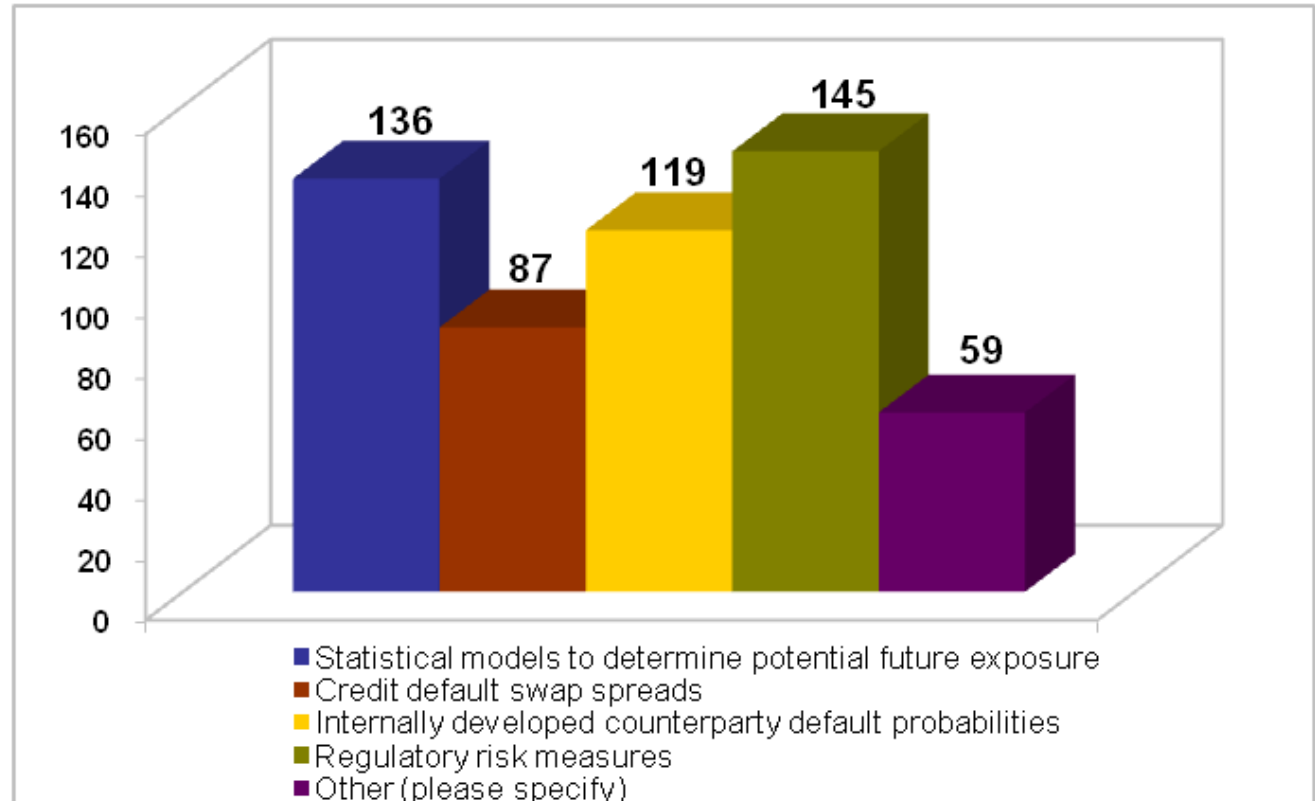
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## Standards

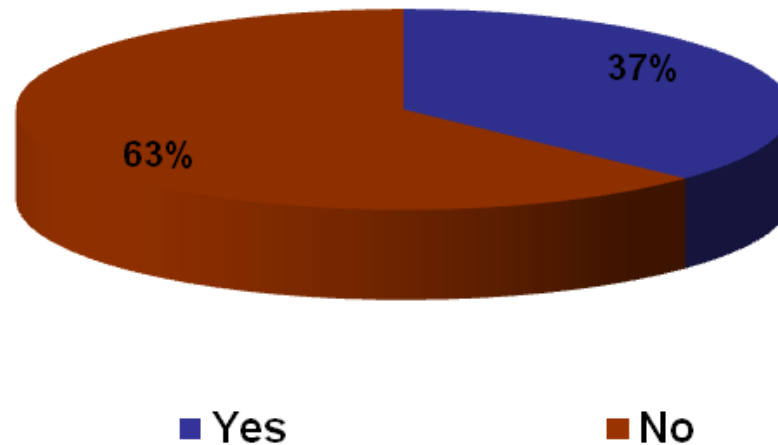
**What methods have you used to implement FAS 157 into the determination of fair value for derivatives?**



- This question was very evenly answered with only regulatory risk measures leading slightly with 26.6% as the method used to implement FAS 157 into the determination of fair value for derivatives.
- "Other" responses included "We do not use credit derivatives" and "Not applicable in my country".

## Standards

Are current standards for the estimation for other than temporary impairments based on liquidity or interest rate changes appropriate?



- 62.9% of respondents do not feel that the current standards for the estimation for other than temporary impairments based on liquidity or interest rate changes are appropriate.
- Again the regulators differed here from the other groups by mostly voting yes.



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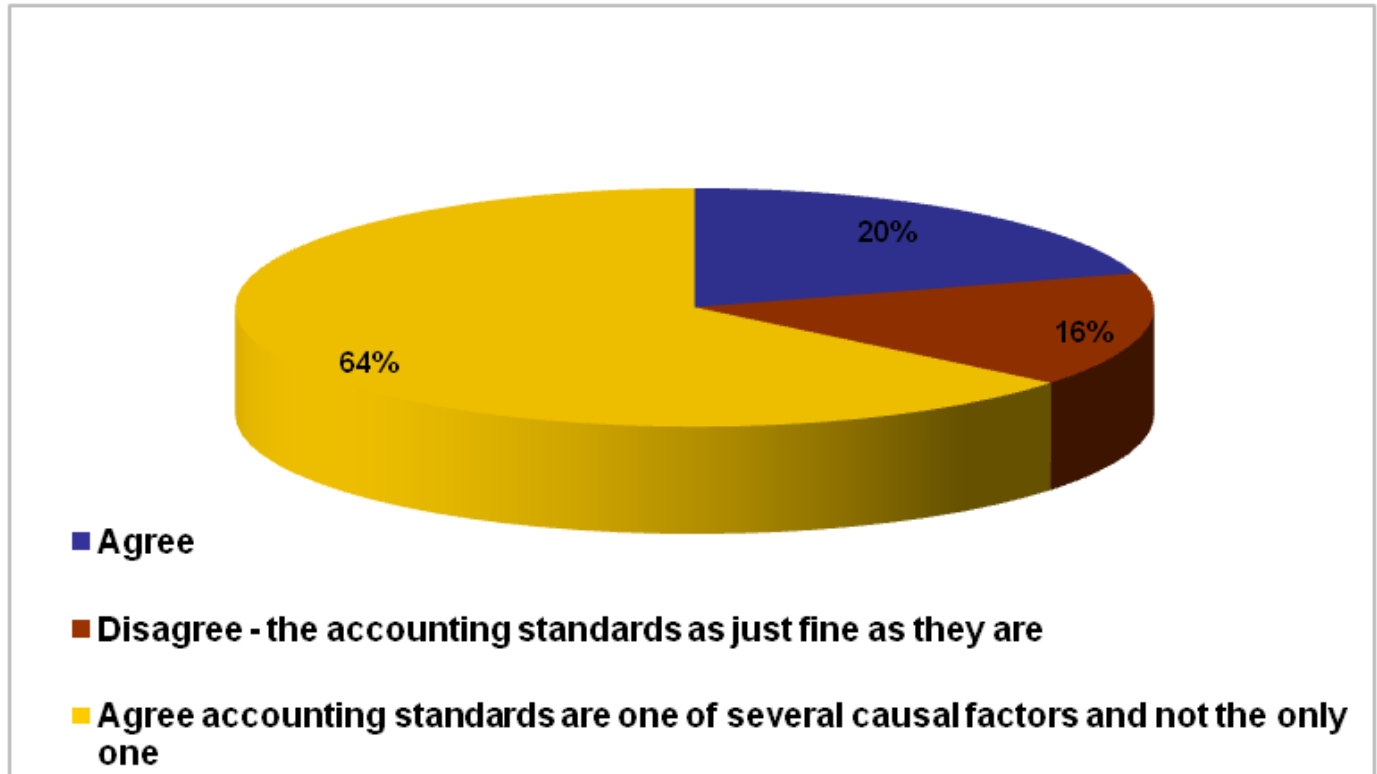
# Standards

Industry practitioners and even some regulators appear to be recognizing the possibility that the current accounting standards were not designed to handle extreme stress situations and therefore should not be used, to evaluate credit assets:



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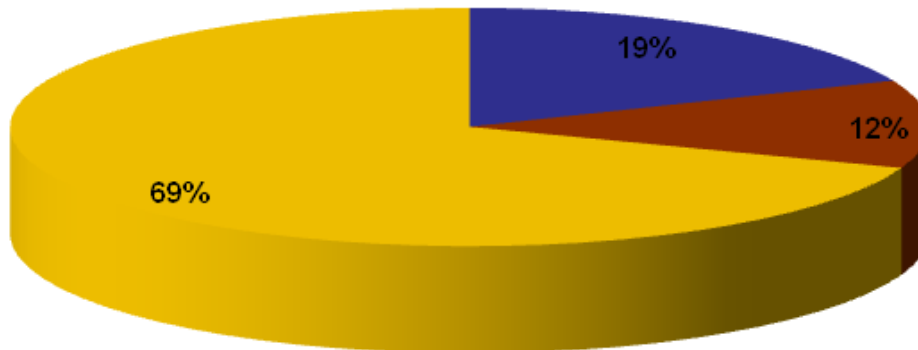
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➤ **84.5%** of respondent believe that that the current accounting standards were not designed to handle extreme stress situations and therefore should not be used, to evaluate credit assets.

# Standards

**IAS 39 is a mandatory accounting standard used to determine provisioning needed to offset credit losses. This standard has caused more harm than good due to the following:**



- **Introduces extreme subjectivity since it is based on 'estimated cash flows'**
- **The discount rate used is the historical interest rate as opposed to a forward rate applicable to the cash flows expected in future**
- **Both of the above**

➤ **69.4% of respondents believe that the IAS 39 accounting standard causes more harm than good because of both the extreme subjectivity AND the historical interest rate it uses as opposed to a forward rate.**



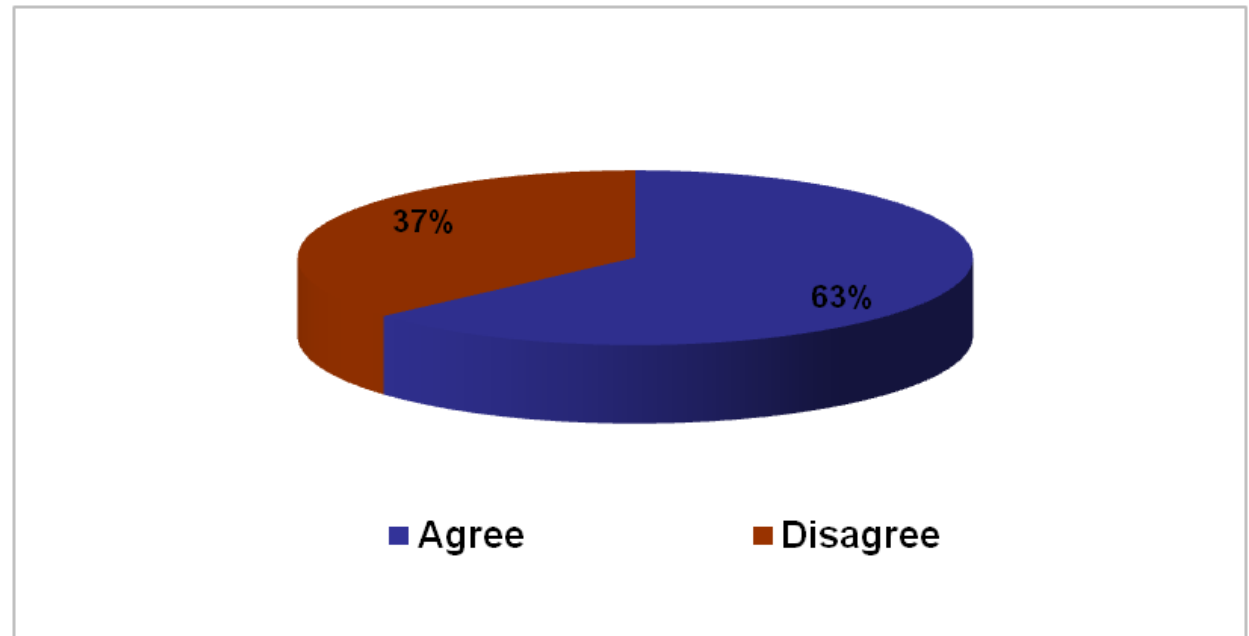
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# Standards

While Basel II recognizes the concept of 'unexpected loss', accounting standards do not. Consequently while the creation of general reserves to accommodate unexpected losses in extreme situations makes intuitive sense, IAS 39 does not permit the creation of general reserves. In fact, had institutions been allowed to create general reserves, perhaps they would have not been in the position they are today:



➤ 63.4% of participants believe that if institutions had been allowed to create general reserves, perhaps they would have not been in the position they are today.



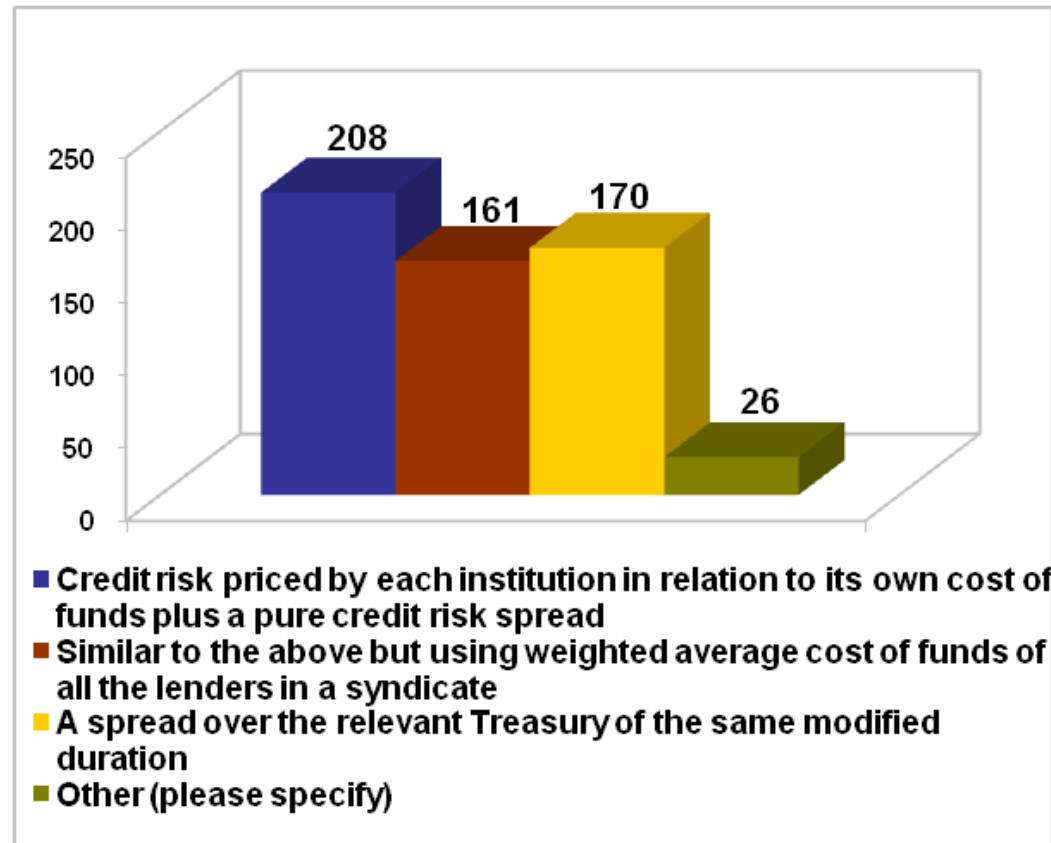
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# Standards

It is now patently obvious that the BBA published LIBOR rate is no longer a valid benchmark to price credit. Given this situation, which is the most efficient metric to price credit:



- The responses were very evenly spread across the three answers provided.
- "Other" responses included "Adjusted LIBOR" and "BBA LIBOR is still the best benchmark available" and "CDS spreads".



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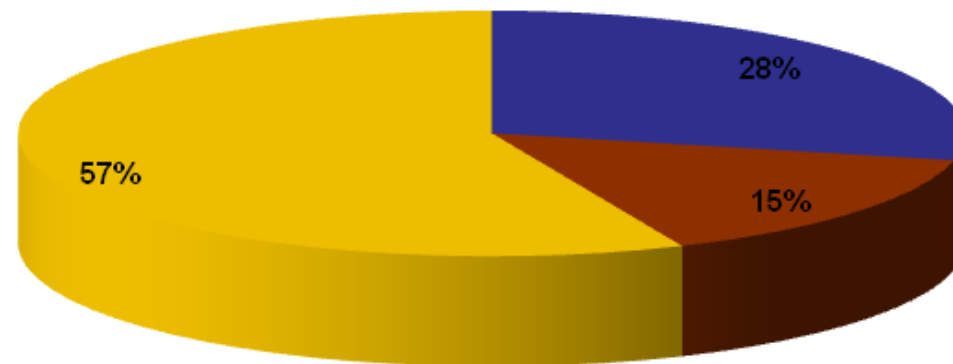
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## Consumer

**How can you use credit score migration to help reduce credit losses in an economic downturn?**

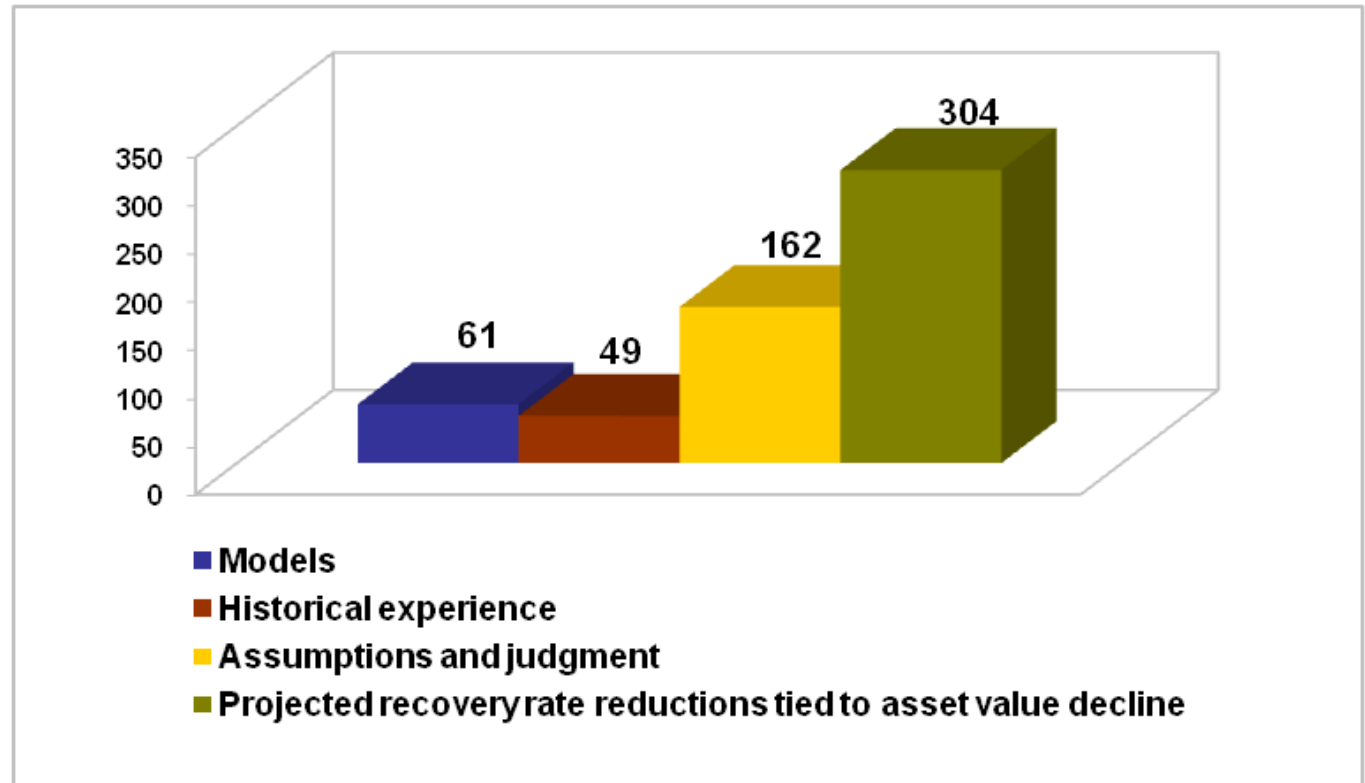


- Change underwriting criteria
- Increase collection efforts
- There has to be a feedback loop from migration to action

- The majority of respondents (56.6%) think that there has to be a feedback loop from credit score migration to action to help reduce credit losses in an economic downturn.
- Most of the regulators believe that a change in underwriting criteria will help reduce credit losses in an economic downturn.

## Consumer

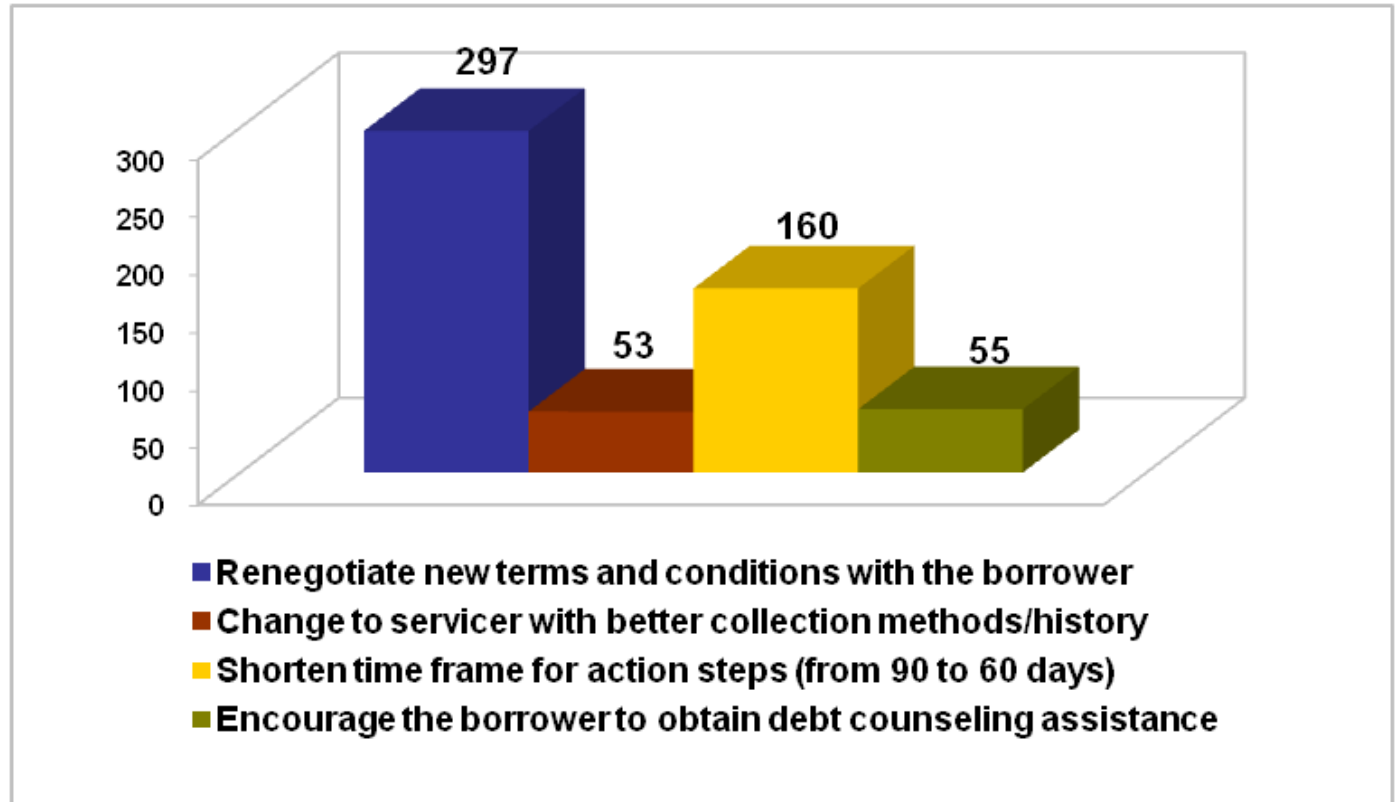
**How should expected recovery rates be adjusted when asset values are in decline?**



- More than half of the respondents (52.8%) said that expected recovery rates should be tied to asset value decline.
- Only 8.5% of the respondents believe that historical experience is of importance.
- None of the 47 regulators that responded opted for models to adjust recovery rates when asset values are in decline.

## Consumer

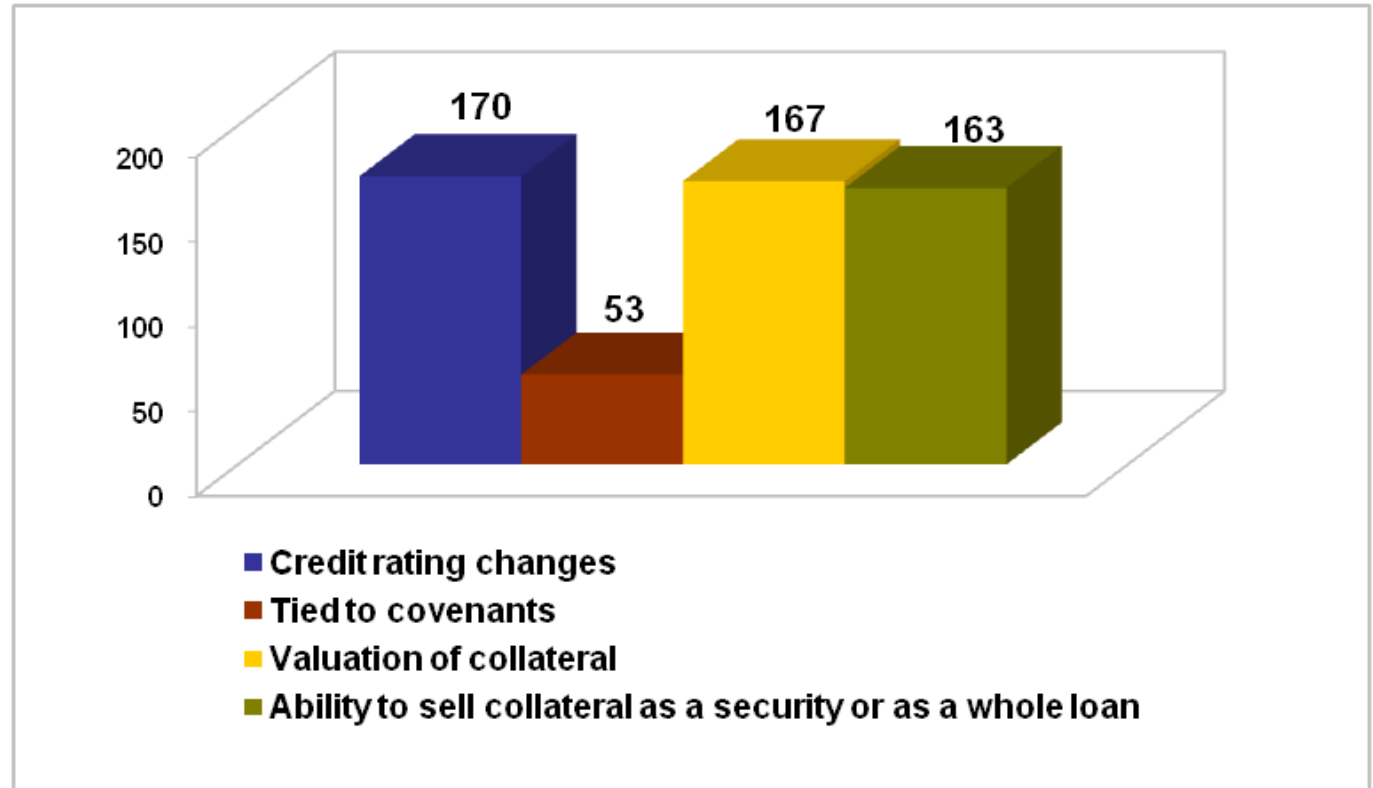
**How should collection strategies change in response to an economic downturn?**



- More than half (52.6%) of respondents believe that lenders should renegotiate new terms & conditions with their borrowers in an economic downturn.

## Consumer

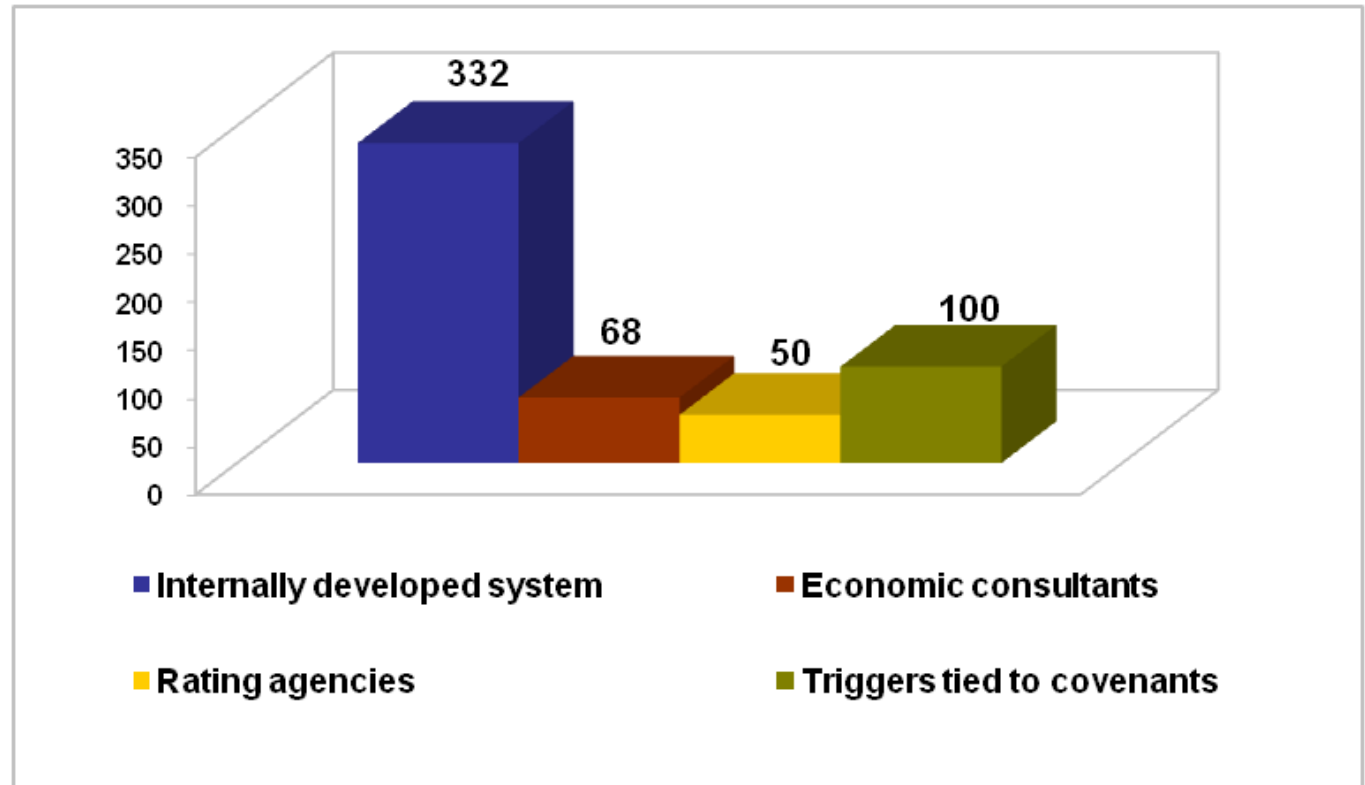
How should advance rates change in response to an economic downturn? Introductory advanced rates should be tied to:



- Most of the responses were very evenly spread across all answers except for only 9.6% of participants saying that introductory advanced rates should be tied to covenants.
- Consultants and vendors opted for valuation of collateral more than the other job definitions.

## Consumer

What “Early Warning Systems” do you use to recognize economic downturns and the impact on your consumer portfolio?



- The majority of respondents (60.4%) use internally developed systems to recognize economic downturns and the impact on their consumer portfolio.



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## Special Contributor

### Dick Stahl

Dick Stahl is President and Chief Manager of Sassafras Consulting, LLC, a Minnesota based credit risk management and international trade and investment consulting firm.

Dick's financial services career encompassed 35 years of global experience with significant managerial and operational successes in business unit management, credit risk management, business development, acquisition due diligence, strategic planning, financial reporting and staff training and mentoring. Dick lived and worked for 12 years in Japan, Singapore, Australia and Taiwan.

Dick has recruited, built and led highly motivated, results-oriented project teams with diverse cultures on six continents.

Financial services employers and positions include: GMAC Residential Capital LLC (ResCap) – Managing Director, Commercial/Counterparty Credit Risk and Governance; The Long-Term Credit Bank of Japan (LTCB) – Executive Vice President with responsibility for the US Midwest and The First National Bank of Chicago (FNBC) – Vice President in the International Banking and Credit Policy Departments.

Dick has a JD from the Indiana University School of Law and an MBA for the Indiana University Graduate School of Business.

# Global Event Series Advisory Committee



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Chris Chaloner, Head of Group Risk, Man Group plc

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Duncan Holmes, Director of FINEX, Financial Institutions, Willis Limited

Malinda Prudencio, Chief Credit Officer, The Energy Authority

Guan Khoo Head, Group Risk (Models Validation), Standard Chartered Bank

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