

## WLN Articles : Credit & Risk Management

### Fortifying Against Today's Higher Risk Environment

Sep 02, 2008

---

Given the rippling effects of the sub-prime mortgage catastrophe, clients from financing companies to trade creditors, have asked how to adjust their risk management approach in response to today's economic and credit conditions. No wonder: financial institutions have already reported hundreds of billion in write-downs, with more to come. A weakening economy, reduction in credit availability from traditional sources, increased credit spread premiums with tighter conditions, the plunging dollar and sharply higher energy costs have degraded the risk landscape for our clients and their customers.

Most companies have already made process and structural changes, such as adjusting pricing and terms, adding more senior management review, and strengthening internal risk resources and capabilities. But in the short term, it's also important to identify more clearly those customers and prospects most likely to become problematic credits in today's environment.

To supplement their normal assessment process, these companies are now screening existing and potential customers with additional tactical filters that focus on credit requesters currently at greater risk. Requesters thus identified are then subjected to supplemental evaluation, either via a more detailed financial analysis and/or by requiring a higher level of review to apply experienced judgment. Approach will vary by type of business and risk infrastructure, but additional scrutiny should be applied to higher risk sets.

#### General Characteristics Filter

In economic downturns and periods of disruption in the credit markets many companies will typically exhibit increased credit risk, (and more so at the low end of the rating scale). However with today's unique combination of factors companies with particularly increased exposure may include the following:

- Low-margin, high-turnover companies, such as retail and distribution: especially vulnerable to volume slowdown coupled with increased financing costs
- Businesses with high levels of floating rate debt, particularly at the lower end of the rating scale: increased credit spreads are exceeding base rate reductions (prime, LIBOR, etc.)
- Companies with expiring credit commitments from the banks or with a need to regularly access capital markets: both sources are pulling back on availability, and in all cases demanding higher spreads and tighter conditions, reducing the company's flexibility
- Entities with significant dependence on vendor financing programs to move product: credit availability tightening (credit crunch) is impacting some vendor financing organizations' continued commitment to the business
- Low-margin businesses dependent on credit insurance backstop to support sales: credit insurers likely to be increasing prices to reflect new market risk paradigm
- Any low-rated companies (e.g., <BBB or lower): highly dependent on banks : i.e., refinancing risk
- Companies in the midst of large projects or transition to new business model dependent on longer-term financing commitments: much evidence in the market of lenders/underwriters



**Joe Boland**

backing off commitments wherever possible

- Corporations with high energy components in their variable cost ( e.g., airlines and their suppliers)
- Businesses highly dependent on exports to the U.S.: impacted by slowing economy and weakening dollar
- Conversely, companies dependent on increasingly higher-priced imports for components or finished product

## **Industry Groups Filter**

Banks and financing companies highly dependent on credit funding and asset quality are suffering, so it's wise to be wary of marginal players in the financing business that are vulnerable to bank/capital-market pullback.

Also vulnerable now:

- Companies selling to banks, e.g., specialized software companies, certain consultants/training companies
- Retail and distribution
- Construction/real estate businesses in the U.S. and Western Europe
- U.S. airline industry and major suppliers
- Mortgage brokers
- Certain credit insurers
- Small and mid-sized enterprises exposed to a narrow client base and relying heavily on bank financing

If your company relies on standard application scoring for parts of this segment, consider analyzing portfolio performance for each change in credit underwriting policies for the past three years. Follow up by analyzing performance of industries and equipment types added in the past three years with remaining portfolio. Finally, revalidate scoring model predictability traits for transactions added in the past three years.

## **Problem Indicators/Warnings Filter**

Using standard tools (delinquency tracking, follow-up, portfolio rescoring, etc.) to identify problem accounts is critical. But also watch for the following indicators in your account set:

- Requests for increased lines or extended terms, which may reflect reduction of bank or vendor credit availability
- Increase in disputed accounts receivable, since many credit-related delinquencies and write-offs begin as dispute claims
- Lower take-up by customers on early payment incentives, which may reflect efforts to conserve cash at expense of financial return
- Delays in submitting financial statements or agreed-upon financial submissions
- Key management changes in a customer's organization
- Inquiries from other suppliers/financers about client performance
- Industry patterns in your accounts-receivable performance
- Banks and finance companies exiting certain sectors

- Lower Paydex or other market indicator scores related to your market
- Reduced risk appetite/higher pricing from your customers' vendor financing partners
- Lower limits or higher specific prices on credit insurance for segments or particular accounts
- Rating agency downgrades to your customer or companies in the same industry segment, indicating a general problem affecting the segment

### **Special Note: Fraud**

Poor credit conditions increase the likelihood of misrepresentation of financial statements, bogus business plans, and phantom guarantors. Knowing your customers well – and the people who introduce them – continues to be the best way to avoid fraud. Educate your field and risk staff on potentially fraudulent situations and review your processes for fraud prevention. These are worthwhile activities in today's uncertain climate.

---

#### **Author Bio**

Joe Boland leads The Alta Group's risk management practice. He has 38 years of experience in financing and risk management, at the Bank of New York, UBS, and at IBM Corporation as chief credit officer for the company and its financing subsidiary, IBM Global Financing.