CREDIT QUALITY BULLETIN

The New Dynamic–Shifting from Tactics to Strategy in Evaluating Credit Risk

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Anyone working within the credit risk management environment has, to some degree, become an active participant in the myriad of changes taking place in measuring and managing credit risk.

It's not that the definition of credit risk has changed. We're still talking about the risk that a debtor will not repay. What has changed, and what is still evolving, are the methods by which credit risk (or the degree of risk) is determined-specifically the "how" involved in predicting expected losses, the probability of default and the overall impact of those losses on the bank.

Historically, evaluating credit risk has been a "looking-in-the-rear-view-mirror" approach. That's primarily due to the limited automation and quantitative tools that have been available in the past. So for years, all that could really be done was watch the credits, report on the credits and try to catch things before they got out of hand. Today, the tools are evolving exponentially and there are more analytical, predictive-based models available to provide information for better decision making.

But despite the advances, many activities involved in evaluating credit are still very process-oriented and defined by the constraints of how things used to be done. The criteria to evaluate the credits are identified, data is extracted from the system, and conclusions are drawn on the extracted data.

While this approach delivers the information needed to get the job done, in an environment of expected transparency and heightened regulations, just getting the data isn't enough.

It is becoming increasingly more important to determine what you want the information to do for you once you have it.

Today, the methods by which credit risk is determined needs to be thought of more like a GPS tracking system instead of a rear view mirror. With a GPS, you plug in the coordinates for the destination and the system calculates and predicts the best, safest, fastest route for you to drive to get there. If there is deviation from that route, it will recalculate everything, revise the route, and once again, determine the best, fastest, easiest way to get from Point A to Point B. In today's credit risk management arena, the missing element is the *coordinates*. To determine those coordinates, a new way of thinking must accompany the technological ability to get your hands on the data. You have to define where you are going and what you want the data to do for you before you can begin to use the tools to help you calculate how to get there.

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Breaking Down Mental Barriers

So how do we make the mental shift and move past the boundaries that are ingrained into our thinking about how we should, as an industry, be evaluating credit risk? First, you have to push past the limitations of "because that's they way we've always done it" and conduct an honest evaluation of how you are currently performing the credit risk management functions. You'll have to shift away from a let's-just-get-it-done mentality to one that continually questions *why* you are doing something, if it makes sense or not, and if it does, determine how you can do it better.

Likewise, if something doesn't make sense, it simply may not be necessary. We often become so focused on "getting data," that we sometimes forget to stop and ask the fundamental question, "is this even significant?" In many cases, the information we receive has no real purpose. Consider the report that continues to be produced even after the individual who requested it is no longer with the bank. The report still faithfully shows up without question and is accepted as part of the process, perpetuating the cycle.

This shift toward questioning old processes and traditional ways of doing things also requires a strong commitment to cultivating and encouraging problem-solving skills. Fortunately, these are skills credit risk and loan review personnel typically already possess and are often a natural extension of their current roles and responsibilities. And exactly what should your credit organization analyze and question? *Just about everything.*

For example, ask when was the last time your bank considered the significance of the credit risk information it receives. Have you ever stopped to consider what questions you are really trying to answer with the information once you have it? For example:

- Why are you analyzing your portfolio? Is it just for current risk? What else can be gained from this analysis?
- Are you taking into account all of your options in the way you look at risk? What would happen if portfolio risk was evaluated based not only on thresholds and limitations, but also from an optimum performance point of view?
- What are the benefits of shifting from viewing your credit risk as "what is it?" to defining what it is you want it to be?

Thinking through these and other hard-hitting questions will help shift your organization from simply going through the motions of performing antiquated or unnecessary procedures, to an understanding of why you even need that data and how you are going to leverage it once you have it.

Lead or Follow

While some banks are taking a wait and see approach to determine what shakes out as industry best practices, the innovative banks in this arena are taking the lead. They are making the shift toward a more strategic approach to managing credit risk, maintaining an open mind in exploring new methods of evaluation, asking the tough questions, and successfully combining state-of-the-art technology with the strong cognitive skills of their staff.

These banks are the ones that will become the de facto leaders in their space and will set benchmarks not just for their organizations, but for the industry as a whole. If your bank has the right tools and the ability to make the mental shift, you can be confident your organization will be among them.

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