RiskCenter.com™ RISKalert™
a financial risk management media company

Headline News, Monday, November 9, 2009

Commentary-Examining Risk Through A Different Lense...The Future and Culture of Risk…William Phelan

Lawmaker's desire to increase home ownership, which reached its highest point right before the crisis, was and remains a worthy social goal. Unfortunately that pursuit created a lending feeding frenzy where no one wanted to be left behind. One result of the global financial crisis is now intense pressure from lawmakers, regulators and bank executives on risk managers. We should determine the causes of the global financial crisis to learn from the past and to avoid making the same mistakes in the future. However, the inclination to place blame can in some cases do more harm than good. One learning is we must educate lawmakers, regulators and management on the limits and capabilities of our risk management tools and the need for continual investment to enhance them.

First Do No Harm…

With the recent stock market recovery it is human nature to start to forget just how close the world came to complete economic collapse. It is therefore instructive to recall the major events of the global financial crisis of 2008 and to document its lessons. It is natural that the regulatory pendulum will swing drastically to stronger oversight. However, regulators and lawmakers must be careful not to create new regulations that destroy the progress made creating underwriting tools that are cost-effective and highly productive.

Some of the major events of the global economic crisis of 2008 are as follows:

- September 7: Federal takeover of Fannie Mae and Freddie Mac effectively nationalizing the $12 trillion US mortgage market and causing panic among every major mortgage lender.
- September 14: Merrill Lynch is sold to Bank of America amidst fears of a liquidity crisis and Lehman Brothers collapse.
- September 15: Lehman Brothers files for bankruptcy protection.
- September 17: The US Federal Reserve lends $85 billion to American International Group (AIG) to avoid bankruptcy.
- September 18: Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke propose a $700 billion emergency bailout with the warning "If we don't do this, we may not have an economy on Monday."
- September 25: Washington Mutual is seized by the Federal Deposit Insurance Corporation, and its banking assets are sold to JP Morgan Chase for $1.9 billion.
- October 6-10: Worst week for the stock market in 75 years. The Dow Jones loses 22.1 percent, its worst week on record, down 40.3 percent since reaching a record high of 14,164.53 October 9, 2007.
- October 14: The US taps into the $700 billion available from the Emergency Economic Stabilization Act and announces the injection of $250 billion of public money into the US banking system.
- October 21: The US Federal Reserve announces that it will spend $540 billion to purchase short-term debt from money market mutual funds.

These events are now well known. It is clear to any rational observer that lax credit underwriting is a prime cause of the global financial crisis. U.S. subprime mortgages increased 292%, from $332 billion to $1.3 trillion over the period 2002-2006, due primarily to the private sector entering the mortgage bond market, an almost exclusive domain of Fannie and Freddie. Mortgage underwriters abandoned loan underwriting standards (employment history, income, down payments, credit rating, assets, property loan-to-value ratio and debt-servicing ability), emphasizing instead lender's ability to securitize and repackage subprime loans. Following the example of Countrywide Financial, the largest U.S. mortgage lender, many lenders adopted automated loan approvals that critics argued were not subjected to appropriate review and documentation according to good mortgage underwriting standards. In 2007, 40% of all subprime loans resulted from automated underwriting. It is a natural tendency then for regulators and lawmakers to blame the credit scoring tools and their managers as a primary cause of the global financial crisis.

Return to the Dark Ages?

Are there realistic alternatives to using scoring as a primary underwriting tool for high volume lending? Not really. A brief history of extending credit to small businesses reveals the challenges. 20 years ago a tax return was used to evaluate small business risk. The IRS filing extension to October 15th makes the use of prior year financial statements out of date. The search for an alternative led to incorporating consumer (owner) credit scores into small business scoring models. These tools are powerfully predictive for smaller exposures, especially those segments where small business capital is primarily funded by credit cards and home equity.

The problem with relying solely on consumer (owner) scores on small business is that, with growth and the addition of new sources of capital, their power diminishes and new variables become even more predictive. As a result, 10-15 years ago small business lenders began the shift to commercial credit scores in the absence of financial statements. The fact of the matter is that these models are the state-of-the-art tool for credit underwriting loans to small businesses or consumers. Neither of these markets will thrive and capital will continue to be scarce without the use of models.

A Matter of Expectations…

Many credit models are showing a 300% increase in defaults after the global financial crisis resulting from a shift in odds of the models. This has been a surprise for lawmakers, regulators and even bank management but it shouldn't be for anyone who understands how these models work. Credit scoring models provide comparative rank orders of risk. Credit scoring models do not measure the absolute levels of defaults. Executive managers are having tough conversations with their retail risk managers about this shift because they did not understand this basic feature of credit scoring models. The options for credit underwriting and risk rating smaller loans are limited, and we have decades of experience by many smart people that have brought us to the conclusion that credit scoring models are a critical part of the credit underwriting process. The alternatives are clear: high cost underwriting with financial statements, or more efficient credit scores, keeping in mind their capabilities and limitations.

Is there anything new to learn?

Improved tools have been developed and are available to navigate the shifting business cycle. Probabilities of default (PDs) that combine loan experience with macroeconomic factors are used successfully in large corporate bonds which weathered the crisis well. Tools that target the overall consistency between expected default frequency and the actual defaults and that can report, and even predict, the changes in expected defaults are critical for smaller loan markets such as small business lending.

Absolute measures of default rates are superior to comparative measures of rank ordering of risk (existing scoring models). Absolute measures eliminate the need to subjectively set cut-off thresholds. They maintain model calibration while maximizing power of prediction. These tools can be used on each obligor as ingredients in credit granting decisions; estimating loss reserves on a portfolio of loans or accounts receivable; determining the lender's economic or regulatory capital; and risk measurement, rating and valuation of structured credit products whose collateral includes private-firm debt.

Regulators, lawmakers and managers will be compelled to place blame for the global financial crisis. Their focus should instead be on the priorities they set and ensuring those that carry them out have the needed tools and capabilities. Blaming the modelers and their models is just another populist scapegoat taking our progress backwards.

What is needed now is an acknowledgement that models are the best tool for consumer and small business underwriting on any large scale. What is also needed is progressive thinking to a future that reflects defaults rather than comparative measures of risk as the best solution.

# # #

Insight and commentary provided by William Phelan, president and co-founder of PayNet, Inc., the premier provider of risk management tools and market insight to the commercial credit industry, collecting real-time loan information from more than 200 leading U.S. lenders and turning it into actionable intelligence. The company's proprietary database, updated weekly, is the richest and largest collection of commercial loans and leases, encompassing more than 16 million current and historic contracts worth over $700 billion. For more information, visit paynetonline.com