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Food For Thought[1]

Six Things Every Credit Risk Manager Must Know

- *It's about posterity* – Remember that the credit decision you are making today will have consequences – however, it's the credit consequences in the near future that should concern you more; in many situations, it is quite easy to be swayed by the business and budgetary needs of the moment and lose sight of the fact that certain credit decisions have a tendency to "come home to roost" at precisely inconvenient times. Case in point - imagine the plight of the credit risk manager who, a few years ago, signed off on significant sovereign exposures to Greece and Spain – decisions to extricate the organization from positions that were built up during "good times" is hard to do after the party is over and the supposed "good times" have ended.

- *It's about concentration* – Remember that over a period of time, you can make individual credit decisions that appear to be sound, and yet accumulate significant credit risk on a portfolio basis to certain industries, geographical regions, structures, collateral etc. For example, a few years ago the prevailing wisdom from most of our "high visibility pundits" in the media was that "all real estate markets are local" and "home prices do not ever depreciate". The implication of this fallacious pearl of wisdom was that it was conceptually acceptable to build up large concentrations to this asset class on a portfolio basis, as long as one was well diversified by region, type of property etc. However, this kind of magical thinking has been made to stand on its head as evidenced by the significant correction in housing and real estate values experienced in the US from 2008 to 2011.

- *It's about being right 99% of the time* – As a credit risk manager, one has very little room for errors in judgment. For example, if one is signing off on an investment grade credit book that has a weighted average spread of say 100 basis points, all it takes is about a one percent decline in the value of the portfolio to virtually wipe out the entire book's profitability. Of course, one can take cold comfort in historical profitability which unfortunately would not pay today's rent.

[1] *Food For Thought* is a periodic publication of JP CONSULTING tailored to address specific issues of interest in the insurance and banking industries. The opinions expressed in this publication are those of its authors alone – Joseph Prakash, CFA and Professor Herb Jacobs, New York University – School of Continuing Education. If you wish to have your name removed from the distribution list, please respond to our e-mail with the word "Unsubscribe" on the subject line of the e-mail.

- *It's about the "big picture"* – Every decision to lend comes with its own unique "story". It behooves you as a good credit risk manager to understand the "story" underlying the reason you are lending to the situation at hand. More importantly, if you do not understand the "story" or are uncomfortable with the "story" and its implications either for the lender or the borrower, it is perfectly acceptable to not lend. Sometimes, it is necessary to go beyond what is being presented to you on paper and instead drill down or read in between the lines to gain a true and more insightful understanding of the deal and your decision to lend.

- *It's about going beyond the numbers* – Sometimes we have a tendency to get lost in the quantitative[2] aspects of the borrower's credit profile, but lose sight of fundamental qualitative factors. For example, if there are concerns about the borrower's ethics and integrity, they cannot ever be mitigated by a borrower's strong quantitative credit profile.

- *It's about being in touch with your credit instincts* – Over a period of time, good credit managers develop what can best be characterized as good credit instincts. In most cases that involve complicated and difficult credit decisions, the decision to lend or not to lend can ultimately crystallize into a gut level comfort or lack thereof with the credit. Remember, at the end of the day you should be comfortable with your decision to lend and it should be yours and yours alone.

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[2] EBITDA, Leverage, Coverage etc. etc.