CREDIT QUALITY BULLETIN

Despite the Credit Market, Now's Not the Time to Be Timid

April 2008

Have you ever wanted to just throw up your hands in the midst of trying something new and go back to doing it the old way? It always seems a lot simpler "the way we used to do it." With the current state of the financial industry, this sentiment has to be crossing the minds of many credit risk professionals.

Despite investing millions of dollars in sophisticated tools, risk models, consultants and new technology to manage risk, we are now in one of the most significant credit industry crises of our time. What happened? How did we get into this mess, particularly despite all these newfound ways to identify risk? It seems logical to ask these questions. It may even seem logical to put your credit risk initiatives on the back burner or even go back to some of your old ways of doing things.

However, the need to continue your efforts in cleaning up your data, consolidating information, redefining best practices and other initiatives has never been greater. Going backwards or shelving key credit risk management programs won't solve your problems, nor will it move your institution forward through this crisis. The truth is, despite today's environment, you must continue to forge ahead with your technology initiatives in the credit risk management arena.

First Things First— Technology Was Not the Problem

Although financial institutions may be feeling a little gun shy about proceeding with their technology initiatives, the first step in getting over the paralysis that some organizations are experiencing is to recognize that what happened in the marketplace is not a result of technology being unresponsive or underperforming. It's more about a lack of understanding of the role technology plays in the credit risk environment.

While there were many reasons for the current credit crises—dependence on unproven theories and speculation, lack of understanding of many of the convoluted investment instruments to name a few—overall, it seemed as though good, solid common sense went by the wayside. Questioning technology became a lost art. As a result, a certain degree of "automation complacency" set in that had many negative side effects.

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Remember, technology only does exactly what we ask it to do. The interpretation and application of those results is always up to us. We can't lose sight of the fact that technology does not replace the need for human knowledge and it most certainly does not replace common sense. It is up to us to understand the concepts behind the technology and how to best apply them to real world situations. Sometimes it is even necessary to turn one's technological auto pilot off and let expertise and instinct be the guide.

Don't Lose Ground

One of the most important reasons to continue pushing forward with your technology initiatives is to ensure your organization doesn't lose the ground it has already gained in just the last few years—and it has been dramatic. The credit risk arena has come a long way in a very short time.

Just think about it. It really wasn't that long ago when evaluating credit risk was a fairly straight forward process. You pulled a sample and based the portfolio risk upon the results of that sample. There were no Chief Risk Officers and the regulators could pretty much tell you what they expected. While tedious and cumbersome, banks were still getting away with manual spreadsheets and Word documents to manage their portfolio.

That has all changed. Now, there not only are Chief Risk Officers, but also a room full of quants and analysts. Regulators are now asking you to tell *them* what they need. Instead of focusing on a single credit we are now looking at risk pools and multi-faceted structured investment instruments. Organizations are using a variety of quantitative and qualitative tools. We are shifting from looking at what has happened to predicting what will happen. There are a myriad of external factors that have to be considered in evaluating impact on the portfolio.

As the industry becomes more and more complex, technology will continue to be a key factor in enabling financial institutions to jump light years ahead of where they were even as little as a few years ago.

And these advances must continue. The pace of change will continue to accelerate at increasing speeds, not slow down. The environment will continue to become even more complex.

That's why an important part of your credit risk strategy is to ensure your organization has the ability and flexibility to implement best practices and solutions that will help you to keep pace with whatever industry challenges are thrown at you, while simultaneously avoiding the pitfalls of past mistakes. Financial institutions today simply cannot effectively manage risk in such a complex, challenging environment without continuing efforts to advance and perfect the use of technology to help them do so.

Part Revolution, Part Evolution

This quest for effectively managing credit risk can be looked at as part revolution, part evolution. The revolution is the development of advanced credit risk management tools that have taken financial institutions from the Dark Ages to modernity and will include those solutions yet to come. The evolution portion is up to you.

You are the financial executives at the forefront of the credit industry. It is in your hands to lead the charge in taking the tools that are available to you and continually applying human knowledge and ingenuity to make managing credit risk faster, more efficient, more strategic, more empowering.

Use technology as the vehicle to drive improvements and advancements in your processes and methods. But don't rely on technology to be the steering mechanism that blindly pulls you along for the ride. Experience and knowledge must always set the course for the direction of your organization.

If you remain keenly aware that technology's role is to support your ability to proactively and effectively manage risk for your financial institution, then you can confidently drive your key credit risk initiatives forward to the next level of success.

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LEADING THE CREDIT **QUALITY** REVOLUTION

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